Université de Montréal

Not Again
The Fear Factor in Policy Complementarity

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Résumé

Cette étude revisite la question de la gouvernance concernant la politique économique. Les agents au sein de l'économie politique cherchent à produire la stabilité politico-économique à travers la création de complémentarités institutionnelles. C'est le cas lors de moments de reconfiguration de la politique économique alors que ces changements défient des intérêts établis. La complémentarité institutionnelle est comprise comme une situation dans laquelle une institution profite de la présence d'une autre institution afin de remplir son rôle structurant dans l'économie politique. Nous démontrons que la gouvernance économique est crucialement affectée par la crainte de répéter des traumatismes institutionnels passées qui ont perturbé la stabilité économique et politique et les routines des processus des politiques publiques. L'hypothèse est que la menace de reproduire les conditions des traumatismes institutionnels passés conduit les acteurs à mettre en œuvre des réformes institutionnelles qui s'appuient sur la présence d'autres institutions afin de structurer la stabilité de l'économie politique, c'est à dire qu'ils créent des complémentarités institutionnelles.

Cette thèse examine trois cas de processus de libéralisation en Amérique Latine ; le Brésil, le Chili, et le Mexique. Ces pays ont connu des crises économiques profondes dans les années 1980, en partie comme conséquence de la disparition définitive du modèle précédent. Ensuite, les trois pays ont mis en œuvre des réformes de libéralisation dans les décennies qui ont suivi. Dans les processus des réformes, la menace de l'instabilité est apparue dans ces trois pays avec une intensité différente. Lorsque la menace était imminente, la complémentarité institutionnelle était consolidée, alors que lorsqu'elle a disparu, aucune complémentarité institutionnelle n'a été effectivement constituée. La méthodologie utilisée est une comparaison croisée d'études de cas qui emploiera le traçage de processus visant l'élaboration d'une théorie puisque ceci est suggéré lorsque les causes menant à un résultat donné ne sont pas connues, mais qui peuvent être généralisées par la suite. Bien que le concept de complémentarités institutionnelles ait été largement utilisé en économie politique comparée, peu d'études ont été faites pour comprendre les raisons pour lesquelles elles sont créées.

Mots-clés : Complémentarité institutionnelle, Amérique latine, gouvernance économique, peur.

Abstract

This study revisits the question of governance regarding economic policy. Agents within the political economy will seek to produce political-economic stability through the creation of institutional complementarities. This is specially the case in moments of reconfiguration of economic policy when such changes challenge significant vested interests. Institutional complementarity is understood as the situation in which one institution takes advantage of other institution's presence to fulfill its structuring role in the political economy. We demonstrate that economic governance is crucially affected by the fear of repeating past institutional traumas that disrupted economic and political stability and policymaking routines. The central hypothesis is that the threat of reproducing the conditions of past institutional traumas leads actors to carry institutional reforms that take advantage of other institutions' presence to structure stability in the political economy, that is, they create institutional complementarities.

The dissertation examines three cases of liberalization processes in Latin America: Brazil, Chile, and Mexico. These countries suffered profound economic crises in the 1980s partially as a consequence of a final demise of the previous model. Subsequently all implemented liberalizing reforms for the next decades. In the process of reform, the threat of instability appeared in those countries with a different intensity. When the threat was imminent the institutional complementarity consolidated, whereas when it disappeared no institutional complementarity was effectively constituted. The methodology used is a cross-comparison of case studies within which theory-building process tracing will be used in so far as this method is used when we do not know the causes leading to a given outcome, which in turn can be generalizable. While the concept of institutional complementarities has been used extensively in comparative political economy, not much has been done yet to understand why in some cases institutional complementarities appear, yet not in others.

Keywords : Institutional complementarities, Latin America, Economic governance, fear.

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List of Abbreviations

AFP – Administradoras de Fondos de Pensiones (Chile)

AMLO – Andrés Manuel López Obrador

ARENA – Aliança de Renovação Nacional (Brazil)

Banamex – Banco Nacional de México

Banxico – Banco de México

BNDE(S) – Banco Nacional de Desenvolvimento Econômico e Social (Brazil)

BNDESPAR – BNDES Participações (Brazil)

BRL – Brazilian Real

CANAEMPU – Caja Nacional de Empleados Públicos y Periodistas (Chile)

CEO – Chief Executive Officer

CIEPLAN – Corporación de Investigaciones Económicas para América Latina (Chile)

CLP – Chilean Peso

CME – Coordinated Market Economies

CNC – Confederación Nacional Campesina (Mexico)

CODELCO – Corporación del Cobre de Chile

CORFO – Corporación de Fomento de la Producción (Chile)

CPI – Comisão Parlamentar de Inquérito (Brazil)

CPIn – Consumer Price Index (Chile)

CPMI – Comissão Parlamentar Mista de Inquérito (Brazil)

CSN – Companhia Siderúrgica Nacional (Brazil)

CTM – Confederación de Trabajadores Mexicanos

CVRD – Companhia Vale do Rio Doce (Brazil)

DC – Democracia Cristiana (Chile)

Diprés – Dirección Nacional de Presupuesto (Chile)

ECLA – Economic Commission for Latin America

EMPART – Caja de Previsión de Empleados Particulares (Chile)

ENAP – Empresa Nacional de Petróleo (Chile)

EPN – Enrique Peña Nieto (Mexico)

FAT – Fundo de Amparo ao Trabalhador (Brazil)

FSE – Fundo Social de Emergência (Brazil)

GATT – General Agreement on Trade and Tariffs

GDP – Gross Domestic Product

GNP – Gross National Product

HME – Hierarchical Market Economies

IBGE – Instituto Brasileiro de Geografia e Estatística (Brazil)

IBRD – International Bank for Reconstruction and Development (The World Bank)

IGPA - Índice General de Precios de las Acciones de la Bolsa de Comercio de Santiago (Chile)

ILO – International Labour Organization

IMF – International Monetary Fund

INEGI – Instituto Nacional de Estadística Geografía e Informática (Mexico)

IPCA – Índice de Preços ao Consumidor Amplo (Brazil)

ISI – Import Substitution Industrialization

ITAM – Instituto Tecnológico Autónomo de México

IUPERJ – Instituto Universitário de Pesquisas do Rio de Janeiro (Brazil)

LME – Liberal Market Economies

Mercosur – Mercado Común del Sur

MNC – Multinational Corporations

Morena – Movimiento de Renovación Nacional (Mexico)

MXN – Mexican Peso

n.d. – No data

NAFTA – North American Free Trade Agreement

ODEPLAN – Oficina de Planificación Nacional (Chile)

OECD – Organization for Economic Co-Operation and Development

ORTN – Obrigações Reajustáveis do Tesouro Nacional (Brazil)

PAN – Partido Acción Nacional (Mexico)

PAYG – Pay-As-You-Go

PDS – Partido Democrático Social (Brazil)

PEMEX – Petróleos Mexicanos S.A.

Petrobrás – Petróleo Brasileiro S.A.

PMDB – Partido Movimento Democrático Brasileiro (Brazil)

PND – Programa Nacional de Desestatização (Brazil)

PPD – Partido por la Democracia (Chile)

PPI – Producer Price Index (Chile)

PRD – Partido de la Revolución Democrática (Mexico)

PRI – Partido Revolucionario Institucional (Mexico)

PROER – Programa de Estímulo à Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional (Brazil)

PROES – Programa de Incentivo à Redução do Setor Público Estadual na Atividade Bancária (Brazil)

PRSD – Partido Radical Social-Demócrata (Chile)

PS – Partido Socialista (Chile)

PSDB – Partido da Social Democracia Brasileira (Brazil)

PT – Partido dos Trabalhadores (Brazil)

PUC/RJ – Pontifícia Universidade Católica do Rio de Janeiro (Brazil)

R&D – Research and Development

RER – Observed Real Exchange Rate Index (Chile)

SAFP – Superintendencia de Administradoras de Fondos de Pensiones (Chile)

SBIF – Superintendencia de Bancos e Instituciones Financieras (Chile)

SHCP – Secretaría de Hacienda y Crédito Público (Mexico)

SIDERBRAS – Siderurgia Brasileira

SINAP – Sistema Nacional de Ahorro y Préstamo (Chile)

SITC – Standard International Trade Classification

SNTE – Sindicato Nacional de Trabajadores de la Educación (Mexico)

SP – Superintendencia de Pensiones (Chile)

SSS – Servicio de Seguridad Social (Chile)

STN – Secretaria do Tesouro Nacional (Brazil)

TINA – There Is No Alternative

URV – Unidade Real de Valor (Brazil)

US – United States of America

USD – United States' dollars

USIMINAS – Usinas Siderúrgicas de Minas Gerais (Brazil)

VaR – Value at Risk

WWII – World War II

A mi papá

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Introduction

This study revisits the concept of governance in relation to economic policy.[1] Because governance "measures the capacity of the state to implement policy, to act within a set of predictable rules, and *to maintain order*" (Faucher 1999, 105 emphasis added), agents within the political economy seek to produce political-economic stability through the creation of institutional complementarities. This happens specially during moments of reconfiguration of economic policy when such changes challenge significant vested interests. Institutional complementarity is understood as the situation in which one institution takes advantage of other institutions to fulfill its structuring role. On this issue, Hall and Soskice (2001b) argue that complementarity is the outcome of reinforcing incentives in different arenas of the political economy. Aoki (1994, 2000, 2001) proposes the existence of a market for institutions where the consolidation of one institution increases the demand for others that might help sustain it; Crouch (2010, 124), in turn, asserts that actors seek available institutions within the political economy to produce stability.

In this dissertation I demonstrate that economic governance is significantly affected by the decision-makers' fear of repeating past traumas that disrupted economic and political stability and policymaking routines. The central hypothesis is that the threat of reproducing the conditions of past traumas leads actors to carry out and enforce institutional reforms that take advantage of the presence of other institutions to structure a sense of stability in the political economy, that is, creating institutional complementarities. Furthermore, if the threat is ambiguous, the resulting institutional complementarity will also be ambiguous as the structuring role of the belonging institutions depends only partially on the presence of each other. Finally, if the threat disappears there is no need for institutional complementarity, as the structuring role of institutions does not depend on each other's presence.

The dissertation examines three cases associated with liberalization processes: Brazil, Chile, and Mexico. These countries suffered profound economic crises in the 1980s partially

[1] By governance we mean "the degree to which power holders manage to make decisions, have them accepted by (or imposed on) all actors concerned, and implement them through established routines." (Faucher 1999, 129).

as a consequence of the final demise of the previous model. Subsequently all implemented market reforms during the following decades. In the process of reform, the threat of instability appeared in those countries with a different intensity. When the threat was perceived as serious, the institutional complementarity consolidated, whereas when this was not the case no institutional complementarity was constituted. The methodology consists of a cross-comparison of case studies within which theory-building process tracing will be used, insofar as this method is used when we do not know the causes leading to a given outcome, which in turn can be generalizable (Beach and Pedersen 2013, 16-18). While the concept of institutional complementarities has been used extensively in comparative political economy (Hall and Soskice 2001b, Boyer 2004, Amable 2000, 2005, Crouch et al. 2005), not much has been done to understand why in some individual cases institutional complementarities appear, but not in others.

This dissertation also explains how the possible disruptions in economic governance, and their subsequent politically-motivated use in policymaking, lead to the constitution of institutional complementarities. The dissertation further seeks to join the institutional foundations of capitalism with the governance arrangements that provide for the necessary stability for its reproduction. Institutional complementarities and the way they are built through independent reforms complete the consolidation of stable patterns of governance. By institutional complementarity, we mean the instance in which the presence of one institution is necessary for other institutions to fulfill their role within the political economy. To this effect, it is worth recalling that institutions are "sets of regularized practices with a rule-like quality, [that] structure the behaviour of political and economic actors" (Hall 2010, 204). Therefore, complementarity occurs when one institution needs another to survive.

Therefore, institutions structure the role of actors within the political economy, which means that actors abide by the rules, or rule-like practices. Thus, the structuring role played by institutions refers to the fact that actors behave according to the precepts implied by institutions. In this sense, institutional complementarity as it is proposed in the present study entails the notion that some institutions need the presence of another institution for them to continuously being accepted by agents; therefore, complementarity indicates that actors abide by two institutions simultaneously. Moreover, as Mahoney and Thelen (2010, 10-14) suggest, compliance with institutions is important to understand institutional change insofar as actors might try to transform them if they consider that they do not fit their interests. Then, complementarity points to the need of some actors to keep two institutions in place because they fear the consequences of their demise.

The question of complementarity between institutions or policies is interesting for at least two reasons. First, this idea has been at the core of some explanations as to why capitalism is organized differently around the world despite the fact that neoclassical economics, the main theory of the behaviour of agents or firms in the market, considers, with all its suppositions and results, that such organizational features are the only way to organize capitalism. The fact that different institutional configurations exist in equally well-performing economies has led scholars to use complementarity as an explanation for that outcome. This verification also implies that institutional convergence is very unlikely, and if it happens at all, it will not produce good results. Institutional complementarities are thus at the core of the analyses about models of capitalism. The second reason stands for the fact that economic policies, some of which are enshrined in institutions, should be understood as a whole set because their effects tend to be systemic. Economic policies are affected by other policies implemented simultaneously. Therefore, this study also sheds light on these concerns, since it explains how different economic policies might rely on each other to exist. This further implies that presently, despite claims in that sense, there are different economic policies, rather than a unified corpus of interventions.

The contribution of the present study to the understanding of institutional complementarity is divided in two main aspects. First, this dissertation presents a definition of institutional complementarity that does not depend on a performance criterion, as has been traditionally the case in the literature on comparative capitalisms. Second, with that definition it tests the hypothesis of the level of fear as a factor leading to the consolidation of institutional complementarities in the context of economies that are rebuilding their patterns of economic governance. The first contribution seeks to offer a possibility to the confusing terms in which the debate has taken place so far. It suggests that different senses of the concept arise of a diversity of interpretations of the empirical record of advanced capitalisms. This clarification is important insofar as the focus of the complementarity debate (Crouch et al.

2005, Crouch 2010) on these interpretations has rendered it less useful to the study of political economy.

The second contribution concerns directly the hypothesis offered about the level of fear as a factor that leads to the consolidation of institutional complementarities. Such contribution is important because the different explanations offered by the literature on comparative capitalisms, complementarities as unintended consequences of processes of incremental institutional change (Schneider 2013, 192-193), or as the strategic creation of rational actors that have stakes in different institutions in the political economy (Hall 2010, 212-214), or as the result of a market for institutions (Crouch 2010, 124), have been far less precise than the model offered by this dissertation. Even if such explanations for the consolidation of institutional complementarities offer important insights about them, their direct operationalization is not as satisfactory. The dissertation offers a more concrete explanation that underscores to what extent the fear of repeating past crisis pushes actors to consolidate institutional complementarities.

This study also shows the importance of complementary institutions for economic governance. Since institutional complementarities have been used as explanations for the persistence of good performance of advanced capitalist economies other analytical possibilities have been downplayed. The focus on the organization of capitalism reprises an often-neglected sense of the concept. However, the sense of organization of capitalist economies offers to scholars interested in political economy the possibility to understand why institutional arrangements have been resilient in the face of deliberate attempts to change them. Any future reform, thus, should account for this side of the institutions in place rather than emphasizing the inappropriateness of current arrangements since institutions come rarely as *tabula rasa*. These interactions are essential for any efforts of reform to succeed; both scholars and policymakers should pay attention to them.

The first chapter begins with a presentation of the concept of economic governance and the effect it has in understanding the relation between the implementation of economic policies and the existence of an order within the political economy. Subsequently, I discuss different theories that examine the socio-political relations underlying capitalism, because these constitute an order within political economies. These socio-political relations are entrenched in institutions that represent rules and procedures that structure the agents' behaviour. The latter can, in turn, model this behaviour according to their interests. Consequently, the theories that consider capitalism as a set of socio-political relations will be presented, and this work is divided between the theories that focus on the advanced capitalist economies, and those that focus on Latin American capitalism. These theories use the concept of institutional complementarities as an independent variable to explain macroeconomic outcome; in a sense, they imply that institutional organization determines economic performance.

I will discuss institutional complementarities in the second chapter. As such, this dissertation proposes a model that explains the reason behind their constitution, which means that, in contrast to the theories that examine socio-political relations of capitalism, it considers institutional complementarities as the dependent variable. In essence, actors within the political economy seek to create stability and maintain order, and by doing so, they mobilize their resources to create the necessary conditions for that order. These conditions are provided through the constitution of institutional complementarities, because they imply a strong relationship between two or more institutions, making it more difficult to create disruption. The hypothesis proposed is that the element that pushes actors to constitute an institutional complementarity is precisely the fear that previous institutional disruptions could reoccur, which in turn leads actors to link institutions to each other in the attempt to produce political-economic stability.

The empirical chapters on Brazil, Chile, and Mexico show how the fear of previous institutional disruptions mobilized actors to enact and enforce institutional reforms. Such reforms, carried incrementally, sought to create a new order by establishing a new set of policymaking routines. These institutional reforms represented the creation of a new political-economic order; however, when such order was threatened, multiple institutions were tied to each other in the attempt to consolidate the new governance arrangements. In Brazil, the reforms sought to liberate the state of the responsibilities that it had developed, which led to hyperinflation. In Chile, the reforms created new markets for pensions and securities; nonetheless the shadow of a return to a troubled past remained, including a socialist government, the military that staged a coup, and a deep economic crisis created by market fundamentalism. Finally, in Mexico, the reforms sought to reduce the political discretion of economic policymaking of the president, that depending on the person in the post, could be considered to be a problematic populist leader.

Chapter 1. What is Variety? Socio-Political Relations of Advanced and Latin American Capitalisms

Economic governance refers to the ability of policymakers to implement policies and enforce them through established means. The existence of such routines provides stability to the political economy, insofar as other agents can act according to them, which in turn is essential for growth. Routines maintain order within political economies as they establish an expected decision-making structure. Governance thus refers to ways of producing rules through the interaction between actors, both public and private (Héritier and Rhodes 2011, 164). Therefore, economic governance is concerned with the elaboration of rules in the economic arena through the interaction of different actors.[2] As van-Waarden (2012, 356) argues, the creation of trust among market participants is essential to the governance of those markets. Consequently, when uncertainties are reduced by the creation of routines and procedures, economic governance is assured, and thus so is stability.

Furthermore, breeding trust creates stability since market participants have the proper incentives to engage repeatedly in similar interactions. Governance assures that actors can plan their strategies according to established routines and procedures. In sum, a high degree of governance creates stability, which means that the political economy constitutes a predictable environment; thus, institutional complementarities are an essential part of it since they imply a mutual dependence on the existence of multiple institutions. In Latin America, the economic crisis that affected the region in the early 1980s broke the prevailing established routines. The conditions within which the economic policy was conducted for nearly half a century came to an end. This was in fact a generalized situation of capitalist economies, as the world's economy at large underwent intense changes at that time; changes to which previous governance arrangements could not respond. However, the persistence of the same kind of

[2] Centeno and Cohen (2010, 120) propose that "*Economic governance* refers to the formal and de facto rules that politics and governments impose on other actors' economic activities, and how the state uses its capacities and resources to shape economic life". Italics in the original.

strategies by many governments in the region reinforced the pervasive consequences of the changing parameters of the international economy.

The profound changes within the international political economy that took place in the 1970s and the debt crisis of the early 1980s had overwhelming consequences for the region. Adaptation to such changes required substantial reforms. During the 1990s, different speeds of reform did not obscure the fact that each country was going through its own process of change towards market openness. The sense of a common fate was largely shared as markets played an increasingly important role in the allocation of resources (Williamson 1990). Nevertheless, explanations for the wave of liberalization across Latin America were varied.[3] At the turn of the century, this common pattern began to disappear when several countries leaned towards the left, while others did not alter their path.

In many ways, the process of liberalization sought to re-establish economic governance throughout the region. New routines and procedures were created in order to adapt to an economic order that did not enable previous ones to work as they used to. Order had to be re-established and, in order to do so, interests that were traditionally served by previous governance arrangements had to be challenged and, eventually, defeated. These political struggles were thus encapsulated within a new set of institutions that structured agents' behaviour, ultimately creating a new order, and new routines were established.[4] Nevertheless, in order to consolidate a pattern and create a sufficiently stable environment, these institutions

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[3] Among important factors considered by the literature on liberalization are transnational policy networks (Teichman 2001), the influence of international financial organizations (Dobbin, Simmons, and Garrett 2007), the increasing importance of finance at the global level (Maxfield 1997) and, most prominently, the role of the technocrats in charge of such changes (Domínguez 1997). These were among the factors that pushed Latin American countries in the direction of liberalization in different sectors. For a combination of economic, ideological, and state-society relations, see Fourcade-Gourinchas and Sarah L. Babb (2002).

[4] Three different types of new institutionalism appeared in the 1980s, each one stemming from different scholarly traditions. The difference can be appreciated when the definition of what is an institution is analyzed according to each tradition. First, in the case of historical institutionalism: institutions are "formal or informal procedures, routines, norms and conventions embedded in the organizational structure of the polity or political economy" (Hall and Taylor 1996, 938). The second tradition, rational choice institutionalism, has a less complex definition. Institutions are "humanly devised constraints that shape human interaction" (North 1990, 3) but can also be conceived of as working rules organizing information about decisions as well as the payoff matrix derived from such decisions (Ostrom 1990, 51). The last tradition is that of sociological institutionalism in which institutions are "not just formal rules, procedures or norms, but the symbol systems, cognitive scripts, and moral templates that provide the 'frames of meaning' guiding human action" (Hall and Taylor 1996, 947).

needed to avoid a re-edition of past political-economic crises. The way to do this was to be linked to other available institutions in order to guarantee stability.

As economic sociologists remind us, political-economic stability is crucial for the proper working of the market, and for profit-making (Fligstein 2001, Halliday and Carruthers 2009). Therefore, a proper degree of economic governance is among the primary necessary conditions for the creation and maintenance of such stability. Since institutional arrangements can be questioned or jeopardized by agents' behaviour, which can in turn lead to unstable conditions, actors within the political economies must try to assure that the institutions that are crucial for their interests continue to fulfill such a role. This is specifically the case when institutions face the threat of an already proven factor of disruption. Therefore, when governance - understood as the capacity to act within predictable rules and the maintenance of order - is disrupted by the threat of an event that leads to disorder and unpredictable conditions, actors will try to prevent the consequences of such an event.

Institutions are an essential part of economic governance since they are "sets of regularized practices with a rule-like quality [that] structure the behaviour of political and economic actors" (Hall 2010, 204). Thus, by their very nature, institutions play an important role in the organization of political economies, and in the provision of stability.[5] Furthermore, institutions do not operate in a void, that is, they exist along other institutions, which leads actors to use each institution strategically. If an institution in particular serves the purpose of advancing the interest of a given group, such a group will try to exploit it to the fullest, while trying to downplay those institutions that might affect it.[6] This strategy can be extended to a

[5] "Institutionalization is the process by which organizations and procedures acquire value and stability" (Huntington 2006, 12).

[6] Whereas for rational choice institutionalism, politics is largely a matter of collective action dilemmas that have to be solved through the coordination of involved actors (Ostrom 1990, North 1990), for sociological institutionalism and historical institutionalism the world is full of institutions, with politics being the interplay of different agents with the currently existing institutions. For sociological institutionalism, the way in which actors perceive the world is mediated directly by institutions, insofar as these are part of the templates through which the world is seen (March and Olsen 1989). For historical institutionalism, the political world involves the power struggles between agents whose preferences are entrenched in institutions against some other agents trying to change these preferences. Nevertheless, historical institutionalism emphasizes the unintended consequences of institutions (Pierson 1993, 2004, Thelen 2004). That is, institutions might not serve the purpose they were supposed to; this gap between the creation and later working of institutions is at the core of the political and conflictive character of these.
The classification offered by Hall and Taylor (1996) has been admittedly the most influential in political science; however, it is by no means the only one. Other accounts are offered by Thelen (1999) and Peters (2005). The

set of institutions rather than a single one, if the combination proves to be important for the group in question. Then, an institution can be affected by the existence of another institution, which implies that governance can also be enhanced when actors use numerous institutions simultaneously.

Economic governance in capitalist economies goes hand in hand with the existence of institutions that structure the interaction between different agents. Stability and order, which are at the center of economic governance, tend to exist when actors build sets of institutions that insure them. Therefore, as Crouch (2010, 124) argues, actors build institutional complementarities to build stability; this, in turn, buttresses the order of the economy and consequently the correspondent degree of governance. Thus, institutional complementarities are yet another element of economic governance. Because institutional complementarities appear when one institution depends on other institutions to play its structuring role in the political economy, their constitution tends to forge stability since the rules embodied in both institutions are harder to contest. These stable rules are thus reflected within the different models of capitalism that show similar performance despite the diversity of their institutional arrangements.

Despite certain claims made by international financial institutions concerning benchmarking practices[7] in economic governance (Colaco et al. 1985, Barr et al. 1996, Islam et al. 2002, Bird and Gendron 2007, IMF 2003), there is a substantial body of literature that argues the opposite.[8] The organization of capitalism presents significant variations across

former builds upon the classification offered by Hall and Taylor (1996) adding, however, an element that would be discussed further in subsequent works, that is, the overlap and possible connections between these traditions (Thelen 1999, 379-381). The limits of such efforts are of course the different conceptions of institutions embedded in each tradition. While rational-choice institutionalism sees institutions as efficient equilibriums appearing in the face of collective action dilemmas, historical institutionalism sees institutions as the product of political struggles in which non-Paretto efficient equilibria are always a possible outcome (Thelen 1999, 382, Amable 2005). For the concept of Paretto efficient equilibrium, see Mas-Colell, Whinston, and Green (1995, 312-316).

[7] A difference exists however among international organizations. The International Monetary Fund – IMF is considerably more rigid in its recommendations than the World Bank. Whereas the latter was faster to adapt to challenges, the former showed less flexibility in the face of mounting problems during the 1990s (Woods 2006). However, after the big wave of one-size-fits-all recommendations, there has also been some self-criticism of the IMF concerning structural adjustment programs (Selowsky et al. 2003) and, more recently, on the rigidity in managing debt (Ostry, Loungani, and Furceri 2016).

[8] This literature considers that economic governance does not depend on a series of institutional blueprints but of the political relations between economic actors. The present chapter discusses this literature at length.

countries without necessarily exhibiting the same degree of difference in performance. This realization has led a group of scholars to study the institutional foundations of capitalism, specifically in advanced capitalist societies. The underlying corroboration is that both economic governance and organization of capitalist societies depends on the social arrangements that exist in each of them without jeopardizing performance. Therefore, we should expect to see different types of capitalism, where economic activity is organized and governed differently according to each type. The present chapter will analyze the literature that studies such socio-political relations that organize capitalism and also provides the necessary arrangements for its governance.

An important argument within this body of literature is that fundamental socio-political relations underlying capitalism are related to each other. In essence, the different institutions through which capitalism is organized and governed configure institutional complementarities. Since the latter are essential to the governance arrangements of capitalist economies, studying the way in which they operate in different capitalist societies is important insofar as they constitute the routines that frame interactions among agents. These routines provide a degree of stability based on the predictability it offers to economic agents about the possible course of action that other agents might take. Since the present dissertation seeks to create a link between two different governance arrangements within three big Latin American political economies through the study of the constitution of institutional complementarities, it is crucial to understand how the latter play a role in governance once they are constituted.

In so doing, the argument of the dissertation seeks to show in the first place how these general governance arrangements are organized. Because such arrangements seem to be fitting sets, and have been studied as such,[9] these will be presented in the first place. This characteristic, however, should not obscure the fact that the institutions that make part of these sets were not conceived *a priori* to be part of them. Once the different ways in which such arrangements that codify socio-political relations are explained in this chapter. The next chapter will explore the specificity of institutional complementarities and the implications that each way of studying them has for the understanding of the ways in which actors are in the

[9] This apparent connection between these institution has given the impression of a functionalist argument (Howell 2003). More narrowly, Streeck suggests that any credible study of institutional complementarity and their origins in the absence of a *master designer* in Crouch et al. (2005, 364 emphasis in the original).

position to build these complex sets. As mentioned previously, the hypothesis of this study is that the fear of chaos, and the political consequences this might entail, is what pushes actors to build these complex sets. Therefore, the rest of the chapter will analyze the different theories that study the socio-political relations supporting capitalism both in its advanced versions and in Latin America.

1.1. Capitalist Systems : A Set of Socio-Political Relations

After the capitalist crises of the 1970s and 1980s, there was an increasing preoccupation concerning the causes behind the difference in the industrial performance of the United States and those of Japan and Germany (Amable 2005, 8). This concern evolved in the 1990s with the Asian crisis, as there was more available evidence that institutions did have an impact on economic practices and their performance (Morgan et al. 2010a, 6). Moreover, what has been underlined across the social sciences is a significant variation, mainly in national settings, of the social relations supporting economic activity. Such variations are represented by institutional differences across societies. In parallel, there was the implicit acknowledgement that economic performance could be delivered by a wide array of arrangements rather than a single one. A concept that seems to capture this notion is that of comparative institutional advantage, which describes the possibilities for different economies to excel in a diversity of industries and economic activities (Aoki 1994, 675). However, these realisations contrasted heavily with the dominant wave of liberalization of the 1990s, which seemed to signal a convergence towards a single model (La Porta, Lopez-De-Silanes, and Shleifer 1999).

Furthermore, the studies posited whether if technological progress and globalization are enough to inspire institutional convergence (Hall and Soskice 2001a, 1). Simple convergence towards a benchmark in the face of globalization was unlikely precisely because of the difference in institutional backgrounds that were present in every country, and because such institutions modelled the kinds of interactions that agents might have in each political economy (Hall and Soskice 2001a, 5). This body of literature also built up on perspectives such as the *Théorie de la régulation* (Boyer 1990) and economic sociology (Crouch 2005, Campbell and Pedersen 2001), all of which consider economic activity to be embedded in social relations that vary from society to society. Institutions are what tie the two together, since they not only organize economic activity but are in turn socially conceived and transformed.

This classification contains a fair degree of arbitrariness, not only because there are works that clearly cross established borders (Hollingsworth and Boyer 1997, Boyer 2002-2003), but also because there have been some collaborations and cross-breeding between them, defying the sense of "gated communities" (Crouch et al. 2005, Amable 2005). The impact on the political economy debate has been different, however. The Varieties of Capitalism approach has had an important impact over the years, while the Governance approach makes important points. Besides their different influences, all of them provide important insights on how institutions, and therefore power, have an impact over capitalism. Thus, the following sections will discuss the Varieties of Capitalism approach followed by the *Théorie de la régulation*. Finally, the Governance approach will be presented.

This analysis seeks to establish the ways in which economic governance is effectively enforced through established institutions. These theories, both those concerning advanced capitalism as well as those analyzed in the next section concerning Latin American capitalism, study the institutions that regulate the main interactions of the market within political economies. In the context of this dissertation, these constitute the kind of institutional arrangements that would appear within political economies involved in lengthy processes of reform in the attempt to re-establish economic governance. As mentioned above, this body of work has focused mainly on advanced capitalist societies, which leads us to present it before the same kind of analyses concerning Latin American economies, the region to which the empirical cases belong.

1.1.1 Varieties of Capitalism

Being an actor-centered approach, this framework argues that the main actor is the firm. Firms face strategic choices by taking into consideration other actors both within and outside their own organization. Because choices are the focus of problems such as moral hazard[10] and adverse selection,[11] which cannot be solved through hierarchies, the main problem of the firm is relational insofar as it must coordinate with other actors in order to succeed (Hall and Soskice 2001a, 6). The five spheres in which authors focus their attention are: first, industrial relations, where bargaining over wages and working conditions with employees and other employers represent a considerable challenge in coordination. The second sphere is that of vocational training and education, by which firms retain a workforce with the necessary skills but workers need to invest in the right kind of skills considering both their time and the transferability of those skills (Hall and Soskice 2001a, 7).

Corporate governance is the third sphere, where issues of coordination arise insofar as this is an indicator that investors follow in order to assess the possible return on their investments. This of course is related to the amount of resources a given firm can secure as well as the timeframe with which it has access to them, revealing also the possibilities of the firm's survival (Hall and Soskice 2001a, 7). The fourth sphere is the relationship with suppliers, that is, to have a stable stream of inputs, and with clients, as buyers of outputs. This also refers to competitors (for instance in the establishment of standards in a given product that affects all the companies involved in the production of a given item, both consumers and producers). The final sphere where firms face a coordination problem is vis-à-vis their employees, inasmuch as both the competencies and the sensitive information held by the latter are important both to avoid moral hazard and to retain the returns on in-house training investment (Hall and Soskice 2001a, 7).

Hall and Soskice (2001b) establish a core distinction between two ideal types of coordination present in political economies by which firms organize the abovementioned

[10] It is a part of the principal-agent problem. It arises when the principal is not able to observe how hard his manager, the agent, is working. The term, however, comes from the literature on insurance: an insurance company cannot observe whether the insured takes the necessary steps to prevent a loss. For an in-depth discussion and microeconomic implications, including mathematical derivations, see Mas-Colell, Whinston, and Green (1995, 477-488).

[11] Adverse selection "arises when an informed individual's trading decisions depend on her privately held information in a manner that adversely affects uninformed market participants" (Mas-Colell, Whinston, and Green 1995, 436). The pioneering work on adverse selection is that of Akerlof (1970) concerning the market for used cars where only the owner of the car knows if his car is in good condition or not. For an in-depth discussion and microeconomic implications, including mathematical derivations, see Mas-Colell, Whinston, and Green (1995, 437-450). An easier illustration of the concept of adverse selection is the article appeared in *The Economist* magazine on July 29, 2016, titled "Secrets and Agents."

spheres. First, liberal market economies – LME – rely heavily on markets in order to coordinate their interactions and resemble the model of neoclassical economics. In these economies, publicly available information is essential to investors because these are dispersed and, as a consequence, cannot directly assess the profitability of a given firm. While firms secure the required resources to operate according to this strategy, it can also make them vulnerable to hostile takeovers. Moreover, labour markets are fluid because costs can be downsized if the profitability decreases, allowing the firm to keep working in spite of a downturn in the economic cycle. The main example of this type of economies is the United States, but other Anglo-Saxon countries are also included, such as the United Kingdom and Canada, among others.

The second category is that of coordinated market economies – CME – that rely on communication between firms, banks, and unions, creating a dense network of actors that share inside information about the firms. The flow of information in these economies is straightforward insofar as the actors belong to the networks where critical data about firms moves fluidly. A consequence of this is to allow investors to evaluate the possible returns, thus providing capital even when the former are not particularly high. Stable labour markets are also complementary, as the firm does not need to reduce these costs if it has access to capital through other members of the network. The main example is Germany, but other countries in Continental Europe such as The Netherlands and Austria belong to this category.[12] This distinction however reproduces earlier research by Albert (1991) who contrasted the models of American capitalism and that of the Rhine region. However, the model of Varieties of Capitalism seeks to be more parsimonious.

The difference in institutional frameworks between economies tends to create concomitant differences in the strategies of firms in the countries associated with each ideal type. Thus, institutions have a great deal of influence in the determination of corporate behaviour as well as the kind of choices other actors make in response to such strategies. This link between the strategies of different actors tends to create complementarities between

[12] There is some debate as to whether Japan or Korea can also be classified as CMEs. Hall and Soskice (2001a, 35) argue that the former is a CME, whereas Amable (2005, 222-223) argues that both economies belong to the Asian model of capitalism, which is different from the Continental European model composed by Switzerland, Netherlands, Ireland, Belgium, Norway, Germany, France and Austria.

strategies and institutions. Following Aoki (1994), complementarity exists when the presence, or efficiency, of one institution increases the returns, or efficiency, of the other (Hall and Soskice 2001a, 17). Therefore, the clusters of complementary institutions determine the degree to which a given economy is coordinated (Hancké, Rhodes, and Thatcher 2007b, 5). It is precisely the presence of such clusters that determines the definition of the ideal types mentioned above. However, no claim in terms of the relative performance of whether one type or the other is made; rather, it is stated that both types deliver good economic performance and wellbeing, even if in different combinations (Hall and Soskice 2001a, 21).

The Varieties of Capitalism approach emphasizes that the performance of countries that mirror the ideal types would be better than those that do not (Hall and Gingerich 2009, 470-471). This conclusion[13] has two consequences: first, there is no one 'best-way' of capitalism, but two (Hancké, Rhodes, and Thatcher 2007b, 7); second, the economies where institutions are not complementary in the same way as are LME or CME do not perform as well as those clearly anchored in one or the other. This conclusion has been criticized by Campbell and Pedersen (2007) who present the case of Denmark and its "flexicurity" arrangements. These seek to increase the market exposure of workers while keeping several of the welfare protections characteristic of corporatist arrangements of the CME with significant results.

Two critiques have been raised. First, that the Varieties of Capitalism approach is static because of its focus on path dependence, which not only diminishes the possibility of institutional change but also leans toward institutional determinism (Crouch 2005, Jackson and Deeg 2008). Another common critique is that the approach is functionalist as the results produced by a particular cluster of institutions would be the force behind its construction (Howell 2003). The former critique refers to the static characterization of political economies

[13] Partially because the original version of this article was published as a manuscript in 2004 (Hall and Gingerich 2004) before the financial crisis in the United States or the debt crisis affecting Europe, the main conclusion at the time suggested that both the United States and Germany were outperforming other countries that did not embrace prototypical institutional sets from each variety of capitalism. In the mid 2010s it is difficult to adjudicate if those economies continue to outperform other economies belonging to each category; journalistic accounts suggest that the United States is currently in the fourth longest cycle of growth on record ("The Dividing of America." *The Economist*, July 22, 2016, p.9), whereas Germany has done well in spite of the European crisis ("Clouds Ahead." *The Economist*, June 14, 2014, pp. 77-78). The European Central Bank's policy of negative interest rates as well as the sluggishness of the European economy and the exit of the United Kingdom from the European Union could hit the latter hard.

despite the explicit recognition by Hall and Soskice (2001a, 54) that their approach does not consider them as such. In fact, later attempts to respond to these criticisms asserted that institutions within political economies are subject to an open interpretation by actors because the former are resources used by the latter to advance their interests in the political economy and, therefore, these are subject to constant change (Hall and Thelen 2009).

The critique concerning functionalism is perhaps a consequence of its rationalist conception of strategic behaviour. Even if in some cases actors provide the support for key institutions in part because they serve specific purposes, this does not entail that these were conceived to serve these purposes in the first place. Often such institutions were created long before; therefore although the current advantage granted by the use of an institution might explain the contemporary support it enjoys, it only rarely explains the creation of that same institution (Hall and Thelen 2009, 14). Furthermore, functionalist critiques focus on the welfare gains that the presence of institutions provides in aggregate terms. However, the politics of coordination is concentrated on gains for actors in their strategic interaction with other actors, and not on the general welfare it can potentially create (Hall and Thelen 2009, 14).

A common theme is the insufficient role that politics seems to play in Varieties of Capitalism's characterization of the political economy, in particular the absence of the state. It seems as if the state as an actor is simply a rubberstamp instance with no apparent role insofar as it reflects the prevalent mode of coordination (Hancké, Rhodes, and Thatcher 2007b, 23, Jackson and Deeg 2008, 699-700). However, the literature on political economy during the 1980s and 1990s emphasized the importance of the state as a political actor in general (Evans, Rueschemeyer, and Skocpol 1985), showing also how its actions were essential in the organization of capitalist activity in countries such as Japan (Johnson 1982) and newly industrializing countries such as Korea, Taiwan, India, and Brazil (Johnson 1987, Evans 1995). In fact these examples contributed to the elaboration of a developmental state in previous decades (Woo-Cumings 1999).

Other critiques revolve around the absence of regional or sectorial differences. The regional dimension can be divided into three, non-mutually exclusive components. First, some regulations might only work in some regions and not others; second, within a region there might be a geographically confined web of firms, whose relations also reflect a particularly defined choice of local actors, e.g. clusters; and third, processes of change could also leave behind legacies of former arrangements (Lane and Wood 2009, 541). Furthermore, with the transformation of the economies produced by processes of liberalization, these relations can also be modified, widening in turn the regional differences that were already present (Hudson 2012, 193-197). However, these regional differences amount to a complex intermingling of local actors rather than an exclusive focus on the possible tax incentives that some governments usually establish as a developmental instrument (Lane and Wood 2009, 542).

Sectorial differences can be the consequence of technological requirements demanding a specific institutional organization that national settings do not provide. Moreover, with the process of globalization, these requirements may respond to special productive needs focused on the markets served. Among these requirements we may find financial needs that might be better met by actors with whom firms do not maintain regular relations, thus jeopardizing in turn their potential innovations (Allen and Whitley 2012). Moreover, sectorial specificities can also be a consequence of industrial regulations, adding yet another institutional layer within a national economy that requires technological or organizational ties between firms (Lane and Wood 2009, 544). Thus, the first source of sectorial diversity is the organizational needs of a given production line, and the second source is the technological requirements that might be introduced by external actors in the process of globalization. These factors tend to be uneven, which in itself introduces more variation. With these variations the question remains as to how much of a national 'model' or variety of capitalism remains when such differences are accounted for.

Thus, the Varieties of Capitalism approach provides an encompassing view of a political economy focused mainly, though not exclusively, on advanced capitalist economies.[14] This general view accounts for the way in which economic activity is socially and politically grounded. Actors use institutions because they provide some kind of advantage even if they have their origin in political struggles faced long ago. Nonetheless, institutions are

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14 For the study of the changing variety of capitalism in Southern Europe, see Molina and Rhodes (2007). For the Eastern European variety of capitalism, see King (2007), Feldmann (2007), Mykhnenko (2007), and Nölke and Vliegenthart (2009). For Asian capitalism, see Feenstra and Hamilton (2006); Johnson (1982) is the classic reference of the Japanese modern economic transformation. For more recent accounts of Japanese capitalism, see Lincoln and Gerlach (2004) and Witt (2006).

constantly subject to potential change because actors are constantly trying to improve their relative position vis-à-vis other actors. These, in turn, are related through complementarities that increase the efficiency of each institution, providing in turn more incentives to increase the engagement in those institutions. Hence, complementarity is what creates the linkages between spheres, but also what provides a sense of unity in the economies.

1.1.2 Regulation Theory

In the search for a holistic view of capitalism, Regulation Theory[15] addresses two important critiques: first, to neoclassical economics and second, to Marxism. Against the former, Regulation Theory contends that market exchanges are a social construction and not simply the spontaneous result of raw interactions among agents (Boyer 2004, 17). While it agrees with the latter that the relationship between capital and labour should be understood as a special relationship among other capitalist relationships, Regulation Theory disagrees with Marxism in the homogeneity of such a relationship in time and space (Boyer 2004, 17, 1990, vii). In fact, it argues that variation in this fundamental relationship, coupled with the monetary or the competition regimes, can create specific accumulation regimes. Essentially, what Regulation Theory provides is an account of how social relations determine capitalism's singularities.

A central argument of the Regulation Theory is that the relationship between capital and labour[16] together with the competition regime constitute the central foundation of the accumulation regime. These two create limitations to the capitalist mode of production and therefore establish a macro-institutional foundation of a market economy (Boyer 2004, 18). Regulation Theory also proposes a distinction between the theoretical construct created *ex-post* by the observer and the series of actions carried out by individual actors who only have a

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[15] The concept of regulation allows a study of the contradictory dynamics of transformation and permanence of a given mode of production (Aglietta 1982). This adoption of the term is a consequence of the double criticism against neoclassical economics, which argues that markets were self-regulated despite mounting evidence against such claims at the end of the 1970s, as well as against Marxism and its structural reinterpretations that emphasized the conditions for capitalist reproduction without paying enough attention to the transformations that prevented its final demise in spite of its recurrent crises (Boyer 1995a, 21).

[16] The term in French is *rapport salarial*. Jackson and Deeg (2008, 683) use the expression wage/labor nexus; however, in subsequent paragraphs capital-labour nexus will be used.

partial view of the consequences created by their decisions, but who, nonetheless, try to steer the economy through such decisions (Boyer 2004, 18). The former is the accumulation regime that comprises the observed regularities that allow capital accumulation by counterbalancing the possible disequilibria that such accumulation creates on a permanent basis (Boyer 2004, 20).

The second element, the set of rules, procedures, and behaviours of actors, both individual and collective ones, which have the possibility to reproduce fundamental relations such as the capital-labour nexus, is the regulation mode. These rules and procedures are historically determined and seek to support and reproduce the contingent accumulation regime by assuring the dynamic compatibility of the whole set of individualized decisions (Boyer 2004, 20). Rules and procedures are enshrined in institutional forms. Five institutional forms are the most important: monetary form, capital-labour nexus, form of competition, form of adherence to the international regime, and form of the state. These forms do not necessarily go hand in hand. In fact, structural crises tend to appear when the gap between these five fundamental forms is substantial and the disequilibria created by the mismatch degenerates into a crisis (Boyer 2004, 24).

Accumulation regime refers to the "set of regularities that ensure the general and relatively coherent progress of capital accumulation, that is, that allow for the resolution or postponement of the distortions and disequilibria to which the process continually gives rise" (Boyer 1990, 35-36).[17] A central tenet for the concept of accumulation regime is its variability in both time and space, meaning that it can take different forms rendering essential the analysis of changes to such practices, both qualitative and quantitative. Therefore, capital accumulation presents a variety of forms, each one engendering different consequences and dynamics both economic and social. Nevertheless, this abstract level of analysis requires another analytical layer (mezzo-level) that allows the creation of a link between agents' activities (micro-level) with a general view of the economy (macro-level).

17 Accumulation regimes come from the analysis of patterns that can be found in how the organization of production evolves, the time horizon for capital valorization (forming the basis for management), how value is distributed (which determines the social classes), the definition of social demand (determines the productive capacity), and the manner of articulation with non-capitalist economic forms (when relevant) (Boyer 1990, 35).

Accumulation regimes, the macro level of analysis, have their foundations in specific institutional forms, which constitute the codification of fundamental social relations (Boyer 1990, 37). Three of these institutional forms are essential to capitalism: monetary form, capital-labour nexus, and competition form. Monetary form is essential because money is the way in which social actors establish economic relations with each other, that is, money is not just another commodity but a crucial link between the subjects of production (Boyer 2004, 19). Additionally, money is often related with the nation-state, providing a sense of homogeneity within its borders to the economic activity through its political authority (Boyer 1990, 38). For its part, capital-labour nexus refers to the configuration of the wage relation, which in turn determines the managerial organization of the firms, as well as the workers' lifestyle supported by their earnings. Typical forms of the capital-labour nexus are Taylorism and Fordism.[18]

For the competition form, two opposite cases can be identified. Monopoly happens when the relationship between production and consumption is defined *ex-ante*, whereas competition is when this relationship is defined *ex-post*. This is important because, in principle, competition refers to the relationship between actors that participate in the production, i.e. firms, which despite being separated entities can nonetheless be related (Boyer 2004, 19). Two elements should however be underlined: these three institutional forms are anchored in the national space giving them a political character defined by the nation-state within which they had manifested historically. This of course has been changing in recent years with the changes brought about by the globalization of the world economy. However, two other institutional forms allow for the establishment of a relationship amongst different

[18] Taylorism refers to the application of the ideas exposed by Frederick W. Taylor in his book *The Principles of Scientific Management* (1911) where several principles of industrial organization were proposed. Essentially it intends to improve productive efficiency through a better allocation of time and the continuous improvement of workers' craft; unlike Fordism, no definition of Taylorism was found in the works of the Regulation Theory's authors. Fordism, in turn, refers to the accumulation regime that combines three characteristics: first, a deepening of the principles of scientific management in which the productive tasks are completely separated, which is illustrated with the assembly line; second, workers are guaranteed a share in productivity gains; and, third, it must be restrained to a national space rather than a cross-national space (Boyer 1995b, 370-371), e.g. France until 1974 (Bertrand 1983). Following the precise definition of Fordism presented above, it is difficult to grasp the difference between both accumulation regimes since Taylorism separated tasks, and even steps within tasks, with stop-and-motion studies, and incentives were provided for workers on the basis of their productivity, while Taylor's movement responded mainly to American concerns even if it was also adopted elsewhere.

national spaces; those are the position within the international regime and the state form, and are dialectically linked (Boyer 1990, 40).

While the position in the international regime is the institutional form that determines the relationship between the economy in question and other economies and what happens with the production processes on a larger scale, including exchanges with other loci, the state form refers to the institutionalized compromises creating regularities in the flow of public revenues and expenses (Boyer 2004, 20). These institutional forms are the product of power struggles instead of an agreement between actors seeking to increase efficiency, as considered by both neoclassical economics and rational choice institutionalism.[19] Another difference between Regulation Theory and other institutional approaches is that the former tries to explain the evolution of the economy from a macro perspective, while the latter have their starter point with actors. This gap notwithstanding, Regulation Theory offers a conception of how actors help to reproduce the macro phenomena described so far.

The regulation mode refers to the set of rules and procedures that serve to reproduce fundamental social relations by combining historically determined institutional forms. These rules also steer and support the prevailing accumulation regime and, finally, guarantee the dynamic compatibility of a series of individual decisions. These individual decisions are not made with a complete knowledge of the workings of the whole system (Boyer 1990, 43, 2004, 20). In other words, the regulation mode describes the way in which existing institutional forms constrain and drive individual actors and their choices, in opposition to the traditional general equilibrium where macroeconomics is determined by the micro level. In fact, another critique it addresses with regard to traditional macroeconomics is that economic phenomena cannot be considered independent from political phenomena, meaning that both spheres are intrinsically connected (Boyer 1990, 43-44). Even the purest of market interactions is thus rooted in social and political relations.

Three main differences can be identified between Varieties of Capitalism approach and Regulation Theory. The first is methodological insofar as the former takes implicitly the

[19] This is critique to new institutional economics and its close relative rational-choice institutionalism with their conception of institutions and why they are created by actors (Ostrom 1986, North 1990, Ostrom 1990, Eggertsson 1990). Regulation Theory shares with historical-institutionalism the concept that institutions are the product of power struggles.

liberal market model as the benchmark to which other configurations should be compared (Gourevitch and Hawes 2002-2003), whereas Regulation Theory, by virtue of its structure, seeks to make a multipolar comparison in which every unit of analysis stands on equal ground (Boyer 2002-2003, 156-157). Second, Regulation Theory proposes that the organization of capitalism is not binary, with some declinations that allow for the accommodation of economies that do not fit perfectly the ideal-types of each category. Moreover, it proposes four configurations: market-led capitalism (essentially the same as the LME in Varieties of Capitalism), meso-corporatist capitalism (Korea and Japan are examples of this type), state-led capitalism (Continental European countries participating in the integration effort), and social democratic capitalism (Scandinavian countries) (Boyer 2002-2003, 160-161).

Third, the changes that took place in different economies during the 1990s epitomized mainly in a liberalization of many markets are interpreted differently. Whereas for Varieties of Capitalism these changes do not represent a significant questioning of the institutional architecture of many economies, for Regulation Theory these changes are a game-changer (Boyer 2002-2003, 166-167). Similarities between Varieties of Capitalism and Regulation Theory should also be considered. Despite the claim of regulationists about their distinctiveness with regard to the ways versions of capitalism can be classified, Regulation Theory argues that there is a better capitalism and regulation mode (Amable 2005, 105): a capitalism whose priority would be growth, albeit volatile, thus disregarding in turn equity concerns in terms of both social protection and income inequality. On the other hand, there could be another type, creating a more stable path of growth while at the same time providing income equality and social protection. Thus, once again the opposition between the type of capitalism that exists in the United States as opposed to that elsewhere appears to make this characteristic a recurrent theme in the literature on socio-political relations of capitalism.[20]

Perhaps the main similarity between both approaches is their rejection of a single model for capitalism based on the main capitalist economy. Instead, both recognize the

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[20] Amable (2005) proposes in turn a typology with five types of capitalism derived from a multivariate statistics analysis. The different models with their respective countries are: 1. Market Liberal Capitalism: Australia, Canada, United Kingdom, and United States; 2. Asian Capitalism: Japan and Korea; 3. Continental European Capitalism: Switzerland, Netherlands, Ireland, Belgium, Norway, Germany, France, and Austria; 4. Social-democratic Capitalism: Denmark, Finland, and Sweden; and, 5. Mediterranean Capitalism: Greece, Italy, Portugal, and Spain. The second and third categories have already been briefly mentioned in footnote 12.

existence of a plurality of possibilities for the organization of capitalist activity and deny the benchmarking strategy that was present during the 1990s (Boyer 2002-2003, 151-153). However, as mentioned above, even if both of them consider the existence of a multiplicity of capitalist varieties, both take the main capitalist economy as the pivot for their studies, i.e. the United States. Finally, the presence of comparative institutional advantages is a recurring theme in both traditions, which points to a certain normative concern about the challenges brought up by globalization (Boyer 2002-2003, 153-154). Some of these themes can also be found in the last approach, which is presented in the next section.

1.1.3 Governance[21] Approaches

The governance approach tackles the problem of studying the social foundations of capitalism by analyzing the social practices and organizational features within capitalist activities across societies. With the emphasis on practices, this approach tries to underscore the agency capable of transforming institutions by the imaginative use of different elements present in the political economy. This feature also goes in the opposite direction of an important concept of neo-institutionalism theory, path dependency, which according to Crouch (2005, 23) is the most deterministic argument on institutionalism. By acknowledging that actors are not unambiguously constrained by their past choices, as well as the fact that they are innovative, this approach seeks to provide a panorama of transforming capitalist practices across different settings, rather than organize capitalism in varieties or types.

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[21] Despite the multiple meanings that governance might imply (Levi-Faur 2012, Rothstein 2014, 738-739), and whether or not this polysemy is convenient, in the literature concerning the study of capitalism these works are regrouped under such label (Jackson and Deeg 2008, 688-689). The meaning of governance embraced here refers to "those mechanisms by which the behavioural regularities that constitute institutions are maintained and enforced" (Crouch 2005, 20). From this definition it should be clear that such a perspective actually reprises the "logic of appropriateness" (March and Olsen 1989) insofar as it seeks to identify regularities across different settings that follow a similar working pattern. Nevertheless, there is acknowledgement (Crouch 2005, 21-22) that the term "governance" has acquired different meanings that might mislead readers, mainly in the sense that governance is a softer alternative to government (Rhodes 1997).
Furthermore, as mentioned above, the present dissertation revisits the problem of governance, which adds another layer to the polysemy of the term. The term was kept to name these approaches while acknowledging also that such a label can lead to confusion since this is the name with which they identify their work. In this subsection, the term governance is just a label without any analytical implications for the rest of the analyses proposed in the dissertation.

Following Crouch (2005, 99-100) et al (Crouch and Farrell 2004), path dependency does not need to be as deterministic as some versions of the argument (Pierson 2000b); instead, it can also be combined with the possibility of changes induced by actors. The deterministic version of path dependency refers mainly to instances in which actors get locked in a trajectory that depends on their abilities but disregards a political aspect of path dependency. Actors do not get locked in a specific path because of lack of alternatives, but mainly because there are power considerations that make such options more plausible. However, the alternatives proposed by this approach are worth considering insofar as they focus on the possibilities that agency might offer for institutional transformation. There are three main possibilities that affect institutional paths: the use of hidden or reduced alternatives that actors already know but have become dormant; the possibility for actors to play in multiple arenas, thus allowing them to draw lessons and experiences; and, participating in networks where actors have access to significant information that allows them to change their path.

The problem that the governance approach seeks to solve, that of constraining path-dependent institutional development, has also been studied in the literature on institutional change (Streeck and Thelen 2005, Mahoney and Thelen 2010). It is only because actors might use institutions differently that established institutional paths can be modified. In both the governance approach and the literature on institutional change, the main reason for change is found in actors' agency rather than in traditionally exogenous disturbance. In the case of the governance approach, agents are capable of transforming institutions mainly by combining elements of several arenas giving a diversity of institutional sets, rather than a basic sample of possible institutions. Nevertheless, even if much emphasis is placed on agency and endogenous change, it is not clear how the existence of multiple arenas is squared with the idea of institutional change in one arena. In other words, if lessons are drawn outside the institution in question, a second institution is no longer considered exogenous because the agent belongs or participates in both of them.

Forms of governance change according to the relevant regulatory zones in which actors maximize different attributes.[22] The regulatory zones are the polity, the economy, and the society, as a residual category. In the polity, agents maximize power, whereas in the economy wealth is maximized.[23] Society is thus more ambiguous, because it is not clear what agents maximize within it, as in the other zones. In the polity, the state is the main form of governance, while in the economy the market and the hierarchy are present. The hierarchy, which is the least clear of these concepts, refers mainly to the corporate hierarchy where a managerial structure commands the hierarchy within the organization but at the same time, from the outside, clients and providers also belong to it. Society is defined residually as all collectivities and organizational patterns not accounted for in the polity or the economy. The main forms are the association, the network, and the community.[24]

Therefore, governance is normally a hybrid because it includes elements of a variety of modes (Crouch 2005, 120-125). While the point is that there is no such thing as pure models in reality, this is deceiving. If governance modes are ideal-types, there would be no pure manifestation of such types because, otherwise, they would not be ideal but a mere classification of observable reality. Nevertheless, the main point of Crouch's analyses is that rigid categories tend to obscure when taken literally, thus preventing the observer from seeing a wide range of possibilities. The complexity of such endeavours becomes evident with the difficulty in trying to grasp the nuances that exist for actors to take advantage of.

Two main concerns differentiate this approach from the preceding ones. First, while Varieties of Capitalism and Regulation Theory emphasize the national level as a privileged arena to derive analyses, the Governance approach considers that the nation-state, when used as a privileged unit of analysis, obscures more than it enlightens the debate (Crouch 2005, 41-44). This criticism does not entail a stark rejection of any analysis of the nation-state; however, it suggests that not only other levels of aggregation but also other types of organization are equally important and representative of how rules and behaviours are sanctioned and enforced. Furthermore, the state is one among many governance mechanisms,

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22 This paragraph relies on Crouch (2005, 110-120).

23 This description of both arenas is reminiscent of the definition of political economy offered by Gilpin (1987, 9).

24 This categorization is strikingly similar to the analyses made by Weber (1968).

though because the scenario in which many parameters are set is the national level, it constitutes a very important one for understanding capitalism as a social phenomenon.

The second disagreement is partially related to the first. In the quest of finding a model or type of capitalism, other approaches like Varieties of Capitalism and Regulation Theory tend to construct categories that overlap with actual cases, which in turn misleads the analyses. Rather than arguing for the establishment of a typology that organizes capitalism among categories, thus obscuring a diversity of cases, this approach suggests the study of governance mechanisms that can be found in multiple cases, whether they are countries or sectors. Moreover, because the typologies often assign specific kinds of behaviours to actors belonging to units within each category, they also prevent grasping actors' innovations; innovations that, if categories were applied strictly, would not even be available to actors in the first place. The typical example is an actor from category A (a company from Continental Europe) that behaves as if he was from category B (i.e., the company takes actions similar to what is expected from a company from the United States).

Furthermore, these "transgressions" of expected behaviour are of particular interest to this approach insofar as they highlight the importance of agency that some categories seem to downplay, but mainly because it underscores recombination. Recombination refers to the use of parts of DNA from different organisms to build another molecule of DNA with other properties (Crouch 2005, 3). In institutional theory, this phenomenon indicates that actors are able to take advantage of different elements present in the political economy with the consequence of accounting for the diversity of capitalist practices. With this approach emphasizing action, as considered in both sociology and political science, it looks at how economic action is governed, which means it focuses on the actions rather than on the structures. Instead, what matters most are the actions carried by agents that create a framework for economic activity (Crouch 2005, 44).[25] Recombination and hybridization can thus be identified in capitalist practices, but their deduction leads to problematic conceptual conundrums. This, however, should not prevent their use in an *ex-post* analysis.

[25] The characterization of recombination presented here is strikingly similar to that of "hybridization" presented by Boyer (2004). This is one of several points in which the classification of different approaches made here reveal the arbitrary character of the exercise.

An important critique that the authors of the governance approach address is the overlap of cases and ideal types. This tends to blur the line between a political agenda concerned with showing that capitalism does not necessarily tend towards neoliberalism (Campbell and Pedersen 2001) and the scientific endeavour that tries to describe and organize social reality, which in turn creates categories to that effect. While the clash between a possibly veiled political agenda can also be referred to as the identification of an economic benchmark, the construction of typologies is somehow problematic. If these are built around an emblematic case, other countries pertaining to one type will fail to show possibly important characteristics of the model, which puts into the question the pertinence of the category itself. On the other hand, another less problematic possibility occurs when an emblematic case within a category does not reveal all of its expected characteristics (Crouch 2005, 27-36).

While the three approaches presented so far have largely developed in parallel, there have been common elements to the debate (Wood and Lane 2012). For instance, in trying to make a classification of capitalisms, Amable (2005) looks at several arenas among Organization for Economic Co-Operation and Development - OECD countries and, by using multivariate statistics' techniques, concludes that five different types of capitalisms can be isolated. This kind of inductive methodology is what Crouch (2005, 38-39) defends as the best strategy against deterministic typologies that oppose two types of capitalisms, while practices cannot be reduced in the same way. Nevertheless, at the end the former also deceives the latter because in the conclusion to his book, Amable (2005, 291-343) frames the debate as consisting of a clash between neo-liberal and social-democratic capitalisms.[26] It is clear, however, that this position brings to mind the Varieties of Capitalism dichotomy, revealing yet further overlapping elements among the different approaches presented above.

However, these approaches all tend to one important element: that what holds together different patterns of capitalist organization are "institutional complementarities." While there is no consensus on the definition of such a concept, the idea is that what happens in one institutional arena depends crucially on what happens in other adjacent arenas. A wide institutional environment is relevant when capitalist practices are studied, whether it provides

[26] To be fair, the title of Amable's conclusion in its French version is "Où en est le capitalisme européen continental?", which shows that he probably did not intend to close the debate but rather reflect on the challenges faced by some European economies.

incentive or compensation for agency. Thus, institutional complementarity is the concept through which this relationship among different arenas of the economy has been characterized. Despite the apparent agreement on this concept to understand the social interactions behind capitalism, it is less clear however what complementarity actually means and how its existence is even identified (Crouch et al. 2005). Nonetheless, if a sense of unity exists in capitalism, institutional complementarities probably provide it.

In principle, each model of capitalism exhibits different institutional complementarities. Broadly defined, the models of capitalism correspond to the different categories that have been previously defined in different characterizations of the welfare state (Esping-Andersen 1990). There are specific institutional complementarities that correspond to liberal economies, whereas there are others that correspond to the social-democratic economies (Schneider and Soskice 2009, 21). A point this body of literature intended to make was precisely that capitalism is not a unified body of interactions between identical agents; instead, it asserts that productive relations are a set of social relations that can be structured differently depending on a diversity of factors. Following this reasoning, some affirm that there are a finite number of models (Amable 2005). There could be specific institutional complementarities to Latin American capitalism that would configure a separate variety for that set of economies (Schneider 2009b).

The theories exposed above concerning the socio-political relations underlying capitalism refer exclusively to advanced capitalism. However, this kind of analysis has also been extended to other capitalist economies. In the particular case of this dissertation, the focus will be the socio-political relations that support Latin American capitalism and the different conceptions of the latter. Thus, the second half of the chapter is a continuation of the debates proposed in the first half, mainly because the analyses of Latin American capitalism reprise the elements that analyze advanced capitalism. In this sense, it is not a real debate insofar as the two bodies of literature do not dialogue with each other, even if in some instances the circulation of ideas has been more fluid than others. The analyses of Latin American capitalism will be divided according to three different traditions: the Latin American version of Varieties of Capitalism; a set of analysis that seek to recast the role of the state vis-à-vis markets; and, the Latin American version of Regulation Theory. I will also discuss the notions of development and developmentalism, since these are important to the study of Latin American capitalism.

The objective here is to build a link between the institutional foundations of capitalism and the concomitant governance arrangements that provide for the necessary stability for its reproduction. Institutional complementarities and the way they are built through independent reforms complete the consolidation of stable patterns of governance. However, it is necessary to first establish what are the correspondent arrangements that constitute the fundamental governance structures that create stability. Second, a specific emphasis on the way in which the different institutional arrangements of Latin American capitalism will be discussed.

1.2. Latin American Capitalism

The study of Latin American capitalism has been a long endeavour. What exactly differentiates the region, if there is anything at all, has been the central question of those engaged in the quest. After almost a century of attempts, it should be clear that, as Schneider (2012, 382) argues, it is a moving target. To understand Latin American capitalism, there has been recurrent reference to capitalism in other latitudes as benchmark.[27] While there have been attempts to characterize it without using predefined moulds, the international context and the region's position within it tend to impose the idea of a benchmark.[28] The current study seeks to analyze Latin American capitalism from another perspective. By analyzing how institutional complementarities - as a mechanism that builds stability - establish new governance arrangements in a number of Latin American countries, this work looks at Latin American capitalism from within.

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[27] Perspectives considering Latin American capitalism as lagging behind on stages, institutions, completeness, or any other dimension, normally set a benchmark to be followed and therefore do not consider it as a different entity. Examples of such perspectives are modernization theory (Rostow 1971) and the Washington Consensus (Williamson 1990).

[28] This is epitomized in the concept of emerging markets that intends to characterize roughly those economies not belonging to the Organization for Economic Co-operation and Development – OECD. Some exceptions apply even to such characterization, for instance Turkey. However, most interesting for the present work are Chile and Mexico.

For Latin America, the concept that explains capitalism is that of development, which encompasses a series of interventions normally carried by the state. "Developmentalism" has a long intellectual tradition, and any attempt to explain it in a few pages will inevitably fall short of doing it full justice.[29] During the 2000s, after certain countries elected left-wing coalitions, a discussion about the consequences of the wave of market reforms of the preceding decade concluded that their one-size-fits-all approach had had profound negative consequences.[30] Consequently, several governments re-assumed the role of central actors within their respective economies while maintaining some of the market reforms enacted earlier.

1.2.1 Development as a Public Policy

Studying Latin American capitalism from within is challenging insofar as what has happened in the region cannot be fully detached from the broader picture of the world's capitalist development, for at least two reasons. First, the regional economy has been integrated within the world's economy for centuries; and second, intellectual attempts to explore regional particularities have used capitalism elsewhere as a reference. Since the former is one of the characteristics defining capitalist activity in Latin America, it should be accounted for in any analysis of it; while having a reference to compare might be productive to explain a series of features, an overreliance on the comparison tends to prevent a deeper understanding of the phenomena at hand. Once again, as Schneider (2012, 382-383) contends, the continent's capitalist history is a long one and it should be understood on its own.

Yet, another tension must be addressed. The vastness of the continent with hundreds of millions of inhabitants and a dozen and a half countries reveals the challenges of classification and abstraction. Generalizing categories might help to grasp big trends, but one should not overlook the fact that such exercises are incomplete inasmuch as they cannot account for the differences and nuances existing within the Latin American capitalist context. A starting point to describe the capitalist trajectory of the region is the publication of the *Manifesto* by Raúl

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29 A discussion will be offered below about development and developmentalism and its importance in understanding Latin American capitalism.

30 About the left turn in Latin America and its consequences in different spheres, see Levitsky and Roberts (2011), Cameron and Hershberg (2010), and Huber and Stephens (2012).

Prebisch, which describes the problems of Latin America in the context of a world economy (Prebisch and Martínez 1949). While the problems discussed were already present in both policy and academic circles for many years, the text offers an apprehensible synthesis that could be used in both arenas. An important argument mobilized by the author is what came to be known as the declining terms of trade in which raw materials producers would need to sell greater quantities of them to get the same manufactured goods. A strategy to break such a vicious circle would be to promote industrialization within the countries while relying on internal markets.[31]

Declining terms of trade were connected with balance of payments crises because it was harder to gather hard currency to pay for imports. The lack of capital thus jeopardized the efforts to invest in machinery that would improve productivity. In turn, low productivity prevented increases in wages causing a fragmentation of the consumer products markets because there were not enough customers. While other arenas such as agriculture were also considered within the mix of problems that development as a goal was supposed to address, the point is that it was conceived by way of linkages amongst economic and policy arenas. Moreover, such linkages implied that the effects of each policy were essential to the completion of its counterpart.[32]

While it is a stretch to argue that development problems were conceived as a series of institutional complementarities, it is also clear that there is something of that sort. Development as a project implies a comprehensive review of capitalism in Latin America, with some specific connections and dynamics among its parts. Such connections were supposed to be addressed through specific interventions that sought to overcome the obstacles created by the position of the region within the world's economy (Fajardo 2015). A concern

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31 An in-depth discussion of how such intellectual and policy endeavors were linked is offered by Fajardo (2015), on whom the next paragraph relies. Furthermore, the literature on development is vast, covering several disciplines and years. Unfortunately, to do it full justice is well beyond the scope of the present dissertation.

32 Development is often associated with industrialization even if the existence of capitalist activities goes back to at least the late nineteenth century in Latin America. Rents also existed in countries that were rich in mineral resources and a more enclave situation was pervasive in many countries, such as the Caribbean. These are also capitalist activities but differ qualitatively from the process of industrialization. One difference is their respective impact in the possibility of democratization (Rueschemeyer, Stephens, and Stephens 1992) as well as the type of incorporation of the labour force into the political systems (Collier and Collier 1991). Capitalist development in Latin America is said to depend on the economic structures put in place during colonial times, which is the traditional structuralist view epitomized mainly in Cardoso and Faletto (1976); other structuralist views on Latin American development are presented by Furtado (1970) and Cueva (1980).

shared by the literatures on the socio-political relations of capitalism and development is the reasoning about social and political specificities determining economic outcomes. If the former uses the main capitalist economy, the United States, as reference, the latter widens its framework to the world economy while keeping a special status for the United States, given their importance in the region throughout the years.

Crucial differences appear, however. If theories on socio-political relations within capitalism seek to prove that there are different ways of succeeding, development, for its part, seeks to explain the lag between Latin American economies and those considered as advanced capitalist economies. Furthermore, the preoccupation around development was transformed into a series of policy prescriptions known as developmentalism. This is yet another difference between Varieties of Capitalism and Regulation Theory, and development as theories of capitalism; the first two do not conceive of the institutional basis of capitalism as a political project to transform society in the same way theories of development were used to justify policy prescriptions. While development as a theoretical endeavour evolved with the policy practice, both before and after its recognition as a concept in academia and policy worlds, it is nonetheless difficult to assess its main components.

Nevertheless, the most consistent links between economic arenas addressed by the literature on development in its many stages are those involving foreign financing and jeopardized industrialization efforts (Prebisch 1963, Fajnzylber 1980, Prebisch 1981). Since industrialization required a significant amount of resources, which Latin American countries did not possess, these had to come from abroad. However, foreign investment was scarce and exports were insufficient to invest into domestic production. The series of institutions governing the relations between Latin American economies and the rest of the world were linked with those institutions governing monetary and fiscal affairs in such a way that the presence and usage of the former led to specific results in the latter. The point is that such links were what constituted the *model* of Latin American economies in the middle of the twentieth century, that is, what defined them. Such models thus allowed policymakers to organize the reality that they would face.[33] This kind of all-encompassing frame is very similar to the types of capitalism discussed in the first part of the chapter.

Such model was also subjected to a thorough intervention by the authorities, partially because these defining characteristics were deemed counterproductive to the economy. The political project seeking to transform that situation was developmentalism. In principle, it was the role of the state to break the bottlenecks preventing Latin American economies from reaching their potential. It was through the implementation of a series of economic policies[34] that the governments of the region would tackle such obstacles and would therefore, or so the argument went, improve the general economic conditions in their countries. Some policies were more dramatic than others but all of them sought to encourage modernity and development.[35] Thus, development and its policy incarnation, developmentalism, were not only the combination of ideas and institutions (Sikkink 1991), but could also be considered as an ideology (Limoeiro 1975).

Development as a goal entailed a broader transformation of Latin American societies. This view was also reflected in the broader intellectual tradition of modernization (Rostow 1971), in which the transformation of traditional societies would follow from a series of stages fuelled by economic growth. Even if the idea of stages waned, economic growth remained as an enduring feature of economic policymaking and, in some ways, represented what development stood for.[36] As mentioned above, the relationship between the region's economy and the world was fundamental for two reasons; first, because in many occasions the

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[33] This is a reference to the concept of policy paradigms advanced by Hall (1993) who reprises Kuhn's notion of scientific paradigms (1962).

[34] These policies consisted mainly in the nationalization of core industries and subsidized credit but also included a restrictive commercial policy.

[35] Part of the literature on development considers these interventions seeking to modernize Latin American societies as attempts to "Westernize" them while disregarding their particularities. For instance, see Escobar (1995), Scott (1998), and Peemans (2002).

[36] The option for economic growth was not politically neutral. Instead, the argument across many countries was that policies had to focus on growth instead of redistribution, equality being another desirable outcome of development, since no distribution could take place without an available surplus. This in part reflects the idea of stages through which economies had to pass, as in the classical view of modernization, but a contemporary reference that explained the relation between growth and inequality is the work of Kuznets (1955) with his idea of the inversed "U" meaning that inequality would increase in the first phases of economic growth, only to decrease later; an example of a statement of a senior policymaker on the secondary character of the inequality is that of Ortiz (1970). Recent research in the field of development (Sen 2000, White and Anderson 2001) has questioned that assumption with mild success in influencing public policies.

constraints posed by the latter affected negatively the former, e.g. the relation between balance of payments and industrialization initiatives; and, second, because the solutions offered were not enough to overcome the obstacles. In fact, sometimes they would even become part of the problem, e.g. trade surpluses that could cause domestic inflation.

A landmark of this conundrum is the role of multinational corporations. In the early postwar period, they represented a most wanted source of foreign currency with their green field investments, which also meant access to technology. For these corporations in turn, investments were a bet on promising rents derived from closed markets. Later on, multinational corporations by the dual nature of their activities, both within and out the region, had priorities that did not correspond to the needs of Latin American economies (Evans 1979). However, the relative importance of such companies *vis-à-vis* the host economies gave them a prominent place in the region's capitalism. Some authors consider them to be a defining characteristic of Latin American economies to this day (Schneider 2013 84).[37]

Development gained significant legitimacy in part because it represented the promise of change Latin American societies hope for. In spite of all the meanings of development, the most enduring understanding of the term is probably that of growth. For this reason, market reforms were partially legitimized as the road to development, whether within an authoritarian regime, as in Chile, or as a response to authoritarianism, as in Brazil. This underlines the difference between Latin American countries: in spite of a shared role as producers of raw materials, the implications of liberalization in each country differ. Nevertheless, it should be clear that while the policy implications are different in each country, the paradigmatic character of development remains similar. The operationalization of what development means in each policy space is constantly redefined depending on domestic politics.

This is clear with regard to the immediate goals of development strategies and policies in each country. For instance, while Brazil and Mexico had the size to accumulate scale economies with their domestic market, for Chile that was not the case. While in Brazil the slogan of Juscelino Kubitschek's presidency (1956-1961) was "50 years in 5," in which big

[37] The evidence is context-dependent as to whether foreign direct investment and multinational corporations produce a positive or negative net effect. A middle ground has emerged on the role of these companies since a catch-all category does not do full justice to the broad range of experiences (Lipsey and Sjöholm 2005).

public investment projects took place,[38] and Mexico's "Stabilizing Development" (1956-1970) represented a period of significant growth (Ortiz 1970), Chile was a laggard in that regard. Kubitschek's coalition represented an equilibrium exercise between rural interests and mostly urban industrialists that would imply the promotion of the latter while still protecting the former (Skidmore 1967, 166-174).[39] "Stabilizing Development" represented the compromise between the orthodox economic bureaucracy and those fostering new industries and investments (Moreno-Brid and Ros 2010, 149-169). Chile's "Commitment State" (1938-1970) represented an attempt to create an internal market in parallel with democratization (Gárate 2012, 128-130); however, these transformations required deep changes such as an agrarian reform and economic responsibilities for the state, which were attempted during the government of Eduardo Frei Montalva (1964-1970).[40]

However, the commitment to development and the corresponding policies necessary to implement it were not the only characteristic. While the debt crisis that affected the region in the early 1980s was a generalized problem, these three countries were amongst the most affected. Since investment and consumption depended on external finance, when the supply of the latter retracted, these policies had to contract as well. This caused a profound crisis.[41] Despite the different ways liberalization policies were carried out, their financial systems were the deepest and most complex in the region at the beginning of the twenty-first century

[38] An excellent online dossier on the years of Kubitschek's presidency is presented by Ferreira (2002).

