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Chile's struggle against populism: a success story

Populism has sparked hyperinflation and exacerbated poverty in much of Latin America. Chile is one country that has implemented public policies and fostered institutions that have curbed populist proposals. It can now offer an important example in countering the new wave of populism in such countries as Venezuela, Bolivia and Ecuador, where its propagators are promoting public policies that have brought political, economic and social instability to the region.

Latin America has a long tradition of populism. It reached a peak in the course of the twentieth century, when the distinguishing feature of so many governments both on the left and on the right of the political spectrum was the wealth of political promises made to the electorate. There was a general ten-

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dency to nurture an illusion that problems could be resolved as though by a stroke of a magic wand. Early on in the twentieth century, Argentina was one of the ten countries with the highest per capita income in the world. In 1929 it ranked eleventh in the world export tables and its level of prosperity was revealed by such details as the fact that it had a greater number of cars per inhabitant than Great Britain.

Populism turned that prosperity into a fleeting commodity. Argentina today is no longer the leading country in Latin America; indeed, approximately 35% of its population is currently hovering around the poverty line.

HYPERINFLATION. Numerous periods of hyperinflation have been one of the symptoms of this populist tradition in Latin America. As shown in table 1, several

countries over the past few decades have experienced periods of inflation out of all control, triggered by populist promises.

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Table 1 • Maximum hyperinflation

	yearly rate	year
ARGENTINA	4,923.3	1989
BOLIVIA	8,170.5	1985
BRAZIL	2,937.7	1990
NICARAGUA	33,547.6	1988
PERU	7,649.6	1990

Source: Cristián Larroulet and Francisco Mochón, *Economics*, McGraw Hill, 1995.

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POPULISM IN LATIN AMERICA. Alvaro Vargas Llosa notes in his book *Liberty for Latin America* (*Rumbo a la Libertad*) that the failure of the idea of freedom in Latin America is deeply rooted in history. The roots in question are corporative self-interest, state involvement in trade, privilege, redistribution in an upward direction and the politicization of law. These phenomena, which date back to the Spanish conquest and predate the independence of Latin American countries, lie behind the continent's underdevelopment. The frustration caused by this underdevelopment is the factor that has made it easier for mainly nationalistic and left-wing ideas to fuel populist postulates. This process has had an impact on culture and on the political, economic and social systems in those countries. Moreover, a globalized and highly mediatic world is further fueling the sense of frustration felt by people who can see with their own eyes how other emerging economies are attaining great levels of prosperity.

The populist process followed a similar cycle in most of the countries on the continent in the course of the twentieth century. The worldwide crisis triggered by the Great Depression had a significant impact on Latin American countries, especially on account of the drop in price suffered by its export commodities. The result was an increase in unemployment and a huge social crisis. The solution that the governments hit on was to lock and bolt their economies so as to protect them against a vacillating global economy, and to boost the state's role in the economy in an attempt to resolve their countries' industrial output problems. However, those policies proved unable to spark economic growth and thus to foster an improvement in the standard of living. The reasons for this are well-known: armor-plating the economy and increasing state intervention works against efficiency in the distribution of resources,

in achieving an increase in output, and in the drive to boost investment and thus create jobs, all of which are crucial to development.

These policies generated genuine poverty, which in turn fueled growing grassroots malcontent. As social protest began to spread, the political system responded with

populist moves: the state resolved problems either in the first person (through state-owned corporations), or indirectly (by protecting private companies with special laws discriminating against all the other players in the economy).



Populism eventually translated into a growing presence of the state and massive corporatism run by an alliance between the governments of the day and the protected private sectors. This populism was funded by ensuring that the central banks provided the governments with credit, and that triggered inflation. Rudiger Dornbusch and Sebastian Edwards have analyzed the phenomenon in their book *The macroeconomics of populism in Latin America*. They conclude that a series of characteristics – including low levels of satisfaction with economic performance among citizens, a leader’s explicit rejection of the conservative paradigm, and a profound belief in policies such as income redistribution – underlie the trend, which has only served to reduce growth, lower living standards and aggravate income inequality on the continent.

