CHAPTER 5

Imminent Threat, Ironclad Response

The 1989 Chilean Central Bank Reform

The previous chapter established the motive for Chile's 1989 central bank reform. Following the outcome of the 1988 plebiscite, the authoritarian regime and its powerful economic constituencies confronted a political future in which they would no longer be in charge. As it became increasingly evident that their heir apparent would hail from the center left, they began to fear what democratization might mean for the fate of their economic interests.

With this transitional political context as a backdrop, this chapter examines the nature of the authoritarians' response. Fearing the prospect of a "hostile takeover" by the Concertación, the Pinochet government sought to safeguard its economic interests by enacting a constitutional amendment to create a highly autonomous central bank.

The primary objective of this chapter is thus to illustrate the strong case of the argument presented in this book, one where the intensity and proximity of the democratic threat are both sufficiently pronounced for a highly insulated institution to result. But in addition to describing the reform outcome, this chapter also has two additional objectives. First, I argue that the extreme nature of this reform left the regime's democratic opposition worse off. Second, I explain why, despite their vocal opposition to the reform in 1989, incoming democratic governments have nonetheless maintained it intact.

I proceed in three steps. First, I show how the government's decision to enact the reform only after its loss in the plebiscite illustrates its role as an insulating device whose primary intent was to constrain the policy choices of future democratic governments. I then confirm this assertion by detailing the specific features of the reform's contents that render the Chilean central bank one of the most autonomous in the developing world. Second, I document the democrats' reactions to the reform in order to underscore its adverse welfare effects. Through a careful examination of their objections to both the content and process of the central bank law, I demonstrate why the democrats would have preferred a very different institutional outcome than the one with which they were ultimately confronted. Finally, I show why, despite the

fact that this institution ran counter to the interests of subsequent democratic governments, they were nonetheless powerless to overturn it. In addition to a series of domestic political obstacles, the democrats were fundamentally constrained in their desire to change the law by the knowledge of the severe economic costs that would attend such an action in today's world economy.

In advancing these arguments, I refute much of the conventional wisdom on the Chilean transition. It is certainly true that one of the most distinguishing features of Chile's transition to democracy has been the continuation of neoliberalism under democracy. In interpreting this turn of events, however, many analysts have concluded that the democrats learned to value the economic model that they once decried and, by extension, the institutional accoutrements (such as central bank reform) that anchored it in place (cf. Hojman 1990; Arriagada and Graham 1994; Weyland 1997). Stated somewhat differently, the assumption behind much of the contemporary scholarship is that the continuation of market-oriented reform in democratic Chile was more by choice than by constraint.

This chapter challenges that view. I build from the premise that far from welcoming the neoliberal policy agenda with open arms, democratic governments in Chile had no other alternative. At least where monetary policy was concerned, they resigned themselves to taking their cues from the institutional legacies of their authoritarian predecessors.

Responding to the Threat: The Reform Resurfaces

After the Plebiscite: The Authoritarians Mobilize

After the opposition's victory in the plebiscite, military officials argued that it had been a "personal defeat for Pinochet, but not for the political and economic system that they had created" (Hojman 1990, 26–27). In light of the extensive range of enclaves embedded in the 1980 Constitution, the authoritarians certainly had the institutional wherewithal to make this a reality. In addition, the authoritarians used their final year and a half in power to even further entrench the central pillars of their authoritarian project. It was clear that they intended to leave the incoming government "todo atado y bien atado" (tied, and well-tied) (Loveman 1995, 309).

In its final months in office, the junta decreed a series of new organic laws to constrain incoming governments in the political and military spheres (Valenzuela 1992; Arriagada and Graham 1994, 250–53). Permanent tenure in office was afforded to civil servants of the military government—particularly in local government—thereby severely limiting the new government's

ability to restaff the public administration. In turn, limited presidential appointment and removal power over military commanders was reinforced, and the military was also guaranteed minimum military budget levels.[1] An autonomous national television council was also created to oversee radio and television programming and the licensing of new stations. Finally, the regime cemented in place an electoral system that was deliberately structured to favor the regime and its supporters in an eventual transition to democracy. This system allowed the right—a minority—to secure representation in Congress far beyond its share of the popular vote. Following the plebiscite, electoral redistricting was further enacted to facilitate the representation of pro-regime supporters in the rural countryside.

In addition to these more decidedly political insulation tactics, the government also enacted a series of measures to cement a market-oriented bias within the economy. First, it passed the Banking Law in mid-1989, which converted all outstanding governmental loans to private commercial banks held over from the 1982 crisis into so-called subordinated debt with the central bank. By renegotiating this debt on exceedingly generous terms, this law served as a guarantee to a powerful group of investors that the government would neither control nor intervene in their banks in the future (Batarce 1993).[2] Second, the government also established a set of budgetary procedures that empowered the president to selectively veto specific spending provisions proposed by the legislature while limiting the ability of Congress to amend items upward (Baldez and Carey forthcoming). Finally, the government also began to legislate a state entrepreneurship law, which placed strict limits on the productive activities of the state. Through such a bill, Pinochet was able to dramatically accelerate the pace of privatization during his final year in power, divesting the government of even formerly strategic state enterprises such as one of the major TV channels and the national airline.

But by far the most significant of these economic insulation strategies was the constitutional law to grant autonomy to the central bank. As noted earlier, the central bank reform had actually been in preparation since mid-1986. But just how much of the law was actually written prior to the plebiscite is subject to some debate. Some members of the government's economic team swear that the central bank reform was all set to go months in advance and merely needed Pinochet's authorization; others close to the president maintain that the reform was done "at midnight" on the eve of the govern-

1. More specifically, a clause was introduced into the Constitution guaranteeing the military 10 percent of all proceeds from Chile's state-owned copper revenues.

2. The subordinated debt issue became a major source of controversy in Chile between the government and private commercial banks in the early 1990s but was ultimately resolved through negotiations between the central bank and the major indebted commercial banks in June 1996.

ment's departure from power.[3] Regardless of which version is correct, what is clear is that one of its crucial elements—the makeup of its incoming governing board—was delayed until after Pinochet's loss in the plebiscite. Its last-minute nature is reflected in the fact that the bill was not passed in the legislature until October 10, 1989, and did not go into effect until December 10, 1989, just four days before the presidential elections were to be held.

The fact that the regime waited until it had been defeated in the plebiscite before it ratified the central bank reform lends plausibility to the argument that the legislation's timing was dictated by political reasons. For if this had been a purely technical initiative, the logical strategy would have been to name the board members and sign the central bank law into practice prior to the plebiscite. That way, the government would have had an institutional guarantee regardless of who won the referendum. This is certainly the order of events that the regime's technical staff would have preferred, and a number of them were disillusioned when Pinochet chose to postpone the central bank initiative until after the plebiscite. As one such individual who worked closely on the initiative commented with regret, "we had discussed the importance of doing this legislation before the plebiscite 10,000 times. But for whatever reason, it just wasn't sent. This was a huge mistake."[4] Instead, just as had occurred some ten years earlier when the Chicago Boys first raised the idea of central bank reform, political calculations again outweighed economic expediency.

One can imagine that Pinochet had two reasons for biding his time. On the one hand, since this was an election year, the government stood to benefit from a dependent central bank. The last thing in the world that it would have wanted was to be saddled with an autonomous institution that might prevent it from engaging in "political business cycle" behavior. And, in fact, during the final year before the plebiscite, the government did introduce a series of measures designed to stimulate the economy by expanding expenditure and consumption, reflected in the fact that growth soared to 10 percent in 1989, 4.5 percent higher than forecasted (Ffrench-Davis and Muñoz 1990, 142).

On the other hand, and in keeping with the argument presented in chapter 3, the government should also have been reluctant to assume the risks entailed in creating an autonomous agency unless it had no choice. It would thus require a loss in the plebiscite before the regime would deem the creation of an autonomous agency necessary. As a weekly political magazine noted at the time, "it is curious that Pinochet has not yet pushed this law through,

3. Based on confidential tape-recorded interviews by the author with economic advisers in the military regime, Santiago, Chile, April–June 1995.