[39] The construction of the new capital was symbolically important in gaining support for the government's program. Kubitschek was clever in crafting coalitions in both the political arena and in society at large; however, a favourable economic environment helped.

[40] These attempts to avoid confrontation only went so far. New leaders fostered them instead, which at the same time gave authoritarian groups within each society the opportunity, successfully most of the time, to take power in the name of stability and social order. In Brazil and Chile, the respective *coups d'État* were made against João Goulart (Skidmore 1967), in office from 1961 to 1964, and Salvador Allende (Angell 1993), in office from 1970 to 1973, respectively, who embraced a more belligerent way of dealing with the contradictions created by the development process and its consequences. The case of Mexico also reveals similar confrontations since the government of Luis Echeverría took a populist turn in part as a response to the events of Tlatelolco (a further discussion will be presented in Chapter 5).

[41] This trend will be analyzed at length in each empirical chapter. Briefly, in Brazil, the favourable conditions to borrow in international markets allowed companies, public and private alike, to make big investments that would mature in the middle of the crisis. Whereas in Chile, a boom in consumption, fueled by international capital flows, caused a serious exchange rate crisis and forced a change in economic policy within the bureaucratic-authoritarian regime. Mexico's overreliance on oil exports with the subsequent fall in oil prices in 1981 also forced desperate measures such as the nationalization of banks, among others.

(Stallings 2006), which represents a continuity not necessarily observed in other countries of the region.[42]

The acceptance of developmentalism varied from country to country. For instance, while development as a goal still creates significant political mobilization in Brazil, even after several decades of economic transformations, in Chile, it is the opposite. However, what matters for the present discussion is the way in which development provided a framework to organize the socio-political relations created by capitalism in Latin America. The relationship of the region with the rest of the world, the relationship between different economic arenas, and the policy prescriptions to change a given situation, were all dimensions of the category of development that served to characterize capitalism in Latin America in the second half of the twentieth century, and in some instances, it continues to do so (Bresser-Pereira 2010).[43] While Varieties of Capitalism and Regulation Theory try to understand the differences that exist among advanced capitalist economies, the intellectual attempts made within the framework of the Economic Commission for Latin America – ECLA, a broad tradition known as structuralism, tried to understand how Latin American capitalism differed.[44]

In recent years, scholars have tried to understand the particularities of Latin American capitalism at the beginning of the twenty-first century. After years of liberalization, followed by a return to more interventionist policies, the question, however, remains: what characterizes Latin American experience with capitalism? At least three answers have been provided: first, Latin American Variety of Capitalism; second, Latin American capitalism with an account resembling a developmental perspective; and finally, an interpretation similar to Regulation Theory. Following the previous discussion on socio-political relations of capitalism, these approaches study the existence of institutional complementarities that structure capitalism in

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[42] Argentina is the natural case in point. About Argentinean economic policies and its series of reforms, see Acuña (1994), Acuña, Galiani, and Tommasi (2007), and Canitrot (1994). For a long-term perspective, see Waisman (1987).

[43] Boschi (2011a, 13) argues that neo-developmentalism is still a model in the making. It postulates "the construction of a coordination space between public and private arenas, with the aim of increasing national revenue and the parameters of social well-being" (Author translation).

[44] Structuralism is the label attached to the intellectual and policy efforts of Latin American policymakers in the elucidation of a model that would explain the conditions of Latin American economies and strategies for change. However, the term first appeared in the debates around the causes of Latin American inflation and the connection with industrialization and agrarian transformation. It was opposed to *monetarism*, which claimed that inflationary problems were more often linked to monetary issues than to the broader development process (Boianovsky 2012, 284-286).

Latin America. Nevertheless, these attempts tend to reproduce the limitations of the broad debate around socio-political relations underlying capitalism.

1.2.2 Hierarchical Market Economies

The rationale for incorporating Latin American economies into the Varieties of Capitalism framework was to fill several gaps. First, as mentioned above, regional capitalism had been the subject of numerous studies from a comparative perspective, but this tradition became increasingly sparse over the years (Schneider 2009b, 554). Second, the emphasis from a firm's perspective - incorporating corporate governance strategies and labour relations, among other characteristics - recast previous analyses that neglected such features. Additionally, the firm's view is also innovative insofar as the state has been the main focus of previous analyses; and, third, Latin American version of Varieties of Capitalism does not emphasize the changes in policy priorities that took place in the first decade of the twenty-first century, but rather the long-term institutional foundations of capitalism in the region (Schneider 2009b, 554). In so doing, it points out what it considers to be enduring institutional complementarities of Latin American capitalism.

Revisiting the main characteristics of the Varieties of Capitalism framework, in which the way firms finance their operations through capital markets in Liberal Market Economies and through arms-length relations with banks in Coordinated Market Economies in Hierarchical capitalism, is also a concern. However, in Latin America, the main sources of financing for enterprises in the long run are parent multinational corporations – MNC –, or business groups to which a given firm belongs.[45] In turn, these arrangements lead managers to establish relations with the MNC's headquarters. The fact that companies do not depend on a third party to finance their activities isolates them from the market (Schneider 2013, 7-8). While this could also be the argument for firms in CME with the main banks, the latter are still outsiders, which represents more constraints than those faced by subsidiaries of MNCs or companies belonging to a given business group.

45 Multinational corporations also use local credit, which is correlated with host-country corporate-tax rates, exchange rate exposure, local currency-denominated sales, and financial development (Lehmann, Sayek, and Kang 2004).

Once again, as in the case of the traditional Varieties of Capitalism framework, labour sector organization is the other arena that provides an institutional framework for firms. The two main characteristics of Latin American labour markets are high informality and the high degree of regulation that exists in the formalized portion of it. Contrary to the institutionalized patterns showed by the corporate side of core institutions, in the labour market, such regularities, by their very nature, do not reveal the same degree of institutionalization. Nevertheless, because actors in the political economy expect such behaviours, they can be considered institutions in the same way as their counterparts in corporate finance and governance.[46] These expectations structure the interaction between economic agents, whether they are owners, managers, or workers (Schneider 2013, 7-8). This way of understanding the features of labour markets in Latin America allows for the limitations caused by the lack of enforcement in an otherwise overregulated market to be overcome.

As previously stated, the first main institution refers to diversified business groups. These groups are frequently family-owned and have activities over several unrelated productive sectors, including finance (Schneider 2008, 386). Their core activities are protected by barriers of entry, either technological or logistical, which increase the rents. Being family-owned and diversified might be strategic in the reduction of risk insofar as a diversified portfolio in unrelated business enables enough liquidity in different moments of the business cycle to be generated. Kinship, in turn, reduces agency problems and facilitates information flow within the control block (Schneider 2013, 51-52). Many groups were also constituted whether in non-tradable sectors or in policy-oriented ones, which means that the state held a non-negligible responsibility in their constitution (Schneider 2004, 2009a). The continuous existence of such groups in no way means that the same groups persist over time; in fact, with the different policy and economic cycles, many groups have faded but others arise, which supports the case for considering business groups as a defining feature of hierarchical market economies – HME.

[46] In making such an assertion, Schneider (2013, 7) acknowledges explicitly his understanding of institutions as Hall (2010, 204) does when the latter uses the term.

Multinational corporations are the second main actors in hierarchical market economies.[47] Their prominence has at least two consequences; first, it makes cooperating with other members of the business elites over priorities difficult because of the short tenure of their managers, and their focus on broader markets and issues is not necessarily linked to an individual government (Schneider 2013, 86-88). Second, there is an impact due to the presence of MNCs on the kinds of skills acquired by the population at large because, depending on the specific sector, they might concentrate on low skills activities in late industrializers. In turn, Research and Development - R&D activities are located in their home countries (Amsden 2001, 207-208). Such activities are precisely those that would promote the use of high skills labour. It is also important to acknowledge that MNCs are amongst the biggest companies in several countries, which makes them significant players in such markets, especially in those where their investments seek to take advantage of protected markets.[48]

Labour markets in Latin America are divided into two or three big segments. First, the privileged, who enjoy not only the advantages of formality, but also hold job tenure; second, people who work in the formal sector but whose tenure is reduced with consequences in the kinds of skills they invest in. Third, people who participate in the informal economy, whether in some sort of dependent relationship or as “self-employed,” which constitutes the majority of the population. Aside from this fragmentation, labour markets in Latin America display five core differences with those in coordinated market economies (CMEs) and liberal market economies (LMEs). Such differences are visible in labour market regulation, labour unions, job tenure, informal employment, and low skills. Labour regulation in Latin America is very encompassing even when compared with CMEs; this is a consequence of the reliance on severance payments as a form of unemployment protection instead of the provision of employment insurance (Schneider and Karcher 2010, 627-629).

Labour unions are small when compared to their counterparts in other regions, even if the situation varies amongst countries. Labour unions are politicized (Murillo 2001 389), which is a consequence of the early political mobilization of unions elsewhere. However, in

[47] Multinational corporations of Latin American origins (multilatinas) are a category of their own since they play roles both as locals in their respective countries with an important presence derived from their participation on big business groups, and also as a foreign in the other markets they participate in. For an analysis of multilatinas, see Santiso (2011).
[48] Also those seeking a competitive advantage granted by virtue of low labour costs as in Mexican maquilas.

Latin America, these strategies were not complemented with an equally important presence in labour markets, which created a dependency on the mobilization that the state or the political parties could provide. This situation led to political negotiations with little connection to shop-floor concerns (Schneider and Karcher 2010, 629-630). This is also a consequence of legislations that forbade sectorial negotiations, thus forcing on them a firm level approach.[49] Although each country presents a different situation, it is rather clear that when compared with other regions, Latin American unions show less density than their counterparts in CMEs or LMEs (Schneider and Karcher 2010, 628-629).

Job tenure shows a lower level than the other varieties. This characteristic is related to the prevailing informality in the labour market, which ranges from 40% in Chile to 70% in Bolivia and Paraguay, when used as a definition of informality based on the type of job (Gasparini and Tornarolli 2009, 16). Despite these differences, it is clear that these also exist between urban and rural jobs with the former suffering a higher informality (Gasparini and Tornarolli 2009, 72). These dimensions are related either because the informal market gives an escape valve for workers who might not last long in a given job, or because the formal labour market provides a temporary safe heaven, while it lasts. The last characteristic of labour markets in Latin America is the prevalence of low skills, which is partially explained by less schooling (Schneider and Karcher 2010, 631).

These core characteristics of the labour market display some complementarities between each other. The informal labour market is complementary to low job tenure, since the former provides a source of immediate income to the worker when he or she is laid off. Other complementarities also exist. Because labour regulation increases the cost of senior employees, it leads to low tenure; in turn, because workers do not expect to remain in any given job, they do not invest much in the acquisition of specific skills. Thus, labour markets' characteristics show an important degree of complementarity as the presence of each of them increases the returns of the others (Schneider and Karcher 2010, 634). Although the labour market in itself shows complementary characteristics, hierarchical capitalism incorporates such complementarities into a broader set, including diversified business groups and

[49] For a positive perspective on that approach from the Minister in charge of pushing for such reforms in Chile, see Piñera (1991). For a more critical stance on labour relations in Chile, see Berg (2006).

multinational corporations. The category of hierarchical market economies, as an attempt to incorporate Latin American capitalism into the Varieties of Capitalism framework, studies the way in which prevailing firms behave and the consequences their decisions have over the economy.

The presence of multinational corporations, which has varied its concentration between manufacturing, leaving commodities and basic transformation industries to big business groups in the mid-twentieth century, to infrastructure again with the new liberalizing cycle of the 1990s (Schneider 2013, 10-11), is the second core characteristic of hierarchical capitalism. Both types of companies took advantage of state policies seeking to close domestic markets in the mid-twentieth century that in turn produced rents. Since large manufacturing in the region remained concentrated in relatively basic industries and primary sectors, which did not require specific skills, these became complementary with a low-skilled labour force. In parallel, hiring was expensive for employers, which fostered the creation of a few high quality employments compatible with the productive needs of multinational corporations and diversified business groups, with the rest of the labour market lingering on an informal market. This, as mentioned above, provided rapid income for those who did not last long in any given employment (Schneider 2013, 32-39).

Unlike the classical argument of Varieties of Capitalism literature, institutional complementarities at the core of hierarchical market economies do not generally produce satisfactory results. While this literature tried to explain the resilience of capitalism without the recourse to American-type capitalist institutions, thus emphasizing good performance, in the context of hierarchical market economies, this was not the case (Schneider 2013, 13).[50] Performance, or the lack thereof, even if it is not central to the general argument of capitalist organization in the region, percolates through the analyses of socio-political relations of capitalism. What matters most is the fact that institutional complementarities are tied to a given result as a part of the explanation. They also provide an explanation of how capitalism is organized by a series of linkages between institutions in diverse arenas.

[50] Criticisms of this assessment of Latin American capitalism are provided by Schrank (2009), Sánchez-Ancochea (2009), and Ebenau (2012).

As argued above, this was not the first approach that considered the socio-political relations in which capitalism was embedded. Nevertheless, the debate concerning Latin American capitalism focused, during the last decades of the twentieth century, on the transformations brought by liberalization. This was partially a consequence of the general sentiment, in the region and abroad, expressed by British Primer Minister Thatcher, "There Is No Alternative," or TINA. Every society had to transform itself to accommodate the overwhelming reality of liberal policies. However, after less than promising results in several arenas, there was a new change towards more interventionist policies. This new wave of state interventions nurtured a series of systematization efforts about a Latin American way of capitalism.[51] This is one of the concerns that will be analyzed in the following section.

1.2.3 States or Markets: A Long Debate

As mentioned, comparative capitalism literature focused on advanced capitalist economies. Including other economies should take into account the institutional conditions within them that could explain positive results. This is even more crucial given that the main point surrounding comparative capitalism during the 1990s, especially Varieties of Capitalism, was the continued good performance of non-liberal economies in the face of liberalization, without the need to adopt liberal capitalist institutions in full. In the case of Latin American economies, this realization only occurred in the 2000s, when some institutions remained in spite of liberalization. In this case, it was only after it was tamed with other policies that good performance seemed to return to Latin American economies. A very important element in providing a suitable explanation for such an outcome was the state, which more or less by definition, was out of the framework of Varieties of Capitalism. While there are shared elements in this account of Latin American capitalism with the broader literature on Varieties

[51] The new wave of state interventions was reinforced by the commodities cycle in which Chinese demand for Latin American raw materials created a decade or so of continuous growth. For more details on the cycles of commodities in Latin America and their impacts over the long-run, see Erten and Ocampo (2013 394).

of Capitalism, the perspective of *Variedades de Capitalismo* that is described in the present section tries to set the debate in its own terms.[52]

Unlike the Latin American Varieties of Capitalism framework presented in the previous section, the one presented in this section did not pretend to build a concise model of Latin American capitalism. Instead, it was a collective effort that sought to understand from a comparative perspective the different performances showed within the region in the face of a stronger intervention of the state (Boschi 2011a, 7-8). There were also at least three gaps in the previous characterization of Latin American capitalism that this work intended to fill. First, the position that such countries have relative to the rest of the international system, as this characteristic is a distinctive trait of their productive regimes (Boschi 2011a, 8-9). Second, the incorporation of the state, given its importance as an actor in structuring the productive regimes of such economies (Boschi 2011a, 9), both in the first phases of development and, more recently, in its participation in the financial sector, especially in the Brazilian case (Stallings 2006). Third, because social inequalities are so pervasive in the region, they should be taken into account as politics and economics are arenas through which such inequalities might be changed (Boschi 2011a, 9).

The second and third gaps are explicitly intermingled since between 2002-2012, approximately, part of state intervention was directed at mitigating the effects of inequality through the implementation of social policies. The main point was to determine the benefits of the intervention of the state in the economy, in complete opposition to the market, as if these could be categorically separated. This framing, states vs. markets, followed the thread of the political debates in the region, with a particular emphasis in Brazil. At least in the last half century, this dichotomy had organized, to a significant degree, many debates in the Brazilian political economy. This can be traced at least to the beginning of the transition to democracy when a public campaign in the late 1970s favoured the "retreat of the state," which meant both an economic liberalization and the return of the military to the barracks (Payne 1994).

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52 *Variedades de Capitalismo* is the Portuguese translation of varieties of capitalism. In spite of the possible confusion that this might create, there is no other suitable name for this body of work, which consists essentially in the book edited by Boschi (2011b). That is the title of the volume and the authors explicitly try to engage in a debate with the work of Schneider and Soskice (2009) and Schneider (2009b), who had as an explicit goal to incorporate Latin American economies into the framework of Varieties of Capitalism (Hall and Soskice 2001b, Hancké, Rhodes, and Thatcher 2007a), without assigning any specific name to identify them.

In Chile, the debate was also framed as state vs. market because the military regime, mainly the economic technocracy within it, considered any intervention of the state as suboptimal given the distortion of the market mechanism (Gárate 2012), which they considered the best possible social allocation mechanism. Besides the national examples of liberalization on which the empirical chapters to follow will elaborate at length, the main point is that the opposition between the state and the market structured economic policy debates. Boschi (2011a, 11-12) concurs with Hall (2007) that states play a larger role in the definition of production regimes than the Varieties of Capitalism approach implied in its formulation.[53] However, essentially, Boschi's point is that the state has played an important role as an actor in the structuration of capitalism, and Latin America is another example of this situation as are other economies, such as Japan, Korea, Taiwan, or India (Woo-Cumings 1999).

Therefore, both the policy debate in Latin America and the role of the state in the organization of productive regimes justified a new look at how such roles were played out. Furthermore, the position of Latin American economies within the world economy is relevant, insofar as their realities cannot be understood without making reference to such relations, because the semi-peripheral countries of the former have the potential to change the latter[54] (Boschi 2011a, 18). The influence of traditional conceptions of development, in which the position of Latin America in the world was its defining characteristic, is clear. In fact, there are explicit references to the notion of neo-developmentalism (Boschi 2011a, 13) that would represent a different approach to the traditional vision of development conceived within the framework of ECLA.[55] Thus, a vision of Latin American capitalism in which the state plays a

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[53] As discussed above, the Varieties of Capitalism approach sees firms as the main group of actors in the political economy. This is even more so since in the face of changes in the economic environment, firms are the actors who must adapt their strategies first; a position reinforced by a strategic and relational view of actors, which are the basic assumptions of the framework (Hall and Soskice 2001a, 6). Therefore, in the strategic coordination in which firms must engage, states play a less important role than clients, providers, workers, or financing, in the decisions taken by the firms. In the case of Hierarchical Market Economies, besides following the same firm-centered approach of political economy, a focus on the state is said to pursue the kind of analysis that directs its attention exclusively on public policies rather than an encompassing view of the capitalist landscape of the region, including the incentives faced by firms (Schneider 2013, 4-6).

[54] The author makes an explicit reference to the works of Immanuel Wallerstein in the book edited by Chesnais et al. (2003). The world-system perspective (Wallerstein 1974) was based in part on the dichotomy of core-periphery (Wallerstein 2004, 11) developed by ECLA scholars (Fajardo 2015, Chapter 1), which also influenced the general perspective of the volume by Boschi (2011b).

[55] Neo-developmentalism re-centers the role of the state in order to lead a *National Development Strategy* capable of mobilizing a significant amount of resources, human and material, in order to create a growth path that fits the

larger role is not a simple return to such theories; however, their influence is readily acknowledged.

The dominant theme is the centrality of the state as the main actor in such endeavours. In so doing, it is clear that the state must reprise the role it had before international and domestic actors promoted the supremacy of the market. Those advocating the supremacy of market mechanisms are represented by what is known as the "Washington Consensus" and its backers, mainly international financial organizations, which promoted liberalizing reforms during the 1990s with less than convincing results in their effort *to generate* development[56] (Diniz 2011, 36). In the domestic arena, a technocratic elite that partook in the vision of such organizations carried these actions out in different sectors. Subsequently, in the first decade of the twenty-first century, the backers of such policies suffered electoral defeats. The most significant change in that respect was the ascension to power of Luiz Inácio Lula da Silva, who won the Brazilian presidential election in 2002. It was after his ascension to power that the state was once again mobilized (Diniz 2011, 31).

Therefore, three elements came together: a shift in the intellectual clout of liberalizing ideas in the international arena, epitomized by Stiglitz's (2002) and Rodrik's (2007) criticisms, an electoral change that brought to power progressive governments, and a reconsideration of the role of the state. Nevertheless, the idea of a zero-sum game between the state and the market was rejected as well as the acceptance of democratic rules, which also implied the rejection of a zero-sum game in politics that could have lead to authoritarian actions. Thus, in this context, the question is not whether or not the state should participate in the economy, but how it should do so (Diniz 2011, 41). A reinvigorated role for the state and a broad agenda in its relationship with the society therefore implies that different types of capitalism are not only foreseeable, but attainable (Diniz 2011, 39).

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needs of the country. In contrast to old developmentalism, the role of the state is more strategic in the sense of the selectivity of its interventions (Bresser-Pereira 2010, 98-99), mainly to some niches where the actors involved (i.e. enterprises) cannot invest in a proper manner so as to guarantee a reasonable economic and social return. In principle, the rationale of state intervention is to create the appropriate conditions (like innovation and investment) for the strengthening and correct functioning of the market, not to replace it (Bresser-Pereira 2010, 80). An account of neo-developmentalism and its political implications, that is, its connection with populism is provided by Bresser-Pereira and Theuer (2012).

[56] Emphasis mine.

This role can be divided into at least two aspects; first, as a supporter of economic activity, with Asian experiences as examples to follow;[57] second, by expanding the welfare provision through robust social policies. The former reprises a long tradition of the Brazilian state, in which it plays a significant role both in the creation of strategic enterprises (Wirth 1970) and in the provision of finance through a strong development bank (Evans 1995). The latter signals a significant shift in line, however, with the electoral success of left-leaning governments. These governments would suggest a new emphasis on poverty reduction programs that would in turn improve the conditions of large parts of the population.[58] The narrative of a strong state with a significant presence in several arenas is clear; it participates meaningfully in capitalist production, as well as in the provision of social services to the population.

The first way the state explicitly supports economic activities has been the subject of scholarly analyses over the years (Schneider 1991b, Evans 1995, Velasco-Jr 2010, Musacchio and Lazzarini 2014). Although it will be discussed further below, the Brazilian *Banco Nacional de Desenvolvimento Econômico e Social* – BNDES (National Development Bank) is the state agency that plays such a role. Unsurprisingly, the renewed activism showed by the BNDES in the first decade of the twenty-first century is an example of the renewed role of the state.[59] A significant change, however, is the way in which such activities are studied, involving the identification of institutional complementarities (Santana 2011, 122, Almeida 2011, 172), which establishes a direct link to the literature on socio-political relations of capitalism discussed above, in general and with Varieties of Capitalism (Hall and Soskice 2001b) in particular. The existence of a national development bank along with public pension funds has shifted the landscape of Brazilian corporate governance (Santana 2011, 148) towards more transparency, in addition to its traditional coordination role.

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[57] Diniz (2011, 42-46) cites the classical works of Johnson (1982), Wade (1990), and Evans (1995) among others.
[58] Even if in principle the subject of analysis is the Latin American experience, it is clear that Brazil is at the center of these analyses, which is not surprising given that the volume (Boschi 2011b) is produced by a group of Brazilian scholars and published by a Brazilian academic press.
[59] Part of this role is to make public investments that compensate for insufficient private investments in parallel with subsidized credit for corporations. More recently, this has been named in Brazilian politics as *Bolsa Empresário* (Businessman's Grant), a clear reference to the flagship social policy in recent years *Bolsa Família* (Family Grant).

With regard to the second aspect, that of a renewed social policy, important innovations had been implemented throughout the region. These programs provided cash to families complying with school attendance and periodical health checks, which changed the life of millions of Latin Americans.[60] Such innovations constitute a further effort of Latin American states to ensure the provision of social rights, insofar as during the 1990s, many states implemented similar reforms. The construction of a welfare regime would be aligned with the type of capitalism proposed by Schneider and Soskice (2009, 20-21), through the combination of the continental and social democratic categories of Esping-Andersen (1990). This alignment, however, does not fully take into account the hybridization[61] that could arise in such systems (Lanzara 2011, 112-113), a process that is intrinsic to capitalism.

Boschi (2011b) tries to bring up the examination of Latin American capitalism from the perspective of a renewed developmentalism by engaging in a debate with the broad comparative capitalisms' literature. Perhaps the most salient issue in such a debate is the role of the state in structuring capitalism in the region. Even if there are explicit attempts to downplay the dichotomy of states vs. markets (Diniz 2011, 50-51), the broad debate continues in that direction because in the process of liberalization, certain actors framed the debate in that way, including in the international arena.[62] A position reinstating the state as a core actor with coordinating roles in the development process thus represents a vindication of its historical undertakings in structuring the type of capitalism prevalent in Latin America in general,[63] and particularly in Brazil.

By bringing in the literature on development, this perspective on the Latin American type of capitalism includes the historical experience of the region. In general, institutional

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[60] For details on conditional cash transfer programs and their impact on education, see Glewwe and Kassouf (2012), ILO (2011), Fiszbein and Schady (2009), and Barrientos and Dejong (2006). On their impact on health issues, see Villatoro (2004). Finally, on the impacts on poverty and inequality reduction, see Bastagli (2009) and Cecchini and Madariaga (2011). These programs are not important in terms of GDP, however. The most expensive are those from Brazil, *Bolsa Família*, and Mexico, *Oportunidades*, each one representing 0.4% of GDP in 2007 (Bastagli 2008, 101-103).

[61] Hybridization recalls the type of institutional change discussed by Boyer (2004, 197) and the notion of recombination advanced by Crouch (2005, 3), who represent Regulation Theory and the governance approach respectively.

[62] The reference cited by Diniz (2011, 36, 41) is from Krueger (1974) concerning rent-seeking. However, the latter published during the 1990s on the topic of economic reform in developing economies (Krueger 1992, 1993).

[63] For an assessment of the traditional ISI model from the point of view of the intellectual history in the light of the current model, see Kuntz Ficker (2005) and Love (2005).

complementarities - both old and new ones - that characterize these experiences are not sufficiently discussed. These attempts to discuss the different ways in which capitalism is socially embedded seek to establish a dialogue with one of the main concerns of the socio-political relations of capitalism by bringing the question of resilience in the face of liberalization to the forefront. Unfortunately, the bulk of such analyses focus on the actualization of past experiences, whereas new arrangements are neglected. Not all market-oriented reforms represented a backlash, nor did every state intervention produce good results. Nevertheless, there had been enough time (almost a decade) to produce such assessments at the time of the preparation of the volume in question (Boschi 2011b). In spite of these shortcomings, these contributions recast the debate about Latin American capitalism by acknowledging its history, while trying to converse with other approaches developed outside the region.

1.2.4 Capitalism of One Country: Regulation Analyses of Latin America

Regulation Theory has already been used to study Latin American capitalism[64] (Ominami 1986, Aboites, Miotti, and Quenan 1995, Marques-Pereira and Théret 2001-2002, Quemia 2001). As mentioned above, the Varieties of Capitalism perspective has also shown its impact on the study of the region, mainly through the contributions of Schneider and Soskice (2009) and Schneider (2009b). An important criticism made by advocates of Regulation Theory is the assertion that in Latin America, there is but one type of capitalism, whereas the configuration of its economies seems to differ (Bizberg and Théret 2015a, 28-29). The firm-centered standpoint characteristic of the Varieties of Capitalism is left aside to privilege the study of the political conflicts behind the creation of institutions within the main Latin American economies (Bizberg and Théret 2015a, 26-27), combining both inductive and deductive views in the development of a theory (Bizberg and Théret 2015a, 25).

In trying to develop a perspective supporting a variety of capitalisms in Latin America, a typology is built using three dimensions. These dimensions are i) the integration into the

[64] A recent contribution in that direction is a special dossier of the *Revue de la régulation* introduced by Boyer (2012).

world economy, ii) the relationship between the state and the economy, and iii) the capital-labour nexus[65] (Bizberg 2015a, 42-43). Subsequently, the privileged dimension from which to organize this typology is the state and its importance in steering the economy. At least three types of capitalism are identified in Latin America. The first type corresponds to the case when the state steers the economy towards the internal market, while incorporating both labour and capital without coopting them and leaving them latitude to coordinate between themselves. Despite the orientation towards the internal market, exports continue to be vigorous, mainly in raw materials. This first type, then, is a capitalism guided by the state with an inwards orientation, which is readily recognized as a formalization of the characteristics of the Brazilian economy (Bizberg 2015a, 43).

The second type also has an important role for the state, although this time it is subsidiary to the market, in which it regulates and defends domestic capital by implementing countercyclical policies. Social actors are weak, which is reflected by weak unions as well as an almost complete absence of coordination between capital and labour. Industrial relations are fundamentally flexible and welfare provision is based on ad-hoc access granted mainly through market mechanisms. The second type is thus a capitalism that is regulated by the state with an outwards orientation, which is a formalization, equally recognized, of the Chilean economy (Bizberg 2015a, 43-44). These accounts of two types of capitalism contrast sharply with the third type, which is considered unarticulated because its structure is decided abroad, with a weak state and weak social actors, making the capital-labour relations completely uncoordinated. Flexibility and residual provision of welfare benefits complete the picture: the third type is a formalization of the Mexican economy (Bizberg 2015a, 44).

Further efforts to classify other Latin American economies stop short of assigning a type on each economy. Rent-based capitalism is identified as the existing type in Venezuela and partially in Ecuador and Bolivia, which represents a departure from the one-country types described above. Nevertheless, the main point in this discussion is to not typify the Argentinean economy: even if Argentina shared some characteristics with Brazil in the first decade of the twenty-first century, for instance its inward orientation, it is impossible to characterize it as a capitalist type, because the country is not as stable and is dependent on a

[65] See discussion above.

volatile political situation (Bizberg 2015a, 44). This is significant insofar as what determines the existence or not of a defined type of capitalism is stability and coherence through time, which presumably would allow the consolidation of a model.

As in the case of Regulation Theory, the specifics of rules and procedures for the reproduction of an accumulation regime depend largely on the socio-political processes behind each institutional form. The analyses range from the impact of the federal structure of each country (Théret 2015), the kinds of democracies developed after the correspondent transitions to democracy (Aziz 2015), the welfare regimes (Bizberg 2015b), the socio-political coalitions leading to the consolidation of each type of capitalism (Bizberg and Théret 2015b), and the labour-capital nexus (Bensusán 2015). A latent tension reveals itself in the abovementioned contributions insofar as their efforts to produce a typology in each dimension has lead them to regroup first Mexico and Chile and then Argentina and Brazil. However, because the political processes taking place in each country differ, such a classification loses part of its theoretical heft.

From the perspective of Regulation Theory, each Latin American country possesses an accumulation regime of its own because each institutional form is the codification of a fundamental social relationship. Therefore, the way in which Brazilians, Chileans, and Mexicans build their institutions including, naturally, the political struggles behind each institutional form tends to align a country with a type of capitalism. Nevertheless, the tension between the groups signalled above is that their similarities are downplayed by the existing particularities of each country. Perhaps the reason for such tensions is the central role that the state plays in the definition of the typology, leaving aside other dimensions equally representative of Regulation Theory, such as the competition form. While the state form is also part of the regulationist framework, in the particular case of Latin America, its centrality casts a shadow over other institutional forms, even those related to the capital-labour nexus, which is the center of a capitalist accumulation regime.

Therefore, the state is the institutional form that is hierarchically predominant over other institutional forms, because it is around the state that other institutional forms revolve. This in turn puts the conflicts among actors for the control of the state's apparatus as the most important political and social struggle. As explained above, the different dimensions of the states' organization, such as the federative structures or the democratic characteristics in each of the countries studied, figure prominently in the studies conducted from this perspective. Moreover, a recurrent theme in these works is how the particularities of each country in fact lead to the constitution of a distinctive type of capitalism, which emphasizes the unique socio-political relations of the countries under scrutiny. Nevertheless, besides such particularities, what transcends is the importance of the state for the organization of capitalism in Latin America, without necessarily prioritizing a specific dimension of it as the cornerstone of its importance for the type of capitalism it builds.

This, however, comes as no surprise since the complexity of the state makes it difficult to agree on its organizing principle. While the transitions to democracy can explain, to some extent, some of the recent changes in the role of the states in the economy, they cannot explain from a long-term perspective the capitalist development in the region because the latter preceded the former (Huber, Rueschemeyer, and Stephens 1993, 78). In this way, the study of existing coalitions in each country is more promising as an explanation of the role played by each state in the construction of its correspondent type of capitalism (Bizberg and Théret 2015b). Nevertheless, the argument has a tautological character; what determines the uniqueness of each type of capitalism are the unique socio-political relations existing in each country. Each country is different because it has different realities.

Despite this unfortunate argumentative loop, it is clear that the strength of the state's intervention in the economy is perceived as a positive outcome of the respective socio-political relations in each country, since it allows more steering capabilities for each type of capitalism. When this is not the case, the situation is perceived as unsatisfactory and potentially unstable. This, however, does not provide the whole picture, inasmuch as the only intention of pursuing interventionist policies does not guarantee that these will produce the expected results, whether political or economic.[66] The obvious case that exemplifies the lack of consolidation of a given type of capitalism, due mainly to the kind of political relations sustaining them in Latin America, is that of Argentina. Since Argentinean elites have rarely

[66] The political argument to intervene in the economy varies depending on each government's priorities. As the literatures on implementation (Pressman and Wildavsky 1984) and policy evaluation (Weimer and Vining 2011) show, having a clear set of goals does not imply these will be effectively attained, nor that attaining them will produce the expected results.

maintained a consensus over the role of the state in the economy, a position that has varied depending on the political views of the government in place, there has not been any consolidation of a given path for the local capitalism.

In contrast, other Latin American economies analyzed in the volume by Bizberg (2015c) have come to a consensus over the extent and type of state intervention they will support. In so doing, their types of capitalisms exhibit a considerable stability when compared to that of the Argentinean case. Even Mexico, considered deceptive because of its strong connections with the American economy, exhibits a consensus on the role of the state on the economy and the kind of integration with the world's economy. If the state is the institutional form that is hierarchically superior in Latin American capitalism, the existence of a consensus over its role is paramount to explain such a position. Thus, other institutional forms tend to emulate socio-political relations that are enshrined in the state. This is the path to the constitution of institutional complementarities.

There are two examples of these kinds of complementarities: the social protection systems and the industrial relations regulations that exist in each country which, when combined, represent the dimensions of the capital-labour nexus. Populist leaders have used both features as incorporation tools of the labour force, thus allowing them to consolidate their political support (Collier and Collier 1991). This strategy has been intrinsically linked to the consolidation of an interventionist state and the industrialization of these economies, based on the pre-eminence of the internal market.[67] Subsequently, when that model fails, there is a divergence in the organization of the social protection systems, which underscores the new complementarities of Latin American economies. For instance, in both Chile and Mexico, the fact that their economies have increased their exports on the basis of a competitive cost structure has lead them to restrain the labour costs with small social protection systems based on particularistic schemes (Bizberg 2015b, 531). These, in turn, are the product of the transformation of the respective economies in the last decades of the twentieth century.

[67] Populism and industrialization came to epitomize politics and economics in several countries in Latin America in the middle of the twentieth century. This theme resurfaced with the commodity boom at the beginning of the twenty-first century when populism as a political strategy resurfaced in Latin American politics. For a long-term perspective on the links between populism and developmentalism, see Ioris and Ioris (2013).

In contrast, Brazil and Argentina maintained an inwards orientation of their economies, preventing the definition of labour costs that depended on the competitive performance of international markets. This led these countries to the constitution of social protection systems based on near-universal provision of social rights, with the state as a significant provider of services and strong labour unions[68] as significant political actors. Nevertheless, Brazilian and Argentinean unions are integrated differently into their respective political systems; the former have created competitive political parties, whereas the latter have been an integral part of the coalitions of Argentinean governments for the last quarter century. If Brazilian unions had consistently resisted all attempts to change the inwards orientation of the economy,[69] the Argentinean ones, on their part, have been less consistent on that matter.[70] However, this characterization of the different Latin American economies overemphasizes the positive outcomes produced by a thorough intervention of the state and labour incorporation, while downplaying its negative consequences.

In consequence, the division fits relatively well in the Brazilian and Mexican cases, with the Chilean case fitting less well (Bizberg 2015c). The Chilean state has been deemed important in its selective interventions to the construction of a Chilean type of capitalism, but seems to be have been restricted to the maintenance of a competitive exchange rate, although there is no evidence for this.[71] If the institutional form of the state is hierarchically superior, the capital-labour nexus, with the respective institutional forms supporting it, only comes in third in importance after the relationship with other economies. Those who control the state

[68] While in Mexico there are also strong unions such as *Sindicato de Trabajadores Petroleros de la República Mexicana* (Oil Workers' Union of the Mexican Republic) in oil, *Sindicato Nacional de Trabajadores de la Educación* – SNTE (National Union of Education's Workers) in education, and the *Confederación de Trabajadores Mexicanos* – CTM (Mexican Workers' Confederation), these were traditionally acquiescent in the context of the *Partido Revolucionario Institucional* – PRI (Institutional Revolutionary Party)'s regime; this characteristic differentiates them from the unions in Brazil and Argentina that suffered a transformation in their respective post-transitional contexts.

[69] The *Partido dos Trabalhadores* (Workers' Party) consistently opposed liberalizing measures during the 1990s and was only tamed into such positions during the terms in office of Luiz Inácio Lula da Silva (2003-2010); for details, see Hunter (2007). His successor Dilma Rousseff (2011-2016) had a more difficult time containing these pressures within the party. For details, see Farmer (2015b, 9, 2015a, 5). The exception in this trend is the *Força Sindical* (Union Force) commonly referred to as The Force (Rodrigues and Cardoso 2009).

[70] For the position of Argentinean unions, see Murillo (2000), Murillo (2001) and Acuña, Galiani, and Tommasi (2007, 51-52).

[71] In fact, Ffrench-Davis (2014, 374-375) shows how during a significant part of the 1990s, the Chilean exchange rate was appreciated, with which the argument of a competitive exchange rate becomes less clear. See also Chile (2016c) for detailed data on the appreciation of the Chilean Peso (CLP).

can subsequently steer other institutional forms to their advantage. In part because labour has been relatively weak vis-à-vis other actors in Latin American polities, the accumulation regimes built in the region tend to leave labour in an equally precarious position (low protection, informality, among others).

1.3. Conclusions

The fundamental characteristic of governance is the provision of stability to political economies allowing actors within them to adapt to prevailing conditions and advance their interests and generate profits. Such conditions may vary depending on the socio-political relations between relevant actors in each political economy. This is the link this dissertation seeks to build: How economic governance is built through the construction of institutions that complement each other for the provision of stability. In this sense, it was necessary to establish both the conception of economic governance, as well as the encompassing institutional arrangements that buttress it. The latter has been mainly studied in advanced capitalist economies and the second part of the chapter sought to discuss these. This effort has also been carried for other economies; the third part of the present chapter discusses how Latin American economies have been studied from this perspective.

The institutions that structure the interaction between actors constitute the main blocks of governance arrangements in political economies. These arrangements, especially after the process of liberalization, apparently show that there has been one type of successful capitalist arrangement. Despite these homogenizing trends, the literature on socio-political relations underlying capitalism has shown that such arrangements change depending on each society's institutions. Each society has its own governance arrangements with regard to the organization of capitalism, which has elicited the discussion on how many capitalisms exist. This, however, has proved less important than the fact that such arrangements have remained throughout time, and this is important in relation to the creation of stable conditions for the reproduction of capital. In the present chapter, three main conceptions of these arrangements have been presented: Varieties of Capitalism, Regulation Theory, and Governance Approaches. The consensus is that each capitalist economy creates the conditions for stability through a diversity of political arrangements, both in advanced and non-advanced capitalisms.

However, with regard to the organization of Latin American capitalism, following the frameworks developed for advanced capitalisms, there is no consensus on its underlying socio-political relations. The differences between the approaches on Latin American capitalism are evident. While the state appears prominently in some instances, it is completely absent in others. Also, some approaches have a more positive perception of how capitalism is organized in the region as opposed to others, which presents specific consequences in terms of policy. However, the most important point is the way each one conceives institutional complementarities and their constitution as the foundation for a type or variety of capitalism, whether the scope is regional or national. The kind of relations that states establish with other significant actors in the political economies, i.e. companies, both national and multinational, and labour, determines the governance arrangements of Latin American economies mainly because of the centrality they possess throughout the region.

Moreover, governance and stability are intrinsically connected through the institutional arrangements that structure the behaviour of different agents in the political economies. This dissertation seeks to connect explicitly the institutional foundations of capitalism with the corresponding governance arrangements that provide stability. In the present chapter, the different conceptions of the basic institutions on which capitalisms rest have been presented. What has been explained is the point of arrival of the kind of political struggles that will be studied in the following empirical chapters. The next chapter will look at the institutional arrangements that agents build through incremental reforms. These arrangements are institutional complementarities, and how they are built through independent reforms completes the constitution of stable patterns of governance, as this dissertation seeks to explain.

Chapter 2. Institutional Complementarities and Economic Governance

Varieties of capitalism were explored as stable institutional arrangements that enhance economic governance. The key for stability can be found, I propose, in institutional complementarities. In this chapter, institutional complementarities will be analyzed through the literature and their formation. A theoretical model complete with a set of hypotheses will be presented to explain why institutional complementarities are crystalized. This process tends to be incremental, with successive changes shaping institutions. Next, incrementalism and incremental institutional changes are considered to render clear the difference between both phenomena. Subsequently, a discussion about case selection will be provided. This last section starts with a brief presentation of the biggest Latin American economies and the way in which their governments implemented economic policy in the mid-twentieth century.

2.1 Institutional Complementarities

Institutional complementarity first appeared in the work of Aoki (1994), who studied Japanese corporate governance arrangements. His model shows the complementarity between lifetime employment, the team-oriented organization of Japanese firms, and the banking system. The main bank system could be a solution to the free rider problem of the team members. Here, the bank would take control of the underperforming firm.[72] This kind of arrangement was prevalent during the transitional phase of the Japanese economy, in part because the banks and the imperfect labour market were complementary to each other, which in the eyes of the author could have informed policy recommendations to transitional economies.

[72] The bank, as a last resort, would liquidate the firm if its financial position was considered untenable in the long run.

This seminal argument about the interaction between the labour market and corporate governance with its subsequent results in Japan contributed to the debate about the diversity of institutional arrangements prevalent in advanced capitalisms. The Comparative Institutional Analysis field developed as a response to the narrowness of the institutional analysis that was common in economics as well as in the search for the policy implications of the resulting diversity (Aoki 1996, 12). The concept of institutional complementarity describes a situation in which a particular institutional arrangement imposes rigidities such that an exit strategy is difficult to implement. This occurs because, once selected, the equilibrium strategies are mutually complementary, then, institutions also become complementary to each other (Aoki 1996, 15). Complementary institutions can be identified when the presence of one increases the returns of the other as each one represents an equilibrium.

This conception of institutional complementarities was used by Hall and Soskice (2001a, 17) in their volume on Varieties of Capitalism (Hall and Soskice 2001b). Theirs is an efficiency argument: one institution, creating a specific set of incentives, will more likely reproduce those same incentives in other arenas of the economy, creating a dynamic equilibrium. While there are many possible institutional complementarities, Varieties of Capitalism is concerned with the coordination problems faced by firms. Coordination in one sphere of the economy is complementary with other spheres, reinforcing the efficiency of each one and, by implication, of the entire economy. If one of the coordinating institutions does not provide the same kind of incentives to relevant actors within the economy, efficiency will be lost. Therefore, one would expect that those economies presenting coordination institutions that give different incentives underperform those that give the same incentives; in some settings, this has effectively been the case (Hall and Gingerich 2009).

Meanwhile, Regulation Theory (Amable 2000, Boyer 2004) considers complementarity between the different institutional forms that exist within each regulation mode. The way in which the institutional complementarity hypothesis is derived here differs from that of Varieties of Capitalism. The latter considers that complementarity accounts for the equilibria found in different economies. Regulation Theory follows a deductive strategy, that is, its starting point is the general premise that regulation modes must involve the close interaction of different institutional forms. In principle, the interaction of institutional forms[73] affecting the whole economy could produce many different types of capitalism, with a significant number that simply do not exist in reality. On the other hand, convergence towards one single type of capitalism has not been verified either. Therefore there should be a limited number of capitalisms (Boyer 2002-2003, 137, Amable 2000, 657). The existence of a reduced number of capitalisms is precisely due to the existence of complementarity between institutional forms.

Only a handful of capitalist configurations exist because the interaction between institutional forms that favours these observed sets possesses a particular trait. This trait is complementarity and, indeed, each regulation mode exhibits complementarities between the historical manifestations of institutional forms. Complementarity between institutional forms is what differentiates each observable type of capitalism. Here, Regulation Theory concur with Varieties of Capitalism, both arguing that there is no single benchmark or superior model of capitalism. Moreover, Regulation Theory agrees with Varieties of Capitalism in its assertion that complementarity is what holds capitalisms together. In this sense, the similarities between Varieties of Capitalism and Regulation Theory are more striking since the deductive procedure produces the same conclusion: that complementarity occurs when the efficiency (presence) of one institution (institutional form) enhances or allows the efficiency (presence) of another institution (institutional form).

Complementarity as advanced by the governance approach differs from the two theories presented thus far. This approach operates according to three logics (Crouch 2005, 50); first, when components of a whole compensates for each other’s deficiencies; second, in the economists sense;[74] and third, as mutual effects. First, complementarity as compensation is a more straightforward concept. A rounded object (ball) is a classic illustration of two components complementing one another and forming a predetermined whole. Institutional analysis is arguably more complex but the illustration works in that it is easy to visualize and understand. Two (or more) institutions are considered complementary in this sense when the elements of one counter the limitations of the other (Crouch et al. 2005, 359).

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[73] As mentioned in the previous chapter, there are five institutional forms in capitalism.
[74] More precisely, this refers to the notion of complementary goods as used in microeconomics.

Examples of compensatory characteristics are for instance, the series of institutions that constrained the excessively risk-taking attitude demonstrated by the United States' banking industry. These institutions were, however, consistently watered down through the years, and, coupled with the incentives offered to homeowners to take big loans, created an unbalanced situation that eventually led to the financial meltdown of 2006-2008 (Campbell 2011). Moreover, compensation can exist between two or more closely related institutions as in the case of the Danish "flexicurity" that seeks to increase workers' market exposure while keeping several of the welfare protections characteristic of corporatist arrangements of Coordinated Market Economies (Campbell and Pedersen 2007). However, the criterion for each compensation from the point of view of the entire political economy is rather clear, but not necessarily from the point of view of the actors involved.

Part two of the governance approach, complementarity in the economists' sense, refers to a concept used in microeconomics: the relationship between two goods within a utility or production function.[75] Two commodities are complements if the demand for Commodity 1 decreases as the price of Commodity 2 increases, or if demand for Commodity 1 increases as the price of Commodity 2 decreases.[76] Crouch (2010, 133) argues that this kind of complementarity can be the theoretical foundation of a thicker discussion about complementarity if used in combination with the sense of mutual effects. In an earlier part of the text (124), Crouch's use of the arguments advanced by Aoki (1994, 670, 2000, 13, 2001)

[75] This condition refers to the hicksian demand function, which follows the expenditure minimization problem. For further details, see Mas-Colell, Whinston, and Green (1995, 69-70). Although this seems to be a negligible detail, it is of the utmost importance. The expenditure minimization problem implies that the utility of agents remains constant meaning that agents possess information about what satisfies them. This information can also refer to the proportion between two given goods that is most likely to maintain the desired utility level.

[76] An example often used is that of tomato and flour in the elaboration of pizza, or bread and butter or bacon and eggs. In all these culinary examples, when the price of one of the two commodities rises, the demand for the other decreases. Yet, it is rather difficult to apply this argument to a definite set of institutions. In the context of institutional theory, the operationalization of the microeconomic definition of complementarity would require that we know in advance the relationship between two institutions that keeps the utility of a society constant. This, of course, as signalled by Arrow (1950), is impossible since a social utility function is not feasible, but also because we neither know in advance the desired outcome of institutions, e.g. growth, equality, both, or something else (the pizza), nor what institutions are needed for such an outcome, e.g. rigid labour markets, progressive taxation, or fluid capital markets (the tomatoes and the flour).

to explain the economists' sense of complementarity reflects the trickiness of such an interpretation.[77]

Crouch (2010, 124) creates even more confusion since it too relies on others' descriptions of another type of complementarity altogether.[78] That is, increasing-returns or efficiency enhancement, as defined in both Varieties of Capitalism[79] and Regulation Theory. The use of the same practical situation to explicate two different ideas shows how slippery the economists' conception of complementarity is when applied to institutional analysis. More generally, this demonstrates that debates around complementarity have also turned around the interpretation of institutional arrangements and their consequences for the political economy.

The third example of complementarity as analyzed by (Crouch 2005, 54) is called *complementarity as mutual effects*, a softer version of the increasing-returns definition: that is, the efficiency of institution 1 is enhanced in the presence of institution 2, and vice-versa. According to Crouch (2005, 54), the fact that many authors (Amable 2000, 657, Pierson 2000b, 478, Whitley 2005) use the term complementarity to describe this phenomenon is misleading because the sense of compensation is much stronger. The weak link between two institutions that "affect" each other might mean many things, creating a certain degree of confusion. Nevertheless, Crouch recognizes that the idea that two institutions affect each other is a powerful one. He expresses concern (in 2005) that if this idea were widely adopted, as has

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77 Aoki (1994) leads to confusion. In the concluding summary of the article, he states: "This paper investigated the second-best solution for the moral hazard problems of teams. It indicated that complementary institutional arrangements are necessary for controlling internal moral hazard problems" (674), which indicates a compensatory role between the contingent governance structure of main banks and team-work within Japanese firms. In the next paragraph he seems to lean towards a definition based on increasing returns :

> "Specifically, it was pointed out that the emergence of the main bank system in Japan was related to the strongly 'team' nature of the internal organization, while the team oriented organization were incentive wise supported by the main bank system and the imperfect labor market. *There were mutually reinforcing effects*" (emphasis added) (675).

78 "Different institutions are brought together, (…) because when they occur together they produce a stable model that is mutually reinforcing"

79 Hall and Soskice (2001a, 17-18) use the article by Aoki (1994) to support the increasing-returns conception:

> "Following Aoki (1994), we extend this line of reasoning to the institutions of the political economy. Here, two institutions can be said to be complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other. […] Of particular interest are complementarities between institutions located in different spheres of the political economy. Aoki (1994) has argued that long-term employment is more feasible where the financial system provides capital on terms that are not sensitive to current profitability"

since proved to be the case, it would be harder to distinguish similarity from complementarity, which for Crouch has the added sense of compensation.

Furthermore, for Crouch (2005, 48-50) similarity refers to the presence of the same kind of incentives in several spheres of the economy. Crouch's characterization of the debate is precisely that those economies that present similar incentives and institutions perform better than those that do not; which is precisely what Hall and Gingerich (2009) find. The concept of similarity, as may be clear now, is strikingly alike if not identical to the definition found within the Varieties of Capitalism tradition. In one passage, Crouch (2005, 49) cites the same pages cited by Hall and Soskice (2001a, 17-21) to explain their conception of complementarity and its significance to their argument. This complementarity debate is one of the many instances in which the scope and meaning of the term has been discussed and analyzed.

The debate up to this point represents a clash of concepts, interpretations, and examples. The empirical record is conceptualized in different ways; interpretations of the Japanese institutional arrangements emphasizing efficiency (Aoki 1994, Hall and Soskice 2001b) versus the economist conception of complementary goods: changes in prices following the adoption of a given institution (Crouch 2010, 124).[80] What is conceptualized as complementarity in the works of Aoki (1994, 1996), Hall and Soskice (2001b), and Regulation Theory (Boyer 2004, Amable 2005) is reworked and divided by Crouch (2005) into something called similarity (48-50) and its softer version, mutual effects (54).

This debate was part of a broader debate on the subject of capitalism. The relationship between complementarity, cohesion, and co-evolution was equally important (Amable 2000). The starting point for all of these concepts was an acknowledgement of the existence of a variety of arrangements in the contemporary capitalist landscape. What was not clear was why these arrangements held in the wake of liberalization. Is it because they embodied such abstract properties as complementarity and cohesion, or because they evolved together historically, that is, they co-evolved? Furthermore, even if the reason behind the empirical verification of the simultaneous presence of a given pair of institutions was a mere

80 While the example provided here is that of the Japanese economy with its system of banks and long-term job tenure in industrial firms, other economies represented the same kind of polysemy. Boyer lists the case of the German economy which also generated numerous interpretations in Crouch et al. (2005, 368-370).

coincidence or a more abstract property embodied by these, there were also several properties that could explain the same outcome.[81]

Thus, until the mid-2000s, complementarity was discussed as a relevant concept in the study of several traditions studying socio-political relations of capitalism in parallel with other concepts even if complementarity attracted more attention than those other concepts. Many works situated their analyses of complementarity in relation to other studies of the same kind (Aoki 1994, 1996, 2000, Thelen 1999, Amable 2000, Hall and Soskice 2001b, Boyer 2002-2003, Amable 2005, Boyer 2004, Thelen 2004, Amable, Ernst, and Palombarini 2005, Boyer 2005, Höpner 2005, Crouch 2005). Parallel to these contributions, there was an attempt to create common ground as to what constitutes institutional complementarity and how it is different from other institutional phenomena (Crouch et al. 2005). Implicit was the notion that complementarity leads to better performance.

This characteristic remained at the core of institutional debates surrounding capitalism. Complementary explained how multiple forms of capitalism persisted in the wake of liberalization. Complementarity was not clearly defined, as shown above, and evidence was inconclusive since various understandings of the concept were in circulation. Broadly considered, capitalist survival and performance were deemed a consequence of complementarity; however, whether this was caused because institutions lead actors to use the same kind of social skills across different economic dimensions through similar incentives or by counterbalancing them was not yet settled. Thus, institutions in different spheres could lead actors to adopt two kinds of behaviours: following a single pattern of economic interaction across dimensions (labour relations, corporate financing, training, among others), or following more than one pattern depending on the dimension (close networks in corporate finance and loose labour relations).

81 Boyer (2005) argues that the presence of a pair of institutions and its possible interactions should not be considered at first glance to be complementary. Similar concepts also try to explain the same phenomena of institutional interaction that would produce a presumably good outcome; however, there is also the problem of the criterion to decide whether a pair of institutions performs better than others or not. For instance, supermodularity implies that there are no better combinations because the specific combination of two institutions outperforms every other possibility; on the other hand compatibility is the single coexistence of two institutions without producing any particular outcome (Boyer 2005, 48-49). The difference between the two is the performance criteria inasmuch as compatibility does not involve any criterion other than coexistence whereas supermodularity and complementarity both require a criterion to judge the performance using an a priori model or hierarchy.

Whether the mongrel or the pedigreed animal offer bigger advantages in terms of performance continued to be the main debate in the late 2000s, with evidence supporting both claims (Hall and Gingerich 2009, Campbell and Pedersen 2007). However interesting, this debate does not clarify what complementarity stands for. Instead, it uses complementarity as an explanation for economic performance with all the limitations such a practice entails. These limitations have to do with the fact that performance depends crucially on the criteria used to evaluate it. Further, the performance of capitalist economies is not stable; that is, capitalism offers cyclical performance. Therefore, to produce a definition of complementarity based on performance is not adequate since the latter varies greatly in time, even when cycles are accounted for, whereas the former does not. That is, the reverse causality between performance and complementarity is inconclusive.

In parallel, the main use of the concept of complementarity has been that of increasing returns or similarity (Deeg 2007, Deeg and Jackson 2007, Amable and Palombarini 2009, Kang and Moon 2012, Schneider 2009a, Büthe and Mattli 2011). Complementarity was increasingly used to describe situations in which two institutional spheres within the economy exhibited the same patterns of behaviour. Büthe and Mattli (2011) explain the different private governance arrangements in finance and industrial standards depending on the institutional strength of some actors. Because the financial sector in the United States was institutionally strong, its standards were adopted as the benchmark for financial reporting. On the other hand, because the manufacturing sector in Continental Europe was institutionally strong, its standards were adopted as a benchmark for manufacturing. While it is difficult to give a plausible explanation for the adoption of the efficiency sense of complementarity as *the* definition, a good candidate is the impact that the Varieties of Capitalism volume (Hall and Soskice 2001b) has had on the political economy literature that followed (Hancké, Rhodes, and Thatcher 2007a, Lane and Wood 2009, Schrank 2009, Schneider and Paunescu 2012, Schneider and Soskice 2009, Sánchez-Ancochea 2009, Lane and Wood 2012, Ebenau 2012).

Later on, the core debate on complementarity moves one step forward. In the *Oxford Handbook of Comparative Institutional Analysis*, Crouch (2010) proposes a typology of complementarity. Instead of separating the concepts of “similarity” and “complementarity” as in previous works (Crouch 2005, 50-52), he proposes that “similarity” is, in fact, a type of complementarity. Compensation, or two parts that make a whole and complement each other, is another type of complementarity. The third type of complementarity is one used by economists. This new development concerning the definition of complementarity clears up, at least to some extent, the confusion over the use of the concept and gives it more analytic leverage. Instead of having numerous concepts with analogous definitions, we have a single concept with some nuances. Crouch (2010, 117) recognizes that the notion of complementarity is of significant value for institutional analysis and for political economy in general; for him, however, it remains difficult to grasp.

Moreover, this attempt to simplify the discussion, keeps the view that institutional complementarities positively affect economic performance recalling the original debate around institutional differences in capitalism (Albert 1991, Aoki 1994, Hollingsworth and Boyer 1997). Nevertheless, while some elements remain from past discussions about complementarity, there have since been other important contributions. Bringing in an argument developed by Aoki (1994, 2000, 2001), Crouch (2010, 124) asserts that a market for institutions might be useful to understanding complementarity.[82] In such a market, actors would search for other institutions that would help to sustain the first one.

Campbell (2011, 212-213) concurs with Crouch (2010) that the debate was reduced to whether complementarities produce good results because they provide the same kind of incentives or because they compensate for the deficiencies of their counterparts. Nevertheless, he subsequently contends that complementarities can also produce bad results and this depends on the empirical cases. Campbell (2011) makes his point using American financial markets and the way in which its financial crisis unfolded in 2006-2008. While this is not the first time institutional complementarity has been used to explain a less than satisfactory result (Schneider 2009b), it is the first time that someone such as Campbell who is closer to the complementarities debate (Crouch et al. 2005) - with his contributions over the Danish case (Campbell and Pedersen 2007) as well as his work regarding the field of *Comparative Institutional Analysis* (Morgan et al. 2010b) - makes such a point.

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[82] In a previous work, Crouch (2005, 53-54) argues against a market for institutions: “There is no real market for institutions: there are too few producers and too few consumers of institutions. The observation that two institutions tend to be found together therefore tells us little in itself; the same producer might have made them all; there might be simple imitation among a small number of institutional producers and consumers”.

The preoccupation over performance has taken over another dimension of institutional complementarities. In the "similarity" or "increasing-returns" version of the concept, institutional complementarities explained the coherence and organization of capitalist economies in their different incarnations. Thus, in the Varieties of Capitalism tradition, the complementarity between institutions in different spheres is what creates the notion of a distinct variety; whereas for Regulation Theory, the complementarity between the different institutional forms is in part what constitutes an accumulation regime. Partially because the debate over comparative capitalism, as well as its close sibling, Comparative Institutional Analysis, sought to explain the resilience and good performance of different economies not adhering strictly to the model of the American economy during the 1990s, the performance criterion has remained a leftover of those early debates. Even if it is only in the background this sense of organization of an economy is still relevant.

Complementarity between institutions in different arenas, whether they are spheres as in Varieties of Capitalism or institutional forms as in Regulation Theory, is what gives a sense of unity to an economy. In fact, as Amable (2005, 14) argues, *models* are not random institutional arrangements. Instead, the close-knit status of complementary institutional forms, gives a sense of *coherence* to the specific institutions of each model.[83] This sense of coherence should be taken with caution. Crouch (2005) reminded us about the flexibility that actors must possess in order to transform their institutional environment in unexpected ways, dampening in turn the degree of coherence of these institutional environments. Therefore, institutional complementarities can explain the links that hold economies together without necessarily defining a model. The next step should be to insert a dynamic element incorporating the transformative possibilities of changing institutions over the existing links, that is, the way in which processes of institutional change create and transform institutional complementarities.[84]

Institutional analyses of capitalism that have focused on the existence of models, by its very nature embedded with a stability element, need also to account in parallel for their

[83] "*Les 'modèles' économiques ne doivent pas être considérés simplement comme une collection de formes institutionnelles plus ou moins aléatoires, mais surtout comme un ensemble de relations de complémentarité entre ces formes, qui sont à la base de la 'cohérence' entre les institutions spécifiques à chaque modèle".*

[84] This suggestion was also made before by Deeg and Jackson (2007). However, that discussion was focused on the Variety of Capitalism and its counterparts and not on institutional complementarity as a concept.

dynamism (Crouch 2010, 134).[85] Thus, there is a tension between the stability of capitalism and how it continues to evolve thanks to the actions of economic agents who seek to maximize their advantages. The stability to which Crouch refers seems more a rigid set of arrangements constraining actors rather than the possibility of structuring actions following a given pattern. This point should not, however, make us lose sight of the critical role institutional complementarities play in such a difficult balancing act. First, they should account for the necessary agency. That is, they must allow for change; second, they should also account for a given order.

Analyzing these links holding economies together is not exactly straightforward. There is some agreement that the very notion of complementarity between institutions implies that more than one institution has an interdependent impact over people's behaviour (Campbell 2011, 212), but it is difficult to assess what constitutes such an impact.[86] However, institutions do not exclusively affect economic actors in a one-sided relationship. Institutions themselves are subject to change. Then, there are two significant issues that should be addressed; first, the need to provide a definition of institutional complementarity, with its corresponding operationalizing criteria, and, second, to explain the role of actors in their fulfillment. Once these criteria are fulfilled, we should try to explain how complementarity affects actors' behaviour. A definition, as complex as it might be to produce it, should help to clarify various uses of the concept over the years. Also, the role of actors is critical since institutions have an impact over them, thus, how they react to such influence is significant.

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[85] The way in which Crouch (2010, 134) express this idea is as follows: "The stability of institutions and their complementarities is the stability of the person riding a bicycle, not that of the person standing still".

[86] Amable (2005, 13-14) asserts for instance that because complementarity exists when the presence of one institution increases the efficiency of another institution, the outcomes linked to each institution, thus the impact of each one of them, are impossible to identify. This formulation, however, expresses the same idea about an interdependent impact over a previously defined criterion. The passage in French is "*Si la complémentarité institutionnelle prévaut, l'évaluation des performances liées aux institutions devient plus complexe, puisqu'il n'est pas possible de considérer l'effet d'une forme institutionnelle indépendamment des autres institutions présents dans l'économie.*"

2.1.1. Operationalizing the Concept : A Definition

A definition of institutional complementarity should provide sufficient information as to how the set of institutions considered to be complementary can create outcomes such as better performance, efficiency, or stability. However, the definition should not depend on these outcomes. This is important insofar as complementarity between institutions can also reinforce undesired outcomes such as poor performance or instability at the macro level. Hence, the core of the definition should account for institutional interaction regardless of the outcome it produces; once interaction between actors and institutions stands on its own, it is possible to produce an explanation of the outcome. In other words, to account for the interaction between agents and institutions should prevent functionalist arguments from appearing as has been frequently pointed out in theories that have institutional complementarities as a core argument, e.g. Varieties of Capitalism (Howell 2003).

Therefore, complementarity between two institutions happens when one institution needs the presence of another institution to play its structuring role in the political economy. This definition adheres to Hall's definition of institutions as sets of regularized practices with a rule-like quality (2010, 204). At the core of such a definition is the way in which institutions structure behaviours within the political economy. In addition we should ask, what structuring roles do we take into account when studying the relationship between institutions? As mentioned, in various institutional traditions (Crouch 2005, 88-93, Mahoney and Thelen 2010, 10-14), institutions have different dimensions that could be taken advantage of by actors depending on their interests. This diversity underscores the fact that choosing any particular dimension essentially involves a political choice, which has consequences over the complementarities that might appear between two given institutions.

The definition of complementarity proposed in the present study supports at least two of the contending meanings and uses the concept has showed so far. In terms of efficiency, there would be increasing returns because the presence of each institution helps to fulfill the other's structuring role. If each institution represents a local equilibrium where actors maximize their utility (Aoki 1994), therefore, in the case of institutional complementarity the absence of the other institution would prevent the existence of such equilibrium. Without the inputs provided by the second institution, the payoffs matrix would not have a solution.

Paretto efficiency would not be attained since some actors could be better off by changing the system.[87] In other words, Paretto equilibrium can only be attained with the introduction of a new institution.

Concerning compensation, the presence of one institution would allow the other to play its structuring role without creating imbalances, either in the short or long run, in the political economy. Compensation provided by the presence of two institutions would keep the undesired effects of a given institution in check. Without the compensatory effects of the second institution, the first institution risks being rendered null and void by its own negative characteristics. These shortcomings include those unintended consequences of institutions, mainly those that could lead to undesired outcomes. The Glass-Steagall Act prevented the pooling of risks involved in investment and retail banking.[88] Without it, banks took on the kind of risks that lead in part to the financial crisis of the late 2000s (Campbell 2011).

A common thread to both kinds of institutional complementarities is stability.[89] It is clear that institutional complementarities are an enduring arrangement. This feature is well understood since the explanation for the resilience of different economies in the face of liberalization, has been precisely the existence of institutional complementarities.[90] Moreover, stability can be actively pursued in the face of a serious threat to existing arrangements; otherwise the continuous existence of a set of institutions without being contested by any actors, would only amount to coexistence or coevolution, not institutional complementarity. These institutions, as products of political struggle, contradict somewhat the functionalist argument. That is, institutional complementarities are built in the face of threats to stability, to which actors must respond by using available institutions in the political economy that would allow them to render functional their respective structuring roles.

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[87] Mathematically speaking, the payoff matrix of the system would have more variables than equations making it impossible to solve the system.

[88] This law separated insurance, commercial banking, and investment banking services since 1933. It was enacted as a response to the excessive risks and opportunism in the financial industry, which were perceived as one of the causes of the Great Depression.

[89] Equilibrium is also important but this is a concept in economics where the highest degree of efficiency is attained. This happens when any change in the market would imply that at least one participant is worse off.

[90] Economies outside the Anglo-Saxon world did not converge to liberal-type capitalisms because they had different institutional arrangements, institutional complementarities that were equally efficient but in different sectors and with a different balance between growth and equality (Hollingsworth and Boyer 1997, Hall and Soskice 2001b), thus convergence towards a liberal capitalism across the Atlantic, not to mention other regions, was unlikely.

It is important to note that available institutions in the political economy are themselves subject to change. That is, institutions had evolved until the threat of instability appeared, which means the current state of available institutions is the product of institutional evolution in time (Thelen 2004, Pierson 2004). Because institutional complementarities happen when the structuring role of one institution depends on the presence of another institution, their constitution – in response to the threat of instability - should imply an adjustment on the part of each. Most likely, such change is incremental insofar as institutions already play a given role in the political economy when that happens. That is, they are not created from scratch.

Therefore, another way to study institutional complementarities is to ask how links between economic arenas or spheres, i.e. the instances where institution "A" depends on institution "B", shape actors' behaviour. The task is difficult because those actors are simultaneously in a position to shape such links through the way in which they use them. Rather than attempt to determine the impact a set of institutions has had over the whole economy, as has been the traditional approach, it would be more fruitful to look at the mutual influence of institutions over behaviours. To do so would be to put this study of institutional complementarity, and to some extent that of institutions as well, in a mezzo level of analysis, as Regulation Theory has classified it.[91] If institutional complementarity analyses and debates have been fairly confusing, both in theoretical and empirical arenas, it is in part because its analyses have tried to evaluate its macroeconomic impact.

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[91] Institutional forms constitute the mezzo-level of analysis in Regulation Theory, since these create a link between the individual decisions of economic agents in the regulation modes, the micro-level of analysis, and accumulation regimes, the macro-level of analysis. Boyer (2004, 18-19) expresses the relationship between the three levels:

> *…la TR [Regulation Theory] distingue clairement entre régime d'accumulation et mode de régulation. Le premier est la création du théoricien qui observe de l'extérieur et souvent ex post la dynamique de longue période de l'économie considérée, le second explicite le comportement des divers acteurs dotés d'une connaissance partielle et locale des interactions qui gouvernent leurs relations. En un sens, il n'est pas de passage du micro au macro sans référence aux* catégories intermédiaires *que sont les formes institutionnelles*. (emphasis in the original).

"Regulation Theory differentiates clearly between accumulation regimes and regulation modes. The former is the creation of the scholar who observes from outside, and often *ex post*, the long-term dynamics of the economy in question; the latter makes reference to the behaviour of various actors endowed with a limited and local knowledge of the interactions that govern their relationships. In a sense, is not a passage from micro to macro without making reference to the *intermediate categories*, which are precisely institutional forms" (Author's translation).

From another point of view, but essentially trying to establish the connection between different levels of analysis, Hall (2010, 214-215) proposes a series of steps to integrate both rational choice and historical variants of institutionalism. This is another way of integrating the agency of rational actors at the micro level with a macro perspective on institutions. Some of those steps point to the environment within which institutional reform takes place, especially to how an institutional reform affects in turn other institutions. That is, institutional change can show broader consequences when more than one institution is accounted for in the process. There is the implication that actors are more likely to invest in institutional change that enhances their position in another institutional realm and, as a corollary, are disinclined to promote a reform that would negatively affect their position in a secondary arena (the one not subject to change).

These general equilibrium effects of institutional change is one way in which institutional complementarities come into being (Hall 2010, 212-214). In a subsequent contribution, Schneider (2013, 192-193) suggests institutional complementarities underlying Hierarchical Market Economies, the Latin American Variety of Capitalism, were formed less by an equilibrium-driven process (Aoki 2001), and more as unintended consequences of other reform processes or through the use of institutions created for other purposes (Thelen 2004). Therefore, the point these authors are making is precisely that institutional complementarities are not previously designed; actors use institutions in an unexpected way, bringing their attention (and ours) to aspects of institutions that were previously ignored or untapped. In turn, this leads them to adapt both behaviours and institutions themselves. Thus, as suggested by Crouch (2010, 134), institutional complementarities and institutional change are two phenomena that go hand in hand.

Schneider (2013, 196) suggests that institutional complementarities underlying Hierarchical Market Economies have been changing recently in a piecemeal process, not one driven by a punctuated-equilibrium logic but by drift[92] and displacement.[93] Therefore, because both institutional change and the formation of institutional complementarities are closely

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92 Although it will be explained in detail below, drift refers to "the change impact of existing rules due to shifts in the environment" (Mahoney and Thelen 2010, 16).

93 It will also be explained in detail below. Displacement refers to "the removal of existing rules and the introduction of new ones" (Mahoney and Thelen 2010, 15).

related, they could, in principle, be explained using similar analytical tools. For instance, both could be explained as a punctuated-equilibrium process where change happens in a short period of time, or as in a piecemeal process with unpredictable consequences for the actors involved. Nevertheless, the main point of such discussion is how agents are able to build a complex set of institutions when institutional change takes place. The broader point of this discussion is the way in which a set of institutions is affected by changes happening to one or more of their components.

There are three explanations for the constitution of institutional complementarities so far. First, the existence of a market for institutions where actors search for available institutions that would guarantee political-economic stability (Crouch 2010, 124); second, a general equilibrium strategy where actors chose the most efficient strategy to maximize their interests in the political economy (Hall 2010, 212-214); and, third, the existence of an incremental process of institutional changes that bring unintended consequences to the attention of actors, who would in turn take advantage of these new, unexpected situations (Schneider 2013, 196). These three explanations are not necessarily mutually exclusive, particularly the idea of a market for institutions and that of incremental change with unexpected consequences. Institutions might change incrementally, through different mechanisms, transforming themselves to a point at which actors can use them in their attempts to create political-economic stability.

This study presents theories that examine those socio-political relations around which capitalism is organized and seek to discuss the different orders within capitalist political economies. A common thread in such theories that study those orders is the close link that exists between institutions that regulate different arenas of capitalism. The term used in the literature to describe these links, is institutional complementarities. In fact, institutional complementarities buttress the order of capitalist economies insofar as each order exhibits different institutional complementarities that represent a particular equilibrium in which institutions come to depend on each other to play a role in a capitalist political economy. It is precisely because institutional complementarities each represents an equilibrium that explains the existence of different orders of capitalist economies.

Aside from an interest in what complementarity does, the present study also seeks to understand what complementarity is. The literature of comparative capitalism, it seems, provides no consensus on the matter. This multiplicity of meanings has been compounded by a confusing use of a handful of examples to illustrate a number of different concepts. In order to fill the gap, this study proposes a definition of institutional complementarity that takes into account a range of understandings and uses of the term. Subsequently a theoretical model underpinning the proposed definition is advanced.

2.2. Theoretical Model and Hypothesis

Instability threatens the existence of institutions on which actors rely to structure their interactions. Motivated by a fear of instability, actors make changes to those institutions they have struggled to build, sometimes looking to other institutions for support. The fear of instability can be subjective and is not easily measured but is nonetheless an effective motivator of change. This study demonstrates that since institutional complementarities buttress stability and order within political economies, a key factor leading to their constitution is the existence of a threat to stability. Since the hypotheses seeking to explain the constitution of institutional complementarities are not mutually exclusive, the present study offers a synthesis of them. These hypotheses are: the existence of a market of institutions, the maximizing behaviour that attains efficiency through the best possible use of available institutions, and the unexpected consequences of incremental changes.

Because threats can be the product of manipulation, with real impact nonetheless, it means that institutions can be used at the convenience of actors. Manipulation of a threat would give legitimacy to a different interpretation of an existing institution. Moreover, this new interpretation could be crucial to the constitution of an institutional complementarity since such enforcement requires the use of the other institution in the political economy. Therefore, the threshold that brings to fruition complementarity is broadly defined and consists on a change in the intervening institutions. What brings actors to cross such threshold is the fear of instability. In turn, instability would mean that institutions are no longer useful to structure actions within the political economy, which would imply a considerable loss for actors in terms of opportunity costs. Once they realize the risks, they would move to change institutions, whether by reforming them explicitly or by changing their interpretation of them, by creating a link with other institutions available.

Moreover, the fear of political-economic instability that triggers institutional changes consolidating institutional complementarity is a specific one. Not every threat to instability should lead to institutional complementarity. Those who perceive a threat are likely to have preconceived notions of the possible consequences: spiralling debt or hyperinflation or any other previously occurring political economic crisis. Therefore, institutional reforms leading to institutional complementarities seek to prevent the repetition, with its implicit consequences, of a previous political-economic crisis. Actors would incorporate those previous events to their current struggles, so a coalition could be assembled in order to prevent a re-edition of the crisis that previously brought instability. In essence, is the direct threat of a previous unstable situation that creates the sufficient conditions for the enactment of the institutional change that constitutes an institutional complementarity.[94]

Fear as a factor to institutional transformation refers to the negative appraisal caused by the belief that something is a threat.[95] This is important insofar as fear relates to the political evaluation that a group of decision makers make concerning what in their eyes is a potentially critical situation regarding the political economy; in this sense, fear combines both political and economic dimensions. These perceivers are those who might lose valuable resources, whether symbolic, political, or material, in the event that institutions crumble in the absence of complementarity. Or, in another way of putting it, those most likely to feel fear, and to push for the constitution of an institutional complementarity, are those who already

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94 *Sensu stricto* the threat of instability does not have to come from a previous crisis within the concerned political economy. It can also come from a threat without any identifiable precedent, which nonetheless is perceived by actors as potentially destabilizing. In this respect, an external event can be interpreted as a possible domestic threat with which the precedent would be established. This possibility however is well beyond the scope of the present study.

