CHAPTER 3

Preemptive Strike

Central Bank Autonomy in the Transition from Authoritarian Rule

The previous chapter provided an extensive discussion of current thinking on central banks in the advanced industrial democracies. To date, the conventional wisdom has posited autonomous central banks as structures of mutual advantage and efficiency. In contrast, I argued for a more explicitly political view of central bank autonomy that emphasizes policy conflict and the unequal distribution of costs and benefits. I concluded by noting the relevance of this more redistributive perspective for the study of central bank reform in the less developed countries.

But even if this alternative paradigm is generalizable to the countries of the developing world, a straightforward application is not as simple as it seems. Rather, this perspective must be modified to accommodate the distinctive institutional context in question. For the study at hand—which focuses on the "moment" of a transition from authoritarian rule—this means that a few quite fundamental changes are in order.

First, the central actors are invariably different. In the advanced industrial democracies, the politicians in various models tend to be presidents, legislators, and/or political parties. In a transition to democracy, the central divisions are much more rudimentary: the authoritarians presently in power and the democrats who challenge their continued hold on office.[1] The relationship between turnover and insulation also shifts accordingly. The normal turnover characteristic of regularly scheduled democratic elections also no longer applies. We are instead concerned with the incentives facing incumbent elites when the much more dramatic prospect of regime change is on the horizon. Finally, some thought must be given to the sorts of distributional conflicts that central bank autonomy is likely to engender in the third world. As noted at the end of chapter 2, it seems unlikely that this battle will take the form of the well-known inflation versus unemployment debate. The political struggle in developing countries is more likely to center around the central bank's role in facilitating or impeding deficit spending and preferential credit policies.

1. For simplicity's sake, I treat both the authoritarians and the democrats in this model as unitary actors, recognizing that in reality, there are likely to be divisions within each. Where relevant, such divisions are taken up in the case studies.

While such changes are meant to capture the distinctive institutional environment of the transition from authoritarian rule, the basic ideas remain the same. The overall environment is one of uncertainty about the future state of the economy. Incumbent elites are motivated not by credibility concerns but by fear of what their opponents might do once elected to office. And the power holders' response to this fear is to design structures that protect their interests against the vicissitudes of domestic political change.

To address some of these points in a more systematic fashion, this chapter develops an argument to explain the choice and persistence of central bank autonomy in the transition from authoritarian rule. This argument is presented in four stages. I begin with a general model of transitional insulation in which I outline the relationship between democratization and institutional change. This argument then is applied to the realm of central banks. I explain why democracy may prove threatening to the economic interests of certain authoritarian rulers, when this might prompt them to delegate authority to an independent central bank, and why, once created, these autonomous institutions are likely to remain. This chapter concludes with a discussion of how the independent and dependent variables will be operationalized in this study.

Transitions and Turnover: The Insulation Incentive

The Drive to Insulate

The previous chapter suggested why an anticipated turnover in power might prompt politicians to use institutional reform to protect their interests. The claim here is that a change of regime drastically increases this insulation incentive. This implies that the turnover entailed in a regime change is more threatening than routine democratic turnover. Why is this so?

To begin with, this is not an everyday loss of power. While incumbent politicians never welcome defeat, releasing the reins of power is likely to be particularly momentous for authoritarian elites who have had an entire state apparatus at their fingertips. For unlike their counterparts in first world democracies, who can expect someday to return to power, this may well be the last "hurrah" for exiting authoritarian elites. If they want to influence the future course of policy, the time to do so is now or never.

Second, a regime transition also heightens the climate of overall uncertainty (Przeworski 1986, 1991). While shifts between governing coalitions within advanced industrial democracies occur within some known (if varying) parameters, there is no blueprint for change between two forms of rule.

In the words of two famous scholars of transitions, authoritarian elites cannot be sure "how—or for that matter, by whom—the normal political game will be played in the future" (O'Donnell and Schmitter 1986, 66).

Above all, however, a regime change is threatening insofar as it jeopardizes the authoritarians' preferred policy outcomes. The hierarchical nature of decision making under authoritarian rule means that, ceteris paribus, these governments are more or less free to make policy choices as they see fit. Democracy, in contrast, requires that more groups will obtain a voice in the polity. In particular, previously marginalized groups whose demands have been limited or repressed can be expected to try to shift policy to their favor. By definition, then, the onset of democracy offers greater opportunities for a change in the direction of policy.

In the wake of this heightened climate of threat, authoritarian elites have an incentive to think about how the onset of democracy is likely to affect their interests in the future. One might be inclined to ask why authoritarian rulers should care about the future at all. If it is true that they are losing power, and may never again regain it, what are their incentives to care about what happens once they are gone? I argue that such skepticism reflects an excessively narrow view of the incentives facing authoritarian leaders and of what happens to them when they lose power.

Short of the rare case of violent revolution, most exiting authoritarian leaders do not disappear entirely. Rather, they can expect to be citizens in the new polity. They will therefore retain an interest in the system and be vulnerable to how that system affects them. This could be due to a variety of reasons. For example, the authoritarians might be concerned about their professional future or their personal economic well-being. They might also be beholden to certain special interests whose welfare will be affected by democracy. Or they might have a collective investment in the particular merit of a certain set of policy ideas. The relevant question is thus not why they should care about the future but rather what they plan to do about it.

In normal times, we would not expect authoritarian regimes to delegate authority as a means of protecting their interests. Given the choice between a constrained and an unconstrained equilibrium, they should always choose the latter and wait until the final period before giving up any power. There are several reasons to believe that insulation should not be a dominant strategy for authoritarian elites.

First, the nature of hierarchy is such that the creation of an independent agency is inevitably characterized by principal-agent problems (Jensen 1983). Even under the most carefully monitored circumstances, some degree of slippage inevitably occurs. As long as the authoritarians are secure in their hold on power, they should therefore want to structure an agency in the most

transparent way possible to allow for smooth, easy political oversight down the road. That way, they can make sure that the agency does not get off track and pursue its own objectives rather than those of the politicians who designed it. Absent a threat from their political opponents, it is not clear why an authoritarian government would want to deny itself this important degree of institutional leverage. After all, insulation only comes at the cost of ineffective organization and reducing their own ongoing control over the agency (Moe 1990a, 132–35).

In addition to these monitoring problems, agency independence also limits flexibility. Committing oneself to follow the dictates of a formal set of rules invariably entails a certain loss of discretion on the part of the government. In particular, those in power lose the ability to use the agency to respond to unforeseen contingencies. This observation is, of course, at the heart of the debate over "rules versus discretion" that first surfaced in the wake of the early credibility literature (Kydland and Prescott 1977). It is again unclear why an authoritarian government would want to risk this loss of responsiveness unless it faced a worse alternative—control by someone else.

A third and final reason to expect that the basic incentive for insulation should be absent without the threat of regime change has to do with the expectations effects that flow from institutional creation. Once established, rules create expectations in the minds of other actors, who conduct themselves on the basis of the existence of a certain set of procedures. It thus becomes quite costly for governments to violate such rules without incurring the wrath of their partners in exchange (Milgrom, North, and Weingast 1990; Lohmann 1998b). The authoritarians are likely to factor in such expectations effects before they choose to institutionalize a set of guidelines in the first place (Cukierman, Kiguel, and Liviatan 1992). Knowing that they may be obliged to respect the rules of whatever they create, they should be reluctant to cede authority to an independent agency unless they have no choice.[2]

For all of these reasons—political control problems, the loss of discretion, and the binding nature of rules—an authoritarian government should not want to risk creating an independent agency prior to realized concerns about a transition. Our story, however, begins at a point in time when authoritarians know that they are likely to lose control of the polity at some point in the future. This knowledge changes the decision-making calculus of authoritarian leaders with respect to insulation. For once we add political

2. To be sure, fewer veto players to check their arbitrary use of authority clearly affords authoritarian regimes greater leeway to violate existing arrangements when it suits their interests (North and Weingast 1989). But precisely because they are aware of the reputational costs attached to violating an established set of rules, they are unlikely to act on these incentives, or at least they risk punishment when they do.

turnover to the equation, the authoritarians begin to fear what will happen to their preferred policies when their enemies are in charge. Since their first best alternative is no longer an option—to stay in power and rule—they instead focus their energy on those aspects of the public domain they can hang on to under the new regime. They should logically choose those policy arenas that matter to them most.