4. Prominent economist formerly associated with the military regime, confidential interview by the author, Santiago, Chile, May 11, 1995.

despite the fact that it is ready. This would seem to reflect that . . . he does not want to tie up everything before he has the certainty that he will have to succumb."[5] A former Chicago Boy noted when commenting on the timing of the initiative, "it was not until 1988 when the government knew that it was going to have to turn the government over to another group that it sped this organic law up. If they hadn't had to hand over the government, they would have never pulled this thing off the shelf."[6]

Suggestive evidence for how the onset of democratization might have influenced the reform's timing is implied in select comments made by various government officials both during and after its legislation. While these officials were never willing to admit an exclusively political motivation, there was often a not-so-veiled link made between the prospect of impending economic chaos and the need for central bank reform. For example, the principal author of the initiative expressed skepticism about the opposition's willingness and ability to preserve macroeconomic stability under democracy, charging that "the acid test . . . [will be] its adhesion to the concept of an autonomous central bank" (Fontaine 1989, 66). And the commander in chief of the Chilean navy, Admiral Merino, was purported to have gone so far as to claim that autonomy "would prevent a socialist economy from being introduced in Chile."[7] Such sentiments were perhaps best summed up by a former official in the Pinochet regime who confessed that "we all had a fear of democracy in mind when we did this."[8]

The political motive I impute to the reform was certainly reflected in the comments of the regime's opposition. In undertaking the reform at this time, opponents charged that the government was motivated by its fear that any future economic team would not be fully convinced of the "virtue and need to protect macroeconomic balance in general and to minimize the inflation rate, in particular" (Zahler 1989a, 101). In this way, the reform was seen as a clear attempt to "freeze monetary policy at the constitutional level" (Zahler 1989a, 101) by establishing a "parallel economic team . . . to perpetuate the Chicago Boy scheme"[9] that would deprive the new government of the "ability . . . to bring about its own economic programs" (Zahler 1989a, 102). As the Concertación's chief legal adviser commented, "it is evident that this is being legislated at the last minute to guarantee a technical-financial enclave that assures . . . groups of power within the present regime a situation of

5. "La Dictadura: Así Gobierna Pinochet," *Análisis,* August 15–21, 1988, 7.

6. Confidential interview by the author, tape recording, Santiago, Chile, April 28, 1995.

7. "José P. Arrellano Confía que Será Revisada, la 'Privatización' del Banco Central," *La Epoca,* August 20, 1989.

8. Confidential interview by the author, tape recording, Santiago, Chile, April 25, 1995.

9. Comment by Ernesto Edwards in "Se Busca Instalar Equipo Económico Paralelo en el Banco Central," *El Diario,* November 28, 1989.

omnipresent veto and control against any alternative economic policy in the future" (Briones Espinosa 1989, 7). As far as the opposition was concerned, it was "difficult to think of a reason other than the results of the plebiscite of October, 1988 to explain the timing of this reform" (Zahler 1989a, 101). As a result, the reform was taken as "irrefutable proof of [the government's] fear of democracy."[10]

There is no question that the decision to wait until after the plebiscite had taken place was a high-risk strategy, since in the event that the "yes" campaign did not prevail, the government might be forced to negotiate some of the reform's contents. But the fact that Pinochet was willing to take this risk reflects the extent to which he had confidence in his ability to win. Even with hindsight, such confidence does not seem unreasonable, given that he did manage to capture 43 percent of the vote. Had the authoritarians won the plebiscite, we can thus imagine an outcome more like the Mexican case: they would have gone ahead eventually with the reform, particularly given its constitutional mandate. But they would have probably designed its autonomy in a much more cosmetic fashion, to enable the central bank to continue to serve the immediate interests of those in power.

In sum, the events and commentary surrounding the 1989 Chilean central bank reform lend plausibility to the notion that its timing was a response to a politically uncertain future by an authoritarian government under siege. Once the authoritarians knew that they would definitively lose power, they quickly pushed through legislation authorizing an autonomous central bank. As one of the foremost experts on the inner workings of this period in Chilean history concluded, "without the transition, there would not have been a central bank law."[11]

The 1989 Chilean Central Bank Reform: An Overview

The intensity and proximity of the perceived democratic threat were reflected in the institution that was created. By formal measures, the Central Bank of Chile is widely considered to be one of the most autonomous in the developing world (Swinburne and Castello-Branco 1991; Cukierman 1992).[12]

10. Comment by Ramón Briones Espinosa in "Ley del Banco Central Facilita Fuga de Capital," *El Diario,* October 11, 1989.

11. Ascanio Cavallo, columnist, *La Epoca,* interview by the author, tape recording, Santiago, Chile, May 24, 1995.

12. Note that the central bank had been nominally autonomous since 1953, when the term *autonomous* was first employed in its legal charter. But it is clear that until 1980, the term *autonomy* did not have much legal or practical meaning. In addition to quite vaguely worded central bank objectives, its board of directors had also provided ample representation to various special interests. More importantly, it was also understood that the central

The high degree of autonomy afforded the Chilean central bank was most evident in those provisions pertaining to central bank lending to the government. On this crucial dimension of autonomy, Chile is known to have the strictest limits in the world: the central bank could provide neither direct nor indirect financing of government expenditures, except under wartime conditions (Central Bank of Chile 1990, 16). These restrictions applied not only to the executive but to all state agencies and enterprises as well. While a similar clause impeding central bank loans to the executive had also been included in the articles of the 1980 Constitution, it had not carried much weight under authoritarian rule.[13] In contrast, the new law represented a rigid set of financing constraints.

To be sure, many autonomous central banks place limits on direct forms of central bank financing to the government. For example, the German Bundesbank stipulates such limits in strict cash amounts, which have been maintained at the same level since 1969 (Swinburne and Castello-Branco 1991, 425). But most central banks do allow for indirect financing of the government by permitting the central bank to purchase government bonds in the course of open market operations. By explicitly excluding the possibility of any financing of any type, the Chilean law made deficit spending by future governments extremely difficult and extremely costly.

The independence of the Chilean central bank was also enhanced through a second aspect of its new charter: the unilateral discretion it was afforded over monetary policy formulation. As noted in chapter 3, autonomy is generally thought to be strengthened to the extent that the central bank is granted complete or nearly complete control over monetary and credit policy. In this regard, the 1989 law clearly met these standards: it gave the central bank full authority to conduct open market operations, to determine the discount rate, and to set reserve requirements.

In addition to these normal central bank functions, however, what was

bank would act within general policy lines set forth by the government (Briones Espinosa 1989). Even after its autonomous status was elevated to a constitutional rung in 1980, the fact that there was no accompanying detailed legislation meant that the central bank continued to respond directly to the executive branch. Thus, despite the fact that Cukierman (1992) codes Chile's central bank independence as fairly high relative to that in other countries over the period 1950–88, it was not until 1989 that this autonomy really took shape (Fontaine, interview).

13. In particular, it had been periodically violated through the so-called triangularization of financing. Under this sort of scheme, third parties such as state financial institutions that were exempted from the "no lending" clause would act as financial intermediaries between the central bank and the government. While loopholes of this sort could still arguably be pursued even under the strict conditions of the 1989 law, they would henceforth require the acquiescence of a fully autonomous central bank, as opposed to one that was autonomous merely in name (Fontaine, interview).

striking about the 1989 law was that it also endowed the central bank with several extra policy-making attributes such as external debt management; financial regulation; and various foreign trade, investment, and tariff policies. While many central banks are charged with some mix of such auxiliary powers, few amass them to the degree demonstrated in the Chilean case. It is of particular note that Chile's central bank had the unique distinction of being the only central bank in the world in control of exchange rate policy. Even in the United States, widely considered to have one of the more autonomous central banks in the world, exchange rate policy is determined by the U.S. Treasury. Although these extra powers do not constitute direct indicators of autonomy per se, they do suggest that the Chilean central bank was afforded substantial influence over a broad range of economic policy arenas at the expense of other government ministries (Arrellano 1989, 92–94; Briones Espinosa 1989, 50).[14]

Many of these powers had been granted to the central bank in its previous 1975 charter, albeit in a less clearly delineated format (Figari Oxley 1989, 14). Under the new legislation, however, these were accompanied by explicit provisions to weaken the veto power of the finance minister. As noted in chapter 3, a key determinant of the effective degree of control afforded the central bank in the formulation of monetary policy is the formal role afforded the executive on the central bank board. In this regard, the Chilean reform most closely resembled the German system: while the minister of finance was permitted to attend the meetings of the central bank board and could even request that a given measure be temporarily deferred, he or she had no voting privileges. And in the event of a dispute with the executive, the law gave the central bank the upper hand across a range of policy domains.[15]

In addition to these many provisions designed to increase the power of the central bank over the government, the legislation also featured one provision that would weaken this control. I refer here to the legislation governing exchange liberalization. Under previous legislation, any international exchange operation not authorized by the central bank had been illegal.