The phenomenon reached a peak in what became known as “Latin America’s lost decade”. Toward the end of the eighties, these countries’ gross domestic product was lower than it had been at the start of the decade. Inflation reached its highest level ever and the reality of unemployment and of poverty reached unsustainable levels. From that moment on, people began to realize the importance of macroeconomic balances, acknowledging that inflation was harmful to a country’s progress. This process of apprenticeship is responsible for the fact that Latin American countries’ average inflation rate dropped to a mere 6.5% by 2005.

NEOPOPULISM. Does this mean that populism has disappeared? No, it does not. Populism in Latin America today is emerging in a different shape, which is why people have taken to calling it “neopopulism”. Chávez in Venezuela, Kirchner in Argentina and Morales in Bolivia all use tools that are populist in nature. They show no respect for such democratic institutions as their own parliaments, seeking rather to establish a direct relationship with the people. That is why representative democracy has become so much weaker in certain Latin American countries.

58 In the economic sphere, instead of pursuing macroeconomic policies to boost the money supply, they have nationalized private companies and subsidized given sectors of industry, distorting price systems and protecting politically selected industries with high customs tariffs. They have found it possible to finance such measures thanks to the fact that their countries are currently benefiting from a significant increase in the price of their exports. However, that is going to come to an end once those prices resume their longer-term trend. That is when “the macroeconomics of populism” is going to return to the scene,

To put it in a nutshell, populism in Latin America today may look new in terms of its shape and its form, but it is still the poorer sectors of the population that are being hit hardest by its consequences.

CHILE’S EXPERIENCE. Chile, for its part, certainly did not escape its historical rendez-vous with populism. The origin of the phenomenon can be traced back to the early part of the last century when the elite began to feel a certain malaise, questioning the country’s capacity for development. At that time, the blame for the country’s economic problems was laid at the door of the racial and structural features of an economy which benefited, comparatively speaking, from certain advantages in the field of natural resources (minerals and farming). Later, the crisis in the thirties dealt

the economy an especially hard blow, and a gradual process of “locking up” began as a means of emerging from those difficulties. A model known as the “substitution of imports” was adopted, and it ended up causing the country to apply customs tariffs that hovered around the 100% mark by the early seventies. The state began to create jobs and to intervene in a proactive manner by setting prices and by laying down a variety of rules and regulations.

The Chilean process culminated in the populist policies pursued by Salvador Allende’s socialist government. The policies in question consisted in organizing a massive monetary expansion in a drive to fund increases in public expenditure; in nationalizing most of the country’s private industries; in putting an even tighter external lock on the economy; and in a plan to use that mechanism to substantively increase workers’ salaries. As we can see from table 2, the results were disastrous: inflation leapt from 34.9% in 1970 to 605.9% by 1973; real salaries dropped in value by 30%; the tax deficit rose to 24.7%; and the country’s international reserves had as good as disappeared by the end of the Allende government. The ensuing crisis was total, and it ended in a *coup d’état*.

Starting with the military government, and on through four democratic center-left coalitions, Chile began to change its strategy for development, shifting away from the populist approach. Today it has turned into Latin America’s leading country in terms of economic development, thanks to its free market model.

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Table 2 • Chile: main indicators under Allende

	1970	1971	1972	1973
INFLATION (% DEC. TO DEC.)	34.9	34.5	216.7	605.9
GROWTH RATE	2.1	9.0	-1.2	-5.6
REAL SALARIES (1970=100)	98.4	115.1	103.5	70.3
PUBLIC EXPENDITURE (%)	26.4	31.1	31.2	44.9
PUBLIC DEBT (%)	2.7	10.7	13.0	24.7
MONETARY GROWTH (% OF GDP)	52.9	99.3	100.9	264.4
INTERNATIONAL RESERVES (millions of US dollars)	320	129	95	36

Source: Edwards and Dornbusch, *The macroeconomics of populism in Latin America*, University of Chicago Press, 1991.

OLD LEADERS, NEW TRICKS. This reality allows us to disprove the contention that problems of “race” or “geography” or “structure” inhibit growth. The very same inhabitants in terms of genetics, of cultural level and of class difference who had proven incapable of impressing growth on the country earlier, led the country to enjoy strong growth in the last few decades of the twentieth century. If we break down the sources of growth, we will discover that, from 1986 to 2000, the accumulation of capital accounted for 2.46% of overall growth (6.64%); the increase in the labor force accounted for 2.22%; and the increase in overall productivity for 1.95%.