In this way, insulation—while previously unpalatable—can become strategically desirable for exiting authoritarian rulers as a means of protecting their interests. By freezing their preferences in institutional structures before they leave office, the authoritarians attempt to maintain de facto influence—if not control—over certain spheres of policy once they are gone. In so doing, they deny their opponents a substantial niche of power under the new regime, thereby constraining the democrats to move within a set of preexisting programmatic parameters.

Introducing Variation: The Intensity and Proximity of the Democratic Threat

The previous discussion suggests why the onset of democracy is likely to lead to insulating behavior on the part of exiting authoritarian elites. That said, not all transitions are going to be equally threatening or, by extension, warrant the same amount of insulation. We must, therefore, unpack this notion of threat in order to determine the different values it can take and its corresponding effects on the likelihood of insulation.

At a first cut, one factor likely to affect the incentive to insulate is the *intensity of threat,* or the extent to which the preferences of exiting authoritarian elites and incoming democrats are expected to diverge. As a general rule, we can think of the democrats' preferences as falling within a band of policy outcomes, centered on a point prediction of distance. This band is similar to a confidence interval. Sometimes, the successor government can be expected to be friendly. Future democratic leaders in such cases are likely to continue the policy preferences of previous rulers, and the corresponding incentives to insulate should be weak. In many cases, however, successors will be perceived as hostile and can be expected to pursue policies that deviate sharply from those of their predecessors. Where such marked preference incongruencies are expected to exist, the onset of democracy represents a strong threat. Under these circumstances, officeholders have a more powerful incentive to cement their interests in an institutional form.

But even where successor governments do have different policy priorities, it is not clear that the transition will always be met with an insulation response. Insulation will also depend on the *proximity of threat.* This dimen-

sion of the threat variable attempts to measure the relative imminence of the transition to democracy. In those cases where the authoritarians believe that they will never lose power—or will do so only at a relatively distant point in the future—they are unlikely to insulate at all. Rather, because of the various costs to insulation identified earlier (e.g., opportunities for slippage, expectations effects, etc.), the authoritarians are unlikely to bother assuming these costs unless the costs are "worth it." Conversely, if they face an imminent threat of democracy, then the authoritarians are more likely to discount such trade-offs and respond with a highly insulated institution.

In sum, the incentives to insulate will vary in accordance with the expected policy distance between the authoritarians and the democrats and the relative immediacy of democratization (see fig. 3.1). We should expect to witness no insulation when there is considerable policy affinity between the outgoing authoritarian and incoming democratic rulers and/or when the transition is sufficiently distant. In contrast, insulation is most likely to occur when there is strong preference divergence and regime change is looming. Note, however, that neither the intensity of threat nor its proximity is dichotomous in nature. Rather, both of these dimensions can assume a range of continuous values. This suggests that the resultant threat that they yield and the concomitant insulation are not "either/or" categories. The model can thus also account for instances of partial insulation.

To be sure, there will also be cases where the sudden and violent nature of the transition triggers a "flight" instinct on the part of incumbent elites. After all, one cannot expect to insulate overnight: it takes some time to design an institution that can effectively protect one's policy interests. Where they lack sufficient time, rather than insulate, the authoritarians are instead likely to take what they can get to maximize their personal safety and wealth before they are run out of town. This class of cases corresponds to a subset of those "mass ascendant" transitions in which sweeping change from below catches elites off guard (Karl 1990). As noted earlier, however, violent revolutions from below are rare. In most cases, exiting authoritarian elites can be expected to have some margin of maneuver within which to act defensively. These instances of unanticipated shock thus constitute an exception to the argument at hand, not the norm.

In short, expectations about the likely impact of turnover are important because they influence the extent to which incumbent elites need to worry about the future and, consequently, the degree of insulation they seek to obtain. Institutional outcomes are likely to be particularly affected by anticipation of a change in policy and the pace at which the transition takes place. These arguments should always hold—regardless of the specific insulation strategy at hand.

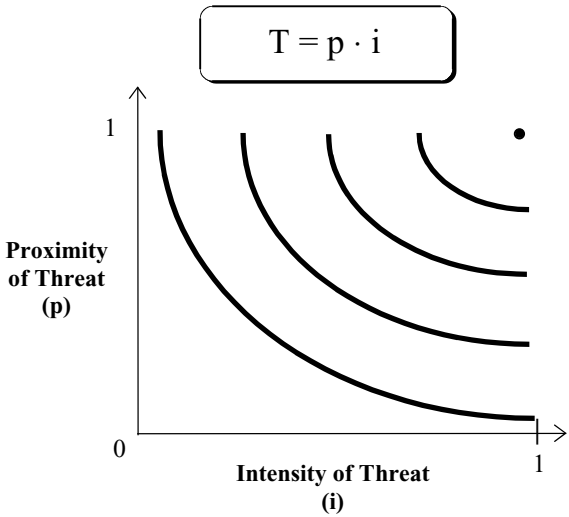

Fig. 3.1. The degree of threat (*T*)

An Application: Actors, Interests, and the Demand for Autonomy

With this basic logic of transitional insulation in place, we can now examine the specific insulation strategy with which this book is concerned: central bank autonomy. In order to elucidate the insulation logic surrounding this institutional form, I begin by identifying the intensity of the threat: how the expected preference divergence between incoming democratic and outgoing authoritarian governments affects incentives regarding central bank reform. This requires an understanding of who the democrats are, what they want, and why this might be threatening to incumbent authoritarian elites.

The Democrats

In this model, the democrats are the political parties of the democratic opposition around whom the democratizing coalition clusters once the transition is under way (O'Donnell and Schmitter 1986, 57–64). If all goes well, they can expect to be the incoming governments of the future democratic regime. Regardless of their ideological stripe, we can expect these opposition politicians to care about their prospects for election. They have, after all, been excluded from the political arena for a considerable period of time. They now have the opportunity not only to voice their opinions but also to govern.

Because they care about getting elected, the democrats have an incentive to respond to constituency concerns and to attempt to garner favor by pursuing policies that will receive a positive response from the electorate. This electoral motive has implications for the sorts of economic policies that they can be expected to endorse.

As a general rule, we should expect the democrats to favor policies that enable them to use the economy for political ends, ranging in scale from modest forms of intervention to more extreme populist measures. While this may seem like a somewhat controversial claim in light of the current era of neoliberal economic restructuring, we can delineate several theoretical and empirical reasons why this might be the case. By definition, the convocation of elections forces politicians to be more sensitive to unemployment and the redistribution of wealth and risk (Garrett and Lange 1996, 61–63). The increased level of political mobilization in new democracies leads to heightened social and economic expectations and increased distributional demands from all sectors of society. No matter who the relevant political actors are, they have incentives to choose policies that benefit social groups who recently obtained voice in the political arena and to redistribute wealth downward (Alesina 1994, 45–47). As one moves from no elections to elections, then, changes should occur in the amount of government spending (increases), in the type of spending (more welfare-oriented expenditures), and in the structure of taxation (a more progressive system).

A second reason to expect politicians in new democracies to favor maintaining some degree of discretion over the economy is their vulnerability to the risk of being overthrown. This is especially true in those cases where groups and constituencies who support the old regime have a voice and a political-military presence. Newly minted politicians are likely to try to use macroeconomic policy to buy out public support by distributing benefits to general allies, rather than risking more austere policies that might further alienate the public (Haggard and Kaufman 1989, 59–60; Ames 1987, 25–27, 42). At the very least, the possibility of a military coup is likely to give them shorter time horizons where the economy is concerned (Geddes 1994a, 13).

A final reason to think that politicians in new democracies may be more interventionist than their first world counterparts has to do with the time horizons of voters. Because they live in countries characterized by low levels of income, extreme poverty, and the absence of extensive social welfare systems to shield them from economic downturns, voters in the developing world typically have shorter time horizons (Haggard and Kaufman 1995, 157–58). This assumption underlies most contemporary models of policy reform in the developing world, which are predicated on what is known as the "*J*-curve" (Hellman 1998, 206–8). According to this model, even while

neoliberal reforms may be good for the majority in the long run, they impose a variety of costs in the short run such as rising unemployment, falling wages, and higher prices on state-subsidized goods (Przeworski 1991, 136–262; Bresser Pereira 1993, 60–62). And because economic agents are presumed to be myopic, they will tend to focus on the short-run costs of such policies, rather than their long-term benefits (Edwards 1990, 5; Sachs 1990). This literature therefore predicts that voters should rationally resist market-style reforms, either because they know that they stand to lose from such policies (Bresser Pereira, Maravall, and Przeworski 1993, 2; Piñera 1994, 227; Nelson 1994, 476–77) or because they are uncertain of how these costs will be distributed and/or fear that they may be in the "losing" group (Alesina and Drazen 1991; Fernandez and Rodrik 1991).