14. There are those who argue that this power was somewhat mitigated where the Finance Ministry was concerned by the fact that all of the government's internal debt was held on the central bank's balance sheets rather than those of the Finance Ministry. This was the product of the 1982 crisis when the central bank had to step in and bail out insolvent commercial banks by absorbing their debt. Critics of the Concertación have suggested that because of this "patrimonial situation," the central bank is not fully solvent, since the Finance Ministry might use its financial leverage over the central bank as a means of influencing policy (Rosende 1993, 317–18; Tapia 1993, 353).

15. In the area of monetary policy, for example, a proposed suspension by the finance minister could be overridden if four out of the five board members were opposed. Where exchange restrictions were concerned, the finance minister's objections could also be overridden by the unanimous opposition of the board.

Under the new law, this provision was reversed; all exchange operations were permissible except those explicitly prohibited by the central bank. Moreover, while exchange controls had previously been ongoing, with the new law these had to be renewed annually. While the temporary nature of exchange controls arguably diminished the power of the central bank over the government, it also constituted a not-so-subtle means through which the authoritarians sought to push future governments toward their ideal point of full exchange liberalization. As one member of the Concertación's economic team put it, "while this doesn't impede that restrictions are renewed every year . . . there is an implicit pressure in the law that forces you to progressively eliminate controls until you arrive at total freedom."[16]

A third indicator of the high degree of autonomy afforded the central bank was reflected in the nature of its policy objectives. Under its 1975 charter, the central bank had been given a quite vague mandate: "promoting the ordered and progressive development of the national economy" (Figari Oxley 1989, 14). As noted in chapter 3, vaguely worded objectives are generally thought to compromise autonomy to the extent that they allow for the pursuit of goals that conflict with price stability, such as growth and unemployment. Chile's 1989 central bank law dramatically increased this dimension of autonomy by substituting its ambiguously worded language with a much more narrowly focused objective: "maintaining price stability and due payment of internal and foreign debts" (Central Bank of Chile 1990, 4). By extending the objective of price stability to include the complementary objective of ensuring a sound payments system, the authors of the reform sought to avoid the type of internal financial or external balance of payments crises that had blocked efforts to maintain price stability in the past (Fontaine 1989, 68; Rosende 1993, 299–301).

In contrast to the legislation's precisely worded goals, however, accountability measures to ensure that the central bank would actually meet these objectives were predictably weak. As in Germany, the law did require the president of the central bank to keep the president of the republic informed with respect to its policies and to "consider the general orientation of the government's economic policies" when passing its resolutions (Central Bank of

16. Nicolás Eyzaguirre, former director of studies at the Central Bank of Chile, interview by the author, tape recording, Santiago, Chile, April 24, 1995. One must, of course, ask why the authoritarians did not simply go ahead and legislate total exchange liberalization at the outset, rather than making the controls subject to annual renewal. This was the source of a great deal of internal debate within the regime in the drafting of the legislation, between free-marketeers such as Fontaine, who favored total freedom, and more traditional central bank bureaucrats who felt that a small and open economy could not risk full exposure to the vicissitudes of the international economic environment. The annual renewal clause was thus a compromise between these two positions (tape-recorded interviews by the author with various individuals involved in drafting the 1989 organic law, Santiago, Chile, April–June 1995).

Chile 1990, 9). The central bank was additionally required to produce an annual report summing up the state of its own financial affairs, as well as two annual reports to the minister of finance and the Senate, one that summed up the policies pursued throughout the previous year and another that made projections for the upcoming year. While, in theory, the Senate and the executive would use these opportunities for active debate and public evaluation of the bank's policies (Fontaine 1989, 69), in practice these reports could be of but little concrete use. Unlike in the United States where Federal Reserve Board members can be regularly summoned before the U.S. Congress, in Chile these appearances did not extend beyond the two required annual visits. And since the Senate's role was really only to discuss proposed policies ex post, this limited how much it could really contribute in any substantive sense (Massad 1989, 86–87).

The final area where the government considerably enhanced the autonomy of the central bank pertained to those rules governing the central bank board. Under prior legislation, an executive committee composed of three individuals had governed the central bank: the president, the vice president, and the general manager. These were presidential appointees with indefinite term lengths, who could be removed at the executive branch's discretion.

The new law radically altered this highly politicized board structure. First, it established a governing board of five members who would be named by the president of the republic, with prior approval of the Senate. While it is true that autonomy is thought to be most enhanced where the central bank itself chooses its own governing board, in practice, this never occurs, and input from auxiliary bodies such as legislatures and/or councils is considered to be a reasonable second-best option. By stipulating Senate confirmation of all nominees, the law thus prevented undue presidential discretion in the appointment procedure. To further reduce political influence in board member selection, the new law established long and staggered terms in office (ten-year terms with partial renewal every two years).[17] The only central bank in the world where board members serve for a longer period of time is the United States Federal Reserve, where the term is fourteen years. Finally, rules governing the dismissal of board members were broadly consistent with those of the Bundesbank. Dismissal was made contingent on technical, as opposed to policy-based, criteria—such as conflict of interest, use of public office for personal gain, or failure to comply with one's duties.[18]

17. The president of the central bank was appointed for a five-year period. All terms were renewable.

18. There was one exception. The legislation authorized the president, with prior approval of the Senate, to remove any or all of the board members on the grounds that the council member had voted "in favor of bank resolutions representing a material and clear breach of the purposes of the Bank . . . and that said resolution has been the main and direct cause of a material damage to the economy of the country" (Central Bank of Chile 1990, 12).

In short, through a carefully crafted set of rules, Chile's authoritarian regime was able to safeguard its interests by making monetary policy largely impervious to the influence of future democratic governments. By then entrenching this institution in the Constitution with an organic law that would require a four-sevenths majority in both chambers of the legislature to overturn, Pinochet further sought to ensure that his economic legacy would not be dismantled.[19] At the end of the day, the outgoing government thus emerged with a highly autonomous central bank in hand.

Reform Reaction: The Opposition Responds

The highly political nature of the reform did not go unnoticed by the regime's opposition, which was exceedingly critical both of its specific components and of its timing. While its unfavorable impact was somewhat mitigated by a set of last-minute negotiations with the government, the net effect of the reform was still resoundingly negative for the regime's opponents.

Reform Negotiations: The Creation of the "Quota"

The democrats were incensed by the creation of a reform that they perceived as highly political in both design and motivation. In particular, they objected to the way in which the reform was enacted, which they saw as the product not of debate and discussion but rather of imposition. As the then vice president of the Christian Democratic Party argued, "let the sovereign people sanction the government if it carries out bad economic policy. . . . we do not need pre-designed tutelaries from rulers that have already been defeated."[20] The opposition's principal objections accordingly centered around Pinochet's ability to unilaterally appoint the entire five-member board, which was deemed "illegitimate" and "an abuse of power"[21] and seen as an attempt to give "technical justification for practices which are authoritarian in nature" (Zahler 1989a, 105). Perhaps this sentiment was most poetically phrased by another leading economist in the opposition, who commented, "even if autonomy had been a good idea, it was a bad handicap to have been 'illegitimately conceived' under another political system."[22]

19. To further change the three clauses of the Constitution guaranteeing autonomy required a favorable vote by three-fifths of both legislative branches.

20. As quoted in "Andrés Zaldívar Cuestionó Normativa del Banco Central," *El Mercurio,* January 21, 1989.

21. Comment by Ricardo Ffrench-Davis in Ricardo Ffrench-Davis and Joaquín Vial, "Ley del Banco Central Deberá Ser Modificada," *El Mercurio,* August 18, 1989.

22. Eyzaguirre, interview.

That said, because the reform was presented as a fait accompli, it did not look as if the opposition would play any role whatsoever in either its plan or its operation. As it turned out, the opposition was wrong. In the final days before the law was to go into effect in early December, the Pinochet government negotiated a political formula whereby the board would be composed of two appointees from the outgoing regime, two from the opposition, and one independent to be mutually agreed upon by the two sides.

By agreeing to politicize the central bank board in this fashion, the government was effectively consenting to a decrease in the autonomy of the central bank. As I argue in chapter 3, outgoing authoritarian regimes have strong incentives to use the first central bank board to stack the decks with handpicked technocrats in order to ensure that their preferred policies will dominate during the first phases of the democratic regime. But in the case at hand, the Chilean government instead made board composition a point of compromise with its political opponents. Unlike the other dimensions of autonomy where the outcome was largely consistent with the expectations, this was the one area where the authoritarians diverged markedly from ex ante predictions.

