The Washington Times

A tale of two economies

Chile has employed free-market principles to outperform Ecuador

By Richard Rahn – July 2nd, 2013

Chile and Ecuador provide an almost perfect test case of competing economic visions. Back in 1980, Ecuador had a slightly higher per capita income than Chile. In the past 33 years, Ecuador has increased its real per capita income a little more than threefold, but during the same period Chile has increased its per capita income more than sixfold. Chile now has the highest per capita income in South America, and most of its citizens are now enjoying a middle-class life style. Why has Chile done so much better than Ecuador?

Chile and Ecuador are both Spanish-speaking, South American countries located on the Pacific. They have similarly sized populations (15.4 million for Ecuador, and 17.2 million for Chile). Ecuador has substantial oil reserves, and its oil accounts for more than 50 percent of the country's export earnings. Chile has huge copper reserves which account for about 19 percent of its export earnings. Both are now functioning democracies with largely capitalistic economies. Chile, however, went through a radical, free-market reform process more than three decades ago, while Ecuador followed the more common semistatist model.

The biggest difference between the paths the two countries took was on economic freedom and the size of government. Back in 1980, Chile ranked only No. 60 in terms of economic freedom, but now it ranks as the 10th most free economy in the entire world. In contrast, Ecuador ranked a respectable No. 33 in 1980, but now has fallen to a miserable 126 rank in terms of economic freedom. While Chile has embraced the rule of law and made property rights very secure, Ecuador is still mired in corruption and suffers from uncertain property rights. President Rafael Correa of Ecuador defaulted on the country's debt in 2008 and then did a reverse auction in 2009 to settle most of the debt issue at a heavily discounted rate, at the expense of the bondholders. As would be expected, these actions greatly reduced foreign investment into Ecuador. The Chinese are now the biggest investors in Ecuadorean government securities.

Chile has actively pursued free trade. It now has free-trade agreements with the United States and more than 60 other countries. Ecuador, by contrast, has been increasing trade restrictions. By opening its market to the world, Chile has also gained access to the major markets across the globe. This has encouraged Chilean industry to diversify, so Chile is becoming less and less dependent on copper. Ecuador, by not pursuing a policy of openness, has made itself hostage to the world oil price. Given the new hydraulic-fracturing technologies, the price of oil may well fall in real terms, which would cause great economic pain in Ecuador.

Chile has kept the size of government relatively low as a share of gross domestic product (24 percent), while government ballooned in Ecuador to European government levels (46 percent) — again, illustrating that welfare states eventually result in more poor people rather than fewer. Chile has, as would be expected, a much lower poverty rate than Ecuador.

Both countries have maintained sound monetary policies for the past three decades after having suffered very high rates of inflation. Ecuador decided to use the U.S. dollar as its currency back in 1980, and it continues to do so. This makes sense for Ecuador since it receives substantial remittances from Ecuadorean citizens working in the United States, and because the global oil price is quoted in dollars.

Why did Chile choose the limited-government, free-market route, and how has the country managed to keep it when so many other governments drifted far to the left? In the mid-1970s, the Chilean economy was in a deep crisis due to the actions of the Marxist government of President Salvador Allende. The military dictatorship of the Pinochet government had little idea of how to right the economy. Eventually, out of desperation, it turned to a group of free-market Chilean and American economists, known as "the Chicago boys" (many having been students of Milton Friedman and his colleagues at the University of Chicago). The reforms that they instituted led to the restoration of democracy in Chile.

The reasons the reforms have persisted through governments of both the left and right in Chile is largely due to one man, Jose Pinera. As the very young labor minister in the late 1970s, Mr. Pinera devised the world's first major, and hugely successful, privatized, social security system, which has now been adopted, at least in part, by more than 30 other countries. Mr. Pinera is considered a "Chicago boy" even though his doctorate is from Harvard. The Pinera plan gave Chilean citizens a choice: Stay with the state pension plan or move to the new system of privatized accounts. More than 97 percent of the Chilean citizens have voluntarily moved to the new system, which has now provided an average compounded rate of return of more than 10 percent for 33 years. Hence, the average Chilean now retires with more assets than the average American.

The privatized pension system provided large amounts of capital investment for Chilean businesses, enabling the economy to grow rapidly while, at the same time, giving every Chilean worker a direct, vested interest in the success of the Chilean economy. It's a win-win.

There is no need for any country to be poor or have slow growth. The lessons of success are there for all to see.