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**ECONOMIC GOVERNANCE AND
GROWTH IN CHILE, 1984-2004**

by
Jorge Marshall*

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Stanford University
John A. and Cynthia Fry Gunn Building
366 Galvez Street | Stanford, CA | 94305-6015

Abstract

Chile has undergone profound economic, social and political changes over the past two decades, marked by high growth and poverty alleviation. Strong economic governance is the main factor behind this performance. Policy quality, institutional capacity and reasonable consensus have created a propitious environment for growth. This paper analyzes the interplay between the governance factors and growth in Chile during five periods from 1984 to 2004. Considering that this transformation has not been a smooth process, changes in the pace of reforms are analyzed to better understand the positive, as well as the negative, interactions between governance factors. This analysis shows that when policies, institutions, and consensus operate in a consistent environment, sustained progress follows. This view demands a balanced agenda that simultaneously strengthens these three spheres.

* Former Vice-Governor, Central Bank of Chile and Former Minister of Economy. Visiting Scholar at SCID. I thank the SCID for providing a stimulating environment and support during my visit in early 2004, and to Erich Eminghizer and Jorge Andrés Marshall for helpful comments. Email: jmarshall@expansiva.cl

1. Introduction

An important part of governing structural reforms is maintaining the virtuous circle of reasonable consensus, good policies and strong institutions. These interrelated factors lie behind the results achieved by the Chilean economy during two decades of transformation. Namely, these results are highlighted by an average growth rate of 6% (1985-2003) and a poverty reduction from 47% to 20% of population (1987-2000).

The purpose of this paper is to explore the interplay between governance, structural reforms, and growth in five periods of the last two decades in Chile. Two of these periods belong to the military regime that ended in March 1990 and the other three characterize democratic governments. Section 2 analyzes the interactions between policies, institutions, and consensus in the growth process. The third section applies this framework to the last two decades in Chile. Finally, the fourth section draws conclusions and offers some recommendations.

2. Governance and Structural Reforms

The effectiveness of structural reforms requires consistency between policies, reasonable consensus, and institutions. Workable consensus allows the decision-making framework to respond efficiently to economic developments. Institutions have an important role in keeping policy implementation in line with the established objectives. Policies are actions that should withstand rigorous empirical assessment. These three factors reinforce each other and create a virtuous circle of reforms and progress. Governance is the capacity with which a government coordinates these factors to manage policies and reforms to foster growth. For instance, building reasonable consensus can significantly improve decision-making. In the same way, strengthening institutions is frequently a necessary step to push for better policies, especially in times of pressure, when political support wanes.

In contrast, an environment of weak institutions, fragmented authority, or polarized politics harms the quality of policies, which further affects existing consensus and institutions. For instance, after an exogenous shock, different actors –including the government– will accommodate their behavior in ways that may or may not follow a trajectory of sustainable

progress. Decision-makers need time to digest the new scenario before adjusting policies. Often, in the meantime, fragmentation increases, policies are undermined, and the economy loses momentum. In contrast, if decision-makers are prepared to pursue sound policies and have a long-term vision, the same shock will hardly disrupt the virtuous circle for a long period.

Consistency between institutions and policies can break down if policy-makers change the objectives of their actions. For instance, in the case of weak institutions, an apparently equal policy scheme of market regulation can be functional for short or long-term visions of the regulator. Since efficient policies need some flexibility to respond to new information, they also allow for a discretionary margin that might be misused for private purposes at the cost of the institution, or could serve to delay some decisions on short-term considerations. Likewise, consistency between policies and consensus breaks if there is excessive fragmentation in the policy-decision process. In this case, additional agents can obstruct policies, with adverse consequences for sound policies.

Each of these cases has negative consequences for growth potential that are difficult to evaluate in isolation, since their effect enhances if the relationship between institutions and consensus is weak, further reducing the quality of policies. Alternatively, growth potential increases if there is consistency between policies, reasonable consensus, and institutions. This is only possible if there are well-defined responsibilities and workable mechanisms in place for decision-making. The high frequency of instability in Latin American reveals that there are significant benefits to institution and consensus building.

Knowing which policies are most suitable in each circumstance is not enough to put them into practice and even less to keep them for a sustained period, as governments must deal with continuous disturbances that challenge their policies, their institutional capacity, and the political consensus. This is why a more comprehensive analysis, including variables of different spheres, is essential to grasp the link between governance and growth potential.

The distinguishing feature of incentives and market-oriented policies lies in the efficient coordination of individual initiative, which is very different from policies that benefit the wealthy or any other stake. Moreover, an important function of the government is to protect market-oriented policies from any group seeking to use them for their own benefit, as is the case of those looking for protection from domestic and international competition.

Examples of market-oriented policies include trade liberalization, favoring competition in financial markets, decentralizing school and hospital management, the introduction of competition-related rules in public utilities, and the liberalization of the labor market. Empirical research shows that these policies lead to higher growth. Lora and Panizza (2002) calculated a structural reform index by observing the application of these policies in Latin American countries. This index measures policy quality, degree of freedom, and neutrality in five areas: trade liberalization, financial reforms, tax reforms, privatizations, and labor legislation. This index shows that structural reforms in Latin America triggered a 12% increase in per capita GDP in the 90s. Similarly, Nicoletti and Scarpetta (2003) use a large dataset for OECD countries to show that similar microeconomic reforms account for much of the growth and productivity performance at sectoral levels over the period 1984-1998.

It is interesting to note that Latin America shows very few signs of reform reversal. Lora and Panizza (2002) find only a few cases of slight and temporary reversion of reforms. Currently, only populist movements back state-centered policies of the type that prevailed in Latin America until the 70s. This fact could give a false perception about the political support for structural reforms because what often changes in adverse circumstances is the decision-making process rather than the overall orientation of reforms, which ultimately affects the quality of policies. In these periods, fragmentation increases and policy-makers use the discretionary margin to accommodate short-term objectives. Then, if consensus splits, the quality of policies will depend more on the existing institutional strength that operates as a sort of second-line defense.

For this reason, there is oversimplification when the analysis of structural reforms leaves out implementation variables, as the fragmentation in decision-making and policy execution may significantly affect the aggregate effectiveness of reforms on growth potential. This analysis leads one to consider governance factors, such as institutions and consensus building as fundamental determinants of overall economic performance.

Empirical research shows that institutions matter enormously for growth, yet growth does not automatically translate into improved governance. Bell (2002) distinguishes two meanings of governance. First, governance is a process that implies steering, coordinating, and legitimating a series of policies. Second, governance is also a set of mechanisms that rule the actions of the government as an agent. Kaufmann, Kraay and Mastruzzi (2003) applies a similar

definition through six dimensions of governance: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. This study concludes that improvements in governance have a significant effect on long-term growth.

A concern with quantitative governance indices is the difficulty in measuring the exercising of authority and the policy decision environment. Institutions need clear objectives and appropriate mechanisms for decision-making. Both are fundamental for sound economic governance. If institutions lack clear medium-term objectives and decisions tilt excessively to short-term considerations, it is hardly possible for institutions to implement good policies. The same happens if the decision process is excessively fragmented.

There are a number of measures used to strengthen institutions. For example, enhancing the policy mandates on specific objectives subject to improved accountability, strengthening selection procedures of public managers, using supervisory boards, improving transparency and accountability throughout the public sector, and requiring independent evaluation of policies. The application of these strategies and its consistency with the democratic process depends on the nature of each policy.

Closely related to the role of institutions is the degree of consensus on key policy issues and the adherence of the political parties to market-oriented policies. Consensus affects the ability of the political sphere to make sound decisions, which sets the stage for the government's capacity to rule the economy. If fragmentation increases excessively or the government vacillates on key issues, decisions are affected and growth falls. Macintyre (2003) formulates a model in which economic governance worsens with either excessive centralization or excessive fragmentation of decision-making, while it performs better in the intermediate range, which is analogous to the reasonable consensus idea developed here¹.

The consensus within the government coalition is always more important because it provides the voting power for policy changes. If the coalition splits on key policies, it is more difficult to implement needed reforms, increasing uncertainty. In addition, the ability to reach agreements beyond the own coalition is also fundamental for an efficient decision-making arrangement. Carmignani (2003) finds empirical support for the hypothesis that ideological

¹ Macintyre (2003) measures fragmentation through the number of "veto players" in decision-making, which is defined as "an individual or collective actor that has the institutional power to defeat a proposed law by withholding formal approval" (p.37).