Recent work has challenged the assumptions behind the *J*-curve, suggesting that voters may in fact be more "intertemporal" than they are myopic and hence willing to trade off short-term costs for the promise of long-term gains (Stokes 1996) or at least to view stabilization as a necessary evil (Rodrik 1996). But precisely because democracy is so new, politicians may not know where voters fall and thus may assume them to be less conservative than they actually are.[3] And even where voters have shown themselves to be willing to support neoliberal reform, that support has been highly conditional, dependent on sustained economic improvement (Nelson 1992, 256; Stokes 2001, chap. 5). Where market-oriented reforms have not led to improved economic performance, voters have been all too willing to punish incumbents, as the elections in Venezuela (1993, 1998) and Poland (1995) attest. Such data suggest that even where politicians do embrace market-oriented reforms, they should be reluctant to do so too wholeheartedly lest they deprive themselves of crucial levers of control with which to guarantee their survival.

In brief, there are a variety of theoretical reasons to believe that newly empowered democratic leaders should favor a more interventionist economic agenda. There will naturally be variation, and not all democrats will be equally motivated to intervene in the economy to the same extent. It is also true that in today's international economic environment, it is increasingly unlikely that any new government would try to pursue an extreme populist program that might trigger capital flight and/or discourage private sector investment. But even where the democrats are not rabid populists, we can still safely say that politicians in emergent democracies are likely to want greater flexibility over the economy in the short term to appeal to different constituencies.

3. The fact that where left-leaning politicians have chosen to undertake neoliberal reforms in Latin America they have frequently concealed their programmatic agendas suggests that politicians believe voters are shortsighted (Stokes 2001).

At the very least, this hypothesis seems borne out by the empirical evidence available. There is no question that in recent years, radical trade liberalizations, fiscal adjustments, and institutional reforms have been implemented by democratic regimes around the globe, often by what were historically populist and interventionist parties (Remmer 1990; Bates and Kreuger 1993; Geddes 1994b). Many have concluded that left-leaning democrats may actually have a comparative advantage at implementing neoliberal reforms precisely because their historical opposition to such policies allows them to more credibly signal to voters why it may be necessary to endure these policies' short-run costs (Cukierman and Tomassi 1998). But while this "it takes a Nixon to go to China" logic may well be an explanation for why left-leaning governments are well positioned to undertake painful adjustment measures, it says nothing about the extent to which they actually carry out those measures. As in the advanced industrial world, the seeming convergence toward markets across the ideological spectrum may mask some important underlying nuances (Rodrik 1997; Garrett 1998).

We know, for example, that historically democratic regimes have spent consistently more than their authoritarian counterparts, particularly on social programs (Ames 1987). We also know that politicians in transitional democracies are more likely to resort to deficit spending and expansionary policies than are politicians in established democracies (Haggard and Kaufman 1989). And even in those Latin American cases where politicians have embraced radical market-oriented reform programs, these leaders have frequently reverted to more classically populist measures in order to obtain electoral victory in the second round of elections (Roberts 1995). In short, democratic governments may not be any less equipped to impose costly neoliberal adjustment packages than their authoritarian counterparts. But they do appear less likely to cut social spending for the sake of reducing the public deficit, even when controlling for the exigencies of the post–debt crisis era (Hunter and Brown 1998). This last finding, in particular, is relevant to the argument advanced in this chapter.

The Authoritarians

Regardless of where the democrats actually fall on the interventionist continuum, equally important for the argument at hand is what the authoritarians believe about what the onset of democracy is likely to mean for the future of the economy. In other words, we are as much interested in what the democrats want in objective terms as in what the authoritarians fear that they want and in how this fear conditions the likelihood of central bank reform. In

order to assess why the "specter of intervention" inherent in democratization might be threatening to existing authoritarian elites, we need to turn now to consider the policy preferences of the authoritarians.

In this model, the economic preferences of the authoritarians are determined by the interests of dominant economic actors (capital)—whether market oriented or protectionist. As Linz (1975) notes, authoritarian regimes must accommodate the interests of some constituency in order to survive; they are accountable to someone, if only the military establishment or other sectors within the state elite. In positing that this constituency is capital, I am merely adapting Lindblom's famous "privileged position of business" argument about capitalist democracies to an authoritarian setting (Lindblom 1977).[4] But whereas under democratic rule, voters' needs and interests often mitigate the power of business, this tension is considerably diluted under authoritarian rule. In effect, capital becomes the government's constituency.

Naturally, the "democratic" economic scenario described previously will not always constitute a threat to outgoing authoritarian elites. This should depend upon the type of capital that they represent. Drawing on Frieden (1991a) and Frieden and Rogowski (1996), the model posits two types of capital. For those authoritarian regimes that cater to the interests of sheltered and asset-specific capital, for example, there is no reason to fear the future in a strictly economic sense. Sheltered sectors contain those firms that produce for the country's internal consumption and whose productive activity is predominantly affected by domestic economic policies. Asset-specific firms are those holders of fixed assets that can only shift their production from one activity to another at great cost. In both cases, these types of capital encompass the protectionist sectors of the economy: import-competing industries and nontradables (retail, construction, and public services) for which it is hard to create international markets. These are firms that seek protection from international competitors and who are vulnerable to changes in government policy.[5]

Like the democrats, the authoritarian governments who represent these sectors of the economy have no incentive to limit the central bank's ability to monetize government deficits and to dole out subsidies and credits. To the contrary, their economic constituents should favor everything that an

4. Lindblom argues that the well-being of a capitalist economy in a democracy hinges primarily on the profits and sales of business. Governments are thus obliged to cater to business interests via various policy "inducements" (tax breaks, investment incentives, etc.) to compensate the risk assumed on the part of investors.

5. Within this group of firms in developing countries, a particularly powerful block is constituted by the state-owned industries, which have traditionally been more dependent upon special favors from the state in order to survive (Haggard and Maxfield 1993, 299).

autonomous central bank is designed to counteract. These are, after all, the sectors that have traditionally benefited from the lowered cost of capital entailed in interest rate ceilings and preferential credit policies (Clark 1994b). To the extent that financing for such policies was historically supplied via various direct and indirect government subsidies to financial intermediaries, the fiscal constraints implied by an autonomous central bank should work directly against these groups' interests (Haggard and Maxfield 1993, 314–15). The elimination of exchange controls that often accompanies autonomy—and which effectively constitutes a tax on export earnings—similarly removes yet another crucial subsidy for imported inputs for domestic industry (Maxfield 1991, 426). Finally, in Latin America at least, labor unions have also tended to be strongest in the protected and nontradable sectors of the economy, particularly in government services and state-owned industries. To the extent that autonomy brings with it the risk of higher unemployment, firms in these industries are also likely to oppose autonomy on the grounds that it threatens the livelihoods of their workers.

But there is also a set of important cases where the preferred policies of the authoritarians will not mirror those of the democrats. These are of course those authoritarian regimes that cater to a different type of capital—predominant in the exposed and non-asset-specific sectors of the economy. Exposed sectors are those economic actors for whom increased international exchange is beneficial (exporters and importers). Non-asset-specific capital encompasses those sectors of the economy based in liquid or mobile assets who can easily shift their assets from one activity to another (domestic financial capital, the financial services industry, and foreign capital). The former prefers a macroeconomic environment that enables it to realize the fullest possible benefits associated with broadened economic horizons (Frieden and Rogowski 1996). The latter welcomes policies that enable its holders to move their funds to whatever activity is earning the highest rate of return (Frieden 1991a, 1991b). Together, they constitute a powerful market-oriented constituency for whom democracy—and its accompanying economic agenda—constitutes a strong threat.