The decision to negotiate was not an easy one for the authoritarians. After all, it constituted a virtual admission that they did not believe that their candidate, former finance minister Hernán Büchi, would triumph in the upcoming presidential elections. For had they been confident of a right-wing victory, there would have been no incentive for them to compromise at all: their self-appointed central bank board would have existed in perfect harmony with the incoming economic cabinet. And, indeed, many within the authoritarian camp, not the least of whom was Büchi himself, were angry when this concession was made (Cavallo 1992, 154). These more intransigent, hard-line factions were particularly critical of the government's principal architect in these negotiations, Minister of the Interior Carlos Cáceres, who was seen as having "sold out," thereby compromising the outgoing regime's economic interests.[23]

The negotiation of the first central bank board ultimately represented a risk-averse strategy for the outgoing government, however. The authoritarians knew that in the likely event that the Concertación won the presidential elections, a Pinochet-appointed board would lack widespread legitimacy, only making its job harder to carry out and providing an excuse for the

23. See, for example, Tapia (1993, 350–51); also assorted editorials in *El Mercurio:* "Banco Central Independiente?" March 24, 1990; "Autonomía del Banco Central," *El Mercurio,* November 14, 1993; "Autonomía del Banco Central," *Estrategia,* January 5, 1994. Cáceres was also criticized for these negotiations during confidential tape-recorded interviews by the author with several former officials in the military regime, Santiago, Chile, April–June 1995.

incoming government to dismiss it as an unjust authoritarian legacy. Were public opinion to buy into this sort of rationale, this could also have negative electoral repercussions for the right. The so-called quota thus represented a way for the authoritarians to assure stability in the transition.[24] They could make the reform more palatable to the opposition by compromising on an important feature, while still obtaining the vast majority of what they wanted.

Nor were the negotiations an easy sell within the opposition camp. On the one hand, there were those such as Foxley who thought that the quota would at least afford the opposition a voice in monetary policy. On the other hand, there were also others who opposed the negotiations insofar as these were seen as indirectly legitimizing the autonomy legislation. Indeed, the first opposition economist who was selected to fill a spot on the board, Ricardo Ffrench-Davis, declined on the basis that he did not want to go forward as a Pinochet appointment (Cavallo 1992, 154).

Ultimately, however, the decision to negotiate on the part of the opposition was based on the simple recognition that it was better to have something than nothing. The democrats foresaw that policy coordination between a Concertación executive and a Pinochet central bank would be exceedingly difficult, especially since the rules were biased so strongly in favor of the central bank.[25] Accepting the 2–2–1 formula was really the best that they could hope for under the circumstances.[26] They did, however, manage to score two minor coups in the negotiations. First, they were able to name a member of the Socialist Party to the first central bank board, which had been a major sticking point with Pinochet (Cavallo 1992, 153). Second, they also managed to guarantee that the first individual to be rotated out of office was the so-called independent, thereby ensuring their own ability to rename the president of the board two years later.[27]

In brief, with just days to go before the central bank legislation was to take effect, the democrats found themselves with a new modus operandi—one in which they, too, would assume a role in the institution that they had proclaimed "illegitimate." While their participation on the board undoubt-

24. Carlos Cáceres, former minister of the interior under Pinochet, interview by the author, Santiago, Chile, May 26, 1995. Moulian (1993, 15–20), employs similar reasoning to explain why the outgoing government chose to negotiate the constitutional reforms.

25. Ricardo Ffrench-Davis, chief economist for monetary policy in the Concertación's economic team, interview by the author, tape recording, Santiago, Chile, April 18, 1995.

26. The opposition had to stand firm even to get this much. In previous months, the authoritarians had approached it with other formulas, including four-to-one and three-to-two in favor of the authoritarian government. But the opposition had stalwartly refused to accept participation in a board that put the Concertación at a disadvantage (Ffrench-Davis, interview). See also Cavallo 1992, 152–54.

27. See comments by Alejandro Foxley in "Cambios a la Ley del Banco Central Serán Por Consenso," *La Epoca,* December 7, 1989.

edly constituted an improvement over the status quo, the question we must ask ourselves is whether—from the standpoint of the democrats—the quota obviated the reform's otherwise nefarious effects.

The 1989 Central Bank Reform: A Critique

It has been argued that the negotiation of the board composition somehow altered the enclave aspect of Chile's central bank autonomy by establishing a norm of multiparty representation within this otherwise authoritarian institution.[28] I contend, however, that such a benign reading of this reform is misguided. Rather, there are many reasons to believe that—even after the quota—the democrats would have chosen to forego inheriting an autonomous central bank altogether.

For one thing, the democrats had virtually no input into the design of the central bank legislation. Negotiations over the composition of its first governing board notwithstanding, the rules governing all other aspects of the central bank's autonomy were never open for debate. Despite an extensive range of objections raised to various aspects of the reform noted earlier, these criticisms were never incorporated into the legislation itself. As a prominent member of the opposition's economic team noted, "until the negotiations of the first board, we were completely shut out."[29] In weighing the net effect of this reform in its totality, it is thus important that the significance of the quota not be overstated. What is relevant is not that the authoritarians chose to negotiate the central bank board but, rather, that this was all that they negotiated.

Whether or not opposition members played a role in the design of this institution would not matter if they felt that they had come away with a good deal. But as one prominent former opposition member confessed, "even after the negotiations, we felt that we had received something very unfair and very unequal."[30] Indeed, if the opposition had been happy with the outcome, one would have to believe that the reams of detailed criticisms and elaborate counterproposals drafted in the months prior to the reform's passage were merely strategic in nature (see the discussion that follows). One would also have to believe that if we were to go back in time and give the Concertación leaders another chance to rechart the course of their future, they would still

28. This line of argument was suggested during a tape-recorded interview by the author with Manuel Antonio Garretón, sociologist and noted political commentator, Santiago, Chile, May 16, 1995.

29. Ffrench-Davis, interview.

30. José Pablo Arrellano, leading economist in the Concertación's first economic team, interview by the author, tape recording, Santiago, Chile, May 2, 1995.

have chosen the autonomous central bank that they have today. The evidence simply does not support this line of argument.

At the time that the initiative was announced, many in the opposition questioned whether a central bank reform was even necessary in the first place. While they agreed with the importance of maintaining macroeconomic stability as a general principle, they argued that "the independence of the central bank is neither a necessary nor a sufficient condition for the stability of prices, and even less so for macroeconomic balance" (Eyzaguirre 1989, 1). Rather, the democrats argued that "low inflation responds more to a coherent, disciplined and coordinated monetary, fiscal and exchange rate policy than it does to an autonomous central bank" (Zahler 1989a, 104). To drive this point home, they pointed to the final years of the Pinochet administration as an example of how a dependent central bank need not necessarily be incongruous with macroeconomic balance. Not only did other alternatives exist for maintaining price stability, such as designing some sort of law to limit government borrowing from the central bank and/or the extent of its internal and external debt, but these were thought to pose considerably less danger to Chile's future democratic rulers (Zahler 1989a, 111).[31] In sum, the prevailing sentiment among the Concertación's leading advisers was thus that the central bank ought to depend politically on the executive (Briones Espinosa 1989; Zahler 1989a).

But even if one wished to argue that the opposition would have chosen to enact a central bank reform in 1989, there is no question that it would have approached the task quite differently. This is readily apparent in the numerous criticisms that the democrats levied against the central bank legislation at the time that the reform surfaced.[32] First, they protested the enormous concentration of power that the initiative conferred to the central bank. Because of the transfer of so many policy-making attributes to the central bank, the opposition feared that the institution would effectively constitute "a fourth power of the state" (Zahler 1989a, 102). The democrats vehemently opposed this extension of central bank functions, arguing that "the larger the independence of the central bank with respect to those organs of power which are generated democratically, the less should be its attributions in areas that do not correspond directly to monetary policy" (Zahler 1989a, 110). Rather than making the central bank independent or more technical, they favored limit-

31. The opposition repeatedly invoked Chile's experiences of 1982–83 as evidence of how an excessively rigid set of rules over monetary policy might preclude the central bank from having the freedom of action it would need to respond to a financial crisis of this order (Arrellano 1989; Zahler 1989a).

