Appendix A

Chapter 24 (Chile): Documents

*1. Letter to General Pinochet on Our Return from Chile and His Reply**

April 21, 1975

Personal
Excmo Sr. Augusto Pinochet Ugarte
El Presidente
Edificio Diego Portales
Santiago, Chile

Dear Mr. President:

During our visit with you on Friday, March 21, to discuss the economic situation i[n] Chile, you asked me to convey to you my opinions about Chile's economic situation an[d] policies after I had completed my visit. This letter is in response to that request.

May I first say how grateful my wife and I are for the warm hospitality that was showered on us by so many Chileans during our brief visit. We were made to feel very much at home. The Chileans we met were all aware of the serious problems your country faces; all realized that the immediate future was going to be difficult; but all displayed a determination to surmount those difficulties and a dedication to work for a happier future.

The key economic problems of Chile are clearly twofold: inflation, and the promotion of a healthy social market economy. The two problems are related—the more effectively you can invigorate the free private market, the lower will be the transitional costs of ending inflation. But they are also distinct: strengthening the free market will not end inflation; ending inflation will not automatically produce a vigorous, innovative free market.

The source of inflation in Chile is crystal clear: government spending is roughly 40 per cent of the national income; roughly one-quarter of this spending is not matched by explicit taxes; it must therefore be financed by creating new money, which is to say, by the hidden tax of inflation. The inflation tax which is currently called on to raise an amount equal to 10 per cent of the national income is therefore extremely heavy—a tax rate of 300 to 400 per cent

* This letter and General Pinochet's reply have not heretofore been published.

(i.e., the rate of inflation)—levied on a narrow tax base—3 to 4 per cent of the national income (i.e., the value of the quantity of money in Chile in the form of currency and demand deposits).

This inflation tax does enormous harm by inducing people to devote great effort to hold down their cash. That is why the base is so narrow. In most countries, developed and underdeveloped, the quantity of money is more like 30 per cent of the national income than 3 to 4 per cent. In terms of total spending, which is a multiple of income, the money in Chile amounts to only about three days' spending, which forces hand-to-mouth operation on the business system and strangles the capital market.

There is only one way to end the inflation: by reducing drastically the rate of increase in the quantity of money. In Chile's situation the only way to reduce the rate of increase in the quantity of money is to reduce the fiscal deficit. In principle, the fiscal deficit can be reduced by cutting government spending, by raising taxes, or by borrowing at home or abroad. Except for borrowing abroad, the other three methods will have the same temporary effects on employment, though affecting different people—cutting government spending will initially affect government employees; raising taxes will initially affect persons employed by taxpayers; raising borrowing will initially affect persons employed by the lenders or the persons who would otherwise have borrowed the funds.

In practice, cutting government spending is by far and away the most desirable way to reduce the fiscal deficit because it simultaneously contributes to strengthening the private sector and thereby laying the foundation for healthy economic growth. It will therefore involve the least transitional unemployment.

A cut in the fiscal deficit is the indispensable prerequisite for ending inflation. A less clear question is how rapidly inflation should be ended. For a country like the U.S., where inflation is around 10 per cent a year, I favor a gradual policy of ending it in two or three years. But for Chile, where inflation is raging at 10 to 20 per cent a *month*, I believe gradualism is not feasible. It would involve so painful an operation over so long a period that I fear the patient would not survive.

There is no way to end the inflation that will not involve a temporary transitional period of severe difficulty, including unemployment. But unfortunately, Chile only faces a choice between evils: a brief period of high unemployment or a long period of high—though slightly less high—unemployment. I believe that the experience of Germany and Japan after World War II, of Brazil more recently, of the post-war readjustment in the U.S. when government spending was slashed drastically and rapidly, all argue for shock treatment. All suggest that the period of severe transitional difficulties would be brief—measured in months—and that subsequent recovery would be rapid.

To ease the transition and facilitate the recovery, I believe that the fiscal and monetary measures should be part of a package including measures to eliminate obstacles to private enterprise and to relieve acute distress.

For definiteness, let me sketch the contents of a specific package proposal. My knowledge of Chile is too limited to enable me to be either precise or comprehensive, so these measures are to be taken as illustrative.

If this shock approach were adopted, I believe that it should be announced publicly in great detail, to take effect at a very close date. The more fully the public is informed, the more will its reactions facilitate the adjustment. Herewith the sample proposal:

1. A monetary reform replacing the escudo by the peso, with 1 peso = 10,000 escudos (or, perhaps 1,000). By itself, this measure accomplishes nothing substantive; but does have a valuable psychological role.

2. A commitment by the government to reduce government spending by 25 per cent within six months, the reduction to take the form of an across-the-board reduction of every separate budget by 25 per cent, the personnel separations to take place as soon as possible, but the spending reductions to be spread over a six-month period to allow for the payment of generous separation allowances. [Any attempt to be selective is likely to be defeated by the machinations of each agency to have the cut bear on someone else. It is desirable first to cut across the board, then redirect the lower total.]