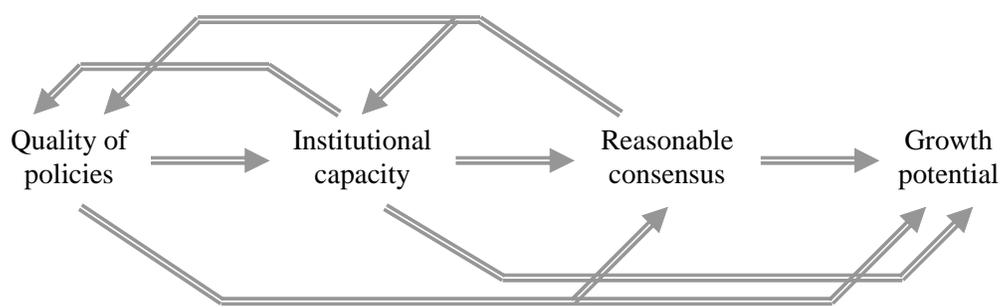
fragmentation of the government coalition has a detrimental impact on growth, since it is likely to affect the behavior of policy-makers. Corrales (2002a) calls this dilemma “presidents without parties” arguing that frequently the key struggle in Latin America is between the executive and the ruling party or coalition. Without the cooperation of its own coalition, the executive loses credibility and the political fortitude to carry out the structural reforms. Applying this hypothesis to the recent Argentinean crisis, Corrales (2002b) states, “the state-without-a-party condition undermines the quality of policymaking and the credibility of policymakers. Whether the shock is produced by presidential imperiousness or by a ruling coalition that comes to office technically unprepared for the job, the casualties are the same”.

Feng (2003) suggests that consensual societies enhance growth by providing commitments to political institutions, which strengthens stability and policy certainty. In fact, these two variables have a statistically significant effect on growth. Consequently, the more solid the agreements on economic principles, the more efficient are the resulting policies. If supporting political parties are split, there is little capacity to achieve policy reform. This situation is similar to an agent that must respond to several fragmented principals, each with its own objective function. Dixit (1999) demonstrates that a scheme of this type dilutes the effectiveness of institutions and incentives, damaging the quality of policies.

Regarding the consensus environment in Latin America, it is interesting to note the contrasting judgments on the market economy shown in the survey Latinobarometro (2003). While 57% of respondents consider that the market economy is the “only model” for economic development, only 16% is “personally satisfied” with the market economy. The case of Chile is not distant from the Latin American average, indicating that achieving consensus or avoiding fragmentation is probably more important in this region than in others. In a related venue, a recent survey shows that public opinion strongly prefers government by consensus. When asked how the government should face the most critical economic and social issues, a large majority indicates that consensus is better than a self-determining agenda. This is true even for the government’s followers. (CEP, 2003)

Political consensus is continuously processing new information, which in turn sets the political scenario for policy reform. A frequent error made in the analysis of structural reforms is to underestimate the effect of changes in the extent of workable consensus, which can hold back or move forward certain policies. In difficult times, for example, dissent frequently leads

to reform freezing. Then, any reform strategy needs to consider consensus formation to prevent excessive fragmentation.



In sum, there is strong support for the idea that sustainable growth requires good economic governance based on the consistency between policies, reasonable consensus, and institutions. As the diagram illustrates, these elements reinforce each other to foster growth potential. Conversely, if there is a breakdown in this cycle, such as if institutions are weak, there is excessive fragmentation in decision-making, or if policies do not withstand intense empirical checks, it is possible to fall into a vicious negative circle difficult to break. In this case, adverse conditions could be greatly prolonged. Sound economic governance relies in the positive interaction of these factors.

3. Governance and Structural Reforms in Chile

This section examines the relationship between economic governance and growth in five periods between 1984 and 2004 in Chile. The first two of these periods correspond to the military regime, while the other three correspond to democracy. In addition, in terms of reforms, three of these periods show forward movement while the other two are rather inactive. The basic macroeconomic indicators for this period are shown in Table 1, while Graph 1 illustrates the evolution of per capita GDP since 1960.

Rather than evaluating specific policies of each period, the objective of this analysis is

to understand better the factors that improve the governance of growth potential². An important focus of this analysis lies on the factors behind changes in governance capacity, exploring the variables that helped in overcoming difficult times.

Table 1 Chile: Macroeconomic Indicators

	GDP Growth (%)	Unemployment rate (%)	Investment (% of GDP)	Current account deficit (% GDP)	Real exchange rate (index)	Inflation (%)	Actual fiscal balance (% GDP)	Structural fiscal balance (% GDP)	Real interest rate (%)	Households confidence (Index)	Import Tariff (%)
1984	6.1	17.5	16.3	10.8	74	23.0	-3.0	-	8.4	6	35.0
1985	3.5	15.0	17.7	8.6	91	26.4	-4.3	-	8.2	17	25.0
1986	5.6	12.1	15.3	6.7	100	17.4	-2.6	-	4.1	27	20.0
1987	6.6	10.9	17.4	3.6	104	21.5	1.9	-0.8	4.3	42	20.0
1988	7.3	9.7	19.5	1.0	111	12.7	1.0	-1.8	4.6	63	15.0
1989	10.6	7.9	21.6	2.5	109	21.4	1.4	-1.1	6.8	70	15.0
1990	3.7	7.8	21.5	1.6	113	27.3	0.8	-0.7	9.4	58	15.0
1991	8.0	8.2	19.8	0.3	106	18.7	1.5	0.2	5.4	72	10.0
1992	12.3	6.7	21.7	2.3	98	12.7	2.1	0.9	5.3	80	9.2
1993	7.0	6.5	23.8	5.7	97	12.2	1.8	1.3	6.4	84	9.1
1994	5.7	7.8	23.8	3.1	94	8.9	1.6	1.4	6.4	73	8.6
1995	10.6	7.4	26.1	2.1	89	8.2	2.4	1.4	5.9	74	8.5
1996	7.4	6.5	26.4	4.1	85	6.6	2.1	1.3	6.9	74	8.9
1997	6.6	6.1	27.4	4.4	78	6.0	1.8	1.1	6.4	70	8.8
1998	3.2	6.2	27.0	4.9	78	4.7	0.4	0.5	9.5	45	8.4
1999	-0.8	9.7	22.2	-0.1	82	2.3	-1.4	-0.7	5.9	23	7.3
2000	4.2	9.2	23.0	1.1	86	4.5	0.1	0.1	5.2	33	6.3
2001	3.1	9.2	22.9	1.7	96	2.6	-0.3	0.9	3.7	27	5.4
2002	2.1	9.0	22.7	0.8	97	2.8	-0.8	0.9	1.9	37	4.6
2003	3.2	8.5	22.6	0.5	106	1.1	-0.8	0.9	1.8	43	3.8

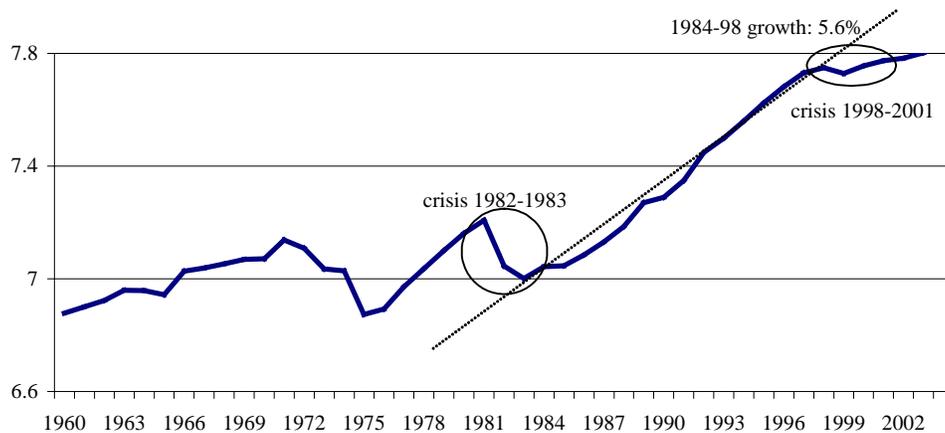
Sources: Central Bank of Chile, Ministry of Finance, National Institute for Statistics, Adimark and Ffrench-Davis (2002).

Before starting this analysis, it is important to mention some important reforms that were implemented before the period considered here and had a substantial long-term effect on

² Larrain and Vergara (2000) and Ffrench-Davis (2002) provide comprehensive analysis of structural

growth. These are trade opening, social security reform, and labor reform³. Trade opening is probably the single most important reform in Chile in the last half century. The average import tariff has decreased from around 94% in the early 70s to around 3% today. This reform eliminated the historical high dispersion of tariff rates, which produced huge distortions in effective protection, restrained exports, and encouraged rent seeking activities.