32. Note that those listed subsequently represent a summary of the major objections to the law. For more specific criticisms of its individual features, see Briones Espinosa 1989; Eyzaguirre 1989; Ffrench-Davis 1989; Zahler 1989b.

ing its powers and dispersing these among other state agencies so that decentralization would not be employed toward generating "technocratic tutelaries, but rather towards consolidating and strengthening the democratic regime" (Zahler 1989a, 111).

Second, the opposition also objected to the lack of explicit mechanisms for assuring coordination between monetary and fiscal policy. Precisely because of the large number of policy-making faculties accorded the central bank, the democrats feared that the potential for conflict with other economic authorities would increase (Arrellano 1989, 92–94). As one opposition economist noted, "to hand over an enormous power, practically without counterweight, to an autonomous body . . . contains the enormous risk of generating a process of formulation of policies that are inconsistent with one another" (Massad 1989, 86). Particularly in light of the demonstrated link between monetary policy and real economic variables, the opposition questioned "whether or not it is possible and even efficient that there be two independent teams acting simultaneously, especially if they are of different economic ideologies" (Zahler 1989a, 112). In short, the opposition felt strongly that it was important to separate technical from political criteria in the execution of monetary policy but not in its design, which should be instead the product of a coordinated effort among various economic agencies (Massad 1989; Briones Espinosa 1989).

Finally, the democrats also objected to what they saw as the proposal's lack of extensive accountability mechanisms. As one opposition leader starkly phrased it, "Why should a group of technocrats have so much power and control . . . without assuring corresponding political responsibility?"[33] The democrats felt that by failing to establish clear mechanisms for overseeing the central bank's budget and monitoring the actions of its board, the legislation offered few incentives to pursue a policy of sound economic management (Massad 1989, 86–87; Zahler 1989a, 102). There was said to be "no way to check if the policies applied corresponded to those previously announced, if they had realized their expected effect, or if they had unnecessary costs" (Massad 1989, 87). Because of the lack of checks on the central bank's behavior, it was said to threaten to "commit an outrage against the bases of a politically open and democratic society" (Zahler 1989a, 111).

The general tenor of these critiques was reflected in the modifications proposed by the opposition with respect to the existing legislation. On all four of the principal dimensions of autonomy explored in this study, the democrats desisted from creating a fully insulated central bank. For example, while

33. As quoted in "Banco Central no Debe Financiar Déficit Fiscal," *El Mercurio,* June 20, 1989.

the democrats agreed in principle with the idea of closely monitoring government finances, they also felt that rather than prohibiting all borrowing from the central bank, the law ought instead to establish limitations (Zahler 1989a, 111). Where coordination was concerned, the democrats argued for integrating the central bank into other areas of economic policy-making, proposing that the president of the central bank attend meetings of the economic cabinet (Massad 1989, 89). With respect to central bank objectives, they questioned the prudence of privileging the goal of price stability to the exclusion of all other policy objectives, arguing that such rigidity would deny the government sufficient flexibility with which to respond to internal and external shocks (Massad 1989, 78–82; Zahler 1989a, 106–7). Finally, while they supported lengthy terms and Senate confirmation of central bank governors, they also lobbied for a partial replacement of the central bank board with each successive administration at the discretion of the incoming president (Arrellano 1989, 95; Massad 1989, 89). In short, a closer look at history suggests that were they to do it all over, the democrats might never have created an autonomous central bank at all or—had they done so—would have gone about it quite differently.

The Pareto-improving nature of the 1989 central bank reform in Chile thus tends to be overstated. There is no question that once a norm of multiparty representation in this otherwise "authoritarian" institution had been established, the democrats were less dissatisfied with the autonomy legislation than they had been previously. In this way, the quota undoubtedly made the reform more palatable for the opposition by softening the blow of a more comprehensive central bank reform. It would be a mistake, however, to conclude that once the quota was negotiated, the opposition was more or less content with the rest of the reform's contents (Arriagada and Graham 1994, 269). Rather, for all of the reasons previously noted, the democrats felt that they were faced with an institution that was excessively powerful and excessively constraining. As far as they were concerned, this outcome might well have been avoided without sacrificing anything on the economic front and, indeed, gaining a great deal where democratic accountability was concerned. And it is worth pointing out that these criticisms were not coming from the more radical fringe elements at the edges of the coalition but rather from its most prominent—and centrist—economists.

Political negotiations over the bank's first governing board notwithstanding, the central bank reform was thus a resounding success for the outgoing authoritarian government. While it had agreed to carve out a role for the opposition in the administration of its cherished institution, the underlying design of the autonomous central bank would continue to bear the regime's unadulterated trademark.

The Reform in Retrospect: Explaining Institutional Persistence

The Persistence Paradox: Alternative Explanations

In the first six years following Chile's transition from authoritarian rule, the autonomy afforded the Central Bank of Chile in 1989 remained unscathed. Nor does a central bank reform of comparable proportions seem likely in the foreseeable future. In light of the considerable controversy that erupted over the reform when it was announced, this outcome might seem somewhat surprising.

After all, the very opposition who once so vociferously criticized this initiative was subsequently elected to office for three successive administrations. Throughout 1989, it had repeatedly affirmed its intention to make the modification of the central bank law a top priority.[34] One opposition member had even predicted that a major legislative conflict would ensue "if there is not a rapid consensus with the sectors of the right to modify this law in the first few days that the future congress is in operation."[35] Such sentiments continued to be voiced even after the 2–2–1 compromise had been negotiated with the outgoing authoritarian government. For example, the day after the agreement was made public, Concertación presidential candidate Patricio Aylwin declared that "we consider it to be indispensable to introduce modifications to this law," noting that "the agreement achieved with respect to the board does not imply that we are renouncing this objective."[36] Various individuals in the Concertación even went so far as to specify which modifications ought to be prioritized when the reform eventually occurred (Ffrench-Davis 1989). Nonetheless, in the months and years that followed, the incoming government never followed through on these proposed revisions.

At the very least, one might have expected subsequent governments to try to staff the central bank board with their own appointees as individual seats on the governing board became available. Instead, despite the fact that it was never written down, the quota persisted under democratic rule. With each successive retirement, an outgoing governor was replaced by someone from the same political party and/or general ideological persuasion, thereby

34. See, for example, comments by Ffrench-Davis and Vial in "Ley del Banco Central Deberá Ser Modificada"; also see the interview with Ricardo Ffrench-Davis in *Informativo: Comercio Exterior* 2, no. 7 (October 1989): 14–15.

35. See comments by Briones Espinosa, "Ley Del Banco Central: Facilita Fuga de Capital."

36. As quoted in "Aylwin y Lagos Satisfechos por Consejo del Banco Central," *La Nación,* December 6, 1989.

maintaining the political balance that was said to characterize the first central bank board.[37] What is more, some of the initiative's most ardent critics went on to assume positions of high leadership in the central bank, including several who became members of the governing board itself.

In light of such apparent anomalies, we must explain why there was no effort to modify this legislation and why, to the contrary, there emerged what seemed to be a tacit acceptance of this institution by the democrats. One potential explanation is that incoming governments were secretly pleased with their institutional inheritance. Despite their public protestations to the contrary, they in fact welcomed central bank autonomy with open arms. By possessing an autonomous central bank of authoritarian origins, they could blame the central bank when they were forced to undertake unpopular economic measures, such as the 1990 adjustment (Arriagada and Graham 1994, 268).

An alternative explanation is that, in the interim, the politicians of the center and left had learned the virtues of macroeconomic stability. This line of reasoning suggests that there had been a convergence of economic thought across the political spectrum about the importance of controlling the money supply in order to control inflation (Weyland 1997). Concertación officials had thus come to appreciate an institution that tied their hands where the economy was concerned, rendering the 1989 Central Bank Law "a blessing in disguise" (Hojman 1990, 33). The implication of both of these arguments is that far from constituting a burden to incoming democratic administrations, autonomy was actually a godsend.

There is no question that in the years since the central bank reform was enacted, Chile's macroeconomic environment continued to flourish. Following an initial adjustment designed to counteract the overheating of the economy in 1989, Chile resumed, and even surpassed, its previous macroeconomic performance over the course of the next several years. Inflation fell from 26 percent in 1990 to 8 percent in 1994; growth averaged approximately 6 percent per year between 1990 and 1994; and the public sector deficit as a percentage of GDP was negative (see table 5.1). Moreover, foreign capital was pouring into the country at record levels (Calderón and Griffith-Jones 1994; Ffrench-Davis, Agosín, and Uthoff 1995). By the early 1990s, Chile was one of but four developing countries that had earned the title "low-risk investment"

37. As noted earlier, the first governor to step down in 1991—outgoing president Andrés Bianchi—was not replaced by another "independent" but rather by the central bank's vice president, Roberto Zahler, one of the original Concertación board appointees. Once this initial change was made, however, and despite occasional controversies, replacements have essentially followed a strict partisan quota.

in the classification scheme developed by the Economist Intelligence Unit (Flaño 1992).