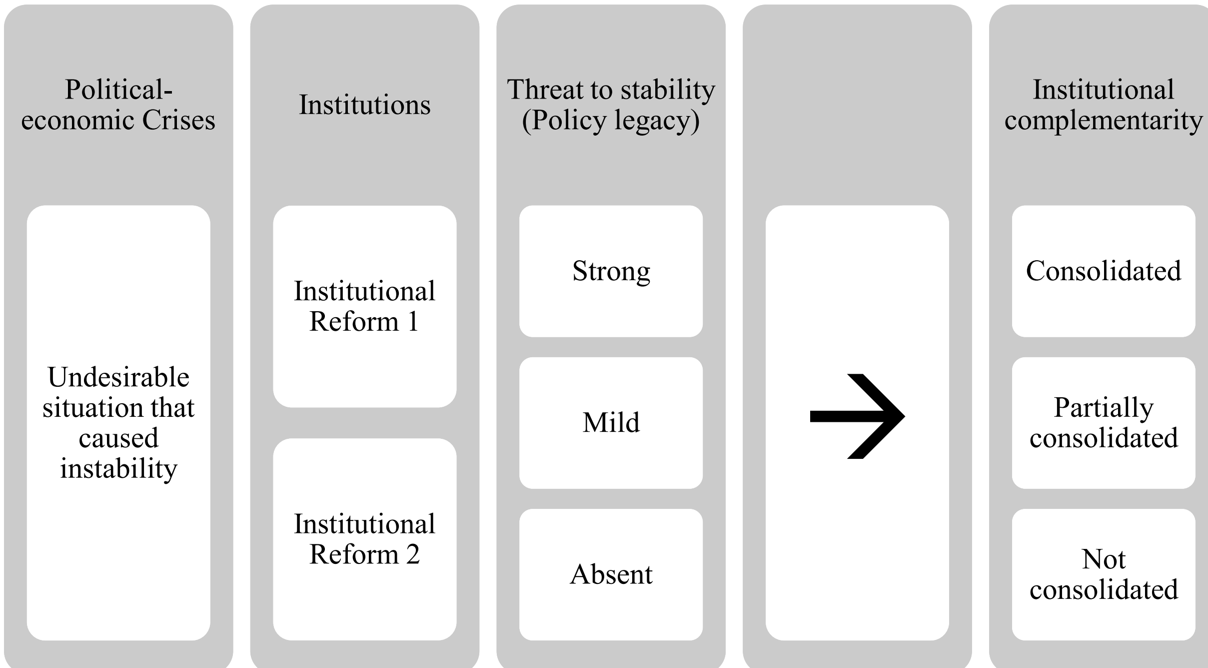
95 The definition of "fear" in the Oxford English Dictionary is extensive and varied but the most significant among the entries with respect to this chapter reads: "The emotion of pain or uneasiness caused by the sense of impending danger, or by the prospect of some possible evil" or "Apprehension or dread of something that will or may happen in the future."

benefit to some degree of institutions.[96] In this sense, is important to underline the fact that fear refers to an entirely subjective evaluation of a situation that could potentially become a factor of instability. Agents assess the degree to which the situation can create instability and they act in consequence. If such appraisals were not subjective, or always corresponded to an accurate analysis of the prevailing conditions in the political economy, crises would never take place because actors would always be ready to prevent them, which is an unrealistic condition to assume.

In turn, this means that if threats to instability are the key factor in the constitution of an institutional complementarity insofar as actors fear them, the degree of the perceived threat will also have an impact on the probability of consolidation of institutional complementarity. It is reasonable to expect this relationship because if the threat were not strong enough, the coalition would be harder to gather. Then the key factor that causes institutions to become complementary is the fear of re-editing a crisis that brought serious political-economic instability. If the fear then disappears, an institutional complementarity will not consolidate. To verify such a hypothesis, a case should consider a big threat to political-economic stability which actors fear deeply, leading them to enact and enforce an institutional reform that consolidates an institutional complementarity; whereas in other cases complementarity is latent because the threat is not strong enough. A derivation of the latter situation, could also be a threat that can be appear as important due to the way in which it is framed by actors. The next figure presents these ideas in an orderly fashion.

[96] Depending on the institution in question these might be those who could expect to benefit from the institution in the future if it does not crumble. This, however, requires that those who benefit are also in the position of pushing for the consolidation of reforms; thus, the actors who most likely fear for instability are technocratic decision makers who can also mobilize resources for reform, or, politicians who might lose power in the next election because they take the blame for the instability brought upon to the political economy.

Figure 1. Preliminary Theoretical Scheme



Thus, the fear of a re-occurring political-economic crisis leads actors to engage in specific actions to counteract the respective threat. These actions consist of incorporating the threat into the policy process.[97] If the threat is strong and the actors fear a return to an unstable state of affairs, their course of action will be to carry out the reform, consolidating an institutional complementarity. This consolidation will imply that the structuring role of each institution concerned will be maintained because of the presence of the other. Consequently, if the threat is mild the response of the actors involved will not lead to a straightforward consolidation of complementarity but only to a situation in which actors muddle through and complementarity is only partially consolidated.

Finally, when the threat is absent the response of the actors involved would be of forbearance insofar as the way in which they use or interpret institutions does not imply the consolidation of an institutional complementarity. In fact, the absence of a threat to stability

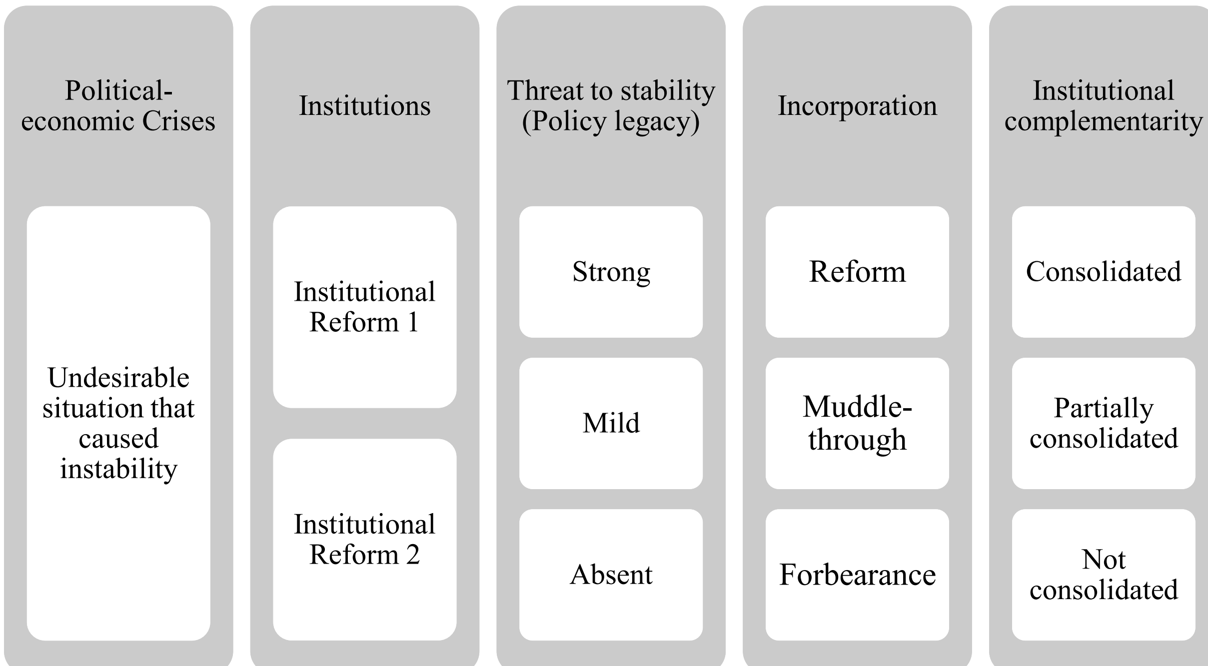
97 The incorporation of a threat refers to using the latter as a justification in the policy process leading to the consolidation or not of an institutional complementarity. In this sense, incorporation implies some kind of response to the previous appraisal of the likelihood of a disruption in the political economy.

highlights the core role of the interpretation made by actors of the situation. Because actors do not see the situation as a re-edition of a crisis that they can prevent with the enactment or enforcement of an institutional change, they will simply attempt to keep the status quo because the institutions under their purview continue to serve their intended purpose. Thus, whereas the threat to instability is crucial to triggering a response from actors, is the way these interpret the situation, how frightened they are about it, that explains the consolidation of institutional complementarities.

It is important to emphasize that compliance with institutions is the key to incorporation of a policy legacy. The likelihood of a crisis might be a necessary condition but is not sufficient in and of itself for the constitution of an institutional complementarity. Otherwise, crises in general would be relatively minor or would not happen at all because agents would prevent them in their pursuit of stability. Instead, the interpretation of a given unstable situation that leads agents to take action is what completes the causal mechanism. Moreover, each interpretation of the critical situation corresponds to a different type of incorporation. When instability is expected to be strong, the incorporation implies that actors carry the reforms on, which means that agents can explicitly enact an institutional reform or simply change the interpretation of the institution so as to render it complementary with other institution in an attempt to prevent instability. Consequently, without instability, agents would have no incentive to change their interpretation of institutions, which means their forbear and keep their interpretation of institutions.

However, if the threat is ambiguous, it is not clear what the possible response would be. It is unlikely to be a clear-cut action consolidating a given reform because instability is not imminent; in parallel, the response is equally unlikely to be total forbearance since the threat is not completely absent. Therefore, there should be some kind of action responding to changes in the political economy but not significant so as to change the institutional landscape. This action, while equally incremental in kind, does not represent a significant transformation in the institutional environment, especially not in the sense of consolidating an institutional complementarity. Thus the difference between the incremental changes enacted to consolidate an institutional complementarity and those that do not can only be verified *ex-post.* As a result the consequences are different but not the kind of changes implemented. The complete theoretical framework can be seen in the next figure.

Figure 2. Complete Theoretical Framework



It is important to highlight the role that agents' interpretation plays in the constitution of an institutional complementarity. Not every possibility of using an unstable situation as an argument in the policy process can potentially create them. There are a number of reasons for this. First, there might not be institutions available that could help to keep in place the structuring role of those eventually affected by the crisis; second, even when institutions are available, the reform implemented by actors can also fall short of what is needed in order to prevent a crisis, which means that the structuring roles of the concerned institutions would no longer hold; third, the threat to instability is interpreted by actors as not being important enough to act on, and consequently, no institutional complementarity is created. This wide variety of possible outcomes shows that both the theoretical model as well as the hypotheses proposed within its framework, do not lead to functionalist explanations, as has traditionally been the case with theories of institutional complementarities (Howell 2003).

Complementarity is observed when an institution requires the presence of another institution to uphold a particular role in the political economy. In this sense, this study concurs with Hall and Thelen (2009, 9-10) when they assert that institutions are resources that actors use to advance their interests. Interpreting a given rule with creativity or a certain degree of originality is one way to advance one's interests. However, to do so is to admit that institutions can be multidimensional insofar as they can serve different purposes, e.g. *Roe vs. Wade.*[98] Therefore, in the search for complementarity we should ask, what is the interpretation that actors seek to uphold and does it line up with the threat that has been identified? And does it depend on the presence of another institution to exist? When that is effectively the case, one finds institutional complementarity.

Following this line of argument, another set of verifications needs to be made. The first one must be to verify the interpretation that actors try to give to institutions since different interpretations can lead to different relationships between institutions. Subsequently, we must verify the kind of threat actors face and if they interpret such a threat as having the potential to destabilize the political economy. That is, could the role of institutions that are of interest to actors be disrupted? Finally, if actors use available institutions to prevent instability in such a way that they depend on each other, then, we could assure that institutional complementarity exists. The three indicators that we should look after when assessing the constitution of institutional complementarities are: first, what is the sense that actors give to the institution in question; second, the impending threat that such role may face, which is attached to instability in the political economy; and, third, if the reformed institutions effectively need each other to continue playing their respective roles.

Therefore, economic governance and the constitution and maintenance of order is less a premeditated and organized attempt to rule over economic forces than it is a subjective

[98] This decision of the Supreme Court of the United States uses the right to privacy to extend the right of women to have an abortion. Thus, the institution that established that people have the right to personal privacy was interpreted as also guaranteeing the possibility of having an abortion. However, the decision as such has been subject to different interpretations itself.

appraisal of previous experiences.[99] The model illustrated above also presents a solution to the tension between path dependency arguments (Pierson 2000a, b) - with their tendency toward social determinism as Crouch and Farrell (2004) argue they have - and the possibilities for action that agents posses. Hall and Thelen (2009) respond to several criticisms concerning both the functionalism of the Varieties of Capitalism framework and the static conception of capitalism (Deeg and Jackson 2007, Deeg 2007, Jackson and Deeg 2008) by stating that institutions are resources that actors explicitly use to change the political economy. Within this model, agents use institutions as rules that structure the behaviour of political and economic agents to secure a stable pattern of governance in the face of a threat of instability.

The interplay between an exogenous threat to instability and the endogenic character of subjective appraisal is worth exploring. A significant number of theoretical models of institutional change exhibit the pattern of a punctuated equilibrium in which periods of stasis are followed by periods of rapid institutional transformation, generally as a consequence of an external shock (Howlett and Migone 2011).[100] Nevertheless, applying this characterization to the institutional changes analyzed in the present study might be misleading. The constitution of complementarities involves the linking of institutions made possible by agents acting to avoid the perceived threat of instability. Therefore, the change that finally attaches one institution to the other is more the result of an endogenous interpretation of institutions. Even if the threat to instability might be exogenous, without the interpretation, no change would be verified; in that sense institutional complementarities are neither completely exogenous nor

[99] The core role that subjective appraisal plays in the model presented here makes especially relevant the point of view of the people involved in processes of institutional change. As a result, interviews with actual and former policymakers are of prime importance for the analysis of the evidence presented in the empirical chapters. With that in mind, I have conducted more than fifteen interviews with people involved in those institutional reforms analyzed in the present study. In most of the cases, they were directly involved in pushing for the reforms but there are also some who opposed them, or at least were critical of them. These attempts to avoid biases have not ruled them out, however; interviewed supporters and critics do not always match up in terms of rank. This is partially a consequence of the difficulties in having access to high ranking officials. Even if many of them no longer hold responsibilities, some were reticent to share information. This withholding of information promotes an even greater degree of asymmetry within the study. Therefore, interviews allowed me to assess the subjective appraisal that policymakers had over the threats or the way in which they saw the role each reform played in the transformation of the institutional architecture of their country. If they explicitly allowed me to acknowledge their participation, their names appear in the annex.

[100] To underscore the importance of incrementalism to the broader explanations of institutional change, the case of punctuated equilibrium is fundamental since the former is frequently accepted as the best depiction of the phase of "equilibrium" in which no substantial change is observed. For an analysis of these models of policy change and their relation with incrementalism, see Howlett and Migone (2011).

completely endogenous. This double character implies a process of institutional change and reform than the incremental change that consolidates an institutional complementarity.

Agents link a specific set of institutions with the aim of stabilizing the political economy.[101] Political-economic order and stability are the product of both the accumulation of incremental changes as well as explicit attempts to prevent new crises. This is a consequence of the institutional environment that contains sets of institutions that can be made to take advantage of each other to maintain their structuring role within the political economy. In addition to fear as a factor leading to the constitution of institutional complementarities, this study also proposes a concrete link between the actions of strategic agents and the construction of bigger institutional arrangements that foster economic governance at the core of capitalist economies.[102]

As previously explained, institutional complementarity should be understood in conjunction with theories of institutional change insofar as the relations that agents create with their institutional environment are dynamic. Even if the theoretical model and the hypotheses presented above do not present the type of institutional change as a source of variation in the outcome, that is, the possibility of creating an institutional complementarity, it is nonetheless important to present them. Not the least because part of the discussion concerning the field of Comparative Institutional Analysis and theories of institutional complementarity presented in the first part of the chapter, deal with the question of institutional change. Therefore, the next sections will present a discussion of incrementalism, its origins and later developments, and the theories of incremental institutional changes in the political economy.

Because the subject of this dissertation is the production of political-economic stability regarding the governance of economic policy, the discussion focuses on governmental arenas. The creation of institutional complementarities provides a significant degree of stability and predictability for the implementation of economic policies. As underscored above, this stability does not imply rigidity; instead, it constitutes a framework within which actors, both public and private, put in place their strategies to advance their interests. In so doing, they

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101 Instability may imply the total demise of the institutions in which actors have invested resources, political and otherwise.

102 The question of stability and change in the political economies and how both outcomes are intrinsically political in nature is one of the issues addressed by Hall and Thelen (2009).

produce institutional changes that transform the political economy mainly in incremental ways. Both incrementalism and incremental changes are critical to the model presented here and, as such, will be explicated in greater detail below. A subsequent section will present the cases studied in the present dissertation and the reasons behind their selection. The chapter ends with a section delineating the limits of this model.

2.3 Incrementalism

Lindblom (1959) established the main grounds of the concept. His analysis starts with the difference between two approaches of thinking about policy problems: by root or by branch. The former would require the relevant decision maker to weigh all the possible factors, both causes and consequences, involved in the decision to move forward.[103] A central tenet of the root method is comprehensive rationality whereas the branch method relaxes such constraint; the latter elaborates also on the works of Simon (1955) concerning the bounded rationality of decision-makers. Lindblom (1959, 80-81) considers the branch method more realistic and also makes its formalization an explicit goal of his article. Reinforcing this point, he asserts that the rational-comprehensive model "assumes intellectual capacities and sources of information that men simply do not possess" (Lindblom 1959, 80).

Five important characteristics of incrementalism are normally considered in the literature (Pal 2011). Limited rationality is the first of the characteristics of the policy process underlined by incrementalism, even if it is a lasting one. The other characteristics are partisan mutual adjustment, the reversibility of incremental decisions, the importance of the American model in the general conception of incrementalism, and the dichotomy between theoretical and practical knowledge. All of these elements, except the last, are important to the present discussion. Each dimension will be discussed and its importance to the broader discussion of this dissertation will be underlined. Unlike Pal (2011, 38), who asserts that incrementalism is

103 Because the analysis by root is presumably well known, it is not analyzed in his article. It corresponds to the perfect rational agent as used in microeconomics and public choice.

weak in three of the five assumptions or dimensions, I will argue that it offers deeper insights into policymaking than is often recognized.

In contrast with the traditional cognitive model of a maximizing agent, satisficing was accepted as a more realistic model of decision making with less heroic assumptions (Simon 1957). The recognition that human capabilities for runing comprehensive calculations are limited at best, leads us to search for an answer to the question, how do people solve complex problems? Incrementalism, with its emphasis on small adjustments to reality, allowing decision makers to predict and measure the possible consequences, offers an adequate explanation as to how agents cope with such a challenge. Organizations would also follow this pattern. Its participants too would have the limited cognitive capabilities and small changes would enhance control over possible outcomes since the fundamental workings of a given organization would not be questioned (Pal 2011, 31). Nevertheless, while an understanding of organizations as filled with satisficers is straightforward, the question of control within organizations seems to give to its leaders more cognitive leverage than it does to street-level personnel.

The way in which heads of organizations make decisions and move forward does not differ all that much from the work that goes on at the bottom of the pyramid. For instance, in policies with a restricted group of relevant policymakers, the hierarchical difference between those who decide and those who implement is small, even non-existent. In such a setting bounded rationality as a control tool within organizations loses its analytical power. However, this fact emphasizes the importance of embracing the cognitive dimension of incrementalism, while downplaying the consequences for political control, which is connected to the reversibility issue discussed below. All agents are equally rational, some of them more systematic than others, with every policymaker facing the same cognitive limitations underlined by incrementalism. Economic policymaking is a case in point, with its small group of decision makers with advanced degrees in economics, eager to show how their knowledge would allow them to make the best decisions.[104]

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104 There is even a joke that states that economists are professionals who are paid to predict the future and once their prediction does not become true, they are paid again to offer an explanation as to why what they thought would happen was not the factual outcome.

It is somehow paradoxical that the element of bounded rationality in Lindblom's work had a precedent in the anonymity of market interactions with its non-predictable outcomes. Obviously, the science of economics has changed since Lindblom finished his thesis at the University of Chicago in the 1940s. While he was participating in the debate about the consequences of bounded rationality in policymaking during the 1950s (Dahl and Lindblom 1953, Lindblom 1958, 1959, Simon 1955), economics was taking another direction.[105] With the advancement in information processing technology and programming, it seemed that cognitive limits could be easily surmounted. In fact, economic models take to the limit the idea of comprehensive rationality with the adaptive expectations revolution (Lucas 1972). Unsurprisingly, economic policymaking embraced the latter path. Markets were no longer unpredictable, even if they continued to be anonymous for other reasons.

The solution offered in the macroeconomic policy arena was the creation of rules that would moderate agents' expectations (Kydland and Prescott 1977, Barro and Gordon 1983). In principle, this would solve the instability created by the maximizing behaviour of policymakers. If efficiency is the consequence of the creation of such rules then political compromise is the order of the day. Moreover, rules governing the economy are limited since they are devised with the same cognitive limitations as underscored by incrementalism. If rules are specific and try to account for every possible scenario, they will probably fail; more abstract or general rules leave more in the way of policy space. Nevertheless, the model of comprehensive rationality is still a fiction that gives economic policymaking a significant amount of legitimacy.[106]

When rules have to be adapted to special circumstances, both their definition and the process through which adaptations are made resembles partisan mutual adjustment. There is a

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[105] A landmark work of this transformation is Samuelson's *Foundations of Economic Analysis* (1947). Even if the latter might have had a bigger influence on the transformation of the economics profession because of the increasing influence of the American academia after World War II, the transformation of the profession was hardly an exclusively American phenomenon; in declining imperial powers this was also an issue linked with the new way to account for national income (Speich 2011), which underscores the idea that the transformation of the profession followed national concerns rather than merely technical ones (Fourcade 2009). For the way in which economists in turn modelled the object of their inquiry, see Porter (1995), MacKenzie (2006), and MacKenzie, Muniesa, and Siu (2008).

[106] Not only economists as a profession nor the organizations where they work derive their legitimacy from the model of comprehensive rationality. This is also the case with the supreme audit institutions (Saint-Martin and Rothmayr-Allison 2011).

contradiction between rules that set clear parameters and some ad hoc arrangements between interested parties. The former seek to constrain the possibilities for action and the latter to broaden them. If actors are rational, rules modify their incentives so that they might attain a given goal, whereas adaptation to different circumstances is merely a means to an end of political stalemate. This is an underlying tension in economic policymaking insofar as rules, however efficiently designed, require actors to consistently adapt themselves to a political reality that was not previously articulated or laid out in the rules. This adaptation among parties could be studied as partisan mutual adjustment.

Partisan mutual adjustment shows that policies must be the result of multiple political compromises, of adapting to stakeholders' objectives. Generally, policies have to be adapted gradually, in part because agents are not fully rational and thus cannot foresee all the obstacles that might arise. Every actor, no matter how powerful, has to adapt to the fact that he cannot have his or her own way in policymaking. This does not imply that every adaptation is the same; instead, powerful actors might concede less than others, but they do it all the same. Partisan mutual adjustment is said to "take the form of fragmented or greatly decentralized political decision making in which the various somewhat autonomous participants mutually affect one another (as they always do), with the result that policy making displays certain interesting characteristics" (Lindblom 1979, 522). Subsequently Lindblom (1979, 522-523) analyzes these characteristics.

The first of those characteristics is that policies happen rather than being decided upon which means that policies should not be divided, not even analytically, between decisions and implementation. Another characteristic, mentioned above, is that numerous actors influence policies. This is related to the previous point regarding policies as a feasible outcome given the necessary accommodations between actors' often conflicting goals. However, Lindblom (1979, 523) contends that the absence or weakness of central coordination will sometimes render impossible any kind of synchronization.[107] Policies would be the result of an uncoordinated equilibrium of goals, some of which could be bargained upon, rather than the enactment of a coordinated effort by a central authority. This sort of general equilibrium view

[107] This is an argument reminiscent of the perfect-competition situation in which no firm can impose a price in the market because their individual contribution to it is not enough to change market conditions. Even so, the social outcome of markets in perfect competition is efficiency.

of policymaking is obviously attached to a pluralistic view of politics already expressed in the contribution of Dahl and Lindblom (1953). Even if partisan mutual adjustment refutes the synaptic model of comprehensive rationality anchored in microeconomics, it is not completely detached from these roots.

Just as partisan mutual adjustment has the look of a market in perfect competition, the political system portrayed by incrementalism resembles that of the United States. The existence of multiple veto points and a reasonable amount of actors endowed with similar resources are all characteristics of it. Also, these actors agree to lose one round with the expectation that eventually they will win in a future round. All of these are underlying characteristics of the kind of environment where partisan mutual adjustment is considered a possible outcome. While these traits are those of the polyarchic system deeply rooted in the imaginary of the 1950s (Dahl 1956), does this mean that partisan mutual adjustment must be abandoned? This should not be the case. Even if the American political system has changed in the last decades (Hacker and Pierson 2010, Gilens 2012), and the consensus over fundamental values has also waned, partisan mutual adjustment can still provide useful insights into the policymaking process, both in the United States and abroad. From the 1950s to the 1970s, the American political system was not as horizontal as was portrayed in partisan mutual adjustment (Pal 2011, 37), but it still presented itself as a useful representation of it.[108]

Similarly, partisan mutual adjustment can be a useful analytical tool in settings that differ from the ideal-type. Partially because incrementalism is policymaking at the margins, it still provides a model for situations in which there is a policy blockade and policymakers must still carry on. Just as the market model is useful even if perfect competition is an ideal-type, partisan mutual adjustment is useful for the study of policy systems that do not conform to the pluralistic and horizontal environment upon which it was based. In fact, the homogeneity in values, supposedly in the background of partisan mutual adjustment, is not a necessary condition for it to hold. For instance, if there is no consensus over values or a more general principle, actors can compromise over less important issues, in a situation that would amount to partisan mutual adjustment in everything but name.

[108] Later on, Lindblom (1977) was also critical of the transformations of the American polity in the sense that it was not the leveling playing field portrayed in his collaboration with Dahl (Dahl and Lindblom 1953).

A last characteristic of incrementalism is the reversibility of policy decisions. The fact that Lindblom (1959, 86) mentioned it as an advantage of incrementalism speaks to the microscopic kind of policy change he had in mind when he proposed the concept. Also, such a view highlights the fact that policymakers were somehow isolated and their decisions would not create any immediate political consequence. However, these small and harmless decisions are only the reality of the street-level bureaucrat who is also a decision maker (Lipsky 2010, Gruber 1987). Other decisions, even if equally constrained by the bounded rationality of the decision maker, are more likely to have far-reaching political consequences. If we accept that partisan mutual adjustment also depicts a situation in which a policy change is also small because it was the only feasible political compromise, then the reversibility of policy decisions no longer holds.

Even if Lindblom (1959, 86) asserts that wise policymakers are aware that their decisions might have unintended consequences, the *succession* of incremental changes would help in the containment of errors (emphasis in the original). Once again, we are in the microscopic world of policy decision making. Nevertheless, policies also create politics through policy feedback (Pierson 1993) in which policy decisions have political consequences. These political consequences are unforeseen and more often than not they are not produced in a succession of policy decisions but, instead, as a decision in which many actors have a stake.[109] Therefore, reversibility of incremental changes is less likely to hold insofar as the mutual adjustment that interested actors had committed to should also be reversed. Rather than reversibility, what is more likely to hold after a policy decision is that policies continue to hold following path dependency (Pierson 2000a). However, concurring with Pal (2011, 35), I would suggest that the idea of the reversibility of policy decisions contradicts the notion that incremental changes can, at some point, amount to a significant change.

The importance of incrementalism as a theory of policy change cannot be overstated given not only the trajectory of the concept but also its continued relevance half a century after its first appearance (Rothmayr-Allison and Saint-Martin 2011). Implicitly, the formation of

[109] Institutions can also change because of the imperatives of the policy process, both political and technical, where incremental changes are common; the different adaptations that institutions go through might end up shaping the institution as such. Policymaking is also a source of endogenous institutional change (Taylor 2009).

institutional complementarities has been understood in terms similar to incrementalism.[110] Moreover, the argument advanced here is alike insofar as its insistence that the institutions forming a complementary set have been the subject of intense reform through time, suggesting a kind of incrementalist change. The main link between the concepts of institutional complementarity and incrementalism is that the latter describes the kind of transformations that institutions experience up to the point at which their structuring role requires other institutions to hold. This implies that the political struggles leading to the institutional transformations underlying institutional complementarities should produce compromises that are incremental in nature, i.e. partisan mutual adjustment. However, complementarities themselves are verified when institutions take advantage of the presence of other institutions to play their structuring role in the political economy.

Even if the concept of institutional complementarity as offered by Schneider (2013) is different from the one offered in the present dissertation he suggests that the relationship between those institutions he identifies as being at the core of Hierarchical Market Economies – HME – have recently been transformed through a process of incremental change (191-197). This type of incremental change is displacement and drift. Because these categories of incremental change have been characterized as important to the understanding of the formation of institutional complementarities and are related to the discussion offered above concerning both the definition of institutional complementarities as well as the incremental pattern of change, the next section will focus on such patterns of institutional change.

[110] The description made by Aoki (1994, 671-673) about the way the main bank system worked and, crucially, that it was developed between the 1940s and 1970s, although the historical circumstances of the 1940s were crucial to their emergence, reflects a transformation of the system that amounts to an incremental pattern of decision-making. Similarly, Hall and Soskice (2001a, 13-14) make the argument about the historical roots of the institutions serving the role of coordination in the political economies they study. These institutions are built by the set of common expectations and repeated interactions between agents and, therefore, they are not created at one point in time but reaffirmed periodically. This continuous adjustment of the central institutions forming institutional complementarities is similar to the idea of partisan mutual adjustment in the sense that actors create common expectations by adjusting their behaviours following their repeated encounters instead of a big change at one point in time.

2.4. Institutional Change

Just as there are many definitions of institutions, so there are various explanations for institutional change. Accounts have tried to synthesize them (Hall 2010). By underlining the strengths and weaknesses of rational choice and sociological institutionalisms, these syntheses tend to favour the strengths while downplaying the weaknesses. It is said that rational choice institutionalism offers powerful insights into how institutions work but its characterization of institutional change is not as effective. On the other hand, sociological institutionalism conceives a world full of institutions, which downplays the relevance of their inception; instead, it underscores how institutions are open to interpretation, that is, it accounts for the ambiguities that may open opportunities to enact changes. Hall (2010, 205-206) proposes as a strategy to expand on the rationalist theme by including elements from historical institutionalism, taking the best from these traditions. This combination between institutionalist traditions implies that agents should act strategically when interacting with institutions. The result of such integration takes into account different sides of the interaction between actors and institutions.

Because for rational choice institutionalism, institutions are formed as a response to collective action problems setting a Pareto-optimum equilibrium, change has to come from outside. This condition recalls the model of punctuated equilibrium in which short periods of intensive change are followed by long periods of institutional stability because change happens when there is an external perturbation. Furthermore, even if analyses of both rationalist choice and historical institutionalism face the same kind of problem, authors in the latter tradition have produced a set of theoretical tools to deal with slow institutional change. Despite the common ground between sociological and historical institutionalist analyses, for instance in their view that actors face a world full of institutions, their common ground does not mean a straightforward integration of both traditions. Take, for instance, the concept of institutions as resources or instruments [111] (Hall and Thelen 2009, Hall 2010), which

[111] "Although some institutions rely on sanctions for their operation, the varieties-of-capitalism approach moves away from a view of institutions purely as factors that constrain action towards one that sees them also as

complements the view of institutions as embodiments of “logics of appropriateness” (March and Olsen 1989), insofar as these are not only important because of the actors’ adherence to them, but mainly because actors can take advantage of institutions to advance their interests.

There is a multiplicity of ways in which institutions and actors influence one other. If institutions constrain the behaviour of actors by structuring their actions, actors can also change institutions. This transformation is operated also by changes in the use of institutions and not exclusively through a conscious intent of changing them, as would be the case with the characterization of rational choice. This is an emblematic case of compliance as a political variable to understand institutions insofar as actors have the possibility to change them through their use instead of an explicit attempts to design them (Mahoney and Thelen 2010, 10-14). While institutions structure the interaction between agents in the political economy, these interactions will be subject to change if actors perceive that they are the losers, or that they could be gaining more. Thus, actors will use institutions in the same way they use the broad range of tools at their disposal.

Nevertheless, the usefulness of a synthesis between historical institutionalism and rational choice institutionalism is that the latter has powerful insights into how institutions work. Limitations remain, however, in the explanation for institutional change. Hall (2010, 206-216) proposed six steps within a broader rationalist model of institutions that could be fully integrated into a research agenda on institutional change, which could advance the abovementioned synthesis. These elements offer insights into the integration of different schools within institutional traditions; they also allow for a broader view of how actors interact with institutions. These interactions[112] are central to understanding the way in which a set of institutions can evolve through time with or without a common ending point.

These six steps allow for the integration of both traditions. The first step is to acknowledge that a precondition for institutional change is the assembly of a coalition. Depending on the institution in question coalitions may vary. The main point is that

resources, providing opportunities for particular types of action, and especially for collective action” (Hall and Thelen 2009, 10).

112 Interactions refers to the way in which agents’ actions are affected by institutions when the latter play their structuring role as well as the way in which actors can modify those same institutions. It is precisely this double influence that is remarked upon because otherwise it would be just influence of institutions over actors or deliberate changes of institutions enacted by actors.

institutional change needs political support to take place. The simple desire for change is not enough, in other words. Because institutions structure the behaviour of actors within the political economy, they should favour (or not) change depending on how their interests are affected. If change were only guided by efficiency, coalitions would not be necessary. Second, instrumental beliefs about the possible effects of these changes are a powerful driver for change as the uncertainty of the possible results of reform is a driver for stability. This point underscores that change brings with it a significant instability and the more it can be controlled, through some reassurances based on experience for instance, the more they have the potential to foster change.

Third, the relative power among actors interested in a given institution is fundamental to assessing the potential for change. For instance, when opposing forces are balanced there is a collective action problem instead of a clear majority. This means that even in the case of a level playing field, with agents similarly endowed, the solution to collective action dilemmas rests on power dynamics, established and reinforced by the organizations. Fourth, even when there is coordination among actors, there are distributive problems around institutions. This last point is in part a consequence of the former because it recognizes the fact that the solution to a conflict between different actors may involve winners and losers. Every actor involved in the process of change may try to avoid being the loser and such efforts should be accounted for in the study of institutional change.

The two last steps focus on the existence of a plurality of institutions in political economies. Plurality is the basic condition for the existence of institutional complementarities. This is of prime importance to our theoretical framework. The fifth step concerns the fact that change in one institution is affected by those other institutional arenas in which the same actors participate. Therefore, actors' preferences are multidimensional. Finally, the sixth step is that proposals for reform are mediated by other institutions which are not themselves the object of reform (Hall 2010, 214-215). The non-reformed institution serves as leverage in the process of institutional change, becoming itself a condition of it.

In spite of the attempts described above to create a synthesis between different institutionalisms, the main model to explain institutional change has been punctuated equilibrium, which describes a moment of substantial change followed by a period of stability

(Katznelson 2003). The moments of institutional change are normally considered critical junctures in which structural political forces are relaxed for a short period (Capoccia and Kelemen 2007, 343), allowing agents to mobilize resources that would otherwise be unavailable. The authors referenced above emphasize that critical junctures are those brief moments when agents' choices have a higher probability to be consequential in determining the outcome of interest (Capoccia and Kelemen 2007, 348). These moments differ from preceding and subsequent institutional development not only in the time span of its existence but mainly in the possibility that such events can trigger a process of path dependency (Pierson 2000a).

Critical junctures can occur within one institution but not in others (Capoccia and Kelemen 2007, 349-350). On a related note, whether this critical juncture affects just one of the components of a set of linked institutions or the set itself is difficult to determine. Equally difficult to prove is how a set could not be affected by a change in one of its components. Another issue of critical junctures has to do with negative cases (Capoccia and Kelemen 2007, 352): those moments when despite the lack of structural constraints, change does not materialize. While it would continue to be a critical juncture, it is useless to the identification of institutional change.

By contrast, gradual institutional change, with its diversity of mechanisms, is meaningful in spite of the speed at which it takes place. These modes of gradual change have been characterized by Streeck and Thelen (2005) and Mahoney and Thelen (2010) as "displacement", "layering", "drift", and "conversion". All these modes of change take into account the conflictive character of political economies by arguing that institutions are constantly the subject of political struggles, that is, its existence and persistence are political outcomes (Mahoney and Thelen 2010, 7-10). Further, they emphasize the various ways in which actors maximize their strategies for institutional change depending on how well their interests are served by the institutional status quo. The advantage of this analysis of institutional change is the dynamic element within institutions, which contrasts with the static vision of punctuated equilibrium.

"Displacement" refers to the process through which actors take advantage of the lack of coherence of institutions and use strategically those features that benefit them the most

(Streeck and Thelen 2005, 19-20). Once the involved actors take advantage of such incoherence, institutional features that have been left aside become less important. Then, they are substituted with new ones without necessarily being formally replaced which implies a break in the institutional path. In other words, salience of one institutional feature increases while the other simultaneously decreases until the political environment allows for a formal change in the whole set of rules. Once the rules are changed, displacement is said to have taken place (Mahoney and Thelen 2010, 15). In turn, displacement is associated with a political context in which there is less discretion in the interpretation of rules where actors seek to subvert the current state of affairs; this is what Mahoney and Thelen (2010, 23-24) refer to as *insurrectionaries*.

"Layering", in turn, refers to the process of adding a new rule *on top* of another. Instead of a blunt replacement of a given institution with a new one, layering adds another institution parallel to an existing one that, with time, can change the evolution of the former. The classic example in the literature on the welfare state is the introduction of voluntary pension systems on top of a public universal one (Streeck and Thelen 2005, 23). These new systems can be framed as adjustments to the old rules but because they are based on different logics, they eventually end up undermining the pre-existing institution. Therefore, layering is used when there are strong veto points attached to an existing institution that cannot prevent the enactment of new rules, either because the possibility of erosion is not obvious or because it becomes politically impossible not to enact new rules. It is a form of political compromise. Actors associated with layering are *subversives* insofar as they appear to support the existing institution while they try to undermine it (Mahoney and Thelen 2010, 25-26).

"Drift" happens when an institution already in place is not adapting to new realities that affect its performance. Although the existence of the institution as such is not compromised, its responsiveness to the new environment can imply a loss of relevance for involved actors who might be forced to ignore it. While the lack of adaptation seems to imply a lack of political action, it is precisely this lack that leads to institutional change (Streeck and Thelen 2005, 24-25, Hacker 2005). The political context in which drift is more likely to appear is one in which strong veto possibilities are present. That is, when the institution has a strong constituency that might be able to block more direct attempts to make changes. For the same reason, actors associated with drift depend on the institution in question but their actions undermine its very existence, thus they are called *parasitic symbionts* (Mahoney and Thelen 2010, 24).

Finally, “conversion” is the process through which an institution is redirected towards a goal that was not originally intended. First, this can happen when unintended institutional consequences (Pierson 2004, 115-119) become apparent, but also when actors not originally involved with the creation of the institution take it over and redirect it to their own ends (Streeck and Thelen 2005, 26). Thus, there are two possible origins for conversion, one strategic in which actors actively seek to redeploy an institution created with a different goal in mind (Mahoney and Thelen 2010, 17-18), but also conversion can be the result of an institution that outlived its creators and one which supporting coalition does not necessarily reflect its origins (Streeck and Thelen 2005, 27-28). In turn, actors involved in such change are *opportunists* as they seize the occasion that fit them best. That is, if institutional preservation with a different interpretation works better they would not seek institutional replacement, hence conversion (Mahoney and Thelen 2010, 26-27).

From a different perspective, that of Regulation Theory, institutional change includes the mechanisms of “recombination” and “hybridization”. “Recombination” refers to the process by which a set of supposedly independent institutions changes the links and relations between them. These changes can completely redefine the whole set, in part because what delineates the set are the links and relations established between their constituent parts (Boyer 2004, 193). Examples of this type of institutional change are those occurring in transitional economies where a broad change in the whole institutional apparatus is triggered in part by substantial changes in some parts of the apparatus. What happened in Russia with the demise of the Soviet Union, when property rights were supposed to bring capitalism, shows how this change was not enough for a full regime change. Instead, what remained at the end of the 1990s were elements of the former system combined with that of the new one (Boyer 2004, 190-192).

“Hybridization” refers to the unintended consequence of an imitation attempt in which an institution conceived in a given context is implemented in another where it proves less useful. (Boyer 2004, 197). Hybridization implies the existence of a given set of institutions with a common logic that is modified by the introduction of an exogenous institution. Following the *regulationiste* agenda, both recombination and hybridization try to capture institutional change on a macro level, in contrast to the micro-level analysis that has thus far been the focus of this chapter. In fact, rather than being mutually exclusive, these two levels of analysis complement each other in the context of the present work. Latin American economies involve both a micro and macro level perspectives on institutional change.

The next section will focus on the selection of the empirical cases in a Latin American context where economic governance sought to create stability.

2.5. Case Selection

Latin American economies were transformed with liberalization policies during the 1980s and 1990s. These changes represented a shift in the development model that most countries in the region had adopted after the Depression. There was not, however, a conscious and deliberate attempt to change this model of economic governance. Observations show that the process contrasted greatly with what has been suggested by this *ex-post* sequence. The international context in which Import Substitution Industrialization – ISI – was implemented was relatively stable from the 1930s-1940s to the 1970s. The Depression and World War II created a situation that legitimized the intervention of the state in the economy.[113] The intervention of the state in many countries around the world took the form of a Developmental state (Woo-Cumings 1999).[114] In Latin America, this intervention took the form of ISI and state capitalism

[113] These were the years when Keynesianism was the main economic paradigm in the capitalist world. Such dominance did not imply that it was implemented evenly across capitalist countries; thus, every country had its own variety of Keynesianism (Hall 1989).
[114] Even if it is tempting to assert that the Developmental state was a phenomenon of the Global South, the main example of it is no less than Japan, which cannot be counted among that particular group of countries. As mentioned in the previous chapter, Johnson (1982) is the classic reference on the theme.

and appeared as a response to the economic crisis caused by the Depression and subsequently consolidated in the aftermaths of the World War II.[115]

The biggest Latin American economies embraced the characteristics associated with ISI in varying degrees, responding to their own priorities, needs, and challenges (Thorp 1992). In some countries there were significant accomplishments in terms of industrialization, notably the case of Brazil and Mexico, while others suffered a continuous decline, notably Argentina and Chile. In the 1970s, the international context changed adversely. Unsurprisingly, the responses in terms of economic policy also varied depending on the political priorities of the authoritarian governments that were in place at the time.[116] There is some similarity to be found in the many differences in policy priorities, however. Despite the changing conditions of the international economy during that decade, the previous patterns of economic policymaking remained in place,[117] signalling that those changes were not initially interpreted as being as fundamental as they would turn out to be.

The continuation of the economic policies, with a significant deepening of their characteristics, created further vulnerabilities in these big Latin American economies. In both Brazil and Mexico, their models of heavy intervention were deepened with the *Plano Nacional de Desenvolvimento* (National Development Plan) in the former (Carneiro 1989) and the discovery of oil and the subsequent largesse in the latter (Lustig 2002, 41-58). In the case of Chile, the extreme liberal policies implemented by the military government were not adapted to the new international environment either (Ffrench-Davis 2014). In Argentina, while there were attempts to change the path of economic policymaking with a timid liberalization in the midst of a strong intervention represented in military expenditures, it was the latter that prevailed (Canitrot 1994, 79). During the 1980s, all of these countries suffered significant crises and a complete disruption in their patterns of economic governance.

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115 The characteristics with which ISI is normally associated, inward looking and inefficient, were developed throughout the years, not as the implementation of a given blueprint. For an in-depth discussion on the early development of ISI, see Thorp (1992).

116 A good comparison between the implementation of developmentalist policies in Latin America is offered by Schneider (1999) concerning Brazil and Mexico.

117 Path dependency is also part of the explanation but there were also mitigating factors such as a favourable international credit market that, at first, eased the constraining conditions of the oil shocks.

The continuation of each policy path in those countries speaks to the interests that had been created around them. In spite of the changing environment, vested interests were capable of keeping the course of action previously established. The crises that affected these countries threatened some of these vested interests, who resisted change. Therefore, incremental changes would give reformers more leverage in the struggle to change the institutions buttressing such interests. One of the main consequences of these crises was precisely the political struggles that followed them, which means that crises are associated with the political consequences they bring upon actors. This is important because the political consequences of economic crises are key to the subjective appraisal of the latter, which materializes in the level of fear of decision makers who later would push for reform, then, consolidating institutional complementarities.

Thus, Brazil, Chile, and Mexico are the countries where ISI was carried more enthusiastically along with Colombia and Argentina (Thorp 1998, 134). However, the latter present two important shortcomings for the analysis presented here. Colombia was not as committed to ISI as the other countries, which in turn makes its inclusion problematic. Furthermore, the demise of the ISI model did not come with the generalized crises brought up by the debt moratorium declared by other countries. In fact, Colombia, along with Dominican Republic, was the only country that did not show negative growth rates in the conjuncture of 1982-1983 (CEPAL 2009, Table 1.1.1.2). Also, it was not amongst the biggest countries in the region and size matters insofar as scale economies were important for the consolidation of the internal markets. Argentina, for its part, made the transit towards liberalism in a rather discontinuous form, which represents a big obstacle for its inclusion since the process of institutional change that most likely led to the consolidation of institutional complementarities were small incremental ones.

After the critical situation into which many Latin American economies fell, economic governance patterns had to change to reflect their new situation. This process that involved mainly a liberalization of their economies represented a new effort to create a new pattern of economic governance. The new pattern of economic governance sought to reinforce stability in the political economy. Therefore, after the crises of the early 1980s, the governments of the biggest Latin American economies reformed some institutions in the attempt to avoid similar problems in the future. Since institutional complementarities seek to create stability in a political economy, it should be present in the medium to long term. However, these transformations presented big ruptures in some countries showing an institutional weakness insofar as policy changes depended on the political figures in place. This is the case of Argentina where liberalization depended heavily on the Ménem administration and its stance vis-à-vis other social actors (Canitrot 1994, Acuña 1994, Treisman 2003, Acuña, Galiani, and Tommasi 2007).

Instead, the other big economies transitioned towards liberalized policies achieving a significant consolidation, that is, without major ruptures.[118] Thus, a condition for the analysis is the general stability of the process of liberalization. Given the increasing importance of the financial sector in Latin American economies after liberalization, this is a privileged scenario to study the institutions that support, from different angles, such a sector. As suggested by Stallings (2006, 13), the most sophisticated financial systems in Latin America are Brazil, Chile, and Mexico.[119] In turn, these countries are also among those where the shift in the development model was more successful, as in the last two cases (Thorp 1998, 243-251). Although Brazil was not as enthusiastic in neoliberal reforms as Chile and Mexico, it showed a significant economic transformation through liberalization.

Despite the similar degree of sophistication[120] of the financial sectors of these countries, these did not face the same kind of challenges. However, all of them were

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[118] The obvious counterfactual would be the case of Brazil, which even suffered a process of impeachment in 1992. Despite such a traumatic political experience, the process of liberalization was not derailed and continued throughout the government of a president who was largely considered to be against such policies. This trait allows us to consider Brazil as a significant case while excluding Argentina from the analyses presented in the present study. Moreover, even in the 2000s when both countries elected a left-leaning government, Brazil continued the policies of its predecessor while the latter made a U-turn. Thus, the evidence supports our claim that Brazil shows a stable pattern of economic governance whereas Argentina does not.

[119] The financial system does not constitute a dependent or independent variable in the model presented in this study; however, since the argument about complementarities involves the financial sector in at least two empirical cases, and figures prominently in the other, the similarity between the financial sector of these countries is meant to serve as a control within the frame of the broader institutional changes enacted in these economies.

[120] Stallings (2006) does not offer specific parameters to measure the sophistication of financial systems. However, the case studies make clear that those financial sectors have complex structures insofar as both banks and capital markets are important for their respective economies, especially because of the scale of resources handled by the latter. Also, banks are owned by both the state and private sector, which account partially for the different results presented by those countries. A relevant question should be that of size since economies of scale are important in financial intermediation and finance in general, which would skew the sample of countries that present significant traits; this question, however, is beyond the scope of the present work.

transformed in the liberalization process that took place in the last two decades of the twentieth century. The financial sectors of Brazil, Chile, and Mexico had suffered deeply with the debt crisis in the first half of 1980s and needed the support of the state. Although it will be further developed in the empirical chapters, some of the measures put in place to support financial sectors will be briefly described. In Brazil the inflationary regime maintained the banks thanks to their ability to collect the inflationary tax through indexed securities allowing them to keep afloat. In Chile the significant crises, both exchange and banking, forced an otherwise reluctant government to step in and take control of the banking sector. Finally, the nationalization of banks by Mexico's president in 1982, led to a significant transformation of the financial sector so as to avoid similar problems in the future.

This critical juncture of Latin American political economies set up a long-term process of change that would have an impact on institutions governing financial relations throughout the region. Such institutions were different in each country and, consequently, were transformed in different ways depending on their respective articulation within a particular political economy. The institutional reforms studied here should not a priori be related, because this would cause a selection bias insofar as the institutional setting would have a tendency to create linkages amongst its parts. Therefore, the institutions studied should be independent from each other at the beginning of the process so as to show how institutional change led to linkages between them and eventually, complementarity. Such individuality includes the promoters as well as the reasons behind the processes; these preconditions help to set the political independence of institutional change's dynamics.

The critical junctures had nonetheless a lasting impact in their respective political economies. The events surrounding such junctures created deep wounds in each society both in political and economic terms. Even if later on such events faded, the spectre of a possible return to the particular traumatic moment at the beginning of the liberalization played a deterrent role. Actors were well aware of the negative consequences to come if institutional reforms did not continue their course. Thus, the existence of a political menace is yet another condition in the setting that would lead to the consolidation of an institutional complementarity. In principle, the cases presented above should all show the constitution of the phenomenon in question since the conditions are similar in all of them. All the countries went through significant transformations of their financial systems between early 1980s to the late 1990s and the beginning of the 2000s. The reforms of the institutions affecting the financial system were carried independently from one another. These reform were not intended as a consistent set seeking to transform in a predefined way the financial system.

The institutions considered in the present dissertation were at the core of the economic transformation of their respective economies. In this sense, they structured the behaviour of a broad array of actors in a different way during the main stages of reform, which also speaks to their relative importance in the economic organization of these countries. These reforms were at the core of the transformation of the role of the state since they implied, implicitly or explicitly, a change in the way in which the states in question modelled the behaviour of economic actors through their own change. As a consequence the reforms that will be analyzed are not considered mere policies; instead, since they modelled, more or less successfully, the behaviour of actors I contend that they should be considered as institutions. Even if policy makers considered them to be another action taken by the state, it should be acknowledged that with these actions, the rest of actors within those political economies changed their behaviour.

Furthermore, given the conditions for institutional complementarities it is of utmost importance that such institutions were not considered at the beginning of the reform process to be a part of a given set of intermingled reforms. Following Streeck (in Crouch et al. 2005, 364-366), any credible theory of institutional complementarity should avoid the consideration of a master designer, which in this context implies that the reforms considered were not planned as constituent parts of a consistent set of reforms. This independent character is represented in the different group of decision makers that started each reform process, which is complemented with the different political aims such reform were intended to achieve. Even if in the process of reform, they might affect each other, in their inception, they must be independent so there will not be any risk of a functionalist argument.

The political and economic changes implemented in Brazil to stop inflation were not simply a matter of monetary reform with some adjustments to consolidate it. On the contrary, its control required a profound transformation of the prevailing institutions in the Brazilian political economy. The study of the Real Plan gives important insights into the understanding of institutional complementarities because it required numerous institutional reforms to achieve its objective, even if these reforms were not rationally planned nor conceived as a series of steps to follow. Privatization represented a transformation of the role of the state from owner to regulator; trade liberalization, in turn, represented a change in a fundamental rule of the economy, whether or not it was open for foreign competition. Therefore, different actors who followed their own paths transformed these institutions until the interaction between them was perceived as fundamental to the stabilization effort. In fact, these more or less simultaneous transformations ran fairly independently from each other, even if in some instances they were considered as a whole.

The Chilean pension reform created a situation in which a group of actors tried to take advantage of the possible returns granted by the new norms. Taking advantage of financial resources within the labour market, using it to finance productive activities, improving growth and creating increasing returns through financial intermediation, leding to institutional complementarity. Nevertheless, neither pension system reform, nor financial system reform, were conceived as a response to the other. While there had been some crossovers between the two systems, the main changes enacted in both spheres were to do with internal concerns rather than the explicit intention of influence one another. After three decades of existence, the pension system is a contentious issue in Chilean politics leading to successive reforms in recent years.

In Mexico, in order to ensure stability after a period of serious financial turmoil, efforts were made to reduce presidential discretion over economic policy. After much debate, central bank independence was granted such that monetary policy is no longer at the discretion of the Presidency. Another major reform was the attempt to introduce a new fiscal rule that would restrict the Executive's ability to run deficits. The new rule required the explicit authorization of Congress. Observation shows that central bank autonomy has been respected, while Congress has continuously approved deficits undermining the effectiveness of the fiscal rule. The Central bank reform mobilized actors in the Mexican polity, not least the bureaucracy within the organization itself. Reform was influenced by foreign precedents and it went through a long maturation process, lasting through more than one administration. On the other hand, the fiscal rule was the product of an ephemeral alliance against a political outsider in the context of a contentious presidential campaign. These reforms sought to change fundamental rules on how actors should behave, specially Presidents in the case of Mexico, which allow me to use them as institutions rather than policies.

All these processes of institutional change leading to the constitution of institutional complementarities conform to small incremental changes that later on result in a significant shift in the institutional landscape. In Brazil, the transformation of its economy was carried out by a careful removal of old rules and the introduction of new ones that did not reproduce inflation. This type of institutional change was identified above as “displacement” (Mahoney and Thelen 2010, 16). For its part, the changes in the Chilean polity demanded a different approach: since the contentious transition to democracy led democratic incumbents to forge compromises by the enactment of new, democratically conceived rules on top of old authoritarian legacies. This kind of institutional change can be characterized as “layering” (Mahoney and Thelen 2010, 16-17). In Mexico, given the sudden change in the broad political environment due to an unexpected electoral outcome, the interpretation of the rules in place could change as fast as the environment. “Conversion” was the mode of institutional change here (Mahoney and Thelen 2010, 17-18).

This multiplicity of types of institutional change leading to the consolidation of institutional complementarities makes clear that the type of institutional change is not a determining factor. It confirms, at least partly, the proposition by Schneider (2013, 196) about displacement and drift as privileged types of institutional change to the formation of the phenomena at hand. However, in the cases presented, drift does not seem to hold, which could be explained by the cases not necessarily by the outcome of interest, institutional complementarities, themselves. What must be clear is the fact that complementarities are not the product of a rational design of an efficient setting to accomplish a given goal (Aoki 2001). In this sense, complementarities are unintended consequences (Pierson 2004) of the first institutional changes launching long-term processes.

The fact that institutional complementarities do not depend on any one type of incremental institutional change to hold makes sense insofar as the phenomenon seems to hold in different contexts and with different institutions. In the present work, not even the sector is a determining factor. The financial sector of the countries studied represent many kinds of institutional change. As mentioned by Mahoney and Thelen (2010, 18-22), the complexity of the political context, the kind of institution in question, and the actors affected by the institution all play a role in institutional change. However, institutional complementarities seem to be independent of those factors as such, which means that they can appear in different contexts and through different processes of change. Nevertheless, the first step in the study of complementarities is to determine the reason behind their consolidation, which is precisely what this study seeks to do.

2.6. Limits of the Study

This dissertation considers governance regarding economic policy. Within this broad issue it places the constitution of institutional complementarities at the center of governance. The question is, why do institutional complementarities appear in a political economy consolidating in turn a pattern of stable economic governance? Yet, institutional complementarities have also represented an answer to the question of what is the difference between capitalist economies and why these differences remain over time. The difference between the two questions outlined above, why institutional complementarities appear and why institutional complementarities remain over time, has to be specifically addressed so as to clarify the limits of this study. Whereas, institutional complementarities have traditionally been thought of as independent variables used, for example, to explain the differences between capitalisms, this study sees them as dependent variables.

Nevertheless, the present study does not seem to establish a difference between Latin American economies. Even if it uses three countries as study cases, the argument seeks to show the reason for the consolidation of institutional complementarities, using for that purposes Latin American economies and their institutional reforms. Moreover, if at the core of this discussion are different types of capitalism in both the region and abroad, the possible conclusions drawn here should not be taken as indicative of a given type of capitalism. Doing so would be to reproduce the aim of works like that of Bizberg (2015a), whose findings indicate that every big Latin American economy presents a different type of capitalism. This is clear evidence that the line between a type of capitalism and a type of economy deserves more analytical attention. This problem is not new however, Crouch (2005, 27-41) had already made such a warning.

Despite the possibilities that the concept of institutional complementarities offers in terms of giving us a comprehensive view of capitalism, insofar as it connects socio-political relations to economic outcomes, this study cannot offer such an assessment. In turn, it shows how the constitution of institutional complementarities requires political mobilization by several groups of actors who push for specific reforms that eventually could transform a given economy. Although it might seem a capricious choice, concentrating on an articulating sector forces one to leave others aside. Financial relations do not imply a big conflict with labour, as opposed to physically productive activities where the ratio capital/labour is less skewed towards the former. While this is not a characterization of Latin American capitalism, as such it can certainly push the debate forward so that we might see how different institutional complementarities came to existence or, indeed, are coming into place at the moment.

However, the study of institutional complementarities can shed light on the possibility of reforms to succeed or not. Even if the present study does not assess whether or not liberalizing reforms succeeded in Latin America, the way in which policies are related to each other within institutional complementarities would provide elements for such evaluation. In addition, for future policymakers, this study can offer a useful framework for implementing future reforms that could become complementary with the prevailing institutions of their political economy rather than the simplistic transposition of a given blueprint. In spite of these possibilities, the present study must leave such concerns aside in order to focus on why institutional complementarities are consolidated. Those questions should be addressed by other studies.

Chapter 3. The Real Plan : Institutional Complementarities, Political Struggles, and Economic Reforms

The question that this dissertation seeks to address concerns economic governance in the context of a reconfiguration of economic policy. A key element of economic governance is maintaining order in a political economy. The constitution of institutional complementarities provides the necessary elements for the creation of stable conditions. Such institutional complementarities happen when one institution depends upon another institution to play its structuring role in the political economy. The key factor behind the constitution of institutional complementarities is the fear of decision makers of losing elections or the privileges they enjoyed before the beginning of institutional reforms. When decision makers perceived that the reforms underpinning the good economic results associated with the government to which they belonged could crumble, they in order to prevent such outcome. A possible consequence of the demise of these institutional reforms was precisely a return to hyperinflation. This situation made them coalesced to buttress institutions with each other so they could still play their structuring role and avoiding the possible return of hyperinflation.

The political and economic changes implemented in Brazil to stop inflation were not simply a matter of monetary reform. Inflation control required profound transformation of the Brazilian political economy. Different actors, who followed their own paths, transformed these institutions until the interaction between them was perceived as fundamental to the stabilization effort, up to the point of becoming its core. These transformations were the result of struggles faced by a certain set of actors in their quest to change a single institution without any regard to the possible systemic effects such institutional change could produce in other arenas. Even if unintended consequences could be expected, neither the particular interactions that arose were conceived as such, nor pursued. Later on these interactions became important for the struggle of another group of actors that saw in those institutional interactions a feasible way to control inflation in Brazil.

The initial actors, those involved in the first steps of these institutional transformations considered only the struggles they were participating in, even if they were fully aware that other changes could happen simultaneously. This was certainly a consequence of a contentious and conflictive political and economic context. Factors such as the ongoing transition to democracy, as well as the successive attempts to eliminate inflation, created the political upheaval for radical changes to take place. These changes, however, did not always produce expected results. A second group of actors not only took advantage of the ongoing changes but also launched their own institutional transformation that finally managed to control inflation. In other words, after the first phase was completed, once the first signs of success became evident, the set of unrelated institutional transformations that together could produce systemic effects, i.e. effective price control, were then intentionally subordinated to the control of inflation. This was done through the consolidation of one institution that was used to buttress other institution after actors feared that both institutions could cease to play their structuring role.

This chapter intends to use the story of how inflation was controlled in Brazil in the first half of 1990s as a way into a more theoretical argument about the constitution of institutional complementarities. I intend to show how independent institutional transformations, each one representing an independent political struggle, became dependent on one another, ultimately staving off the politico-economic upheaval that a return of hyperinflation would have caused. This mutual dependence between institutions constitutes an institutional complementarity, since the structuring role of each institution in the political economy depended on the presence of the other to function. This chapter provides a description of the political and economic conditions in which the institutional changes took place, as well as an account of the problems faced by Brazilians when dealing with inflation. This mise-en-scène will not be exhaustive. The goal here is to provide a general overview of the conditions in which relevant political and economic decisions were made.

The institutional changes that will be analyzed are: the privatization of diverse assets owned by the Brazilian government, the commercial liberalization that allowed the entry of a variety of imports to the Brazilian market, and, finally, the matter of monetary and budgetary reform. When a big privatization was pushed forward to receive the proceeds in foreign currency actors were well aware that these resources would help to smooth the exchange rate, at the time the main instrument of commercial liberalization. The argument about the complementarity between these institutional changes will be supported with an account of how by taking into account the possible political consequences of a return of inflation, unrelated institutional changes were subordinated to price control. This set of institutional reforms were fundamental to the Brazilian economic authorities tasked with the job of keeping price increases under control in the second half of the 1990s, who regarded the whole set of reformed institutions as essential to controlling prices. The fear of a return of hyperinflation helped to trigger the decision of privatizing a company so the proceeds, in foreign currency, could be used to ease the pressures over the exchange rate. In conclusion, some theoretical implications and preliminary remarks about the Brazilian case will be advanced.

Privatization and commercial liberalization became complementary when both policies implied that the state no longer held the same number of responsibilities. As will be explained in detail below, privatization implied a better use of resources considered scarce, because state-owned enterprises in bad financial shape demanded a lifeline with substantial use of public resources. Even if privatization can be read as the end of some rents captured by bureaucrats (Niskanen 1971), the process of divestiture was an initiative of those bureaucrats who saw how public resources were misspent used as they were to sustain non-profitable businesses. At times these businesses sold their products below their marginal cost, with the effect of providing subsidies to their clients. Therefore, privatization ended the cost-externalizing strategy of some businesses that bought their inputs at below-market prices. While politicians also used public enterprises for patronage and consequently represented a political obstacle to surmount, this practice did not have a significant economic consequence in terms of inflation.

On the other hand, a complex structure of protection was in place that allowed for local producers to pass over their costs and their *ad hoc* profit margins to consumers. Thus, commercial liberalization prevented the continuation of this cost-externalizing strategy, as external competitors would come with lower prices capturing a considerable share of the Brazilian market. Without enough competition from external producers, locals could increase prices without any danger of losing their clients to other producers as a closed market allowed them to capture rents. Both policies, privatization and trade liberalization, barred the continuation of a well-known game in Brazil in which personal costs or failures could be paid for by others. When political actors faced some of the costs of their actions, failed state-owned enterprises could be sold out and inefficiencies could not be translated into higher prices. Such effects reinforce each other, thus becoming complementary making stabilization possible. As will be explained in detail below, both privatization and commercial liberalization represented in their respective arenas the end of the cost-externalizing strategy of different actors within the Brazilian political economy.

For a while, inflation was considered functional insofar as everyday political interactions were supported by it. The budget became a political arena in which politicians raised expenses as a way of showing to their constituencies their political clout over the government.[121] The counterpart of these demands, namely the revenues that would sustain them, was not among politicians' concerns. However, the Treasury[122] had a better solution. Given the high inflation, the way to "pay" for those expenses was simply to delay payments, even salaries, because the real value of those expenses would be eroded by the running hyperinflation (Cardoso 2006, 141-142, Bacha 2012a, 122). Even if the importance of its presence in the Federal sphere and the bigger states was systemic, it is no less true that it was generalized among all governmental spheres.

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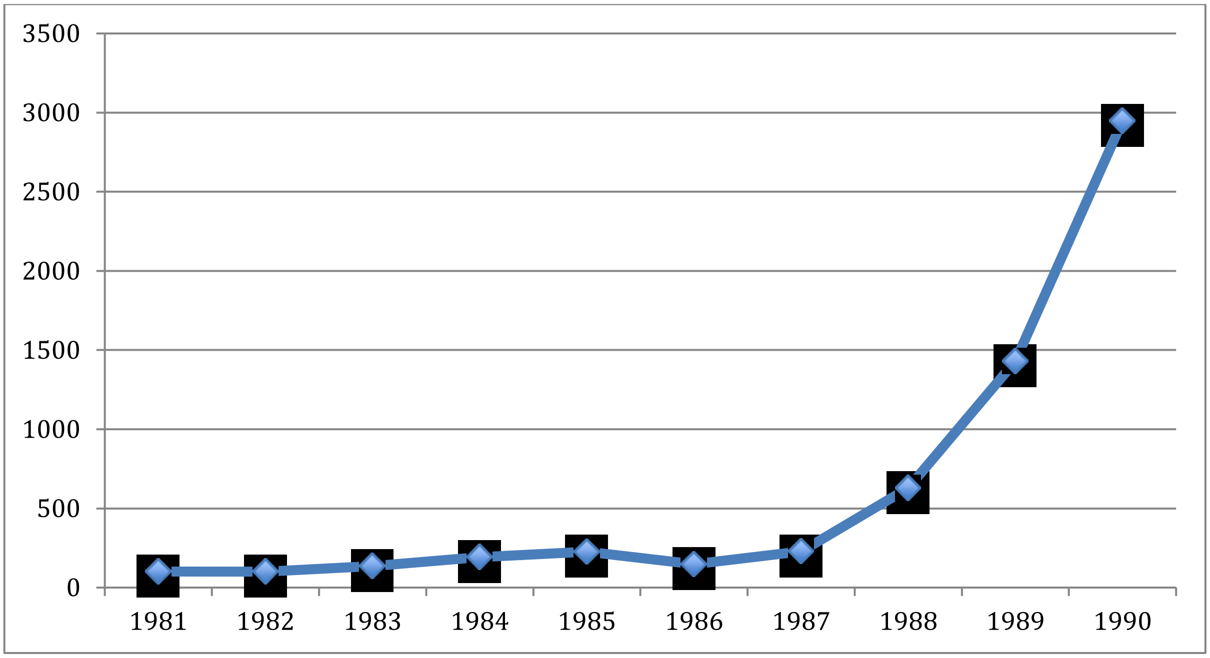
121 Edmar Bacha. Interview by the author. Rio de Janeiro. February 21, 2014. Edmar Bacha is a founding partner and Head of the Instituto de Estudos em Política Econômica/Casa das Garças. He was President of the *Instiuto Brasileiro de Geografia e Estatística* – IBGE (Brazilian Institute of Geography and Statistics) during the Cruzado Plan in 1986. Later he was nominated as President of different institutions during the Real Plan and was a member of the team behind it.

122 The *Secretaria do Tesouro Nacional* – STN (National Secretariat of the Treasury) is subordinated to the Ministry of Finance. While the relationship between the two instances depends on their heads, Secretary and Minister respectively with the former subordinated to the latter, the institutionalization of the STN represented a professionalization of its tasks and a better organization of the relevant information on assets, debts, and, generally, patrimonial stance of the Brazilian Federal Government.

Figure 3. Inflation. Consumer Prices. 1981-1990. In percentage



Source: Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as annually. The Laspeyres formula is generally used. International Monetary Fund, International Financial Statistics and data files IBRD (2016c).

Inflation was a problem with which Brazilians lived for several decades. However, during the 1980s, inflation increased at a pace only seen in the 1920s in Germany and other Eastern European countries (Figure 3).[123] During the decades-long process of living with high inflation, Brazil developed a series of institutions to lighten its burden, mainly for a privileged sector of society. However, at the same time, inflation was fostered through monetary emission, in its many iterations, with fiscal roots. In part, inflation, within certain limits, was seen as a natural and relatively inoffensive consequence of a larger process of development in which the state played a central role.[124] State intervention took on the form of ensuring a closed economy that created a protected environment for new industries and, more directly, through the state's ownership of some of these industries, or the subsidies it provided.

123 For the figures on Germany and Eastern European countries in the 1920s, see Franco (1995a, 144).
124 For a critical evaluation of the relationship between development and inflation, see Franco (1999, 219-222).

State intervention in the economy had as a core objective to promote growth, which came to epitomize the pursuit of development. For such an endeavour, policy instruments varied depending on the specific target. Heavy industries such as steel mills, mining, and public utilities, became the responsibility of the state because they were considered public goods with large sunk costs or strategic value. On the other hand, private investments were promoted through market protection, subsidies, and soft loans, among others. The state became ubiquitous because even when it was not directly involved with productive activities in any given sector, these were supported with some kind of policy instrument guarantying a return. In the 1980s, this massive intervention in the economy showed its weaknesses when the conditions in which it was previously conducted changed dramatically. The rise of interest rates affecting the world economy, would make too onerous the pattern sustained up until then. The developmental state in Latin America crumbled.

Inflation became a household name in Brazil, in part because it was considered a relatively harmless consequence of development. This consideration notwithstanding, some sectors (organized industries, labour, and the state itself) demanded protection from its effects, demonstrating that it was not innocuous. This protection came in the form of indexation,[125] which is the process of adjustment of a given price with the previous inflation rate as a way to recover the losses produced by it. However, when this actualization is done at different paces depending on the price, a coordination problem occurs since there is the possibility that a price changes because of an exogenous shock, such as a bad harvest for instance. Then, every single price in the economy will vary accordingly with that price variation.[126]

Indexation made an appearance in the first military government, that of Humberto Castello-Branco (1964-1967), because one of the problems he had to face on the economic front was precisely that of controlling inflation[127] and establishing a mechanism to coexist with its consequences (Simonsen 1970, 183). Even if comparing the response of the military

125 Indexation was used in salaries, exchange, taxes, financial contracts, and later in contracts in general. See Franco (1999, 225). Indexation will be further discussed below.

126 For a simple explanation of the indexation dynamics in Brazil, see Sardenberg (1987, 24).

127 Following the information available in the historical statistics compiled by the *Instituto Brasileiro de Geografia e Estatística* – IBGE (Brazilian Institute of Statistics and Geography) (IBGE 1990, 186), the difference between January 1964 (23.992) and January 1965 (41.335) was of 17.343 percentage points using January 1967 as 100. The increase would have been a total of 72.28% in the year of 1964.

government to its contemporary inflationary crisis is beyond the scope of this work, it is worth mentioning because it established an enduring legacy. Even if Brazilian legislation started to account for an automatic correction of an asset value as of 1958, it was not until July 1964 that indexation made its first appearance on the economic landscape with the enactment of the Act 4357 that created the *Obrigações Reajustáveis do Tesouro Nacional* – ORTN (Adjustable Liabilities of the National Treasury). The value of this security corrected its value in response to the observed inflation, creating an incentive for the public to buy it. For the state, it was a way to recover the possibility of financing public deficits through non-compulsory debt as well as the indexation of tax revenues[128] (Simonsen 1970, 184-185).

However, financial markets would benefit the most from indexation because many of its instruments were also indexed with shortening terms to the application of such measures (Simonsen 1970, 188). Thus, indexation allowed those few with access to financial products to be protected from inflation, or even to profit from it. The fact that indexation came as a response to some groups' demand for protection from the effects of inflation says a great deal about its political character. First of all, tax revenues were indexed while expenses were not granting a protection to state revenues. Some contracts were indexed *ex ante* whereas others were indexed *ex post*, creating a difference in the protection granted depending on the asset possessed. This difference in the level of protection granted to different groups in Brazilian society fostered a collective action problem insofar as every person had the incentive to seek better protection than that granted to others with the consequence of accelerating the next actualization of the numerous indexes.

Then, the high rate of inflation in Brazil was not only a consequence of fiscal or monetary policies, but also a consequence of how specific markets adjusted to price increases: increasing their prices, often surpassing the official rate of inflation. Therefore, policies that fostered inflation also created their constituencies, who had all the incentives to bet against any attempt to control it.[129] Also the numerous factors influencing inflation allowed those who benefited from it to avoid the consequences of their actions and putting in a more than precarious position those who lacked any protection whatsoever against price increases.

[128] Although there were other measures introducing indexation in contracts, the abovementioned examples make reference to the ways of financing state activities, debt, and taxes.
[129] This constitutes another example of feedback effects (Pierson 1993).

Paramount among those blame avoidance instruments was indexation because it allowed for price correction independent of the fundamentals of production processes or seasonal shocks. As every price was attached to an index, when there was a price increase, that index was corrected and with it the rest of the prices in the economy, creating a cascade effect. At the end, it was nobody's responsibility.

The phenomenon of generalized indexation in the Brazilian economy came out as another element fuelling inflationary dynamics. This relationship was created through what came to be known as inertial inflation (Bresser-Pereira and Nakano 1987), which refers to the automatic reproduction of inflation without any other fundamental change in the economy. Even when theoretical debates on the matter thrived, the policies put in place to fight inflation ignored the hypothesis of inertial inflation, focusing instead on a traditional view of fiscal and monetary restraint. In the first half of 1980s while the military was still in power, discussions about the inertial inflation became common not only from a theoretical point of view but also from a practical point of view.[130] Also the serious consideration of the theory of inertial inflation was a consequence of the ineffectiveness of the traditional programs implemented by the last military government.

Indexation worked at the end of a time period (a year, a month, or even a day) when there was a correction in the value of a given financial instrument actualizing its real value following the losses caused by inflation. Indexation protected against inflation after a given time, but not before, except for tax collections, meaning that there was a loss of value while waiting for the correction. This gap between the moment of correction and inflationary corrosion opened up many possibilities for action. First, those who already enjoyed the advantages of some kind of indexation demanded that it be corrected at a faster pace. Because the time gap would be reduced, the possibilities of losses would decrease. Second, financial institutions practically arbitrated and collected the inflationary tax through indexation because if their assets were corrected faster or by a better index than their liabilities, there was a margin to rely on.

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130 Cabello (2014) asserts that Mário Henrique Simonsen, a prominent economist and Minister of Planning during the military regime had proposed the same concept during 1960s and 1970s. Whether Simonsen coined the term, or not, is less important than the fact that he certainly participated in the discussions during the 1980s about such a phenomenon.

Indexation was also subject to significant differences among interested groups, each one enjoying different degrees of indexation. The effectiveness of the protection depended directly on the index correcting a given asset. The degree of protection granted by indexation also depended on the periodicity of the value correction. This meant that there was a direct relationship between the pace of correction and the effective protection against inflationary depreciation. Moreover, these attempts to increase the pace of price correction fuelled inflation. On the other hand, when the state delayed indexation, the real cost of its debts decreased; in turn, this increased the government's credit, fuelling inflation further. The alignment of incentives by significant actors, from the state, to the banks both public and private, to those who could press for a better indexation of their revenues and assets, fostered the creation of several indexes. The possibility of being protected by the better correction index depended on the liquidity of the asset in question so it could be transferred towards the best available correction, but also on the amount of resources to be protected.