Graph 1. Per capita GDP: 1960-2003 (log. scale)



The quest towards more sound and flexible labor markets in Chile has evolved through several steps. The first dates back to the late 1970s. Setting aside its problematic political legitimacy, this reform changed excessive rigidities that had accumulated in the several decades leading up to the mid-60s. Barriers to laying-off workers were eased, restrictions on performing certain tasks were eliminated, and collective bargaining was allowed only within companies.

Another important reform in the early 80s was social security, which switched a bankrupt pay-as-you-go system to a privately funded capitalization system, in which funds

policies in Chile during most of this period.

³ These are the reforms that changed policies maintained for several decades, while there are others that just reverted to measures taken in 1970-1973. Galetovic (1998) compares the reforms in 1973-1981 with those accomplished in 1985-1989, concluding that the first reform round established the fundamentals of a market economy.

belong to workers and benefits depend only on past contributions and their corresponding capitalization. This reform has had a great influence on developing the capital market and fostering saving and investment.

3.1 Dispute and disagreement: 1984-85

Adverse shocks, external or domestic, political or economic, damage the virtuous circle of governance and structural reforms. Typically, in crisis periods, established policies are considered wrong, policy goals change to the short run, government followers split, and important decisions are postponed. All of these happened in Chile after the 1982-1983 crisis. In its aftermath, in late 1983 and early 1984, the general opinion of entrepreneurs and high government officials was rather distant from market-oriented reforms. Additionally, the business confederation (CPC) proposed a set of policies with a “flavor of protectionism and state interventionism” (Vial, 2002).

It is important to recognize that crises are often beset by doubts about their causes and the policies needed to restore economic progress. Under these conditions, authorities usually take few irreversible decisions. While this attitude makes governance easier in the short run, it also entails a serious risk of moving away from sound long-term policies. Historically, this dilemma has often appeared in Chile, as well as in other Latin American countries, with different consequences for structural reforms. For many decades, economic crisis generated long periods of political disputes, fragmented decision-making, bad policies, and weakening institutions.

The lack of a clear agenda led many observers to foresee this new episode as another step towards economic decline. After all, that was common in Latin America in the 80s. However, the most interesting question after a crisis is not whether the government has lost its path entirely, but rather how long it will take to rebound.

There were four Finance Ministers between April 1982 and February 1985. Economic policies of rival platforms were tried out, but many responded more to specific events or interest groups than to a coherent focus. The events that followed the crisis led to a major breakdown of the principles that had inspired the reforms of the late 70s. From 1983 to 1985, two rival approaches co-existed within the government (Buchi, 1993). The first, which prevailed up until

February 1985, emphasized expansive macroeconomic policy to stimulate aggregate demand and a certain inclination towards protectionism. This approach favored a more activist government and was less favorable to pro-market reforms.

A sign of this tendency, for example, was the government's decision to reverse trade opening that had reduced tariffs to 10% in 1979. Thus, toward mid-1983, the general tariff rose to 20% and to 35% in September 1984. GDP growth reached 6.1% in 1984, but the current account deficit widened from 4.7% of GDP in 1983 to an unsustainable 10.8% in 1984 because of excessive spending expansion without a proportional output response. Expectations increasingly judged this as a precarious recovery that could hardly persist. Since another group defended an alternative strategy to face the crisis, there was a vigorous —although undercover—debate within the government, which included a careful scrutinizing of economic results.

In the analysis of this period, the historian Gonzalo Vial states, “Economic policy stumbled along for more than two years, with no clear orientation. In this sense, the President seemed to have no defined route, to be trying anything” (La Segunda, 17 April 1998, authors' translation). Hachette (2000a) expresses an equally negative opinion of this period, “Political authorities, very weakened by social problems exacerbated by the crisis, were willing to give up the guiding principles of the model they had wanted to implant. They surrounded themselves with less technical people, more flexible to the socio-political environment and the complaints of business, and less committed to the model” (authors' translation).

Towards the end of 1984, there was a sense of exhaustion in the country as very different policies were tried, with indifferent results. However, the pragmatic reading of policy results, which seems to be one of the consequences of the economic transformation, was a recourse that would prevail in policy-making. Policy-making became less ideological and focused more on empirical outcomes.

Also, during the crisis Chile retained its institutional capacity for economic governance. Higher and medium level officials had the capacity to prepare alternative platforms, so changes in the political mood could be speedily translated into policies. In addition, the political authority was highly centralized, with strong discipline in its military base. Therefore, the political discord had only transitory effects and was far less intense than in other Latin American military governments.

3.2 Take-off: 1985-1989

Pragmatism, institutional capacity and centralized decision-making made it possible to quickly redirect the policy path. The appointment of a new Finance Minister in February of 1985 indicated another change in the course of economic policy. This new platform revealed a coherent medium-term view that boosted government confidence in returning to pro-market policies and gave a new thrust to economic progress. Rapidly, the heated discussions and disputes of previous years were left completely behind.

The diagnosis was that the troubles of the economy were not caused by previous pro-market reforms but rather by terms-of-trade and international interest rate shocks, which were aggravated by financial weaknesses in the enterprise sector and by some policy incoherences. The latter consisted of two key issues, loose financial regulations that exacerbated moral hazard problems in banking, and conflict between wage rigidity —set in the labor code— and a fixed exchange rate. This required that domestic prices adjust to external shocks while wages remained inflexible. The new wave of structural reforms rectified these two issues.

The financial weakness and lack of competitiveness in the enterprise sector were two sides of the same coin, and accounted for the low output effect of demand policies. Consequently, the new platform's aim was to restore economic progress by pushing transformations that could strengthen private sector financial conditions in terms of flows and stocks. This objective was an indispensable step towards increasing saving, investment, and employment, although the latter would take some time to materialize. The platform priority was put on the supply side, which rapidly generated a renewed support for pro-market policies among entrepreneurs who around 1984 were rather skeptical about the benefits of structural reforms.

This turnaround in the government and business sector support shows that having a feasible agenda is an important step for future success, especially in a centralized decision-making environment. Market-oriented policies are far from being an objective in themselves or a recipe applicable in any context, but rather a set of common sense tools based on compelling empirical evidence.

The right sequence in a reform program is diagnose, formulate policy objectives, and

implement policy actions. If this sequence is consistently applied, there is a high probability that favorable results will soon appear. Also, when data show some progress in terms of activity and employment, expectations will improve and policies will receive wider support.

The reforms of the 1985-1989 period fall into three categories. First were those aimed at directly increasing private profitability, essentially through a fiscal adjustment. Second were microeconomic policies aimed at establishing lasting rules for enterprise development, mainly financial sector reform, competition policy, and privatization. Third were policies that focused on improving the net asset position of the private sector, which included debt-conversion and debt-alleviation programs.

The first category of structural policies received higher priority due to the diagnosis of financial weakness and low competitiveness as the most pressing restrictions on economic progress. Several actions were directed to this end, but these policies involved a large fiscal adjustment. First, corporate tax on retained profit was significantly reduced and later exempted from taxes. The tax rate on distributed profits decreased from 50% to 10% and was considered credit for personal income tax. These initiatives increased corporate flows and introduced a significant incentive for saving, as the tax burden for retained profit was lower than distributed profits⁴.

Another important tax initiative in this period was the reduction of the import tariff from 35% to 15%. This measure was a clear signal that export sector growth was decisive for further progress in a small economy, as import tariffs are effectively an indirect tax on exports. Consequently, the tariff increases of 1983 and 1984 —when the uniform tariff rose from 10% to 35%— were reversed, with tariffs being cut to 20% in 1985 and 15% in 1988. This idea was maintained in all subsequent periods, as tariffs were reduced again in 1991 and in 1998. Also, drawback mechanisms were introduced to promote exports, which further enhanced the external competitiveness of the tradable sector.

The counterpart of these initiatives was severe austerity in fiscal spending, which was fundamental for credible stability. Current spending decreased from around 30% of GDP in 1984 to around 20% in 1989 (Buchi, 1993). Without the decline in spending, it would have been impossible to reduce several taxes and simultaneously produce a budget surplus since 1987. The

⁴ This tax break is estimated as the equivalent of 2% of GDP.

latter was fundamental in keeping a low interest rate and a competitive exchange rate. In fact, compared with their levels in 1984 the interest rate declined by approximately 2.4 percentage points and the real exchange rate depreciated around 35% in the 1985-89 period. Meanwhile, inflation continued within the 20% to 25% range, and further reduction was not a priority. In addition, government policies at the time focused on keeping wage costs moderate. Thus, the minimum wage fell in real terms, and increases in public sector salaries and pensions were limited. Therefore, the initial drive for increasing private sector profitability came from fiscal adjustment.