In short, throughout the first half of the decade, Chile was experiencing many of the "goods" commonly associated with an autonomous central bank (Fontaine 1993; Rosende 1993). But the relevant question to ask ourselves is not whether the democrats would have chosen to forego this stable macroeconomic environment but, rather, whether they would have preferred an outcome that would have enabled them to do more to achieve their programmatic agenda. I argue that they would have preferred such an outcome. A closer look at the evidence reveals that the existence of an autonomous central bank did impede the government's ability to redistribute wealth and stimulate demand as it might have wished.

Revisiting History: Why the Democrats Were Worse Off

There are many reasons to believe that the democrats who came to power on the heels of Pinochet found it costly. Above all, we must recall that this was a coalition that had campaigned—and won—on a platform of promising to bring an end to the profound socioeconomic inequities that had characterized military rule in Chile. Declaring that "there can be no economic progress without social justice,"[38] the democratic opposition had repeatedly underscored its primary objective of "reconciling economic growth with social equity."[39] By looking more carefully at the redistributive objectives of incom-

TABLE 5.1. Chile: Selected Domestic Macroeconomic Indicators (1990–94)

Year	Growth of GDP	Public Sector Deficit[a]	Inflation	Unemployment Rate[b]	Rate of Overall Investment
1990	3.3	–0.58	25.7	5.7	26.2
1991	7.3	–1.81	16.5	5.3	24.8
1992	11.0	–2.05	8.9	4.4	28.2
1993	6.3	–1.53	6.7	4.5	29.8
1994	4.2	–1.36	7.8	5.9	28.9

Source: Central Bank of Chile, *Boletín Mensual* (Santiago, Chile: Central Bank of Chile, various years).

[a]As percentage of GDP (minus sign indicates a surplus).

[b]Percentage of labor force.

38. Former president Patricio Aylwin, as quoted in "Es Prematuro revisar el ajuste Económico," *El Mercurio,* March 15, 1990.

39. Patricio Aylwin, *Message of the President to the Cámera de Diputados, April 10, 1990, Cámara de Diputados,* Legislatura Extraordinaria, 319a, Session 8a, 376.

ing democratic governments prior to coming to power versus what they were actually able to achieve, one can thus evaluate the extent to which the existence of an autonomous central bank effectively "cramped their style."

Consider first the case of fiscal policy. Upon coming to power, the Aylwin government's first legislative initiative was to enact a tax reform to finance new social programs and make the country's tax structure more progressive. But while this reform was presented as the linchpin in the government's strategy to respond to the needs of the poorest groups in Chilean society, the final product was quite moderate in nature, entailing only a modest extension of tax instruments and social spending practices already in place (Boylan 1996). And although the tax reform did enable the government to increase social spending for the poorest segments of the population by 17.4 percent in 1990 and 12 percent in 1991 (Vergara 1994, 249), for everyone outside this safety net, emphasis remained on the provision of private insurance. Such a system generated a social dualism of sorts, in which those who could afford market-based services could enjoy good care, while those who lacked sufficient resources were forced to rely on inefficient services provided by a shrinking state (Vergara 1993, 1997). In short, far from representing an innovative or dramatic departure from the social spending practices of authoritarian rule, social policy under democratic Chile instead continued to rely on similar programs and organizations and even on the same market-based ideology (Petras and Leiva 1994, 122–35). While it would be difficult to attribute such moderation exclusively to the central bank's inability to finance government spending, there is no question that the central bank's rigid commitment to inflation control restricted a more aggressive social policy that might have benefited a broader swath of Chilean citizens (Vergara 1994, 248).

A similar tale of restraint emerges where labor policy is concerned. Before taking office, the Concertación team had promised "profound changes" in labor legislation, in which the strengthening of labor rights and labor organizations would in turn contribute to the establishment of a more "equitable distribution of the fruits of development" (Aylwin 1990, 25). Four years later, incumbent president Eduardo Frei similarly declared, "Labor policy constitutes an essential component of the modernization of the country in a context of further democratization and socio-economic development" (Frei 1994, 59). But while democratic governments did effectuate some real changes on behalf of labor, including increases in the minimum wage and some improved scope for collective bargaining, labor legislation under both administrations remained heavily tilted toward the interests of business (Frank 1997).

While it is true that workers saw a steady increase in both wages and employment under democratic rule, such favorable trends must be under-

stood within their larger historical context. By 1993, average and minimum wages had not yet returned to their 1981 levels, and only in 1994–95 did they go beyond the levels reached in 1970 (Frank 1997, 26). And even while wages were growing at an average of 3.6 percent per year from 1990 through 1992, productivity grew at a corresponding 3.8 percent, resulting in a productivity/wage gap that grew by 1.7 percent during this period (Petras and Leiva 1994, 168). Above all, however, the labor reforms proved meager insofar as they failed fundamentally to afford labor organizations more effective institutional mechanisms through which to increase their collective bargaining power. At the end of the day, only 75 percent of all organized workers had the right to strike, while but 12.9 percent of all waged labor could negotiate collectively (Frank 1997, 28). To be sure, the lack of significant progress on the labor front was due primarily to the intransigence of business elites, who stalwartly resisted attempts by both Concertación governments to allow for cross-sectoral bargaining and better representation of nonunionized workers. But to the extent that low wages were deemed crucial to maintaining Chile's competitive edge (Petras and Leiva 1994, 170–71), the relentless pursuit of price stability by an autonomous central bank could only serve to reinforce these existing structural income inequalities between capital and labor.[40]

The government's inability to follow through on its avowedly redistributive objectives was also reflected in Chile's income distribution during the period in question. For while the incidence of poverty was cut by nearly a third between 1990 and 1994 and absolute poverty was cut in half, the income share of the lowest 40 percent of the population fell only slightly from 13.3 percent in 1990 to 13.1 percent in 1994 (Sheahan 1997, 19–20). Indeed, Oscar Altimir has calculated that the Gini coefficient of income concentration for 1992 remained 23 percent higher than in 1968 (Altimir 1995, 16). Despite all of the efforts by two successive Concertación governments to prioritize a pro-equity agenda, the distribution in the share of income between the lowest 40 percent of the population and the highest 20 percent remained hardly unaltered from the preceding twenty-five years. While one cannot attribute such inequities to the legal status of the central bank, its implicit restraints on government spending precluded any serious attempts at income redistribution on the part of the democrats.

The manifest tension between the policy objectives of democratic governments and the autonomy of the central bank is further revealed by looking at the nature of various conflicts that arose between the two over the course of the 1990s. While one can trace such strains back to the austerity program

40. Not surprisingly, labor militancy increased considerably during the second period of democratic rule under the Frei government (1994–99), when the country witnessed its first mass labor demonstration since the transition (Loveman 1995, 322).

carried out by the central bank in October 1992,[41] they began to escalate in earnest in late 1995. Following the government's successful negotiation of an 11 percent increase in public sector wages in November, the central bank publicly admonished the Finance Ministry for failing to contribute to the central bank's annual inflationary goal of 6.5 percent.[42] After interest rates again rose in April 1996, Finance Minister Eduardo Aninat responded publicly by saying that he hoped that this adjustment would be "intense, but brief,"[43] to which central bank president Roberto Zahler retorted that the rise "would last as long as necessary to obtain the desired objectives."[44]

Such conflicts ultimately came to a head in June 1996 when Roberto Zahler announced his sudden resignation as president of the Central Bank of Chile after nearly seven years on its governing board. While the proximate cause of Zahler's resignation lay in disagreements with the rest of the board over how to resolve the outstanding debt owed the central bank by several prominent commercial banks, it was no secret that this came on top of a series of disputes between the central bank and the Finance Ministry over the course of macroeconomic policy, in general, and interest rate policy, in particular.[45] More specifically, while Zahler wanted to keep interest rates at their currently high levels, Aninat urged the central bank to ease its relentlessly tight monetary policy to facilitate renewed growth.[46] To be sure, one might be inclined to chalk up such conflicts to the invariable tussles that occur within any system with an autonomous central bank. But the sudden and dramatic nature of Zahler's resignation would seem to lend credence to the notion that the Frei government felt inordinately restricted by the central bank in its ability to pursue a more aggressive growth-oriented policy agenda.