These dynamics created a hierarchical structure in which only a few were capable of protecting a significant amount of their wealth, sometimes even increasing it. Some groups were able to protect their assets only partially from inflation, with the possibility of not losing at the end of the month. The large majority of the population, namely those who had fixed incomes such as salaries suffered with inflation because indexation was only applied at the end of the month.[131] Those people with salaries did not fully recover the losses produced by inflation and, accordingly, they could not save either to put some income away in a financial instrument, or even a bank account, that would protect them as well. On the other hand, the absence of indexation on any instrument or contract on which somebody's income depended had direct consequences over the relative exchange value within the transaction. Therefore, indexation as such represented a sample of power instruments on which the state distributed, at the end, the revenues of the inflationary tax.

Furthermore, the way in which the financial sector worked says a great deal about how functional inflation was over the years. Indexation allowed banks to make profits out of the permanent rollover of different financial instruments that circulated in the Brazilian economy,

131 The saying with which Brazilians referred to this situation was: There is still too much month at the end of the salary.

effectively capturing the *seignoriage* tax. Private and states-owned banks were in distress. The long inflationary regime allowed small banks to make profits even if their operational margin was not significant. Even though banks represented the most prominent example of taking advantage of indexation, every business with available resources could invest in indexed securities allowing them to profit with activities other than their main commercial activity. Banks owned by the states rolled over several times the debt of their controllers (Jayme-Jr 1995) taking advantage, among other things, of the difference in the indexation of their revenues and their liabilities.

There were eight stabilization plans after democratization[132] in 1985 and several attempts before that were made by the authoritarian regime. This unfortunate succession of attempts created deep wounds in Brazilian society. The fact that these plans did not stop inflation as such does not mean that lessons were not drawn and some legacies did not remain. At the same time, it created opportunities and constraints for different actors: whether to work below the radar of the main anti-inflationary policies, with more or less success, passing through some political obstacles, or, on the other hand, to join in the fight against inflation with the aim of capitalizing on the possible success of the current policy.

The succession of stabilization plans turned out to be a trial-and-error process throughout the years. Each plan emphasized what it considered to be the most important factor causing inflation.[133] However, after several years of living with inflation and the possibilities it offered of passing the consequences of one's decisions off onto others, there was not a single factor behind inflation, but many. The successive adjustments in the anti-inflationary policies ranging from sudden price freezes to unfair debt reductions from 1986 to 1992 showed what measures were needed to produce lasting results. This combination of policies became

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132 These plans were: Cruzado, Cruzadinho (Little Cruzado), Cruzado II, Bresser, *Arroz-com-feijão* (Rice-and-beans but the correspondent expression in English would be bread-and-butter), *Verão* (Summer), Collor I, and Collor II. Their number changes if the first three are considered only one with subsequent adjustments. An account is given by Henriques (1993, 58):

> "In the Brazilian experience the desperate trial of public regulation of the social order reaches the paroxysm. Brazil in the last decade is an example of this: 8 economic stabilization programs, 15 wage policies, 54 changes in the price control system, 18 changes in the exchange policy, 21 proposals of foreign debt renegotiation, 11 inflationary indexes, 5 price and wage freezes, and 18 presidential mandates to cut drastically public expenses" (Author's translation).

133 These anti-inflationary plans will be further discussed in the section 3.3.1 of the present chapter.

complementary when the possibility of the return of inflation represented a political downturn forcing political actors to incorporate such political legacy so as to link two unrelated policies. Privatization and liberalization each responded according to their own logic, without clearly joining the fight against inflation. While there were some instances in which these policies were linked, for the most part they were not giving any wiggle room to those in charge. When these become complementary, the fight against inflation finally began to succeed.

The next section will cover the privatization process, outlining the way in which it was carried out in various stages and how it related, or not, to the fight against inflation.

3.1 Privatization : Development, Scarcity, and Reform

3.1.1. Trying to Make Serious Commitments

The Brazilian elites have been rather confident in the advantages of their intervening in the market. The Brazilian economy originally performed as a traditional nineteenth-century Latin American economy: as a raw materials producer and manufactures importer (Thorp 1998, 54-58). Nevertheless, the twentieth century would show a very different path in which the state definitely played a more significant role in the economy. An important precedent in this trend were the price agreements upheld by coffee producers beginning in 1906 (Franco 1999, 216) that would later evolve into a very complex scheme after Getúlio Vargas (1930-1946, 1951-1954) got into power in 1930 (Furtado 2003).

During the twentieth century, political and economic conditions changed, sometimes dramatically, but the state remained a major player in the Brazilian market. This was the case during the Vargas era with the creation (in 1941 and 1953 respectively) of both the *Companhia Siderúrgica Nacional* – CSN (National Steel Mills) and *Petrobrás* (Brazilian Petroleum). Whereas the first was more closely related to the figure of the President and was the product of a II-World-War bargaining with the US to acquire industrial autonomy, the latter elicited a massive campaign led by the military with an eloquent title, *O petrôleo é nosso*

(The oil is ours).[134] Even if the latter represented a complex negotiation with the army, among other sectors, given the democratic character of Vargas' second term, economic nationalism was a powerful argument for the creation of both enterprises (Wirth 1970). It should be stressed though that these negotiations represented the clash between nationalistic forces and what could be called "economic liberalism" representing groups more critical towards a heavy participation of the state in the economy.

This clash reappeared later on with the advent of the military regime in 1964. Whilst the schism at that time was between populism and liberalism, soon, the economic and political reality would reignite the debate. The increasing importance of foreign capital to foster growth and the national security, as defined by the military, to guarantee political stability created a situation in which the state played an even bigger role (Bruneau and Faucher 1981, 1-2). This new role implied that the accumulation was appropriated by the state itself. A division was created in which state-owned enterprises were concentrated in the production of raw materials and related activities while foreign capital centered on the production of consumer goods. This division, however, was arbitrated by the technocracy within the state, which negotiated both with foreign capital and the military.[135] The first, representing economic power given the secondary position of the Brazilian market in the global economy, whereas the second, represented political power given its monopoly over repression (Faucher 1979, 755).

The process of privatization started officially during the last military government of General Figueiredo (1979-1985) with Decree 86.215 issued in 1981.[136] However, it was the crisis' context that made it possible for interested actors to take advantage of the possibilities granted by the decree. Initially the rationale for a privatization policy was to respond to specific groups whose main interest was privatization as part of a larger effort to change the

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[134] No significant oil exploration or production took place in the country at the time (Wirth 1970).

[135] Paramount among the technocratic pockets within the Brazilian state was the *Banco Nacional de Desenvolvimento Econômico e Social* – BNDES (National Development Bank), whose role will be further discussed below.

[136] It created a special Commission composed of the Ministers of Planning, Finance, and Debureaucratization in charge of creating a list of businesses that could be sold to private interests for different reasons. Its provisions were fairly limited as the President had the power to decide if an enterprise could be considered important for National Security reasons, legal state monopolies, social or economic basic infrastructure, and those allowing for the national control of the development process (Brasil 1981).

regime.[137] The withdrawing of the state from the economy would also imply its "retreat" in the event of a change of regime. These efforts notwithstanding, the political will of a group of bureaucrats from within the BNDES, was the decisive factor in the transformation of the role of the state in the economy.

Nevertheless, before the regime decided to privatize, there was a political mobilization of industrialists who called for a *Desestatização* (retreat of the state) from the economy. The regime's economic policies had become too expansionist, controlling many aspects of the economy, also causing slow growth. The primary goal of these industrialists was to draw attention to such facts. In their vision, this excessive intervention of the state in economic matters was undermining the possibility for private capital to expand. The second goal of the campaign focused on the pre-eminence foreign capital had acquired in the Brazilian capitalist landscape (Payne 1994, 62-63, Skidmore 1988, 201). This second effort, of course, was only supported by the national private initiative, because the government had granted big contracts to foreign companies[138] when Brazilian companies manufactured similar products (Payne 1994). This particular trait shows the ambiguous character of the industrialists' economic liberalism and also why they did not call for a retreat of the state and not a straightforward privatization.

After several decades in which the state played a capital role in the Brazilian economy, the weaknesses brought by this model appeared in the early 1980s[139] (Thorp 1998, 255). This debate notwithstanding, the state accumulated a series of equities in different industries that were not profitable.[140] These businesses had convertible loans with public banks such as the *Banco Nacional de Desenvolvimento Econômico e Social* – BNDES (National Development

[137] Therefore, the efforts to privatize responded to such demands with the aim of controlling the pace of the retreat of the state while simultaneously granting some symbolic concessions to those groups.
[138] The campaign was based on a general support for representative government and the rule of law, but mainly because in a more democratic regime business could better influence policy in contrast to the situation in which bureaucrats favoured foreign business (Skidmore 1988, 201).
[139] Although there is some debate about the exhaustion, or not, of the ISI model (Serra 1979, 120-126), it would be no less true that during the 1980s it became evident that the former model was not working as it used to, in part because of decreasing total-factor productivity (Franco 1999, 35-42).
[140] The industries in which these companies acted were copper and steel mills, mining, ferroalloys, cellulose, and machinery. For more complete details on these enterprises, see Velasco-Jr (2010, 317).

Bank),[141] which were then forced to assume the control and administration. (Velasco-Jr 2010, 312).

Bureaucrats at the BNDES realized their available resources were consumed by the administration of those controlled businesses.[142] Financially, the bank had to dedicate resources to these enterprises without generating much profit. This unfortunate outcome was partially because these were behind price adjustments because of the common practice of using public business' prices to control inflation. In an inflationary context, this means these companies were always in a deficit. Moreover, the BNDES never intended to control such companies but to support Brazilian industry through minority participations or credits.[143] However the situation in the 1980s was completely different, as the successive crises had forced many companies into the bank's portfolio.[144]

These enterprises became a burden to the BNDES in terms of human and financial resources. Its staff had to spend time administering very complex enterprises as well as supplying financial resources that otherwise would have been directed to more productive loans. This situation meant that scarce resources that could have been used in more pressing tasks related to development, the main goal of the bank, were being used to sustain unprofitable operations. The directorate realized that it was in the best interest of the bank to sell those assets, which represented mostly liabilities.[145] The allocation of resources brought

[141] The foundation of the Brazilian *Banco Nacional de Desenvolvimento Econômico* – BNDE in 1952 is remarkably late, given its importance as a development bank in general. It was first founded to finance infrastructure projects and other long-run investments that the Brazilian government wanted to promote such as metals, chemicals, and cement among others (Musacchio and Lazzarini 2014, 84-86). However, soon, during the government of Juscelino Kubitschek (1956-1961), it became the financial instrument for the ambitious National Development Plan (Evans 1995, 61) with its provision of the kind of patient capital needed for the development process. The adjective "Social" was added during the 1980s in order to highlight a new scope in the bank activities relative to the development process (Schneider 1991b, 275 fn. 18). For a more detailed account of BNDES history, see chapter 10 of Musacchio and Lazzarini (2014).

[142] Velasco-Jr (1997b, 13-14) cites a press article from the President of the BNDES at the end of the Sarney government arguing that privatization sought to recycle the resources of the bank as well as to get rid of bureaucratic responsibilities in the administration of such companies. Scarcity is a way of seeing this problem, whereas opportunity costs would be another.

[143] Velasco-Jr (1997b, 13 fn. 7) asserts that such was the role of the BNDES *vis-à-vis* Brazilian industry.

[144] Another solution would have been the liquidation of such enterprises if they were not able to pay the credits. However, this solution was not considered until the 1990s. Instead, the bank would hold their equity even if this would imply the control of such enterprises. For a list, see Velasco-Jr (2010, 317).

[145] However, a legitimate question would be how relatively autonomous the BNDES was to actually make a decision on divestiture. During the transition to democracy, there was a high degree of continuity among the bureaucrats staffing economic bureaucracy (Schneider 1991b, 230-233). On the other side, being a bank, profits

about by the control of the bank over these unprofitable companies was inefficient from a strictly economic point of view, but mainly from a social one.

The presence of these companies in their respective markets should not be underestimated. For instance *Caraíba Metais* was the only copper metallurgy in the country and *Sibra* was the biggest producer of ferroalloys at the time. Both had a near monopoly on their respective markets. *Aracruz Celulose* had as well an important participation in the cellulose market. Across the table, *Siderurgia Brasileira* - SIDERBRAS (Brazilian Steel Mills) the governmental steel holding, also had an interest in selling its failing subsidiaries[146] as a way to guarantee the survival of the group as such.[147] Moreover, given the experience of the BNDES with the privatization of its own subsidiaries, SIDERBRAS designated the bank, through one of its subsidiaries, as the privatization agent[148] (Velasco-Jr 1997b).

In its turn, the BNDES also had an interest in SIDERBRAS' privatization processes because it had credits from those businesses. These credits could not be recovered in full because the Treasury guaranteed them. Consequently, they could only be rolled out. The public nature of the BNDES, in which the Federal Government was the only shareholder, implied that any credit against the Treasury was a credit against its controller. Therefore, in practice, those assets were really liabilities the bank had to carry on without any possibility of recovering them. Nevertheless, once the businesses were privatized, the possibility of transforming those unusable assets into useful ones became real. That situation also holds to SIDERBRAS itself as the bank also had credits against it. That is, with the privatization of

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matter if its funding sources are taken into consideration. One of the main sources is the *Fundo de Amparo ao Trabalhador* – FAT (Worker's Protection Fund) for which the bank is responsible both in terms of administering it as well as paying interests over it. This remuneration would come from the intermediation rate, the difference between the rate paid and that charged over loans, which depend critically on the profitability of the whole operation (Velasco-Jr 1997b, 14-15). Both these factors might add to the reasons for the bureaucracy within the BNDES to make a political decision that politicians were not ready to make.

146 These enterprises were *Usiba* (Steel Mills of Bahía) and *Cofavi* (Vitória Iron and Steel)

147 Licínio Velasco Jr. Interview by the author. Rio de Janeiro, February 24, 2014. Licínio Velasco Jr was the Chief of the Department of Privatization Services of the BNDES in 1999 and worked on that department since at least the late 1980s. He entered the bank through one of its subsidiaries in the 1970s and made his career in the BNDES bureaucracy; during the 1990s he completed a Master's degree in Political Science at the *Instituto Universitário de Pesquisas do Rio de Janeiro* – IUPERJ (Institute for Advanced Research of Rio de Janeiro) where he also completed a Ph.D in political science in the early 2000s.

148 The relationship between BNDE(S) and steel goes back several decades in which the bank was a major player on the sector before the constitution of the governmental holding. Despite this, the bank continued to have stakes on the major players through equity and debts. For details about the relation between the BNDE and steel, see Schneider (1991b, 102-105).

SIDERBRAS' subsidiaries the bank would recover the credits against the businesses and increased the possibility of recovering what the holding owed too.

Thus, these players sought this strategy as a way to improve the efficiency of their available resources. Moreover, it was a means of extracting themselves from a situation in which valuable resources were being wasted. However, this apparently win-win situation had also its detractors. They came from the private sector, especially from the companies that took advantage of the difficult situation of the businesses to be privatized. Also, public companies were used by the authorities to control inflation by not allowing them to increase the prices of their products, with the consequence of holding an eternal deficit. Nevertheless, their clients made profits with the effective subsidies granted by the behind-the-schedule prices.[149] As a consequence of the privatization process, these actors asked the BNDES, formally, to suspend privatization (Velasco-Jr 1997b, 10 fn. 4).[150] Also, many of the auctions conducted to privatize these companies were subject to temporary judiciary suspension until the BNDES contested such decisions (Velasco-Jr 1997b, 15).

The privatization process also had its limits insofar as its approval had to do with its importance to presidential political negotiations with and support from Congress. The government lacked significant legitimacy as a consequence of the proximity José Sarney (1985-1990) had with the military regime.[151] Therefore, it was forced to gather support by making concessions to different groups. Then the privatization process was conducted at the margins of the core political negotiations seeking the support of the government (Schneider 1991a, 28). However, once the Congress agreed to increase the presidential period to five

[149] Low prices of state-owned enterprises were not only aimed at controlling inflation but mostly at subsidizing private companies. These subsidies also applied when public companies were forced to buy from local suppliers even if their product was more expensive.

[150] Wiring and rolling mills, main clients of a copper mill – *Caraíba Metais*, were the actors asking for such a suspension, which represented a not-so-veiled attempt to keep the status quo.

[151] José Sarney was a member of *Aliança de Renovação Nacional* – ARENA (National Renovation Alliance), the party created by the military regime to support its policies. Following a longstanding tradition in Brazilian politics, Sarney defected from Arena and joined the *Partido Democrático Social* – PDS (Democatic and Social Party), also pro-dictatorship, and then to the *Partido Movimento Democrâtico Brasileiro* – PMDB (Party of Brazilian Democratic Movement) in the last days of the military regime. Subsequently he was the Vice-president of Tancredo Nêves on the indirect election held in 1985. However as the latter became severely ill and eventually died before taking office, it was Sarney who became the first president of the transition.

years, a change that was the main political goal of Sarney,[152] privatization could be strengthened because it could no longer be used as a bargaining chip in the political game within Congress. This new strength came not only through the explicit support the president could offer but mainly because the privatization could emerge to the main political agenda, granting the support the BNDES' bureaucrats lacked before that particular moment. Moreover, the government's economic priority was inflation, still leaving privatization low in the government's political agenda despite this new support (Velasco-Jr 2010, 313).

Privatization has even been characterized as a public policy that was not present in the public agenda (Velasco-Jr 1997b, 6-7). This is perfectly compatible with the idea that mid-level bureaucrats modeled, up to some extent, a public policy according to their priorities and within the limits of the broader political game (Almeida 1999, 432).[153] This institutional transformation was initially somewhat removed from the main political struggles involving the economy, namely inflation. The military government embraced privatization half-heartedly as a response to mounting political pressures. Also after the transition, as the new civilian president lacked legitimacy, one of his attempts to gather political support was through public businesses. That is, with inflation increasing every moment, a common way to hold price increases was not allowing public businesses to increase their own prices.

While privatization had to overcome some political resistances, these were of low intensity when compared with the broader post-transitional political landscape. This is clear because privatization could only go as far as the government - in search of political support - would let it, confirming its status of subordination to bigger political struggles at the time. On the other hand, the groups against such a policy could not contest it openly. Had they done so, it would have become evident they were taking advantage of failing businesses to make profits. A difficult position to hold for groups who often claimed to be efficient. Therefore with no big constituency against it and of secondary importance within the incumbent's political priorities, privatization had a non-negligible success during the Sarney administration. Such policy would reach new heights with a new government.

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[152] The constitution of 1967 established a six year period but Tancredo had promised a four year term, so Sarney asked for a five year period (Schneider 1991a, 28).

[153] This is reminiscent of what Carpenter (2001) shows for mid-level bureaucrats in the US at the end of nineteenth century. Is also reminiscent of the argument by Armijo and Faucher (2002) when they assess the importance of an insulated technocratic elite that can push through market reforms even if these are not popular.

The process of privatization during the Sarney administration was not linked to the fight against inflation. In fact, both policies represented a different level of political priority in the broad Brazilian political system. However, the struggle described above was the breakthrough in a process that would allow Brazilians to control inflation some years later. This institutional reform implied that the state should retreat from a series of responsibilities accumulated over the years, on behalf of some interested parties. The control of inflation would require the constitution of an institutional complementarity formed by privatization along with other institutional reforms, further discussed below. This process was the first step. Lessons were then drawn from it by those seeking to continue such policies.

3.1.2. Collor Government: Taking Privatization to New Heights

When Fernando Collor (1990-1992) took office, privatization took on another dimension (Almeida 1996) with the creation of the *Programa Nacional de Desestatização* - PND (National Program for Privatization). The first economic measures taken by the new government, including the PND with the monetary reform and the seizure of financial deposits, demonstrated the relative importance the new administration gave to downsizing the state.[154] This enthusiasm notwithstanding, the privatization effort carried out by the newly-elected government was heavily conditioned to the political support it could gather among congressmen because Collor did not have a clear mandate on a liberal policy stance[155] (Schneider 1992, 226). On the contrary, his government relied on the political advice of his

154 Among the economic measures taken by the new government, privatization ranked third in the list published in the aftermath of its inauguration. For more details, see Faria (1990).

155 While Collor ran his presidential campaign with a discourse against the *Marajás* (Maharajas) at the head of public agencies, once in office his words were not backed by his actions as the eliminated or transformed agencies lacked any political significance showing the mostly superficial character of his policy proposals "Governo extingue IAA, IBC e mais 22 órgãos."*O Globo*. March 17, 1990. An exception was SIDERBRAS, which was also closed with the first group of agencies. However, as discussed above, it was already in a big crisis mainly because of its financial problems but also as its political significance as far as many politicians were concerned had disappeared with the privatization of many of its businesses in the preceding decade. Moreover, what was closed was the holding company leaving the businesses it controlled untouched by such measures.
Because Collor's government bundled his anti-inflationary policies with broader policy reforms, such as privatization and trade liberalization, Congress and the Judiciary approved the whole package during the new government's first months in office. However, since these policies did not produce quick results, the political support granted at the beginning waned as the government lacked a strong political coalition (Pinheiro, Bonelli, and Schneider 2007, 79-80).

bureaucrats about the best moment to carry out the privatization processes. These bureaucrats learned the political practicalities[156] surrounding their work and would later use them when advising on the political soundness of the privatization process.[157]

Collor's government position *vis-à-vis* privatization can also be assessed when it becomes clear who helped his team to write the presidential decrees to privatize. These were the economic advisers of the defeated PSDB - *Partido da Social Democracia Brasileira* (Brazilian Social-democracy's Party) campaign headed by Mario Covas.[158] However, this should not be surprising inasmuch as within the Brazilian polity it is hard to delineate the ideological borders of the parties[159] and privatization as a contentious issue would hardly elicit a firm position from an outsider as Collor. He needed to gather support in a Congress with very few members perfectly convinced of the adequacy of the whole policy, including the PSDB (Schneider 1991a, 39-40).

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156 With the involvement of bureaucrats in the administration of complex enterprises, they got to know the interested parties and their political connections during the privatization phase. This expertise was important insofar as it helped the authorities to avoid political confrontations that otherwise would have arisen.

157 Licínio Velasco Jr. Interview by the author. Rio de Janeiro. February 24, 2014.

158 Gustavo. H. B. Franco. Interview by the author. Rio de Janeiro. March 13, 2014. Gustavo H.B. Franco was President of the Brazilian Central Bank, head of the International Directorate of the same institution and Deputy Secretary of Economic Policy of the Brazilian Ministry of Finance. He is founding partner of Rio Bravo Investimentos in Rio de Janeiro. He was part of the team behind the Real Plan.

159 For a discussion about the absence of clear ideological borders for Brazilian parties see Lucas and Samuels (2010).

Tableau I.Privatization by Brazilian Administrations. 1979-1992

Administration	Number of Companies	Direct Revenues (Millions of USD)	Transferred Debts (Millions of USD)	Number of Employees
João Batista Figueiredo (1979-1985)	20	188.51	n.d.	4864
José Sarney (1985-1990)	18	548.3	620[160]	22707
Fernando Collor de Mello (1990-1992)	18	3397.8[161]	n.d.	43469

Source: Elaborated by the author with data by Almeida (1996, 219).
n.d.: No data
All monetary figures are presumed to be in current dollars as there is no indication in any source of any actualization of their value following dollar inflation. This caveat however should not prevent the comparison between periods because of the difference in order of magnitude between each one of them.

Despite the lack of support for Collor's initiatives, the results of the privatization processes during his term in office are anything but lackluster when compared with Sarney's and Figueiredo's terms (Table 1). While during Sarney's term, the state received USD 549 million and a debt transfer of USD 620 million (Velasco-Jr 1997b, 9), during Collor's government the revenues were USD 3.9 billion (Velasco-Jr 1997b, 19). From another point of view, support is not only a matter of Congressional approval of governmental initiatives, but foremost, how the society and its most vocal members perceive such initiatives. In this sense, it is important to make reference to a landmark privatization process, that of USIMINAS - *Usinas Siderúrgicas de Minas Gerais* (Steel Mills of Minas Gerais) for at least two reasons; first, it was a profitable enterprise and second, its new selling model set a benchmark and helped to gather subsequent political support.

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[160] Velasco-Jr (1997b, 9) offers slightly different figures for the Sarney administration record on privatization. He reports 17 companies with revenues of 549 million and debt transfers of 620 million, being the only source for the latter figure. His sources are the report (1985-1989) of the *Conselho Federal de Desestatização* (Federal Council on Privatization) and the document, *"Privatização: A experiência da BNDESPAR no período 1987—89"* (Privatization: the experience of BNDESPAR. 1987-1989) involving some criteria conciliation. Almeida (1996, 219) cites the Executive Secretariat of the Federal Council on Privatization for the same period. None of the sources used by those authors were available to the author.

[161] For this period Velasco-Jr (1997b, 19) offers, once again, different figures. He reports 16 companies with revenues of 3.9 billion. There are no sources for such figures.

The importance of the privatization of USIMINAS[162] besides the fact that it was profitable is its signalling character. Up to that point, almost all privatization processes conducted were of failed private businesses that instead of facing liquidation, were kept afloat by the state.[163] As a consequence of that, many such businesses demanded a significant restructuring in order to continue with the selling process. On the other hand, USIMINAS was profitable and did not demand any streamlining. This characteristic was critical in showing to interested parties that privatization was not only for losses-generating assets but also for profitable ones. As the government lacked a significant political support, its strategy was to implement decisive actions showing a firm commitment to policies that would help to gather such support. In this respect, the selling mechanism was paramount through the atomization[164] of the property gathering a fairly diverse coalition.

The first privatizations conducted by the BNDES, both as the seller of its own assets and as a privatization agent of SIDERBRAS, had a privileged buyer or, at least, the property structure of the company was previously defined. The selling mechanism of USIMINAS was a significant departure from this strategy. For this case, neither was there a prequalified buyer, nor an expressive minimum bid, allowing for a broader participation of interests in the business as such. Also the absence of a privileged bidder created an incentive for numerous players to participate in the operation because no property structure was defined *a priori*. Furthermore, because no group perceived the operation to be against its interests, as would have been the case with a privileged player, many actors decided to participate according to their resources. The distribution of USIMINAS' equity after the auction also deactivated the possible opposition that could appear.

The selling model was not conceived as a way to get political support. It was clear, however, that to sell privileging a block of control could further opposition to the process insofar as those who had stakes in the industries where the enterprises acted would resist the entry of a big competitor. On the contrary, the auctions did not define *a priori* the structure of the company but allowed different bids from people with the capital but without the

162 The next paragraphs rely heavily on Velasco-Jr (2010, 351-357).
163 Thus the low revenues collected, which was compounded by the fact that small firms were the first to be sold.
164 Schneider (1992, 234) translates the Portuguese word *pulverização* into people's capitalism. This translation is preferred.

experience within the industry. This approach contrasts with the first privatizations when experience within the industry was paramount. These unrestricted bids were the base for the wide support of the process inasmuch as not only more actors became "owners," but also those who did not, foresaw the possibility of becoming one in future processes.[165] Therefore the political success of this strategy was twofold as it prevented the rise of big opposition and gathered wide support to legitimize the process.[166]

The opposition to the privatization process in general came from two different groups. First, the competitors who would subsequently face a stronger and empowered owner when compared with state-owned businesses caught in political games and not on running a business efficiently. On the other hand, unions who perceived that a transfer of the business to private hands would jeopardize its working conditions were among the groups who defended a strong role for the state in the economy. Also, these were groups who benefited from a cozy relationship with state managers and profited from the possible largesse these could provide. Nevertheless, the Collor government conducted privatization very much the same way it conducted every economic policy, that is, isolating the decision team and privileging technocratic decision-making (Schneider 1992, 234-235). Moreover, economic reforms, among them privatization, were closely associated with a comprehensive solution to the fiscal crisis of the Brazilian state (Almeida 1996, 217).[167] This association proved to be ambiguous regarding the possibility of gathering political support.

The shortcomings of such an association were partially a consequence of the severity of the fiscal crisis as such. Because the public sector needed a thorough reorganization, finally conducted throughout the 1990s, it could have not produced the necessary results to receive

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[165] Two interesting cases of these new owners were that of some public employees' savings trusts, notably that of *Banco do Brasil* employees (Bank of Brazil is the biggest public retail bank) with 15%, and foundations belonging to other public enterprises, with 7.7%, and even public enterprises (*Companhia Vale do Rio Doce* – CVRD), with 15%, at the time. These participations helped to neutralize the claims of statist advocates of a complete retreat of the state (Velasco-Jr 1999, 199 fn. 15).

[166] Whereas USIMINAS had 3 significant shareholders with more than 1% of the shares before privatization, after the process was completed it counted 7 individual shareholders above this threshold and many other with less, among which 17 pension funds with 3.4% of the company taken as a group. For more details, see Manzetti (1999, 174).

[167] Kingstone (2000, 193) suggests that privatization was viewed, along with de-indexation of the economy, as "key parts of the effort to stimulate competitiveness in the private sector." He argues that privatization sought to encourage investments and competitiveness and not to solve fiscal problems. However, this account ignores the fact that, by legislation, revenues from privatization had to be used to pay public debts and, as discussed further below, many public bonds were accepted as "privatization currencies" or "privatization legal tenders."

the support the government needed in the short run. Also the lack of results was a consequence of the ill-conceived stabilization plan, which did not stabilize the economy but succeeded in creating widespread uneasiness towards the government behind it. The association between the fiscal crisis and privatization also was useful in the creation of an unexpected support group, even if not by its own initiative. This strange situation was caused by the compulsory acquisition of *Certificados de Privatização* (Certificates of Privatization).[168]

These certificates were securities that could only be used to buy privatized companies and would lose one percentage point of its value every month after the first privatization auction (Schneider 1992, 233).[169] Because financial institutions were forced into buying such securities, these had strong incentives to get rid of the certificates, as these were not as profitable as other available instruments. Insofar as the privatization processes continued and the possibility of minimizing loses increased, financial institutions constituted yet another support group for privatization. While the participation of financial institutions in the privatization efforts represents itself a broadening of those groups supporting privatization, the flexibility in type and size of the bids undoubtedly helped to bring more interested parties that would otherwise be indifferent or even oppose the general program.

This was the first time the Brazilian government tied several economic policies.[170] This attempt, however, represented more an obstacle to the political success of such policies.

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168 These certificates were created within the package of economic reforms made by Collor in the aftermath of his inauguration. As mentioned, they were of compulsory acquisition with its quantity depending on the total assets of each financial company. After the first privatization auction, these would lose one percentage point per month, which would in turn create the incentives for financial institutions to participate directly as bidders or to finance their clients with their Certificates (Velasco-Jr 1997b, 27). Whilst it is difficult to assert the reasons behind the creation of such certificates, it would not be a stretch to argue that forcing investors into compulsory debt to finance fiscal deficits represented a lasting tradition in the Brazilian context, from which the creation of the ORTN in the 1960s was a departure (Simonsen 1970, 184-185).

169 The Certificates of Privatization were one among many "privatization currencies" or "privatization legal tenders." Because the legislation stated that revenues from privatization had to be used to pay for public debts, different securities were used as legal tender to pay for privatized businesses (Velasco-Jr 1997b, 27). The process involved the transformation of every security into a new one that could be used as legal tender in privatizations or sold in the secondary market. In any case, the Treasury discounted the securities when giving the new ones. There were even "rotten currencies," as the press called them, because no one was aware of their existence but were still considered public debt. These were mainly of agrarian origin (Licínio Velasco Jr. Interview with the author. Rio de Janeiro. February 24, 2014).

170 This bundling of economic policies was the first attempt in that direction. Collor's government tied the policies together against inflation with broader reforms such as privatization (Almeida 1999, 432). By all counts this represented a significant change with the previous status of privatization in the public agenda. While this first

Partially because the priority of this bundling attempt was to reign, on a largely *ad hoc* fashion, over hyperinflation, the lack of success here originated a rush on disassociation strategies. The continuation of hyperinflation on very much the same conditions prevailing before the implementation of Collor policies, demanded from policymakers, generally mid-level but also second-ranking bureaucrats, an adaptation to the new political situation. This adaptation often involved a silent continuation of the policy whilst taking advantage of the isolation created by the government in an effort to avoid the criticisms and scrutiny received by the fight against inflation. It is worth noting that neither the associated policies, that is, those subordinated to inflation fight, nor explicitly anti-inflationary ones, produced immediate results with which the association between them would have received the necessary support to continue.

As the privatization policy was strongly associated with the Collor government once his impeachment process concluded with his departure,[171] Itamar Franco, the vice-president who assumed the presidency, was expected to completely stop the process. This for at least two reasons. First, the corruption scandals surrounding his predecessor cast more than a little doubt over his government policies and, second, because his own views about the role of the state in the economy[172] were against the whole idea of privatization. He tried, however, to slow down its pace as several re-evaluations of the companies to be privatized were ordered,[173] without any substantive changes on the price, giving continuity to the policy.[174]

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effort was not successful, later the complementarity between privatization and other reforms would prove fundamental to stabilization. This linkage between those policies will be further developed below.

171 Collor was suspended from office in September 29, 1992, but resigned officially on December 29, just before being found guilty by the Senate of "responsibility crime," which is the name for the administrative actions taken by a political agent that are contrary to the Constitution. This interregnum added more uncertainty to the direction of many policies.

172 The uncertainty of having those reforms started during the Collor administration then aborted is expressed in the literature on both privatization (Velasco-Jr 1997b, 7, Manzetti 1999, 168) and commercial liberalization (Bonelli and Pinheiro 2008, 100, Pinheiro, Bonelli, and Schneider 2007, 81). The literature makes some reference to the ideas of Itamar Franco on the role of the state in the economy, however, the main reason is probably the strongly negative view of Collor's administration and its association with his corruption scandals. Therefore the probability of a move rejecting its policies by stopping or changing the path set with them was non-negligible

173 Each privatization process demanded an evaluation from two different consulting firms hired by a special procurement process. This intended to avoid accusations of inside trading on the part of the privatized enterprises or the BNDES, the privatization agent. Hence, the re-evaluations ordered by Itamar Franco showed his reservations about the process.

174 In this line, the most important change comprised the composition of the tender used to make payments represented in current money and not only debt bonds as with previous processes (Velasco-Jr 1997b, 34).

The explanation given by Velasco-Jr (1997b, 35) for such an outcome is the existence of policy feedback (Pierson 1993).

Moreover, the privatizations carried out during Itamar's government were not only of big businesses measured by their value, but mainly by their symbolic importance as, for instance, *Companhia Siderúrgica Nacional* – CSN – that once represented the decisive step towards development carried by the Vargas government during WWII (Wirth 1970). Also some of the main acts of privatization carried out during his term were done so against big corporatist interests embedded within the state. This was the case of *Ultrafértil*, a fertilizer producer owned by *Petrobrás*. Despite successive attempts from opposition parties and unions to stop the process with judiciary action (Almeida 1999, 437-438), as well as an explicit suspension by the President following some agitation by the corporatist interests within *Petrobrás*, the privatization process continued as planned (Velasco-Jr 2010, 358).

In the Congress, the opposition to privatization surfaced with a *Comissão Parlamentar Mista de Inquérito* – CPMI (Mixed Parliamentary Commission for Inquiry) for the whole privatization process.[175] Whereas in the first moment it seemed that the opposition held the upper hand by proposing a negative parliamentary account of the PND, it was replaced by a new account that was favourable to the government. The CPMI had no practical effects on the inner workings of the PND (Velasco-Jr 2010, 358-359). The BNDES as the bureaucracy in charge of the PND throughout its different stages was able to keep a contested policy on its tracks because a significant set of actors ended up backing privatization. These actors, whilst not being a formal coalition, favoured the continuation of the privatization process because they believed they could continue to win, if they had already been winners, or become winners in yet another privatization, if they had not. These informal coalitions were formed because the selling model that started with the USIMINAS auction allowed many players to get in on the game.

The opposition coming from the usual suspects, that is, left-leaning parties, unions, and corporatists interests affiliated with the sold enterprises, was gradually defeated turning many of them into members of the supporting coalition. This defeat can also be the result of some

[175] Velasco-Jr (2010, 358) asserts that the mandate was "to investigate issues related to and as a consequence of the implementation of the National Program for Privatization - PND" (Author translation).

public organizations participating actively as bidders in those privatization processes weakening the case for a complete state retreat (Velasco-Jr 2010, 356). Moreover, unions affiliated with the *Força Sindical* (*Union* Force)[176] changed their opinion towards the PND when the Act 8031 granted to public employees a percentage of the sold enterprises (Almeida 1999, 437). Then, the explanation for the successful policy is twofold as it deactivated the more powerful and vocal opponents allowing some of them to participate directly in the process, while empowering some key constituencies that benefited from its continuity. Therefore, atomization turned out to be an instrument for gathering political support.

During the Collor administration, privatization, along with other policies, was explicitly attached to the fight against inflation. While at this point the association between privatization and a solution to the inflationary problem in the Brazilian political economy was not successful, it is important to underline that this was the first time that an explicit attempt in such a direction was made. The bundle between such policies did not produce lasting results in part because both policies suffered significant drawbacks. Even if inflation did not wane, privatization required not only a significant streamlining of the companies on sale (Pinheiro, Bonelli, and Schneider 2007, 84), but also, significantly, the political support to implement it took some time to gather. The bundle between policies in the fight against inflation would reveal some years later its crucial character when an institutional complementarity appeared, even if the circumstances in which it took place were far apart from those presented during Collor's tenure.

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176 It is worth noting that *Força Sindical*, commonly referred to as *a Força* (the force) is a post-Soviet-era union, which implies a different set of priorities than its counterparts. For more details see Rodrigues and Cardoso (2009).

3.2. Trade Liberalization : Preliminary Measures

3.2.1. There is Hope Beyond Our Borders

The relationship between Brazilian and international economies is ambiguous. The advantage of being a big market is the manoeuvring space it allows during international crises insofar as there is a substantial amount of consumers to rely on while a given crisis lasts. On the other hand, this condition fosters an attitude that tends not to encourage a more prudent approach in the face of such crises. Naturally, this attitude is not only a matter of market size. It also has a great deal to do with a nationalistic impulse shared by several groups within Brazilian society. The international crises of the 1970s were no exception; in fact after both oil shocks (1973 and 1979), military administrations launched big infrastructure and capital goods initiatives with external financing despite the widening current account gap.[177]

Given the restrictions produced by the dried financial markets following the 1981-3 crisis, the authorities reacted with significant devaluations[178] (Kaufman 1988, 22). These devaluations created more inflation and commercial surpluses simultaneously showing one of the links between the external front and inflation in Brazil.[179] Also, the need to solve a current account deficit justified restrictive trade policies that prevented the entry of foreign-produced goods. In a context where inflation was becoming hyperinflation, the absence of foreign competition was yet another factor fuelling an already out-of-control process. Moreover, the successive defaults on foreign obligations became another set of problems to be solved.

Even if later developments showed that foreign net debt was not a fundamental factor driving Brazilian inflation, in 1987 the two main problems of Brazilian economy were

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177 A complete analysis of the economic responses to the oil shocks of the 1970s from the Brazilian military governments, the political implications for the transition, and the general economic policy is provided by Lamounier and Moura (1986).

178 Between 1981 to 1984, the accumulated devaluation of the Brazilian currency amounted to 1980% (CEPAL 2009 Appendix 5).

179 An important actor in the discussions surrounding the responses to financial crises was the International Monetary Fund - IMF. Nevertheless, the options favoured by IMF staff did not always address the complexity of the Brazilian economic challenges. For a discussion of one such debate, see Bacha and Dornbusch (1983).

inflation and the defaulted debt.[180] For the latter, the solution provided by then Minister Bresser-Pereira (April 29 – December 18, 1987) was a securitization of the debt. With this move, he launched a multi-year process that would eventually finish with a bond exchange, mainly with the commercial banks holding them. At the time of the final exchange, the foreign debt was no longer considered to be an important factor for stabilization,[181] even in the midst of the Real Plan that finally stabilized the economy. The political and economic events that took place during Collor's tenure as President are partially responsible for this change in point of view.

However, the changes in the commercial policy, as such, started before the beginning of Collor's government. This process made the unification of a complex set of tariffs without any substantial changes to the protection structure already in place, given its redundancy with non-tariff barriers (Kume, Piani, and Souza 2003, 13). In 1988, imports policy consisted of a series of instruments to isolate the Brazilian economy from foreign competition, including: a tariff structure kept in place for the most part since 1957, which were redundant on many occasions;[182] a sample of additional taxes on exchange and for the use of ports; non-tariff barriers such as importation lists, previous importation authorization, quotas, and 42 special regimes allowing for tax reduction (Kume, Piani, and Souza 2003, 10-11). The complexity of the protective structure explains in part the slow pace with which it changed.

This process was negotiated within the *Comisão de Política Aduaneira* (Customs Policy Commission) where representatives of the government as well as some sectorial (agriculture and industry) interests were represented. Despite the fact that this corporatist strategy might have helped Brazil to surmount some crises, the responses provided through such a body might have reflected more the interests of its members than the broader society (Baumann, Rivero, and Zavattiero 1997, 559). Tariffs were not the only policy instrument, not

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180 Luiz Carlos Bresser-Pereira. Interview by the author. São Paulo. March 26, 2014. Luiz Carlos Bresser-Pereira is Emeritus Professor of Getúlio Vargas Foundation in São Paulo. He was Finance Minister from April 29 to December 18, 1987 and Minister of Federal Administration (1995-1998).

181 André Lara Resende. Interview by the author. São Paulo. March 25, 2014. Andre Lara-Resende is an Adjunct Senior Research Scholar at the School of International and Public Affairs, Columbia University. He is a founding partner of Instituto de Estudos em Política Econômica da Casa das Garças and a member of the board of directors of the International Advisory Board of Itaú-Unibanco. He thaught economics at PUC-Rio de Janeiro, was a member of the board of directors of the Central Bank of Brazil and President of BNDES. He was part of the teams behind the Cruzado and Real Plans.

182 For details on the nominal tariff for different sectors see Table 1 of Kume, Piani, and Souza (2003, 20-22).

even the most important one, used to regulate Brazilian international trade (Almeida 1996, 229 fn. 13). Nevertheless, this implied a rationalization of the protection policy inasmuch as it aligned the tariff structure with the relevant differential between internal and external prices (Kume, Piani, and Souza 2003, 11).

Diplomats had been active during the Sarney government in the negotiation of a commercial liberalization with Argentina in what was seen as a bigger trend towards liberalization in the political realm. Both countries found themselves in a process of democratic revival with renovated unions and freedom of speech after hard military regimes (Medeiros 2000, 33). A major change in bilateral relations was the final demise of the traditional mistrust derived from the strategic regards held by the military in both countries, allowing both governments to focus on their similarities. Within this climate of distension and mutual understanding, both governments began negotiating a set of agreements that would later become the foundation of the Southern Common Market – Mercosur[183] (Medeiros 2000, 148-155). Despite these efforts to pool the experiences and resources of Brazil and Argentina, the challenges faced by both countries in the economic and political arenas prevented the surge of a stronger association during the 1980s.

3.2.2. Opening the Doors

Fernando Collor de Melo had traits of a typical populist Latin American leader, even if he did not entirely conform.[184] During his successful campaign for the Brazilian presidency, he founded his own party, which did not survive the next election; sold himself as an outsider (Martins 1993, 31-32); and, most of all, tried to communicate directly with the masses, selling an image of himself as a handsome playboy. One of his emblematic phrases "*Nossos carros*

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183 The Treaty of *Asunción* with Argentina, Brazil, Paraguay, and Uruguay as signatories officially established the Southern Common Market in 1991. The Treaty establishes the free movement of goods and services, the creation of a common tariff, the coordination of macroeconomic policies, and the commitment to harmonize the legislation necessary to improve integration ("Tratado para la Constitución de un Mercado Común entre la República Argentina, la República Federativa del Brasil, la República del Paraguay y la República Oriental del Uruguay" 1991 Art. 1). The significance of Mercosur for commercial liberalization will be further discussed below.

184 For a larger discussion about Latin American populism, see Weyland (2001) and for the relation between populism and neoliberalism, see Weyland (2003).

são verdadeiras carroças," meaning "our cars are really carts," signalled in a rather sympathetic way the degree of backwardness of the Brazilian industry caused by the continued protection it enjoyed from international competition. This protection had been present since the beginning of the industrialization process back in the middle of the twentieth century.

With Collor's government, a new commercial policy was implemented.[185] The global trend towards a liberalized economy created a viable environment in which to discuss commercial liberalization, and broader agreements with Argentina took place, leaving aside sectorial ones focused on industrial policy (Cason 2011, 48). On the other hand, South America in general, and what would later become Mercosur in particular, were seen according to Brazilian foreign policy as Brazil's natural zone of influence (Malamud 2011, 6). Furthermore, a more controlled liberalization in the context of a regional agreement in which Brazilian voices would likely be heard was an ideal leverage to the kind of hemispheric integration sought by the United States (Cason 2011, 53). Consequently, Mercosur was seen as an ideal scenario to start a broader process of liberalization; such a path would be reinforced through the reduction of the tariff structure creating a common external tariff for the bloc; however, the reduction of commercial barriers was an autonomous decision on the part of the Brazilian government (Kume 1996, 2) insofar as the common external tariff would be implemented some years later (Table 2).

[185] An account of this implementation is provided by Frisch and Franco (1993, 27-32).

Tableau II.Evolution of Tariffs 1988-1993

a. Nominal Tariffs*

Indicator	July 1988	September 1989	September 1990	February 1991	January 1992	October 1992	July 1993
Unweighted Average	38.5	31.6	30	23.3	19.2	15.4	13.2
Weighted Average†	34.7	27.4	25.4	19.8	16.4	13.3	11.4
Minimum	0.2	0.1	0.1	0.1	0.0	0.0	0.0
Maximum	76.0	75.0	78.7	58.7	48.8	39.0	34.0
Standard deviation	15.4	15.9	15.1	12.7	10.5	8.2	6.7

b. Effective Tariff*

Indicator	July 1988	September 1989	September 1990	February 1991	January 1992	October 1992	July 1993
Unweighted Average	50.4	45.0	45.5	35.1	28.9	22.5	19.9
Weighted Average†	42.6	35.7	33.7	26.5	21.7	17.2	14.5
Minimum	54.5	-4.4	-4.3	-3.3	-2.8	-2.3	-2.0
Maximum	183.0	219.5	312.9	225.2	185.5	146.8	129.8
Standard deviation	33.4	39.8	53.3	39.7	32.7	25.2	21.7

*: Calculations based on average tariff by activity, defined as tradable, following the Input-Output Matrix of IBGE (*Brazilian Institute of Statistics and Geography*)/1985.
†: Weights depend on the value added by free trade.
Source: Kume (1996, 3).

Business on its part was not a monolithic bloc in the discussions of commercial liberalization. Non-tradable sectors were conspicuously indifferent to the process of liberalization and integration to Mercosur. Multinational corporations with substantial operations in the country favoured the whole process because they had the scale to take full advantage of liberalization and integration. However, many of these companies also opposed the process insofar as their investments relied on the protective barriers of the Brazilian market, such as public subsidies (Cason 2011, 53-54). Brazilian companies somehow reproduced the same pattern. That is, bigger companies had the opportunity to take advantage of their scale to enter into the Argentinean markets, whereas many middle-sized ones that relied on protective barriers struggled with the process having little or no political leverage to change the direction it took.

The negotiation of commercial liberalization on behalf of business followed the traditional corporatist pattern. Given the fact that business is organized by industry as well as regional bodies, it is difficult to aggregate demands and speak through a representative voice. However, due to the absence of national representative voice, every business interest – whether regional, sectoral, or both – has the incentive to lobby for better particularistic conditions, hampering in turn the possible returns of a more collective action (Kingstone 2004, 168-170). Within this frame, different firms responded differently to the challenges involved with liberalization. Whereas in some industries, mergers and acquisitions prevailed, in others a transformation from producers to importers of the same good was the preferred response. In any case, business cannot be accused of relying exclusively on lobby to prevent a transformation from taking place since Brazilian producers endured a significant transformation throughout the 1990s (Kingstone 2004, 171).

The rationalization of the protective structure was carried by the team of the empowered Ministry of Economy, Budget, and Planning (Baumann, Rivero, and Zavattiero 1997, 559). They received relative support from some diplomats who were convinced of the importance of the openness of the Brazilian economy (Bonelli and Pinheiro 2008, 98). Partially because the Ministry of Foreign Affairs had already been working on commercial negotiations with Argentina, they were among the groups supporting the trade liberalization carried out by Collor's government.[186] The implementation of commercial liberalization was not different from other economic policies insofar as the team in charge of tariff reductions centralized the decisions.[187] Moreover, Mercosur as a paramount scenario for Brazilian liberalization, was a highly presidential initiative, i.e. depended heavily on a particular

186 A discussion of the different traditions of Brazilian foreign policy which in turn affects the diplomatic corps can be seen in Pecequillo (2008), Puntigliano (2008), and Faria (2012).

187 Kingstone (2004, 166) mentions the exclusion of business from policy deliberations concerning trade liberalization, among other policies, by the Collor government.

president's will, highlighting the top-down character of liberalization within the context of the regional integration effort (Cason 2011, 51).

As emphasized in this work, Collor's reforms were conceived as a set, to be implemented more or less simultaneously. The element that gave cohesion to the package was the end to hyperinflation, and, indeed the policies constituting the core of the reform were directed towards this goal. These policies included the freezing of financial assets as well as prices, which were specifically targeted to inflation. Secondary policies, but attached to the general reform nonetheless, were privatization and commercial liberalization (Carneiro 1991, 157-159). However, given the disastrous results in terms of inflationary reduction as well as his populism as a political strategy, soon Collor and his government were politically isolated.[188] Despite the initial bundle of economic measures with very ambitious goals, structural reforms such as the commercial reform and privatization were relegated to the background of political discussions in part because what kept the attention of political actors were the price freezes, wage freezes, and the financial assets' confiscation included in the Collor I plan (Albuquerque 1993, 151).

Generally speaking, the policies of the Collor administration were sudden path-breaking changes and commercial reform was not an exception. Such policies involved a change in the level of instruments used until that moment and also a change in the instruments themselves, as the exchange rate started to play a more important role. The explicit goal of this policy was productive transformation while keeping a price differential (Kume, Piani, and Souza 2003, 13-14). Despite the apparent generalized change, there were some criteria to carry out the program, mainly to avoid the rise of possible opposition from those likely affected by these changes. The first phase involved a bigger drop in tariffs to capital and intermediate goods relative to consumer goods. At least two reasons can be identified for this choice: first, a smaller drop in consumer goods' tariffs would prevent a flood of imported products in the internal market (Kume, Piani, and Souza 2003, 15). Second, it would promote an increase in productivity of the national producers (Longo 1997, 38-39).

[188] For further discussion of the theme of political isolation and its relation to populism as a political strategy of the Collor government, see Albuquerque (1993).

This differential between tariffs for intermediate and consumer goods also reflects the need for building a coalition, that is, the imperative of not alienating possible political support. Beyond the economic rationale involving also the general balance of payments, it is clear that that particular schedule of tariff reduction was also conceived as a way to avoid possible opposition to the policy mainly from the competitive internal producers (Kume, Piani, and Souza 2003, Bonelli and Pinheiro 2008). On the other hand, it must be considered that the tariff reduction schedule also reflected the clout of certain firms.[189] Tariff reductions by industry gave certain firms, especially large ones, the possibility of bargaining for exemptions on the schedules as well as different fiscal treatment by the use of their market power (Armijo and Faucher 2002, 25). It is important, thus, to underline the fact that the accommodation of the tariff schedule responded to political as well as economic imperatives as either could account for the changes implemented.

Nevertheless, liberalization in general faced little resistance from the interested sectors, in part because businesses were also dealing with the recession caused by the drastic measures of the Collor Plan. Additionally, the whole policy lacked credibility, that is, very few in the business community thought the liberalization was going to be real (Bonelli and Pinheiro 2008, 99). In general, the liberalization policy was conducted in a pragmatic way. For example, when it was clear that Itamar Franco (and his nationalist positions in several policy areas) would replace Collor, the schedule of tariffs reduction was accelerated so as to guarantee that the new president would not reverse the entire process (Bonelli and Pinheiro 2008, 100).

The relative isolation of the team in charge of the tariff reduction schedule is also a testimony of the independent way in which different economic reforms were carried out in Brazil. Although commercial liberalization was among the top priorities of Collor's administration soon, along with the unfolding of the whole set of measures to stop inflation and its disastrous consequences, it descended to a low priority status. This secondary status was in fact what allowed it to keep going not only because the government perceived it as such but also because many economic actors dealt with an economic recession simultaneously

[189] This is the case, especially for the automotive industry which enjoyed the maximum effective protection between 1987 and 1998 (Kume, Piani, and Souza 2003, 30). For a more detailed account of the nominal tariff schedule by industry in the same period, see (20-22), and for effective tariff schedule, see (27-29).

with the enactment of liberalizing measures. This "low-politics" character would not remain as such for long as the introduction of the new currency in 1994, with the subsequent appreciation, implied the subordination of the trade liberalization to the stabilization effort.

Bonelli and Pinheiro (2008, 101-102) identify four factors that improved the chances of success of the reform. First, its initial impact was confounded with the recession caused by the Collor Plan; second, the public supported liberalization because it allowed them to consume goods to which they did not have access before; third, the tariffs and its levels were an exclusive competence of the Executive preventing the interference of other political actors such as Congress or the Courts; and, fourth, the claims of powerful groups were attended very pragmatically without reducing the average tariff but increasing its variance. However, once these factors are identified, it becomes clear that decision-makers enjoyed some margin of arbitration as they responded to the lobbies against liberalization with some *ad hoc* responses, leading nonetheless to a general decrease in the protection level.

Just as the political struggles surrounding commercial liberalization were, no doubt, complicated given what was at stake for several groups, it is no less true that these were of low intensity when compared with other policies, namely those targeting inflation. It is interesting to note that the reforms that showed some degree of success during both Sarney and Collor's respective tenures, especially the latter's, were those outside of the core political debates. Privatization advanced during Sarney's tenure up to the point of not interfering with his coalition-building efforts. During Collor's tenure, commercial liberalization showed significant progress when it was detached from the main political game of his inflationary policies as well as the impeachment that would finally end his mandate. In the next section, the policies specifically directed to fight inflation will be discussed.

3.3 Main Front: Fight Against Inflation

3.3.1. Managing Frustration and Defeat

In the first half of the 1980s, there was intense discussion in the Economics Department of the Catholic University of Rio de Janeiro – PUC/RJ – about the possible solutions to the general indexation of the economy. Part of the diagnosis of the Brazilian inflation was that indexation created a cascade effect over prices. Price adjustments tried to recover the losses caused by inflation, but in so doing, the prices increased even more. This phenomenon became clearer in the last phase of the military regime as severe measures, such as a tighter monetary policy and fiscal expenses' cuts, were implemented without any effect over inflation. The explanation provided was that Brazilian inflation had another component besides the fiscal problems that were apparent to many observers. The answer was that inflation had an inertial component that prevented any changes, continuing on its own.[190]

Multiple solutions arose in the debate but two positions were prominent.[191] First, those who proposed a shock capable of forcing everyone to coordinate their actions to solve the collective action problem created by the generalized indexation of the economy (Lopes 1984). Second, other solutions included a general indexation of the economy so as to align the expectations at the same time to the same index (or no inflation-corroded currency) to subsequently de-index the economy (Lara-Resende 1984, Arida 1983, Arida and Lara-Resende 1985). These were options addressing the unique feature of inertia that seemed to characterize Brazilian inflation and, presumably, the reason for the ineffectiveness of the most traditional stabilization programs used by the economic authorities at the end of the military regime.

After the indirect election of a civilian government took place, a new economic policy was expected, despite the compromises offered to authoritarian elites by the President-elect, Tancredo Nêves. However, given his premature death, Vice-President José Sarney took office, and gradually changed the economic team built by Nêves.[192] Soon, a new plan to end inflation based on the idea of inertial inflation appeared. The Cruzado Plan and its intended adjustments *Cruzadinho* (Little Cruzado) and Cruzado II, concentrated on indexation and price

190 A latter attempt to make a theory about inertial inflation is the account made by Bresser-Pereira and Nakano (1987).

191 There was a larger debate, however. This was between those who considered a gradualist approach to solve inflation while the economy continued to grow (the *gradualistas* or gradualists) and their counterparts who defended that inflation should be stopped as a shock treatment. Simonsen (1970) is a classic on the theme.

192 Transitional dynamics led Nêves to nominate a cabinet of compromise in which some of its members represented interests linked to the authoritarian government or simply were close to him; however, with his passing, the place of these ministers became largely disposable as far as the new president was concerned. These changes represented a real departure from those economic teams thoroughly imbricated with the authoritarian regime and their diagnostic of Brazilian inflation.

management during 1986.[193] The plan initially consisted of a fiscal adjustment coupled with a price freeze as a subsidiary measure. However, the latter became the landmark of the plan creating the perception that inflation was suddenly a matter of the past. Because prices seemed to be under control, the fiscal adjustment never materialized because politicians wanted to capitalize electorally on the early success of the plan without further changes. Therefore, the price freeze became its hallmark. Inflation returned after less than a year. Price freeze, therefore, could not be maintained for long without other necessary adjustments.[194]

The next plan, named Bresser after the minister who created it, dealt with foreign debt and tried to manage a price freeze in a more orderly way. The plan also included a fiscal adjustment, which was not possible because there was no political will to cut expenses to the degree required. A significant difference with the preceding plan was its goal of a higher inflationary threshold. That is, the Bresser plan did not intend to bring inflation to zero but merely to control it on a lower level. This approach may have to do with the following. First, there was a tacit recognition that it was unfeasible to control inflation without the problems of the Cruzado Plan; second, there was an awareness of the difficulty of controlling inflation, in a more credible way, in the long run without a serious commitment on the fiscal front. Thus, given the impossibility of making a fiscal adjustment, the plan only tried to use another index simultaneously with a price freeze (Modiano 1989, 366-371).[195]

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193 Its launch date was February 28, 1986 to start on March 1st, surprising economic agents. It was thought that an unexpected shock would halt inflationary pressures. Further adjustments were made on July 24 and November 22. The latter was exactly one week after the general elections.

194 Modiano (1989, 357-365) offers a detailed description of the Cruzado Plan and its subsequent adjustments from an academic economist point of view, while Sardenberg (1987) is a journalistic and accessible account of the same events. Instead, for a detailed contemporary analysis see Modiano (1987), Carneiro (1987), and Meller (1987).

195 There were two more stabilization plans during Sarney's government. First, *Feijão-com-Arroz* (Beans with rice) - the corresponding expression in English would be bread-and-butter making reference to the simplicity of the meal - consisting of a tighter monetary policy, expenses reduction, and a more sophisticated indexation. Second, the Verão Plan (*Summer*), consisted of a new monetary reform and a combination of measures, like those of *Feijão-com-Arroz*, and more heterodox ones with the aim of eliminating the many indexes that reverberated through the system and creating inertial inflation without previously defining indexation rules. However, while this plan lasted throughout 1989, this was quietly abandoned at the end of that year and the government merely administered hyperinflation until the new government took office in March 15, 1990. For a more detailed account see Modiano (1989, 375-381). Because these stabilization plans did not have significant legacies in terms of policy learning and were generally perceived as the administration of hyperinflation, they are not presented in a more detailed fashion.

It is important to make reference to a significant political actor of that point in time: the PMDB. This was the party giving political support to President Sarney but its main members did not entirely trust him, despite the fact that he was also a member. When prices were frozen with the Cruzado plan, there was significant pressure from politicians to keep the freeze so they could capitalize on its initial success. Naturally, to PMDB politicians, there was no connection between inflation fighting and any sacrifice from them in terms of reducing patronage resources. This was also the case during Luiz Carlos Bresser-Pereira's tenure as Minister of Finance, who also lacked the political support needed to make a fiscal adjustment. The lack of collaboration from politicians can also partially the consequence of a new set of elites who were finally participating in the distribution of resources insofar as the military government had kept them at bay for twenty years. One might suggest that these elites were merely trying to satisfy long-repressed demands.

Another moment with profound consequences for future plans was during the government of Fernando Collor de Mello (1990-1992). The stabilization plans implemented by his government, popularly known as Collor I and Collor II, consisted of a series of drastic measures involving severe monetary restriction in the form of asset confiscation. Among the usual suspects for causing inflation was the large internal public debt. This debt circulated in the form of bonds corrected by indexation and traded in the secondary market on a daily basis. In the first days of his government, these assets were no longer tradable and had to be in the Central Bank's custody for eighteen months. While the assets remained out of reach inflation did not decrease, in part because of the discretional exceptions to the confiscation (Carneiro 1991, 161), but mainly because public debt as such was not *the* cause of inflation in Brazil.

The confiscation of assets was the measure implemented by the Collor administration specifically directed towards controlling inflation.[196] Secondary measures of this economic plan were commercial liberalization and privatization. At the beginning of his term, these were considered to be as important as asset confiscation in controlling inflation. However, the lack of success in inflationary control prevented any further association between those policies and inflation, at least until a new government was elected. These policies continued to be

196 The asset confiscation represented a major political toll for the government because it created some resentment amongst some sectors of society and empowered the opposition that would eventually lead the president's impeachment process.

implemented despite the political upheaval caused by Collor's impeachment. In turn, this dissociation with core anti-inflationary policies allowed them to pursue the reforms further. During the Collor administration, there was a partial incorporation of policy legacies insofar as both privatization and trade liberalization advanced in tandem with anti-inflationary policies; however, the incorporation was not successful since it represented a political backlash at the time, therefore the complementarity could not materialize.

Given the political salience of inflation, these policies constituted the core of the political debate. In a mixture of political and economic (theoretical) debates, the fight against inflation compelled political actors to mobilize their resources to secure positions. Inflation's political salience is a consequence of the uncertainty surrounding the situation brought up by the possible upcoming stabilization plan and the possibility of big losses. On many occasions, this possibility implied betting against its success. While many of the plans proposed a thorough reform of the state, the results on this front depended on how the reform could be isolated from the core political game. This isolation is evident with privatization during Sarney's government and liberalization during Collor's government. Therefore, these secondary political struggles succeeded in the mid-term because they represented incremental changes, which were, for the most part, unnoticed by political actors.

Given the slow pace of change brought about by the incremental reforms that would finally succeed, it is not surprising that inflation could not be controlled sooner. Substantive results appeared after several years of incremental changes. Before that, the returns produced by privatization and commercial liberalization could not be accumulated because there was still a way to counterweight them through other means, that is, inflation was still present creating opportunities for those who could take advantage of it. Therefore, in the successive stabilization plans, Ministers of Finances with their respective teams, concentrated on the fight against inflation, and in so doing, relegated other significant policies that would help in the task at hand to the background. While many of the teams were aware of the necessity of carrying on with the non-core policies for the stabilization plans to succeed, this was not possible. This impossibility was due to political reasons such as coalition-building compromises, or simply because it was not clear in the eyes of politicians whether these changes were necessary.

Many of the stabilization plans, not to mention all of them, were based partially on the idea that people should be taken by surprise in order to break the pattern created by indexation, or self- perpetuating inflationary spirals. However, as in the children's tale of the lying shepherd who cried wolf, people can be fooled once, maybe twice, but not indefinitely. Surprise worked with the Cruzado in 1986 but it proved harder to be effective in subsequent freezes like that of the Bresser plan or those of Collor, to name a few. Furthermore, this learning process, of both economic authorities as well as citizenry, complicated even more the chances of success of every stabilization plan. People's expectations changed and every time a new plan was in the horizon, they prepared for the next freeze, jeopardizing, in turn, the logic behind the plan. On the other hand, those who were not able to adapt to the freezes accumulated loses.

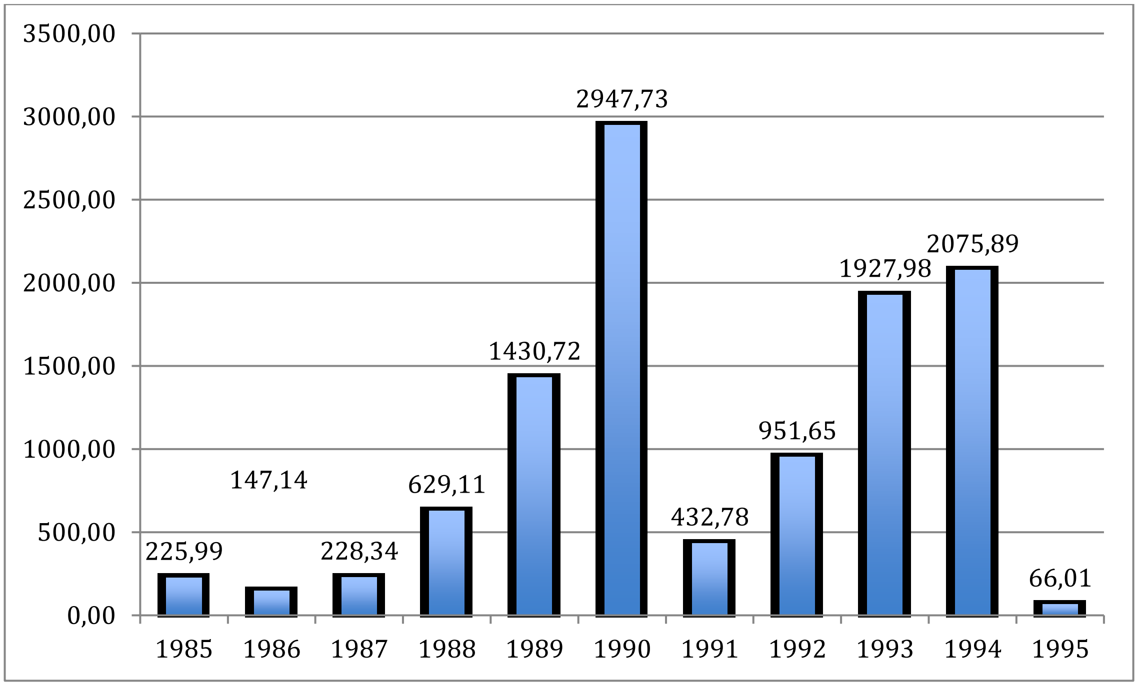
3.3.2. This Time it is for Real

It was after these failures[197] that the measures that would later be part of the Real Plan were conceived. However, given that surprises were not feasible anymore, the best course of action was instead to inform the population of every change affecting them directly so as to manage expectations and prevent defensive strategies or violent disruptions to the economic situation. Even so, this was not self-evident given the political uncertainty in Brazil at the time with a recently impeached president and with no signs of controlling inflation. Between September 1992 and April 1993, there were three Ministers of Finance. The lack of results in the fight against inflation created even more uncertainty. In this context, President Itamar Franco nominated as Minister of Finance, Fernando Henrique Cardoso from Minister of Foreign Affairs in May, 1993.[198]

[197] There were several stabilization plans; they were: Cruzado and its adjustments in 1986; Bresser in 1987; *Feijão-com-arroz* in 1988; *Verão* in 1989; Collor 1 in 1990; Collor 2 in 1991, and Real in 1994.

[198] The nomination of Fernando Henrique Cardoso represented above all the support he enjoyed amongst significant parts of the Brazilian political system, both partisan and non-partisan.

Figure 4. Inflation. Consumer Prices. 1985-1995. In percentage



Source: Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as yearly. The Laspeyres formula is generally used. International Monetary Fund, International Financial Statistics and data files IBRD (2016c).

The political uncertainty in which this latest plan took place cannot be underestimated.[199] There were several fronts on which the newly nominated Minister had to fight. Some were defined as preliminary. First, the budget and the way it was used by political actors had to change. Second, the financial relationship between the Federal Government and the states, in which the latter did not pay their debts with the Federal Government showing in turn the fiscal stance of both levels of government. The budget did not reflect the real expenses. It was a collection of initiatives coming from a variety of politicians who pushed for them as a way to show their political clout over the government without acknowledging their real value. By delaying some of these expenses, the Federal Government allowed their

199 The general uncertainty surrounding the whole economic policy making at the time brings to mind the conditions described by Capoccia and Kelemen (2007, 343) as characteristic of critical junctures: "a situation in which the structural (that is, economic, cultural, ideological, organizational) influences on political action are significantly relaxed for a relatively short period". Whether this moment can be considered as a critical juncture depends on the future evolution of the Brazilian economy.

inflation-corrected value to corrode with high inflation. This was the political game played in and around the budget over the years.

It was in the best interest of the economic authorities to change the game, however.[200] The gross volume of the expenses had to be reduced by 20% in exchange for the possibility of actually making the effective expenses without inflationary corrosion. As politicians were fully aware of the plausibility of stabilization with its political consequences (i.e. electoral success), they authorized the general cut.[201] The political relevance of this approval cannot be underestimated. It required convincing politicians that even if the expenses were cut in nominal terms, the result of that cut would be effectively spent. The cut expenses constituted a fund called *Fundo Social de Emergência* – FSE (Social Emergency Fund).

Nevertheless, it also had some drawbacks. The Ministry of Finance's initial intention, as well as that of his aides, was also to include those expenses earmarked for the states' constitutional fund. This part of the initial attempts of the Federal Government was not approved by Congress and had to change. The governors mobilized their political resources in Congress[202] to prevent a general cut in the earmarked expenses benefiting the states; therefore the cuts were approved without these earmarked expenses (Cardoso 2006, 153). The other possibility was a complete rejection of the measure, which would have considerably weakened the economic feasibility of the new plan, not to mention the political position of the Minister of Finance and his team. On the other hand, an unrestricted approval could represent a significantly bigger contention of Federal expenses given the size of the Constitutional fund relative to the Federal Government's revenues.

On their end, the governors were struggling to solve a fiscal crisis in their sphere despite the advantages granted by the Constitution. Many of their debts were contracted with

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200 On top of that, in Congress there was a *Commisão Parlamentar de Inquérito* – CPI (Parliamentary Commission for Inquiry) investigating the corruption problems surrounding the definition of the budget within the Congress, known as the scandal of the Budget Dwarfs because of the short stature of the presumably benefiting congressmen.

201 Edmar Bacha. Interview by the author. Rio de Janeiro, February 21, 2014

202 Given the centralization of political and economic resources made by the military at the head of the Federal Government, during the transition states' governors mobilized their minorities in Congress to defeat some centralizing initiatives. This was yet another occasion in which governors used their political power against a federal policy. To see a more in-depth discussion of the political centrality of Brazilian governors within the Brazilian political system, see Abrucio (1994).

the Federal Government in an attempt to solve the insolvency the resource centralization left them with during the military regime. The Brazilian federalist politics were considered at the time a zero-sum game in which the states always tried to keep the upper hand over the Federal Government (Jayme-Jr 1995). The preliminary phases of stabilization were no exception, partially because the transition involved a series of concessions from the Federal Government to the elected governors, which in turn were reinforced by the Constitution. The latter continued with their non-cooperative actions *vis-à-vis* the Federal Government. They acted as though they were not a part of the public sector or as though the possible stabilization would not affect their fiscal stance (Afonso 1996, 34), something they realized a few years later.

As the preliminary reforms were carried out, nominations in key posts within the economic bureaucracy brought together the people who had implemented the core ideas of the Cruzado Plan eight years before.[203] This resonated throughout the Brazilian political system. Besides the popularity of the authority that declares the freeze, in this case the President and the Minister of Finance, the main political consequence of a price freeze is the election of the party in power. That was the case during the Cruzado Plan. Then, when politicians perceived that the same team was once again assembled, their bets were naturally that a new price freeze was coming. However, the team had learned their lesson. Once you offer to politicians a price freeze there is nothing else to offer.[204] Therefore your hands are definitely tied.[205]

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[203] Given the important presence of the IMF in Brazilian economic policy-making since early 1980s, its complete absence in the monetary reform carried out by the Real Plan is surprising. The IMF had supported every stabilization plan attempted in Brazil from the Cruzado Plan onward. As discussed above, the two main characteristics of those plans were price freezes and expenses cut. The former had been tried with success, at the time, in Argentina and Israel eliciting not only respect but also interest from IMF staff. The latter, on the other hand, had been part of the IMF advice as a part of the conditional reforms for its loans. At the moment of implementing the monetary reform of the Real Plan, the IMF had several caveats concerning its success as the political uncertainty cast more than a doubt over its feasibility. The IMF had learned the lesson over the years that the political support needed for stabilization was elusive to say the least. In the eyes of the IMF, the necessary conditions for the success of the Real Plan were not present as the budgetary adjustment was only partial. The second point with which the IMF did not agree was the absence of a price freeze. For the IMF staff this might smooth the conditions for a peaceful transition between monetary regimes and might trigger a stronger fiscal adjustment. However, as discussed above, the inertial component of Brazilian inflation was a core component of the problem and a price freeze would not stop it as many of the previous stabilization plans had shown. There was almost no single incentive for the IMF to become involved in the Real Plan given the political uncertainties surrounding it, as well as the technical novelties such as the *Unidade Real de Valor* – URV (Real Value Unit). Therefore, the only successful Brazilian stabilization plan was the one not supported or endorsed by the IMF.

[204] The price freeze enacted with the Cruzado Plan created the false expectation among political actors that no further actions were required to effectively control inflation, e.g. fiscal adjustment, liberalization, etc. The absence of such measures during the Cruzado Plan in the mid-1980s was crucial to the failure of the plan.

The conceptual ground about the inertial component of the inflation remained at the core of this new attempt to control inflation. Nonetheless, the general principles behind the measures used to solve it had changed. The central tenet for the whole team was to take advantage of the habit Brazilians had of indexing all kind of contracts, offering them a general index in which they could trust while the "old" currency corroded with inflation. This was different, comparatively speaking, from the Cruzado experience. In fact, there was a consensus about the need to avoid a price freeze. The solution was a device in which the principle of general indexation of all contracts prevailed without a price freeze; also every change was announced prior to implementation so as to gain the public trust (Bacha 2012b, 139-141). The latter was hard to achieve because after numerous economic plans the public did not trust economic authorities.

The *Unidade Real de Valor* – URV (Real Value Unit) was born.[206] It allowed for the general indexation of every contract on a voluntary basis offering at the same time a rule for the conversion to the corroded currency, as well as an exchange rate. The rules involving the URV were complex because they had to encompass not just the whole monetary regime, but also the use that people gave to the currency. Currency, within modern societies, plays different functions. It preserves value, is an accounting unit, and a payment instrument. With hyperinflation, Brazilian currencies had lost the first two to financial instruments and different indexes respectively. The URV was to recover the lost functions of the currency leaving the last function still to the *Cruzeiro Real*, the circulating currency at the time. If contracts in general could be indexed in URV, prices in retail had to be expressed in *Cruzeiros Reais* in order to create menu costs[207] avoiding an inflationary temptation.

Besides the monetary complexities described above, there were also the political ones. President Itamar Franco wanted a price freeze to capitalize on the popularity granted by such a measure. On the other hand, there was a need to find political support in Congress because the

205 Edmar Bacha. Interview by the author. Rio de Janeiro, February 21, 2014.
206 This paragraph relies on Franco (1995b).
207 Menu costs refer to the explicit cost faced by a retailer when he attempts to change his prices as fast as inflation. In principle this would include, but is not limited to, the cost of printing a menu every time the price changes with inflation. In this particular case, if prices were in *Cruzeiros Reais* there were some costs in changing prices as opposed to just pricing in URVs.

Medida Provisória[208] (Preliminary Measure) creating the URV had to be eventually transformed into law for which the consent, or at least the acquiescence, of the PSDB – to which the members of the economic team belonged - was required.[209] Even if in the eyes of President Itamar Franco the solution had to be a price freeze, the respect he showed during the whole process towards Fernando Henrique Cardoso during his tenure as Minister of Finance was paramount to the success of the whole enterprise.[210] Franco supported Cardoso and his team even when their proposals seemed to be counterintuitive.

With the PSDB politicians, the situation was very similar. Given the uncertainty surrounding it and the complex nature of the whole stabilization program, the tentative timing for its completion was November, 1994. That is, after the elections.[211] What the economic team asked for from politicians was to risk a likely electoral defeat if something were to go wrong. The support was granted on the basis of a division of tasks within the party: politicians were in charge of political guidance, technocrats were in charge of technocratic guidance (Bacha 2012b, 141, Cardoso 2006, 184). It was not just a matter of a political sense of duty, even if it is difficult to assess its validity, it was also a matter of trust between politicians and technocrats. This trust had already been built during many campaigns in which the latter assisted the former as chief economists.[212]

The complexities of the plan launched with the corresponding legal instruments may obscure the political background in which it took place. While it does not account for political factors revolving around stabilization, the potential campaign for the presidency of Fernando

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208 Special presidential decree. It remains valid for three months and has to be approved by Congress to become an Act, otherwise it has to be re-enacted by the presidency after that period to remain valid.