The fiscal policy in this period illustrates two conclusions. First, that a sound fiscal position is conducive to improved economic performance over the medium to long term. The historical experience of Chile, repeatedly found in Latin America even today, shows that lack of credibility leaves little room for an effective fiscal policy with either stabilizing or competitive purposes⁵. Also, the sustained sound fiscal stance in the last two decades, reflected in an average budget balance of 0.3% of GDP, has been one of the main factors behind the successful Chilean economic performance.

The second conclusion is that the short-term output effect of fiscal policy is uncertain as it depends on several factors. Together with the Keynesian multiplier effect, there are other demand and supply side effects. For instance, budget sustainability influences the interest rate, the exchange rate, and business confidence. In addition, private wealth may change due to the impact of fiscal policy on the financial market or on expectation of future taxes. Also, there are structural effects due to distortions arising from market constraints or government intervention, and competitive effects as public wage compression can affect private sector wages. The magnitude of each of these effects depends on credibility and on the cyclical position of the economy.

Thus, while in 1984 fiscal policy had little success in restoring credibility, from 1985 to 1989 there was an expansionary fiscal consolidation. The aim of fiscal policy was to improve private sector competitiveness, and it was achieved through a significant cutback on spending. Hsieh and Parker (2002) argue that the reduction of retained profit tax rate induced a saving and investment boom because many firms were financially constrained. They test this hypothesis

⁵ See Calderón; Duncan and Schmidt-Hebbel (2003).

using data on the investment behavior of “constrained” vs. “unconstrained” firms in Chile. In these conditions, the taxation of retained profits is more distorting than the taxation of dividends because constrained firms are unable to raise sufficient external funds to undertake investment. This result is consistent with the finding of Medina and Valdés (1998) that Chilean firms face constraints on investment financing. Using a different approach to assess these changes in the fiscal stance, Cerda, Gonzalez y Lagos (2003) also find empirical support for the expansionary fiscal adjustment hypothesis, which according to these authors responds mainly to the expectation of a permanent fall in government spending.

The second area of significant transformation in this period is microeconomics. The reforms consisted of a new banking law, a new bankruptcy law, the updating of bank regulations, a new round of privatization, and competition policy in public utilities. These sectoral reforms defined long-lasting rules capable of attracting new investment.

Before putting the financial sector reform into practice, a broad scheme to hurdle the banking emergency after the 1982-83 crisis was applied. There were foreclosures of financial institutions and portfolio purchases with a buy-back clause. Although expensive, these policies established incentives for bank recapitalization and recovering bad loans, which accelerated the banking upturn. Then, a new banking law was enacted in 1986, granting more powers to regulatory agencies, imposing limits to asset holdings and related lending, and updating asset classification norms. Institutional development of the supervisory capacity was an important part of this reform.

The main purpose of privatization was to transfer ownership of a large number of enterprises that were in state hands, because of the banking crisis or because they were previous public enterprises. However, this reform also aimed to improve the financial strength of the newly recreated corporate sector. This objective was pursued by using different privatizing schemes, such as popular capitalism, employee stock options, and large investors —domestic or foreign — capable of transferring ownership of a significant portion of domestic assets. The objectives were entirely achieved, although in some cases there were doubts about lax corporate governance practices. These are difficult to assess fully given the magnitude of the privatization program, which according to Hachette (2000b) reduced the value added share of the public enterprise sector from 24% of GDP in 1983 to 13% in 1989.

In the assessment of Chilean privatization, the priority of institution building stands out, especially if compared with other Latin American experiences. Privatization was accomplished under a reasonable regulatory framework, which was completely independent from the privatization process. All kinds of market privileges were entirely absent from privatization dealings. Countries that aimed at maximizing revenues rather than efficiency added monopoly privileges to the privatizing enterprise. Instead, in Chile, a framework of market competition prevailed in each privatized industry, such as telecommunications and energy. The same rules of market competition were applied to the remaining public enterprises, impeding any non-commercial task for these enterprises. This made it easier to continue privatizing in the 90s.

The third category of structural policies in this period intended to alleviate private sector debt. The tax and fiscal reform was a significant step towards enhancing the private sector's financial position, but in the aftermath of the debt crisis this was considered insufficient to ease the deficient private sector net asset position, which was considered a prerequisite for a saving and investment increase. Initiatives in this area included financial subsidies for indebted companies, such as a preferential exchange rate and the favorable rescheduling of domestic debts. In addition, foreign-debt conversion plans designed to rapidly reduce external indebtedness were offered. After an aggressive use of these plans, Chile rescued around half of its external debt between 1985 and 1991, most of which was drawn into domestic assets, including equity of Chilean companies. Although debt-conversions offered the potential for major commercial debt reduction, their cost was high because most of the discount went to foreign investors.

Among all the reforms in this period, the domestic and foreign debt subsidies leave some efficiency doubts. If subsidies are not linked to saving or investment incentives, their costs tend to exceed their benefits. This is a frequent design fault of programs dealing with the consequences rather than the causes of social or economic troubles.

Regarding institutional capacity, this period is noteworthy for the Central Bank independence that came into effect in December 1989. Together with the fiscal reform of the 70s, the new independence of the Central Bank was a big leap in Chilean institutional development, leaving behind decades of fragmentation in key areas of economic governance that resulted in high inflation and instability. The effectiveness of this reform was further ensured after an agreement was reached on the membership of the Central Bank's Board. Also

important for institutional development in this period were the improvement of banking supervision and establishing the capacity for public utility regulation.

Although these are relevant institutional reforms, aspects like strengthening the civil service, instituting broader state reform, and increasing transparency and accountability were absent from government priorities. This neglect became of importance after the restoration of democracy since it restricted the government's capacity to drive new policy reforms.

It has been widely argued that these reforms were possible only due to the authoritarian rule in Chile. On one hand, it is likely that the intensity with which some economic policy was applied –particularly fiscal adjustment– would have been difficult in a democracy, which demands negotiations and broader political agreements. On the other hand, the objective of improving enterprise sector competitiveness has proven to be the only way to restore economic progress. Bergoening, Repetto and Soto (2003) use plant-level data to show the output effect of structural reforms that improve profitability, based on the resource reallocation from low to high efficiency producers. This process may occur either across sectors (e.g., tradable vs. non-tradable) or within industries (e.g., low to high technology firms). In addition, static gains also lead to important dynamic gains as a more fluid process of market entry and exit allow producers to adopt technology more efficiently.

The choice of stimulating domestic demand was not effective enough and other countries' experiences demonstrate that if this had been applied in Chile, recovery would have been considerably slower. This makes it possible to conclude that the goal of improving competitiveness as the first step to reactivating the Chilean economy was correct. In democracy, the policy mix would have been different, refining some of the reforms implemented in this period. However, the final effect on growth is unknown since the counterpart of another policy package would have been a different policy-decision process, with short and long-term consequences. In fact, the imminent return to democracy towards the end of the 80s was a condition that had increasing influence on corporate decisions.

The authoritarian government underestimated the role of consensus in policy-making, which was crucial for reform sustainability. Only towards the end of this period was there an explicit search for agreements to support reforms. Perhaps, its own defensiveness and the old ideological split in Chile led the government to neglect the broad transformation of

development ideas that was happening in domestic and international spheres. This undervaluation of political dialogue also extended to the government's followers, as is evident in the near lack of communication between business leaders and the political opposition.

An important factor for reform continuity was the positive evolution of the opposition's assessment of market-oriented policies that made possible future consensus. Although this was unrelated to policy implementation at that time, it would have important consequences in the consolidation period. Through the work of several NGOs, the opposition was learning from the poor results of other transitions in Latin America as well as from the mediocre historical performance of the Chilean economy. By examining its own thoughts and empirical experiences, the opposition embraced market economy ideas, but voiced disagreement on the priority the government was giving to social policy.⁶ This was another demonstration—this time in the opposite political spectrum—that the pragmatic reading of policy results was an institutional recourse that would continue playing a vital role in the governance of structural reforms.