But perhaps the best support in favor of the argument that the central bank legislation was a constraint on incoming governments is the fact that dissatisfaction with its contents persisted well into democratic rule. For

41. In his annual report before the Senate in 1992, the central bank president reiterated the need to have "fiscal policy cooperate in order to maintain the objectives of the central bank" no less than eight times (Rosende 1993, 315).

42. See "Discrepancia por Reajuste Público," *La Epoca,* November 23, 1995. The central bank had made a similar critique one year earlier when the administration had negotiated a 12.2 percent increase in public sector wages, again claiming that such an action put the central bank's inflationary goals at risk.

43. "El Gobierno Espera que Medida del Banco Central Sea de Corto Plazo," *La Epoca,* April 10, 1996.

44. "Zahler Dice que No Hay que Creer que el Alza de Tasas Durará Poco," *La Epoca,* April 11, 1996.

45. See "El Adiós de Zahler," *La Epoca,* July 7, 1996; "La Verdad de la Renuncia," *Hoy* 989 (July 8–14, 1996): 30–32.

46. "Test for Chile's Central Bank: Resignation of Chief Raises Autonomy Questions," *Financial Times,* July 3, 1996.

example, the former head of studies at the central bank under the first Concertación administration openly argued in 1994 that inflationary control should not be the central bank's sole objective but, rather, a means through which to obtain the broader objective of "equitable development."[47] And even those former opposition economists who subsequently went on to form part of the central bank's leadership acknowledged that despite the existence of the quota, the underlying structural power of the central bank remained unaltered and potentially problematic. In particular, they pointed to the inadequacy of existing coordination mechanisms, which enabled the central bank to totally override the Finance Ministry when it saw fit—a concern that was subsequently realized in the wake of the Zahler-Aninat battles of 1996.[48] They also noted that the central bank continued to enjoy an excessive amount of economic policy-making ability. As one prominent central bank official observed, "given the degree of autonomy that the central bank has, it would be better to focus on a few objectives and get rid of the rest. I would take many of these other powers away because they just aren't necessary."[49] Perhaps these lingering doubts were best summed up by one high-ranking economist in the Frei administration who concluded, "I think that autonomy is overrated."[50]

Without going so far as to say that the existing autonomy legislation was uniformly negative, I can state that democratic governments in Chile quickly came to discover that many of their initial fears about central bank autonomy—for instance, the lack of coordination, the "fourth power of the state," and the weakness of accountability mechanisms—had been borne out in practice. More to the point—and to employ the language put forth in chapter 2—autonomy has precluded the democrats from obtaining their ideal point on the short-term Phillips curve. It is, of course, entirely possible that these governments simply did not want to do more, and hence their limited redistributive achievements reflect instead a deliberate effort at self-restraint (Weyland 1997). And yet, such a line of argument is not supported by their behavior in other policy arenas. Note, for example, that in the case of the tax reform, the government initially sought to obtain considerably more than it ultimately got both in terms of the overall amount targeted and the reform's specific components (Boylan 1996, 14). And while the administration was initially aggressive where labor policy was concerned, most of the labor code

47. See comments by Ricardo Ffrench-Davis in "Control de la Inflación No Debe Ser la Única Responsabilidad del Banco Central," *La Voz de la Libre Empresa,* January 26, 1994.

48. Eyzaguirre and Arrellano, interviews.

49. Member of the Central Bank of Chile's governing board, confidential interview by the author, tape recording, Santiago, Chile, May 20, 1995.

50. Arrellano, interview.

reforms found in the Concertación program went unfulfilled (Silva 1996, 233).

Extrapolating from these two experiences—and in light of the Concertación's incentives to respond to the concerns of their support base—one can only infer that the Concertación saw central bank reform as more a constraint than an opportunity. By inheriting an institution that made price stability its number one priority, democratic governments in Chile thus had no choice but to shelve their redistributive objectives or at least tone these down considerably. When all is said and done, the net result is that the country witnessed "economic growth but not the growth of equity" (Frank 1997, 31).

Domestic and International Constraints: Why Insulation Works

The previous section suggests that the democrats did not grow to embrace the central bank's autonomy but, rather, continued to have serious objections to some of its key features. If this is true, then we must return to the question with which we began this discussion: why did they not attempt to overturn or, at the very least, modify the legislation upon assuming power? In other words, if the two Pareto-improving interpretations of institutional persistence do not seem borne out by empirical reality, then how do we explain the inertia that has characterized this law since its passage? I would submit that there are several explanations for why the legislation was not overturned. All suggest that while the democrats might have wanted to change certain aspects of the central bank legislation, they were powerless to do so, constrained as much by the deliberate lock-in strategies of their authoritarian predecessors as by the nature of the international economy itself.

Recall from our discussion in chapter 3 that authoritarian governments frequently employ a variety of domestic entrenchment strategies in order to make reversal of their enclaves difficult for incoming governments. In the Chilean case, we see a particularly dramatic case of such lock-in tactics at work. As noted in chapter 4, among the enclaves built into the 1980 Constitution were a series of quite difficult procedures for constitutional reform. While these varied across different kinds of reforms, the threshold for a change of any sort was quite considerable. By establishing these quorums, the authoritarians consciously sought to ensure that new governments would not be able to modify existing institutional forms without the blessing of some supporters of the military regime.

For an organic constitutional law, such as that governing central bank autonomy, the Constitution required a four-sevenths majority in both cham-

bers of the legislature. In other words, the Concertación would have needed 69 votes in the Chamber of Deputies and 27 in the Senate in order to have changed this law. While it met such conditions in 1989 in the Chamber of Deputies, where it held 72 seats, it was 5 short of the necessary votes in the Senate, where it held only 22 seats. Naturally, had two complementary enclaves themselves not existed—the designated senators and the electoral system that disproportionately advantaged the parties of the right—one could argue that the government might have easily secured the necessary seats. But because of the existence of the four-sevenths majority clause on top of an already biased electoral system, the incoming government had no choice but to accept defeat. As one member of the incoming economic team noted, "Yes, we thought seriously about changing the law . . . but we were convinced that we couldn't because we lacked the majority in the senate, and we knew that we would lose."[51]

Of course, one might argue that the democrats could have chosen simply to flout the autonomy legislation, ignoring the arguably artificial veto role afforded their opponents. But as we noted in chapter 3, incoming democratic governments have little incentive to break extant laws and practices. Rather, precisely because they need to prove their democratic credentials, they have every incentive to obey existing legislation, even where this runs directly counter to their interests.

Such incentives were particularly strong in the Chilean case. Because the polarization of political parties was widely blamed for having triggered the breakdown of democracy in 1973, the Concertación had a vested interest in showing that democracy could work without producing the instabilities of the past. As Loveman notes, "the Aylwin government was determined to restore legitimacy and credibility to civilian government, prove itself an effective economic manager, and survive four years in office without provoking a military coup" (Loveman 1995, 309). The first challenge facing the new leaders thus consisted in "stimulating . . . rules for political behavior that would allow for the full force of the state of law and civilian institutions" (Huneeus 1994, 14). The democrats also needed to show themselves to be capable of cooperating with the authoritarians and their civilian counterparts: the right and business groups. President's Aylwin's chief adviser and political strategist, Edgardo Boeninger, was convinced that Chile's fundamental political problem was the lack of trust among social and political actors and that reestablishing such trust was a prerequisite for reestablishing democratic rule (Puryear 1994, 93). In light of these multiple exigencies for establishing stable

51. Ffrench-Davis, interview.

and lawful democratic rule, the authoritarians could be fairly sure that the democrats would be unlikely to do anything to tamper with the existing institutional order.

In addition to these legal considerations, one must also factor in a third constraint: those domestic constituencies empowered by the authoritarians to ward off any and all threats to the status quo. Chief among these where the economy was concerned was the existence of a powerful business class. By accelerating the privatization of the economy before leaving power, the Pinochet regime had effectively rendered the private sector an irreversible authoritarian enclave of its own (Rehren 1995, 36). Even with Pinochet's subsequent loss in the plebiscite, "the idea was that the capitalists would still be strong enough to defend the market economy on their own from the social democrats" (Silva 1991, 119).