For these market-oriented authoritarian regimes, the creation of an autonomous central bank is a very attractive strategy. Above all, central bank autonomy increases the costs of borrowing for incoming democratic governments (by raising interest rates), while at the same time lessening the effectiveness of doing so (by eliminating the expansionary effects of borrowing stemming from seignorage). Autonomy thus promises an end to the inflationary consequences of deficit spending, the hallmark feature of Latin American populism (Dornbusch and Edwards 1991). Low inflation is highly

valued by exposed sectors and foreign capital seeking to expand opportunities for international trade and investment, who need macroeconomic stability in order to adequately forecast investment decisions. Banks and other financial institutions whose real interest rate earnings are eroded by surprise inflation also prize stability (Maxfield 1991, 425; Posen 1993).

A second reason that autonomy should be appealing to these authoritarians is that it institutionalizes a policy of financial liberalization. By removing the allocative inefficiencies and sectoral biases that characterized the era of "financial repression" (McKinnon 1973, 1991), an autonomous central bank frees financial policy of its political underpinnings that are thought to be a disincentive to savings and growth (Fry 1982, 1984). Without such barriers to investment, those who hold non-asset-specific capital are free to move their funds to wherever they see fit. The reduced reliance on reserve requirements will similarly afford private banks greater discretion in administering their funds (Maxfield 1991, 427).

Finally, central bank autonomy also has important implications for exchange rate policy. First, autonomy is generally accompanied by the gradual elimination of exchange controls, which, in reducing the red tape required to move foreign exchange in and out of the country, facilitates the free flow of capital to productive domestic investment opportunities (Frieden 1991b; Maxfield 1991, 426). Foreign capital holders, in particular, are likely to welcome this aspect of central bank autonomy, as well as the more dynamic export-oriented sectors of the economy that stand to benefit from an infusion of foreign investment. Second, to the extent that an autonomous central bank can prevent substantial currency volatility, this is also likely to be favored by internationally oriented investors, financiers, and traders, for whom such uncertainty is costly (Frieden 1998, 85).[6]

Briefly, for those authoritarian regimes that are beholden to exposed sectors and non-asset-specific capital, central bank autonomy offers several distinct advantages. By impeding a government's ability to costlessly finance its deficits, autonomy helps to eliminate the primary cause of inflation in LDCs. And because an autonomous central bank views credit policy through the lens of macroeconomic management, it also hinders a government's ability to distort financial policy for political ends. By establishing a monetary regime

6. It is true that there is often a trade-off between price stability and exchange rate stability. While the financial sector should have a preference for a stable currency, exporters are likely to prefer some measure of devaluation to make their products more competitive in home and foreign markets. But since this conflict has less to do with preferences over the level of the exchange rate than it does with central bank autonomy per se, it is only of secondary importance to the argument here.

where populist economic alternatives are virtually off the agenda, conservative authoritarian regimes can thus set up powerful constraints on the types of policies that governments can pursue in the future.[7]

Autonomy Observed: Hypothesizing Insulation Outcomes

The previous section outlines how the onset of democracy should affect the baseline preferences of actors in a transition with respect to the creation of an autonomous central bank. Our next task is to identify the conditions under which this outcome is likely to be observed.

As we have seen, the amount of autonomy afforded a central bank should hinge critically on two factors—one dependent upon the preference differences between the actors (the intensity of threat) and one dependent on how soon democracy is likely to occur (the proximity of threat). Neither of these factors is sufficient in and of itself. Rather, in order for central bank autonomy to occur, it is important that both conditions be present.

Taken together, these two dimensions of threat yield three sets of potential outcomes. Where there is no clash between the economic policy preferences of the outgoing regime and incoming democrats and/or democratization is sufficiently distant, there should be no change to the legal status of the central bank. Among other things, this corresponds to the transition from a protectionist regime. For these elites, democracy is not likely to constitute an economic liability, and so the demand for central bank autonomy should never even arise in the first place. But where there is a sharp preference divergence and regime change is imminent, the incentives to insulate will be strongest. These cases encompass those market-oriented regimes where the onset of democracy does constitute a strong threat to the economic interests of the outgoing authoritarians and autonomy should be full. In between, we should find a range of outcomes that we can term *partial autonomy*. These are

7. To be sure, one might reasonably argue that market-oriented authoritarian regimes would have an even stronger incentive to leave the economy in utter disarray, so as to have a ready-manufactured justification for coming back into power and fixing democracy's "mess." While this is an interesting theoretical possibility, there are several reasons to believe that it is unlikely to be the strategy they adopt. First, these authoritarians (and the capitalist factions they represent) are presumably already privileged and powerful anyway. Were they to deliberately wreak havoc on the economy, not only might they jeopardize their own positions, but the general populace might also want to hold them accountable. Second, there are no guarantees that such a strategy would ultimately prove functional, as many events might ensue in the interim that might preclude them from returning to office. Finally, to the extent that the authoritarians were driven by office-seeking motives and the economy were to perform well over time, they could claim credit subsequently for having acted in the best interests of the country.

cases where the preference divergence is lower than in the full case and/or the democratic threat is more distant.

Why Insulation Matters: Explaining Institutional Persistence

We now know why authoritarian governments have incentives to create autonomous central banks and when they are likely do it. But before this discussion is concluded, a final theoretical puzzle hangs in the air. The thrust of the argument presented in this chapter is that central bank autonomy should run counter to the interests of the democratic opposition to the authoritarian regime. If this is the case, then why do the democrats not simply turn around and reverse this legislation once they are elected to office? We have already noted that the transition is a moment of institutional flux, where rules are created "on the fly" (O'Donnell and Schmitter 1986). Institutional reversal would thus seem to be perfectly in keeping with such a fluid political environment. If so, then how can the authoritarians be so sure that what they create is going to last?

The short answer is that they can't. Insulation is really only the best that the authoritarians can do, and they have no formal guarantee that this effort will not be in vain. I argue, however, that the authoritarians can be reasonably confident that their institutional creations will survive and even thrive into the future. How can we explain this seemingly counterintuitive outcome?

Evaluating Theoretical Alternatives: Are the Democrats Worse Off?

One potential explanation is that despite their public protestations to the contrary, incoming democratic governments are secretly delighted with autonomy. The logic here is similar in flavor to those arguments that suggest that international financial institutions provide a convenient scapegoat for painful economic reforms that governments would prefer to enact but are otherwise prevented from doing for fear of domestic political reprisals (cf. Agénor 1994; Giavazzi and Giovannini 1989, 111, 126; Giavazzi and Pagano 1994). Much in the same way that LDC governments can credibly claim to domestic audiences that the International Monetary Fund (IMF) "forces" them to undertake costly adjustment measures (Cotarelli and Giannini 1998), so too could one argue that autonomy permits these same governments to absolve themselves of all responsibility for anti-inflationary policies (Kane 1980).

A second explanation for persistence is much more straightforward. It argues that precisely because the democrats may lack credibility with various capitalist audiences, they eagerly welcome central bank independence as an early deal to signal their own macroeconomic solvency. This sort of argument is consistent with recent claims that left-leaning governments actually stand to benefit most from the credibility boost afforded by an autonomous central bank (Simmons 1996).

Both of these arguments suggest that, far from harming the interests of the incoming governments, central bank autonomy would actually leave the democrats better off. While compelling in their reasoning, both arguments suffer from the same fundamental weakness: they assume politicians with very long time horizons who are willing to look beyond the next election by implementing policies that are politically costly to their constituencies. As noted earlier, this is not a realistic portrayal of these politicians, particularly for newcomers to the political arena who face unusually high redistributive demands. Without denying the host of benefits an autonomous central bank might afford the democrats in the long run, in the short run they are more likely to be concerned with getting elected. And to the extent that things such as the sacrifice ratio preclude them from achieving this goal, an autonomous central bank is likely to be perceived as a constraint, not as a godsend.

But just because the democrats would prefer not to have an autonomous central bank does not mean that they are free to ignore markets entirely. There are, however, a variety of other ways that they can demonstrate their credibility short of delegating authority to an independent agency. They might, for example, choose to enact some sort of corporatist wage bargaining between business, government, and labor in which various interest groups choose to forsake distributive conflict in the name of promoting both lower inflation and higher unemployment (Lange and Garrett 1985; Alvarez, Garrett, and Lange 1991). Or they might design an incentive contract through which the central bank commits to a quantitative inflation target that is then enforced through some sort of reporting requirement (Walsh 1995b; Persson and Tabellini 1993). They could also delegate budget preparation responsibility to a bureaucratic agency that ultimately reports to politicians (Hallerberg and Van Hagen 1997) or enact numerical limits on fiscal deficits or public sector borrowing (Poterba 1994; Bohn and Inman 1996). Precisely because the preceding devices entail less absolute loss of discretion than an autonomous central bank, they may constitute a welcome alternative for politicians wishing to retain a greater degree of flexibility over the economy. The point, then, is not that the democrats should eschew credibility entirely but that they should logically prefer mechanisms that are less costly than creating an independent agency.