3.3 Consolidation and modernization: 1990-1997

The consolidation of structural reforms began with the return to democracy in March 1990. The sustainability of market-oriented policies required democratic endorsement, which was only possible through a more active political inquiry of the social consequences of reforms and an efficient decision-making framework. This period challenged the policies implemented during the military regime. While the new authorities were well aware of these circumstances, private confidence had yet to be boosted to fully consolidate the growth process.

In this scenario, the reforms of the 1990-1997 period fall into four categories. First, there was an explicit effort to reduce uncertainties and consolidate economic and social stability, particularly in the first two years. Second, several initiatives were aimed at expanding social programs throughout the period. Third, there was a clear effort to rebuild ties to the international community and extend economic liberalization. Fourth, around 1993, there began a strong wave of microeconomic reforms, mainly in infrastructure, that characterized the second part of this period. Therefore, within the consolidation period the foremost priority passed from

macroeconomic stability to microeconomic reforms.

Accordingly, the economic program at the beginning of this period focused on maintaining macroeconomic stability and gaining credibility, which had mainly suffered from popular lack of confidence and the absence of dialogue between people of different political backgrounds. This objective was welcomed not only by the private sector, but also by the citizenry at large because political and economic stability are linked and the restored democracy needed both. Thus, the goal of stability was easily embraced by all political factions.

As mentioned, the new Chilean authorities had learned from the policy mistakes made by other Latin American countries transitioning to democracy, errors that resulted in high inflation and almost zero growth. Therefore, it was clear that modern economies should not put macroeconomic stability at risk, which is a hard restriction on economies integrated into international markets. Countries that fail to achieve credibility in their commitment to stability pay a heavy cost. In this sense, the emphasis on stability showed a degree of pragmatism and served to keep a reasonable degree of centralization in economic governance. As mentioned, these features contrasted with the extremely ideological and fragmented policy-making in the past and would significantly contribute to generating several agreements in the following years. Moreover, this improved economic governance has become an asset contributing favorably to Chile's credibility.

The policy actions for this objective were once again a tight fiscal policy and an effective coordination between the newly independent Central Bank and fiscal authorities. Fiscal spending fell by around 5% real in 1990, underlining that the commitment to maintaining a balanced budget was one of the top government priorities. In fact, maintaining a balanced budget was considered a "tough political objective" (Arellano, 1995) that operated like an implicit policy rule until 1998.

It is interesting that this policy objective was measured through the actual fiscal balance, which provides a rather pro-cyclical fiscal stance since it does not consider any adjustment for the economic cycle or the copper price. For instance, in an overheating economy or with a copper price above its average, an actual balance rule corresponds to a fairly expansive fiscal stance. In fact, the average cyclical effect during 1995-1997 accounted for around 1% of

⁶ Marshall and Morande (1989) analyze the economic proposals of different parties and ONGs.

GDP, which indicates a looser fiscal stance than the one shown by the actual balance.

In addition to a tough fiscal stance, the Central Bank started a systematic effort to control endemic inflation in Chile. In the late 1980s the economy was overheating, and monetary policy tightened as the interest rate increased to around 10% real in 1990. Inflation gradually descended from 27.3% in 1990 until attaining the Central Bank's target of an inflation rate around 3%, set in 1999. On average, the 90s was a decade of high interest rates because of strong private expenditure growth, partly fuelled by large foreign capital inflows.

The Central Bank used a band mechanism to stabilize the exchange rate around a targeted level, an objective that was considered essential for maintaining a sound equilibrium in the external accounts. However, this aim would become increasingly challenging, given the combination of improved domestic confidence and a favorable external scenario. Consequently, a conflict between stabilization and exchange rate policies emerged in the early 90s. Since stabilization was the foremost priority for monetary policy, a reserve requirement on capital inflows was introduced in order to avoid excessive appreciation⁷. The reserve requirement that had the form of a one-year non-remunerated deposit in the Central Bank placed a wedge between domestic and foreign interest rates, giving monetary policy more leeway. This sequencing of trade liberalization in advance of capital account liberalization provided in the early 90s the needed framework to boost private investment and growth.

The second main concern of this economic program was increasing social spending, which had been largely postponed during the fiscal adjustments made in the 1980s. The electoral campaign fuelled expectations of higher social spending, which generated significant demands. The idea of an inherited "social debt" was widely endorsed. Therefore, part of the funds to finance the increase in social spending came from a transitory value-added tax and a corporate tax increased in 1990. However, over time, most of the additional resources for social spending originated from economic growth.

From 1990 to 1997, social spending, including education, public health, housing, and pensions, rose by around 75% real. This huge spending boost went beyond anything the authorities had imagined in 1990, making it more difficult to develop the most efficient programs. A significant part of the additional spending went to wage and cost increases without

updating incentive mechanisms, resulting in limited output increase.⁸

At the beginning of this period, the issue of incentives and the efficiency of social programs received little attention, and so ended up having a less lasting effect. This neglect could be considered a policy mistake, especially in light of the significant increase in social spending. As the government gradually realized the need for structural reforms in health and education, there were fewer resources available to support them. If the government had first worked through successful scenarios more thoroughly, its proposals would probably have been different, and the social challenge would not have been treated simply as “social debt” but rather as a more comprehensive policy reform. Later, the second approach would prevail and social policy proposals would include explicit incentives and efficiency criteria.

Deepening trade liberalization was another reform in this period, stimulated by the restored political ties with the world community. This produced significant results in terms of exports and foreign investment, but also helped to bridge the gap between the center-left government and the business sector, as foreign investors were untangled from the historical apprehensions of domestic entrepreneurs about the new government. The main policy here was an import tariff reduction from 15% to 11% in 1991, and an additional gradual fall to 6% from 1999 to 2003⁹.

Additionally, bilateral trade agreements have been a powerful device in international economic policy. In the 1990s, Chile signed free trade agreements with major Latin American countries, which were important for trade and for the wave of Chilean investment abroad that took place when neighboring countries started liberalizing their economies and privatizing state-owned companies. Also, in 1990 the U.S. government launched the Initiative for the Americas and Chile pushed to start negotiations of a Free Trade Agreement (FTA) with the U.S. This initiative was postponed several times until it was finally signed in 2003. In addition, a FTA was signed with Canada in 1997, with the EU in 2002, and with Korea in 2004. The unilateral tariff reduction has helped avoid an excessive cost of trade diversion of bilateral or regional

⁷ Some appreciation of the peso was allowed as the band widened from 5% to 10% and the target rate was adjusted. See Morandé and Tapia (2002).

⁸ According to Tokman and Rodriguez (2000) health-care public spending increased by 130% real between 1990 and 1997, while output grew by 10% in the same period.

⁹ The current average import tariff rate is less than 3%, which compares to around 95% when trade liberalization began in the mid-70s.

trade agreements.

By 1992, the economy was growing at 12%, evidence that the government's objectives had been fully achieved and the credibility of macroeconomic policies restored. Hence, the concern gradually shifted to microeconomic reforms that appeared as preconditions for sustainable growth. Some of these reforms were pending issues, but most arose from the changes underway. In particular, fast growth increased the demand for infrastructure investment to a level that the fiscal budget was unable to satisfy.

The shift to microeconomic policy started rather timidly in 1992-1993 with three important initiatives. A fisheries law established an improved regulatory framework to curb the depletion of fish stocks. A telecommunications bill agreement was reached that would introduce the multi-carrier system and encourage overall market competition in long distance services. This system generated a 25% annual growth in long-distance calls over five years. Finally, a new concession scheme emerged allowing private infrastructure investment.

At this stage, it was clear that future political support would not come from the old authoritarian–democratic alignment of the citizenry, but rather from effective economic and social outcomes. In this scenario, maintaining fast growth became essential to ensuring political support and pushing forward the social and microeconomic reform agenda.

If in the early 90s the key words were economic stability and social debt, by 1993 the ideas of social and microeconomic modernization appeared at the center of economic policy. Thus, the second Concertación government (1994-2000) started an ambitious program of structural reforms in several sectors, with the main priority being infrastructure investment. This was the distinctive feature of the modernization years.

One of the important microeconomic reforms of this period was in water and sewage. This reform included a change in the regulation framework, the privatization of several public enterprises, and new investments in water treatment. It captured significant political and technical attention from 1994 to 1998, when Congress approved it. Beginning in late 1998, the government started to offer minority but controlling interests in state-owned water companies. These companies required large amounts of new investment in sewage treatment plants. Urban water treatment coverage increased from 8% of households in 1990 to 48% in 2003, and investment plans project 80% coverage by 2009. This reform opened up investment

opportunities that caught the interest of several international utilities.