209 The party was created as a dissidence of the PMDB in the late 1980s. It was formed mainly by urban middle class professionals who saw "modernization" of the Brazilian society as a combination of social changes to reduce inequalities without necessarily pressing for a heavy state intervention in the economy. In this latter dimension, it established a clear difference with the *Partido dos Trabalhadores* – PT (Workers' Party) which, at the time, saw the state as a privileged venue to promote social change. Heavy state intervention in the economy, in other words, as in the contemporary Soviet bloc. For more details about the formation of the PSDB, see Cardoso (2006, 131-135).

210 Both Edmar Bacha and André Lara Resende in the interviews conducted by the author refer to the paramount importance of Fernando Henrique Cardoso for the success of the whole plan. His prestige garnered the required respect and support coming from President Itamar Franco, and the political system in general, as well as the intellectual respect from the members of his team.

211 During the interview conducted by the author with Edmar Bacha, he reckons to have told Mário Covas that the timing for the unraveling of the program would be before the elections.

212 Edmar Bacha. Interview by the author. Rio de Janeiro, February 21, 2014.

Henrique Cardoso can be an explanatory axe for that scenario. Given the lasting challenge of Brazilian inflation, the electoral possibilities of the one who could control it were overwhelming. Because Cardoso was the leader of the team behind yet another attempt, it was clear for many actors that his chances for becoming president would increase with every success the plan could claim. This realisation notwithstanding, uncertainties remained high and in the preliminary stages of the plan it was difficult to assess how viable Cardoso's bid for presidency would be. Undoubtedly his exposure to the media with the announcement of every policy measure undertaken within the Real Plan, had two possible outcomes, whether his chances increased with successes or decreased with failures.

Communication with the public, on the other hand, was a conscious strategy on the part of the team insofar as the preceding stabilization plans relied heavily on the element of surprise, causing profound disturbances in the economic stance of many actors. Therefore, the strategy was to announce with due anticipation each and every change that could affect actors' expectations. This feature granted the necessary transparency lacking in preceding attempts to control inflation. However, this had also the political consequence of increasing the electoral chances of those responsible for such announcements. On the economic side of the problem, transparency allowed for different actors to adapt to the new environment while preserving existing commitments. On the political side, it created confidence in the authorities and increased recognition for the person responsible for it and with it, increased chances to win the presidential election.

After the enactment of the Real Plan's necessary legal instruments at the end of February 1994, two issues became clear. First, that the URV was embraced by the population with the conversion of many contracts to such an index, says a great deal about its perceived benefit; and second, following his resignation as Minister of Finance in April, it was clear that Cardoso was going to be the presidential candidate.[213] Even if initially the final stage of the plan was to take place at the same time as the elections in October, events would eventually unravel differently and the completion of the monetary reform was indicated to be in July 1st 1994 when the URV became the Real. The central tenet of transparency was maintained and,

213 The Complementary Act No 64 enacted on May 18, 1990 on the Article 1-II-a-1 establishes that a person could not be candidate to the presidency if he or she has been minister in the six months preceding the election date.

with a reasonable anticipation, an official announcement was made before this change took place. Even though it seems marginal when compared with many changes introduced by the Real Plan, transparency and the possibility of anticipation is a fundamental difference with the preceding stabilization plans.

Once the monetary reform was completed, what worried economic authorities was keeping the stabilization going without losing the ground already gained. The external environment was unfriendly towards the recently stabilized Brazilian economy. During the second half of the 1990s, several financial crises appeared in the horizon of the international economy (Mexico 1994, South East Asia 1997, and Russia 1998), putting in distress the transformations undergone by the Brazilian economy. This hostile environment created some pressure over economic authorities to decide the proper moment for adjustments in economic policy. Some of these will be discussed below. However, an important point is that stabilization as such, that is, slow or no price changes at all, is achieved with specific economic measures as made evident with the Cruzado Plan during the 1980s. What is difficult is to maintain the pace of price change. The way in which this happened in Brazil involved many changes that would include a deepening of the transformations discussed above, privatization and liberalization, with their specific political debates and challenges.

3.4. Securing the Big Conquest

One of the lessons drawn from the Cruzado Plan experience was that stabilization understood as a reduced pace of price change could be achieved with the right measure at the right time. More difficult, however was keeping such a pace in the medium to long term. This double-layered nature of inflation speaks to the politico-economic complexities underlying it. Institutional changes in other arenas were not present during the Cruzado Plan making a sustained stabilization a daunting task. Thus, the institutional complementarity backing stabilization could not exist for at least two reasons. First, there were not significant changes in both state ownership of enterprises and protection of national producers maintaining longstanding strategies of passing costs to others, i.e. there were not institutional changes of any kind; second, political actors did not perceive any political cost for their inaction which means no incorporation of the legacies of inflation was made. The latter was the determining factor during the Real Plan so as to enact the necessary measures to keep inflation under control.

Institutional complementarity appears when one institutions needs the presence of other institution to play its structuring role. In the context of the transformation of the Brazilian political economy brought by the Real Plan and the developments it implied, this happens when the consolidation of one institutional reform buttresses other institution in a way that without such a move, both institutions would cease to be functional. This consolidation was triggered precisely by the fear of the responsible officials, both politicians and bureaucrats alike, of the possible return of inflation. Such return would have had significant political consequences insofar as their mandate was based on the premise of their success against inflation. These actors feared that with a return of inflation they would subsequently lost the forthcoming election, therefore they took the necessary actions to prevent that outcome.

3.4.1. Changing Roles: From Owner to Referee

At the end of Itamar's government, all the businesses not protected by a constitutional provision were privatized, demonstrating the overall success of the privatization process in spite of its shortcomings[214] (Pinheiro, Bonelli, and Schneider 2007, 84). During Fernando Henrique Cardoso's administration, there was also a close association between privatization and inflation control. It had, however, a different character, this time being less discourse-driven and more pragmatic. They responded to the challenges posed by the economic junctures in at least two venues: the banks owned by the states' governments and the telecommunications sector, a constitutionally protected monopoly. The latter as a general

[214] As described above, these shortcomings were mainly related to the delays caused by new evaluations of the enterprises to be privatized. For more details, see section 3.1.2. Collor Government: Taking Privatization to New Heights

trend in privatization of public utilities including electricity[215] as well as some petrochemicals (Amann and Baer 2000, 1812), and the former as a part of redefinition of federal relationships, both with debt relief in mind (Amann and Baer 2000, 1816).

Public banks owned by the states' governments rolled over the bond-denominated debts of their controllers as a way of relaxing the budgetary restriction these faced. A good indicator of the Real Plan's success in de-indexing the economy was the generalized banking crisis after its implementation. Many public banks were privatized in exchange for a rescheduling of states' debts with the Federal Government mainly because the life support system indexation had become ceased to exist, forcing the controllers to face the size of their deficits (Beck, Crivelli, and Summerhill 2005). The program designed to carry out these tasks was called *Programa de Incentivo à Redução do Setor Público Estadual na Atividade Bancária* – PROES (Incentive Program to Reduce States' Public Sector Banking Activities).[216]

With this program, it was the first time states' governments participated actively, albeit constrained by circumstances, in the stabilization effort. As mentioned above, when the FSE - Social Emergency Fund - was created, they opposed the initiative that would partially cut the constitutional transfers. With such a move, they continued the non-cooperative federalist arrangement played out during the early stages of the transition from military rule after 1974, throughout the transition, and even after the enactment of the Constitution in 1988. One of the ways in which this game was played was precisely the use states' Treasuries gave to their banks in order to finance the governments' activities (Jayme-Jr 1995), taking advantage, in turn, of the possibility of capturing the inflationary tax through indexation. However, once stabilization was in place, it became evident that such a game was not available anymore. Therefore, they were forced to relinquish control of their banks in exchange for a refinancing

215 The electricity market was fragmented with the Federal Government owing a small portion of distribution while having a substantial part of generation. This, of course, changed the latitude with which it could move in that particular market. For more details, see Velasco-Jr (1997a, 31 Fn.36)

216 Just as in the case of public banks owned by states' treasuries, a special program was created to handle the bankruptcy of private banks; its name was *Programa de Estímulo à Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional* – PROER (Stimulus Program to Restructuring and Strengthening of the National Financial System). It allowed for the merging or acquisition of the troubled banks by other national or foreign banks avoiding runs on the troubled banks, which would have increased the costs to the whole economy. Both crises of public and private banks speak to the way in which these organizations funded their activities during hyperinflationary times; once indexation disappeared, they found themselves in a big crisis.

by the Federal Government of the debts the former carried in the form of bonds. This exchange implied a subsidy of the Federal Government to the states with the different interest rates paid in the debt restructuring (Beck, Crivelli, and Summerhill 2005, 9-11).

Other important acts of privatization carried out after the stabilization had taken place was that of the telecommunications sector. Established in 1988, its constitutional monopoly required substantial changes in order to get the privatization going. However, unlike other symbolic enterprises such as the CSN - National Steel Mills - the main public provider, *Embratel*, did not elicit the same debate or political mobilization against its possible privatization. The privatizations of public utilities, including the *Telebrás* system,[217] were made with a significant delay after the final introduction of the Real in July 1st, 1994. This delay was a consequence of the required legal reforms.[218] Included in such reforms were incentives for national and foreign companies to participate in the privatization bids as associates (Velasco-Jr 2005, 60). These associations presented a division of tasks in which Brazilian companies (banks, pension funds, communication and industrial companies) pooled their respective capital and expertise while a foreign operator brought to bear its know-how of the business (Velasco-Jr 2005, 66). Although it seems unimportant for the present discussion, these resources would become essential in maintaining stabilization later on.

In general, the arguments advanced by the literature agree on the moment in which privatization revenues became important to the stabilization effort but differs in the specific reasons for why this is so. The importance of the absolute values is one of them emphasizing the macroeconomic relevance of privatization revenues after 1996, contrasting sharply with what happened before (Modiano 2000, 325); a second argument is its importance in the response to the Asian crisis of 1997 as it allowed the entry of substantive resources protecting the economy from the instability created by it (Pinheiro and Giambiagi 2000, 33); and, finally, because the influx of foreign direct investment helped to finance a current account deficit (Pinheiro 1999, 166), allowing for the smoothing of the exchange rate.

217 *Telebrás* was the holding of telecommunications companies that operated one company per state.

218 These included the removal of its strategic character forcing it to be a state monopoly with the 8th Constitutional Amendment in August 15th 1995, the correspondent legal development of this amendment (Act 9295) creating a regulatory agency enacted in July 19th 1996, and finally the Act 9472 of July 16th 1997 regulating the market as well as establishing the general guidelines for the privatization of the public enterprises acting on that sector (Velasco-Jr 2005, 56-59).

It is important to note how these accounts present two different channels through which privatization revenues were important to stabilization. The first, referring to the size of transfers to the public coffers[219] would be linked to the fiscal stance, that is, the possibility of keeping the fiscal deficit at bay. The rest of the arguments refer to the relevance of foreign currency in keeping the exchange rate as an anchor of the stabilization effort. These reasons are not by themselves contradictory, if one takes into account how the authorities conceive of such interventions. Moreover, these reasons underline how privatization was paramount to the stabilization effort. There is a bundling involving the privatization of important assets insofar as the revenues produced by privatization[220] were used to ensure that the stabilization process was not jeopardized (Velasco-Jr 2005, 44). The difference with the first bundling attempt, as stated above, is that in the latter the stabilization had been successful to some extent while in the former the stabilization had not produced the desired effects in time.

In fact, this is a clear example of the reinforcement between these institutional transformations. Privatization was crucial in the latter phase of stabilization because it was taken advantage of to keep the exchange rate, which at the time was the paramount instrument of commercial liberalization, at such a level that would allow it to fulfill its pretended role. In turn, this interaction between both institutional transformations was at the core of the stabilization effort, because at the time it faced a considerable challenge given the conditions of the global economy. A possible return of inflation would have implied an enormous political cost for the government insofar as it sought to pass a constitutional amendment authorizing re-election. Success in controlling inflation would certainly increase the possibilities of this amendment (Dalmazo 2000, 200, Velasco-Jr 2005, 44). Therefore, the complementarity was possible because actors could take advantage of some results produced by the transformed institution, but mainly because their actions implied the full political incorporation of the policy legacy of inflation and its possible consequences.

The action of incorporation of a policy legacy is important to understanding the constitution of institutional complementarities. The main explanation for such an outcome, as

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219 From 1996 to 1998 the revenues from privatization amounted to more than 35 billion USD, with 22.6 billion alone in 1996 (Manzetti 1999, 171-172).

220 Total revenues for the privatization of the *Telebrás* system comprising mainly the right to operate some bands of the electromagnetic spectrum were of BRL 22.05 billion at the end of July 1998. Foreign resources amounted to the equivalent of BRL 15.8 billion (USD 13.6 billion) or 60% of the total value (Dalmazo 2000, 211).

Hall (2010, 212-214) argues, has been the incentives produced by a change in one sphere of the political economy allowing for possible changes in others. The other explanation relies heavily on the idea of a market of institutions in which actors find out about institutions through a series of serendipitous trials that, eventually, show them possible matches for their needs for politico-economic stability (Campbell 2011, 225). These approaches, however, take out the political struggles that institutional change embodies, giving instead the impression that there is only the need to attain a certain threshold (Pierson 2004) to build institutional complementarity. What the stabilization in Brazil shows is that neither incentives, nor serendipitous trials of available institutions led to the complementarity of institutional reforms. It was precisely due to the political needs of a government wanting to avoid the possible return to inflation.

Telebrás' privatization generated a substantial amount of revenue,[221] allowing it to respond in a more efficient manner to the challenges posed by the economic conjuncture. Less clear are the original motivations behind the privatization of these assets. Did the authorities plan to sell regardless of how the resulting resources would be used? Was this a perfectly planned response to the fiscal crisis? On the other hand is hard to imagine that a complicated process involving a constitutional reform would have been planned as a response to a crisis. Thus, reinforcing the argument about the independence of the political processes leading to the privatization within the Brazilian state rather than a plan perfectly conceived involving a series of goals and stages to follow. The argument seems to be, once again, that privatization was in place responding to its own logic, including a solution to the fiscal crisis, rather than as an instrument to keep the exchange rate in order to save the stabilization process. It seems that the path toward stabilization was more indirect than straightforward.

In the present case, as the privatization of assets represented a big transformation of the intervention of the state in the economy, it also helped the stabilization effort carried out by Brazilian economic authorities. Revenues derived from privatization replaced *seignoriage* or inflationary tax to control the fiscal deficit, even if these were earned only once (Pastore 1997, 32-33). On the other hand, once the Real was in place, the exchange rate was key to keeping

[221] For values, see note 220.

prices down.[222] Economic authorities in charge of the general stabilization policy were clearly aware of the importance of the external transfers derived from the sale of big assets like those of telecommunications as mentioned above, among other public utilities, to control the exchange rate (Pinheiro 1999, Pinheiro and Giambiagi 2000).

When the successive global financial crises of the second half of 1990s appeared on the horizon, the connection between privatization and commercial liberalization became more straightforward. With each new crisis, the stabilization policy seemed fragile because the exchange rate was considered paramount to keeping prices down. Thus, the influx of foreign investment received through the privatization of public utilities were fundamental to the continuous success of the stabilization policy.[223] However, because foreign investment does not account for the full importance of the commercial liberalization and the external front for the stabilization policy, this will be analyzed in the next section. This transformation also demanded political struggles that would reveal themselves to be as important as those of privatization for the success of the stabilization policy.

3.4.2. Exchange Rate: To Change or Not To Change?

In 1994, when the Real was introduced, the external front turned into a very important arena for the consolidation of stabilization, even to the point of becoming centrally attached to it. In the first phase of the program, a further reduction in tariffs was ordered to control price increases caused by the higher demand in the aftermath of stabilization. However, at some point, tariff reduction was not the only instrument used to liberalize or to control prices. The exchange rate was even more effective. After the monetary reform that finally introduced the Real as the Brazilian currency on July 1, 1994, an appreciated exchange rate helped to stabilize prices because national producers had to keep prices down in order to compete with cheaper imports. As will be further discussed below, liberalization was implemented using a combination of instruments: tariffs and exchange rate.

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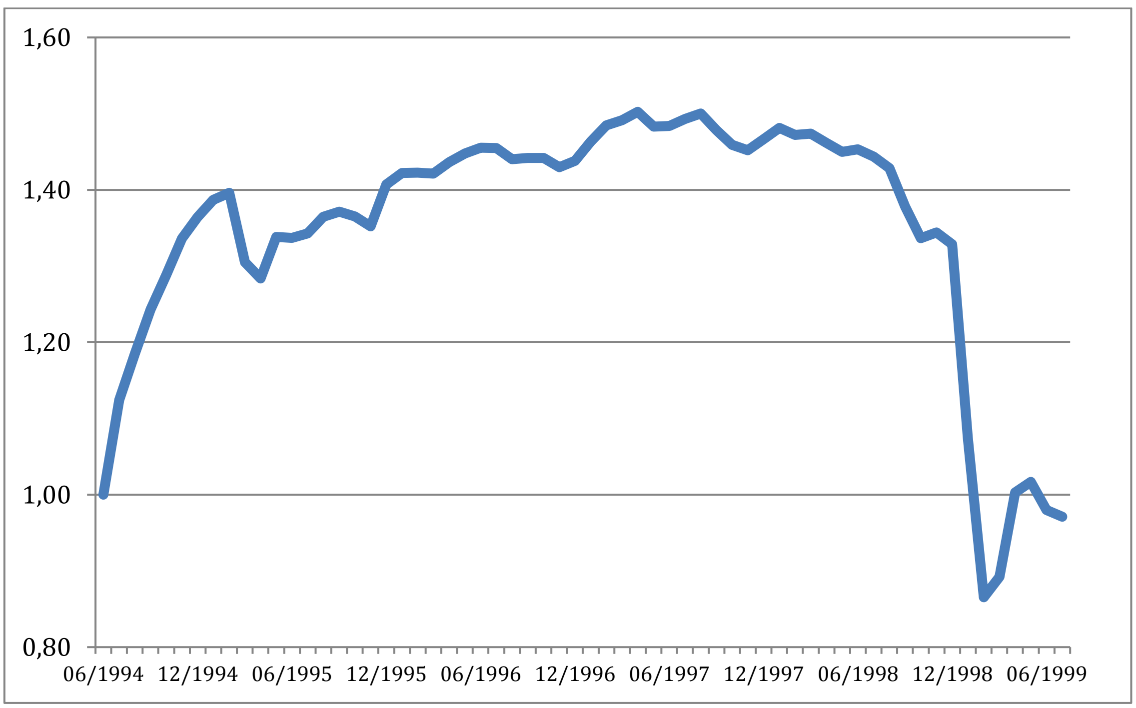
222 Edmar Bacha. Interview by the author. Rio de Janeiro. February 21, 2014.

223 Figures concerning the size of foreign investment on the privatization of public utilities vary from USD 13.6 billion (Dalmazo 2000, 211) to the 75% of USD 19 billion, which is 14.25 billion (Manzetti 1999, 217).

Although this early appreciation (Figure 5) of the Real can be identified as a market reaction or trust in the monetary reform and the Brazilian economy in general (Franco 1999), it is also recognized that the exchange rate was kept down by the economic authorities precisely because it was identified as central to the stabilization effort.[224] Nevertheless, this was not a preconceived policy; instead, a different exchange policy was on the agenda during the first Cardoso government (1995-1999) given the difficult conditions faced by Brazil on external and internal fronts (Cardoso 2006). In fact, the exchange policy was a contentious topic for the economic authorities. These debates prevented the creation of the political conditions to make a change in the exchange policy (Cardoso 2014).

Figure 5. Exchange Rate Index (IPCA).[225] June 1994 = 1



Source: Elaborated by the author with data from Brasil (2015).

224 Edmar Bacha. Interview by the author. Rio de Janeiro, February 21, 2014.

225 The *Índice de Preços ao Consumidor Amplo* – IPCA (Broad Consumer Price Index) includes households within the one to forty minimum wages of household income whatever the source and it has been calculated in the main metropolitan regions of Brazil every month, since 1979 in some regions and for Brazil as an aggregate since September 1981 (IBGE 2015, 4-6).

Debates over the exchange rate centered mainly on the moment to alter its level, on the best instrument to pursue such a policy, and on the necessary measures to prevent market actors, whether international or domestic, from betting against this central change.[226] The first of these debates took place in early 1995 when the global financial system had to face the Mexican crisis. The three groups of technocrats and their positions over how to change the exchange rate consisted of the following. First, José Serra, Minister of Planning who defended a sudden change to a lower level (i.e. a maxi-devaluation); second, Pérsio Arida, President of the Central Bank, supported by some of its directors, who defended a mechanism of a wide exchange band where the central bank would intervene in the market only to tame the more risky investors (i.e. a market dominated intervention). Third, Pedro Malan, Ministry of Finance and Gustavo Franco, director of the international area of the Central Bank, who defended a narrow exchange band with a heavier intervention of the central bank that would induce a controlled devaluation[227] (Cardoso 2006, 339-345).

The uncertainty produced by the successive financial crises during the 1990s was partially responsible for the lack of consensus among economic authorities.[228] On the other hand, these debates also reflected how the exchange policy became a centerpiece of stabilization after the monetary reform was completed. The link between the exchange rate and stabilization was the possibility of controlling price increases through the direct competition of Brazilian industries with foreign producers. This renewed competition implied a significant change in the productive structure of the country involving many industries, though not all (Barros and Goldenstein 2000, 12). Another sign of the challenging moments

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[226] These debates could be somehow summarized, like in the preceding paragraph, as how and when to depreciate the currency with the smallest impact over the general economic conditions of the country. These debates are narrated in Cardoso (2006, 377-398, 406-413) for various moments of his first government (1995-1999).

[227] In January, 1999, the exchange policy was finally altered in a rather disorderly fashion. Lucas Lopes offered the notion of an Endogenous Diagonal Exchange Band, which seemed to provide both space for the market and control for the authorities without increasing interest rates, as the solution offered by Gustavo Franco, President of the Central Bank at the time, would imply. The latter was fired and even if the former was supposed to assume his post, the failure of his mechanism led the President to seek the advice of Armínio Fraga who became the head of the Central Bank. However, inflation did not return to former levels as authorities feared.

[228] Economic authorities changed over the years mainly because people asked for voluntary resignation. Key posts remained the same, however. People who had already participated, for instance, as director of the Central Bank could become President of the same institution. Broadly speaking the economic authorities consisted of the Ministry of Finance, Ministry of Planning, the President and some Directors of the Central Bank, the President of the BNDES, among other members of the government acting as counselors all commanded by the President when a political decision was unavoidable.

faced by the Brazilian economy in the second half of 1990s was the differing and contradictory policy instruments used to manage the external front.

A significant tension involving other actors within the political economy was the fiscal balance discussed above. This issue was contentious on the external front because of a double-sided connexion of the interest rate with both the possibility of attracting capital - hence preventing speculation with the currency - and, the necessary fiscal restraint of states' and municipal governments that were also indebted. On the other hand, a more restrictive fiscal policy would allow more latitude to economic authorities insofar as inflationary expenses would have disappeared from the horizon decreasing the possibility of a return to inflation. Therefore, an instrument that was attached to the core effort of stabilization resonated through the economy generating controversies with other political actors.[229]

The negotiation of special protection for some industries reflects somehow their political clout, as in the case of the auto industry, or the pressure any given sector could make over the government to receive protection. Nevertheless, from a more general perspective, the concerns affecting business leaders had to do with the continuity of Brazilian systemic costs (mainly labour costs) combined with commercial liberalization (Kingstone 1999, 208). There was a coordinated attempt from the business community to press for direct commitments from both the Federal Government and the Congress. The event was called "March to Brasília," which involved two to three thousand businesspeople demonstrating in the city, pushing for reforms that would eliminate some of the systemic costs and aiming for some concessions in the adjustment process. The government's response was to appoint a Minister more sensitive to industrial concerns (Kingstone 1999, 215-216).

Later on, the government would respond by increasing some tariffs for sectors where dumping was rampant and, in a pragmatic gesture, special credit lines were offered to firms affected by commercial liberalization. Moreover, pragmatism on both sides guaranteed a sound relationship between parts, business and government alike. Cardoso's government and business maintained good communication and the latter believed the former to be the only one

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229 The relevant argument about the discussion with states' governments over the privatization of their assets, of which banks were the most prominent, was made in the preceding section versing precisely on the privatization during the Cardoso administration.

who could push for the reform agenda they believed in. Finally, a cleavage within the business community based on the possibilities liberalization brought up also prevented a more consistent action on its behalf. Multinational corporations and the financial industry benefited from the possibilities of an open economy through reduced costs and economies of scale. On the other hand, for those producers focused on the internal market, or aligned the old corporatist lines and the ISI production standards, were hit hard. This division allowed the government to respond to the most pressing issues without necessarily derailing the adjustment process (Kingstone 1999, 224-227).

The preferred instrument, an overvalued currency, allowed for the entry of those products competing with internal products (Figure 5 above), while at the same time tariffs were increased in order to protect industries from that same competition. This at the end of 1997, even after a renewed use of non-tariff barriers (Kume, Piani, and Souza 2003, 18). It is interesting to analyze the contrast between the ease of changing particularistic instruments such as tariffs and non-tariff barriers to trade and the intense debates around possible modifications to the exchange rate mentioned above. A possible explanation is the ability of certain groups to press the corresponding authorities for protection without any regard for either the rationale of the given policy or for the consequences of the policy adopted (Barros and Goldenstein 2000, 16).

On the other hand, the exchange rate was too exposed to different actors including the international financial system. A possible speculation with the currency could have been disastrous for stabilization. Consequently, debates had to be held in private.[230] As a fundamental price of the economy, the exchange rate did not have a specific constituency defending a precise change. Instead, multiple constituencies defended contradictory modifications adapted to each particular necessity. Even among those who were in favour of a change in this price, there was the question of when such a change could be made, adding yet another point of consideration to an already difficult debate. On the other hand, if the exchange rate was considered central to stabilization, as discussed above, tariffs were again

230 An example of the sensibility of the issue can be identified with the reference made by Barros and Goldenstein (2000, 18-19 fn. 5) about the posts held by both authors preventing a more open debate despite the lack of direct operational responsibility on the exchange policy.

raised to avoid the problems of current account deficit accumulation (Kume, Piani, and Souza 2003, 32)

The institutional complementarity appears when political actors face the possibility of losing the ground already covered. In the event of the return of inflation, the Cardoso administration,[231] seeking re-election, would indeed have been hampered. The influx of foreign resources produced by the privatization of telecommunication assets allowed economic authorities to keep the exchange rate at a level permitting controlled inflation, while also signalling the administration's commitment to state reform (Velasco-Jr 2005, 44). All these elements show that the Cardoso administration was perfectly conscious of the risks implied by the return of inflation. Policies were coordinated in part under the fear of its return. The Cardoso administration incorporated the legacy of past policies insofar as institutional reforms were politically supported precisely to avoid the materialization of such legacy, which would have jeopardized the political goals of the administration.

3.5. Preliminary Conclusions

After the demise of the old economic model in which the state played a core role, a number of institutional reforms – both liberalization and privatization coupled with explicitly anti-inflationary policies - became dependent on one other to succeed. Together, these reforms constituted an institutional complementarity inasmuch as each one needed the other to play the structuring role within the Brazilian political economy. This outcome was the result of political actors facing the possibility of a return of hyperinflation and pushing for reform. This was not just a matter of the right incentive to bring the same logic across two institutional realms. There was a political imperative, namely to avoid the return of inflation.

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[231] As discussed above, economic authorities encompass Ministers, second, and third rank bureaucrats whose insights, ideas, and actions contributed to some extent to the stabilization. By the very nature of their posts, there was some rotation in the people occupying such posts and for this reason the generic economic authorities is preferred to a more detailed account of its composition. Moreover, the implication for this is precisely that, given such posts, there was a perception that they could take advantage of the transformations taking place at the time.

Had inflation returned, the possibilities of Fernando Henrique Cardoso's re-election would have been definitively quashed. Even though it might seem that the re-election was the main political driver of reforms, this fact cannot be disconnected from the underlying political argument of the administration; the main accomplishment of the administration, indeed the base of its electoral strategy, was the end of inflation. Advancing the administration interests meant first and foremost preventing the return of inflation, otherwise its political capital would have waned. The political legacy of inflation had in the case of Brazil a clear consequence to be avoided, which helped in the consolidation of the ongoing reforms.

The solution for the hyperinflationary regime in Brazil required several institutional changes. It was the complementarity between them that would finally achieve the difficult task of controlling inflation. Each change by itself would not be enough to curb Brazilian inflation as previous attempts can attest. The unrelated political process involving the privatization of public assets and the liberalization of trade were capitalized upon by a group of economic authorities who, through their own political struggle, reformed the budget preparation rules as well as the monetary structure of an economy no longer used to a stable monetary pattern. The institutional complementarity of Brazilian monetary reform was formed through the strategic conjunction, made by a group within the political economy, of political struggles (privatization and trade liberalization) carried out by different actors in order to succeed in their own battle. When the proceeds of the privatization of *Telebrás*, representing the consolidation of privatization, were used to smooth the exchange rate, the main instrument of trade liberalization at the time, both institutions became complementary insofar as they buttressed each other so they could continue to play their structuring role in the political economy.

Successful institutional complementarities require for their completion the continuous support of involved actors. The Brazilian case shows that even after big institutional reforms were carried out, setting the foundations for stabilization to succeed, it was necessary for actors to continue in the struggle because otherwise they would be defeated. Institutions as a product of political processes are susceptible in their initial stages to political pressures to avoid a consolidation that would later be even harder to overcome. The difficulties shown by the Brazilian economy are a reminder of how fragile institutional arrangements can be in their first phases. Even if incentives are a powerful element to launch institutional transformations, these have to be supported by larger political processes in which conflicts have to be overcome in order to last so as to deliver the returns society expects of them.

Chapter 4. The Chilean Pension System: Are Pensions Really Meant for Growth? Institutional Complementarities and Economic Transformations

Asking why independent liberalizing reforms became dependent of each other to succeed in the Chilean context may seem odd at first. After all, Chile has been portrayed time and time again as an example of comprehensive liberalizing reforms enacted by a military government, in opposition to a socialist government, and therefore, it appears to uphold a sense of purpose and unity. In theory, this is the perfect case to understand the full consolidation of an institutional complementarity, and why such phenomena come into existence. The institutions involved in the present study are i) the pension system that was created in 1981, based on individual accounts with a defined-contribution scheme, and ii) the financial system that was reorganized according to different, sometimes contradictory, steps between 1975 and 1986 by the military government. This mixed legacy proves to be a significant challenge to cope with. There was a tension between a possible return to socialism or authoritarianism.

The military government (1973-1990) sought to justify its actions as a response to the situation into which the socialist government of Salvador Allende (1970-1973) was putting the economy. In turn, subsequent, democratically-elected governments of the post-dictatorship coalition (1990-2010) had to tread carefully, as the possibility of a return of the military loomed on the horizon. The ambiguity of these complex political heritages thus made the policymaking process painstakingly incremental. Moreover, such ambiguity also defined the likelihood of consolidating an institutional complementarity between the individual accounts-based pension system and the capital markets towards which the financial system tried to converge. As such, the incorporation of the policy legacy was contested throughout the whole process of institutional evolution, which led to an ambiguous consolidation of the institutional complementarity. Because policymakers did not face the threat of political backlash, if the institutional complementarity did not consolidate, they did not push for further reform, which would, in turn, have cemented the link between the institutions. The fear was limited.

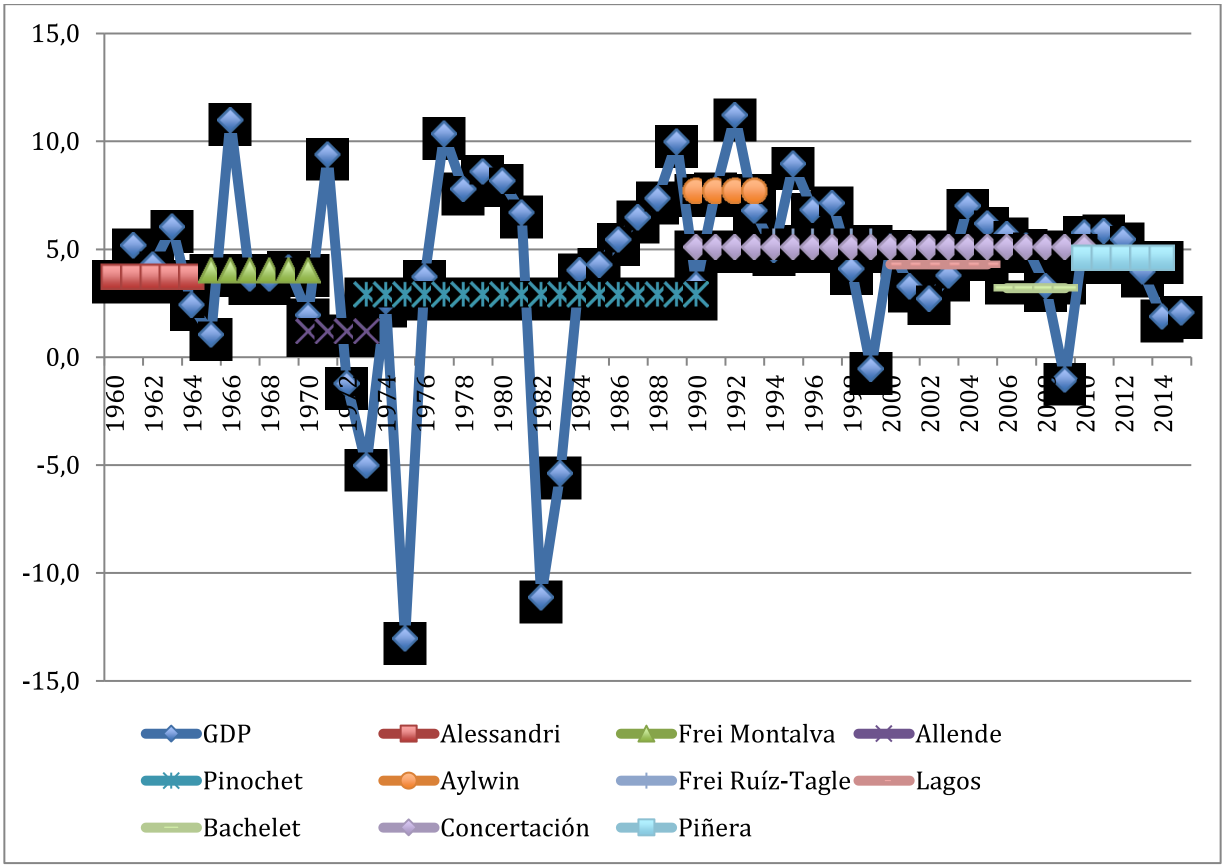
The pension system of individual accounts with a defined-contribution scheme is considered a prime example of the positive legacies of the military government; it remains, however, a matter of furious dispute in Chilean politics. In post-transition Chile, many debates oppose those defending the heritage of the authoritarian regime and those who challenge them. Perhaps because of its special status among the legacies of the military government, debates about the pension system have an apologetic character. This situation is in turn compounded by the fact that pensions granted by the system are less than what people expected. These do not preserve living standards; a situation that did not change with the reform since the old system did not preserve them either. Therefore, the system has always suffered a legitimacy crisis due to both its origins and its outcomes, and this has led to a series of reforms intended to improve these in order to improve its legitimacy.[232]

The controversial origin of both reforms implied that subsequent adjustments carried out by democratic governments sought a balance between the perceived red lines of the advocates of the military regime and a more progressive agenda. However, it is crucial to note that neither the menace of a return to military rule nor of an irresponsible economic policy created a vacuum, in which subsequent reforms to both pensions and financial systems would require a politically motivated intervention to ensure their survival. Until the mid-1990s, both systems grew increasingly integrated, not because of the steady growth of resources but, mainly, because the failure of either of the two systems would have been a political disaster. Had this been the case, the democratically elected government would have self-fulfilled the prophecy foretold by military-government supporters;[233] for the latter, it would have implied a tacit recognition that a cherished policy had significant flaws.

[232] For a discussion of the legitimacy problems of the pension system, see Sojo (2014), in particular sections IV and V.

[233] Economic groups and business leaders argued that the opposition would return to the kind of policies implemented by the Allende government and, therefore, to economic chaos. An economic team composed by Christian Democrats and Socialists would bring the kind of social situation that, by their own account, was characterized by social protest, fiscal deficits, and overwhelming demands. Most likely, their concerns were dominated by the last item on their list, i.e. the questioning of the privatization processes, from which they had profited dearly (Gárate 2012, 361). In turn, Cavallo (1998, 57) indicates that the lack of trust was not only

Figure 6. GDP Growth, 1959-2014. Administration Growth Averages



Source: The GDP series was elaborated by the author with data from Chile (2016a) and the presidential series with data from Ffrench-Davis (2014, 30).

In the first half of the 1990s, stakes were high on both sides of the political spectrum. The first democratically-elected government in twenty years was trying to prove that a good management of the economy was compatible with democracy. This was also the period during which the Chilean economy grew at its fastest pace ever, compared to the average annual rate between 1960 and 2010 (Figure 6). In the mid-1990s, the chances for an institutional complementarity between the individual-accounts pension system and the capital-markets-based financial system were higher than at any other point in time. Additionally, Chilean capital markets were increasingly important as a source of funding for companies, and most of these resources came from the pension system (Stallings 2006, 159-161). Other significant

towards the new economic team, but also towards international financial centers, because these conducted center-left economic policies. Quoted in Gárate (2012, 432 fn. 48).

changes took place during the second half of 1990s, such as the financial crisis of South East Asia in 1997-1998, which also affected the general economic results of the country. Simultaneously, it became clear that neither a return to authoritarian rule nor flagrant mistakes of economic policy were politically on the horizon. Institutional complementarity between the pension system and the capital-markets-based financial system was thus on the path towards consolidation. However, because the fear of a return to authoritarianism or socialism had peaked during the first post-transitional government, the possibilities for the constitution of an institutional complementarity were limited.

Institutional complementarities are the situation in which the success of one institution depends on its interactions with another institution, which means that neither institution could play its structuring role in the political economy if the other was not present. Institutional complementarities appear when decision makers fear that some institutions would cease to play their structuring role and they would bear the political costs of such outcome. Thus, in the Chilean case, the presence of institutional complementarity would imply that the resources provided by the pension system, based on capitalization, transformed the financial system firmly into a capital markets-based financial system, instead of a banking-based one. Both institutional reforms were carried independently from each other; neither was conceived of as a predetermined set of institutions nor as a way to align the incentives of involved actors. Even if at some point there were some hopes about the possibilities for such alignments, it was not the goal of the reformers, nor was it their priority.

The socialist and military governments and the profound wounds created by the convulsed history of the country led to a complex set of political legacies. The possibility of a return of past situations proved to be a powerful political argument to mobilize resources immediately after the transition to a democratically-elected government. The possibility of a return of the military remained present during the first half of the 1990s, since Pinochet was still Commander of the Armed Forces. At that point in time, political legacy was in the process of being incorporated since different forces, both pro-military and democratic ones, supported institutional reforms enacted by the military government. However, as the clout of the military waned, when it became clear that democracy did not bring chaos, the push to consolidate institutional complementarity also faded.

From the economic point of view, both institutions studied here also lost momentum in the mid-1990s. Among the causes for this outcome was the financial crisis in South East Asia that instigated a withdrawal of resources from emerging economies, thus hampering the consolidation of Chile's capital markets.[234] Furthermore, competition between different *Administradoras de Fondos de Pension* – AFP[235] (Pension Funds Administrators) revealed its limits. Changes between providers based on on-the-spot gifts and a big sales force brought profitability down, impacting the accumulated resources of future retirees as well. While some evidence pointed to the contribution of the pension system to the deepening of the financial system (Schmidt-Hebbel 1997, 1998), it is less clear why such trends did not consolidate in spite of the continuous accumulation of resources in the pension system.

The consolidation of institutional complementarity depends on the political mobilization for institutional reform of a group of actors trying to consolidate such reforms in the face of a potential political backlash. This shows how independent institutional transformations stop short of becoming dependent on one another, as the political costs of the lack of dependence between institutions becomes less clear without necessarily disappearing. With regard to Chile, it is precisely the ambiguity concerning the political legacy - i.e. the contentious political debate over the military government and its implications - that prevented the consolidation of a complete institutional complementarity.[236] However, I will provide some contextual elements so as to situate the relevant decisions within the respective institutional reforms.

This chapter discusses how the pension system and the financial system in Chile, both thoroughly reformed under a military government, became increasingly dependent on each other, up until the political costs of failing to achieve the desired outcome ceased to be prohibitively high. Therefore, this is neither a history of the pension system nor of the financial system, even if the evolution of both institutions is important for the theoretical argument about institutional complementarities. This is argued in relation to how the gradual

[234] Also, by the time of the South East Asian crisis, the Chilean peso (CLP) started to depreciate in real terms after a long trend of appreciation. Obviously, with an appreciated exchange rate, foreign capitals poured into the country helping also to consolidate the local capital markets.
[235] Further discussed below.
[236] Because not every change to the institutions studied here is relevant for the argument, their presentation is not exhaustive.

consolidation of democracy, within the correspondent limits of the influence exercised by the military, prevented the continuation of a process that in turn led to the consolidation of institutional complementarity. Supporters of the military government and democratically elected officials both pursued a similar path given the symbolic importance of the pension system. An analysis of the theoretical implications, as well as some preliminary remarks about the Chilean case, will be advanced.

There are several accounts of the importance of the pension reform to the Chilean economy. For instance, Schmidt-Hebbel (1997, 1998) is very enthusiastic about the importance for the economy of this reform, as it favoured the deepening of capital markets and broaden the financial sector. In fact, a later contribution by Corbo and Schmidt-Hebbel (2003) became *the* reference about the relation and contribution of the pension reform to the Chilean economy. It places the privately administered pension system at the center of Chilean growth. While financial deepening might be a necessary condition for a functional growth-fostering financial system, it is not a sufficient one. Other less systematic accounts of the importance of the reform emphasize the creation of side markets, which sought to respond to the needs of the AFPs for their normal operation (Bustamante 2006), while others simply acknowledge its importance for the steady provision of finance to the housing market (Larraín 2006, 99).

The contribution of the new pension system to growth is a matter of debate. The fact that such arguments were used during the transition to democracy made it difficult to question its direct contribution. The authorities have concentrated mainly on keeping the regulatory framework up-to-date, adapting it to new market practices and failures identified along the way. In general, the system's structure was not substantially modified, since its inception in 1981, until 2008, with the creation of a scheme providing a minimum pension for the poorest 60% of the population.[237] While such changes represented the most important modification of the Chilean pension regime in decades, many social actors considered that the opportunity for a more radical transformation was lost. The difference in the perceptions concerning this reform reveals the balancing act that the state has been playing with respect to pensions since the return of democracy.

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[237] This scheme is included in the pension system and is called "solidarity pillar". The other pillars are the contributive, which is the system studied in the present work, and the voluntary pillars. For details on the solidarity pillar, see Ruíz-Tagle (2013, 499-502).

4.1 The System the Reform Sought to Change

The Chilean social security system was established in 1924, which made it one of the oldest in Latin America. It was organized on a corporatist basis in which each sector would have its own *Caja*[238] with its corresponding conditions to grant the right to a pension. Not surprisingly, when the economic crisis of the 1930s occurred, the authorities used social security resources to stimulate economic recovery. The resources were mainly used for infrastructure building; however, not necessarily for big projects. Some new neighbourhoods, such as the Civic Neighbourhood, near downtown Santiago, were created.[239] In principle, workers benefited from these investments, as real estate prices increased, guaranteeing a reasonable return for them. Infrastructure has always been one of the most important investments. This is not unexpected given the amount of resources needed for infrastructure combined with a non-matured social security system.[240] This creates a temptation, rather than an incentive, for authorities to use the money as they judge most convenient.

Lack of resources was not a problem in subsequent years. The system's corporatist origins would prove a heavier burden as each corps was given very different conditions to access the pension as well as benefits (Table 3). The parameters on which pensions usually depend (i.e. age, time of contribution, size of contribution) varied substantially depending on the beneficiaries. The three main Cajas were i) *Servicio de Seguro Social* – SSS (Social Security Service), which targeted the "workers"[241], i.e. blue-collar workers, ii) the *Caja de Previsión de Empleados Particulares* –EMPART (Retirement Cooperative of Private Employees), which targeted white-collar workers and iii) *Caja Nacional de Empleados Públicos y Periodistas* - CANAEMPU (National Retirement Cooperative of Public Employees and Journalists). Other *Cajas* also existed, reflecting a corporatist vision of social security.

238 The Spanish word *Caja* refers to the organization that keeps the money and grants an interest according to the *Diccionario de la Real Academia Española.*

239 Jaime Ruiz-Tagle. Interview with the author. Santiago de Chile. July 30, 2014. Jaime Ruíz-Tagle is a sociologist. He was director of the Labour Economics Program and Head of the Office of Forecasting Studies at the Ministry of Planning. He has been involved in social security issues since the 1980s.

240 This refers to the situation in which the revenues of a pension system, whether they are defined benefits or defined contributions, are higher than its expenses, thus reflecting an accumulation of assets without an equal amount of liabilities.

241 The word in Spanish is "*obreros*".

Banking employees, central bank employees, and many other categories had their own retirement regime administered by its corresponding *Caja*.

Tableau III.Requirements for Retirement Pension by Regime or *Caja* Before 1978

Caja	Time Requirements	Income to Calculate the Pension
Public Employees†	Between 15 to 30 years	Last 36 monthly incomes Last income for pursuers[242]
Private Employees†	35 years	Last 60 monthly incomes
Banks' employees	Between 13 to 35 years	Last 30 monthly incomes
Journalists	Between 12 to 20 years	Last 12 monthly incomes
Equestrian workers	Between 10 to 30 years	Last 12 monthly incomes
Bank of the State	Between 15 to 35 years	Last 24 monthly incomes if contributions < 35 years Last 12 monthly incomes if contributions ≥ 35 years Last income for pursuers
Santiago's Municipal Employees†	30 years	Last 36 monthly incomes
Republic's Municipal Employees†	35 years	Last 24 monthly incomes
Municipal Workers•	Men: 65 years old Women: 55 years old	Last 24 monthly incomes Formula: 40% of basic salary plus 2% for every year over 5 years of service
Merchant Navy: Crew and mechanical workers	60 years old	Average of last 36 monthly incomes Formula: 70% of basic salary plus 1% for every year over 10 years
Merchant Navy: Officers and office employees†	30 years	Last 12 monthly incomes
Railways	Between 15 to 30 years	Mostly last 12 monthly incomes. In practice most are pursuers

242 A particularity of the Chilean pension system was the "pursuer" pension, which meant that the pension corresponded to the same amount of the salary paid for the active worker holding the post of the retired person.

Social Security Service (workers)*	Men: 65 years old Women: 55 years old	Last 5 years

Source: Elaborated by author with data from Hepp (1980, 15).
* In Spanish the word is "*obreros*" meaning blue-collar workers.
† The precise word in Spanish is "*empleados*" which is used in relation to white-collar workers.

The existence of regimes with a wide variety of conditions for obtaining a pension was already perceived as problematic in the 1950s.[243] To this effect, a report was commissioned to the *Comisión de Reforma de la Seguridad Social* (Commission on the Reform of Social Security) or Prat Commission[244] (Prat 1964). The main solution that it proposed was the creation of a general regime in health and in pensions.[245] It is not surprising that the solution proposed by the Prat Commission was a universal Pay-As-You-Go[246] - PAYG - regime, with the same retirement conditions for everyone. Although this suggestion represented a significant departure from the system's corporatist origins, it was not so much of a departure considering the main instrument of the policy as a Defined-Benefits-PAYG scheme was kept in the suggested system.[247] This must not come as a surprise, as at the time of the Prat Commission, this kind of regime was the standard in Latin America and in Western Europe (McGillivray 2006, 232-233).

The best example of the proliferation of pension regimes is provided by the special status given to equestrian workers. Due to the nature of their activity, this category neither represented a substantial number of workers in the economy, nor a defined sector of production; however, they had their own regime nonetheless. This regime was the most

243 The diagnosis involved not only the pension system but also the whole social security regime.
244 The Prat Commission was created in 1959 to address the problems of Chilean social security and was chaired by Jorge Prat, a respected politician (Chumacero et al. 2007, 126), presumably because this characteristic would made him a deal broker. Nevertheless, Gárate (2012, 185, 239) asserts that Prat was member of a profoundly antidemocratic current in Chilean politics.
245 The focus here will only be the pension system.
246 This kind of system is based on intergenerational transfers. As the current working members of the population make their contributions to the system, these resources are made readily available to pay the pensions of the precedent generation on the spot, i.e. pay as you go.
247 A pension system with defined benefits offers the workers contributing to the system a given income regardless of their contributions provided they fulfill a series of conditions. In contrast, a pension system with defined contribution establishes a given periodical contribution to workers throughout their working lives but offers no warranty as to how much the retirement income will be. In the former system, financial and actuarial risks are the responsibility of the funds administrators because they must provide a given income; in the latter, the burden of the actuarial risks are on each worker as the funds administrators do not offer any warranty concerning incomes once the worker retires.

generous, among many generous regimes. For instance, in some cases, equestrian workers could have the right to a pension after contributing for only ten years (Hepp 1980, 15). Other regimes granted full benefits according to the income of the last year of work (Hepp 1980, 18), and not based on an average of incomes of a given amount of months, as in the case of other retirement regimes. However, those who did not have any political clout were those with the worst retirement conditions. In particular, the Social Security Service, to which blue-collar workers paid their contributions, required a minimum of sixty-five years of age, among other conditions.

Tableau IV.Correspondence Between Users and Resources of Chiliean Pension System. 1970-1978. Percentages

	Indicator	1970	1978
Users	Affiliated workers/ employed	80.2	78.6
	Effective workers†/ employed	62.3	58.7
	Pensioners/ Total population	6.6	9.1
	Effective workers†/ pensioners	2.8	1.71
Resources	Social Security System Expenses/ GDP	13.5	13.6
	Social Security System Expenses/ Taxable Income	65.5	61.6
	Taxable Income / Total salaries	57.5	55.8*

Source: Elaborated by the author with data from (Hepp 1980, 12).
*: 1977
†: Effective workers are those making contributions to the system on a periodical basis.

The conditions to have access to a pension and its corresponding benefits were thus not actuarially sound (Table 4) and, most of the time, a fiscal effort was required to meet the financial needs of several pension regimes.[248] Investments made by the *Cajas* often broke the principle of long-term inter-temporal return, on which several pension schemes were based. Many of these investments granted benefits to the workers as they contributed funds to the system, for instance through cheap subsidized loans or special privative retailers.[249] Loans were scarce given high inflation and low interest rates. This, in turn, caused a disincentive to save because there was no assurance that the money that had been put away would be available later on with the same value. It was more likely to represent a loss for those saving through traditional ways.

This situation is related to how monetary supply was administered by the Central Bank.[250] From the political point of view, the government did not dominate over its Board of Directors. Instead, representatives of workers, congress and private interests, including those of individuals in the banking business, were thoroughly represented across the Board. While such institutional arrangements were modified later on, the central bank operated essentially as a source of funding for both the government and commercial banks, both of which took advantage of the inflationary tax. The former took advantage of direct transfers from the central bank to the Treasury, while the latter took advantage of the arbitration of rediscounted funds and a complicated intermingling of reserves in a variety of instruments. Because inflation was higher than interest rates, savers lost the real value of their resources, while people with access to credit were subsidized since the real value of their credit decreased with inflation.

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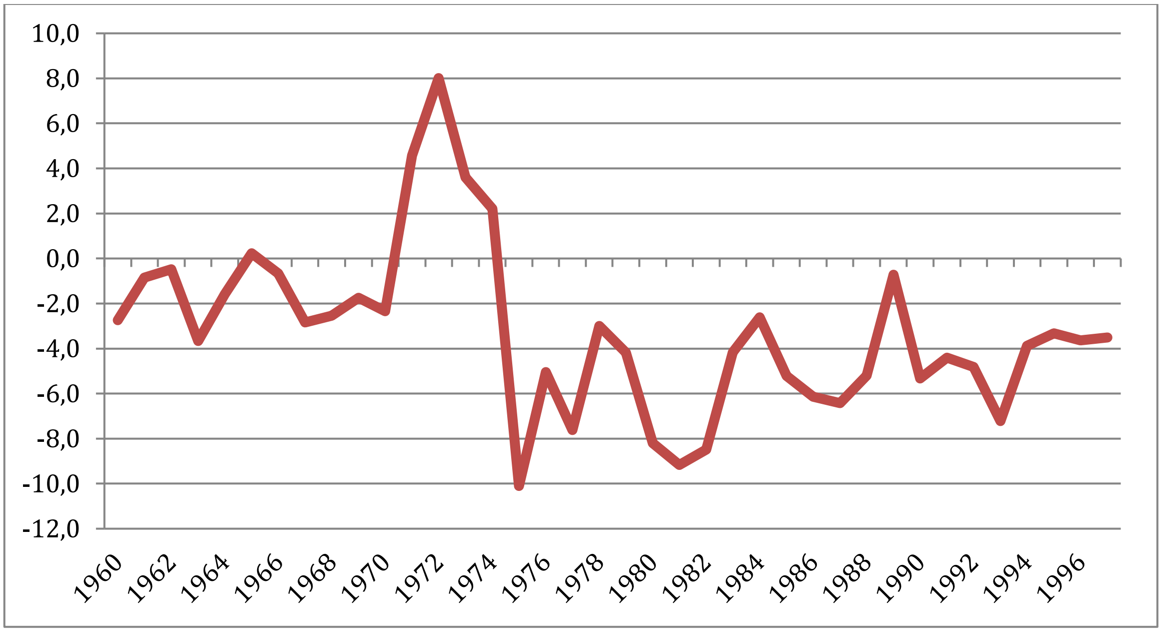
248 A pension regime can be considered actuarially sound when the present value of its liabilities, i.e. pensions to be paid, is equal or less than the present value of its revenues, i.e. contributions received from the present until the maturing of its liabilities. Therefore, if there is an imbalance between workers making contributions and retirees receiving pensions, the system will be increasingly imbalanced. Moreover, this situation can be made worse if not all members of the active population effectively pay their contributions every month, which is precisely the situation showed by Table 3.

249 Joaquín Vial. Interview with the author. Santiago de Chile. August 5, 2014. Joaquín Vial is a member of the Board of Directors of the Chilean Central Bank. He has been the Chief Economist of the Global Trends Unit of the Economic Research Department at BBVA (a bank), and was Chief Macroeconomic Adviser to the Minister of Finance (1992-1994) and Head (1997-2000) of the *Dirección Nacional de Presupuesto* – Diprés (National Budget Directorate).

250 This account relies heavily on Ffrench-Davis (1973), especially on Chapter 5.

Figure 7. Voluntary* Household Savings. Chile 1960-1997. (% GDP at Current Prices)



Source: Elaborated by the author with data from Bennett, Schmidt-Hebbel, and Soto (1999 Table 5).

*: Because the contribution to the pension system is compulsory the relevant indicator is voluntary savings instead of total savings, especially after 1981.

The public banking sector was reorganized so as to concentrate retail operations in one institution, the Bank of the State, alongside the merger of several sectorial institutions. Moreover, banking regulations were differentiated by the regional presence of their branches in the regions of Santiago and Valparaiso, and throughout the rest of Chilean territory. Furthermore, the concentration of the banking industry was remarkable, with two big private banks accounting for the bulk of credit operations to the private sector. In practice, legal reserves financed the operations of big enterprises that had access to credit, while other actors, e.g. small enterprises, did not. Savings rates were negative (Figure 7) because the real value of deposits decreased with high inflation,[251] but also because the marginal propensity to consume was very high, thus protecting the purchasing power of household incomes.

251 Chile suffered from high inflation at many points in history. This is not surprising since the Treasury used fresh resources from the Central Bank on a regular basis (Ffrench-Davis 1973). Another important factor fuelling inflationary spirals was the shortage of foreign currency leading to a depreciation process of the national

The financial system was divided according to types of credit. Public development banks were important for industrial activity, agriculture and housing, each one with a dedicated institution. Private banking focused on lending to big companies, even if the high inflation environment represented a serious challenge given the possibility of negative real interest rates. This was a consequence of the legal limit on interest rates with the aim of helping borrowers with low interest rates (Fontaine 1996, 23). In practice, the main user of the credit was the public sector, which financed a chronic fiscal deficit, by taking advantage of the inflationary tax.[252] Also, the allocation of the remaining credit passed through the authorities who were in charge of different sectorial banks (Fontaine 1996, 24). This fact was complemented with the creation of a Unitary Fiscal Account in the Bank of the State, through which all public institutions had to administer their resources, thus increasing the grasp of the Treasury on financial resources (Ffrench-Davis 1973, 131).

Indexation was developed with the issuance of inflation-protected bonds aimed at developing long and medium-term financing for affordable housing and agricultural loans. In part, this was also a response to the crowding out of most borrowers, except for some privileged employees. These enjoyed access to mortgages and loans that were effectively subsidized by the social security system, since the latter was the main provider of such loans. However, after the introduction of mortgage operations by the Bank of the State after its creation in 1953, these became increasingly important for the whole circulation of the economy's savings, even if the situation did not change significantly. Indexation was supposed to protect savers and, ultimately, to encourage the accumulation of assets, but it could only go so far; since real interest rates were not high enough, savings did not increase (Jud 1978, 69-90).

Because commercial banks were no longer authorized to offer mortgages for more than two and a half years, a special kind of organization was authorized to operate this particular market. The *Sistema Nacional de Ahorro y Préstamo* – SINAP (National System of Savings and Loans) was in charge of supplying these products through a set of Savings and Loans

currency, a consequence of the fluctuations in the price of Chilean exports. For a discussion on the role of monetary issues and their relation with development, see Fajardo (2015).

252 Another factor fuelling inflation at the time was the set of nationalized enterprises supported through an expansion of credit. Subsequent privatization sought to release the Treasury of that burden (Harberger 1985, 452).

Associations. Subsequently, in 1964, these associations were authorized to take deposits from the public; because these deposits offered higher liquidity than other instruments of the broad financial system, deposits in the SINAP increased more than six fold in five years. In fact, the SINAP represented almost a fifth of all Chilean deposits in 1970 (Valdés 1993, 408-410).

The pension system and the financial system during the mid-twentieth century Chile were in a situation that one could hardly characterize as ideal, but neither were in the course of an imminent crisis. This was also a consequence of the kind of social pact that existed at the time, where no single group was powerful enough to impose its vision on the rest, requiring rather a series of accommodations from everyone. In this setting, some groups created niches from which they profited silently of the status quo. This was true of public workers, big businesses, and even the state, to name a few. This state of affairs would be profoundly shaken with the administration of Salvador Allende. For reasons that will be discussed below, a dispassionate assessment of his legacy has been difficult to come by; nevertheless, it should be clear that his government did not represent a particular rupture with regard to the pension system. On the other hand, the trends of the financial system were significantly disturbed during his administration. The next section will present these facts.

4.2. From Allende to Bureaucratic Authoritarianism

While the pension system was not significantly modified during the government of Salvador Allende (1970-1973), the financial sector was. Between 1930 and 1970, the government increasingly became the main player of the financial system, not only its regulator. Afterwards, it virtually crowded out the private initiative. Through takeovers of commercial banks, the government nationalized the banking sector and used different instruments to allocate resources depending on the established priorities (Valdés 1993, 411). Nevertheless, this trend only represented one side of the increasingly important role of the state in productive activities, since the state was responsible for a bigger portion of production; it also controlled the financial means to carry such operations. In fact, in 1970, the *Corporación de*

Fomento de la Producción – CORFO[253] (Production Development Corporation), essentially a development bank, represented almost three quarters (73%) of the total credit of the economy (Valdés 1993, 410-411) and was the preferred instrument for the nationalization of commercial banks (Held 1990, 176-177).

Whereas the pension system did not change significantly during the government of Salvador Allende, it is clear that his intervention in the financial system created havoc on the industry. Nevertheless, the Chilean economy exacerbated the problematic trends in which it was already caught up for at least a couple of decades. The increasing isolation of the economy and the overwhelming presence of the state within it represented the nadir of a secular process of decline beginning with the Depression. A difficult political environment, both international and domestic, compounded this situation. At times, the policies implemented by the government divided its own ranks, which in turn fuelled the process of polarization that characterized this period of Chilean history. Therefore, even though it is impossible to deny that Allende's policies created significant economic distortions, as in the case of the financial system as a whole, many other policy arenas were already in a process of significant misalignment between their intended goals and the means to serve those goals, as in the case of the pension system.

The thorough intervention of the Allende government and a perceived need to backtrack on many of its measures led to a paradox concerning the regulatory role of the state in the context of the beginning of the Chilean bureaucratic-authoritarian regime.[254] Because regulation was a form of intervention on the market, an expected reaction vis-à-vis regulation as a whole might have been expected. Yet, there were some policy arenas in which regulation

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[253] The state had increased its presence in the economy since the Great Depression with organizations such as CORFO, which served as a holding for several state-owned enterprises. Through CORFO and other means, during the Allende period, the state nationalized 500 medium and large-sized firms, among which 64 of the largest in the country (Chumacero et al. 2007, 97). For a brief account of the process leading to the creation of CORFO as well as its subsequent development, see Lüders (1993, 138-144).

[254] The concept of bureaucratic-authoritarian regimes was first proposed by O'Donnell (1973) and subsequently developed in the volume edited by Collier (1979a). Such regimes are defined in opposition to previous "populist" and "oligarchic" regimes that existed before in Latin America. The main characteristics of the bureaucratic-authoritarian regime are the centrality of a coalition composed by high-level technocrats, both military and civilian outside and within the state, and foreign capital; this elite eliminates electoral competition and prevents political participation of other sectors; finally, the main policy goal of such coalition is industrialization (Collier 1979b, 24).

was maintained and even reinforced.[255] This was most probably a consequence of the debates within the groups supporting the military regime in its first days. The majority of officers believed in a strong presence of the state, in line with the populism incarnated by a former dictator and constitutional president, Carlos Ibáñez del Campo (1927-1931 and 1952-1958, respectively), but they did not have a defined economic project. The lack of expertise of the officers in economic matters led them to seek advice from a group of liberal economists[256] (in the European sense), whose main preoccupation was to reform the economy without concern for the repression carried out against the population (Gárate 2012, 181-188).

The clout of these economists did not increase immediately, nor did they encompass every policy arena; some spheres, like the financial system, were in fact deregulated, whereas others, like the pension system, were not. To some extent, enthusiasm over the markets' advantages was considerable.[257] The deregulation of the former sought to loosen the grasp of the Central Bank over the whole system by leaving to supply and demand forces the determination of the interest rates, as well as a moderation of the reserves' level. Other measures included the end of the market segmentation in which some institutions were specialized in certain kinds of credit, eliminating the monopoly over agricultural credits and increasing the periods of loans in several markets. Nevertheless, the most remarkable fact is

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255 The literature considers this a paradox because in the quest of reducing the role of the state by, therefore, weakening it, there is a demand for a stronger state, capable of imposing the necessary reforms (Haggard and Kaufman 1992).

256 These economists came to be known as *The Chicago Boys*. It was a group of economists who graduated in economics from the University of Chicago during the 1950s and 1960s. When they returned to Chile, they became industrialists, heads of banks and, after the military coup (ca. 1975), they became the technocratic core of the military regime's economic policies. For more details about the Chicago boys and their relation with the military regime, see Silva (2010), especially chapter 5, and Valdés (1995).

257 Important sectors reformed early on by the military government were the privatization of some assets held by CORFO, international trade, and financial intermediation. As a significant amount of firms had been nationalized during President Salvador Allende's term, one of the first goals of the new economic authorities was to sell some assets as the first step to redefine the role of the state within the economy. The state however, retained ownership in strategic sectors, namely mining, with *Corporación del Cobre de Chile* – CODELCO, the national copper mining company, and the *Empresa Nacional de Petróleo* – ENAP, the national oil company (Lüders 1993, 149). Trade liberalization was also perceived as a priority given the actual disorganization of Chilean international trade before 1973, and the process started to consolidate when Chile pulled off the Andean Pact in 1977 (Chumacero et al. 2007, 112). Significant barriers, both with tariffs and non-tariffs were in place mostly on an *ad hoc* basis. The reforms, therefore, implied an equalization of the former in a significantly low level, while the latter were practically eliminated (Ossa 1993, 374). For a critical evaluation of the trade liberalization, see Foxley (1983, 56-65) and Ffrench-Davis (2014 chapter 2).

that risk valuation did not change with the significant changes implemented in the financial market (Valdés 1993, 412-414).

In the case of the pension system, the fact that participation in it was mandatory for formal employees implied that the state should play a bigger role in the regulation of the system. From the perspective of the bureaucrats in charge of the pension system, had any problem taken place in the system, the public trust[258] could have been severely undermined; thus, they chose the path of close oversight.[259] Nevertheless, another important argument in favour of a close regulation of the pension system was the widespread conception among a significant group of the officialdom that the resources held by the *Cajas* in the pension system should not be relinquished by the state. Therefore, it was clear that there was a difference in the attitudes towards both systems, which is also a reflection on the lack of consensus within the military about the course of action for the economy.

4.3. The Pension System: Aligning Costs with Benefits

The corporatist origins of the pension system led different groups to seek special conditions enshrined in a particularistic regime with a *Caja* of its own. These were the rules of the game and each group advanced their interests accordingly. This situation was compounded with a political system in which significant reforms required a majority that was difficult to obtain in Congress (Alcántara 1999, 137-146). In this context, there was a proliferate diversity of regimes[260] in which the costs borne by their members were not in line with the benefits received. Moreover, there were doubts about the sustainability of the system in the long run because contributions were not based on the whole income; instead, only a portion of the

[258] The exact expression in Spanish is "*fé pública*".
[259] Alfonso Serrano Spoerer. Interview with the author. Santiago de Chile. August 20, 2014. Alfonso Serrano Spoerer was the Under-Secretary of Social Protection from 1976 to 1985, making him an important member of the team in charge of shepherding the reform from conception to completion. He was later nominated (in 1985) as Vice-President of the Chilean Central Bank and, after the reform that granted independence to the institution, in 1989, he was chosen to be a Member of the Board of Directors.
[260] Table 3 provides some information on some of these regimes and the conditions needed to grant the right to a pension.

income was accounted as taxable, decreasing in turn the resources available to the system. However, had sustainability been a widespread concern, a reform would have probably happened before.

Instead, the diagnosis of a misalignment between costs and benefits was probably the product of the increasing importance that liberal economists acquired in the first phase of the military regime.[261] This group was relegated to second-ranking posts or as advisors in the first months of the military government, while some economists close to the Christian Democracy implemented a gradualist approach to privatization and against inflation. This approach reflected mainly how many economists fundamentally agreed with the economic model applied, within some limits, by a diversity of governments between the 1930s and the 1970s. This broad consensus was supported by the bulk of the high officialdom, the members of which had made their careers in the military precisely when one officer, General Carlos Ibáñez del Campo, first as dictator and later as constitutional president, implemented these policies. Nevertheless, this state of affairs did not last for long.

Because inflation did not stop after a year of gradualist policies, and the prospects for 1975 were strikingly similar to those of 1973, a group of officers led by Pinochet as Commander of the Army, and José Merino as Commander of the Navy, decided to definitely break with the past. In so doing, they offered the group of liberal economists the opportunity to put in place their preferred policies. It was thus after 1975 that the most radical liberalizing policies were implemented, despite opposition from some officers who still believed in the previous arrangement, in which the state played a significant role. These officers, led by Air Force Commander General Gustavo Leigh, were gradually isolated because, on the one hand, many of them retired and, on the other hand, their attitudes were deemed unfit with due military obedience.[262] This situation created the conditions for Pinochet's consolidation of his power within the military.

In the specific case of the pension system, the lack of consensus over the role of the state also prevented an earlier reform of the *Cajas*-based system. A group of technocrats, who

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[261] The next paragraphs rely heavily on the account by Gárate (2012, 189-195).

[262] This was certainly the case of the latter who, after an interview in the *Corriere della Sera*, in which he severely criticized the government, was removed by the military junta (Gárate 2012, 242 fn. 45).

worked in close relation with Miguel Kast, Deputy Director of the *Oficina de Planificación Nacional* – ODEPLAN (National Planning Bureau),[263] sought to break from the past by creating a system based on market principles, i.e. the freedom to choose. The second position in that debate, held mainly by active members of the Army, led by General Leigh before he was dismissed, believed that the state should not relinquish control of the significant resources administered by the different *Cajas* that, at the time, were headed by army officers. The former saw the complexities[264] of the system and its disparities as a consequence of rent-seeking behaviour from groups who did not bear the costs of the system,[265] while the latter saw a source of legitimacy for the state through the provision of social benefits.

When Pinochet consolidated power within the Army, he could also isolate these statist factions, which had been set aside with the dismissal of General Leigh in 1978. The way was paved for market-based proposal to be transformed into law. Even if the organizing principle of the system proposed by liberals like Kast and his team was not entirely new, given that capitalization was already in use as a complement to mandatory systems (Arellano 2007, 3), the Chilean attempt to put it at the center of the whole system certainly was. In this context, doubts were reasonable in terms of the convenience of the measure. When confronted with the problematic state of the system, its proneness to rent-seeking behaviour was considered to be at the core of the issue. Within this framework, the main problem was the lack of correspondence between the costs borne by each individual actor and the actual benefits received (Chile 1980, 4).

The core of the new proposal was an attempt to create a strong link between the individual efforts, i.e. costs, and the pensions obtained, i.e. benefits. Under the old system,

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[263] ODEPLAN was officially created during the government of Eduardo Frei Montalva (1965-1970) under the direct command of the president to assist him in the complex process of planning the country's development. Although it was officially created in 1967, it was operational since the beginning of Frei's government (Silva 2010, 141-142). For a discussion about the relation between ODEPLAN and the different generations of Chicago Boys, see Gárate (2012, 215-221).

[264] Chief among the complexities observed by the reformers was the proliferation of regimes, both in terms of organizations, i.e. *cajas*, and conditions to obtain benefits. Even if the existence of a diversity of such organizations is not problematic *per se*, this trait was considered as an incentive to seek benefits without incurring the corresponding costs.

[265] Hepp (1980, 1) lists as the first symptom of the crisis of the pension system that there "does not exist a direct relation between the level of contribution from affiliated workers throughout their lives and the benefits, in form of pension, they receive" (Author translation).

benefits were systematically higher than the costs borne by a significant amount of actors.[266] Therefore, according to Miguel Kast and his team, the best possible solution was to create the strongest relation possible between both ends of the system, namely, the costs and the benefits for each actor.[267] Individual savings accounts were the answer to the problem, since pensions would then depend exclusively on the balance of such accounts at the moment of retirement. Since the misalignment between costs and benefits was considered pervasive under the old system and, thus, likely to be reproduced if only minor changes were implemented, transfers between the systems were minimized. The limits on transfers prevented cost-shifting behaviour, which was considered to be the main characteristic of the PAYG system.

However, even after incremental reforms were enacted to prevent these problems,[268] the team was not convinced that these would not appear again, since the perverse incentives of the PAYG system were still in place.[269] Therefore, the focus had to be to establish a system on different foundations, that is, the benefits that each worker would receive at the end of his work life should be perfectly aligned with the contributions made during his work life. Individual savings accounts offered this kind of alignment since the funds to finance future pensions would then come exclusively from these accounts and, in principle, without any

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266 Many *cajas* granted the right to a pension on generous terms. For instance, pensions were calculated based on the last incomes, regardless of incomes incurred during the worker's entire life. Some regimes even granted "pursuers," which represented an even higher burden on the system since no effort in terms of contribution was necessary, only to reach a rank within the organization. Many situations that were common in the old system were considered abusive by the team of reformers.

267 Alfonso Serrano Spoerer. Interview with the author. Santiago de Chile. August 20, 2014.

268 Among the incremental changes to the old system were the leveling of the minimum pensions for blue-collar and white-collar workers with the Decree-Act 255 of January 1974; other non-minimum pensions were equally adjusted to the purchasing power they had at the moment of retirement with the Decree-Act 2444 of September 1978. Finally, with the Decree-Act 2448 of February 1979, mandatory requirements were established , such as time of contribution (35 years) and different age requirements for women and men, automatic adjustment of pensions following the Consumer Price Index (CPIn), and the final substitution of "pursuer" pensions with a simple adjustment of the last income following the CPIn instead of receiving all the benefits of the active worker (Hepp 1980, 5-8).

269 In essence, these incentives were akin to rent-seeking and free-rider behaviours. Rent-seeking refers to the action of deriving a rent that, almost by definition, does not correspond to the fair price of a good or service in the market. Free-rider behaviour refers to the action of a given agent that takes advantage of a public good, to which he does not contribute, while making it impossible to stop him from doing so. For a precise definition of free-rider and the microeconomic implications, see Mas-Colell, Whinston, and Green (1995), specifically chapter 11; for a discussion on the logic of rent-seeking, see Krueger (1974). The problem of free-riding has also been studied within the framework of collective action, of which some classics on the theme are Olson (1965) and Ostrom (1990). In the case of the old Chilean pension system, rent-seeking occurred when a group of workers tried to enact a generous pension regime well above the prevalent conditions of other regimes. The free-rider problem came about when a group of workers enjoyed the benefits of a social security regime as a public good without making the corresponding contributions.

other contribution from society as a whole. Private managers, organized in the form of *Administradoras de Fondos de Pensiones* – AFP (Pension Funds Administrators), would administer the individual accounts with a clear separation between the savings and the managers. Thus, in the event of bankruptcy of one of these entities, savings would only be transferred to other AFPs, thus protecting savers.

At the time of the reform, the authorities' enthusiasm over the advantages of market-based reforms was prevalent, including the arguments about the incentives for each worker to make the contributions to the new system.[270] Since individual accounts were the only source to finance pensions, each worker would have the incentive to contribute to his fund. This individual contribution was in opposition to the old system where pensions were financed through contributions of the state (Hepp 1980, 6). These incentives transformed workers into a new class of capitalists ready to participate in the market (Gárate 2012, 269), and in which AFPs could compete for their contributions. The continuous concern manifested by Miguel Kast and his team was later embraced by the then Labour Minister José Piñera.[271] Piñera would later became the main promoter of the defined-benefit individual-accounts system at the international level (Weyland 2006).

Discussion about the new reform included some fear from the authorities, mainly the military, that these mandatory savings could be diverted from their intended use.[272] This was especially salient given that the new system would use the profit maximization of private administrators as one of its main organizational features. These new entities were the AFPs. However, authorities feared that this characteristic would lead administrators to take advantage of available resources to boost businesses instead of maximizing benefits for savers; moreover, given the custom of using pension resources for goals other than pensions, there was also a fear of faulty management of these funds, and the possibility of taking advantage of

270 From 1973 until the 1982 crisis, economic authorities carried out a public sector reform that would later produce an important crisis on the external front (Ffrench-Davis and Laban 1995, 50-55) and an important banking crisis, which will be further discussed below.

271 Alfonso Serrano Spoerer. Interview with the author. Santiago de Chile. August 20, 2014.

272 Promoters said the new system would provide financing for activities in need of a significant amount of resources, such as infrastructure and housing (Piñera 1988a, 317), however, others like Myers (1988) suggested that the enthusiasm of Chilean officials in the possibilities of spillovers of the new pension system should be moderate because a pension system, obviously enough, is basically conceived to pay pensions.

them in order to support side businesses of the funds' administrators.[273] This change of logic within the mandatory system – the emergence of a new organizational pattern, i.e. profit-making administrators instead of retirement cooperatives – was path breaking.