In what follows, I offer a third and more comprehensive explanation for institutional persistence whose logic would hold even in the absence of the other two theoretical possibilities. Unlike either of these two efficiency-based alternatives, my argument suggests that the democrats need not be pleased with this institutional legacy but, rather, may have no choice but to accept it.

International Constraints: The Logic of Reputation

My explanation for the persistence of central bank autonomy in new democracies is rooted in the concept of reputation. Reputation is the view formed of an individual or organization by another based on past experience that is subsequently used as a basis for forecasting future behavior. The idea is that as actors interact with each other over time, they build a reputation for a certain type of behavior. This reputation then conditions the extent to which others will bargain with them in the future. This mechanism works because it is accompanied by a built-in punishment mechanism: failure to live up to one's reputation precludes the opportunity to make profitable deals in the future. Reputation thus serves as an informal norm that fortifies existing institutional arrangements and can even serve as a proxy form of commitment itself (Kreps 1990).

My basic claim is that, once established, international investors come to count on central bank autonomy as a guarantee of a secure investment climate. Regardless of how it got there, new governments are going to be reluctant to tamper with autonomy lest they pay the high costs associated with transgressing this sort of reputational mechanism: the massive outflow of foreign capital from their economies. This logic is very similar to that invoked in the first section of this chapter to explain why the authoritarians only create insulated agencies when they know that they are losing power. There, I argued that because rules create expectations, violating them is very costly. Absent the threat of turnover, authoritarian governments should thus be reluctant to commit themselves to an overly binding set of constraints lest they be obliged to respect them. But it is for the very same reason—the costs attached to violating an established set of rules—that once established, these autonomous agencies are likely to remain.

The analogy here is to the costliness of devaluations. One feature common to many exchange rate–based stabilizations is that once a government decides upon a given peg, it will generally do whatever it takes to maintain parity, even long after it becomes clear that a devaluation is necessary. This is because deviations from committed exchange rates are perceived to be very costly, even if the currency is subsequently repegged at some other level (Cukierman, Kiguel, and Liviatan 1992). In addition to whatever electoral

losses may be attendant on such behavior, financial markets can also be expected to engage in destabilizing speculation, capital flight, and so on (Lohmann 1998b, 11). If reneging on a preestablished currency peg has thus been shown to have a variety of negative political and economic consequences, a similar story should also hold true for other commitment devices such as an autonomous central bank.

To be sure, if the reputational value of an autonomous central bank is so high, we must also ask ourselves why the democrats would not have an incentive to set one up on their own. Two explanations prove relevant in this regard, both of which require us to think about the nature of international investors. First, there is a big difference between not having an institution in the first place and destroying one that already exists. Markets may well be willing to tolerate the absence of an autonomous central bank, as long as a given LDC government has some other means of demonstrating credibility. In contrast, the literature on "herding behavior" suggests that even tiny changes in a country's policy behavior may drive large waves of capital to exit (Calvo 1995; Calvo and Mendoza 1996). Abolishing an independent central bank would be a highly transparent signal that a government intended to inflate the economy, thus triggering immediate capital flight.

Second, even if one wanted to argue that central bank autonomy would eventually bring all sorts of positive externalities for the democrats, the coordination required to build a favorable foreign investment climate emerges only gradually over time (Stone 1996). To the extent that my earlier portrayal of the democrats is correct, we might believe that incoming democratic governments would be willing to forego the discounted future benefits of creating an independent central bank in order to enjoy the short-term benefits of greater flexibility over the economy. But we might also believe that they might be willing to relinquish such flexibility rather than pay the immediate costs associated with eradicating an autonomous central bank that already exists.

The logic I offer for why central bank autonomy is not overturned thus bears some resemblance to the notion of "audience costs" in the sanctions literature. Audience costs are those costs associated with failing to make good on threats or promises. Once an actor has made a public institutional commitment to a given action, reneging on this commitment causes it to lose face with other members of the international community (Martin 1993). But while the literature on audience costs implies that actors deliberately invest in costly signals as a means of making commitments credible, I propose that in the case at hand, the commitment is thrust upon them. All things equal, the newly elected democratic governments would rather not inherit an autonomous central bank from their authoritarian predecessors. Once the

bank is there, however, the costs of exclusion are higher than those associated with having "joined" in the first place (Gruber 2000). As a result, the democrats have little choice but to abide by the central bank's new rules. Though this is not their first best alternative, they are obliged to grin and bear it.

Ultimately, it is impossible to definitively prove why autonomous central banks persist under the new regime. Not only does this constitute a counterfactual, but even if the democrats do oppose autonomy, they are not likely to openly admit it in light of the reputation considerations noted earlier. There is, however, some suggestive evidence that the institutional persistence argument I offer is at the very least plausible. While a variety of central bank reforms were undertaken in the developing world between 1989 and 1993, no country took steps to decrease its autonomy (Maxfield 1997, 50–70). While this is not conclusive proof that an international constraint is in operation, it does suggest that in an age of increasing global capital mobility, few developing countries are willing to tempt fate. Stronger evidence in this regard comes from Venezuela. In early 1994, a populist administration elected on an anti-neoliberal platform announced that it was going to reduce the autonomy of this country's central bank. Within hours after the announcement, the stock market plummeted, and capital began flowing out of the country at a massive rate.[8] International investors were simply not willing to run the risk of staying in a country where they could no longer have the financial guarantees that an autonomous central bank provides. Venezuela's attempt to buck the system was thus met with an automatic, market-based penalty.[9]

In short, as long as the international economic environment continues to favor the policy outputs of an autonomous central bank, it is likely to reinforce the longevity of this institutional form. For once this institution is up and running, it is easier for the democrats to keep it than to pay the sudden and certain costs of demolishing it.

Bolstering the International Constraint: Domestic Strategies for Entrenchment

It would be a mistake, however, to attribute the persistence of central bank autonomy entirely to international forces. In addition, one can point to a variety of domestic factors that might serve to further lock in this institutional

8. *Latin American Weekly Report,* May 12, 1994.

9. It is true that the newly elected Caldera administration was not initially deterred by this capital flight and stuck by its intention to force out the president of the central bank. The argument here does not predict what all governments will do under all circumstances. It merely underscores the rational incentives they face given the costs attached to overturning a preexisting set of rules.

reform. Taken together, these constitute a powerful set of reasons to believe that the authoritarians' attempts to insulate the economy will prove a resounding success.

One domestic factor likely to enhance the persistence of an autonomous central bank is the fact that powerful actors associated with authoritarian rule—such as business and the military—may have a stake in its continued existence. As Przeworski (1992, 122) notes, "decisions made ex ante create conditions that are difficult to reverse ex post, since they preserve the power of forces associated with the ancien regime." No one would go so far as to argue with the claim that changes to central bank statutes are likely to incite a military coup. But the implicit threat of force and/or capital flight by such powerful constituencies may be sufficient to ward off any would-be effort to tamper with the authoritarians' preferred institutional forms (Valenzuela 1992; Loveman 1998, 128). This would seem to be particularly true to the extent that the authoritarian regime has deliberately strengthened certain capitalist groups prior to leaving office who then threaten to destroy the economy unless the democrats respect the rules (such as central bank reform) that ensure its operation (Bates 1991).

One might argue that such a constraint is epiphenomenal, in that it will last only as long as the current balance of power persists. But even if the influence of these "inherited" constituencies fades, the central bank is also likely to generate a new clientele over time who will come to benefit from its policies and thus have a significant stake in autonomy remaining (Bates 1994, 32; Rodrik 1994, 83–84; Tornell and Esquivel 1995). As Geddes (1995) notes, periods of rapid institutional change occur only rarely; once a given institution is created, the vested interests that emerge behind it tend to reinforce the status quo. That autonomous central banks promote the securitization of assets that in turn makes possible their rapid exit gives this sort of capital both a stake in and the power to defend this institution. Central bank autonomy may thus become embedded in a certain form of interest group politics over time.