A second reform in this period aimed at extending the private concession mechanism to major highways and airports. This scheme had started years before with particular projects¹⁰, but in 1994 this policy was broadened to cover the entire highway network in central Chile. In recent years, private investment in infrastructure has accounted for around 5% of gross domestic investment¹¹.

A third policy of the microeconomic program launched in 1994 was port reform, as the government realized that the modernization of ports was crucial to the expansion of commerce and new free trade agreements. Therefore, after around 18 months of technical preparation, the reform reached Congress. The basic idea was to change the multi-operator system (introduced in 1981) to a concession scheme based on a mono-operator system that is in place in most modern countries. Congress approved the reform at the end of 1997, after some 14 months of parliamentary debate.

The reform transformed 10 ports owned by one company into independent state-run companies, which paved the way for a partial privatization of some of Chile's largest ports by granting concessions to private companies responsible for developing, operating, and managing parts of the port. This scheme promotes investment in infrastructure and technology and improves efficiency in cargo handling by stimulating competition between ports. Additionally, the bidding process resulted in significant fiscal revenues.

Other microeconomic reform regarding public enterprises was the ending of the implicit budget subsidy to ENACAR, an unprofitable coalmining company that closed in 1996 after several postponements, even during the military regime. It is noteworthy that Congress refused to approve the coalmine subsidy, arguing that it had low efficiency and deleterious budget consequences, and subjected it to an independent economic viability assessment that was impossible to obtain. Again, this case shows the relevance of pragmatism and rational debate in policy-making. Also in this area, the privatization in 1996 of Colbún S.A., a large hydroelectric company, continued the electric sector privatization that began ten years before, when the main companies of generation and distribution were privatized.

¹⁰ The first of which was a tunnel in the north highway.

¹¹ The extension of double lane highways increased from 320 to 2,200 kilometers between 1990 and 2002.

Structural reforms in social sectors had less success in this period. The government tried to set new priorities for social policies in education, poverty, health-care, and justice. However, of these only the last was fully accomplished in this period. A new code of criminal procedure was introduced in 2000 to improve the character and quality of criminal justice. The new code for the first time allowed public trials, oral hearings, and the presentation of conflicting evidence. It also introduced two new institutions, the office of the public defender and a national prosecution service.

In the case of education, the first move was to create a national commission to develop a comprehensive modernization proposal. This commission finished its work in mid-1996, suggesting reforms aimed at strengthening educational management and teaching. Only parts of the recommendations were finally implemented, as teachers opposed most of the incentive mechanisms. The most important change was the full school day, which required an investment in buildings of almost US\$300 million.

Finally, health reform was left aside soon after the opposition of health workers' and doctors' associations became noticeable. The government moved slower in this area, postponing previous proposals to increase efficiency.

The growth effects of the reforms introduced through the mid-1980s have been highly significant. Gallego and Loayza (2002) find that better macroeconomic policies, structural reforms, political stability, and public infrastructure explain 73% of the increase in growth from the 1970-85 period to the 1986-98 period. Also, Jadresic and Zahler (2000) show that the rapid growth of the 1990-1998 period was essentially due to the productivity increase attributed to the structural policies that began in the mid-70s and an improvement in the political conditions in the 90s. Furthermore, because income distribution has remained roughly constant over time, poverty reduction heavily depends on growth, which explains more than 80% of the poverty alleviation achieved in Chile. However, part of the growth effect of some microeconomic reforms of the mid-90s, especially infrastructure investment, would be perceived only after some time, because the international economic environment for emerging markets remained rather depressed for several years after the Asian crisis of 1997-98.

One important difference between the first and second half of the 1990-1997 period is the role of consensus in policy-decisions. In the early-90s, the government successfully carried

out a consensus building strategy, especially in the areas that might generate greater disagreement, such as tax and labor reform. However, around the mid-90s the new structural reforms faced an environment of increasing political disputes and fragmentation, especially within the government's ranks. Although the government proposed an ambitious reform program in 1994, the political consensus started to decay. Agreements achieved between 1990 and 1993 grew steadily weaker, especially within the government coalition. This phenomenon did not affect the basic principles of the economic framework, like trade liberalization, macroeconomic stability, or reliance on markets, but rather the new agenda of microeconomic and social reforms.

Two questions arise in this scenario. Why did the initial consensus deteriorate? And, what are the consequences for future economic performance? Although the answers can only be tentative, it is useful to explore the questions.

The fading of political consensus resulted from the interplay of three factors. First, sizable sectors of the ruling coalition had doubts about social and microeconomic reforms. Second, some features of the electoral regime heightened the differences within each major coalition. Finally, the government had clear objectives but showed insufficient leadership to gain support for them.

Most political parties in Latin America have been experiencing ideological switches, originating from the empirical evidence that market-oriented policies produce better economic performance. This change is more evident in center-left parties, but it has also spread across the whole political spectrum¹². The economic and social transformations that gradually shift the interests of business and workers drive this change in the medium-term. However, on the policy-making horizon, this shift should be combined with both effective bargaining and a demonstration of the benefits of structural reforms, and with reasonable consensus in policy-decisions. In the case of Chile, political parties were split on the emphasis the government gave to infrastructure modernization, and, at the same time, were unwilling to raise seriously the issue of social reform because of both workers' resistance and remaining skepticism about the benefits of market-oriented policies. Consequently, the government faced a challenging environment in which to carry out its reform platform.

After 1995, an increase in fragmentation in decision-making occurred, as new actors appeared to have veto capacity over government policies. A characteristic of the binominal electoral regime is that it produces two major coalitions, but at the cost of accentuating the differences within each coalition, since candidates compete primarily with their list-mates. This endangers one of the benefits of the binominal regime, which is the generation of two stable coalitions for the policy-decision process. In an extreme case, the ruling coalition might be willing to combine its votes to elect parliament members, but not to support the government's proposals. This may lead to political fragmentation, a feature that was usual for several decades in Chile with negative consequences for policy-making.

The leadership exerted by the political cabinet was insufficient to overcome the split in the coalition parties. In fact, the first political cabinet in 1994 lasted only 6 months in office, with enduring consequences for the rest of the period. Also, the emerging political split swept rapidly into the government committee structure, making it ineffective. Consequently, a wedge appeared between the technical and political spheres of the government, which brought more internal disputes, frequently unrelated with the policy issues at stake. In these conditions, the political management of many reforms remained in technical spheres, with an under-involvement of the political cabinet. Then, this disenchantment with structural reforms had less to do with the economic and social outcomes of the 1990s –when the economy boomed— than with a failure of the capacity to make the case for market-oriented policies, based on the undisputable empirical evidence.

The main consequence of weak political consensus, soft institutional capacity, and fragmented policy-making was an unsurprisingly lower level of policy quality. This meant frequent delays, costly compensations to interest groups, and the withdrawals of some policies. This was particularly visible in a more lax fiscal discipline, frequent tax increase initiatives, a 30% real raise of minimum wage between 1997 and 2000 –in spite of adverse external shocks and a 40% raise since 1990– and a labor-protection project. In most cases, these proposals did not take into account a serious evaluation of previous reform results. Hence, the policy platform gradually shifted its focus from medium to short term.

Thus, this fragmentation in policy-decisions affected economic governance. In less

¹² In a survey made in 17 Latin American Countries, 57% of the respondents agree that the market

certain scenarios, public managers tend to seek short-term objectives, avoid risky projects, and reduce cooperation with other managers. These processes rapidly extend uncertainty to policies, reducing their effectiveness, which in turn makes it harder to obtain political support for structural reforms. Thus, one important lesson of this period is that political consensus requires hard work backed by institutions of political governance, as difficulties in the political sphere may place constraints on economic policy.

Separated from these political developments, economic events started to signal some shortcomings in the macroeconomic policy framework. Large capital inflows around the mid-90s became too powerful a force for this framework to remain unchanged. The current account deficit increased from around 3% of GDP in 1990-1995 to around 4.5% of GDP in 1996-1997 and the peso appreciated by 18% real in the same years. The impossible trinity of an exchange rate band, international capital mobility, and an active monetary policy was increasingly evident. Large capital flows were feeding credit and demand expansion, which reached double digit rates. Monetary policy dictated an interest rate with an upward differential over the international rate and extra breathing space was needed that the reserve requirement on capital inflows –despite all the amendments– was unable to provide¹³. On top of that, the rather pro-cyclical rule of a balanced budget made fiscal and monetary policy coordination troublesome.