However, this change conditioned the entire structure of the system, since it had to reassure the authorities that resources would not be taken advantage of by the administrators; a balancing institution thus had to be created, concomitant to the new system. From the institutional design to the regulations governing the new scheme, a strict regulatory framework was required in order to get the reform approved. Regulations covering the assets in which AFPs could invest funds meticulously defined several quantitative limits for the composition of the portfolio. At first, AFPs could invest exclusively in fixed income instruments, such as bonds issued by the Central Bank, the Treasury, certain corporate bonds, or bank deposits (Berstein and Chumacero 2003, 3). These were considered to be the safest investments in the Chilean market. As discussed above, since one of the fears of the reformers was that administrators could capitalize on their own businesses with workers' savings, related investments were not authorized.[274]

In order to enforce these regulations, a special entity was created, the *Superintendencia de Administradoras de Fondos de Pensiones* – SAFP (Superintendency of Pension Funds Administrators), to whom AFPs had to present monthly reports on the state of the portfolio. While the regulation of the system was strict, perhaps the most important organizational characteristic of the new scheme was market discipline, as it would create proper incentives for its many actors to create a pareto-optimal solution. Consequently, it is not a surprise that many regulations concentrated on possible improvements of market performance, such as the entry of new competitors, the possibility of changing funds for affiliates, and risk assessment, among others.[275]

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273 Alfonso Serrano Spoerer. Interview with the author. Santiago de Chile. August 20, 2014.
274 Berstein and Chumacero (2003) and Iglesias-Palau (2009, 17-18) point out that a fraction of the funds could be invested into companies belonging to the same group that owned the AFP; however, neither of them provide a date in which this change might have taken place. The change probably took place in the 1980s (ca. 1985), since Pérez (1988, 226) refers to this possibility too.
275 Examples of changes in such dimensions include: Act 18255 of June 1983, Act 18398 of January 1985, Act 18646 of August 1987, Act 18964 of March 1990, Act 19301 of March 1994, and Act 19389 of May 1995.

At the beginning, the system was overregulated to reassure its critics that it was safe for workers to put their retirement in the hands of private administrators. Another consideration was to respond to the events that permeated the old PAYG system, where investments did not correspond to workers' long-term needs. While the latter situation is understandable given the implicit governmental warranty on acquired pension rights, it is also clear that the intention was to not repeat past mistakes while taking the lowest possible risk. This tension, however, is difficult to solve. If past mistakes, like breaking the inter-temporal logic of long-term savings with contemporary benefits – i.e. cheap loans to the members of different *Cajas* in the previous regime – were easy to avoid, others proved harder to overcome. Returns on investments on low-risk instruments were low and, therefore, the accumulation of resources was slow, which directly affected the resources available to calculate an individual's pension at the time of retirement.

From a broader point of view, it is not clear how competition was to be enforced if the instruments in which resources could be invested were restricted to public bonds. Moreover, the concentration of market power within financial markets derived from the accumulation of contributions made only to a select few created doubts about the effective competition that would exist (Arellano 1982, 120). The risk of an oligopoly and the subsequent market power was real; in fact, two big economic groups created their respective AFPs, amounting to almost 40% (4 of 11) of the total supply. The tension between profit maximizing on behalf of workers and the strict control and reduced risk was present from the beginning of the system. Investment possibilities were restricted with the aim of guaranteeing that public trust would not be affected given the novelty of the system. Also, conditions to create an AFP were strict, which in turn reinforced barriers to entry.

During the Chilean financial crisis of the early 1980s, the first AFPs created by big economic groups bankrupted with their controllers, but savings did not get lost.[276] This result was the product of a design feature of the system in which the funds (pooled resources) were separated *de jure* from their administrators. In the case of bankruptcy, the implication was that the AFP would disappear while the funds would be transferred to another AFP, thus safeguarding workers' interests. Nevertheless, the financial crisis also revealed some design

276 Alfonso Serrano Spoerer. Interview with the author. Santiago de Chile. August 20, 2014.

flaws, such as the deep fiscal commitments implied, which were partially responsible for the deteriorated fiscal balance (Arellano 1988, 136, Uthoff 2001).[277]

The choice of the authorities has always been to avoid the risk of losing savings altogether. This, however, has not been costless in the long run; one of the constant critiques, levelled against the system as a whole, has been that it does not allow workers to keep their living standards after retirement. Even though replacement rates are never 100%, in Chile, it seems that these are fairly low, regardless of the percentile in which the worker is in the income distribution. Even if replacement rates are nearly 60% for men, with half the average income, the replacement rate for women, with one and a half the average income, is less than 30%, both in the case of a labour history where contributions were always made (Sojo 2014, 33). Nevertheless, in the absence of bankruptcy of the AFP, where every affiliate lost their entire contributions, authorities were right with the strict regulatory framework.

After the reform was enacted, there was a transitional period for its full implementation. This period included the possibility of remaining in the old system for the workers who wanted to do so, as well as a timeframe to decide what would be the best scenario for each worker. This apparently flexible situation notwithstanding, many workers did not have a choice but to join the system. One condition set by the new pension system was a smaller monthly contribution to the retirement fund. This smaller contribution represented an 11% increase in a worker's available income (Ruíz-Tagle 2001, 9). The context in which this choice was made was that of a severe recession, which implied a growth rate of -14% in 1982-83 (Ffrench-Davis 2014, 48), as well as a high unemployment rate that was near 20% (Ffrench-Davis 2014, 305).

Clearly, many workers decided to change because of the severe short-term conditions, without, however, necessarily taking into full consideration the possible long-term consequences. Moreover, there was a big campaign in the media that framed those who stayed in the old system as "*pánfilos*", or naïve and silly,[278] adding a chastening character to the decision context of every worker. Nevertheless, in spite of the campaign, probably what

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[277] Also, with regard to the financial crisis, as the economic activity fell, the fiscal equilibrium policy was abandoned for a more pragmatic approach towards state intervention in the economy.
[278] Jaime Ruíz-Tagle. Interview with the author. Santiago de Chile. July 30, 2014.

mattered most for every worker was precisely the difference in income between both systems. Moreover, to choose consciously between the two systems by weighting all relevant variables was simply impossible given the complexities in terms of commissions and hidden costs, despite what promoters argued at the time about the low degree of financial sophistication or literacy needed to understand the individual accounts system (Piñera 1988b, 327).

After the implementation of the reform, political debates around it were deeply divisive as a consequence of its problematic origin. Supporters of the individual accounts' system, apart from those directly interested, such as owners of the AFPs, were mainly people who were close to the military regime. Criticism in turn came mainly, but not exclusively, from public employees who had lost some privileges with the 1981 reform.[279] However, following the pattern of Chilean post-transitional debates, critics were legion in social organizations opposing the military regime and its legacies. The national government tried to play the role of referee in these debates by enacting some reforms intended to improve workers' situation while still preserving the system. As will be discussed further below, the *Concertación*[280] did not challenge all the legacies of the military regime. In fact, their leaders[281] considered that every reform in economic policy had to preserve growth.

After the first decade, the reforms were scrutinized. First, a complex regulatory structure was put in place, with the aim of controlling the way in which resources owned by workers must be invested. Second, a substantial amount of resources was accumulated because few pensions had to be paid, whereas contributions kept a steady pace. The latter characteristic was the subject of debate, mainly during the 1980s, but also throughout the 1990s, as enthusiasts argued these resources meant an increase in the aggregated saving of the country (Schmidt-Hebbel 1997). Critics argued that it did not represent an increase in the aggregated

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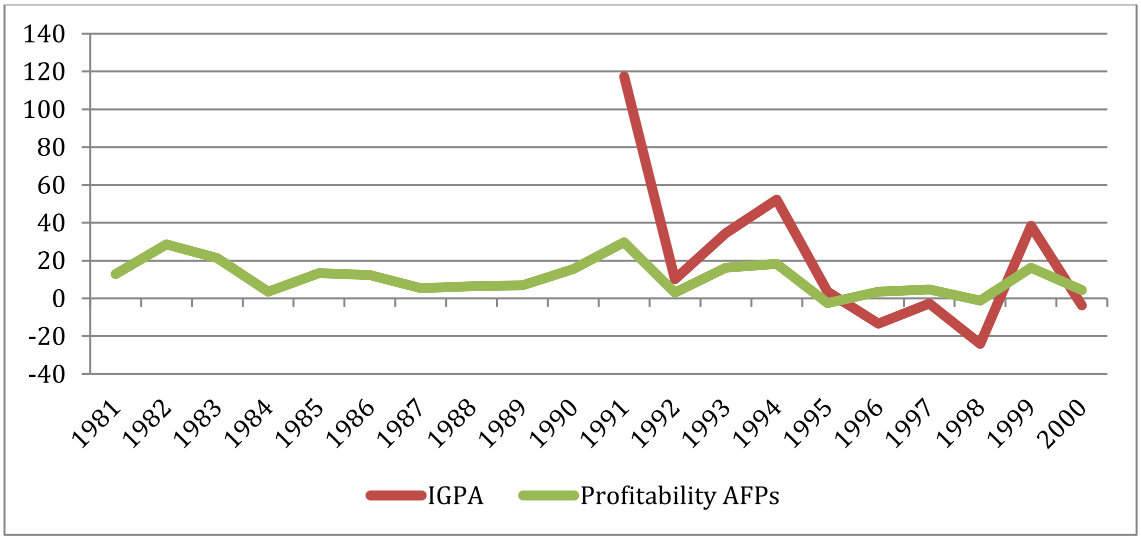
279 Joaquín Vial. Interview with the author. Santiago de Chile. August 5, 2014.

280 The coalition of parties opposing the military regime that have won all the elections but one since the democratization in 1990. The main parties are the Christian Democrats (DC), the Party for Democracy (PPD), Radical Social-Democrat Party (PRSD), and the Socialist Party (PS). Later on, Michelle Bachellet in the campaign for her second term (2014-2018) proposed a new name for the coalition, the New Majority, which incorporates, among other social movements, the Communist Party.

281 Both José Pablo Arellano, Chief of the Budget Office, and Carlos Ominami, Minister of Economy of the government of Patricio Aylwin (1990-1994) and long-time members of the *Concertación* as technocrat and Senator respectively, mentioned in the interviews conducted by the author that growth had to be preserved as a political insurance against the opposition. For a broader view of the implications given to the priority of preserving growth as a prerequisite for any other change, see Arellano (2012) and Ominami (2013).

saving, but rather a transfer of assets between the state and the private sector (Arellano 1988). As the main investment was public bonds, this meant that there were indeed no new resources saved, but an increasingly indebted state.[282]

Figure 8. Profitability of the Pension System and the Stock Market. 1981-2000



Source: Elaborated by the author with data from Carrasco (2001, 948-949) for the profitability of the AFPs and from Chile (2016b). The *Indice General de Precios de las Acciones de la Bolsa de Comercio de Santiago* - IGPA (Chilean Stock Market Index) reflects the difference in December of each year to the precedent one. The profitability of the AFPs corresponds to the weighted average of each AFP's portfolio. Correlation = 0.9408

During the 1990s, limitations started to be more evident.[283] Competition between AFPs was supposed to play a paramount role in terms of efficiency, service provision, profitability, and so on. Results in that regard had been disappointing nonetheless (Figure 8), and regulation is said to be one of the causes. An important provision of the regulatory regime consists on the

[282] The terms of that debate illustrate to what extent this was an obscure subject for the majority of the Chilean population. It continues to be the case. The problem of ignorance about how the system works was mentioned to the author as one of the main weaknesses of the system today by Alfonso Serrano Spoerer, Undersecretary of Social Security (1976-1985) and one of the main architects of the system, and by Joaquín Vial, Member of the Board of the Central Bank of Chile who acted as a high executive within a financial group owning of one of the biggest AFP in the 2000s.

[283] Subsequent paragraphs rely heavily on Uthoff (2001, 236-238).

averages that the AFPs must respect.[284] If they do not do so, they are severely penalized, causing herd behaviour and subsequently diminishing the competition incentives within the market. All AFPs try to stay as close as possible to the market's average in order to avoid possible sanctions. While this regulatory strategy has proved to be a reasonable one insofar as losses have been rare, on the other hand, herd behaviour does not allow the consumers (workers) to choose among significantly different providers.

Because in the pension market the difference between each provider is minimal, incentives lean towards similarity among suppliers, leaving little room to enforce competition. Furthermore, the main price charged by AFPs is a two-tiered fee, a fix fraction and other fraction proportional to the balance, which in turn has low price-demand elasticity, thus transposing competition to another arena. An increase in the sales force was the AFPs' privileged strategy, which impacted the number of transfers of affiliates, thus reducing the system's efficiency given that costs were much higher with essentially the same market. The decrease in efficiency was also transferred to workers as their yield diminished in consequence (Berstein and Micco 2002). The response from the authorities was to limit the possibility of transferring from one AFP to another, thus relieving the pressure over prices, but not significantly given their composition.

Following the pattern of relaxing the straight provisions of the AFPs' investment regime, a reform was introduced in 2002 allowing the latter to offer a plurality of portfolios. The multi-fund reform, as it was named, pretended to diversify the risks borne by each worker depending on his or her preferences. The multi-fund structure consists of five different portfolios with distinctive risk levels. The rationale for this reform was to maximize the possible returns of workers' savings following their life cycle, among other significant variables. Salaries from first employments are low compared to later ones; however, those will be more significant to the calculation of the pension, as they will have produced a return over a longer time, namely the whole work life. Before the multi-fund reform, the risk was a flat average, which affected young contributors more because they could afford higher risks

284 If the profitability of a given fund falls short of the industry average, the AFP must use its own resources on the compulsory deposit to compensate its affiliates. Therefore, the incentive is to avoid such patrimonial drawback.

insofar as they would have more time to recover potential transitory loses (Ruíz-Tagle 2013, 499).

On the other hand, the reform allowed AFPs to diversify their risk, following the authorities' directives nonetheless. Not surprisingly, each fund within the multi-fund scheme had been regulated according to the same strategy used in the case of old funds, that is, using an industry average as a benchmark. Thus, the multi-fund reform only reproduced the model on a broader level, since it had been implemented before. While the rationale behind the reform was fairly sound, risk diversification depended on the moment in life, the time for it to produce significant results was well beyond any reasonable timeframe for a successful political evaluation. Furthermore, uneasiness with the system increased significantly as it did not solve several of the problems that retiring Chilean workers had to contend with. Even if the system was not supposed to solve each and every issue, it was perceived, however, as exacerbating them, albeit without being their direct cause.

Critics point out that the system did not guarantee the living standards of the pensioners. This implied a growing discontent, since consequences started to surface with the increase in the number of people in age of retirement, many of whom decided to keep working.[285] Arguments revolved around the fact that so far the system had not paid complete pensions, because many pensioners in recent years had the right to recognition bonds.[286] While the state is the main source of financing for current pensioners, in any case, if the argument about the importance of the accumulated resources of the pension system were advanced, their counterpart would argue that contributions to the social security system should pay for pensions and not to increase the available resources for companies to grow.[287]

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285 The evidence for this point remains anecdotic.

286 The recognition bond is a one-time deposit made by the state to the pension account of each worker who had contributed to the former system.

287 Gonzalo Cid. Interview with the author. Santiago de Chile. August 1, 2014. Gonzalo Cid is currently (2014-) head of the Pension Studies Directorate within the Chilean Ministry of Labour. Before that he was the Head of the Pension Unit of *Centro de Estudios Nacionales de Desarrollo Alternativo – CENDA (Center for National Studies on Alternative Development), a Chilean think-tank located at the left of the political spectrum. The latter organization is part of what is known in Chile as the extra-parliamentarian left, which seeks through its policy propositions a replacement of the Chilean model of democracy-market, and, therefore, does not participate in the market of ideas of Chilean policy and is not recognized as legitimate by other think-tanks (Gárate 2012, 476).*

In fact, the reforms enacted during the 2000s have had the intention of improving the performance of the system. In 2002, the introduction of a multi-fund structure, in which each worker could decide the risk level he could afford depending on his personal situation (age, savings, time of contribution, and so on), had the intention of improving the returns on the investment. While the 2008 reform had a broader scope, as it created a subsystem that guaranteed a minimal pension for the poorest 60% of the population, the commission in charge of discussing proposals had the mandate to propose reforms to personal savings accounts, not their full replacement (Iglesias-Palau 2009, 55). This accounts for the scope of that reform, as it tried to enhance the performance of the system, even for those who might have stayed out of the system. Another initiative of the 2008 reform was the introduction of a bid for new entrants as a way to reduce costs and therefore improve performance.

Despite this situation, interests had been created around the system aside from the expected winners, i.e. funds administrators and economic groups. Many workers are now used to knowing how much their pension accounts grow, and are not ready to renounce this possibility. Therefore, the approach to transform the system has been through incremental changes, mainly in the regulatory sphere, but also in its general architecture with two reforms proposed during Michelle Bachelet's administrations in 2008 and 2014.[288] While critiques remain with regard to its scope,[289] in general, the reform of 2008 is considered the most important one, having also as an asset a broad democratic discussion (Arenas-de-Mesa 2010). Furthermore, the pension system will continue to be reformed because it is a politically salient subject revealing the still unsettled general evaluation of the authoritarian legacies of Chilean society.

288 As of 2016, the government of Michelle Bachelet continues to face the social uneasiness with the pension system as demonstrated by the protests that took place in Santiago on August 21st. For details see, *Economist,* "The Perils of Not Saving; Chile's Pensions." August 27, 2016.

289 Carlos Ominami. Interview with the author. Santiago de Chile. August 12, 2014. Carlos Ominami was Minister of the Economy (1990-1992) during the government of Patricio Aylwin. He was elected Senator in 1993 and reelected until 2009. He participated in the transition team from the military government to the democratically elected government.

4.4. The Financial System : From Banks to Capital Markets(?)

The Chilean financial system went from a situation in which credit allocation was tightly controlled by the state, through the Central Bank, to a situation in which credit allocation was entirely decided by market mechanisms in less than a decade during the 1970s. While the regulations covering the allocation of credit were part of a longer tradition in which the Central Bank played the main role, the nationalization, during Allende's government, of almost the entire banking system represented a departure from traditional Chilean policies. Interest rates were negative in real terms (Larraín 1989, 3), which also amounted to an emission that fuelled an inflationary process.[290] While negative interest rates might have affected the aggregated savings of the economy in any given moment, this was not a new problem in Chile.[291] After the *coup* took place, financial regulations changed towards a liberalized financial sector (Figure 9).

In the middle of the twentieth century, holding foreign currency was not necessarily a way to channel savings either. At the beginning of the 1960s, Chileans who held non-declared assets abroad had the opportunity to repatriate them with a series of measures implemented by the authorities at the time. Chiefly among such measures was the possibility of holding such assets in dollar denominated accounts in Chilean banks (Ffrench-Davis 1973, 129-130). However, the tight control over interest rates proved a stronger incentive than the possibility of holding dollar denominated assets within Chilean borders, which implied the existence of capital flight. Except for foreign trade, commercial operations in American dollars were strictly forbidden, fostering in parallel the existence of a peer-to-peer credit market in which companies were the main creditors of their clients (Fontaine 1996, 24). This, in fact, is consistent with the concentration of the financial market before 1970 (Ffrench-Davis 1973, 152), when the government of Salvador Allende was first put in place.

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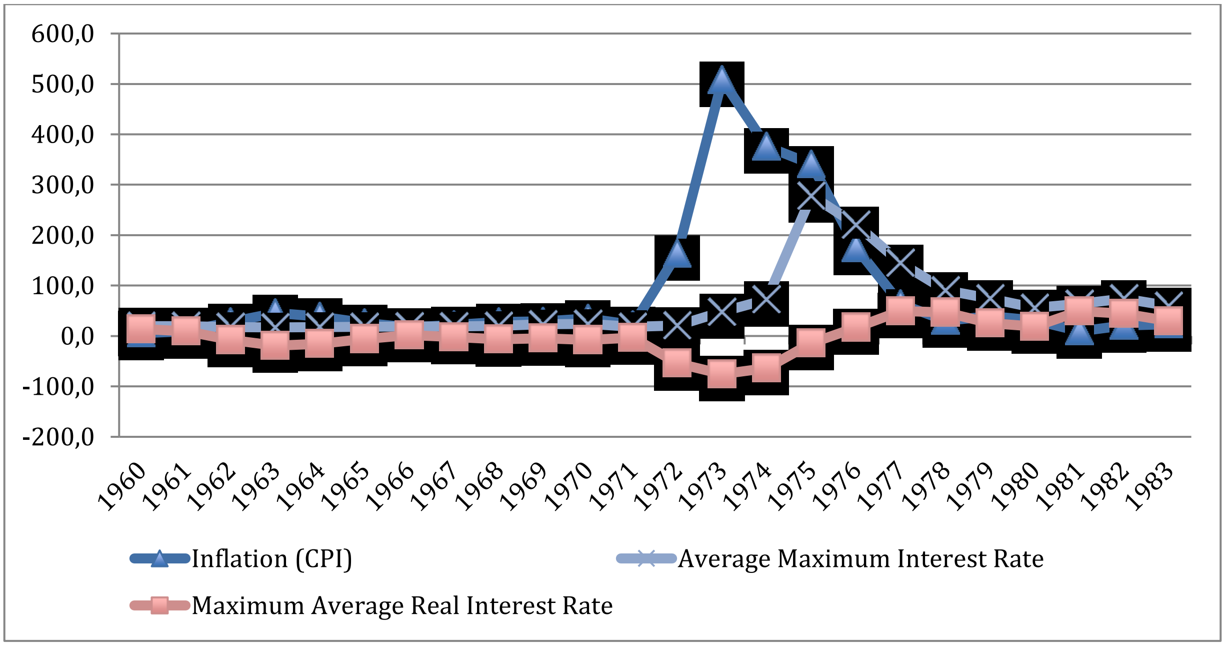
290 Real interest rates are negative when nominal interest rates do not cover the change in prices, i.e. inflation. This means that the purchasing power decreases. This situation is different from negative nominal interest rates in which savers pay the bank to hold their assets. Between 2015 and 2016, the central banks of Japan and Switzerland implemented this kind of policy.

291 Joaquín Vial. Interview with the author. Santiago de Chile. August 5, 2014.

Figure 9. Inflation and Real Interest Rate. Chile 1960-1983



Sources: Elaborated and calculated by the author with data from Carrasco (2001, 310) for inflation data and from the CD-ROM contained in Carrasco (2001). From 1960 to 1973, the calculus is the arithmetic average of the *Interés máximo convencional* (maximum legal interest rate) of the first and second semesters. For 1974, the number corresponds to the arithmetic average of the maximum legal interest rate until May 24th and the annual rates thereafter. From 1975 until 1983, the arithmetic average of the maximum legal interest rate is indicated.

Although it was the state that commanded at arm's length via the central bank, financial intermediation before 1974, the market would organize the Chilean financial system, through competition between providers, after liberalization in 1974-1975. Despite this change in the organizing principle of the financial system, the regulatory framework for administering risk continued to be the same. Regulations concerning risks and financial provisions - in the event of an increase in non-performing loans - were conditioned to an over-controlled or financially repressed banking system, while the practices suddenly became those of a free market. However, the lack of correspondence between practices and regulations posed risks on financial intermediation. Also, given the liberalization of credit, consumers were eager to take out loans so that they could access consumer goods that had not been available before. While this consumption boom occurred mainly in high and middle classes, lower ones also participated in it.[292]

The main change implemented by Allende's government to the financial system was the nationalization of several banks. Thus, the first response from the military government was to privatize the previously nationalized institutions, which was consistent with governmental policy since many other previously nationalized companies were also privatized.[293] Also consistent with policies in other arenas, the state held a participation in the financial industry with a big retail bank, the Bank of the State, and a downsized development bank, CORFO.[294] Further changes in the financial system reversed not only the policies of the deposed government, but broke from a traditional policy of the Chilean state in which credit was administered by the Central Bank through caps in the legal interest rates and market segmentation. This policy meant that different institutions administered different types of credit.

An important indicator for the liberalization of the financial system was the real interest rate as this is a key price for that market. For instance, interest rates went from negative during Allende's government to very high in 1975[295] (Edwards and Edwards 1987, 54). Nevertheless, it is important to understand the reasons for this significant hike, both from the point of view of the general context in which the event took place and from the perspective of the agents that intervened in its development. As the change in question was from a tightly controlled financial system to a withdrawal of controls, economic agents responded in disorder.[296] The combination of these two conditions highlights the enthusiasm about market reforms, both of state officials and of market operators, since the former took a hands-free approach and the latter did not properly evaluate the risks implied by the loans granted.

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292 The causes of this participation are difficult to weigh, however. If lower classes had more access to credit to finance consumption goods, such goods had also become less expensive because of commercial liberalization (Ffrench-Davis 2014, 126).

293 For a broad political perspective on privatization in the Chilean and international contexts, see Schamis (1992).

294 As mentioned above, the state retained control over CODELCO and ENAP.

295 Edwards and Edwards (1987) do not give an exact figure. However, as shown in Figure 9, the five-fold nominal increase represented mainly a change from a negative real interest rate to a positive one.

296 de-la-Cuadra and Valdés (1992) present a detailed account of the unraveling of the crisis step by step. The way in which all the involved actors made serious mistakes is analyzed.

Besides this, there was also the intention to develop the market itself, of which the privatization and the end of market fragmentation were important factors.

Changes in financial markets, like interest rate liberalization, quantitative credit controls, and the end of market fragmentation, had to be backtracked by the government after unintended consequences appeared.[297] Partially, the importance of the inflationary tax on the government's finances is responsible for such reversals, even if the decrease in the price of copper also played a role. In an inflationary economy where indexation is fairly well developed, as the Chilean's was in the 1970s (Jud 1978), inflation is the main government revenue.[298] Also, the first stages of liberalization, between 1974 and 1977, reflected that some of the policy measures were not necessarily part of a well pre-conceived plan; instead, many changes were muddled through as challenges surfaced. These appeared with the lack of coordination between policies, mainly because the control over the financial system was implemented with a wide range of instruments, which complicated the liberalization process.

If enthusiasm over market reforms was widespread among authorities and market operators alike, lack of experience with an unregulated environment was also a shared characteristic. Regulators, bankers, and the general public made serious mistakes during the deregulating process that exacerbated the intrinsic risks associated with banking. Whereas the literature mentions the bankruptcy of *Banco Osorno y La Unión*, a middle-sized bank, and the way in which the authorities handled it as a landmark event in the unraveling of the Chilean banking crisis,[299] it was not the only event in those years that signalled serious problems intrinsic to the whole financial system (de-la-Cuadra and Valdés 1992, 46-67, Harberger 1985, 453-454, Larraín 1989, 10, Barandiarán and Hernández 1999, 8). On top of the domestic financial market problems, by the end of the decade, a fixed exchange rate created yet another factor of instability to the balance sheets of several banks and other financial institutions.

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[297] This paragraph relies on Valdés (1993, 412-420).

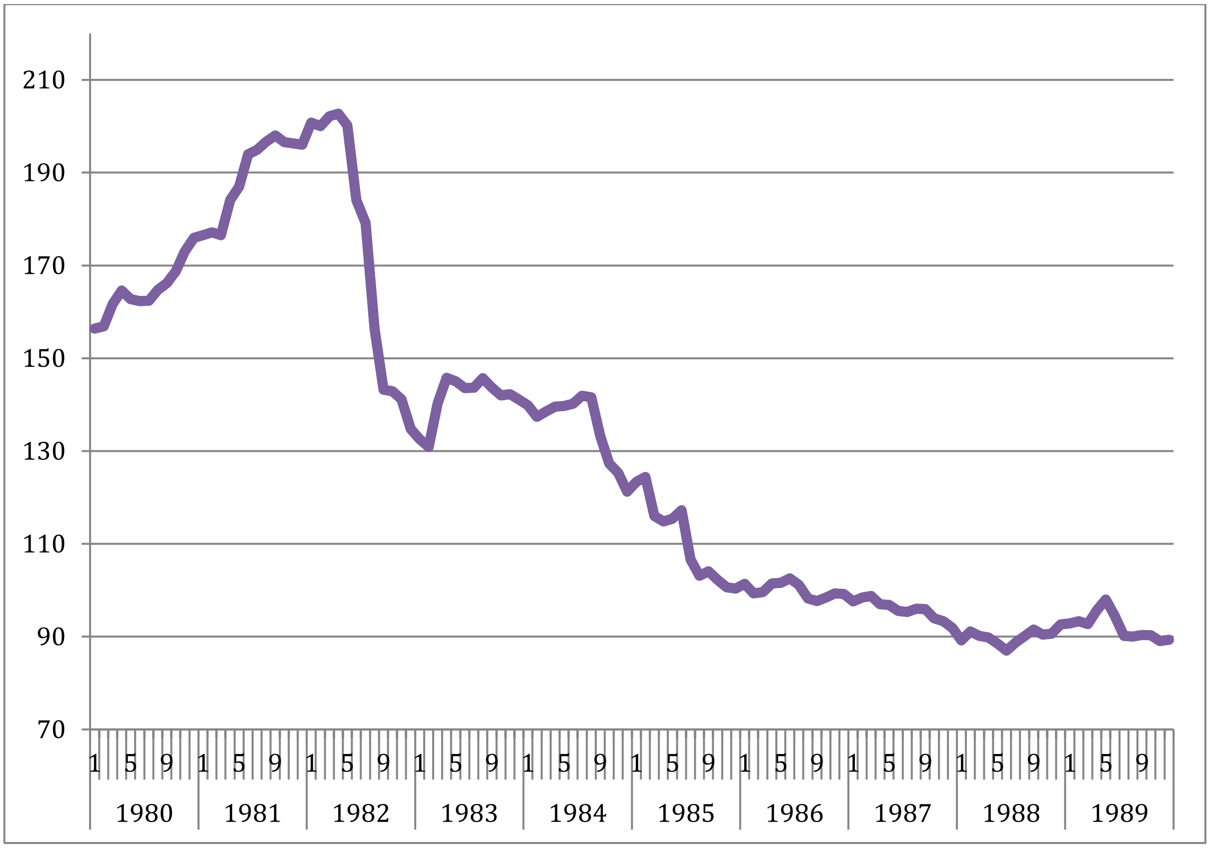
[298] Indexation prevents the deleterious consequences in terms of revenue of the Oliveira-Tanzi effect. This effect appears when the real value of the collected tax disappears between the moment in which the tax is caused and the moment it is paid. For a discussion of how inflation can be central to governmental finances, albeit focused in the Brazilian hyperinflation of the 1980s and 1990s, see Bacha (2012a).

[299] The main problem with the bailing of *Banco Osorno y La Unión* was the signaling of an implicit unlimited warranty over deposits by the government. This, in turn, led actors to engage in riskier practices.

The government made a commitment in June 1979 to a fixed exchange rate. However, neither interest rates nor inflation converged to international levels. This scenario was unfortunate given the importance that interest rates were given in the context of the U.S. Federal Reserve Board fight against inflation with its consequent hike (Roberts 2010). Companies paid at the time real interest rates, ranging from 11 to 57 percent on 30-day loans (Chumacero et al. 2007, 122). The consequences of these patterns were increased external disequilibria that would eventually force the government to devaluate the peso in June 1982, which started a long process of depreciation of the currency (Figure 10). Because many companies, as well as banks, were heavily leveraged in dollars, the devaluation hit them especially hard.[300] On top of that, related loans were prominent in bank portfolios, making it difficult to execute such loans (Edwards and Edwards 1987, 60-62, de-la-Cuadra and Valdés 1992, 41-45), as it would have implied taking a collateral that already belonged to them. By 1981-82, the crisis was serious enough to require a full intervention.

300 Quantitative restrictions to external indebtedness of commercial banks were gradually lifted between 1975 and 1979, without changing fundamentally the exchange regulations in place since the early 1960s. However, between June 1979 and April 1980, these were lifted completely without changing the destination of such operations, that is, foreign trade loans or domestic dollar denominated loans. Therefore the access to foreign currency was artificially restricted, giving the banks some rents over these assets, which were taken advantage of by their controllers through related loans, giving in turn the controllers a lower interest rate than that prevailing in the domestic market (Fontaine 1996, 66).

Figure 10. Real Exchange Rate Index 1980-1989. Average 1986 = 100



Source: Elaborated by the author with data from Carrasco (2001, 403-407). The Observed Real Exchange Rate Index (RER) is calculated by multiplying the nominal exchange rate by the ratio of relevant external inflation and the domestic Consumer Price Index (CPIn). External inflation is calculated with the Producer Price Index (PPI), expressed in USD (or the correspondent CPIn's if PPI is not available), of the main trade partners, weighted by the relative importance of imports and exports – excluding oil and copper – that Chile makes with them. Both PPIs and exchange rates are incorporated as monthly variations.

Authorities debated about the course of action. The first possibility was to let banks go bankrupt, which would have implied political costs given the lost deposits. The second possibility was to take over the banks as lender of last resort and let the state assume the costs of bailing out the failed banks. The third possibility was a compromise in which the state would intervene the banks, but make the shareholders and taxpayers pay for the intervention. This option did not receive a consensus among authorities. The event surrounding the banking crisis brought in significant political consequences. Politically, the banking crisis of the early 1980s put an end to the hegemony of the most representative liberal economists that took over economic policy in 1975, as well as their market-oriented recommendations. Santiago de

Castro, Minister of Finance and one of the leaders of that group, lost his post to Hernán Büchi, who was also a liberal economist although a milder one; he would bring a more pragmatic approach to economic policy.

It is interesting to point out how the balance of power, as well as the dominant economic point of view, changed over a short period of time. The bailing out of *Banco Osorno y la Unión* in late 1970s was comprehensive because the authorities thought that this type of bankruptcy would represent a blow to the reforms that were underway at the time. It was seen as a compromise between the free market policies and the necessary intervention to save those policies.[301] Nevertheless, because such interventions were among the main causes of the banking crisis in early 1980s,[302] there was a change among the economic team as well, in part due to the pressure over the government. Later on, in the banking crisis of the early 1980s, the choice of bailing out the banks while making shareholders and managers pay for some of the burden of the crisis represented a more complex compromise. It implied a thorough state intervention in the banking system by taking over the management, that is, a shift from a no-intervention vision towards a more pragmatic one.

This intervention implied the take-over of several financial institutions and the forced liquidation of many others, mainly small ones; a third group was neither taken over nor liquidated, but received public support (Fontaine 1996, 56). This represented a departure from the official policy,[303] which led to what came to be known as the "odd sector," because even if these banks were privately owned in legal terms, the government nominated managers that administered them (Chumacero et al. 2007, 131). The direct intervention of financial institutions was not the only action taken by the government. Starting with the nationalization

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[301] At the end of the 1970s, when the *Banco Osorno y la Unión* was bailed out, this move seemed to be a small compromise since other liberalizing reforms, such as trade liberalization, were being implemented simultaneously. Thus, to avoid the bankruptcy through a thorough state intervention in the middle of a broader liberalizing process was a small price to pay to save policies that were high in the policymakers' priorities. For details concerning the bankruptcy of the *Banco Osorno y la Unión* along with some other financial institutions representing a backlash in the liberalizing efforts in the financial system, see Valdés (1993, 422-427).

[302] The conditions of the bail out created moral hazard because actors considered that there was no limit in the guarantee of savings in the financial system provided by economic authorities, thus leading a diversity of actors to take bigger risks. The weak position in which many financial companies were in the early 1980s was among the reasons for the generalized banking crisis.

[303] This was not the only change in economic policy implemented by the government. In general, there was a more pragmatic approach from economic authorities *vis-à-vis* the role of the state in the economy. For details, see Ffrench-Davis (2014, 210-213). For other perspectives on how the Chilean state played an important role in fostering sectors and supporting entrepreneurs, see Silva (1996) and Schurman (1996).

of foreign debt, followed by the rescheduling of several loans and the provision of a subsidized exchange rate for indebted companies, all represented substantial costs, both financially and in human resources, for the state and the Central Bank, in the resolution of the financial crisis (de-la-Cuadra and Valdés 1992).

Tableau V.Assets Diversification of AFPs. 1981-1988. Percentage

	Public Institutions				Private Companies			
	Central Bank	Treasury	Other	Total	Financial Institutions	Enterprises	Available Assets	Total
1981	95.53	2.43	0.00	97.96	0.00	2.04	0.00	100
1982	4.27	21.73	0.00	26.01	73.39	0.60	0.00	100
1983	14.07	30.40	0.00	44.47	53.37	2.17	0.00	100
1984	16.50	25.56	0.00	42.06	55.65	1.81	0.48	100
1985	20.29	22.14	0.00	42.44	55.97	1.11	0.48	100
1986	25.98	20.49	0.16	46.64	48.66	4.59	0.12	100
1987	29.71	11.60	0.05	41.36	49.44	8.82	0.38	100
1988	29.99	5.40	0.03	35.41	50.06	14.49	0.04	100

Source: Elaborated by the author with data from Carrasco (2001, 947-948). Proportions calculated at December 31 of each year.

The decision to save the banks also had implications outside the financial sector. When the pension system was launched, some of the investments were channelled through the banking system (Table 5). If several banks had filed at once for bankruptcy during the banking crisis, the pension reform would have been aborted (Chumacero et al. 2007, 124). This would have implied yet another political cost, when the country was already hit by recession. This, in turn, gave space to political dissent that capitalized on the economic slowdown to mobilize the population against the military regime (Silva 2010, 183). While the traditional accounts of the relation between the new pension regime and the financial sector emphasize its importance for the Chilean economy, the first instance of this relation was fundamentally political.

Because the liberalization process in Chile created significant problems for the economy, it raised the question of the proper sequence in which these reforms should be implemented (Fontaine 1996, 83-85). Nevertheless, besides the discussion of a liberalization benchmark, what this debate reveals is the way in which different economic policies affect each other. Even if there are some technical connections between policy spheres, including the idea of a proper way to liberalize, the main concern is mainly political: solving the crises required a great deal of political compromises, but so did liberalization. Whether the economic costs of taking one reform path were higher than the other was less important than the overall political costs. Thus, what the relation between the banking and the pension systems shows is how the political cost of failure could have led to insurmountable obstacles for the larger political project of the military.

In the worst moment of the crisis, a major intervention in January 1983 was called for, which consisted in the receivership of a substantial part of the financial system, there was also a modification of the banking law and related regulations.[304] There was strong authority reinforcement of the *Superintendencia de Bancos e Instituciones Financieras* – SBIF (Superintendency of Banks and Financial Institutions) to handle similar crises while reducing, similarly, possible future costs to be carried out by the state. A combination of interbank negotiations and prudential regulations was formalized so as to limit state intervention. Nevertheless, the provisions of the 1986 Banking Act (No 18576 of November 27th 1986) granted extensive powers to the SBIF to render public the relevant information of its supervised institutions, among other competencies (Ramírez and Rosende 1992). Despite the efforts to reassure different agents about the soundness of the financial system, in 1986, the perspectives were less than promising (Edwards and Edwards 1987, 207).

In the middle of 1980s, a new privatization of recently bailed banks took place. This time, there was an attempt to use "popular capitalism" through the extension of governmental soft loans (Chumacero et al. 2007, 123). Successively, the depth of the Chilean financial sector grew in subsequent years, including the creation of a securities market. As such, the crisis influenced the way in which these developments were undertaken so as to stabilize a bank-

304 Because, in June 1982, the government had made the decision to allow a devaluation of the Chilean Peso by 14 percent, to then subsequently allow it to float in July, this created an exchange crisis. With the banking crisis that reached its peak in January 1983, alongside the major intervention in the system, Chile found itself with 'twin crises'. The term 'twin crises' refers to when a banking crisis takes place at the same time as a balance of payments crisis. The classic reference on the theme was actually developed using the Chilean case (Diaz-Alejandro 1985). Since then, other instances of the same phenomena have been analyzed by Demirgüç-Kunt and Detragiache (1998) and Kaminsky and Reinhart (1999); also, for historical perspectives on financial crises, see Reinhart and Rogoff (2009).

based financial system (Ramírez and Rosende 1992, 213-216) while, at the same time, different types of securities became available, thus marking a movement towards a capital-market financial system. Moreover, since the companies listed in the local stock exchange (*Bolsa de Comercio de Santiago*) were limited to big enterprises that, in any case, would have been able to finance their own operations through traditional credit operations, capital markets in general were concentrated on public bonds. Whereas it is tempting to argue in favour of the rise of corporate and mortgage bonds representing *the* deepening of capital markets, this account is hard to sustain with regard to the modest increase of 1.5% to 4.5% of GDP in corporate bonds during the second half of the 1980s (Stallings 2006, 158 Table 6.3).

A policy arena in which the new democratic authorities showed their commitment to keep a sound economic policy was the capital account. The liberalization of the capital account involved a series of considerations. On the one side, in the beginning of the 1990s, the presence of institutional investors in the domestic capital markets grew steadily, mainly AFPs; on the other, the general increase in growth of the economy[305] demanded an increase in long-term securities, even though domestic capital markets were not prepared for the amount of available resources.[306] Therefore, changes in the financial market regulation were necessary to cope with these trends. Authorities were fully aware of the importance of enacting these measures to better organize capital markets, also in line with the increasing insertion of the Chilean economy within the world economy (Foxley 1991, 17). Moreover, as there were attempts for a return to voluntary international debt markets in Chile, policy measures in line with the opening of the capital account were also necessary (Foxley 1992, 52).

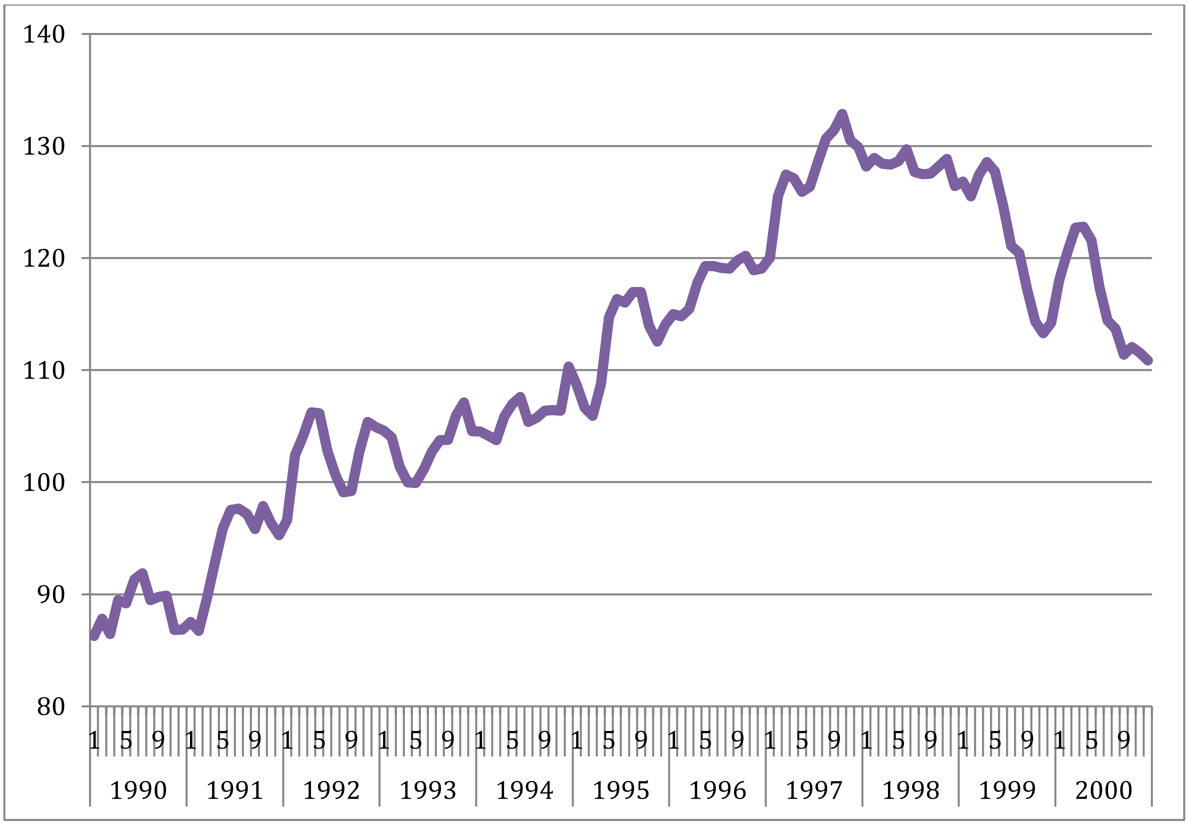
Furthermore, in principle, from the point of view of institutional investors such as AFPs, portfolio diversification was a wise policy. Nevertheless, given the appreciation of the Chilean peso, there was little incentive for this course of action, as it would generate losses (Figure 11). This trend was clear until 1997, when the AFPs had only invested 0.5% of their resources abroad (Ffrench-Davis 2014, 358-359). Even then, the amount of resources handled

305 As Figure 6 shows, in the early 1990s, the government of Patricio Aylwin (1990-1994) was the presidential period that presented the highest average rate of GDP growth (7.7%) from 1960 to 2010. However, the average growth in the decade between 1986 and 1995 was 7.2% (Chile 2016a) indicating that other years were potentially as good.

306 In fact, it is worth recalling that in the last part of the 1980s, the market was already starting to saturate with the volume of resources managed by the pension funds (Pérez 1988).

by AFPs had increased steadily, with which that modest fraction could well amount to macro-economically significant resources. Therefore, even if the authorization to invest administered funds in foreign markets seemed to be in order, it turned out to be just a small escape valve at the time of implementation.

Figure 11. Real Exchange Rate Index 1990-2000. Average 1986 = 100



Source: Elaborated by the author with data from Chile (2016c). The Observed Real Exchange Rate Index (RER) is calculated by multiplying the nominal exchange rate by the ratio of relevant external inflation and the domestic Consumer Price Index (CPIn). External inflation is calculated with the Producer Price Index (PPI), expressed in USD (or the correspondent CPIs if PPI is not available), of the main trade partners, weighted by the relative importance of imports and exports – excluding oil and copper – that Chile makes with them. Both PPIs and exchange rates are incorporated as monthly variations.

Within the financial sector, efforts have been made to improve the performance of capital markets with different reforms[307] aiming for its deepening as well as an improved accessibility. Moreover, general stability and risk management in the traditional banking system continue to be a top priority for authorities, reinforcing the importance of the profound wounds left by the financial crises of the late 1970s and early 1980s. While risk management has evolved towards prudential regulation implying marginal increases in the risk borne by financial institutions, it is clear that the long-term consequences of these crises are still felt in the regulation of the traditional banking sector. This is not the situation in the *shadow-banking* sector,[308] where regulatory arbitrages are common, which can also imply significant risks for the financial sector in general (Gallegos 2013, 360-361).

The development of the financial sector and the presence of institutional investors, of which AFPs are the most significant, happened simultaneously. A causal argument exists in both senses. Whether the financial sector flourished *because of* the presence of institutional investors, or whether institutional investors flourished *because of* the development of the financial sector, remains unclear. Moreover, the Chilean financial sector is still largely bank-based, since most businesses depend on bank loans to finance their operations, given that capital markets continue to be restricted to the biggest companies in the country, in part because they can afford the administrative costs involved in participation. Furthermore, banking sector reforms were driven mainly by the consequences of the events of the early 1980s. These were successful in organizing financial intermediation and stabilizing it, despite its liberalization while, at the same time, making a transition towards prudential regulation.[309] On the other hand, the successive reforms of capital markets opened a space for a more

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307 Acts 19768 and 19769 enacted in October 24th 2001, 20190 enacted in June 5th 2007, and 20448 enacted in August 16th 2010.

308 The shadow-banking sector refers to some institutions, mostly retailers, which participate in the credit market by offering financial services like credit cards without the risk-assessing capabilities and regulations to which banks are bound. This situation can create systemic risks, as such institutions participate in the payments system in which all traditional banking institutions participate. For a broad discussion on shadow banking, see Pozsar et al. (2010).

309 Prudential regulation can be divided between micro-prudential and macro-prudential. The latter has been the matter of intense debate after the financial crisis of late 2000s. Essentially, micro-prudential regulations seek to deal with the responses of individual financial institutions to exogenous shocks; macro-prudential regulations seek to deal with risks posed to the financial system by individual institutions, thus trying to minimize the impacts for the whole financial system following the bankruptcy of a single institution, as was the case after the fall of Lehman Brothers. For details on macro-prudential regulations, see Brunnermeier et al. (2009).

systematic use of the available resources in the hands of institutional investors. How this space was actually used, if it was at all, remains a matter of open debate.

Financial regulation in Chile is not detached from broader international trends. The sole existence of an indigenous banking crisis, and the preoccupations it might have produced, could not be enough to isolate the regulatory behaviour of Chilean authorities. International regulatory frameworks such as Basel I and II were taken into account in further regulations, where *Value at Risk* - VaR - models are the cornerstones of the regulatory model now in place. Whereas these models have not proven to be the safest option for regulators, it must be recognized that they continue to be a favoured regulatory model in many economies. Whilst some argue that Chile is leaning towards a more flexible approach of financial regulation, in the very moment that a different answer is required (Gallegos 2013, 365-369), it is hard to square with the absence of a big crisis on the banking industry, even with events such as the fall of certain retail credit entities (Gallegos 2013, 365-369).

4.5. Institutional Complementarities

The connection between the financial system and the pension system has been a matter of debate. However, these debates revolve around the evaluation made by the participants of the reforms and its consequences. The intention here is to show in what moments each reform moved or not towards the consolidation of an institutional complementarity. In so doing, it will underscore the fear of bearing the political costs of instability, insofar as it mobilizes actors to push for institutional changes that could foster a stronger connection between both systems. In the Chilean case, such legacies are considerably complex because of the political-economic instability caused by both left- and right-winged governments. This characteristic is important because actors push for the consolidation of institutional complementarities, in order to avoid instability. However, in a polarized polity, what constitutes a cause of instability can change, depending on the political position of the actor. In what follows, I present, in chronological order, the development of this situation, and provide the necessary context within which policy actors made their choices, and how these modelled future reforms subsequently.

Complementary institutions depend on the presence of one another to play their structuring role in the political economy, which, in principle, should bring stability to the latter. In the present case, institutional complementarity would exist when the resources accumulated in the individual-accounts' pension system are used to deepen the Chilean capital markets. Subsequently, deep capital markets would allow for the pension system to offer pensions that preserve, to a reasonable extent, the living standards of the retirees, even though the reforms conducing to those conditions would not have been carried out with those specific goals in mind. Instead, the reforms involved in each of these institutions responded to the specifics of their policy arenas; that is, the institutions that structure the financial system should not be reformed, in principle, with the goal of providing pensions, and vice-versa. Rather, the reason leading to the creation of an institutional complementarity should be the incorporation of policy legacies that would push agents to create a strong link between two institutions.

It is significant that agents in charge of financial regulations were not the same that managed investment decisions on behalf of institutional investors. While this may seem unimportant, it constitutes a strong tenet for the understanding of institutional complementarities. Had the agents been the same, this would have strengthened the argument about incentives for the constitution of institutional complementarities, that is, actors build them because they strategically change a complex set of institutions so they can fit their interests. However, even if the political struggles involved in the transformation of capital markets were influenced by the presence of large investors, these did not necessarily respond automatically. The Chilean experience provides an explanation for the limited role that incentives play *vis-à vis* the political struggles in the constitution of institutional complementarities. If the agents in charge of financial reform and of the promotion of deeper financial markets had been the same as those in charge of investment decisions within the pension system, opposition to the reforms might have been stronger. Therefore, the independence between both spheres is what creates sufficient conditions for the creation of an institutional complementarity.

Given the traumatic events that happened in Chile during the 1970s and early 1980s, the policy legacies that affected the consolidation of institutional complementarities are very complex.[310] The early connection between the financial system and the pension system is a precedent for the phenomena explained here. Because at the time of the pension reform there were not enough financial instruments in which to invest the monthly contributions of affiliated workers, bank deposits were one of the authorized instruments. These resources became significant to the financial system, amounting to 7.7% of the Chilean financial assets at the end of 1982 (Arellano 1985, 734). From the point of view of the pension funds, bank deposits represented 73.39% of their assets at the end of 1982 (Carrasco 2001, 947-948), just before the banking intervention.

One of the considerations made by the authorities when they decided to carry out a thorough intervention in the financial system was precisely the significant pension resources that would have been lost if bank deposits disappeared with bankruptcy (Chumacero et al. 2007, 124). Despite the fact that after 1980, it was relatively clear that Pinochet would remain in power for at least nine more years, and that the loss of pension resources would thus not affect the government as in a democratic regime, an aborted pension reform on which the government have invested considerable time and political capital would have blown the reputation of a government that considered itself as modernizer. Even authoritarian governments seek the approval of their policies.

In 1988, the same year that Pinochet lost the plebiscite, some concerns were already in place regarding the consequences of the increasing resources administered by the different AFPs. This was because once the system was in place, the severe regulations around how AFPs could invest their assets were gradually lifted. Furthermore, since the domestic market was already saturated, the financial risk increased, because a bigger portion of those assets was invested without proper diversification. One solution for this kind of risk diversification was to

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[310] The list of complex policy legacies is a long one. In the political realm these include a socialist government that practically nationalized the entire economy and one of the harshest bureaucratic-authoritarian regimes. To the list of events that would later affect policy decisions, we should also add an economic crisis that contracted the economy by almost 15% in 1982. This event is an important part of the policy legacies that affected the constitution of institutional complementarities between the financial system and pension system. This is due to the political consequences that these events created and the ways in which political actors throughout the 1980s and 1990s used them immediately after the crises and during the transition to democracy to justify their policy decisions.

allow AFPs to invest abroad. This process, however, had also an implicit conflict, insofar as it was not clear why the diversification should be exclusively external, or how this policy would affect workers' retirement. Nevertheless, if nothing was done, in the mid-term, there were other important risks, since the domestic financial market did not supply the necessary instruments to match the demand of the AFPs.

As a consequence, prices could increase artificially which, once again, could affect workers (Pérez 1988, 217). This mismatch could create a bubble in which prices no longer reasonably corresponded to the assets' intrinsic value, consequently increasing financial risks given the possible correction in the alignment between the prices and value of assets, even though, at that point in time, the situation was not on the edge of a crisis. However, the time frame for the appearance of significant problems was between three to eleven years (Pérez 1988, 241). While one solution would be to allow the AFPs to invest in foreign markets, there was also another consideration, insofar as Chile not only needed resources to pay back its external debt,[311] but a real appreciation of its currency was starting to take place.[312]

In October 1988, a plebiscite was held with the aim of reconfirming the mandate of Pinochet, as established in the Constitution written by the regime in 1980.[313] For the regime, it was another rubber-stamping instance, like the plebiscites of 1978 and 1980, to extend the military government for another eight years. However, defying all expectations, the results gave a landslide victory to the "No" option, putting an end to the military government. Throughout the negotiations concerning the transition, both through institutionalized and informal channels, the military and their allies showed how they saw their counterparts representing a danger to the country because of their intentions to return to the kind of policies implemented by Allende's government. In consequence, the military government enacted a

[311] José Pablo Arellano. Interview with the author. Santiago de Chile. August 8, 2014. José Pablo Arellano was Head (1990-1996) of the *Dirección Nacional de Presupuesto* – Diprés (National Budget Directorate) and Minister of Education (1996-2000). He was a prominent member of the *Corporación de Investigaciones Económicas para América Latina* – CIEPLAN (Corporation of Economic Research for Latin America) from its foundation in 1976 onwards, and has served as its Senior Researcher, Member of the Board of Directors and Executive Director.

[312] This was also partially a consequence of the preceding cycle in which depreciation was its main characteristic with a 130% accumulation between 1982-1988 (Ffrench-Davis 2014, 356).

[313] This paragraph relies heavily on Valenzuela (1997).

series of "tying Acts",[314] which involved mainly civilians-military relations and, somehow surprisingly, also granted independence to the central bank, among others,[315] which institutionalized certain authoritarian enclaves (Garretón 1989, 51-63).

The main reason for shielding any possible reform of a cherished policy for authoritarian elites is precisely to avoid any possible changes that the opposition might bring once in power. This is especially the case of the central bank, the only economic law within the tying acts, because authoritarian elites were sure they would lose power soon (Boylan 2001a). The absence of any mention of the pension system or the financial system in such provisions can be attributed to at least two reasons: first, the perceived institutional consolidation of both policy arenas by the authoritarian elites and, second, their mild importance, in the eyes of the opposition to the military regime, vis-à-vis civilians-military relations or the organization of the Judiciary. Between the plebiscite of October 1988 and the inauguration of Patricio Aylwin in March 1990, a heavily charged discourse, which indicated that the military might return to power if they considered it necessary, dominated political debates.[316]

Before it became clear that the military would no longer remain in power, the opposition started to use the same kind of language used by the government's technocrats. This was a way to actually oppose the government because their language could not be dismissed as non-technical, but rather accepted as equivalent to the government's own discourse[317] (Silva 2010, 188-190). However, the priorities of the opposition to the authoritarian regime focused mainly on the consolidation of suitable conditions to the successful transition to democracy, such as civilians-military relations, human rights concerns

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314 The term in Spanish is "*Leyes de Amarre*".

315 These acts regulated: 1. The suspension of possible inquiries by the Chamber of Deputies of any military or public servant of the military government; 2. A freeze of the civil service, which restrained to 400 the available nominations for the incoming president from a peak of 30'000; 3. The central bank autonomy; 4. A law about municipalities, in which Pinochet would nominate council members responsible for subsequent mayors' nominations; 5. Regulation of the Judiciary, allowing for the nomination of a favorable Supreme Court; 6. Civilians-military relations; and 7. An electoral law establishing the binomial system (Valenzuela 1997, 35-37).

316 For a sample of the way in which Pinochet saw the transition and the role of the armed forces and their role in Chilean society, see Valenzuela (1997, 32-34).

317 This was precisely the strategy of CIEPLAN from the mid-1970s; since its members' academic credentials were impeccable, and very similar to the Chilean economic policymakers at the time, they could not be dismissed (Kinney 1997, 237). A decade after, in the last years of the military government, this continued to be the case. For a complete analysis on the role of intellectuals on the opposition to the military government and subsequent transition to democracy, see Puryear (1994).

and, generally, democratic consolidation. In the context of a contentious, if not violent transition, it was important to choose carefully the subject that debates would start on. Consequently, the whole authoritarian heritage was not questioned, including the new pension system.

In fact, reforms were considered an issue that should be cautiously discussed. To the leadership of the opposition,[318] the experience of Raúl Alfonsín in Argentina was to be avoided at any cost. His remarkable political reforms did not prevent the catastrophic management of the economy, which in turn had important political consequences for the unraveling of the transition. The lesson, then, was to conduct the political reforms with the above-mentioned priorities while the economy had to keep working as best it could, so as not to provide the supporters of the authoritarian regime with any arguments to attempt a reversal of the political transition.[319] The democratic forces, that later would form the *Concertación*, were critical of many reforms enacted by the authoritarian government, but they were conscious about the need to keep most of them as a price to pay for democratic consolidation.

My hypothesis is that in the face of the credible threat of a return to deeply unstable situations, the agents that are likely to be affected by such instability will mobilize their resources in order to consolidate institutional complementarities. With the beginning of the transition to democratic rule, in the event of the suggestion of any policy contrary to their priorities, loosely defined, the military threatened a reversal of the transition. Despite the fact that not every menace coming from the deep core of the military regime was taken seriously (Valenzuela 1997, 34-35), it was clear that policy had to be conducted carefully, and reforms had to be subordinated to the survival of the transition. Because not every legacy of the authoritarian regime was questioned, some of them could be carefully enhanced so as not to create political reasons for authoritarians to intervene, whether these reasons focused on political issues, e.g. privatization of banks, or on economic issues, e.g. liberalization of the capital account.

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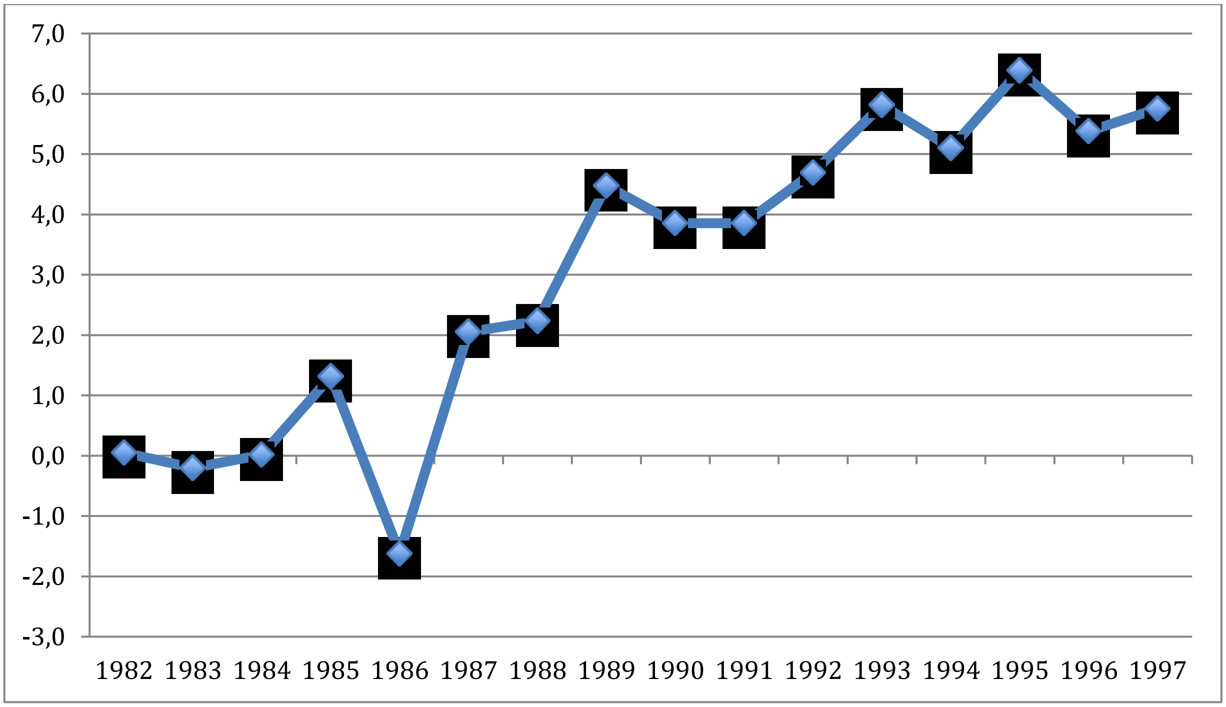
318 While only Carlos Ominami, Minister of Economy (1990-1992) of the Alwyn government (1990-1994), was interviewed by the author, he consistently referred to the opposition as a group during the interview.
319 Carlos Ominami. Interview with the author. Santiago de Chile. August 12, 2014.

At the end of the military government, the pension system had accumulated a significant amount of resources that were saturating the domestic financial market, given the controls imposed on authorized investments. A solution to this saturation was to open the capital account and authorize AFPs to invest abroad, with the aim of diversifying their portfolio in mind as well. At the beginning of the first democratic government, the threat of a reversal to authoritarian rule was moderate, and policy changes had to both preserve macroeconomic stability and foster growth. Opening the capital account in the first two years of the democratic government involved many considerations, including the possibility that Chile return to international debt markets and the need to prepare the country for a better insertion into the world economy (Foxley 1991, 17, 1992, 52). Another consideration was the possibility for AFPs to invest abroad in a move that would allow them to diversify their portfolio. Therefore, in the face of a credible menace to the political-economic stability, agents pushed for a reform that would foster the complementarity between institutions.

Gradually, a consensus emerged among Chilean elites about the general direction of economic policy. Growth with equity was the official strategy. It allowed for the combination of some continuity with the economic policy of the authoritarian regime, focusing on growth, while simultaneously putting emphasis on an aspect in which the regime had clearly underperformed. Therefore, social policies represented a significant change as they were considered the main instrument to increase equity within Chilean society, but always carefully subordinated to the maintenance of growth. This subordination was both present in the instruments chosen and the type of instruments used by social policies. The preferred instruments were those that would not create inefficiencies affecting growth; the scope of social policies had to be in line with the possibilities of the economy, mainly in fiscal terms, but also with attention to the macroeconomic stability of such policies as a way to guarantee them in the long term (Arellano 2012, 11).

Figure 12. General Government Savings. 1982-1997 (% GDP)



Source: Elaborated by the author with data from Bennett, Schmidt-Hebbel, and Soto (1999, 49).

Two particular traits arise in the first half of the 1990s. From a political point of view, the new pension system was not questioned, because it was broadly considered as a positive legacy of the dictatorship, thus had to be carefully handled. However, as there were more pressing challenges, and the available information about the general working of the system was limited at best, giving its recent enactment, it was not considered an important subject.[320] From an economic point of view, the costs were carried out by a significant fiscal effort, in which the public sector had to increase its savings (Figure 12) in order to pay the debts contracted years before, when the pension system started. Even if the national statistics did not have an item focused on the transitional period between the PAYG system and the individual savings account, the responsible official was perfectly conscious of the transfers that fiscal surpluses implied, given the composition of the debt.[321]

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320 Carlos Ominami. Interview with the author. Santiago de Chile. August 12, 2014.
321 José Pablo Arellano. Interview with the author. Santiago de Chile. August 8, 2014

In subsequent years, the political salience of both these traits would switch strikingly. Whereas the fiscal cost of the transition started to decrease as a proportion of fiscal accounts,[322] the political debate around various characteristics of the system soared. At the end of the 1990s, there was far more evidence about the failures of the system, insofar as the accumulated individual savings did not amount to expectations. On the other hand, the transition was more consolidated, as Pinochet was not Chief Commander of the army (1998) and the *Concertación* had, as presidential candidate, a member of the Socialist Party, Ricardo Lagos. These conditions allowed for a wider debate about the whole system that would eventually materialize through a series of reforms that took place in the 2000s.

Supporters of the new pension system argue that it has increased aggregate savings of the country (Schmidt-Hebbel 1997), following the argument advanced by then Minister of Labour José Piñera when the system started (Piñera 1988a). In connection with this reasoning, the substantial amount of resources accumulated by the AFPs throughout the years is presented to the public as available resources that could be used by different economic agents. That is, the resources administered by AFPs have been one of the engines of Chilean growth over the years (Corbo and Schmidt-Hebbel 2003). This fact, however, should be taken with caution; having a register of a given amount of resources does not mean such resources are new. In fact, if funds under the administration of the AFPs grew in the first years of the system, some other sectors saw their available resources diminished, i.e. the public sector (Arellano 1988, 137).

In the mid-1990s, several critical events took place. After the end of the first government of the *Concertación* in 1994, the daunting scenarios depicted by the military authorities at the end of their reign failed to materialize. The *Concertación* implemented an economic policy that could hardly be called socialist, since it respected the basic lines established during the second half of the military regime, i.e. market economy only intervened pragmatically when necessary. After several years, during which neither economic nor political chaos took place, the clout of the hard-liners waned with the plausibility of their predictions. In the economic arena, the Southeast Asian financial crisis exploded, thus increasing the risk aversion of world markets, while also putting an end to the consolidation of

[322] Joaquín Vial. Interview with the author. Santiago de Chile. August 5, 2014

the Chilean capital market. The pension system was openly criticized because the sales war between AFPs affected the profitability of the savings accounts, which forced authorities to intervene.[323]

Therefore, in the mid-1990s, the path leading to the consolidation of an institutional complementarity was no longer straightforward. The deepest concerns about political-economic stability were absent, and political questioning of the reforms started to appear, in part because democracy was more consolidated. The absence of a direct political threat decreased, and so did the force behind the consolidation of an institutional complementarity. When the financial market started to show signs of a change in direction, the answer of the authorities was not to push for a deeper integration with the pension system. Instead, given the importance of the international financial crises (Mexico 1994-5 and South-East Asia 1996-7), economic authorities tried to regulate the influx of foreign capital to the domestic market. On the other hand, the answer of the authorities to the crisis of the sales-war and the commissions of AFPs was precisely to forbid transfers between AFPs, so as to avoid more losses on the individual saving-accounts.

This is a significant trend for the regulation of the pension system as it considered every flaw as a market failure.[324] It is a natural consequence of the way in which the system has been understood, that is, it is a market, and any problem in the efficient allocation of the resources or price misalignment is a consequence of market failure. This approach, nonetheless, did not prevent the appearance of new failures from time to time, subsequently tackled with new reforms. Following this reasoning, regulation can be considered as recurrent attempts to address market failures. While severe crises of the system involving the loss of retirement savings or the misuse of funds were prevented, regulations revealed consistently the

323 In the mid-1990s, AFPs competed for new clients based on transfers of already affiliated workers, thus the increase in their sales force. However, this increased the costs of the AFPs and, therefore, decreased the return of workers' funds. Because this was a consequence of a loophole in the regulation that stated that transfers between AFPs were unlimited, the answer of the authorities was to restrict the possibilities of transfers to very specific situations and to impose a series of relatively strict conditions.

324 Market failures are defined by Mas-Colell, Whinston, and Green (1995, 350) as "situations in which some of the assumptions of the welfare theorems do *not* hold and in which, as a consequence, market equilibria cannot be relied on to yield Pareto optimum outcomes" (italics in the original). The intuition behind this notion is that there are situations in which the market allocation of available resources in a society does not necessarily lead to the most efficient outcome, thus market *failure*. Examples of market failures are externalities and the provision of public goods, market power, e.g. monopolies and oligopolies, and asymmetry of information.

limits of the system and of the regulations themselves to avoid criticisms concerning its functioning. Successive reform attempts, more or less one reform in each government of the *Concertación*, testify to this discontent.

The complementarity between the presence of AFPs and the financial market also started to show its limits in the middle of the 1990s. Institutional investors, which include AFPs, insurance companies, and mutual funds, were an important source of demand for corporate bonds and other kinds of long-term securities. The maturity of these instruments extended continuously up to a point in which twenty-year maturities became a common trait in the middle of the 1990s (Cifuentes, Desormeaux, and González 2002, 96). The Central Bank was instrumental in this modification, as it issued bonds both in domestic and international markets, in order to create a country benchmark, even if Chile had a long tradition of fiscal surplus. These progresses notwithstanding, this market was incapable of promoting a broad deepening of the financial markets that would actually bring up smaller firms. Subsequent reforms did not transform significantly this situation.

The argument that a connection between the resources handled by AFPs and the development of capital markets automatically creates a virtuous circle has been present since the beginning. Thus, by the same account, arguing about the existence of an institutional complementarity in such a setting is tempting. Nevertheless, the measures that were meant to let AFPs invest their resources in foreign markets at the beginning of 1990s did not imply that the interested parties automatically took advantage of them. In the same venue, capital market reforms made available new investment opportunities for institutional investors, mainly AFPs, but not exclusively. At the end of the 1990s, the Asian crisis would have an important effect over the market capitalization of Chilean stocks, launching in turn a debate over the possible causes of such effects.[325] While the terms of that debate are beyond the scope of this discussion, it is clear that the link between a steady provision of finance through AFPs does not necessarily imply these resources will be used in productive activities.

Moreover, subsequent reforms that fostered a closer link between the pension system and the financial system failed to materialize their imbrication. The multi-fund reform of 2002

[325] Cifuentes, Desormeaux, and González (2002) offer a detailed discussion over the causes of the market shrinkage in the mid- 1990s.

had the potential to deepen Chilean capital markets, since a significant amount of resources would have been invested with a diversified risk profile, admittedly the mean of the reform to increase workers' retirement funds. However, the capital market peaked in the mid-1990s (Cifuentes, Desormeaux, and González 2002, 88-89), just before the Asian crisis, indicating that even if the multi-fund reform had an impact over risk diversification, this impact was not enough to deepen it further.[326] Additionally, the incorporation of policy legacies was less pressing, since neither economic nor political instability hung over the horizon, as was the case in previous reforms, despite the political pressure to improve the functioning of the pension system in favour of the workers.

The 2008 and 2014 reforms to the pension system reveal how the complexity of policy legacies affects the consolidation of institutional complementarities. Both reforms tried to enhance the individual accounts' based system, but in no way were they meant to replace it. An attempt to replace it would have been political suicide for the first Bachelet government (2006-2010),[327] since the system is considered one of the positive legacies of the military regime. Thus, in Chile, it is politically untenable to completely replace the system based on individual accounts. Instead, such reforms sought to enhance some of its features, so as to include a bigger portion of the population in a system that provides a minimum pension for the poorest 60%, even though such a significant departure from previous reform attempts was also received with deception by sectors that saw the possibility of replacing the system, which would have represented a true breaking with the past. The fact that such policy goals were present in the political debate is evidence of the presence of another policy legacy that some people hoped to wipe out.

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326 Braun and Briones (2008, 158-159) provide an explanation for the virtual oligopsony in the market for corporate bonds where AFPs and insurance companies account for 80 to 90% of the outstanding corporate bonds. Both AFPs and insurance companies are legally bound to buy securities rated above the BBB level, which restricts the pool of successful issuers in the bond market. This insight also offers a possible explanation for the lack of consolidation of a deeper capital market despite the increasing availability (~70% GDP in November 2016) of resources administered by AFPs. By definition, non-risky investments must be a small share of the whole pool of possible investments; therefore, AFPs would have a difficult time deepening more capital markets so as to invest in smaller businesses, which are riskier. Otherwise, their investments will continue to be concentrated on the bigger, and less riskier, companies with which the argument about the impact of AFPs on Chilean growth is weakened. For the figure of share of GDP, see Chile (2016d, 1).

327 This is also the case during the second government (2014 – 2018), when another reform was discussed.

The institutional changes implemented to the pension system during the 2000s, such as the multi-fund reform of 2002 and the introduction of the solidarity pillar in 2008, tried mainly to bring some modifications without fully replacing it, because a complete departure from the system was not politically feasible. This indicates that policy legacies from the military government have not disappeared. Even if in the late 2000s and during the first half of the 2010s an authoritarian reversal is unthinkable, there are important sectors of the population that consider a significant departure from the current status quo to be an incitement to political action to change the government that implemented it. Michelle Bachelet, the president that pushed for the 2008 and 2014 reforms, was perfectly aware of the governability crisis that a bold move, such as eliminating the individual accounts' pension system, would bring. In this sense, the threat of political instability still exists, caused by policy legacies, even if it has been greatly diminished. Therefore, institutional complementarity would only be partially consolidated, insofar as both institutions remain in place. Thus, in a sense, institutional complementarity is still a possibility.

4.6. Concluding Remarks

Whether the new pension system that replaced the old PAYG system has been good for the economy, in general or not, remains a contentious issue in Chilean politics. The settlement of this dispute is beyond the scope of this work. The relevant question is whether or not the new pension system is a manifestation of an institutional complementarity. An institution that belongs in the labour market is used in a complementary way with another institution from the financial market in order to create a virtuous circle of stability and growth. The hypothesis advanced by the present work with regard to the incorporation of policy legacies shows that when legacies do not represent a direct political threat to the stability of the political economy, institutional complementarities are only partially consolidated. Since policy legacies remain present, however, they can be fully incorporated later on. These concluding remarks will weigh those arguments *vis-à-vis* the theoretical comprehension of phenomena like institutional complementarities.

There is not enough evidence that suggests, unequivocally, that the Chilean pension system fostered economic growth. Although there is some evidence pointing in that direction, the limited amount of pensions that the system pays leads us to move carefully in this analysis. Had the system started to pay pensions, and had it helped the financial system to keep some of its dynamism, an argument in favour of its role in fostering growth would be more convincing. On the other hand, the system is perceived rather as reproducing the big inequalities present in Chilean society. Regulation has been portrayed as the way in which the state can protect the people who forcefully invest in the financial market from its uncertainties, due to its asymmetric information characteristics (Berstein and Chumacero 2003, 17-18). However, this kind of protection is not enough to solve its inequality-reproducing biases.