But even if we were not to assume that the central bank would develop a constituency of its own, there is still good reason to believe that this institutional form will not be easily reversed. Precisely because the authoritarians know societal support for autonomy may not last indefinitely, they are likely to employ some sort of domestic entrenchment strategy before leaving power to make sure that a reversal is next to impossible. They might, for example, lodge a rule in the constitution that makes it necessary for a two-thirds legislative majority to approve any changes to the central bank. This sort of device was used amply by the outgoing authoritarian elites in the Chilean transition as a means of protecting their interests. To the extent that democratization is all about the move toward the rule of law, the democrats will

have incentives to respect these rules in order to give legitimacy to their newly minted democratic polity. They are thus likely to heed the rules governing the autonomy of the central bank, even when they might have preferred to avoid it entirely.

Even without these sorts of legal constraints, however, there are a variety of other reasons to believe that a democratic political environment will serve to guarantee institutional compliance. As Tsebelis (1997) has shown, the responsiveness of policy to a change in societal preferences is inversely related to the number of formal veto players in the political system—for example, the number of institutional actors whose assent is required for a policy change. One of the defining characteristics of democratic rule is precisely that decision making involves more institutional actors than is the case under authoritarian rule. At the most basic level, then, the greater number of veto players under democratic rule will automatically make shifting the status quo more difficult (North and Weingast 1989). Particularly where such checks and balances are complemented by ideological polarization—in which some members of the enacting coalition retain veto power under future governments—this is all the more reason to think that central bank autonomy should endure (Keefer and Stasavage 1998, 1999).

In turn, more sociological factors may also play a role in preserving the central bank's autonomy. Once an institution is in place—and regardless of how it got there—it tends to generate shared expectations. Over time, these become a force for stability as domestic actors get used to abiding by its rules and making decisions based upon its existence (Moe 1987, 255–56). Simply because they reflect the common experience of actors, these shared expectations are likely to reinforce the autonomy of the central bank, even among those who might otherwise oppose it.

A final reason to think that central bank autonomy is unlikely to be overturned stems from the notion of path dependence (David 1988). As institutions unfold over time, they acquire an institutional momentum of their own: other institutions form around them, and they come to generate increasing returns to scale (Arthur 1989). A given system becomes entrenched, not because it is necessarily the most efficient for those involved but because it becomes locked in by a series of small initial choices. Once these choices are in place, there is no incentive to change the initial institutional framework, even though more attractive arrangements might have been selected at the outset from the point of view of the incoming power holders.

Whatever the dominant constraint at work—whether international or domestic—the bottom line is that there are any number of reasons to think that, once created, an autonomous central bank is likely to last. And none of them requires that the democrats be left better off. Rather, incoming govern-

ments will have little choice but to accept the institutional legacy with which they are confronted.

Measurement and Operationalization of Variables

This chapter concludes with a discussion of how the independent and dependent variables will be operationalized in this study.

The Independent Variable: The Degree of Threat

The Intensity of Threat

In keeping with the earlier theoretical discussion, the threat variable is made up of two component parts. The first dimension corresponds to what I call the *intensity of threat.* In the model at hand, this threat is determined by the distance between the ideal points of the outgoing authoritarian and incoming democratic governments, as measured by the sectoral support base of the authoritarian regime and the democrats' economic agenda. Let us consider these in turn.

I have argued that the onset of democracy constitutes a strong threat for those authoritarian regimes where non-asset-specific capital and exposed sectors are dominant. The stronger this market-oriented capital base, the greater the resultant incentive should be to create an autonomous central bank. At its most basic level, the strength of non-asset-specific and exposed capital should be reflected in its economic power. Percentage contribution to gross domestic product (GDP), annual growth rates, and percentage share of exports in GDP should all serve as indicators of the power these capitalists can be expected to wield. In order to evaluate more precisely which groups within this capitalist block are driving economic policy, I divide them into their sectoral components (e.g., finance, manufacturing, etc.).[10]

In addition to the sheer economic might of these economic actors, I also consider their political power. A measure of the formal political power of the financial, foreign, and export-oriented sectors is first necessary. In those cases where a peak organization exists, the relative weight given to these sectors on its governing board should serve as a reasonable proxy for their formal business power. Political power can also be imputed to these sectors to the extent

10. It is possible that the sectoral distinction I employ here may be highly correlated with other more salient distinctions such as firm size and/or region. For example, larger firms may find it easier to integrate into the international economy, while smaller firms may face greater hurdles in adjusting their production for the international market.

that their business organizations are given an official role in the policy-making process. A second measure of the political power of business is informal and attempts to measure influence. One indicator of influence is the extent to which certain types of capital do not have to go through business organizations at all but are instead afforded direct access to high-level government ministers or even the president. The existence of small groups or clubs of very powerful market-oriented capital with whom the government consults on an informal basis is often indicative of their political clout. Reputational indicators can also be illustrative in this regard, in that they suggest the extent to which these capitalists are perceived to command influence over government policy.

As a general rule, however, we should expect traditional strategies of collective action to be less relevant when assessing the strength of the non-asset-specific and exposed sectors of the economy. By definition, non-asset-specific capital is not tied to any one country or industry. Those who hold it are therefore free to leave their country of origin and invest this capital elsewhere if they are not content with the economic policies of a given government. This permanent exit option enables this type of capital to maintain permanent leverage over government policy (Offe and Wiesenthal 1980). As a result of this silent clout, the first set of economic measures of power may in some ways be the most telling when evaluating the importance of non-asset-specific capital.

Finally, because the intensity of threat is meant to capture the expected policy distance between the authoritarians and the democrats, we must also know something about the economic policy preferences of the democrats. As noted earlier, some democrats will clearly be more populist than others and will—by extension—be more threatening to the interests of outgoing authoritarian elites. It is therefore important to look at the expected nature of the democrats' economic agenda in evaluating the intensity of threat. Opposition party platforms, mobilization activity, and statements to the press should all prove helpful in assessing where the democrats actually fall on the ideological spectrum. The attitudes and beliefs that the authoritarians and their constituents hold about such preferences, as measured through press statements, opinion polls, and elite interviews, should also give us some purchase on what the authoritarians perceive about the interventionist content of the democrats' economic message.

The Proximity of Threat

Even if the demand for central bank autonomy is dictated at a first cut by the intensity of the democratic threat, this economic incentive is necessary but not sufficient. As noted earlier, the demand for central bank autonomy is also

a function of the proximity of the democratic threat. While the latter notion is conceptually clear, it is difficult to measure directly.

Ideally, we could assign a time-based metric to evaluate the proximity of the transition. Were the authoritarians to expect the transition to occur in, say, fifty years, we would probably not expect them to insulate at all. Conversely, if they anticipated a regime change within the next year, they would be likely to undertake full insulation. In between these two extremes, however, lies an array of outcomes that might be closer to high, low, or medium threats. But how to establish the appropriate temporal cutoff through which to code, say, a medium threat? Is it two years? Four years? Ten years? Since it is almost always impossible to identify the precise time at which democratization will occur ex ante, we need to measure the proximity of threat in a more tractable fashion. The empirical measure used for the proximity of threat is thus the strength of the democratic opposition, on the assumption that this should reveal something about the relative imminence of democratization. The presumption is that the stronger the democratic opposition, the closer the onset of regime change and the more immediate the consequent need to insulate.

Since the opposition has been defined as the political parties of the opposition, the first measure of their strength should be the degree of fragmentation that exists among them. To the extent that the parties of the opposition are united under one umbrella, they are likely to be stronger and more threatening to exiting authoritarian elites. If they are instead divided and competing, they pose less of a political risk to incumbents. The ideological distance between opposition political parties is thus likely to be a good indicator of the opposition's relative strength, as reflected in the degree of overlap or convergence in the parties' programmatic agendas. If all parties are more or less in agreement on a range of policy issues, they are more likely to find common ground and unite. If sharp divisions exist within the polity over major spheres of policy, then they are less likely to cohere.

A second measure of opposition strength is the degree of popular support that opposition parties enjoy. To the extent that the opposition block has a relatively high degree of support from the populace, it can be expected to have more leverage in combating the authoritarian rulers. If elections exist and are reliable, percentage vote share should be a good indicator of the popularity of opposition parties. If there are no elections and/or these are not reliable, then other signals of popular approval can be utilized, such as mass attendance at public rallies sponsored by the opposition, public opinion polls, and/or the degree of engagement in informal partisan activity.