In other words, Chile’s experience proves the importance of the accumulation and quality of production factors, as well as the importance of putting them to good use. What are the policies that led to the achievement of such results? They are policies that made it possible to improve the quality of health and education; to open up a capital market for channeling savings and funding investment; an open economy forcing business to adopt a more efficient industrial approach; limited government intervention; barely distorted prices thanks to a free market; greater civil liberty; and more and better infrastructures. Moreover, the complementary and consistent nature of all the policies, in conjunction with a favorable external economic context, account for no less than a 73% rise in growth over the period from 1986 through 2000. One of the most significant aspects is the consistency between public policies and the goal of economic growth.

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Chile’s experience shows that with a policy based on a free market economy open to the world, with macroeconomic balance, and on condition that such policy is applied in a consistent and continuous manner, developing countries can indeed grow and leave underdevelopment behind them.

LESSONS TO COUNTER POPULISM. The most important lesson that we can learn from the case of Chile is that, in order to counter populism in an effective and lasting manner, the kind of policies required are those that foster progress and that build institutions capable of thwarting populist promises.

An independent central bank. Populism fosters the illusion that it improves people’s standards of living by resorting to issuing money and adopting tax saving programs. Chile has managed to bring its yearly inflation rate down from 600% to a mere 3%. The political conviction that the tax deficit financed with credit from the central bank was what lay behind inflation made it possible to forge agreements to introduce the central bank’s independence into the constitution. Thus the constitution now sanc-

tions the independence of the central bank and prohibits it from making loans to the government. The Chilean Central Bank operates autonomously and the mechanism regulating its authority makes it independent of whatever government is in power, obliging it to focus on keeping a tight rein on inflation.

Fiscal discipline. Populism also gains in strength when parliament gives it too free a rein in the area of public spending and taxation. To prevent that from happening, the Chilean Constitution specifies that the executive power alone can take the initiative of proposing new taxes. Similarly, any increase in public expenditure requires the executive power's approval. In other words, congress cannot raise taxes or increase public spending of its own initiative. That way, it is the government that is responsible for maintaining fiscal discipline. By the same token, public expenditure policy is designed to maintain a long-term balance between revenue and spending. This means that whenever there happens to be a period in which external factors determine an exceptional increase in public sector revenue due to outside factors, that additional revenue must be set aside for use at a time when there is a drop in revenue.

Opening up the economy. After being one of the most tightly sealed economies in the world, Chile has now become one of the most open. It has a single 6% customs tariff, which translates into a real tariff of 1.9% when combined with all of its various free trade agreements. It is the country that has signed the highest number of free trade treaties in the world. The creation of an extremely open economy has also served to curb populism. And thanks to this reality, any attempt to artificially in-

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crease the amount of money in circulation or public expenditure – or to artificially protect one or the other area of industry – rapidly triggers imbalances and protests.

Thus, an open economy enforces discipline on governments and on parliaments.

Social security system for individual savings. Starting in the eighties, Chile began to replace its “pay as you go” social security scheme with a new system in which each individual worker saves up to fund his own retirement, being free to choose among a variety of private companies, which then invest his savings. This system also provides for a solidarity fund guaranteeing a basic pension for all salaried workers. Also, such institutions curb populism by making it difficult for governments to use social security resources for populist purposes. When workers fund their own retirement and not one else's, they have a vested interest in defending their right to private property and so they react negatively to the expropriatory designs of populism.

Privatization. In implementing its reforms, Chile has assigned priority to private-sector participation in the various areas of the economy. This policy has made it possi-

ble to privatize most of the state corporations in the energy, transportation, telecommunications, steel and drinking water industries, while simultaneously opening up to private participation in the area of port and highway infrastructures through a system of government concessions. These policies have also helped to curb populism, as the influence of state-owned corporations – historically one of Latin American populism’s chief tools – has waned.

CONCLUSIONS. Populism has returned to Latin America. The policies of Chávez in Venezuela, of Kirchner in Argentina and of Morales in Bolivia are leading this process. The losers, once again, will be the lowest echelons of society; it is the poor who will be the hardest hit by the drop in growth, rising inflation, and rising unemployment. Chile has provided an example of how populism can be kept at bay when free market policies are systematically and consistently implemented and when institutions are built to provide these policies with stability. May its neighbors, on the threshold of another disastrous experiment, look to Chile as a model of economic growth, diminishing poverty, and democratic stability.