However, even if the conditions have been met, it is still unresolved whether the Chilean pension system turned out to be an institutional complementarity. The answer is admittedly ambiguous. A positive answer would require that labour market savings (i.e. pensions) are part of a deep financial system from which enterprises can take advantage in order to finance their activities. This must be accomplished while paying the pensions, admittedly the main goal of the system. The second condition is not present yet, given that workers contributing to the system are still working. Thus, the system has the potential to become an example of institutional complementarity, but proof is not yet available. Besides the industries that benefited from the pension system since the beginning (e.g. housing, insurance, infrastructure), the system also supplies financing for Chilean firms to internationalize their operations. This would be more expensive without the available resources offered by the system.[328]

Enthusiasm about the system notwithstanding, it has not paid many pensions; therefore, at present, there are insufficient clear scenarios for a cash-flow profile, when liabilities may still become as important as accumulated assets. Moreover, the manifestation of complementarity will depend on the possibility of keeping a steady supply of financial resources for Chilean enterprises, while paying a significant amount of pensions. This point is often left aside by enthusiasts of the system, while critics readily point it out. The pensions currently paid by the system have as their main source the transitional transfers from the old

328 Joaquín Vial. Interview with the author. Santiago de Chile. August 5, 2014.

regime to the new one, thus they are paid by the state,[329] which, in turn, means that these pensions correspond to a transfer from the state to newly retirees. After many years of functioning, paradoxically, the pension system as such has not paid many pensions.[330]

Despite that several years have passed since the political and economic crises that affected the stability of Chilean political economy, some of these events still play a crucial role in everyday politics. This influence, however, has waned over the years in comparison to the immediate afterwards of the transition to democracy, when an authoritarian reversal was still a possibility. However, the economic legacy of the authoritarian regime has been framed in a positive way, which in turn makes significant changes to some of its landmark policies politically difficult. The presence of these legacies in the political arena, in a milder form than they were before, has caused a situation in which the constitution of an institutional complementarity is less likely than in the aftermath of the transition to democracy. The threat posed by these legacies to the stability of the political economy is not as strong as it was at the end of the military government, but it has not disappeared completely either.

Another dimension that continues to be contentious in Chilean politics is the regulation of the pension system, since many actors question the entire regulatory regime and how it protects workers' interests within the system. In fact, it is quite the opposite, insofar as the *Superintendencia de Pensiones* – SP (Superintendency of Pensions)[331] is supposedly referred to by the industry as *La Sucursal*, or the affiliate.[332] It is difficult to determine whether regulations have been tailored to the needs of the industry or not. This dimension, however, has been a source of political discontent with the system, and could trigger a reform of the system down the line. This situation also points to the negative consequences of the creation of institutional complementarities, and to what extent the positive effects in terms of growth are perceived as such by the different actors of Chilean polity. The same analysis holds for its regulation.

329 These transfers are called *Bonos de Reconocimiento* (Recognition Bonds) and are a one-time deposit made by the state to the pension account of each worker who contributed to the former system at the time of retirement.
330 Gonzalo Cid. Interview with the author. Santiago de Chile. August 1, 2014
331 With the 2008 reform, the old SAFP was transformed into the SP.
332 Carlos Ominami. Interview with the author. Santiago de Chile. August 12, 2014.

The changes enacted by the last reforms were paired by the proper regulatory measures, thereby shaping the system using the latter. Following the trait of essentially solving what are perceived as market failures, the oligopolistic character of the system was tackled with an inversed auction[333] strategy. Since the entry barriers were high, the 2008 reform stated that the winner of the inversed auction would bring together all new entrants into the system for a two-year period, in an attempt to bring down the average fee of the system. Every two years, there will be a new auction to keep the fee down. While following the first auction (2010), a new AFP was created, thus bringing a new provider into the market, it is not clear if this will become the trend for the whole system.

There is, however, an important caveat to the inversed auction strategy. The system will soon arrive at a threshold, at which point it will start to pay pensions to the people who started contributing since its inception. In order to pay these pensions, new costs will be added to the production function of the AFPs, thus reducing their profit margins. Nevertheless, insofar as the prices remain at a low threshold, the only way to make profits will be to downgrade the quality of services provided by AFPs.[334] On the other hand, the strategy of lowering the prices of the system matches how one of the problems of the system was framed; that is, the accumulated savings of the workers could be higher, if the prices are lower.

333 The inversed auction implies that the bidder with the lowest price will win the auction. In this case, the AFP offering the lowest fee will win the auction.
334 Joaquín Vial. Interview with the author. Santiago de Chile. August 5, 2014.

Chapter 5. Tying Hands, But Not Too Tightly. Institutionalizing Mexican Economic Policy

We are concerned here with economic governance and the way in which institutional reforms depend on one other to succeed, success being measured in the form of political and economic stability. A certain group of actors, seeking to prevent instability, try to create institutional complementarities between liberalizing reforms out of the inclusion of policy legacies. Some Mexican Presidents used the formal and informal powers of their office to implement economic policies that adhered to their political priorities while simultaneously disregarding measures that were more prudent at a time when the Mexican economy suffered its worst crisis in decades. Thus, in the Mexican context, the result of presidential power over economic policy became associated with economic instability. The institutional complementarity, or, in this case, the lack thereof, is composed of an institution limiting presidential discretion over monetary policy and other institution limiting discretion over fiscal policy, more particularly, using debt to finance deficits.

Not all presidents thought or acted alike. Nonetheless, new institutional reforms seeking to limit presidential discretion over economic policy were introduced, partly to quash a threat in the form of a serious contender for the presidency, one whose political agenda would presumably lead to another bout of instability. This threat never materialized because the candidate was defeated. And, in spite of these institutional reforms, Mexican presidents still maintain a certain degree of maneuverability when it comes to running deficits. The institutional complementarity in this case did not come into force. This chapter intends to show *why*, in the context of the Mexican political economy, institutional complementarity could not be achieved in spite of efforts to keep fiscal policy out of the president's reach, which would have complemented the lack of discretion over monetary policy. Moreover, it will also show how the increasingly important role of the market has nonetheless allowed economic authorities to maintain a significant margin of action.

Two stories: *Banco de México*'s independence in the early 1990s and budgetary reform taking place between 2003 and 2006, are part of the argument. The former spanned a decade (1982-1993) during which bureaucrats sought to confirm their authority over monetary policy using a combination of ideological and material resources of both domestic and international origin. The latter occurred during the presidency of Vicente Fox (2000-2006) as a result of the increasing popularity of left-wing politician, Andrés Manuel López Obrador, whose opponents sought to restrict his possibilities both electorally and in terms of policy space. López Obrador lost the Presidential election in 2006 and with this loss, the perceived threat of political instability disappeared (or was at least deferred).

The financial needs of the state depend on the role of the state in society - providing public goods for instance - and on the market in the form of investment. The role of the state results from political struggles within and out the state. At the center of such struggles is the redistribution of power from the Executive, as the head of the state, to other political actors and institutions. Both the independence of the central bank and a commitment to a balanced budget are a means of limiting the ability of the political authorities to act discretionally. Whereas these reforms by themselves do not entirely describe the role of the state in the economy, they certainly establish limits as to what the state can or cannot do. The structuring character of such limits varies and some can be more effective than others.

This chapter explores the way in which two institutions, the central bank and the budget, traditionally considered central to modern statecraft, were reformed, altering the way in which monetary and fiscal policies were implemented. These reforms differ both in the moment in which they were carried out and by the political process leading to their implementation. Even if these transformations appear to have decreased the margin for action of economic authorities, as specific policy paths have been locked in, there have been a series of adjustments. This has been a process, in other words. I first consider the autonomy of the *Banco de México* – Banxico (Mexican Central Bank)[335]. The second institutional transformation is the creation of a new budgetary Act, which enshrines budgetary responsibility as one of its central principles. Thus, the fear of instability can trigger an

335 The acronym Banxico is going to be used in this work to refer the *Banco de México*, not the least because this is the way in which the institution in widely known in Mexico and abroad.

explicit reform, meaning a formal change to institutions, or a new interpretation of current institutions. If the fear subsides for whatever reason, a reinterpretation of institutions is expected. This in turn affects institutional complementarities from forming.

The first reform is important not only because it changed the way in which monetary policy was applied but also because of the way in which actors shaped it without any significant reference to expectations concerning central bank independence. The second institutional transformation is important because it imposed limits on debt accumulation; thereby changing the way in which economic authorities used debt as a policy instrument. Complementarity between both institutions would imply a tight restriction on the president's discretion over economic policy. The legacy of this crisis of the early 1980s led actors in the Mexican political economy to demand and create such reforms. However, once one institution was in place, the threat to stability posed by those policy legacies disappeared. In turn, complementarity between those institutions seeking to limit the Mexican president's discretion over economic policy also disappeared.

Historically, presidential discretion over economic policy was a rare occurence in Mexico. Economic policy was in the hands of the *Secretaría de Hacienda y Crédito Público* – SHCP (Ministry of Finance) through several instruments. There was also an agreement among the elites about the model the Mexican economy should follow. Even if there was some debate about the way to implement such a model, the authority of the Ministry was never fundamentally questioned until 1970. When President Luis Echeverría (1970-1976) got into office, the *Partido Revolucionario Institucional* – PRI (Institutional Revolutionary Party)'s regime was in a deep legitimacy crisis because of the events of Tlatelolco in 1968.[336] For Echeverría the solution was to increase government spending but the Ministry and Banxico did not agree. In the middle of his term (ca. 1973) the president declared, "Economic policy is made at *Los Pinos*" (the presidential mansion). The phrase was intended to signal the upper

[336] Tlatelolco is a centric and historic square in Mexico City where, in October 2, 1968, policemen and students clashed violently leaving many students dead. The acting President was Gustavo Díaz Ordaz (1964-1970) but the *Secretario de Gobernación* (Minister of the Interior) was precisely Luis Echeverría. The latter responded to a criminal process in the 2000s, for which he was acquitted in March 2009 (Avilés 2009), for his responsibility in the violence against students. For an academic analysis, see Zermeño (1981), whereas some literary and journalistic accounts of those events are presented by Paz (1987) and Poniatowska (1991), which is the English translation of Poniatowska (1988).

hand held by Echeverría in his struggle with the financial apparatus of the state (Centeno 1994, 82-83).

The presidential influence over economic policy increased as the former checks and balances in this arena were reduced following Echeverría's claim. His successor, José López Portillo (1976-1982) reproduced the same pattern when he began to conduct economic policy against the advice of his bureaucrats (Centeno 1994, 159-160). This episode was staged within a broader conflict over the running of the exchange policy (Maxfield 1997, 102). While 1982 may be a turning point in the broad reform agenda of the country, the presidential influence over economic policy continued to increase. The ascension to power of Miguel de la Madrid (1982-1988) in the middle of a large crisis provided legitimacy to a new elite claiming their economic competence. It also catalyzed a series of reforms that would change the role of the Mexican state in the economy.[337]

The presidential power over economic policy increased steadily when Miguel de la Madrid took office. De la Madrid brought with him a new bureaucratic style in which competence in economics was essential for promotion (Centeno 1994). Conflict ceased partly because the new president came from the economic bureaucracy. Efficiency was among the highest priorities in this gradually changing role of the state in the economy. This new vision was more a response to Presidents Echeverría and López Portillo's "populist"[338] deviations from sound economic policies than the triumph of better economic or bureaucratic doctrine. It was also during these governments that the new bureaucracy increased its power within the Mexican state (Centeno 1994).

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337 This reform process was incremental, however. At the end of his period, López Portillo nationalized the banking sector enshrining this change in the constitution leaving little room to maneuver to the next government. De la Madrid sold the brokerage houses belonging to banks as well as the maximum equity allowed to retain control of the banks. With this approach the government still complied with the constitution by retaining ownership and control of the banks while also changing the role of the state in the economy.

338 Populism is defined as "a political strategy through which a personalistic leader seeks or exercises government power based on direct, unmediated, uninstitutionalized support from large numbers of mostly unorganized followers" (Weyland 2001, 14). However, among the many definitions discussed by Weyland, there is another one referred as the populist policy cycle that is "characterized by overly expansionary macroeconomic policies which lead to high inflation and severe balance of payments crises." "Economic populism" it continues "(…) has been adopted by governments representing a wide range of the political spectrum, and has not been the exclusive province of the left or right" (Sachs 1990, 139). Given the shared professional backgrounds of high-end Mexican bureaucrats and the author of the latter definition undoubtedly this was their conception too.

The crisis came after Mexico had been "managing abundance," as López Portillo's government described it, for some years. This abundance was a consequence of the oil rents that started to flow into Mexico after big discoveries in the mid-seventies. With the hike in oil prices, the flow of foreign revenues increased substantially. These new resources piled up with some newly acquired debt (Figure 13), which expanded the permanent expenses creating in turn an unstable situation. Soon, the foundations of this strategy revealed their weaknesses. When oil prices fell in 1981, the market conditions for refinancing the running debt subsequently deteriorated. The following year was particularly agitated. Mexico not only defaulted on its debt but also nationalized its banks. The monopoly of the PRI over the Mexican political system guaranteed that such bold measures were not challenged.[339]

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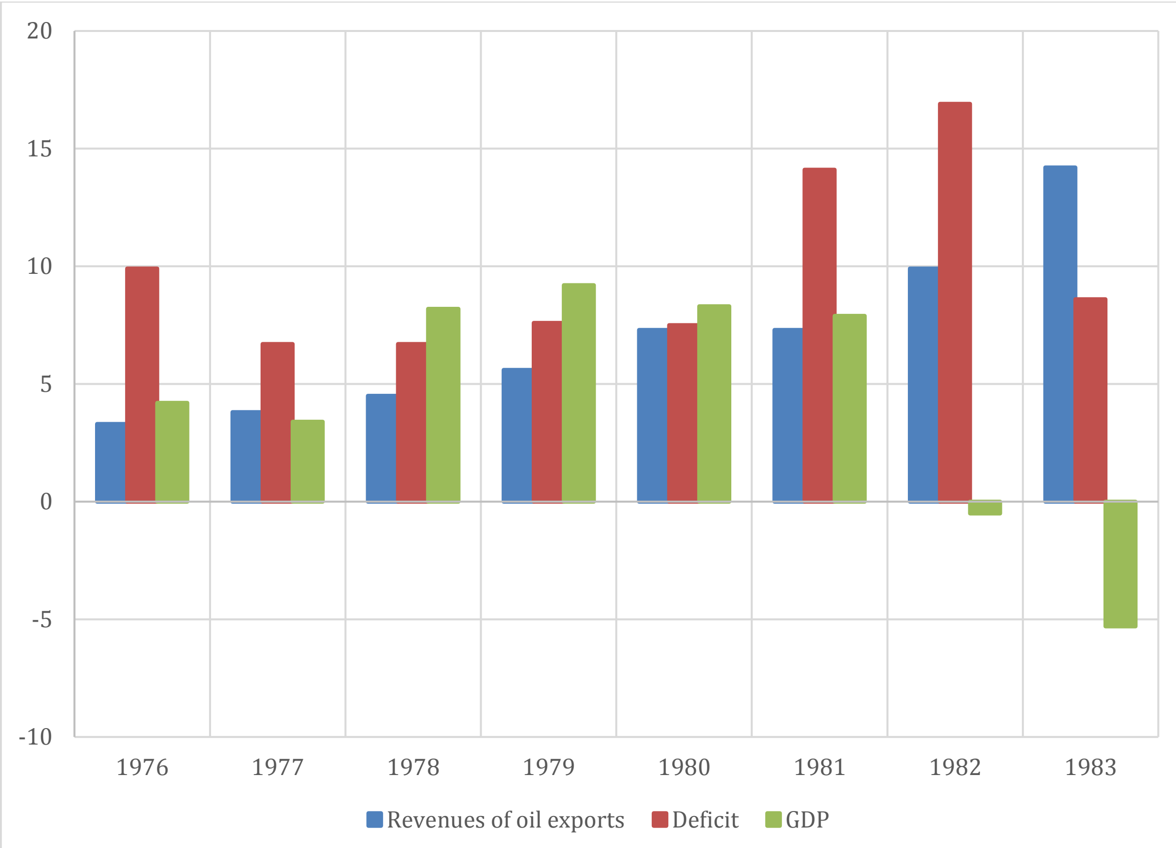
[339] The PRI established a corporatist regime in 1929 after the Mexican Revolution, where the bureaucracy always held the upper hand while the other members of the "Revolutionary Family", workers, through its control of the *Confederación de Trabajadores Mexicanos* – CTM (Mexican Workers Confederation), and peasants, through the *Confederación Nacional Campesina* – CNC (National Peasant Confederation), acquiesced while providing a veil of democratic legitimacy. The President, in turn, as the head of the state, had a say over the career path of the members of the bureaucracy who sought to advance through its ranks. Because the President controlled the bureaucracy, which in turn controlled both workers and peasants, no significant opposition could have appeared. For the way in which the PRI incorporated labour, see Collier and Collier (1991); for the way in which the state became autonomous from peasants, labour, and capital in the aftermath of the Revolution, see Hamilton (1982); for the relationship between the bureaucracy and the broader Mexican political system, see Centeno (1994), especially chapters 3 and 4 where an extensive discussion and bibliography on the Mexican political system appears.

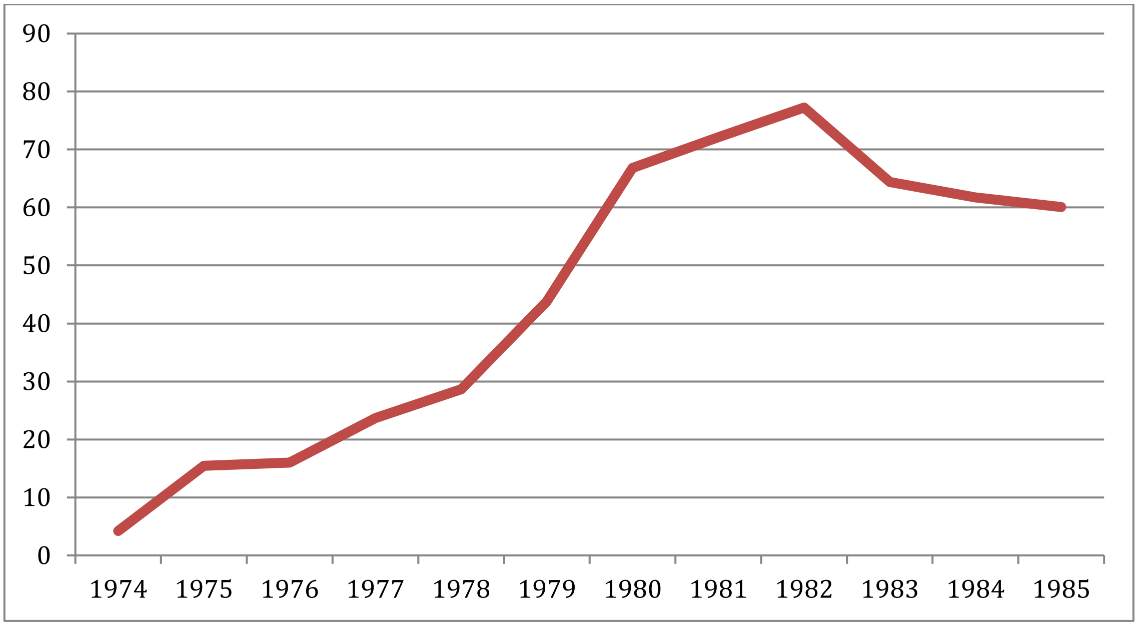
Figure 13. Public Revenues of Oil and Public Deficit. (%GDP)



Source: Elaborated by author with data from Moreno-Brid and Ros (2010, 350-351); GDP series indicates the annual variation. The correlation coefficient between revenues of oil exports and deficit from 1976 to 1982 is 0.7436.

Lustig (2002, 48-52) asserts that Mexican authorities were both responsible for not taking the proper measures regarding the situation and victims of circumstance, as they were not the only group to misread the signals. On the domestic front, the mismanagement of the newly acquired resources derived from the oil discoveries was the main issue. On the international front, the combination of a fall in oil prices as well as the significant hike in interest rates, made debt service very difficult because oil was the main source of foreign revenues (Figure 14). The response to these restrictions involved attempts by López Portillo to micromanage the exchange rate creating conflicts with his bureaucrats, and triggering bank nationalization. This last can be understood as an effort on the part of the Mexican government to secure some financing when other sources were no longer available.

Figure 14. Fuel exports (% of merchandise exports)



Source: IBRD (2016b) World Bank staff estimates from the Comtrade database maintained by the United Nations Statistics Division. Weighted average. The classification of commodity groups is based on the Standard International Trade Classification (SITC) revision 3.

On more operational issues, the bank nationalization had a lasting impact on Banxico's position within the financial structure of the Mexican state. Because of the banking sector nationalization and the impossibility of the government to divest itself of these assets, Banxico was charged with the task of administering the nationalized banks. In the long run, this discretional action gave a political argument for those who, later, would argue in favour of autonomy for the central bank.[340] This episode became the main symbol of recent political-economic instability mainly because it was based on the absolute discretion of the president over economic policy. This situation caused instability because no credible institutional check or balance could have prevented such a move; thus, institutions were reformed to prevent future presidents from dictating economic policy at their discretion.

340 While the *Banco de México* was created as an autonomous institution in 1925, soon its statutes were modified following the new economic conditions after the Depression and the settlement of the Mexican Revolution with the government of Lázaro Cárdenas (1934-1940), therefore autonomy was not a characteristic of Banxico during the five subsequent decades of its existence. In fact, it always served as the financial agent for the state. There were five reforms to the statute governing Banxico throughout the twentieth century (1934, 1954, 1972, 1983, and 1993), which are studied by Maxfield (1997), in which the autonomy of the bank was modified. This particular institutional trait is, partially at least, an indication of a shift in conception surrounding the relationship between monetary and fiscal policies with more autonomy meaning less subordination of monetary policy to the financial needs of the state.

This moment of Mexican history is critical because of its political and economic implications. Whereas the political consequences of the crisis did not go as far as causing a regime change, it is clear that political actors in Mexico felt that this event should not repeat itself. Because the crisis was serious, a series of reforms, such as privatization and trade liberalization, started to gain traction. The events of the 1982 crisis - including a decrease in exports due to the fall in oil prices, the subsequent debt moratorium, and the bank nationalization - were manifestations of a deep economic crisis indicating that the accumulation model was no longer viable. Even if political decisions were the cause of only some of those traumas, the decision makers were deeply associated with all of them. With such an association, an enduring legacy was created insofar as it became politically salient not to reproduce any of the political and economic events of that time. These were the seeds of many political reforms in the years to come.

The second reform studied here was produced as a result of a political conflict between the two poles of the Mexican political system: the President Vicente Fox (2000-2006) and the mayor of Mexico City Andrés Manuel López Obrador (2000-2005), right and left respectively. The popularity of the latter throughout his tenure as mayor resonated with his possible contenders. While his mandate was challenged through judicial procedures to prevent his possible candidacy at the presidential elections of 2006, simultaneously in the Congress, a bill reforming the budget and curbing the state's ability to run deficits was presented. These two seemingly disconnected facts were related by the fact that the candidate was considered a menace to Mexican economic institutions, thus the need to prevent the possibility of deficits. The implicit message was that a López Obrador government would reinstate Echeverría and López Portillo's policies, which would lead, inevitably, to a return to the 1982 crisis. Therefore, the possibility for an institutional complementarity in the Mexican case was increased when Mexican politicians feared that a presidential candidate would create an instability similar to that created by Echeverría and López Portillo, because elections and privileges would be lost if such a candidate would become president.

This chapter is divided into five sections, the first of which has been this introduction. The second and third sections will analyze the political and economic processes behind the transformation of the core institutions of monetary and fiscal policies, namely the status of

Banxico *vis-à-vis* the Federal Government, and the budgetary rules involving mainly the debt and its administration. The fourth section analyzes the potential for institutional complementarities. The last section draws some preliminary conclusions about the institutionalization of Mexican economic policy and the challenges and possibilities for present and forthcoming economic authorities.

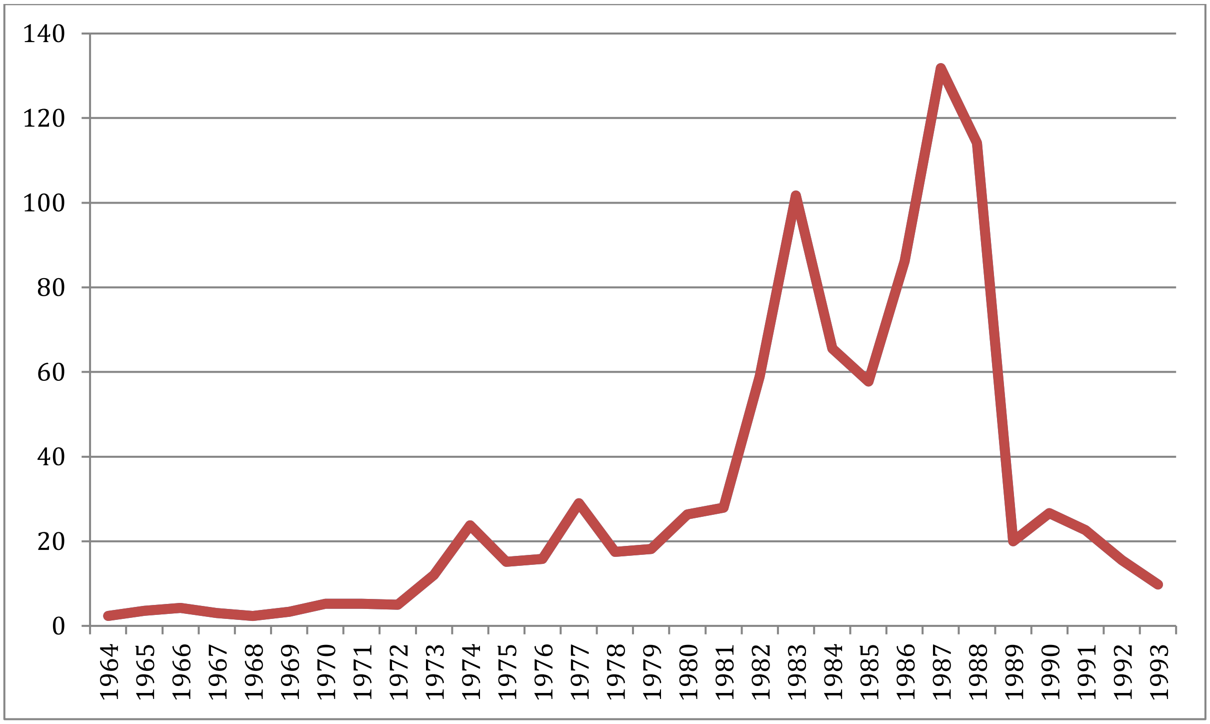
5.1 *Banco de México*: Mexican Economic Policymaking as Eternal Return (of Crises)

Conventional wisdom asserts that an independent central bank is essential to controlling inflation.[341] This certainty was the product of an intellectual trend beginning in the 1970s that would consolidate in the 1990s. In 1993, *The Economist* magazine declared "The intellectual case for central bank independence is more or less won."[342] However, when the Mexican experience is closely analyzed, the relationship between the control of high inflation and the independence of the central bank is less clear. While inflation in Mexico started to increase significantly in the second half of 1970s, reaching its peak in 1987, it was controlled in a two-year window with a reduction of 87% respective to its highest value (Figure 15). The reform that granted independence to Banxico was enacted in 1993 after an easy journey through the National Congress. If the institutional reform that would theoretically bring inflation down was passed after it was effectively achieved, what are the reasons behind such reform?

[341] A central bank is considered independent when its decisions do not depend politically on any other actor within the political economy. This independence normally implies that political authorities cannot change central bank governors, cannot change budgetary provisions for the bank, and in many occasions do not participate in its decisions. The main example of an independent central bank is the European Central Bank, which was modelled on the Bundesbank.

[342] "Narrow Money," *Economist*, August 28, 1993, p.16.

Figure 15. Inflation, Consumer Prices (Annual percentage)



Source: IBRD (2016c). Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as annually. The Laspeyres formula is generally used. International Monetary Fund, International Financial Statistics and data files

This section will analyze those theories notably by explaining central bank independence. Political science's models are particularly concerned with reform in the Global South.[343] Because the Mexican experience conforms neither to economic nor to political science models, the factors behind such reforms in Mexico will then be analyzed. As mentioned above, these factors are of both national and international origin.

[343] The expression "Global South" refers to those economies that are not advanced capitalist economies; 'Emergent economies' is yet another designation for these countries. The blurriness of these denominations is exemplified by Chinese officials resisting the change from "emergent economy" to "market economy" within the frame of the World Trade Organization as the latter would render illegal many subsidies offered by the government.

5.1.1. Central Banks. Theory and Practice

The end of Bretton-Woods and the oil shocks of 1970s created deep wounds in economies around the world. Coping with a problem such as inflation became an intellectual as well as a policy challenge. Rational expectations and its implications to monetary policy were discussed (Lucas 1972), and the solution offered to policymakers was the role of rules in the conduction of economic policy. The argument is thus: that the fully rational policymaker can change his policy path as the economy changes. However, this practice may bring suboptimal results in terms of economic performance. Therefore, the best possible solution, is to implement rules for how economic policy was to be conducted (Kydland and Prescott 1977). Advanced by the literature, is the importance of business and political cycles to the sitting government, particularly when it comes to manipulating macroeconomic instruments to stimulate growth as a means of staying in office.

When that is not possible, politicians tend to make it more difficult for their successors to carry out their promises, again through the use of macroeconomic policy (Nordhaus 1975, MacRae 1977). Essentially, politicians will try to manipulate economic policy disturbing key economic variables and ultimately laying the blame for such disturbances at the feet of the incoming administration. These kinds of cycles would promote inefficiency and instability in the economy. A solution to this plague on economic policy would be to take macroeconomic policy out of the reach of short-term, short-sighted politicians while granting that responsibility to a third party, preferably with a more long-term vision. This would bring stability to macroeconomic policy (Alesina 1988, 39-40).

As Boylan (2001a, 30-35) argues, it is not clear why politicians should value stability above everything else. Instead, left-leaning politicians should value redistribution or control of the economy while their right-leaning counterparts should value stability and expenditure restraint. This argument makes an important point about the different preferences of economic and political agents. Because the models of Lucas (1972), Nordhaus (1975), Kydland and Prescott (1977), MacRae (1977), and Alesina (1988) take a representative politician as the relevant agent,[344] they cannot take into account the crucial differences existing in the political arena. In this literature, the evidence suggests that countries with independent central banks[345] had less inflation and a lower government expenditure/Gross National Product – GNP ratio (Alesina 1988), which is a stylized fact. Rogoff (1985, 1187) explains "why many countries set up an independent central bank and choose their governors from conservative elements of the financial community".[346]

Further inquiries to find a causal relationship between central bank independence and low inflation were carried out since conclusions were far from unequivocal. According to Cukierman, Webb, and Neyapti (1992, 283) causality operates in two directions: when inflation is high, the turnover of central bank governors is high, which in turn causes higher inflation. Some new evidence, less rigorous though, put forward by Alesina and Summers (1993, 159) suggests that monetary discipline along with the central bank's independence reduces inflation levels. Also, after offering some caveats about this relationship, these authors suggest, "Our results here do, however, create some presumption that the inflation benefits of central bank independence are likely to outweigh any output costs" (1993, 159). Again, theoretical models appear to confirm and validate conventional wisdom: an independent central bank reduces inflation.

From another perspective, central bank independence has also been studied by scholars interested in the delegation of responsibilities to an independent government agency that exists within the realm of public administration. The main issue is how an agent – the independent bureaucracy – responds to its principal: Congress or the president, or both. Discretion would exist if the bureaucracy pursued a policy that the principal did not expect at the moment of its appointment (Calvert, McCubbins, and Weingast 1989, 605). In such a setting, independent central banks would represent an attempt to delegate monetary policy to an outsider mainly

344 In microeconomics, normally the agent is the median consumer, firm, and so on. This is a consequence of the conditions for a competitive market demanding that all actors are alike. Thus, taking into consideration the median politician in this context means that he is the representative agent.

345 Bade and Parkin (1988) and Masciandaro and Tabellini (1988), among others propose that independence is affected by four factors: 1. Institutional relations between the Bank and the Executive; 2. Informal relations and contacts between the Bank and the Executive; 3. Budgetary and financial relations between the Bank and the Executive; and, 4. Macroeconomic relations. However, is not clear what criteria were used for such an assessment.

346 Adolph (2013) argues that the career paths of central bankers explain why in that moment in time such a trend was in place.

with the goal of keeping inflation low. Following the arguments of Calvert, McCubbins, and Weingast (1989), independent central banks do not exercise discretion insofar as they pursue the goal politicians want them to pursue at the moment of delegation. New Public Management provides some explanations about the delegation of public responsibilities to independent bodies (Thatcher and Sweet 2002), such as central banks (McNamara 2002).

Although theoretical arguments were derived from, or studied using as evidence, the experience of both industrial and non-industrial economies (Cukierman, Webb, and Neyapti 1992, 355), a different kind of explanation was developed for central bank independence in the Global South. Developing countries as well as transitional economies made the change towards an independent central bank in the 1990s. During the first half of the decade, at least thirty countries, most of them classified as developing, reformed their laws governing central banks (Maxfield 1997, 51). Maxfield's argument is that developing countries grant autonomy to their central banks for external reasons. As global finance became more important during the 1990s, what foreign investors had to say regarding economic policy also became important. Therefore, politicians would try to signal their country's creditworthiness to foreign investors by granting independence to their central bank (Maxfield 1997, 4). This change however varied depending on a number of factors: balance of payments, politicians' tenure, expectations about the effectiveness of such change, and the restrictions of financial transactions. Maxwell's explanation emphasizes the international arena.

Boylan (2001a) argues, in turn, that transitional politics is one of the most important explanations for central bank independence. The cases in her study are Chile and Mexico. According to Boylan, central bank independence reform occurs only when authoritarian elites expect to lose power. When the transition begins, they have a strong incentive to protect what they consider to be an important policy. Central banks are a privileged venue insofar as their control of significant instruments of economic policy makes them especially important for the continuation or rupture sought by authoritarian incumbents or democratic reformers, respectively. Another reason behind the shift towards an independent central bank relies on bureaucratic politics. That is, incumbent bureaucrats might push for reform while politicians may not want to grant them their desired autonomy (Ballinas-Valdés 2011, 111).

Theoretical arguments explaining the move toward an independent central bank vary from the more abstract in which a representative agent uses macroeconomic policy in *ad hoc* fashion to foster short-term interests, to the more mundane arguments of transitional and bureaucratic politics. However, none of the preceding arguments fully describes the Mexican experience. For example, a central assumption in the literature, that central bank independence *causes* low inflation, does not account for the Mexican experience. As will be shown below, managerial and bureaucratic isolation do not conform either to the Mexican case given that the Minister of Finance retained non-negligible competencies in key economic instruments, thus putting into question the extent of the bureaucratic isolation. The creditworthiness hypothesis suffers a serious blow when one considers that neither was there a crisis on the horizon nor were financial constraints foreseeable when Mexican reform was enacted. While the idea of policy isolation in transitional times has some traction to explain such reforms, the transition had not begun at the moment of legal reform.

5.1.2. Brewing a Reform

In this section, the various hypotheses seeking to explain the process of granting independence to a central bank will be applied to the case of Mexico. The first hypothesis is that such reform seeks first and foremost to control inflation. That is, an independent central bank is the reason why countries are able to control inflation. The second hypothesis is that politicians delegate to an independent body, a central bank, a highly technical policy such as monetary policy because they want to control inflation. The third hypothesis is that some countries grant independence to their central banks in order to signal to foreign investors their country's creditworthiness, this being a response to the increasing importance of international financial markets. Finally, the fourth hypothesis concerns transitional politics insofar as authoritarian elites facing an imminent transition seek to protect monetary stability by granting independence to the central bank. Let us consider the first hypothesis.

Throughout the years, the place of Banxico within the structure of the Mexican government remained more or less unchanged. While there were periods in which the functioning of the Bank was not disturbed by interferences on the part of the Federal

Government, it was clear that the former was just an extension of the latter. During the period of "Stabilizing Development,"[347] in which the Minister of Finance was Antonio Ortiz Mena (1958-1970), Banxico enjoyed moments of stability in its roles and functions. This encouraged a relationship of mutual respect between the Ministry and the Bank in which the former did not push for policy measures not supported by the latter. During the second half of López Portillo's government, on several occasions, the president began to manage exchange policy ignoring not only the advice of his own counsellors but also overriding Banxico's high level bureaucrats.[348] While these two accounts show extreme cases of the relative position of Banxico within the structure of Mexican economic policymaking, its position was usually that of just another organization, among many, at the disposal of those who exercised power.

Banxico's bureaucrats, who saw their priorities ignored, recognized this secondary status. There was, however, some ambiguity in the relationship between Banxico and other economic authorities. Because Banxico held a certain degree of prestige among economists and the financial community in general, not following its advice had consequences, if only symbolic. This was especially the case when its officials were called to deal with the consequences of politicians' actions on behalf of the Mexican state. It is worth noting that these situations were more of an issue during financial crises, mainly during the early 1980s but also from 1994 to 1995, which affected the Bank's reputation. While in the short run, both parties - Federal Government and Banxico - would not change their roles and therefore would not have any reputational costs to bear, in the long run, the Bank held the upper hand.

In 1982, because the international reserves were a central part of the debt crisis, the management of the exchange policy was paramount to crisis management. When the president decided to impose exchange controls, Miguel Mancera, Director General of Banxico,

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347 "Stabilizing Development" is how economists and historians refer to the period between 1956-1970 in which economic growth was combined with low inflation. As pointed out below, it is also associated with the tenure of Antonio Ortiz Mena as Minister of Finance from 1958 to 1970. For more details about this period, see Lustig (2002, 41-46) and Moreno-Brid and Ros (2010, 149-169).

348 In the final days of his presidency, López Portillo meeting with his then Minister of Finance David Ibarra and Banxico Director General, Gustavo Romero Kolbeck, and listening to their claims that the peso should be devaluated and deficits could not be perpetual, simply told them "not to worry" and eventually dismissed them (Centeno 1994, 159-160). Maxfield (1997, 102) says that after Romero had argued several times for the devaluation, the president responded by refusing to meet with him again because López Portillo was not going to leave a "depreciated" president. This series of events says a great deal about the hubris of López Portillo concerning the new oil exporting character of Mexico and his command of the country at the time.

published his disagreement with such a policy in a rather abstract way that nonetheless left little doubt as to his having had differences with the president (Mancera 1982).[349] The change of government in December of that year eased the confrontation between the president and the bureaucrats at Banxico. In fact, Maxfield (1997, 103) argues that Miguel de la Madrid's government (1982-1988) began increasing the bank's autonomy. This, however, requires some qualification, since the improved relationship between the acting President and Banxico's bureaucrats was not necessarily translated into greater autonomy.

Miguel de la Madrid and his government were more sensitive to the costs of the banks' nationalization implemented by his predecessor just three months before leaving his post. Whereas the political costs of such a policy were important, these would not have been solved with a move towards more bureaucratic autonomy for the Bank. In fact, such a move might have been counterproductive since it could signal that the government was taking a hands-off approach to a serious problem in the Mexican economy. In a moment of profound crisis, this could not have been an appropriate response. Furthermore, de la Madrid was not ready to relinquish the tools and privileges of having control over monetary policy, i.e. the control over Banxico. Even if later in his government (1985) a reform of the Bank's statutes was enacted, this did not contain any significant provision indicating an increased autonomy. This reform merely sought to reinstate the kind of relationship between the Presidency and the Bank that had prevailed before the governments of Luis Echeverría and José López Portillo.

The political legacies of these administrations persisted. The power struggles these presidents had with the economic bureaucracy were associated with the general economic conditions of the Mexican economy. However, the economic crisis was not exclusively a consequence of their policies, even if some of their decisions might have compounded its effects. In 1973, President Echeverría asserted his authority over economic policy since in his view, this was the best way to legitimize the regime. Furthermore, the way in which López Portillo managed the oil discoveries of the late 1970s created economic disequilibria that proved crucial when the prevailing conditions of the international economy changed.

[349] When the banks were nationalized, Mancera quit Banxico and the President nominated a counselor in his place who was behind the measure to nationalize the banks. This change was short-lived however, because a new president had already been elected and when he took office he re-nominated the former Director General (Maxfield 1997, 102).

Nevertheless, Echeverría's populism and López Portillo's hubris resonated with Mexican economic governance for years to come. Their political style and their economic decisions were implicitly invoked to promote important reforms affecting economic governance and potentially leading to the creation of institutional complementarities.

Given the complicated economic situation affronted by Mexico both on external and internal fronts, it is unlikely that President De la Madrid would have granted autonomy to the central bank. In fact, Banxico's autonomy was never a priority for De la Madrid's government and he believed the president should control economic policy.[350] Therefore, Banxico continued to be an economic agent of the Federal Government and helped to control inflation with a mixed record during De la Madrid's administration. Following the debt crisis (1982), and the need to handle its consequences, one of the measures taken by the Federal Government was to reinstate the former Director General of Banxico to regain the confidence of external and internal creditors.

Two additional elements influenced the relationship between the Federal Government and Banxico during De la Madrid's government. First, there was a need for stability. Not only was inflation soaring but also, relations with the private sector had been deeply affected following the nationalization of the banking sector.[351] Therefore, avoiding confrontation about the responsibilities, role, and institutional status of Banxico was key if the confidence of the private sector was to be regained. Second, further steps towards autonomy were not in the interest of the president, because the critical situation seemed to require a centralized command of every available instrument. Hence, the circumstances were not optimal for granting independence to the central bank. Furthermore, at the time, theoretical evidence about the convenience of independent central banks was just in its inception and it hardly informed policymakers.

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[350] Miguel Mancera. Interview with the author. Mexico City. March 25, 2015. Miguel Mancera was Banxico's longest serving Director General. He oversaw the transition from a completely dependent institution towards a formally independent one. He entered the bank in 1958 and climbed the ranks of the organization until his appointment as Director General in 1982. He retired in 1998 as Governor.

[351] An interesting compilation of testimonies of the people involved in the nationalization, including former presidents can be found in Espinosa and Cárdenas (2010). For the consequences of the nationalization, re-privatization, and rescue of the banking sector, again with an emphasis on the testimonies of the people involved, see Espinosa and Cárdenas (2011).

Even if conditions improved with the government of Carlos Salinas de Gortari (1988-1994), a significant change would only come into effect many years later. Contrary to the literature about the correlation between central bank independence and low inflation,[352] Mexican inflation was controlled by a non-autonomous central bank. Instead of relying exclusively on a tight monetary policy, a pact involving many significant actors was crafted in order to control prices in as many sectors as possible.[353] Because inflation decreased substantially in the first year of Salinas' term,[354] it was a *fait accompli* even before any serious discussion over central bank independence was on the horizon. Even if the highest economic authorities, the President, Carlos Salinas and the Minister of Finance, Pedro Aspe, were sympathetic to a stable market-oriented economy, such an idea seemed unrealistic at the beginning of their term. These conditions notwithstanding, stability was the preferred path and Banxico's Director General was given a renewed mandate, a rare measure given the bureaucratic changes taking place during a change in government.

Thus, the first hypothesis explaining the shift towards an independent central bank as a cause of low inflation, and therefore, a strategy in the struggle against does not adequately explain Mexico's experience. First, inflation was controlled by a dependent central bank in the 1980s. Further, inflation was not an issue during the 1960s when the bank was fully subordinated to the Ministry's authority. Instead, taking advantage of its overwhelming dominance, the PRI under the leadership of the President, was able to force the acquiescence of the most affected actors. It was not advanced economic theory in practice, but traditional carrot-and-sticks politics.

At the beginning of Salinas' government, the priorities in economic policy were elsewhere. Foreign debt was still a concern even if the preceding government made significant

352 Discussed above.

353 This was obtained through a corporatist agreement akin to the iron triangle (Lowi 1969). The *Pacto de Solidaridad Económica* (Economic Solidarity Pact), regularly known as *Pacto* or Pact was the Mexican version of a corporatist arrangement to conduct macroeconomic policy. The Federal Government, workers, agrarian producers, and organized business signed it and its main components were fiscal deficit reduction, tighter monetary policy, commercial liberalization, and an income policy covering in fact the whole range of prices and wages. For a brief introduction to the Pact, see Lustig (2002, 81-89). For a more detailed account, see Lustig (1991).

354 Mexican presidential terms begin on December 2 of the inauguration year therefore 1989, when inflation was around 20%, was the first year of Salinas' term.

efforts to improve the situation on that front.[355] Although the advantages of Salinas' solutions are debatable,[356] he presented them as the best way to deal with debt and used them to strike a political victory, presenting himself as a competent defender of Mexican interests.[357] Furthermore, relatively early in his term, Salinas signalled his intentions to seek a free trade agreement with the United States.[358] This was a clear departure from what, up to that point, was the traditional Mexican policy towards its Northern neighbour. It is clear though that Salinas' government priorities did not rest on reforming the status of the central bank.

There was some agreement among government officials and Banxico's bureaucrats that the recent history of Banxico's relationship with the presidency was less than harmonious, and to appease relations in the future was not only desirable, it was necessary. Banxico's bureaucrats sought to learn from relevant experiences abroad and then Minister of Finance, Pedro Aspe, kept a balanced budget[359] showing that reliance on primary emission was not necessary to finance government activities (Figure 16). Therefore, if for these officials it was possible to implement economic policy[360] without financing from the central bank, from that moment on, it was clear that subsequent Mexican governments could do it as well.

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355 Debt negotiations were difficult within and outside Mexico. At the beginning of De la Madrid's government orthodox measures were implemented in order to repay the debt and gain the confidence of external creditors. However, as oil prices fell again in 1986, making it even harder to maintain the payment schedule, negotiations became acrimonious. This created a difficult domestic scenario as more advocates of radical measures gained traction. Finally, an agreement was brokered with relatively soft conditions for the Mexican government (Kaufman 1988, 89-90).

356 As the debt continued to be a problem, the new administration decided to search for a new deal to accelerate the economic recovery the debt was supposedly preventing. Mexican officials were among the first to adhere to the Brady Plan of debt relief brokered by the US Treasury Secretary after whom the plan was named; however, savings in terms of cash-flow were less than expected amounting to 9 to 10% of yearly interest payments for five years or a billion dollars in the same time span. In 1992, with the decrease in interest rates, savings were even lower. Therefore, the new conditions were not a great relief to the Mexican economy (Lustig 2002, 90-91).

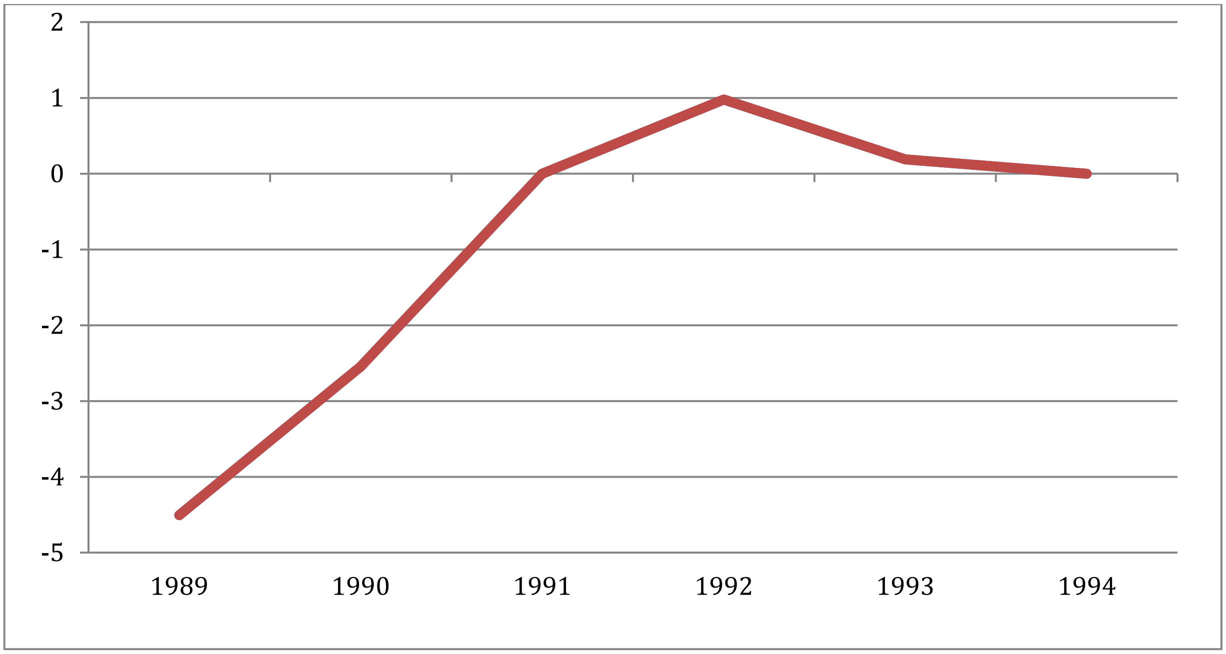
357 This selling point was possible because Salinas had previously acquired a reputation for being a strong and "serious" leader (*un hombre serio*), therefore his strategy could only be good for Mexico (Centeno 1994, 236-237).

358 Salinas and George H.W. Bush signaled their intentions to seek a free trade agreement between Mexico and the United States during the former's visit to Washington in June 1990. In August, Salinas asked Bush for the formal opening of negotiations (Lustig 2002, 23 fn. 1). A precedent had been established with Mexico's entry into the General Agreement on Trade and Tariffs - GATT in 1986.

359 In an interview with the author (Jorge Chávez Presa. Interview with the author. Mexico City. March 9, 2015), it was suggested that high-end officials pressed formally and informally for expenditure restraint in many ways. This must have been particularly hard for those used to the two presidential periods of Echeverria and López Portillo for whom a balanced budget was not a priority.

360 And by extension every policy as the budget covers every government activity.

Figure 16. Net Lending (+)/Net Borrowing (-) (% GDP) 1989-1994



Net lending (+) / net borrowing (-) equals government revenue minus expense, minus net investment in nonfinancial assets. It is also equal to the net result of transactions in financial assets and liabilities. Net lending/net borrowing is a summary measure indicating the extent to which government is either putting financial resources at the disposal of other sectors in the economy or abroad, or utilizing the financial resources generated by other sectors in the economy or from abroad
Source: IBRD (2017).

Central bank independence was not necessarily a priority but it might be part of a set of liberalizing reforms.[361] This was in part because inflation was already under control in the first two years of the Salinas government (ca. 1990). Hence, even if the literature about the relationship between central bank independence and low inflation was abundantly available at the time, the Mexican experience did not conform to it. Also, the insulation of monetary policy from elected officials was undoubtedly part of the motivation for granting autonomy to Banxico, as it was elsewhere (Roberts 2010). In the minds of politicians and bureaucrats alike, experiences like those of López Portillo's presidency were to be avoided and granting formal independence was a feasible solution. While there has been considerable debate surrounding the reasons for and timing of Salinas' government granting autonomy to the central bank (Maxfield 1997, Boylan 2001b, Ballinas-Valdés 2011), it is hard to assess the weighting of

[361] Other reforms in that direction were the end of agrarian reform, the North American Free Trade Agreement – NAFTA – with US and Canada, and the privatization of public enterprises.

these factors. Moreover, the government's decision was not yet made public. Operations began with a draft of the independence statute in the early 1990s.[362]

Banxico's Director General sought to learn from Chile's experience. In 1989, Chile reformed its central bank granting it independence from an operational, legal, and political point of view from the central government.[363] While there were others that soon followed,[364] the Chilean experiment's influence was primordial. This was the case not only because Chile was the first country in the region experimenting with these policies but also because the two heads of the Chilean and Mexican central banks, Andrés Bianchi and Miguel Mancera respectively, were friends and communicated with each other in several fora about their respective experiences.[365]

After the decision was made, the Chilean experience on the subject was more useful. Its institutional provisions served as an example of the measures that could possibly be implemented in Mexico. In essence, it served the purpose of providing practical lessons of central bank independence from which the future statute could take advantage. Since the decision was already made, a political argument in that sense was not necessary anymore. The Chilean experience was a repository of experiences and solutions. The frequent communication between Bianchi and Mancera allowed the latter to have a role model, but also the possibility of learning from the experience of a first mover within the region. At first, the

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362 Roberto del Cueto. Interview with the author. Mexico City. March 24, 2015. Roberto del Cueto is currently a member of the Board of Governors of Banxico. He entered the Bank in 1973 and climbed the ranks to Deputy Director in 1994 when he resigned. He worked in the financial sector as Chief Executive Officer – CEO of *Banco Nacional de México* – Banamex (National Bank of Mexico) and other posts in the Mexican financial sector. He also held academic positions in the Law School of the *Instituto Tecnológico Autónomo de México* – ITAM (Autonomous Technological Institute of Mexico), a private university, and finally was re-nominated as Member of the Board of Governors of Banxico in 2007.

363 The constitution established by the authoritarian government in 1980 contemplated an autonomous central bank. However, it was not until 1989, just after Pinochet had lost the plebiscite in 1988, that a detailed legislation was enacted. As Boylan (2001a, 75-138) discusses at length, what mattered most in that reform was the threat of a newly democratically elected government, presumably interventionist and disrespectful of monetary stability. The importance of Boylan's argument is that it questions the extent to which such reforms were enacted in the quest for economic credibility *vis-à-vis* markets, but for political reasons involving mainly domestic considerations. Bianchi (2009) offers a broader historical account of this policy change from an insider's perspective.

364 Maxfield (1997, 51) reports that Argentina, Colombia, Ecuador and Venezuela changed the status of their central banks in 1992.

365 Miguel Mancera. Interview with the author. Mexico City. March 25, 2015; Ariel Buira. Interview with the author. Mexico City. March 6, 2015. Ariel Buira served as a Member of the Board of Governors of Banxico from 1994-1996 and previously was Director for International Organizations and Agreements within the Bank 1985-1993.

exchange was sporadic insofar as both officials held responsibilities in their respective institutions. However, when Bianchi's appointment period (1989-1991) ended, he was capable of assisting his Mexican counterpart on a more sustained and intimate level in shaping a statute granting independence for Banxico.[366]

The corresponding statute was enacted in December of 1993, after a six-month legislative process involving symbolic changes. This happened when other reforms were either being implemented, e.g. privatization of public enterprises and agrarian reform, or realized, e.g. NAFTA. The Bank's new statute was certainly a triumph for Banxico's bureaucrats who through the past twenty years had seen how presidential authority prevailed over their priorities. It seemed that prohibiting interference on the part of political authorities in the normal functioning of the bank would prevent future crises. The perception of political interference was critical to advancing the reform even if the acting President and Minister were not particularly interested in reproducing it. Nevertheless, the legacy of previous experiences loomed large over the actors involved, leading them to engage in the kind of reform deemed necessary to prevent its repetition. This is significant insofar as other reforms to economic governance were also carried with the aim of preventing the possible interference of political authorities.

While it was clear that primary emission must remain out of the reach of politicians, exchange policy affected more than just monetary variables and, consequently, the Federal Government kept it under its control. The mechanism to square the circle of surrendering a source of monetary emission while keeping control of it was the creation of an Exchange Commission. The Commission was composed of three members of the autonomous central bank board and three members of the Ministry of Finance, the Minister and two of his deputies. However, every decision had to receive the support of at least one vote from the Ministry. Moreover, the proceedings of the Commission were public, which deterred Ministry officials from making arbitrary decisions. Interested parties could observe the respective positions and the reasons behind them and could make the Federal Government bear the cost in other sensitive markets such as bonds.

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[366] Miguel Mancera. Interview with the author. Mexico City. March 25, 2015.

The second hypothesis, the delegation of macroeconomic policy to an autonomous agency, is worth some consideration. While it is clear that the delegation of monetary policy to an autonomous body means isolating it from everyday political debates, the Mexican case does not conform to the archetypical example. First, although Banxico had a reputation for being a highly technical agency, politicians at the time had the same kind of knowledge. Both the president and the minister were professional economists. Hence, such delegation was not a matter of handing responsibilities over to a more qualified, technical agency. Even if some international experiences seem to suggest that savvy bankers, having saved the world from the turmoil caused by inflation, should be compensated with the power to continue doing just that (Roberts 2010), Mexican inflation was not controlled by savvy bureaucrats but, as explained above, through corporatist politics.

Second, it is not clear why the government would want to isolate a policy that in all likelihood would not be questioned by future governments given the homogeneous and predictable character of their cabinet and deputies. Moreover, as McNamara (2002, 51) suggests, delegation is seen as a solution to electoral and partisan politics where left-leaning parties would try to stimulate the economy to get elected. This, however, does not seem to fit the Mexican experience either. First, the highest authorities were not particularly keen to stimulate the economy because they thought the role of the state in the economy should be reduced, not expanded.[367] Second, the PRI was hegemonic in Mexican politics. It did not face a serious threat from the left that might force it to stimulate the economy, not even from the left-leaning faction of the party that had long been isolated; and, third, at the moment of the reform there was no credible menace to its hegemonic status at the federal level forcing the government into fiscal profligacy.

The third hypothesis, concerning developing economies, explored by Maxfield (1997, 4) argues that a country's quest for the recognition of its creditworthiness will lead to a change

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[367] The highest authorities are undoubtedly the President and the Minister of Finance. However, many members of the cabinet shared the same kind of ideas concerning the role of the state in the economy. In fact, the cabinets of Salinas' government were composed mainly of people with backgrounds in economics, which represented a departure from traditional Mexican cabinet politics. For more details, see Centeno (1994). This particular trait of Salinas' cabinet was a part of a longer trend that started at least with De la Madrid's cabinet when the latter was the first cabinet remarkably composed for the most part by professional economists giving it a high degree of homogeneity in terms of world view as well as the policy goals to be pursued; for an analysis on De la Madrid's cabinet see Hernández (1987).

in the status of its central bank. The corollary of this analysis is that international markets have become more important than ever and states have to play the role that these impose on them. This factor was especially salient at the moment of the reforms in several regions and countries, in part because at the time liberalization of capital accounts allowed international actors to play significant roles in the definition of economic policies. These actors were both institutional, such as international organizations, and included individual investors abroad. In the context of the increasing importance of international markets, creditworthiness is an international factor.[368]

The weakness of Maxfield (1997) argument, the relevance of international creditworthiness, when applied to Mexico is that the relevant financial crisis requiring a clear manifestation of the Bank's independence happened after the reform was already enacted. In fact, because the crisis came after independence the reform was severely questioned. During 1994, political turmoil would have serious economic consequences as capital flight followed several major events even after NAFTA came into effect on January 1. That same day a guerrilla uprising started in the Southern state of Chiapas, the Zapatista movement, reminding the world that in spite of the government's claims of Mexico's modernity, there were serious challenges contradicting this claim. Some months after, another political shock would have dire economic consequences. The political assassinations of the PRI presidential candidate, Luis Donaldo Colosio in April, and that of the party's Secretary General, José Francisco Ruíz Massieu in September, showed foreign investors that political stability was not assured in Mexico. Again, there were important capital flights (Figure 5) as manifestations of instability and vulnerability.

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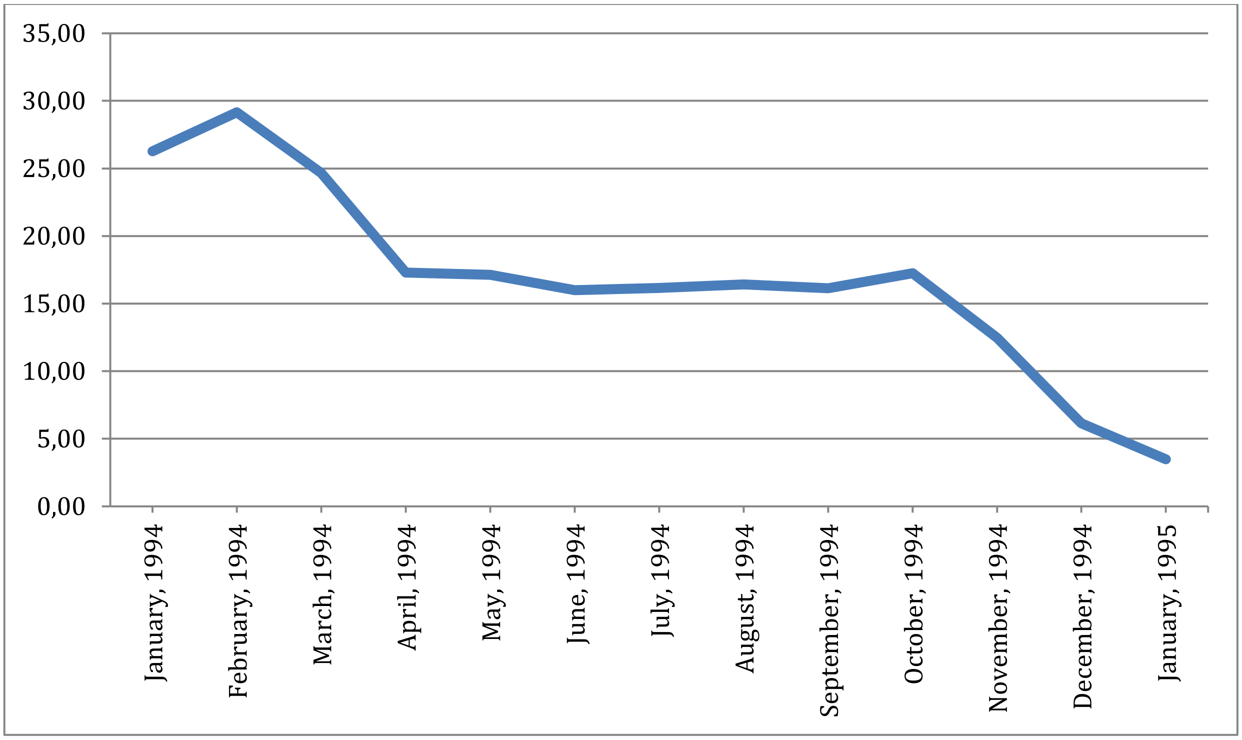
368 Even if the divide between international and domestic factors is not relevant to the present discussion, it is important to explain where the possible sources of change were located. In fact, the main international factor leading to the reform granting independence to the central bank was the cooperation established between the heads of Banxico and the Central Bank of Chile, who had been friends since their time in graduate school (Miguel Mancera. Interview with the author. March 25, 2015. Mexico City). Nevertheless, this collaboration was most important after the reform was enacted. Therefore, distinguishing between a domestic or systemic source is not relevant to this discussion. Rather than establishing a clear distinction between the two for each relevant factor, the focus here is to provide an explanation accounting for Banxico's independence, regardless of its origins.

Figure 17. *Banco de México*. Assets in Foreign Currency. International Reserves* At the end of each month (Billions of USD)



*As defined by the *Banco de México*'s Act, valid since April 1994
Source: Elaborated by author with data from Banxico (2015b).[369]

Perhaps because the political threats demanded the government's attention, the economic cabinet did not meet as much as it had,[370] increasing the economic vulnerability through a lack of coordination among economic authorities. When the new government took office in December 1994, exchange rate policy once again became a salient issue. A mishandling of information from those officials responsible led to a severe capital flight, forcing a change in the exchange policy instrument from a crawling-peg to a simple floating currency.[371] While what came to be known as the Tequila crisis or Peso crisis concerned

369 This information has been retrieved from Banxico's website and shows the general patterns followed by the international reserves, which responded to the different political events in that year. A more detailed figure can be found in Banxico (1995, 48) in the Figure 19.
370 Jorge Chávez Presa. Interview with the author. Mexico City. March 9, 2015. During the 1990s, Jorge Chávez Presa was a mid-to-high level bureaucrat at the Ministry of Finance. In the period 2000-2003, he was elected to the Chamber of Deputies representing the PRI. He currently runs a consulting firm in Mexico City.
371 The events surrounding that decision were those of the Peso crisis. The literature concerning such issues is abundant and a review of it is beyond the scope of the present work. For brief accounts, see Lustig (2002, 191-

exclusively the exchange policy, for which the Federal Government was primarily responsible, Banxico bore the main reputational costs associated with those events. Formally, there were no serious challenges to Banxico's autonomy but market actors held serious doubts about the extent of it.

As a response to those claims, the explanation offered by Banxico officials was that political factors were responsible for the capital flights and, therefore, the crisis that followed (Gil-Díaz and Carstens 1996). Once again, the impression was that Banxico was covering for someone else's mistakes. This situation was a blow to an institution that had made significant efforts to build a political consensus around its independence, relying, to a certain degree, on its reputation, to see it then tainted in the aftermath of obtaining it. The answer to the financial crisis required an intense political and financial effort from Guillermo Ortiz, President Ernesto Zedillo's (1994-2000) Minister of Finance, who brokered a solution to the financial mayhem after the crisis bottomed out.[372] His career in Banxico and his experience in the Ministry of Finance, where he was Deputy Minister during Salinas' government, were essential to gathering the necessary support, politically and financially, to solve the crisis.

Because the final outcome was more than satisfactory, Ortiz enjoyed a powerful position within the cabinet. Even if his time as President of the Banking Privatization Committee as well as his role in the subsequent rescue of the sector might open him up to a questioning of his credentials, politically he retained substantial influence due to his handling of the financial crisis in 1995. After the banking crisis that followed the financial crisis, a new reform on Banxico's Act was introduced in 1997, but in this reform there were no provisions

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224) and Pastor (1998). International reserves declined substantially during 1994 because of the political events that happened that year. The need of a depreciation naturally increased with the lost reserves; however, the outgoing administration of Salinas delayed any meaningful decision on that issue. Later on, the *Error de Diciembre* (December Mistake) refers to a comment made by the new Minister of Finance, Jaime Serra Puche, concerning the necessity of changing the exchange regime. This led investors to speed up the accumulation of foreign exchange (Roberto del Cueto. Interview with the author. March 24, 2015. Mexico City). Serra was dismissed from his post as Minister of Finance briefly after taking office, which renders President Salinas and his Minister Pedro Aspe responsible for the depletion of the reserves that occurred throughout 1994, as they were in charge until the end of November. For a more detailed account of the events surrounding both the Peso crisis and its subsequent resolution, see Whitehead and Kravis (1996).

[372] The solution consisted mainly of a big credit coming from the US Treasury, the International Monetary Fund – IMF, and other lenders of the Paris Club and amounting to USD 53 billion. In late January 1994, there was already some clarity about the general lines of the credit; it was signed later in mid-February, and implemented in March when the slide in the Peso was finally controlled (Pastor 1998, 141).

affecting its autonomy.[373] Changes refer only to the administration of an account concerning the necessary resources for the banking rescue. Nevertheless, a few years later Ortiz was appointed Governor of Banxico. The significance of this appointment cannot be underestimated given that his predecessor had remained in place for sixteen years, and foremost, through three presidential periods.[374]

This discussion takes us to the fourth relevant hypothesis explaining central bank independence in Mexico. Transitional politics have an impact over the attempts to isolate monetary policy. Boylan (2001a) proposes a model in which the degree of autonomy ceded to the central bank would depend on the importance of the electoral threat faced by authoritarian elites. If authoritarian elites fear they will soon be ousted, they would try to insulate monetary policy as much as possible. Consequently, if the electoral threat was only partial, then the insulation would also be partial. The former case would be that of Chile in which the insulation happened between the defeat of Pinochet in the referendum of October 1988 and the arrival of the *Concertación* to power in March 1990. The latter is that of Mexico in which the electoral threat faced by the PRI was weak and, as a result, so was the insulation (Boylan 2001b).

As mentioned above, the 1993 reform is considered by those officials involved to be the moment in which Banxico acquired its autonomy. The regulation of internal credit supply and the interest rate remained Banxico's prerogatives. Exchange policy remained under the Federal Government's control, in spite of its importance to monetary policy. Moreover, in exchange policy the rules of the Exchange Commission clearly stated that the responsibility was of the Federal Government and not Banxico's. Following Boylan (2001b), this partial insulation would explain the weak electoral threat the PRI faced; however, if the insulation of

[373] Ballinas-Valdés (2011, 129-132) suggests that the 1997 reform to the *Banco de México*'s Act completed the process of granting autonomy to the Central Bank involving also the nomination of Ortiz as its governor. Nevertheless, the text of the Act, available in Banxico's web page (http://www.banxico.org.mx/disposiciones/marco-juridico/ley-del-banco-de-mexico/%7B6A70B07F-127A-0079-220C-83843B089097%7D.pdf. Retrieved on May 13, 2015) does not indicate such changes. Also during interviews with actual and former upper-level Banxico officials, all of them signaled 1993-4 as the moment in which the Bank became *de facto* autonomous.

[374] Four if the brief period before the bank nationalization by López Portillo in September 1982 is counted.

the 1993 reform was perceived as complete,[375] despite exchange policy arrangements, the argument loses some traction insofar as the transition did not start at the moment of the reform. Nevertheless, when the transition to democracy took place, the practical autonomy of the bank was tested suggesting that insulation and electoral and political threats are relevant to an understanding of the central bank's autonomy.

In 1998, before the beginning of the formal transition and after the lackluster electoral results for the PRI in 1997 (Rubio 1998, 33-35), President Zedillo nominated a new governor of Banxico. The electoral factor was no longer a threat but a reality the Zedillo government had to cope with. Even if it was self-inflicted, insofar as Zedillo refused to use the nomination powers of his office, both for presidential and gubernatorial candidates, electoral change was clearly significant. As mentioned above, the nominee was Guillermo Ortiz, the Minister of Finance behind the recovery after the Peso crisis. Ortiz's term as the head of Banxico implied that a very powerful Minister of Finance would become a very powerful central banker. This would become especially important when in 2000, President Vicente Fox (2000-2006) was elected, and from a different party – *Partido Acción Nacional* – PAN (National Action Party).

The insulation in the face of an electoral threat seems to be confirmed but not from the expected source. That is, insulation is not only a matter of institutional design but also a consequence of the political power projected by the bureaucratic leader at the head of such an organization.[376] Insulation, thus, depends critically on the way it is received by the political actors surrounding the organization and is not only a matter of the formal power granted by a given institutional reform. In this case, the powers were there but Ortiz's stature led President Fox to nominate him once again in 2003 as Governor of Banxico. The Minister of Finance, Francisco Gil-Díaz, convinced the president that it would be wise to do so, given the good performance Ortiz had showed in his post, not to mention his longstanding reputation in the

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[375] This was stated by Miguel Mancera, Director General of Banxico from 1982 to 1998, Roberto del Cueto, actual Member of the Board of Governors and former Deputy Director General of Banxico in 1993, and Ariel Buira, member of the Board of Directors in 1990s. All of them confirmed such condition in the interviews conducted by the author.

[376] This is reminiscent of the argument of Carpenter (2001), where bureaucrats modeled the institutions despite the absence of the formal power to do so.

financial community.[377] The need for continuity after the transition supported the degree of independence Banxico kept during the PAN governments.

As demonstrated above, none of the hypotheses presented can fully explain central bank independence in Mexico. Nevertheless, some of them offer interesting insights that help to explain such reform. The perceived need to keep monetary policy out of the presidential reach was of central importance to all actors involved: both to the bureaucrats who had to acquiesce to presidential authority and to new incumbents who thought past policies were not economically wise. Because the President had to relinquish his authority over monetary policy, the question was when to do so, while keeping within the range of limits imposed. Bureaucrats eager to be autonomous, in turn, tried to learn from abroad in their attempt to offer a model fitting presidential expectations on the matter without overriding presidential authority. International financial markets were increasingly important in the consolidation of the reform. The respect a Director General enjoyed in those circles, meant continuity in the post even after a transition to democracy.

Consequently, there was not a single event triggering the decision to grant autonomy to the central bank. It was, rather, an accumulation of undesirable situations that convinced incumbent officials of the desirability of an autonomous central bank. In the middle of the reform process, adjustments were made to accommodate issues and challenges affecting other areas of economic policy. While both international and domestic factors can be understood as part of the process, the assertion of pre-eminence of one set over the other can be misleading. Depending on the stage of the reform process, both are weighted differently. Therefore, the best approach is to have a long-term view of the process. The institutionalization of monetary policy was a gradual process in which the margin for discretionary action was severely reduced allowing other actors to play a more significant role.

This long-term view points to the enduring legacy of the conflict-ridden relations between President López Portillo and Banxico's upper-level bureaucrats during the 1982 crisis. Even two decades after these events, the president under whose term the PRI's dominance foundered still hesitated to re-nominate the first Governor appointed after

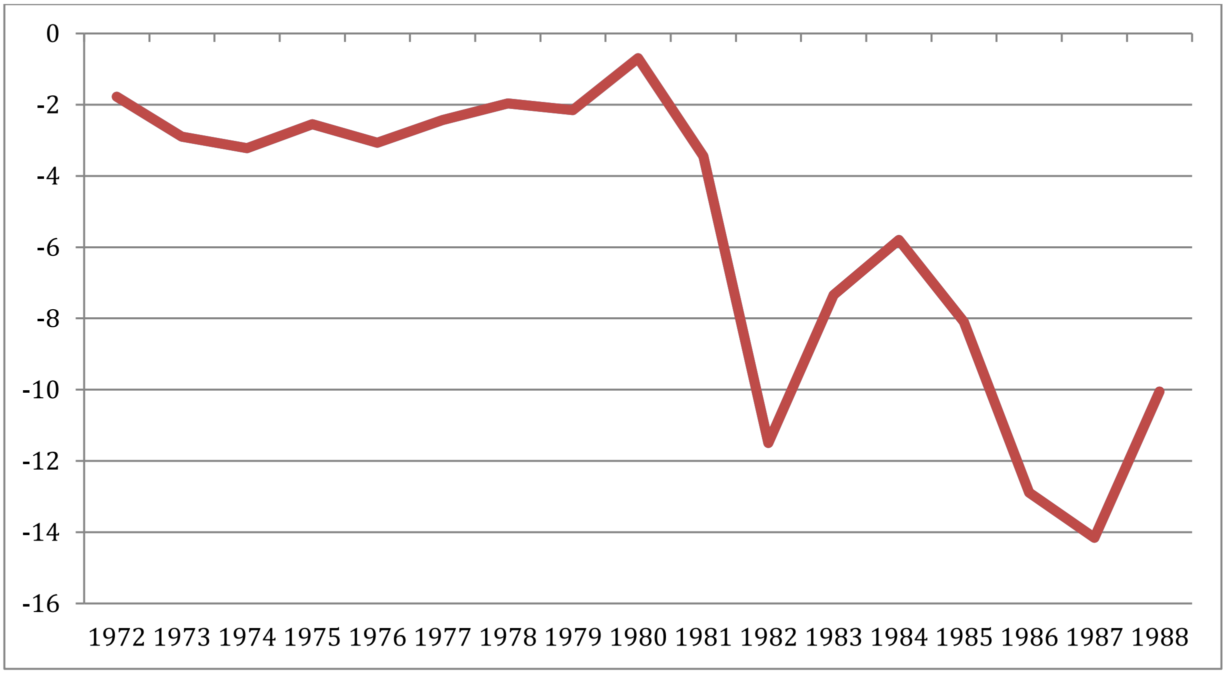
377 Roberto del Cueto. Interview by the author. Mexico City. March 24, 2015

institutional reform. The presidential power over monetary policy, which might increase incrementally through the appointment of a sympathetic new Governor, was still a temptation, even if such power was carefully contained within a frame of formal institutional independence. In spite of the reform and the various steps taken to achieve it, the possibility of the president having a strong say in monetary policy and the consequences associated with it loomed large during the whole process of institutional change. In the next section, another instance where the particular legacy of a president willing to risk economic stability as a political strategy appeared once again in the political arena, fostering in turn new institutional reforms.

5.2 Budget and Fiscal Responsibility Federal Act

Keeping a balanced budget was not a priority for Mexican authorities, or at least economic conditions prevented them from doing so. At the end of the 1970s, and throughout the 1980s (Figure 18), a balanced budget remained elusive. It was not until the 1990s that budget surpluses became a reality in Mexico. Also, as mentioned earlier, presidential priorities prevailed when economic decisions were at stake. This condition also implied that if it was deemed necessary to increase expenditures in order to rescue banks for instance, there were no limits other than what the general domestic and international economic conditions allowed. Therefore, it is of interest to study why and how a piece of legislation that pretended to restrain the president's ability to run deficits was enacted.