But since power is a relational concept, a second measure of the power of

the democratic opposition should be reflected through the strength of the outgoing authoritarian elites. The key issue here is the internal cohesion of the regime. This is defined as the state's ability to overcome internal principal-agent and collective action problems to pursue coherent policies (Donor 1992). Where authoritarian states are tightly organized and united, this should facilitate the leadership's ability to pursue its policy goals. In contrast, if multiple factions exist within the ruling elite, this should undermine the authoritarians' effectiveness. Such divides not only hinder the leadership's ability to execute policies in a timely fashion, they also open up opportunities for alliances between liberalizing factions of the authoritarian regime and its opposition (O'Donnell and Schmitter 1986). While internal cohesion is difficult to operationalize, it should be indicated by the extent to which there exists a unity of views among the ruling elite, as reflected in the continuity of personnel, common professional or educational training, and/or similar socioeconomic origins. Evidence of any open disagreements within the ruling elite should similarly attest to the regime's vulnerability.

A second indicator of the strength of the authoritarians should be captured in their external popularity. Even the most repressive authoritarian regimes face a legitimacy constraint. If there are thus widespread signs of citizen dissatisfaction with the ruling elite, this is likely to make it increasingly difficult for the regime to stay in power. Because an authoritarian regime can typically repress its opposition and/or mobilize artificial support, it is difficult to measure its true popularity. Accordingly, vote share (where elections exist) and/or the existence of antiregime activities such as strike activity, popular protests, armed insurgencies, and so on, should serve as reasonable proxies.

It is worth noting that this entire argument is predicated on the assumption that all authoritarians that wish to insulate are empowered to do so. To be sure, some authoritarian regimes are weaker than others are, and on occasion this may disrupt their ability to pass laws as they see fit. Earlier in the chapter, for example, I referred to those "overnight" transitions where the authoritarians are caught off guard and lack the time or ability to dictate the institutional framework that follows. Absent this set of circumstances, however, it seems reasonable to presume that even in an authoritarian regime with severe internal collective action problems, the organizational threshold to pass a new law must be lower than in a democracy.[11]

11. Take the case of Argentina, which is generally recognized as a case where exiting elites were less able to control the terms of the transition than most. Even there, the military was able to stay in power for a year after its defeat in the Falklands/Malvinas conflict and to pass protective legislation making subsequent civilian attempts to control the military more difficult than they might have otherwise been (Agüero 1992, 168).

The Dependent Variable: Central Bank Autonomy

The literature on central bank independence has identified two distinct dimensions of autonomy: formal/legal and informal (behavioral). Formal measures of autonomy involve the legal relationship between central bank decision makers and the government. They tend to emphasize factors such as the appointment and composition of the central bank board, the extent to which the government has financial and/or budgetary control over the central bank, and whether or not the central bank is legally obliged to accommodate the government's fiscal policy.[12] Informal measures attempt to gauge less visible aspects of central bank behavior. Unofficial arrangements between the central bank and various parts of the government, the quality of the bank's research department, and the personalities of key individuals in the central bank are all variables thought to affect behavioral autonomy.

Neither of these measures is without its problems. Although perhaps a better reflection of the day-to-day reality, behavioral indicators are inherently difficult to quantify in an impartial manner. For example, while one would ideally like to measure the extent to which monetary and fiscal authorities consult with one another on an informal basis, this information is not likely to be readily available or easily scored. Most studies thus develop indices of central bank independence based upon their legal attributes, although there is some variability with respect to which features ought to be included in these indices and how they should be weighed.[13] Even with such discrepancies, however, the correlation among various formal/legal indices is typically quite high (Walsh 1995a).

As a general rule, formal/legal measures of central bank autonomy have been significantly correlated with low inflation in the industrialized countries (Grilli, Masciandaro, and Tabellini 1991; Cukierman 1992; Alesina and Summers 1993). The third world presents a less clear-cut picture. In light of the more fluid legality that tends to characterize developing country polities, formal/legal indicators are thought to be a poor measure of independence. Nor have they shown any empirical effect on inflation (Cukierman 1992; Cukierman, Webb, and Neyapti 1993). This has prompted most empirical analyses

12. See, among others, Bade and Parkin 1980; Alesina 1988; Masciandaro and Tabellini 1988; Cukierman 1992.

13. Note, for example, that while Belgium is ranked fifth among advanced industrial countries in the scale used by Alesina (1988), it is ranked fourteenth according to the scale of Cukierman (1992). Japan illustrates a similar point. For a discussion of various measurement-related problems associated with formal/legal indices, see Pollard 1994; Eijffinger and De Haan 1996.

of central bank independence in the developing world to rely instead on behavioral indicators.[14]

But it is not clear that existing behavioral measures are much better, despite their statistically significant relationship with low inflation in this set of countries (Cukierman, Webb, and Neyapti 1993; Cukierman and Webb 1995). For example, in order to capture the political instability of LDCs, Cukierman (1992) has used governor turnover as a behavioral measure of central bank independence. The assumption is that autonomy should be positively correlated with the experience and prestige of the governor. As Maxfield (1994, 560) has pointed out, however, using turnover rates as proxies for independence is not ideal, since a governor may enjoy a long tenure period precisely because he or she is more politicized. More recently, Cukierman and Webb (1995) have attempted to develop a measure of the "political vulnerability" of the central bank, as measured by the fraction of political transitions that is followed within six months by a replacement of the central bank governor. While their evidence seems to confirm the intuition that political instability is likely to be correlated with changes in the head of the central bank, they do not examine the extent to which such instability is itself a product of larger swings in the economy (Cukierman 1996, 15). The possibility of such reverse causality makes any claim about the causal relationship between central bank autonomy and economic outcomes based on this measure speculative at best.

Just what ought to serve as the best measure for autonomy in developing countries is thus not clear, rendering this a ripe avenue for future research. This study will focus primarily on formal/legal measures of autonomy, although behavioral indicators will also be considered in the case studies where relevant. While recognizing the demonstrated shortcomings of this approach for the class of countries at hand, there are several arguments that weigh in its favor.

First, unlike behavioral indicators that are difficult to measure and highly idiosyncratic, formal indicators favor systematic comparisons across countries. Second, it is entirely possible that the observed difficulties in employing formal/legal measures within LDCs may have less to do with their inherent unsuitability than with the fact that the measures themselves are not appropriate. Third, if what precludes formal indicators from serving as an adequate measure is, in fact, a question of tenuous legality, then we are likely to find tremendous variation across both countries and regime types. Since this study is concerned with how such rules hold up under democratic

14. Keefer and Stasavage (1999) have suggested that formal legal indicators of central bank independence do hold up as a reasonable predictor of inflation in LDCs, as long as there are a sufficient number of veto players and a sufficiently high degree of ideological polarization.

regimes, the formal/legal indices may be presumed to hold more sway.[15] Finally, to the extent that LDC governments face an increasingly internationalized economic environment, their incentives to comply with existing rules should thus be all the greater. This was not the case during the bulk of the time period that the Cukierman, Webb, and Neyapti data set covers (1950–88), when the forces of international integration were on average considerably weaker.

In what follows, I elaborate upon four broad sets of rules that facilitate the creation of an autonomous central bank (Cukierman 1992). It is important to underscore that autonomy does not hinge on just one of the following dimensions but rather on how they combine as a whole. In all cases, a central bank's autonomy is enhanced to the extent that political influence over monetary policy is minimized or eliminated entirely.

Limitations on Lending

The first formal dimension thought to affect a central bank's autonomy has to do with the limits placed on central bank financing to the government.[16] As a general rule, the more legal constraints there are on such financing, the more autonomous the central bank is thought to be. The logic here is straightforward: limits on central bank lending to the government impede the latter's ability to use the proceeds of monetary expansion (seignorage) to monetize government debt. More autonomous central banks on this dimension tend to be those, such as in Germany and Switzerland, where there are strict limits set on direct central bank credit to the government. A more lax set of rules is found in the Bank of England, where there are no special legal limits on the amount of credit the central bank can give to the government.