However, the Central Bank observed that inflation was descending in accordance with its target and terms-of-trade were falling, as the copper price towards the end of 1996 was around 40% lower than a year earlier. These factors, plus an increase in emerging market risk in the aftershocks of Thailand's financial crisis, in mid-1997, were expected to curb demand expansion without further monetary policy restraint or a pressing change in the policy scheme. This view lasted until after the Asian crisis, when it was evident that the country needed a more resilient macroeconomic framework.

In sum, the second half of the 1990-1997 period started with an ambitious platform. Most of the microeconomic reforms progressed, generating effects that would become visible in the next several years. However, the support for the reform strategy ebbed, slowing the reform

economy is the only system for the country to become developed. (Latinobarómetro, 2003)

¹³ Most evaluations of the reserve requirement in Chile show success in the first period by allowing some monetary policy independence and shifting the composition of capital inflows to long-term, but the effectiveness of controls tended to erode over time, despite the amendments introduced to close some loopholes. See De Gregorio, Edwards and Valdés (2000).

pace, particularly in social sectors. The disputes within the ruling coalition fragmented decision-making and reduced the government's degree of maneuverability to enact the needed policy changes. In addition, the macroeconomic policy scheme had less flexibility than in the early 90s.

3.4 Shocks and slowdown: 1998-2001

As said, in 1997 the economy was still on a path of continuous growth, low unemployment, and reduced inflation. The consequences of the political disputes on the reform agenda were not visible as yet, although some of the troubles that emerged after the Asian crisis were incubating and would become manifest in the reaction to the new scenario. In the economic sphere, the policy framework —although with less resilience— had the capacity to deliver a more than reasonable performance.

The reaction to the December 1997 parliamentary election was a tipping point for signaling that something was not running properly in the political sphere. The second negative shock —this one completely exogenous— would arrive in early 1998 as the Asian crisis hit most emerging economies. These two events marked a new period in which the pace of reforms slowed to a crawl.

The most controversial aspect of the December 1997 parliamentary election was an unexpected reduction in electoral participation and a considerable increase in null and blank votes. Only 60% of eligible voters cast valid votes, down from 65% in 1996 and 76% in 1993. Intriguingly, the split of votes between the government and the opposition did not change much from the 1996 Municipal election.

Two hypotheses competed to explain the participation puzzle. One viewed it as a warning against market-oriented policies. The other saw it as a phenomenon without a clear relation to government policies¹⁴. At first, most opinions within the ruling coalition leaned towards the first hypothesis. In particular, political parties blamed the electoral result on structural reforms of the past decade —however tenuous the connection may be— and called for more social spending, despite the 8.5% annual growth in the previous 7 years. The coalition

¹⁴ For example, there is evidence that voter participation is a positive function of predicted closeness of the election (Shachar and Nalebuff, 1999).

then endorsed an increase in social spending of around US\$450 million, directed to specific areas like pensions, in order to reverse the electoral decline. This proposal did not take into account the volatile scenario created by the emerging market financial crisis.

Over time, detailed analysis of the electoral results concluded that the second hypothesis had more empirical support. Correlation between electoral participation and social conditions like unemployment was almost nonexistent at the local level. Moreover, participation increased again in the next election to 71% in spite of worse social conditions. However, this time the election was a narrow contest and captured the interest of the public.

The bottom line of this episode is that the political parties interpreted the electoral results erroneously because of incomplete evidence. Household confidence in Chile is highly correlated with both GDP growth and the unemployment rate¹⁵. However, this was not correctly perceived at that moment, diminishing the political priority of the reform agenda. What is more relevant, the focus of the policy-making debate was completely disconnected from the incoming news of the Asian crisis.

The second negative shock arrived in early 1998, when the Asian crisis struck most emerging economies. The terms-of-trade drop and contraction of capital inflows sparked a number of speculative attacks on the currency owing to contagion from the series of emerging market crises. As mentioned, the deterioration in the external environment coincided with a strongly expansionary economic cycle due to a foreign-financed boom in private domestic spending and accommodating fiscal and monetary policies. In addition, the Central Bank prevented excessive currency depreciation during speculative attacks, which could have affected inflation expectations with a further decelerating effect on economic activity¹⁶.

The appropriate response to the new conditions was monetary and fiscal restraint, necessary to adjust demand expansion to sustainable levels in view of the external scenario and allow for a real depreciation. However, the 1998 budget was quite expansionary due to a 7% GDP growth projection and the corrective actions were slow, reducing credibility and stressing the needed coordination between fiscal and monetary policy. In this uncertain scenario, the monetary policy framework faced a difficult trade-off between the inflation target and currency

¹⁵ Correlation of households' confidence and GDP growth using Table 1 figures is 0.67, while correlation between households' confidence and unemployment rate is -0.79.

¹⁶ See Morande and Tapia (2002) for an analysis of exchange rate policy in this period.

depreciation, particularly while demand outgrew its sustainable capacity¹⁷.

In assessing the institutional strengths of the economy in these years, it is important to acknowledge the solid banking position, which is essential to prevent contagion from external turmoil. On one hand, non-performing loans as a percentage of total loans increased, within reasonable levels, from around 1% in 1997 to nearly 2% during the slowdown. On the other hand, the risk-adjusted capital-asset ratio rose to well above domestic and international standards. These results reflected strict banking regulation and supervision in Chile that enabled this sector to play an active role in growth recovery.

The response to an international financial crisis require credible and effective policy coordination besides solid institutions, but political constraints and a fragmented policy-decision environment would limit the extent to which this was possible. These events show that exogenous changes continuously challenge the policy-making capacity, but in more resilient societies it takes a shorter period to restore the normal course of action.

Most of the domestic political debate remained rather disconnected from economic events during 1998. In fact, during the first semester, two groups within the ruling coalition engaged in a manifesto confrontation. The first group stressed the positive results of seven years in office and outlined an agenda in that direction, although they also included some amendments. The second group took a rather skeptical view of recent progress, calling for a deeper revision of economic policy. It is unnecessary to say that this was the wrong moment for an inflammatory debate between the most influential leaders of the government coalition. There are some similarities between this disagreement and the dispute period of 1984-1985 as in both cases a division within the ruling coalition became visible.

Consequently, after 1997 a sequence of adverse events led to a pause in structural reforms. The political split in the government coalition and the external economic shocks put the transformation process in a vicious circle that was difficult to break.

¹⁷ Corbo and Tessada (2003) develop a short-term macroeconomic model showing that the Central Bank's inflationary concern was beyond what was needed to only respond to the Russian crisis, in August 1998.

3.5 Restoring a reform agenda: 2002-2004

After the Asian crisis, the external scenario for Chile remained gloomy. The second semester of 1999 witnessed some recovery of domestic activity that did not last. The Brazilian crisis in early 1999 exposed the vulnerabilities of Latin American economies to the financial market, increasing sovereign risk throughout the region. Around mid-2000, U.S. stock prices started to fall and monetary policy tightened. The U.S. economic growth slowed markedly in the second half of 2000 and fell into a short recession in 2001 that affected world trade and most emerging economies. The Argentina crisis in 2001 further damaged the external scenario, and the default on its debt and the peso devaluation in December of that year extended this situation to most of 2002. Also, terrorist attacks on the United States in September 2001 seriously disrupted expectations towards the year's end, while the global consequences became a major factor influencing international markets. In synthesis, the external environment did not contribute positively to reactivate the reform agenda.

A scenario as adverse as this one was not on the radar of the new government. To the contrary, the recovery during the second half of 1999 was projected forward, anticipating a growth scenario that would enable the new government, which took office in March 2000, to finance an ambitious social program. However, the extent of these reforms heavily depended on the resources coming from growth. Without that growth, the social agenda had little chance to capture the needed support.

It took almost two years to delineate a new reform agenda and another year to see results in GDP growth and unemployment reduction. Two factors that facilitated refreshing the agenda were the strong institutions of economic governance and a broadened effort towards consensus beyond the coalition. Two institutions playing a decisive role were the independent Central Bank and the government, which had substantial authority to conduct fiscal policy. However, it is also important to mention the decisive influence of the Executive on the structure of the legislative agenda. Regarding the supporting alliances for the new agenda, the most remarkable phenomenon was the incorporation of such new actors into constructive consensus building as business organizations, NGOs, and opposition parties. This strategy established the conditions needed to break the vicious circle and prepare the country to make the most of the improved external environment since mid-2003.