And this is precisely what they did. As Rehren notes, "from the moment Aylwin took power, the CPC understood that its role before the new authorities was none other than defending the economic system of a free market" (Rehren 1995, 60). This guardian function manifested itself in two ways. First, business groups began to assume a tutorial role vis-à-vis the maintenance of a market economy, constantly reminding the authorities of what had "yet to be done" (Montero 1993, 62). Second, business also took on a much more active role in the policy-making process, replacing its historically intermittent involvement with a "sustained, systemic influence" (Rehren 1995, 56). For example, business groups participated actively in the governmental commissions set up to study the labor reform, steadfastly denouncing all modifications of the existing legislation, which were seen as fomenting unnecessary instability. In what some might interpret as a not-so-subtle threat, the then head of the CPC, Manuel Feliú, charged that "the labor reform will make Chile a mediocre country, impeding its normal development; if this reform does not satisfy us, we will not invest in the country" (Rehren 1995, 72). By virtue of its sheer economic clout, business was thus able to modify most of the government's significant policy initiatives in a direction more conducive to its own interests (Silva 1996, 231). The democrats implicitly understood that tampering with any preexisting arrangements designed to safeguard the market economy—such as the autonomy of the central bank—was similarly "off limits."

Finally, there was an additional, arguably even more important international constraint that made reversal of the central bank legislation unlikely. As noted in chapter 3, the contemporary international economic environment places enormous limitations on the ability of developing country governments to alter extant commitments to macroeconomic stability. In the

words of a prominent Chilean economist, "greater international interdependence, greater financial integration of our economy in the rest of the world, and the development of a capital market . . . all make the consequences of an inconsistent monetary policy appear more rapidly and with higher costs" (Arrellano 1989, 94). To the extent that disarming the autonomy of the central bank might be perceived by international investors as tantamount to "inconsistent monetary policy," one can thus reason that the more integrated the developing country economy, the higher the costs associated with this sort of transgression.

The Chilean case readily displays the enormity of such international constraints. Consider the volume and nature of foreign investment. During the period 1990–93, foreign capital inflows, already high, increased by nearly 50% with respect to the period 1986–89 (see table 5.2). While foreign direct investment played a leading role in this surge, portfolio investment (which had been temporarily suspended following the financial crisis of 1982) also came back with a vengeance in the 1990s. In 1993, it represented almost 20 percent of all capital inflows, rising as high as 26 percent in 1993 (Calderón and Griffith-Jones 1994, 6). In 1994, the amount of foreign capital flowing into Chile via secondary ADRs intensified even further, rising as high as U.S.$1 billion and constituting an additional net capital inflow equivalent to 2 percent of GDP (Ffrench-Davis, Agosín, and Uthoff 1995, 109).[52] In turn, speculative short-term capital flows were also strongly positive in the period 1989–92 (Ffrench-Davis, Agosín, and Uthoff 1995, 112–13). Because their highly liquid nature affords them a permanent exit option, both of these types of foreign capital are considered among the most volatile (Maxfield 1997). With their sudden surge in the 1990s, Chile was thus increasingly vulnerable to the whims of international capital markets.

But while all emerging markets were arguably highly sensitive to international capital markets during the early 1990s, Chile was exceptionally so. As Hojman (1990) notes, capital flight from Chile had been remarkably low under Pinochet, due largely to the high degree of confidence that owners of short-term capital placed in this regime's long-term economic strategy. As of the early 1990s, the Aylwin administration had not yet been invested with the same degree of confidence; to the contrary, foreign capital was rather biding its time to see how economic policy would pan out under this center-left administration. Particularly in light of the economic program's demonstrably ambiguous attitude toward foreign investment as well as the historically sta-

52. ADRs are American Depository Receipts, gleaned through the sale of shares by Chilean companies on the U.S. stock exchange.

tist leanings of the Christian Democratic Party, the danger of substantial capital flight under Aylwin at the slightest signal of something going wrong was a strong possibility (Hojman 1990, 35).

In light of this inherent skepticism on the part of international capital, incoming democratic governments were acutely aware of the need to promote an image of political and economic stability. Precisely because Chile had lived through periods of uncertainty in the past, newly elected officials realized that once the fundamental rules of the game were established, any change to them could have disastrous economic effects. Were such sudden and unexpected policy shifts to take place, Chile might be labeled "a high risk

TABLE 5.2. Chile: Volume and Composition of Medium- and Long-Term Private Capital Flows, 1980–94 (millions of dollars)

Average Annual Inflows	1980–82	1983–85	1986–89	1990–93
A. Foreign investment	373	119	879	1,131
1. Foreign direct investment	332	119	857	663
Direct effective foreign investment[a]	332	92	118	605
Debt -equity swaps[b]	0	27	739	58
2. Portfolio investment	41	0	22	468
Bonds[c]	41	0	0	81
Capital	0	0	22	387
Investment funds[d]	0	0	22	100
ADR's	0	0	0	287
B. Medium- and long-term credits[e]	3,626	1,231	727	1,266
Credits associated with DL 600	134	53	324	630
Other credits[f]	3,492	1,178	403	636
C. Total	3,999	1,350	1,605	2,397

Source: Calderón and Griffith-Jones 1994, 5. Reprinted with permission.

[a]Corresponds to the net inflows through Legal Decree 600 and chapter XIV of the Compendium of Norms for International Exchange (CNIE) of the Central Bank of Chile.

[b]Corresponds principally to the net inflows through Chapter XIX of the CNIE.

[c]Bonds emitted exclusively through private companies. In 1991 and 1992, there were emissions of bonds on the part of state entities on the order of U.S.$200 and U.S.$120 million respectively.

[d]Corresponds to the funds created through Law 18657.

[e]Corresponds to the gross flows (disbursements) of private medium- and long-term credits.

[f]Includes disbursements of medium- and long-term credits from creditors; those that came in through Article 15; and those assigned to banks, companies, and individuals by international private commercial banks.

country, with all of the implications that this has for investment, technological innovation and development possibilities" (Cortázar 1990, 70).

The democrats needed only to look to the experiences of their neighbors to realize the costs involved in sudden, unpredictable swings in policy. We have already noted the punishment inflicted on Venezuela by international markets when a neopopulist government attempted to tamper with the autonomy of this country's central bank. The Mexican peso crisis offers a similar lesson. While this crisis was not prompted by a sudden change in monetary policy per se, the mismanagement of the Mexican currency over the course of 1994 triggered a swift and dramatic outpouring of international reserves from this country (see postscript to chap. 7). Such examples served as a potent—if not proximate—reminder of the perils associated with inconsistent policy choices in an era of highly integrated financial markets.

In light of the nature and extent of Chile's international integration in the early 1990s, then, it seems unlikely that incoming governments would not have realized that to place Chile's relationship with foreign capital in jeopardy was to play with fire. Stated somewhat differently, even if incoming governments had won the necessary legislative majorities, they still would have been loath to overturn the existing central bank legislation for international credibility reasons. While talk of an additional reform thus was probably sincere before this legislation was enacted, there is no evidence that the government ever really intended to carry out this threat once the reform had been passed.

Another way of saying this is that had central bank autonomy never existed, the democrats would have been perfectly happy to live without it. Once it was in place, however, any attempt to modify or reverse this legislation would have been costly. The same can be said for the ongoing persistence of the quota. All things equal, democratic governments would have probably preferred to stack the decks with their own people. But once the norm of multipartisan participation became established, it acquired an institutional legitimacy of its own that would be very difficult to undo.

Governments in Chile's incipient democracy have thus been forced to live with this essentially coercive economic institution in their midst. While there was a great deal of programmatic affinity between the central bank and the executive during Chile's first two democratic administrations, this does not alter the essentially imposed flavor of this reform. Indeed, if it was possible to produce a major conflict of interest under allegedly like-minded agencies—as we saw in 1996—one can only wonder what might occur in a more antagonistic political setting. In particular, were a populist government to lock horns with a conservative central bank board in the future, democratic politicians would quickly discover that in many respects, their economic policy choices had already been made for them.

With the more paradigmatic Chilean case as a backdrop, the next two chapters consider the Mexican central bank reform of 1993. While sharing a number of basic features with the Chilean reform of 1989, the Mexican case differs in one key respect. Specifically, it demonstrates that the amount of autonomy an authoritarian government will cede to an independent agency hinges critically on the relative proximity of the democratic threat. In this way, it furnishes us with excellent grounds for comparison for the argument at hand.