In addition to the overall amount of lending allowed, there is a series of more technical criteria that affect the relative severity of the terms attached to such lending.[17] In all cases, the greater the role given the executive in

15. This assertion is based on the assumption that, all things equal, we should expect greater violation of existing rules under authoritarianism than under democracy. When we bear this in mind, it is perhaps less surprising that legal indicators have done a relatively poor job of predicting actual central bank independence in the developing world. The most widely cited index—Cukierman, Webb, and Neyapti 1993—is based on decade-long averages of central bank autonomy for fifty-one developing countries during 1950–88, a time when many of these countries underwent significant periods of authoritarian rule.

16. The central bank can extend credit to the government in one of two ways: through its direct credit facilities or by buying public debt in the primary market (indirect financing).

17. Relevant indicators here include the extent that limitations on financing are expressed in fixed cash amounts rather than as percentages of revenues or expenditures, who controls the terms of lending to the government (e.g., the maturity, interest, and amount of loans), and the breadth of potential recipients of such loans (e.g., federal government, state governments, or public enterprises).

influencing the amount, conditions, or extent of the financing the government receives, the more autonomy is potentially compromised. In the Cukierman index, this measure has greater proportional weight than the others do, suggesting that this is a very important component of autonomy.

Formulation of Monetary Policy

A second dimension of autonomy pertains to the process through which monetary policy is formulated. While some degree of coordination between the executive branch and the central bank is generally thought to be prudent, a central bank should be given complete or near complete discretion over the formulation of monetary policy if it is to be truly insulated from political control.

At one extreme there are those counties, such as Germany, where the central bank has an extraordinary amount of control over how monetary policy is made and carried out. The Bundesbank not only has full responsibility to determine monetary policy but is also obliged to support the general economic policy of the government only to the extent that such policy is compatible with its own statutory objectives. On the other extreme, there are countries such as Japan, where—at least until 1997—monetary policy was either explicitly or implicitly in the hands of the minister of the economy (treasurer). Countries such as Switzerland fall in between these two limits. In Switzerland, the central bank and the government are legally obliged to consult one another before implementing policies, although executive approval is not necessary for the enactment of actual policy decisions.

One indicator of the degree of control the central bank exerts over monetary policy formulation is reflected in the relative veto power granted to the executive branch on the central bank board. In countries such as the United States and New Zealand, the executive branch is explicitly prohibited from attending central bank board meetings. In other countries, such as Germany, the executive branch is permitted to attend the meetings of the central bank board and can even request that a measure be temporarily deferred but has no voting privileges. Also significant in this regard are those rules governing conflict resolution in the event of a policy disagreement between the central bank and the executive. Where such mechanisms exist, they are also thought to be conducive to autonomy as they decrease opportunities for behind the scene influence by the government.[18]

18. As a general rule, most countries do not have any explicit arrangements for the resolution of conflicts. There are exceptions. In both the Netherlands and New Zealand, for example, the government and the central bank have the ability to make disagreements public, although to date, neither country has resorted to this practice. Other countries embed dispute resolution mechanisms in the veto power afforded the executive branch over monetary policy decisions, as I note in my discussion of the Chilean case.

Central Bank Objectives

A third component of autonomy derives from the statutory objectives that the central bank is obliged to pursue by law. The more the central bank's goals are centered on maintaining price stability, the less room it is thought to have to use monetary policy to achieve political ends such as growth or unemployment. The Bundesbank, for example, is legally obliged to make safeguarding the stability of its currency its number one priority. In contrast, the Bank of England's legislation only requires that it "promote the public good," leaving the actual interpretation of such an objective open to speculation. While rare, there are also cases such as Switzerland where despite considerable latitude in the phrasing of monetary policy objectives—"to pursue a credit and monetary policy serving the interests of the country as a whole"—quantitative monetary stock targets are rigidly pursued in order to ensure that price stability is in fact achieved (Central Bank of Chile 1989, 27).

An important informal indicator of the strength of the central bank's objectives is thought to be the corresponding strength of the central bank's accountability mechanisms. The underlying premise is that a commitment to a given objective is not enough to guarantee autonomy. Rather, the public needs evidence that those making monetary policy are actually carrying out their job.[19] But even the most independent central banks are not generally characterized by strong accountability measures, a testimony to the "secretiveness" that is often said to characterize these institutions. This is likely to be particularly true in the cases with which this book is primarily concerned—democracies in transition from authoritarian rule—where it seems unlikely that exiting rulers would be interested in setting up such checks and balances before leaving office. After all, subjecting the central bank to scrutiny only opens up an avenue of potential control by the democrats. The authoritarians thus have strong incentives to design an institution that limits such accountability to the greatest extent possible.

The Central Bank Board: Term Length, Appointment, and Dismissal

A fourth and final formal dimension of central bank autonomy pertains to the rules surrounding the central bank's governing board. Several different

19. There are a variety of ways to augment a central bank's accountability. In New Zealand, the central bank is obliged to publish policy targets agreed upon in advance by the central bank governor and finance minister. In the United States, accountability assumes the form of semiannual reports to Congress and regular appearances by members of the Federal Reserve before congressional committees. The very structure of the central bank board itself can also serve as a form of accountability insofar as it allows for a system of checks and balances on the execution of central bank functions, as occurs in the federalist countries of Switzerland, Germany, and the United States.

issues come into play here. First, there is the question of term length. The conventional wisdom is that the longer the term of appointment, the less likely it is that prevailing political trends and ideas will influence members of the board. The United States, where the governors of the Federal Reserve serve for fourteen years, is a good example in this regard. Even more important than the actual length of board member terms, however, is the extent to which these overlap with those of elected officials. The eight-year terms of Bundesbank board members are deliberately staggered to avoid the influence of four-year parliamentary sessions on board selection. This arrangement contrasts starkly with the pre-1993 French system, where board members were appointed for indefinite terms that in practice frequently coincided with those of French presidents (Swinburne and Castello-Branco 1991, 431).

Second, the procedures governing the appointment and dismissal of central bank governors are also thought to be relevant to autonomy. The less discretion afforded the executive in choosing or removing members of the board the more independence is favored, as this is thought to give precedence to more technical criteria regarding board composition. Since there is no country in the world where the central bank is exclusively empowered to choose its own members, the important distinction for appointment procedures is how much discretion the central bank enjoys. In Switzerland and Germany, central bank councils are consulted in nominations that are ultimately made either by the legislature (Switzerland) or the executive (Germany). In other more classically dependent central banks such as that of Japan, the head of state makes all appointments in consultation with the cabinet. Autonomy is also enhanced to the extent that technical—as opposed to policy-based—criteria are invoked for the dismissal of governors. In Germany, for example, governors can only be removed for technical causes such as bankruptcy, criminal offenses, and major conflicts of interest. Contrast this with the situation in France prior to 1993, where there was no limit on the president's ability to remove incumbent governors, rendering the central bank no more than an arm of the presidency.

In addition to how appointments are made, who is chosen for these positions is also significant. In many countries, the composition of the board provides an avenue of potential influence for different groups in the formation of policy. In Germany and the United States, where the central bank is based on a series of decentralized reserve banks, regional influences are felt. In New Zealand, financial and/or private sector experience is prioritized as a criterion in the selection of board members. However such representation is ironed out, the key point to underscore is that central bank board composition can be used to shape decisively the tenor of monetary policy.

This dimension of independence assumes particular importance in a regime change. Rather than limiting their executive discretion over board

composition, conservative authoritarian regimes should logically create rules that give them as much input as possible. Particularly since the first central bank board will protect their interests during the first—and potentially most "dangerous"—phase of democratic rule, appointment power should be employed as a means of safeguarding their economic policy preferences. The authoritarians are therefore unlikely to select a pluralistic governing board with a wide range of sectoral or regional interests. They instead have incentives to handpick a small group of technocrats and/or members of the financial community whose preferences closely align with their own.

In short even among what are generally considered to be the world's most autonomous central banks—those of Germany, the United States, and Switzerland—there is no blueprint for the optimal way in which to secure independence. As this brief discussion reveals, there are any number of different combinations of features that can collectively yield an autonomous central bank. But with these general guidelines in place, we have a baseline from which to evaluate the nature of the dependent variable privileged in this study.

With this theoretical model in place, the next section of the book provides an in-depth exploration of the events surrounding the central bank reforms in Chile (1989) and Mexico (1993). This is followed by more examination of a variety of other cases in the developing world. My main objective is to explain some of the observed variation surrounding central bank autonomy in the developing world through the lens of the argument presented in this chapter. More generally, I also hope to elucidate the broader phenomenon of institutional insulation of which central bank reform serves as an important instance.