Three topics had a crucial role in the new reform agenda. First was a focus on upgrading the country's macroeconomic resilience to the new sources of international financial volatility, such as contagion and external shocks. This led to a renewed macroeconomic policy framework, with improved coordination between monetary and fiscal policies, and enhanced credibility. Second, microeconomic reforms were back at the center of the agenda, due to the convincing persuasion by business organizations. Third, a state reform was possible after a broad agreement with the opposition. Each of these initiatives escaped from the incubating fragmentation in the policy-decision environment.

The reform of macroeconomic resilience started with the Central Bank's decision in September 1999 to abandon the exchange rate band and adopt a floating regime. This was a strategic move in advance of additional external turmoil, including Argentina's crisis of 2001. In two years, the currency depreciated more than 40%, peaking in October 2001. Furthermore, the capital account was fully opened, as international financial integration was considered one of the key elements for improving resilience. An inflation-targeting scheme, high standards of monetary policy transparency, and improved accountability mechanisms completed this approach in 2000¹⁸. Therefore, by late 2000, the Central Bank had substantially updated its policies and regained credibility. This sequence shows that reforms can commence within the institutions of economic governance and later obtain the necessary public endorsement.

The second step in the reform was the fiscal rule of a 1% structural surplus. In the case of Chile, the structural balance is defined as revenues minus expenditures if GDP were equal to potential and the copper price equal to its medium-term trend. The idea is to set the fiscal policy stance exclusive of the cyclical effect of domestic activity and the short-term variability of the copper price. The new rule started in 2001 and has been achieved since then, increasing policy credibility and making it possible to apply a counter-cyclical fiscal policy.

The rule-based approach to macroeconomic management has increased the transparency of fiscal accounts and facilitated institutional coordination between the government and the Central Bank. This shows that if objectives are defined clearly, more effective policies are the result. Drazen (2001) observes that deficit reductions usually signal that discord within the government has come to an end and that a period of political stability is to follow. As expected,

¹⁸ See Massad (2003) for a detailed analysis of Central Bank's policies in these years.

since mid-2002 domestic demand has been expanding due to a low interest rate and counter-cyclical fiscal policy. Also, increased credibility in the macroeconomic framework reduced Chile's sovereign spread, further stimulating domestic activity.

As mentioned, this framework of macroeconomic policy was possible because of institutional reforms accomplished in the 1970s and 1980s. The new fiscal rule utilized the reform enacted in the late 1970s, which introduced a centralized budget administration. The rule ended the chronic fiscal deficit since the late 1930s, which had caused economic instability for several decades. The new scheme gave the Executive exclusive powers over initiatives involving increases in spending or changes to public revenues.

In addition, without Central Bank independence it would have been very difficult to renew the monetary policy framework. After the Asian crisis, the Central Bank was seriously questioned, since the most visible factor behind the economic slowdown was the interest rate hike of 1998. However, in 10 years of independence the Bank had accumulated enough strength to react by enhancing macroeconomic resilience and restoring its credibility.

The microeconomic reform aimed at bolstering economic growth was proposed by the business sector at the end of 2001. So far, the business organizations had mostly reacted to government initiatives, but this time they took a leading role¹⁹. The government saw this initiative as an opportunity to overcome fragmentation and delineate policies for a number of sectors. Therefore, a formal agreement was signed in early 2002, shifting the policy debate to the microeconomic terrain. This agreement probably hints at a change for future policy initiatives, as political parties are no longer the exclusive intermediaries for public policy and will share the stage with the private sector and civic society organization. This agenda included initiatives to cut red tape and bureaucracy in the public sector, amend several regulation laws, such as fisheries, financial services and electricity, negotiate international agreements to avoid double taxation, and establish independent tax and competition courts.

In addition to progress on the microeconomic agenda, economic prospects received a boost from the FTA with the EU in 2002 and with the US in 2003. Hence, these agreements consolidated the microeconomic agenda of returning to the transformation path. This time, the interplay between policies, institutions, and consensus reinforced each other, pushing in the

reform direction.

The third transformation accomplished in this period was state reform, particularly in political financing and the hiring of public managers. Although there are several institutional weaknesses in the public sector, these proposals obtained political endorsement because independent NGOs had spent considerable time in their preparation. In January 2003, amidst severe political and judicial questioning of dubious administrative measures within the government, the two political coalitions promptly reached an agreement.

Hiring public managers was to be based on an independent technical filter to prepare the short-lists submitted for the President's final decision. Thus, discretionary appointments fell from 3,110 to about 600 government positions. Independence in preparing each short-list would be obtained through a senior public management board. This is an independent agency headed by a five-member board, four of whom are appointed by the Senate, while the President of the Republic directly appoints the fifth. The appointees serve a six-year term.

Beyond these reforms, the most important initiatives to boost governance capacity are the prevention of excessive fragmentation and the use of scientific evidence in policy decisions. In Chile, there is a growing tendency to evaluate policy results, but they frequently utilize spending or inputs as a replacement for outputs, which give no guarantee of efficiency or effectiveness. Also, evaluations are not always public. However, even admitting its deficiencies, this state reform agenda has helped end the vicious circle of disappointment after the Asian crisis and restore confidence. The fact that parties are taking economic development seriously is a positive indication for future consensus and institution building, hinting that sustained economic growth is possible.

4. Concluding Remarks

Chile has undergone profound economic, social and political changes over the past two decades, marked by fast growth and impressive poverty alleviation. The main message of this paper is that when policies, institutions, and reasonable consensus operate in a coherent environment, sustained progress follows. If one of these factors fails, the probability of running

¹⁹ Several technical studies, authored by a wide range of experts, served as background for the negotiation

off the growth path increases. This conclusion differs from the naïve hypothesis that a set of well thought-out structural policies or an appropriate institutional design is enough in and of itself to generate good economic performance, without regard to the interplay with the other factors.

This view demands a balanced agenda that simultaneously strengthens three spheres: policy reforms, institutions, and reasonable consensus. The effectiveness of each of these factors depends on the state of the other. From this analysis, five recommendations arise.

First, future economic and social progress in Chile requires new reforms. Health, education, poverty, labor market, and microeconomic policy are high priorities (OCDE, 2003). The challenge for policy-makers is to maintain a reform agenda for current international and domestic conditions. However, as mentioned, it would be naïve to think that further transformation is a matter of technical design alone. Only strengthening governance through institution and consensus building conveys the potential to avoid excessive fragmentation in policy decisions and continue exploring new reform opportunities.

Second, institution building does not result automatically from growth but from reforms that must be sustained over time. The most relevant institutional challenge in Chile is to strengthen the quality of the policy-making process. This means avoiding an excessively fragmented decision environment and employing empirical evidence as the main source of policy legitimacy. Future reforms need to consider increasing the independence of economic governance, which implies reducing political bargaining in economic policy and taking up a rule-based approach. Frequently, policy reforms commence within the institutional sphere, even under a weak government, and gather public support only when results are visible. In this sense, the idea that consensus always precedes reform is an oversimplification of a more complex interplay. The better course requires an emphasis on institutional accountability, public reporting, and the transparency of the decision making process. This should be a democratic rather than a technocratic route to improving governance.

Third, this approach requires enhancing the capacities of the Congress and executive branch agencies to evaluate and formulate policies. High-performing institutions require systematic policy evaluation, informed deliberation, greater transparency, and clear objectives.

of this agenda.

The process of trial and error should be open to the public. In addition, professionalizing public agencies, including the legislature advisory capacity, is an indispensable component of this approach. This calls for a strengthening of technical skills and the use of tools such as working papers, technical reports, policy briefs, seminars, and public conferences.

Fourth, the public policy debate that produces political consensus for policy reforms should acknowledge the complexity and plurality of the current society. This process is already underway, as political parties have to share the public stage with well-prepared organizations of the private sector and civic society. The new stage for consensus building is more exposed to public scrutiny, requires rigorous technical preparation, and is constantly confronted with empirical evidence. This is producing a tougher environment for political parties, which will probably try to resist, thereby avoiding new competition on ideas and proposals. However, this trend is a healthy stimulus for better policies.

Fifth, the interplay between policies, institutions, and reasonable consensus is far from linear. Some policies may originate in institutions with consensus following in a later stage. Other policies need to start with a basic consensus. There are neither definite rules nor unique sequences for the generation of reforms. Instead, the Chilean experience shows the benefits of a pragmatic approach –specific to each country– that uses existing opportunities to push reforms forward. This requires new leadership capacities generous in networking, dialogue, negotiation, and consensus formation among political and societal leaders. The approach should be open and transparent. This new pragmatism contrasts with the tendency of Latin American countries to dream up new development paths without the discipline to critically assess their consequences.

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