3. A national stabilization loan from the public to supplement the reduction of spending during the first six months in order to permit a faster reduction in money creation than in spending. The terms should include provision for inflation readjustment to give the public confidence in the government's determination to end inflation.

4. If possible, a stabilization loan from abroad for the same purpose.

5. A flat commitment by the government that after six months it will no longer finance any government spending by creating money. [As economic recovery occurs, the desired quantity of money in real terms, i.e., the quantity consistent with stable prices, will rise, but this increase should serve as the base for the expansion of a private capital market rather than be used to finance government spending.]

6. A continuation of your present policy of an exchange rate designed to approximate a free-market rate.

7. The removal of as many obstacles as possible that now hinder the private market. For example, suspend, with respect to newly employed persons, the present law against discharging employees. That law now causes unemployment. Remove the obstacles to establishing new financial enterprises. Eliminate as many controls over prices and wages as possible. Wage and price controls are not measures to cure inflation. They are one of the worst parts of the disease. [Remove obstacles, but do *not* substitute subsidies. Private enterprise is entitled to receive the rewards of success only if it also bears the penalties of failure. Every businessman believes in free enterprise for everyone else, but for special favors for himself. No obstacles, no subsidies should be the rule.]

8. Provide for the relief of any cases of real hardship and severe distress among the poorest classes. Note that the measures taken will not of themselves harm this group. The discharge of present government employees will not reduce output but simply eliminate waste—their discharge will not mean the production of one fewer pair of shoes, or one fewer loaf of bread. But indirectly, some of the poorest classes will be affected and whether they are or not, the program will be blamed for their distress. Hence it would be well to make some provision of this kind in the program. Here, especially, my ignorance of the present situation and arrangements in Chile makes it impossible for me to be specific.

Such a shock program could end inflation in months, and would set the stage for the solution of your second major problem—promoting an effective social market economy.

This problem is not of recent origin. It arises from trends toward socialism that started forty years ago, and reached their logical—and terrible—climax in the Allende regime. You have been extremely wise in adopting the many measures you have already taken to reverse this trend.

The end of inflation will lead to a rapid expansion of the capital market, which will greatly facilitate the transfer of enterprises and activities still in the hands of the government to the private sector.

In addition, the most important step is to free international trade so as to provide effective competition to Chilean enterprises and to promote the expansion of both exports and imports. This will not only improve the well-being of the ordinary Chilean by enabling him to obtain all items at the lowest cost; it will also lessen the dependence of Chile on a single major export, copper. Perhaps the greatest gain in this area would be obtained by the freeing of the importation of motor vehicles.

I know that your administration has already taken important steps and plans further ones to reduce trade barriers and to liberalize trade, and that as a result Chile's true competitive advantage is better reflected in its trade today than for decades past. This is a great achievement. I recognize also that in this area, a strong case can be made for gradualism in order to give Chilean producers an opportunity to adjust to the new conditions. However, gradualism should not mean standing still. Personally, I believe Chile would be well advised to move toward liberalization of trade more rapidly and to a far greater extent than has so far been proposed. Complete free trade is the desirable final goal, even if it cannot be achieved in the very near future.

May I close by saying that I am persuaded that Chile has great potential. It has an able, literate, inventive, and energetic people; it has a long history and tradition of an orderly, peaceful society. Some forty years ago Chile, like many another country, including my own, got off on the wrong track—for good reasons, not bad, because of the mistakes of good men not bad. The major error, in my opinion, was to envision government as the solver of all problems, to believe that it is possible to do good with other people's money.

If Chile now takes the right track, I believe it can achieve another economic miracle, that it can take off into sustained economic growth that will provide a widely shared prosperity. But to benefit from this opportunity Chile must first surmount a very difficult transitional period.

Sincerely yours,
Milton Friedman

Santiago, Chile May 16, 1975

Distinguished Mr. Friedman:

I am pleased to acknowledge receipt of your courteous letter of this past April 21 in which you gave me the opinion you formed about the situation and economic policy of Chile after your visit to our country.

On this matter I appreciate your concern, a concern which is transmitted through your interesting letter.

The valuable approaches and appraisals drawn from an analysis of the text of your letter coincide for the most part with the National Recovery Plan proposed by the Secretary of the Treasury, Mr. Jorge Cauas. The Plan is being fully applied at the present time—a plan for which we have high expectations of advancing the Chilean economy.

For the undersigned President of the Republic it was very pleasant to be able to receive you during your stay in Chile and also to know that you as well as your wife enjoyed the hospitality of those who had an opportunity to become acquainted with both of you.

Along with reiterating my gratitude for your personal contribution to an analysis of the economic situation of my country, I am also taking this occasion to express my highest and most respectful regard for you.

Courteously yours,
Augusto Pinochet Ugarte
General of Army
President of the Republic

(Translation by Gloria Valentine.—M.F.)