Figure 18. Net Lending (+)/Net Borrowing (-) (% GDP) 1972-1988



Net lending (+) / net borrowing (-) equals government revenue minus expense, minus net investment in nonfinancial assets. It is also equal to the net result of transactions in financial assets and liabilities. Net lending/net borrowing is a summary measure indicating the extent to which government is either putting financial resources at the disposal of other sectors in the economy or abroad, or utilizing the financial resources generated by other sectors in the economy or from abroad
Source: IBRD (2017).

This piece of legislation would be another attempt to reduce the president's control over economic policy. Like the reform on the status of the Mexican central bank, the Budget and Fiscal Responsibility Federal Act sought, among other things, to establish rules for the Federal Government on the running of deficits. That is, the authority President Echeverría claimed to have over economic policy was incrementally restrained, particularly when it came to running deficits.[378] Those two restrictions on monetary and fiscal affairs have the potential to become complementary. Therefore, this section shows the political processes leading to the creation of a new institution within the Mexican political economy that, together with an independent central bank, would be consistent with the construction of institutional complementarity. This account explains how the rules intended to restrain the President's policy margin over deficits and debt came to exist.

378 Primary emission was also a way to run deficits, so an independent central bank can also be seen as a restriction on running deficits.

5.2.1. A Long Presidential Campaign

Transitional politics are contentious because there is much at stake for both governments and populations alike. New incumbents embody non-negligible hopes for change and populations are led to believe that democracy will deliver all that is hoped for and has been promised. While some policies can fulfill these expectations, economic policy is frequently beyond a government's control. This creates opportunities for political debate, attracts a wide range of criticism, and may even result in the fall of elected governments.[379] Mexican economic policy followed this pattern after the transition to democracy in 2000,[380] as its general traits remained unchanged, with a significant difference, however. Those in charge of economic policy, that is, upper-level bureaucrats remained.[381] This is not to say that the ministers were the same but they shared the same profile. In fact, the head of the Ministry of Finance was among those members of the transitional cabinet with the most experience in government (Hernández 2005, 209).

The difficulties experienced by President Fox in building up consensus with other political actors increased conflict in an already contentious transition. Moreover, his appeal to public opinion through electronic and mass media, as in a marketing campaign in which he was well versed given his experience in the private sector, complicated things further. Instead of privileging fluid communication with legislators, the presidential communication strategy created uneasiness among elected representatives and an even more tense political environment (Hernández 2005, 208). The presidential strategy was not restricted to the

379 The Alfonsín government (1983-1989) in Argentina faced several economic crises that finally forced Alfonsín out of office.

380 The transition to democracy in Mexico is commonly referred to as the moment in which the government of Vicente Fox, from the PAN, took office ending seventy years of PRI dominance. This event was the consequence of a series of events that could date back to at least the election of Carlos Salinas in 1988 when serious doubts about the electoral results were aired, eroding the veil of legitimacy on which the PRI relied for decades. Nevertheless, the rise of other parties, including the *Partido de la Revolución Democrática* – PRD (Party of the Democratic Revolution), itself a dissidence of the left wing of the PRI, says much about the crumbling regime that would eventually lose the mid-term elections of 1997 and the presidential contest in 2000. For a brief account of the political conflicts concerning economic policy and governance in 1997, see Dresser (1998); for more detailed accounts of the transition to democracy, see Domínguez and Lawson (2004), Eisenstadt (2004), and Peschard-Sverdrup and Rioff (2005).

381 For a discussion on how the technocracy remained in the government during the PAN administrations, see Hernández (2011, 89-93).

relationship between the two branches of power, but also with political opponents among which the main rival was undoubtedly Andrés Manuel López Obrador. López Obrador as Mayor of Mexico City (2000-2005) was the target of several scandals during which the President did not remain neutral.

While these confrontations dominated the general political environment, the first draft of a new budgetary regulation called *Ley Federal de Presupuesto Público* (Public Budget Federal Act) was presented in the Chamber of Deputies. One of the main motivations expressed by the Congressmen authoring this initiative was to adjust those budgetary rules issued in 1976 to the new transitional environment (Chávez 2003, 37). Among the goals pursued through such reform was the reorganization of public finance in which a clear framework for expenses and revenues was established. Also proposed was a reorganization of the budgetary process prohibiting last-minute adjustments proposed by different government entities hoping to avoid proper scrutiny on the part of Congressmen. The point was to strengthen the planning process within the executive (Chávez 2003, 38).

The second explicit goal established for the future Act was "To assure fiscal discipline…" (Chávez 2003, 39). Those presenting this initiative wanted a thorough reorganization of the budgetary process that would include a comprehensive look at public finance including debt, expenses, revenues, and assets, among other issues.[382] Fiscal discipline remained paramount for the broader parliamentary debate. Unsurprisingly, another text was also submitted to the Chamber, this time with the aim of establishing limits to budgetary imbalance. These limits would depend in turn on the preservation of macroeconomic stability as well as the accessibility to international credit of private agents (Regis 2003, 176). While this text also provided for improved budgetary processes like the one presented above, what makes it remarkable is the party behind it, the *Partido del Trabajo* (Labour Party).

While it is hard to assess the real intentions behind this initiative, it should be clear that the project represented a departure from what is normally a left-leaning party's agenda. Most likely, this effort represents a response to a politically salient issue at the time of a political

[382] Jorge Chávez. Interview with the author. Mexico City. March 9, 2015.

campaign where small parties[383] had very much at stake. In June 2003, there were the mid-term elections, the first since the transition, where a portion of the lower Chamber was in contest. Small parties had the opportunity to consolidate themselves as political alternatives, a goal they actually attained during this election (Concha 2004, 11). This is not to say that a particular project consolidated a small party, but given the state of the political transition at that time, the PAN had much to lose because the hopes brought up by its ascension to power in 2000 did not materialize, offering instead opportunities for smaller players. On the other hand, the PRI kept most of its core voters and representation (Camacho 2004).

In the second half of Fox's government, between 2003 and 2006, what dominated the Mexican political arena was the increasing importance of the future PRD candidate, López Obrador. While he was Mayor of Mexico City (2000-2005), he positioned himself as the most visible politician in the country, except for the president, with a clever communication strategy (Espino-Sánchez 2007, 294). This position put him in the center of legal controversies involving either his actions as an elected official or those of his cabinet. However, the most significant of these was the one that sought to take out his legal immunity between 2004-5 so that he could not later participate in the presidential contest of 2006 (Espino-Sánchez 2007, 299).[384] His opponents' strategy backfired. After the whole legal procedure was over, López Obrador's popularity increased to historic heights (Espino-Sánchez 2007, 302).

While the tensions between the Federal Government and the Mayor were escalating, the Deputies presented two different proposals concerning public finance. These, however,

383 Small parties are those that are not part of the mainstream Mexican political establishment – *Partido Revolucionario Institucional* - PRI, *Partido Acción Nacional* - PAN, and *Partido de la Revolución Democrática* - PRD. These parties are *Partido Verde* (Green Party), *Partido del Trabajo* (Labour Party), *Movimiento Ciudadano* (Citizen's Movement), *Nueva Alianza* (New Alliance), *Morena – Movimiento de Renovación Nacional* (National Renovation Movement), and *Encuentro Social* (Social Gathering).

384 López Obrador was accused of contempt of court because the Government of Mexico City unduly expropriated land to build an entrance to a hospital back in 2001. The judge ordered a restitution, which was done after the time allotted to do so. Given his post as elected official, the legal immunity could only be taken away by the Chamber of Deputies. Because the head of the City's government was accountable for this, the Attorney General started a prosecution process that would eventually lead to López Obrador being stripped of legal immunity by the Chamber of Deputies. Following an outdated legislation, all those subject to a legal process would not have the right to participate in any election. Thus, this was important for his contenders, given López Obrador's popularity and his intention to participate in the next presidential elections to be held in 2006. After this stage of the process was completed, the Judge considered the case to be inconsistent and the charges withdrawn (Espino-Sánchez 2007, 298-304). For a discussion of the legal inconsistencies around the process against López Obrador, see Cárdenas (2006).

gave continuity to the debate about the budgetary procedures initiated by the preceding legislature. The PRI parliamentary group, following the general lines of the project of the preceding legislative period, presented the first text. It included provisions to organize the budgetary process changing the balance between the Executive and the Legislative in favour of the latter. However, besides being a generally oriented project, it contained as a major theme fiscal responsibility principles in order to maintain macroeconomic stability with sound public finances (Rojas 2004, 58-61). This project was published in the *Diario de los Debates* (Journal of Debates) of the Chamber of Deputies on April 15, 2004, which is about one month before the General Attorney announced the beginning of the case to take out López Obrador's immunity on May 17.[385]

The Labour Party parliamentary group presented the second proposal, which in a way reproduced most of the matter presented in the preceding legislative period. It kept the core proposition: budgetary balance with fiscal responsibility. Nevertheless, the way in which this policy was conceived is fundamentally different from that of the PRI. The Congress would authorize the deficit if its objectives were focused on promoting national economic and social development, and it in turn was subordinate to the country's needs (Padilla 2004, 23).[386] Two characteristics should be noted. First, the vagueness of the intended authorization to carry deficits; and, second, the timing of this project presented as it was on May 26, 2004, roughly a week after the process against López Obrador began. While it is clear that the subject was neither new to the parliamentary debate, nor to the Labour Party's initiatives, the timing of the proposal reveals a trait that would later become more important regarding the left more broadly and López Obrador in particular.

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385 "MEXICO: Government Goes After Lopez Obrador Again." *Latinnews Daily*, May 18, 2004.
386 The exact phrasing is:

> "*Dicho déficit sólo será autorizado si los fines que persigue están enfocados a la promoción del desarrollo económico y social del país y si se sujeta al cumplimiento de las necesidades [sic] reales de nuestra nación, en función de la coyuntura económica, así como del cumplimiento de los programas sectoriales que se contengan en el Presupuesto de Egresos de la Federación.*"

(Such a deficit will only be authorized if its aims are oriented towards the promotion of social and economic development and is contingent on the satisfaction of our nation's real needs, depending on the economic conjuncture, as well as the fulfillment of the programs by sector contained in the Federal Expenses Budget). Author's translation.

Simultaneously, opposition to the most visible, and viable, candidate from the left was rising. At the time of the process against López Obrador, a former member of the Federal Cabinet asserted that he must be stopped at any cost.[387] This kind of characterization of the candidate would be repeated two years later during the presidential campaign in which López Obrador would compete against Felipe Calderón, the PAN candidate, and Roberto Madrazo, the PRI candidate, in the first semester of 2006. It is worth noting the continuity of the hostility against López Obrador, because it would later degenerate into a negative campaign against his presidential intentions. During this campaign, the associations between his political style and that of Hugo Chávez, the populist Venezuelan president were prominent (Treviño 2009, 640-641). The comparison began to circulate only when López Obrador first became a viable presidential candidate.

An important caveat must be considered, however. During his time as Mayor, López Obrador never showed any sign of fiscal profligacy.[388] as the comparison with the Venezuelan president might imply. If this had been the case, that kind of criticism would have emerged before. It only surfaced when the presidential contest was in the foreseeable future. Thus, it should be clear that the characterization of the candidate as a danger to fiscal and macroeconomic stability was a political strategy rather than a warning based on past behaviour. This did not, however, prevent the theme of fiscal responsibility from remaining in the political debate, even if the consequences for the candidate remained weak,[389] since his record as Mayor, was enough to deter these kinds of accusations.[390]

The year of 2005 was pivotal in the political discussions surrounding the legal process against López Obrador and the release of the definitive text of the Budget and Fiscal Responsibility Federal Act. In the first half of the year, the Congress had to discuss the case of

387 "Pugna ex Canciller por Derrota de AMLO." *Reforma*, May 19, 2004, p. 6.

388 Political Operator. Interview with the author. Mexico City. This interviewee asked for anonymity; thus, a generic identification is used.

389 It is hard to assess how much the candidate was affected by the claims about his fiscal profligacy. In November 2003, it was clear that Mexico City's debt was rising and so were its revenues, with the consequence of keeping the debt under control ("The Man Who Would Be President." *Economist,* November 21, 2003). Nevertheless, in May 2005, only eighteen months after, López Obrador was compelled to clarify that if would he become President he would respect macroeconomic stability ("Will the Real Andrés Manuel López Obrador Please Stand Up?," *Economist*, June 3, 2005), potentially indicating that there were doubts about his record as Mayor. In any case, it was the framing of López Obrador as a "populist" that mattered more rather than his actual "populist" behaviour.

390 Political Operator. Interview with the author. Mexico City.

López Obrador's legal immunity, finally removed on April 7.[391] Later, in the second half of the year, the Federal Government presented the text of the Budget and Fiscal Responsibility Federal Act, with the modifications representing its point of view,[392] to the Congress so the normal legislative process could continue. Between those two moments, concerns about the President's neutrality were raised during his Annual Report to Congress about the State of the Nation in September. These concerns were raised not only as a result of his government's actions related to López Obrador but also because of sudden changes made to some policies,[393] presumably, to favour the PAN candidate.

In December 2005, when the final legislative procedures for the approval of the new law were taking place, it became clear that the Executive had had an active role in the elaboration of the new text. This fact was underlined by an opposing Congressman who signalled that many of the amendments presented by the Federal Government were approved by the Chamber as part of the final text of the Act (Diario de los Debates de la Cámara de Diputados 2005, 351). Historically the influence of the Mexican Federal Government over the legislative process had even prompted the creation of the Meta-constitutional powers doctrine (Carpizo 2002).[394] Nevertheless, after the transition the president lost a substantial amount of his influence. Not only he, but also elections could determine politicians' careers. Thus, during the first PAN government, the relationship between the Executive and the Legislative branches was not as rigidly defined as it had been during the PRI regime (Hernández 2005). Therefore, if the Congress approved as a rubber-stamp assembly a text created by the Federal

391 "The Lopez Obrador Saga. Swings and Roundabouts." *Latin American Regional Report. Mexico & NAFTA*, April, 2005, pp. 4-7.

392 Part of the normal legislative procedure. In the Mexican legal jargon, this document is called *Controversias* which would be disagreements or amendments introduced by the Federal Government concerning the legal text initially proposed in Congress, including the respective positions of the former on these issues.

393 "The President. Concerns about Impartiality," *Latin American Regional Report. Mexico & NAFTA*, September, 2005, pp. 7-8.

394 The metaconstitutional powers of the Mexican president refer to the overwhelming powers he held during the time the PRI-dominated Mexican politics. Carpizo (2002) refers to the composition of this set of powers that includes the leader of the party's – PRI - power to nominate and remove governors, and to nominate his successor. As far as the Congress was concerned, what mattered most was the first stipulation that the president was able to control the career path of Congressmen by possibly making appointments out of the federal bureaucracy over the governorship.
This influence was not exclusively restricted to the President and his control of the political careers of Congressmen; in fact, the bureaucracy was the main political actor in Mexico during the long PRI reign, being above Congress, which was supposedly the depositary of the people's will.

Government, something more was at stake. The way in which the presidential campaign operated during the first half of 2006 might offer some additional insight.

What matters most is the venue of both political discussions presented in the preceding paragraph, as well as the actors involved. The 59th Congress (2003-2006) decided to take out both the legal immunity of an elected official and the opposition leader and to accept almost without any modification a bill written by the Executive at a time when the interaction between the two bodies was less than fluid. Furthermore, the bill concerned a certain "populist" leader of the opposition, at least as far as members of the cabinet were concerned. This means that most likely both political debates were considered strategic by the majoritarian parties who voted to strip López Obrador of his legal immunity and voted for a bill restraining the formal feasibility of running deficits.

Partially, the president and his subordinates intended these political debates to affect López Obrador's electoral support, of which the most significant was the case to take out his legal immunity. The campaign was merely the continuation of those confrontations between the immediate post-transitional poles of the Mexican political system: the president and his party, the PAN, representing the right; and, López Obrador and his coalition,[395] representing the left. One of the arguments used by the President during the electoral campaign in the first semester of 2006 was the importance of keeping the macroeconomic model in place. On the other hand, López Obrador emphasized a war against social inequality and the role the state should play in this fight (Escamilla 2007, 258).

Moreover, if this was a significant distinction during the January to July 2006 campaign, most likely the arguments used by the President were already present in the Federal Government's discourse, more precisely, during the second half of 2005, when the amendments to the Budget and Fiscal Responsibility Federal Act were presented. Nevertheless, the technicalities of fiscal responsibility were not necessarily a major theme in the campaign as compared to the mutual disqualifications of both the President and his party

395 The official name of the coalition was *Coalición por el bien de todos* (Coalition for the Good of All) representing the *Partido de la Revolución Democrática* - PRD (Democratic Revolution Party), *Convergencia Democrática* (Democratic Convergence), and the Labour Party. López Obrador was officially a member of the PRD.

and López Obrador.[396] While this topic might have been in the background of the political campaign, what mattered most was the latter's presumed lack of interest in such issues, which could affect Mexicans in the same way they had been affected by the economic crises in the preceding three decades.

The possibility of a candidate like López Obrador becoming president was presented by those who opposed him as a return to the chaotic moments of the early 1980s when President López Portillo (not related) declared the debt moratorium and nationalized the banks. The mere fact that such arguments were mobilized during the presidential campaign a quarter of a century later says much about the wounds caused by that crisis. In Congress, those same arguments were certainly present when an unlikely coalition of the PRI and the PAN was put together to pass the new Budget and Fiscal Responsibility Federal Act. The legacy of the policies implemented during the crisis of 1982 were thus incorporated insofar as these served the purpose of enacting an institutional reform that sought to prevent an analogous situation. The salience of fiscal responsibility grew substantially during the second half (2003-2006) of Fox's six-year term precisely because of the possibility of the rise of López Obrador to the Presidency.

Whether this frame of mind was grounded in reality or not is another question. Most likely it was not because during López Obrador term as Mayor of Mexico City public finances did not break into chaos, as Obrador's opponents implied would be the case if the left prevailed in the elections. Moreover, in 2006, the Budget and Fiscal Responsibility Federal Act had already been enacted, so his power to increase expenses without any regard to budgetary equilibrium had already been reduced. However, the most important point is that López Obrador gave priority to expenses reduction in order to better allocate available resources.[397] He did not increase them without any regard to the consequences. The campaign

[396] An indication of such disqualifications is provided by two instances. First, the way in which López Obrador referred to the President by using the Mexican popular bestiary. Presumably appealing to the Mexicans' sense of humor. Second, the construction of the former as a "danger" to the Mexican society because of his lack of interest in maintaining macroeconomic stability, among other values cherished by Mexican society. For a full discussion of the context of the disqualifications, see Treviño (2009) and the construction of López Obrador as a danger, see also Hiller (2011) and Espino-Sánchez (2011). For a detailed analysis of the campaign, see Bruhn (2009).

[397] Political Operator. Interview with the author. Mexico City.

in general was conducted in a particularly negative fashion for Mexican standards[398] one which detracted from the candidate's real record as a fiscally responsible administrator.

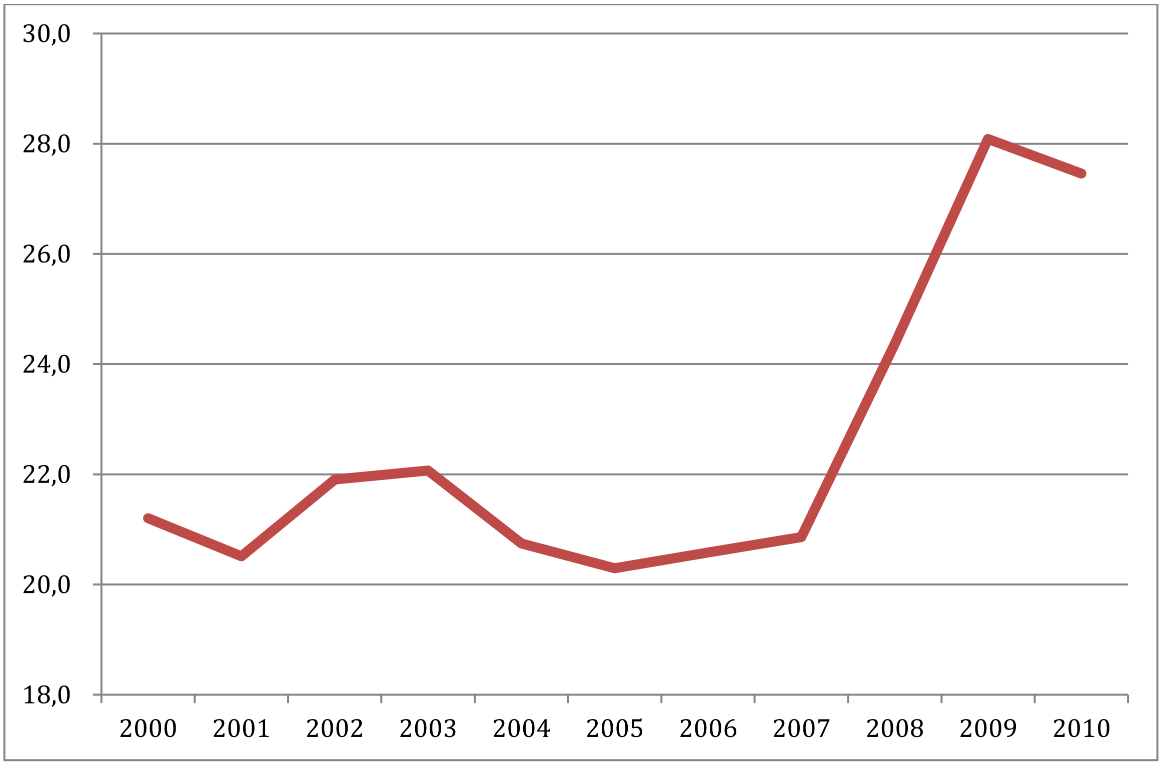
5.2.2. Not Too Tight

Once the campaign was over and Felipe Calderón (2006-2012), the candidate of the PAN, was president, all issues concerning the possible mismanagements of López Obrador would vanish. However, an enduring legacy of these debates remained. The Budget and Fiscal Responsibility Federal Act reduced the Federal Government's ability to autonomously run deficits. Therefore, one would expect the running of deficits to become a rarity in the aftermath of this institutional change. Quite the opposite happened (Figure 19). In the government's defense, the world's financial crisis started in 2007-2008, leading many governments around the world to run deficits.[399] This was the case both because of the implementation of countercyclical policies and because finances were crushed by the decrease in revenues, a result of the generalized economic downturn caused by the financial meltdown.

[398] There are only three presidential campaigns so far where arguments about candidates could be taken seriously: 2000, 2006, and 2012. But neither that of 2000 nor that of 2012 presented the degree of negative campaigning showed in that of 2006. In 2000, there was some degree of negative campaigning that reached its peak with that of 2006, whereas in 2012, there were explicit attempts to avoid the same degree of confrontation seen in the previous election, in part because negative campaigning was outlawed by an electoral reform in 2007. For negative campaigning in 2000, see Moreno (2004), and for that of 2012, see Bruhn (2015, 41-45). To see how the electoral reform affected the campaign, see Magar (2015).

[399] Data concerning the Mexican government cash flow for the period of interest (2006-2014) is patchy. The original series in current local currency (MXN) exists and is made available by Banxico (2015a) but is not inflation-adjusted; the cash-flow position as a proportion of GDP can be found in IBRD (2016a) but it only includes the period 1990-2000. The figure shows the central government debt as a proportion of GDP from 2000 to 2010, which indicates that deficits had been run. Data on general government deficit as a proportion of GDP between 2003-2013 is provided in OECD (2016c) whereas the general government debt as a proportion of GDP from 2003-2014 is provided in OECD (2016b), both of which include subnational governments.

Figure 19. Central Government Debt. Mexico (% GDP) 2000-2010



Source: OECD (2016a). The coverage of the data is limited to central government debt issuance and excludes therefore state and local government debt and social security funds.

The crisis no doubt was a lasting one. Why in Mexico is it possible to run deficits when legislation has deliberately been put into place to restrict them? While the orthodoxy of Mexican economic policymakers has been present for a while (Hernández 1987, Centeno 1994, Ballinas-Valdés 2001, Babb 1998), it appears that keeping a balanced budget was not necessarily a priority. Therefore, even in the presence of legislation demanding a balanced budget, deficits can still be conceivable if the circumstances require them. Even if to do so, the Executive must convince the Legislative that it is in the interest of the country to run a deficit and to propose plans to return to a surplus, or at least to the equilibrium, in the foreseeable future.

The act of convincing the Legislative, as hard as it might be, has not been a problem (Figure 19). Is it legitimate to ask if this is a consequence of the special conditions faced by the Mexican economy in the context of a global crisis? Perhaps. In 2016, it remains impossible to give a satisfactory answer to that question given the persistence of the crisis. Nevertheless, there are some signs that this is not the case. There is a general understanding that if the Federal Government perceives that a deficit is necessary, authorization from Congress might be obtained without significant difficulty.[400] Thus, from a political point of view, running deficits is not severely constrained; from the economic point of view, conditions are also favourable to that course of action.

Does this mean that the fiscal responsibility provisions of the Budget and Fiscal Responsibility Federal Act are irrelevant? Not necessarily. The mandate contained in the Act to provide for a clear source to finance the proposed deficit might force the economic authorities to deepen its pro-cyclical character, as was the case in the first years of its application (IMF 2010, 21-22). Even if the pro-cyclicality of the Mexican economy is not just a result of fiscal rule, the latter has intensified the former (Esquivel 2010, 54). This opens up the possibility for future reforms to transform the short-term fiscal rule into a structural one, that maintains its benefits while reducing its shortcomings (IMF 2010, 32). However, this reform from a short-term to a long-term fiscal rule cannot be taken for granted because the margin for action available to policymakers has not been tightly closed. Had this happened, the reform would have been readily enacted.

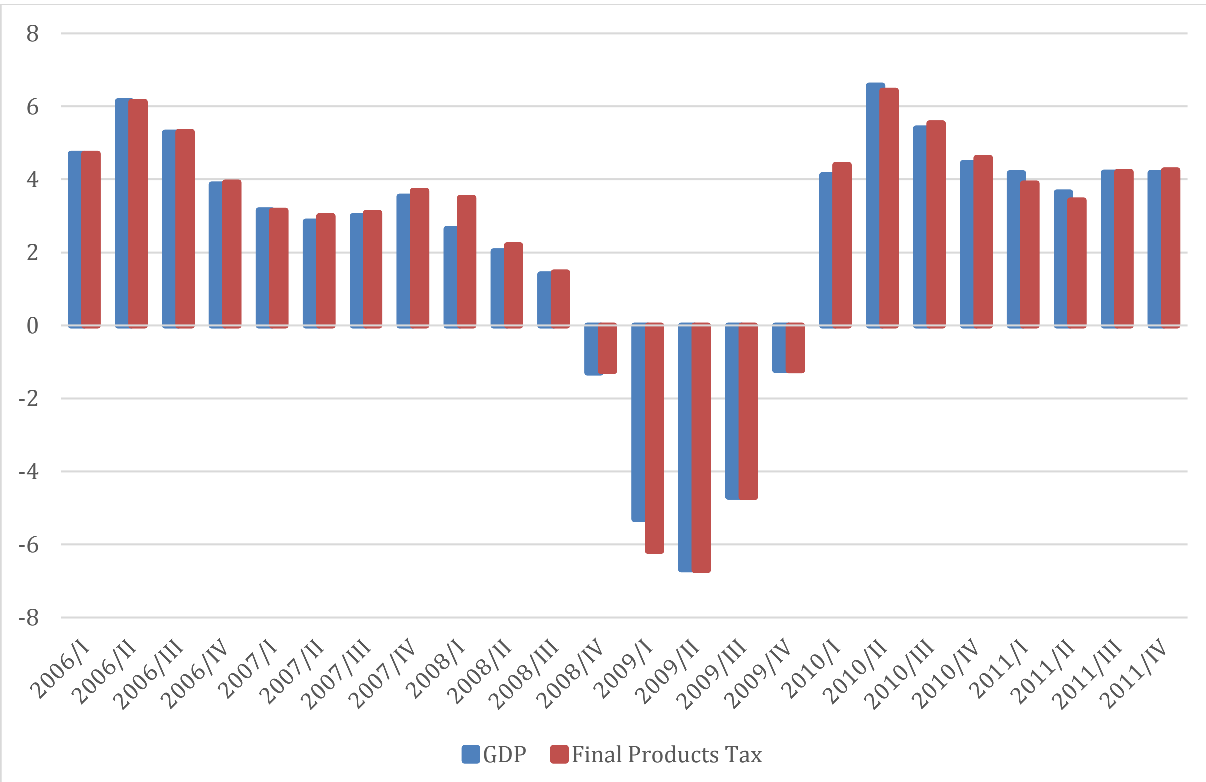
So far, the fiscal rule established by the Budget and Fiscal Responsibility Federal Act has not been rigidly enforced. There are two reasons for this. The first is the world economy, and by extension Mexico's economic situation since 2007-2008.[401] The slowdown of economic activity normally reduces tax revenues (Figure 20) leading those states with high fixed expenses to rely on debt. Mexico is not an exception. The second, is that it is not difficult for the Executive to gather the necessary support in Congress to obtain the

400 Political Operator. Interview with the author. Mexico City.

401 The price of oil affects the federal budget, therefore with the drastic reduction carried out in the fall of 2014 and its improbable return to former levels in the short to mid-term, there would be more arguments for increasing the debt. This argument, however, is contingent on the price of oil. While the 2007-2008 financial crisis did not cause the economic mayhem previous financial crises had in the past, it also brought to light some weaknesses of the Mexican economy. For instance, the strong ties established by Mexican manufactures with their American counterparts were problematic in the wake of the American crisis. Nevertheless, because the Mexican economy was in relatively good shape compared with previous crises, the countercyclical response was non-negligible, even if bigger savings of windfall oil related revenues in earlier years would have made such a response easier. The mostly foreign-owned financial sector lead global banks with Mexican operations to try to strengthen their global balance sheets by reducing their Mexican lending operations. For further details, see IMF (2010).

authorization to run deficits, even in the post-transitional scenario where presidents no longer control Congress. Congressmen and Congresswomen would be affected in the short run if they happen to cut the expenditures of the Federal Government. Only in the improbable case that some politicians campaign successfully on austerity, they could make the case for reduced expenses but not on a harsh reduction of the deficit.[402]

Figure 20. Quarterly GDP and Final Products Tax Variation. Year-to-year. Percentage



Source: Elaborated by the author with data from INEGI (2016b) for GDP and from INEGI (2016a) for Final Products Tax. Seasonally adjusted yearly variations calculated quarterly. Series calculated directly by the *Instituto Nacional de Estadística, Geografía e Informática* – INEGI (National Institute of Statistics, Geography and Informatics) through econometric methods from raw series from Quarterly GDP.

402 Is unlikely that a politician could campaign successfully on the national stage with an agenda of austerity in the European style, albeit not impossible. This is a consequence of the perception among Mexicans of the Government's limited ability to attend to their needs. Moreover, the main liberalization policies, having already been implemented during the 1980s and 1990s, leaves little to implement in that direction. Corruption could be a good argument, but again it would be hard for a politician to gather a solid and lasting coalition against corruption because even if he is not corrupt, he would became the target of those who are.

The possible changes to the Budget and Fiscal Responsibility Act in the second dimension, if there are changes at all, are going to be incremental. That is, the conditions for the Federal Government to run deficits can be tightened mainly with the necessary increase in revenues. Moreover, these possible changes would reinforce the lack of policy space the Federal Government already faces with monetary policy, in the autonomous hands of Banxico. The possible adaptations would include attempts to increase tax collection, mainly through higher rates of the value added tax given the difficulty of incorporating the substantial informal economy. Nevertheless, as change would be incremental, the Federal Government could retain some space to increase the indebtedness of the companies it controls, like *Petróleos Mexicanos* – PEMEX (Mexican Oil) for instance, or the development banking sector that has traditionally played such a role in the past (Arès 2000).

5.3 Institutional Complementarities

Institutional complementarity is about the creation of a series of restrictions on presidential powers over economic policy. First, an independent central bank prevented possible episodes of an expansionary monetary policy. Second, a fiscal rule in which the possibilities of running deficits was reduced and could prevent still more attempts to expand governmental expenses. In this case, institutional complementarity means the mutual reinforcement of restrictions on the possibility for the Executive to act discretionally on economic policy, particularly with respect to monetary and fiscal matters. If we consider that one of the aims of each reform was precisely to restrain presidential discretion over some instruments of economic policy, they would be complementary when both institutions effectively constitute restrictions to it. An independent central bank restricts the ability of the Executive to use monetary emission as a way to finance government-led actions; also, a fiscal rule restricts the ability of the Executive to use debt as a way to carry out expenses without properly consulting with other branches, such as the Legislative.

Because institutional complementarity exists when the structuring role of one institution depends on the presence of the other, in this case complementarity between both institutions would appear when the aim of restricting presidential discretion over expenses is effectively enforced thanks to the presence of the other institution. It is clear, however, that other goals were pursued; keeping inflation low might be the most popular among economists for the reform of the central bank, whereas the Budget and Fiscal Responsibility Act sought also to reorganize outdated budgetary procedures. Also, in the process leading to the latter, reformers drew from a political legacy of economic mismanagement in order to curtail the powers of a presidential candidate.[403]

The hypothesis has been that institutional complementarities are formed when political actors mobilize their resources to prevent the reappearance of a policy legacy. The fear of instability created by this legacy mobilizes actors to promote institutional reforms that would prevent a repetition of a critical outcome. It is through such reforms that complementarity appears as one institution takes advantage of the presence of another to fulfill its structuring role in the political economy. In the Mexican case, the reform that created a fiscal rule sought a balanced budget in the face of an anticipated threat associated with the candidacy of López Obrador. Therefore, the setting for an institutional complementarity was complete with each institution using the other to reduce presidential discretionary powers.

However, the Mexican case illustrates the role of the fear of instability in the consolidation of an institutional complementarity. Because the risk posed by López Obrador disappeared when the other candidate won the election, this situation offers a significant insight into the role of fear in the consolidation process of institutional complementarities. Two significant points should be considered, one theoretical and the other factual. First, if the threat and institutional complementarities are causally related, as this dissertation argues they do, we should not expect the appearance of institutional complementarity when there is no

[403] While other liberalizing reforms such as trade liberalization with both Mexico's entry into the GATT in 1986 and later with the signature of NAFTA also restricted the discretion of Mexican authorities over economic policy, they do not necessarily constitute an institutional complementarity with an independent central bank or a fiscal rule. The former reforms, carried out in the 1980s, structured Mexican political economy without the need for an independent central bank. Although it is beyond the scope of the present work, such reforms might have played an important role in the success of the Economic Solidarity Pact through which Mexican inflation was controlled. Nevertheless, the evidence gathered for the present work does not indicate that those institutional reforms had a role in the consolidation of either of the institutions studied here.

threat. Second, if this was effectively the case in the Mexican setting presented above, we should see that the president still has the ability to run deficits in a discretionary way. Moreover, this also points to the role of perception in understanding institutions and their role in the political economy. Actors can anticipate a problematic situation and as a precaution enact institutional reforms. These precautionary actions can play a significant role in the consolidation of institutional complementarities.

As the example of the central bank independence in Mexico makes clear, the perception of the role of institutions is as important to its structuring character as its formality. Neither independence nor complete subordination alone reduced inflation in Mexico. It was the way in which actors perceived institutions would model their behaviour that built the structuring characteristic sought by the reformers. A subordinate central bank is not the cause of high inflation as it was during the 1960s, and even if the contrary has not yet occurred (an independent central bank with high inflation), there is enough reason to believe that the formal character of an institution is not enough to materialize its intended effects. An institution requires actors to behave as expected in order for it to play its intended role. So far, central bank independence in Mexico has led actors to reinforce the policy path established with it. Their positive feedback was more a consequence of the possible costs associated with breaking the policy path than their conviction of its convenience. This was the case for the second nomination of Guillermo Ortiz as Governor of Banxico even though the president would have preferred another person.

As central bank independence has been successful in structuring Mexican political economy, the opposite can be said about the fiscal rule. The former has kept the Federal Government at bay in monetary affairs, even when the exchange rate is considered. While the latter has had some limited effects as the pro-cyclicality of expenses has increased, the Federal Government still has significant latitude in running deficits. As seen above, this restriction was behind the debate about the Budget and Fiscal Responsibility Federal Act. Because López Obrador's approval was increasing in the polls, his success was framed as a menace to Mexico's stability. In the context of such debates, the Act was modeled partially to prevent the possibility of fiscal profligacy by a "populist" president. Two factors must be considered. First, because López Obrador did not win the presidency the menace built around him was voided. Second, the financial crisis led many governments around the world to expand debt in response to it, including Mexico's government.

These pieces of evidence, however, point to the relationship between the incorporation of a past policy legacy and the effective constitution of institutional complementarities. In spite of the fact that the reform had already been enacted, the push for such reform disappeared when it became clear that the threat no longer existed. Subsequently, deficits appeared when the 2008-2009 crisis affected the Mexican economy through its deep integration with the American market, itself the center of the crisis. However, even if the crisis especially affected the Mexican economy because of its connection with its Northern neighbour, deficits have continued to exist even if the crisis is no longer as critical as it was in the beginning. Had the deficits been only a consequence of the worst moments of the crisis, the Executive would have difficulties getting the authorization to continue running them.[404] The problem with deficits is the perceived notion that a leader like López Obrador could use that instrument of economic policy discretionally, not the use of the instrument as such.

The example of Mexican fiscal rule shows the extent to which institutions' effects are contingent on the use actors give to them. Timing is an important factor. If the world crisis had not happened, the Federal Government might not be running deficits. This situation exemplifies the notion of institutions as resources, as advanced by Hall and Thelen (2009), in which the use of institutions depends on the possible struggles for which these can be used. Once the main struggle for which the institution was conceived is no longer present, the institution is no longer useful, or is no longer intensely relied upon. This in turn affects the possibility of institutional complementarity from appearing in full.

This particular issue points towards an often-overlooked aspect of institutional complementarities. They do not appear as a consequence of the pursuit of efficiency by economic agents. It is more complex than that. Institutional complementarities demand the active involvement of agents using political as much as economic strategies. The evidence

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404 Journalistic accounts indicate that deficits are contentious and their exact level is subject to intense political negotiations that happen every year (Mendoza 2013, Luna 2014, Pazos 2016), as well as "Paquete Económico de EPN, Cero Déficit Presupuestal," *Aristegui Noticias*. Last Modified on December 7, 2012. Retrieved in : http://aristeguinoticias.com/0712/mexico/paquete-economico-2013-de-epn-cero-deficit-presupuestal/. Accessed December 16, 2016.

brought up by the Mexican experience suggests that the interplay of both spheres can create an institutional complementarity. Neither an economic nor a political advantage alone may lead actors to push for reforms or even to use institutions in a particular sense. The timing of the reforms is also important for the consolidation of institutional complementarities insofar as institutional transformations might actually occur but their implementation might not be feasible at a given moment. This being the case with the Budget and Fiscal Responsibility Act.

The attempts to restrict political authorities' discretionary powers were only partially successful. This means the coordinating role of the Mexican state has only partially been modified despite liberalization in many spheres of the economy. While the state conceded the role of resource allocator to the market through trade liberalization and privatization, there is doubt as to how tied the government's hands actually are. It is true that this instrument is no longer fully controlled by the government, as rates are fixed by the independent central bank taking into consideration market trends. The government still commands significant resource allocation capabilities, and with it, possesses a non-negligible degree of control over the economy. Whether or not this capability will be used in the future is an empirical matter. What should be clear is that it exists.

The subsequent question should be, does this resource allocation capability amount to a coordination of economic agents? The Mexican presidency still has considerable power especially through its control of strategic resources such as mining,[405] and the authority to grant the use of many other resources, such as contracts of public infrastructure. In fact, besides the construction of López Obrador as a "populist" menace during the 2006 campaign, what apparently was at stake was the possibility of losing public contracts or a monopolistic position on markets where competition regulators could be more adamant in demanding compliance on antitrust legislation.[406] This also implies that liberalization has transformed the coordination role played by the state. With market forces playing the main role in many arenas (free trade, banking, among others) the state had to change the way in which it steers the economy.

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405 Even after the liberalization of the oil market in 2015-2016, Pemex continues to be as strategic as ever and for the foreseeable future there will not be any flotation of the company's shares mainly because it would imply a prohibitive political cost for a party to propose such a policy.
406 Political Operator. Interview with the author. Mexico City.

Economic coordination and governance changed with liberalization. It has not disappeared. While the blunt interventions of Echeverría and López Portillo in the 1970s and early 1980s relied on their direct control of both political and economic instruments, in the 2010's this intervention is much more subtle. This is a result of a change in the way bureaucratic elite in charge of the economic agencies within the state saw their role. If the market was to play a bigger part, this by no means implied a complete surrender of their steering capabilities. They were undoubtedly committed to a market-oriented economy but, at the same time, they were fully aware of the political power that came with the command of state resources, both material and symbolic.

The institutionalization of Mexican economic policy could create an institutional complementarity. So far, the consolidation of the structuring characteristics of its components has been partially successful. While the independent central bank has limited presidential control over monetary policy, thus regulating agents' behaviour, the fiscal rule and its limits on debt tell another story. These limits have not been strictly enforced, which means its structuring character is incomplete. While the differences in legal status of both reforms (Banxico's independence is in the Constitution whereas the Budget and Fiscal Responsibility Act is not) may say something about the depth of each reform, this line of reasoning could be misleading. Because the central bank is also a bureaucratic organization, any change to its structure or core competencies require a thorough legal change. The budget, on the other hand, is normally a legal instrument authorizing the use of public resources and stating, more or less clearly, where these come from. Thus, the difference in the type of legal instruments required to enact the reforms is not necessarily an indicator of the reforms' importance.

In any case, the reform has already taken place. The legal framework required to enforce tight limits on the ability of the Federal Government, with the President at the top, is in place when actors deem its use necessary. Whereas the legal reform was enacted during a presidential campaign when a threat was thought to be imminent, the full application of the law no longer demands complicated legal and political procedures to play its structuring role. If a candidate is perceived as a threat to the political-economic stability of Mexico because of his or her presumably fiscal profligacy, it would only require that the Legislative enforce the Budget and Fiscal Responsibility Federal Act in order to prevent such a candidate-turned-president from running any deficit. This scenario would naturally demand that the opposition still control the Chamber of Deputies. There would be a window of opportunity of at least three years between legislative elections. However, this institutional complementarity would only exist if the threat of political-economic instability motivates actors to prevent a discretionary President from accumulating deficits, presumably irresponsibly.

Beyond the legal character of each reform, what mattered most was how economic agents used the institutions resulting from such reforms. Liberalization brought about significant changes in Mexican economic policymaking while economic authorities kept non-negligible coordination capabilities. The coordinating character of its composing institutions has been reformed to some extent but is not what is generally expected of a thorough reformer like Mexico. The coalition for the independent central bank was stronger because there was a recent breach of trust concerning the role of Banxico. Whereas the coalition behind the fiscal rule was built in anticipation of a change that never come into existence as the candidate López Obrador was not elected president. Consequently, the perception about the pertinence of the fiscal rule diminished with the election of Felipe Calderón as president in 2006.

5.4. Concluding Remarks

This chapter showed that both institutional transformations were carried out by different actors within the Mexican political economy in the context of different political struggles. First, the autonomy of the central bank was brokered by a coalition of its bureaucrats with the incumbent government, with a few factors coming from abroad. Second, the enactment of the short-term fiscal rule happened in a context where a left-leaning candidate appeared as the most likely winner of a presidential contest, a menace that gathered the necessary opposition to create a formal restriction on the possibility of running deficits. Thus, the basic setting for an institutional complementarity within the realm of Mexican economic policies is now in place. However, because the threat became less imminent when the "populist" candidate was not the winner of the presidential contest, the institutional complementarity became latent insofar as presidents having to negotiate with political actors for the possibility of running deficits.

These negotiations with political actors about the level of the deficit indicate that the Federal Budget and Fiscal Responsibility Law constrains to a significant degree the discretion of the Executive regarding the possibility of running deficits. Even if so far, the president seems to be able to run deficits, the fact that negotiations take place are also indicative of the potential that the fiscal rule carries. The forbearance of the fiscal rule up to the mid-2010s could be shifted to a strict enforcement if the political conditions change. These conditions may involve the labeling of a candidate as "populist", as was the case with López Obrador during the presidential campaign in 2006. The institutional complementarity in this case depends on a new episode of fear in which a new threat to macroeconomic stability appears on the horizon. The political process leading to it has already been completed.

The Mexican experience in the institutionalization of economic policy shows the way in which fear, prompted by a particular policy legacy, can lead to institutional reform. While the threat was perceived to be imminent, resources were mobilized in order to carry out an institutional reform that would reduce the discretionary presidential power over economic policy, admittedly the expected consequence of the threat. Nevertheless, once the threat was no longer imminent, the manifestation of the institutional complementarity, through caps on discretionary spending was not required. Even with the formal institution in place, one of its main aims has been used only at the margins and with significant political negotiations. Once the threat of a populist president failed to materialize, institutional complementarity remained only as a possibility. The restrictions on presidential discretion created by a fiscal rule creating limits on deficits were never enforced because the Chamber of Deputies have, so far, authorized the existence of them.

Two possible, but opposite, results of this setup might exist. First, a rigid budget with little margin for indebtedness in conjunction with an independent and restrictive monetary policy can be the stage also for another reform restricting even more the possibilities of the Federal Government, e.g. exchange policy. This will be characterized as an institutional complementarity insofar as every component of economic policy would be out of reach of the Federal Government forcing it to negotiate even more with other actors within the political economy. Every institution will reinforce the others' limits, leaving little or no margin for economic authorities. While both institutions studied in the present chapter actually limit economic policy space, mainly that of the independent central bank, these retain some loopholes the Federal Government can exploit.

Second, the little margin for indebtedness can be exploited to the full, rendering the limits practically innocuous. While these limits would still formally exist, its structuring function would not. However, these institutions are already in place and can be used according to the priorities of actors, regardless of the reasons behind their original constitution. If monetary policy becomes very strict, making domestic debt prohibitively expensive, some signs of reinforcement could arise because the authorities should be forced to find other sources to finance government activities or reduce these activities significantly. This scenario would depend on external conditions as foreign debt could relax such restriction as Mexico is now issuing very long-term bonds in international financial markets,[407] which might lessen the burden of using debt as a resource allocation instrument.

In consequence, the probability for an institutional complementarity between an autonomous central bank and a restrictive fiscal policy depends on how actors perceive the changing political and economic conditions. At the present moment, the fiscal rule will unlikely reinforce the expense restrictions implied by the absence of direct control over monetary policy by the Federal Government. It is possible, however, that both institutions continue to coexist without any further consequence either for the institutional development of the Mexican political economy, or for the economic performance of the country as a whole. In fact, what seems to be the case is that some political actors are using the restrictions in the use of debt as a way of reigning in the latitude of the Executive. Fiscal rule has been applied in part because of the conjuncture but also because there has been a coalition that could turn economic policy in that direction. It, therefore, has remained weakly enforced.

The lack of a credible threat could become a credible one. Just as López Obrador became a viable candidate for the 2006 electoral campaign, another candidate with similar views on economic policy can arise. If the Mexican left is somehow in disarray in 2015-2016,

[407] Roberto del Cueto. Interview with the author. Mexico City. March 24, 2015.

this does not mean that a candidate will never arise. In such an event, the provisions limiting discretionary presidential action on economic policy would be called upon, which would complete the constitution of an institutional complementarity. Therefore, the consequence for Mexican economic governance of the institutional reforms studied here would depend, once again, in the incorporation of a policy legacy pushing actors to rigidly enforce the existing institutional provisions. For now, since no credible menace exists, no institutional complementarity exists.

Conclusion : The Problem of Economic Governance

This study revisited the question of economic governance. It sought to explore the link between the concerns of economic agents over political-economic stability and the creation of patterns of governance of economic policy. The constitution of institutional complementarities - understood as the situation in which one institution takes advantage of other institution's presence to fulfill its structuring role in the political economy – constitutes this link. Institutional complementarities explain the existence of different models of capitalism; they also explain the existence of different orders within political economies. Economic governance in turn is enhanced through the existence of such orders because political-economic stability allows the state to implement policy through established routines. To the question of why these orders are constituted, the literature has proposed the existence of a market within which actors can search for available institutions that would help to sustain others (Crouch 2010, 124), either because they reinforce each other or because they produce stability.

In this study, I sought to demonstrate that economic governance, at least in part, is affected by the fear of repeating past institutional disruptions that created political and economic instability. The link that is formed between institutions to maintain stability is the constitutive element of an institutional complementarity. In fact, there is a range of possible responses to a perceived threat to stability. Actors can implement a reform so as to directly prevent a new crisis if the threat is imminent; actors can muddle-through by enacting reforms that respond to specific concerns, which nonetheless do not create long-term stability; where the fear is not credible, where a "real" risk is lacking, the possibilities for the constitution of an institutional complementarity decrease significantly as actors are less inclined to push for institutional reform. Thus, the constitution of institutional arrangements that organize economies and maintain stability depend on the way in which actors incorporate the possibility that a previous crisis comes back

As highlighted by Campbell (2011, 212), stability is a fundamental characteristic of political economies. Institutions help to maintain it; however, such stability depends crucially on the way in which actors use the institutions in question, the way in which they strategically order, alter, and create arrangements between, institutions. The term used to describe such arrangements is, models of capitalism. The focus of a significant part of the literature on comparative capitalisms has been on advanced capitalist economies. Relegated to their own separate category, Latin American capitalist economies are at the center of this particular study.

The concept of institutional complementarities has been used extensively in the literature on comparative capitalisms as an explanation for the differences between models of capitalism. The significance of this causal relationship was undermined somewhat by liberalization insofar as it seemed to imply that there was only one successful kind of capitalism. And yet, countries that departed from prototypical liberal arrangements performed equally well in the international economy. Institutional complementarities account for the differences between capitalisms in terms of organization, but are also the reason for the relatively limited types of capitalism. Despite the widespread use of this concept to explain differences between capitalisms, there has not been consensus as to the different types, its theoretical and policy implications, and, above all, the proper use of the concept.

1. Institutional Complementarities

The debate around institutional complementarity (Crouch et al. 2005) reflected the wide variety of understandings about the concept. Scholars of political economy all agree, however, that institutional complementarity explains the resilience of capitalist economies when these faced the challenge of liberalization. The existence of complementary institutions prevented the mere convergence of institutional arrangements towards those liberal types prevailing in the most important economy in the world, that of the United States. Instead, many of the economies with different arrangements to organize capitalist production, whether labour or financial markets, presented a remarkable resilience in terms of stability and performance of their institutions in an increasingly liberalized world. The field of Comparative Institutional Analysis was born out of attempts to explain precisely such phenomena.

Even if there was consensus as to the consequences of complementary institutions in the political economy, why they presented these effects was less clear. Behind such disagreements, there were different conceptions of complementarity. The most accepted version was that of increasing returns, that is, institutional complementarity exists when the presence of one institution increases the efficiency of another institution, creating increasing returns. This view was espoused by Hall and Soskice (2001b) as well as by the Regulation School (Boyer 2002-2003, 2004) both of which greatly influenced the field. Another view on complementarity that held wide appeal was the notion of complementarity as compensation: one institution compensates for the deficiencies of the other (Crouch 2005).

Even if the concept of two complementary goods characteristic of microeconomics was taken as a reference, its being applied to institutional analysis was less evident. The empirical examples used to illustrate complementarity made reference mainly to the Japanese economy, where the main bank system was complementary with lifetime employment (Aoki 1994). It was not clear if that particular arrangement of the Japanese economy was complementary because it created increasing returns, as implied by (Aoki 1994, 675), or because it emulated the definition provided by economists as implied by (Crouch 2010, 124). Nevertheless, this is just one example where the empirical record was interpreted differently, which led to a variety of theoretical implications. The debate was about whether an economy performed well because its institutions produced increasing returns or because one of its institutions compensated for the shortcomings of the other.

Once again, the evidence was not conclusive. In some instances, it seemed that performance depended on the similarity of the incentives produced by institutions (Hall and Gingerich 2009); whereas in others, it seemed that performance depended on the compensation that each institution provided for the shortcomings of others (Campbell and Pedersen 2007). Later on, it was proposed that institutional complementarities could lead to poor economic performance (Campbell 2011), a notion that was much taken up by scholars. This association between institutional complementarity and overall economic performance has made it difficult for those working in the social sciences to fully grasp the scope and the utility of institutional complementarities.

Essentially, there are two shortcomings in the literature on institutional complementarity. First, the gap concerning a clear definition of the concept that does not depend on a macroeconomic outcome such as growth since this can change with economic cycles. Second, despite the agreement concerning the role of institutional complementarities in organizing political economies, there is no explanation for their constitution. This study sought to fill such gaps. It presents a definition that does not rely on growth or performance but nonetheless substantiates the existence of different ways of organizing capitalism. The definition proposed asserts that institutional complementarities happen when one institution requires the presence of another institution to play its structuring role in the political economy. Even if such a definition breaks the traditional connection with macroeconomic performance, it is still useful for explaining the organization of capitalism, which has long been a concern of Comparative Institutional Analysis.

The second gap, the absence of a reason for the constitution of institutional complementarities is also filled by this study. In the context of a reconstruction and redefinition of the institutional structure of a set of political economies, past institutional disruptions are taken into account by actors who, depending on the extent of the threat of a new disruption, will use different institutions to uphold their structuring roles in the political economy. Even if it seems like this explanation is confined to the institutional reconstruction of an economy, the fear of a return to instability is likely behind the constitution of institutional complementarities. It is also important to underscore the difference between the constitution of institutional complementarities and the creation of institutions. The former appear because the latter already exist in political economies; thus if institutions are created in moments of crisis and explicit political struggle, the constitution of institutional complementarities are those where crises are avoided.

The definition presented here includes the notion of increasing returns and compensation, as presented in the literature on comparative capitalism. The only component that this definition does not include is microeconomics. This for at least two reasons; first, the definition of complementarity in microeconomics is clear enough and refers to two goods in the specific expenditure minimization problem of a consumer with a defined utility function. In spite of the hope that such a definition raises (Crouch 2010, 133), the restricted conditions needed to observe it, make it very difficult to operationalize it in institutional theory. The second is a consequence of the first, since the empirical situations used to exemplify the microeconomic definition of complementarity are precisely the same as those used to illustrate the traditional definition in the sense of increasing-returns, i.e. the Japanese main bank system and the team-oriented labour market.

Furthermore, if we accept that stability is the key characteristic in the political economies where complementary institutions are considered (Crouch 2010, 124, Campbell 2011, 225), it is not clear how complementarity in the microeconomic sense would be useful. Hence, to focus on a definition that includes the most used and accepted meanings of complementarity in institutional theory, while also offering a better empirical criterion to determine whether the concept holds or not, makes sense from the practical point of view of taking the debate one step forward. This is a key contribution of the present study to the understanding of institutional complementarities. In addition, this study seeks to build upon the debates around complementarity, underlining the importance of stability without necessarily falling into a deterministic argument that does not leave enough space for agency. In other words, stability is dynamic.

Stability is a fundamental condition for economic governance because it maximizes the possibility that actors will accept government policies. In spite of the responsibility that might be attributed to policymakers for compounding the consequences of events, that are in fact beyond their control, by not responding in an appropriate manner, what matters more is that these overwhelm the abilities and capacities of policymakers. Subsequently, policymakers perceive new crises as re-editions of those events that overwhelmed them, leading them to consolidate institutional reforms that would prevent crises from reoccurring. Economic governance is enhanced and strengthened in the face of the possibility of a disruption because agents try to anticipate through compromise, creating long-term commitments. These commitments forge the foundations of a stable order. Somehow, paradoxically, the possibility of a disruption promotes stability.

The constitution of institutional complementarities explains this paradox. Since institutional complementarities come into existence when one institution depends on the other to fulfill its structuring role in the political economy, this means that the coalition behind an institution is joined by the coalition supporting the other institution. This enlarged coalition supports a new stable order since institutions would continue to play their structuring role. The link between the institutions that tend to regulate a specific arena of the economy with the establishment of an order that assures governance of economic policy is the one this dissertation intended to make from a theoretical point of view: The fear that institutions regulating specific arenas may crumble is what lead actors to create a larger order where those separated institutions depend on other institutions to survive.

The implication for economic policy analysis is that the effects of each policy cannot be understood as being *ceteris paribus*. Not only because the effects are extremely complex and frequently are not controlled by policymakers, but mainly because each policy depends on other policies to have the desired effects. This is especially the case in moments when the survival of the whole political economy is in jeopardy because of an overwhelming threat. Economic actors should take economic policies as a whole into account to fully grasp their effects. Nevertheless, each policy is normally conceived of and implemented as though independent from others. This is a consequence of bounded rationality, which is behind the incremental pace of institutional reform. The fear factor, meaning a subjective appraisal of reality, is fundamental to explaining the creation and maintainance of order within political economies. A fear of repeating past disruptions pushes actors toward institutional consolidation.

This condition also casts doubt over the possibility of designing institutions as rational, top-down endeavours. Actors must be aware that other institutions that also exist within the political economy affect new institutions and that these may interact in unexpected ways. To maximize the possibilities of success for a newly created institution, reformers should take into account these interactions; otherwise, there is a strong possibility that expected results will not materialize. Another way to see the same issue is to explicitly account for interaction when designing institutions. However, there is always the possibility of unexpected consequences. Therefore, institutional design and the expectations that surround it should be approached with caution. This is not to argue that no institutions should be devised because unintended consequences will always override reformers' intentions. Because incremental change is so important in the consolidation of institutions, attention must also be paid to maintenance as much as design.

2. Fearing the Past

Latin America is a region with a long history of institutional disruptions. Time and again, there are events that seem to put economies off course. Their causes are less relevant to this analysis than the consequences. Institutional disruptions led to a profound resetting of the prevailing arrangement within the cases analyzed in this study. These changes in economic policy implied for the most part a change in the model of the economy around which the different interventions of public authorities were organized. The institutional crises that took place as a consequence of changes in the world economy forced Latin American governments to break with their past policies, whether these were more or less interventionist. As the ISI model faltered, some governments continued with their previous policies until the consequences were impossible to ignore. However, this is not a matter of good policy vs. bad policy or ISI model vs. neoliberalism.

With the crises of the early 1980s, big Latin American economies had no choice but to reform the arrangements governing economic policies. Institutional disruptions created turmoil within those patterns of economic governance that had long guided policymakers. These disruptions had long-term consequences too because for years to come they represented the kind of situation policymakers sought to avoid. Fearing that a similar crisis could happen again, despite the different circumstances and the numerous reforms that had been carried out, policymakers set out to insure that independent policies were each sustained by others. When they believed that threats to economic governance were not as significant, they responded accordingly. Therefore, the way in which policymakers judge a critical situation leads them to push for institutional changes that may transform independent policies into complementary ones.

In Brazil, the disruption that symbolized the need to change the pattern of governance of economic policy was hyperinflation. Even if inflation was part of life in Brazil, the levels it attained during the 1980s were previously unseen. It was the consequence of the political and economic strategies of many actors attempting to externalize their costs. At a moment in which the state could no longer arbitrate these conflicts because its own resources – both political and economic - were exhausted, the externalization of costs had systemic consequences, i.e. hyperinflation. Many attempts to solve hyperinflation were implemented, none of them representing the silver bullet many in Brazil imagined they could be. After institutional reforms prevented the externalization of costs, inflation was controlled in the short to medium run. Despite those accomplishments, the threat of inflation continued to loom over Brazilian policymakers.

The possibility of a re-edition of an inflationary crisis was deemed too big to ignore. Brazilian policymakers feared that the return of inflation could derail the government to which they belonged. They also considered it to be the same kind of disruption to economic governance that inflation had represented in the past. In the face of such a threat, they implemented reforms that tied two institutions to one other creating an institutional complementarity. It is important to underscore the fact that they did not seek this outcome from the beginning of the process of institutional reform. This was more a solution to a pressing problem than the result of a preconceived idea as to how the political economy should be organized.

The political-economic crises Brazil is experiencing in the mid-2010s can be partially explained by the theory proposed in the present study. Since inflation has increased steadily since the late 2000s, the reforms that are currently (December 2016) being approved by the Brazilian congress seek, in part, to control those inflationary increases. Even if the externalization of costs is also reduced this time around, with all the political and economic factors that such an issue mobilizes, the current government is politically weak. In the event that a sense of order in public bills is restored before the next elections, such a government will try to preserve that sense of order; it may involve a complementarity with the cap on public expenses the present government is currently seeking to put in place. These events, however, will depend on the political fate of many politicians that might be involved in the corruption scandal surrounding *Petrobras.*

In Mexico, the disruption was caused by two successive presidents choosing to break with the tacit arrangement that as far as economic policy is concerned, the president is a mere referee between two bureaucracies. These decisions were taken in the context of an attempt to restore the regime's lost legitimacy as well as the poor administration of a windfall of new oil resources. The direct consequence was the nationalization of the banking sector, but the main consequence was the realization that the power of the Mexican presidents concerning economic policy should be checked. A long process of institutional reform was launched in which the Mexican Central Bank was granted operational and political autonomy. In spite of some shortcomings in which such independence was questioned, it was finally consolidated. In parallel, Mexican presidents limited their actions in economic policy to being arbiters of forces above the control of any office, even theirs.

Nevertheless, a return to an unstable situation in which a president could carry out a more interventionist approach, mainly unchecked policymaking, loomed on the horizon. For the Mexican government and a large majority of legislators at the time, this new threat to the stability of the Mexican economy had to be stopped. A fiscal responsibility law was enacted to prevent any possible mismanagement by a president who, in their view, did not prioritize macroeconomic equilibrium. The interpretation that Mexican policymakers and legislators made of the increasing appeal that a left-leaning politician had over the electorate led them to believe that their cherished macroeconomic stability, represented in a balanced budget, could be jeopardized. Institutional reforms were enacted to tie further the hands of the Executive so as to prevent fiscal profligacy.

After all these reforms were in place, their *raison d'être* disappeared. Andrés Manuel López Obrador, the left-leaning candidate, lost the election by a narrow margin. The perception of the existence of a threat vanished with the election of the other contender. In the wake of the global financial crisis of 2007-2008, many governments, including that of Mexico, ran deficits to counter the downturn in economic activity caused by the uncertainty of a financial crisis in the United States. The lack of a credible threat coupled with an uncertain situation in the international arena led the Mexican government to run deficits in the following years. However, almost a decade after the financial crisis, the Mexican Federal Government is still running deficits with which the argument concerning the perception of an increased threat as the real motive behind the reform becomes stronger.

When the perception of a threat vanished, so did the political will to consolidate the link between an independent central bank and a fiscal rule. The purpose of this link between these two institutions is to restrain the latitude of the Executive in terms of economic intervention. The former prevents the use of monetary policy to finance government initiatives and the latter prevents the government from running deficits unless how this deficit is to be be paid down is explicitly addressed. Is important to note that if one of the institutions is not strictly enforced, the Federal Government possesses significant latitude in terms of economic policy, which has been the prevailing pattern of governance in Mexico. Had the constraints been strictly applied to the Executive, the fiscal rule would have been complementary with the independent central bank. Both institutions may become complementary if agents' perceptions change and the fiscal rule is implemented as strictly as possible.

This might be precisely the case in the context of the presidential election in 2018. With Donald Trump as US President, the Mexican economy might have a difficult time ahead and the arguments for fiscal restraint may become especially salient. If López Obrador campaigns for the presidency, he would have even less political space than he once enjoyed in early 2006. This time the arguments against his presidential aspirations would emphasize the international context but the fear of political-economic instability will probably stem from what he plans to do in office. However, López Obrador's possibilities are hard to predict; even if he is currently the frontrunner in the presidential polls for 2018, he is not as popular as he was back in the early 2000s - he does not hold any position in government - and a confrontation in the style he once had with Vicente Fox is very unlikely. Irrespective of who is the next Mexican president, the most important issue on the economic front will be the disruptions the American president might create, whether in the value of the currency or in the trade-related controversies that are likely to appear. This will dictate Mexican economic policy in the years to come and no institutional architecture will prevent that.

In the Chilean case, the threat to politico-economic stability was acknowledged both on the right and on the left, but for different reasons. For the left, the arrangements left in place by the authoritarian government had many problems but on many occasions had to be upheld because of the threat of a possible authoritarian regression. For the right, every change in the institutional architecture left by the military was a step toward a socialist government. The left possessed political legitimacy but it lacked the confidence of economic actors in its ability to rule the economy, this a consequence of the socialist government of the 1970s. The right was in exactly the opposite situation. It lacked significant political legitimacy as it had lost the plebiscite for a renewed mandate, but claimed positive results in the economic arena. Such a complex setting was the backstage of institutional reforms that were first enacted during authoritarian rule but were incrementally changed by successive democratic governments.

The privately administered pension system, created during authoritarian rule, helped to strengthen capital markets insofar as its resources had to be channeled through them. However, because of its regulatory architecture as well as the size restrictions of domestic capital markets, the pension system started to show its limitations. In the political arena, a democratic reversal seemed unlikely and the governing coalition would not repeat the mistakes made in the 1970s in terms of economic policy. In the mid-1990s, the threat to stability was ambiguous insofar as there was no credible factor, in the short term at least, that might lead to a complete demise of the arrangements in place in post-transition Chile. The pension system went through different phases of reform, but none represented a significant overhaul of the system or a definite change to consolidate Chilean capital markets.

The reforms implemented sought to deepen capital markets while opening new investment opportunities for pension funds allocation on one side, while on the other diversifying the risk profile and some regulations concerning administrative fees. Every Chilean government from the left had enacted a reform to the pension system, and some changes in the financial system have also been implemented. Nevertheless, the financial heft provided by the accumulated savings was not enough to transform Chilean financial markets from a bank-based system toward one based in capital-markets. Even if some companies can fund themselves with bonds floated in the domestic market, banks continue to be the core of the Chilean financial system. Besides the link between pensions and capital markets, further progress has been difficult because there is no consensus as to whether the pension system as is is worth keeping or if it should be profoundly reformed. This is still a contentious issue in Chilean politics and it will likely remain so for the foreseeable future.[408]

In this context, it is difficult to consolidate an institutional complementarity even if, in principle, there is already a link between the two institutions. While the setting for an institutional complementarity exists, the threat to political-economic stability is ambiguous and the institutions do not depend on each other, yet, to play their intended structuring role. Capital markets received a significant boost from the mid-1980s with the resources of the new pension system, but in spite of these, financial markets continued to be dominated by banks. On the other hand, the pension system is not mature enough so it does not pay pensions yet; nevertheless, the estimate is that given the actual level of contributions, workers will not have enough resources to keep their standard of living when they retire. The link between the two systems is not strong enough to fully transform the structuring role of one another. Capital markets did not change the financing opportunities for Chilean firms and the pension system falls short of its purpose, which partially explains the continuous efforts to reform it.

Previous crises represented a situation policymakers sought to avoid. When they feared that a re-edition of a crisis in their political economies was imminent, they enacted reforms in order to avoid the instability that comes with crises, which would be a political problem for incumbents. Nevertheless, what mattered most was not institutional change as such, but the way in which such change was implemented. This includes whether or not actors comply with the new norms. Their interpretation of institutions might change and the chances for an institutional complementarity increases or vanishes depending on the new interpretation. Interpretations change depending on how pressed policymakers feel by the situation. If Brazilian policymakers felt inflation could pose a serious threat to political-economic stability and acted accordingly, Mexican policymakers considered that the newly-elected president, in 2006, did not represent a serious threat since he was not "a populist" as was the defeated candidate.

408 *The Economist,* "The Perils of Not Saving; Chile's Pensions." August 27, 2016.

3. The Problem of Economic Governance

The ability of governments to impose initiatives in the economic arena and the rules governing the interactions between different actors shaping economic life is the backbone of economic governance. In principle, once there are established routines, such tasks involve mainly their implementation and acceptance for the majority of actors; nevertheless, when known routines no longer hold because of an event outside of policymakers' control, the creation of new, stable and uncontested routines require much in the way of political mobilization. The creation of new rules that effectively structure actors' behaviour in a stable setting involves long processes of institutional change in a variety of arenas. These institutional changes tend to be incremental insofar as actors neither have the intellectual capabilities to devise complex reforms in different arenas of the economy nor the political resources to implement them all at once. Also, political compromises required to enact the desired reforms are easier to agree upon when changes are incremental.

Nevertheless, governance over economic policy is frequently pictured as a perfectly rational endeavour. In this image of economic policymaking, the key supposition is that everything else holds equally, which is difficult to assure in an increasingly complex economic landscape. The image of fully rational policymakers controlling the many dimensions of an economy should be re-cast. To be sure, it does not help that economists, the overwhelming majority of economic policymakers, often pretend that their actions fit the model of perfect rationality, i.e. *Homo economicus.* Yet, as this study has demonstrated, integrating two dimensions of economic policy in Latin America required the existence of a tangible threat to political-economic stability. Until such a threat appeared, each institutional arena was reformed independently, which means that it was dominated by a series of political concerns that apparently were restricted to the same arena. Indeed, this is the normal condition of policymaking and economics is no exception.

To argue that a fully-integrated economic policy is better than having several policies in different economic arenas, is fairly straightforward. Nevertheless, drawing such a conclusion should take into account what, in specific contexts, it would imply to have an all-encompassing economic policy. *Cui bono?* Who are the beneficiaries of such integration? asks

Susan Strange with respect to distributional outcomes of changes in the international economy.[409] The question may be applied in this context. Who would benefit from an integrated approach to economic policymaking? Rather than weigh in on the desirability of such an outcome, I suggest that the cases in this study serve as a cautionary tale for full integration. Whereas in Brazil, an integrated economic policy was desperately needed in order to end hyperinflation in the medium run, the same approach between monetary and fiscal policies in Mexico would have rendered less likely a reasonable answer to the critical conditions that followed the financial crisis of 2007-2008.

Institutions depend on the interpretation each set of actors makes of them. Some interpretations might be beneficial to the large majority of actors in the political economy while others would only benefit a few. To fully understand economic policymaking, such considerations should be incorporated in the analyses. The fear that some actors feel about instability leads them to enact reforms and behave accordingly, but not everyone fears the same things. In this respect, Chile is a case in point. The big coalitions of Chilean politics feared different outcomes and struggled hard to model institutions that would prevent their worst fears from coming true. The consequence of a privately administered individual accounts pension system in the attempt to meaningfully pass to financial markets based in capital markets rather than in the traditional banking system is not yet settled. It continues to be highly contentious, even after several decades of attempts to bring it to fruition and to improve upon it. Naturally, the fact that the system has not been eliminated says a great deal about the interest around it.

The continuous reform of the Chilean pension system shows that there is dissatisfaction with what the system provides. The lack of a consolidated institutional complementarity between capital markets and the pension system left an open space for these reforms to take place. Had it been perfectly consolidated, the case for reform would be harder to make in part because there would be a bigger opposition. Hence, governance of economic policy also depends on the perceived benefits that specific groups derive from current and future arrangements. That is, distributional effects are at the core of the possible acceptance of

[409] Susan Strange reportedly asked this question repeatedly (Tooze 2000, 284), but no printed reference has been traced.

the implementation of economic policies. This is especially the case if a group has the means to contest the status quo; these distributional effects are important for economic governance. Unlike Chilean workers who have contested the pension system over the years, Brazilians who earned a fixed income during hyperinflation could not directly contest the economic order.

Therefore, instead of emphasizing the role that institutions play in the governance of economic policy, this study suggests that institutions are merely the means to achieve certain goals. Because institutions are the product of political struggles, the way in which the latter shape the former is the true determinant of economic governance. Because actors will mobilize economic and political resources to build institutions that fit their interests, it is essential to understand the latter to assess whether any given institution will effectively play the role that others perceive as fundamental to economic governance. The example of Mexico and its Central Bank shows that even if the bank's independence is ideal for economic governance, there were several occasions during which the country suffered from the kind of instability the institution was supposed to prevent.

Institutional complementarities and the processes leading to their constitution are a manifestation of the political struggles at the core of the governance of economic policy. The fact that they underpin political-economic stability shows that successful economic governance should take into account both political and economic considerations. In other words, is not enough to have the right institutions and expect them to have the desired effect; instead, it is necessary to have them be accepted by the interested parties if they are going to play any significant role. The stability created by the consolidation of institutional complementarities is nothing more than the manifestation of the acquiescence of actors to a given order, which is the key feature of economic governance. Such stability in any case should not be taken for granted indefinitely. In that sense, the problem of economic governance involves actors' behaviours and preferences as well as the institutions that structure them. Frequently, only the latter is taken into account.

This is the case in the domestic arena, but is increasingly to be found in the global arena as well. Institutions as such are useless if they are not capable of structuring the actions of interested parties. Global economic governance has focused mainly on the diffusion of the same kind of institutions across different countries, such as independent central banks and fiscal rules. However, as the Mexican case shows, these institutions have had some difficulties in effectively structuring economic behaviours. Even after they were legally enacted, these institutions were disregarded, or there were attempts in that sense, which underscores their intermediate role in the consolidation of a stable pattern of economic governance. Rather than limiting one's assessment to actors over institutions or vice-versa, economic governance should be studied as the combination of both elements. Approaches that emphasize one over the other will only give us half of the picture.

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Appendix

List of Interviews

The semidirected interviews were conducted between February 2014 and March 2015. Each interview lasted between thirty minutes and two hours and was held in Portuguese or Spanish. These authors accepted the use of their names in the text.

José Pablo Arellano was Head (1990-1996) of the *Dirección Nacional de Presupuesto* – Diprés (National Budget Directorate) and Minister of Education (1996-2000). He was a prominent member of the *Corporación de Investigaciones Económicas para América Latina* – CIEPLAN (Corporation of Economic Research for Latin America) from its foundation in 1976 and has served as Senior Researcher, Member of the Board of Directors and Executive Director of it.

Edmar Bacha is a founding partner and Head of the Instituto de Estudos em Política Econômica/Casa das Garças. He was President of the *Instiuto Brasileiro de Geografia e Estatística* – IBGE (Brazilian Institute of Geography and Statistics) during the Cruzado Plan in 1986. Later he was nominated as President of different institutions during the Real Plan and was a member of the team behind it. Interviewed by the author in Rio de Janeiro, RJ on February

Luiz Carlos Bresser-Pereira is Emeritus Professor of Getúlio Vargas Foundation in São Paulo. He was Finance Minister from April 29 to December 18, 1987 and Minister of Federal Administration (1995-1998).

Ariel Buira served as a Member of the Board of Governors of Banxico from 1994-1996 and previously was Director for International Organizations and Agreements within the Bank 1985-1993.

Gonzalo Cid is currently (2014-) head of the Pension Studies Directorate within the Chilean Ministry of Labour. Before that he was the Head of the Pension Unit on *Centro de Estudios Nacionales de Desarrollo Alternativo* – CENDA (Center for National Studies on Alternative Development).

Roberto del Cueto is currently member of the Board of Governors of Banxico. He entered the Bank in 1973 and climbed the ranks to Deputy Director in 1994 when he resigned. He worked in the financial sector as Chief Executive Officer – CEO of Banco Nacional de México – Banamex (National Bank of Mexico) and other posts in the Mexican financial sector. He also held academic positions in the Law School of the Instituto Tecnológico Autónomo de México – ITAM (Autonomous Technological Institute of Mexico), a private university, and finally was re-nominated as Member of the Board of Governors of Banxico in 2007.

Jorge Chávez Presa was during the 1990s a mid-to-high level bureaucrat at the Ministry of Finance. In the period 2000-2003 was elected to the Chamber of Deputies representing the PRI. Currently runs a consulting firm in Mexico City.

Gustavo H.B. Franco was President of the Brazilian Central Bank, head of the International Directorate of the same institution and Deputy Secretary of Economic Policy of the Brazilian Ministry of Finance. He is founding partner of Rio Bravo Investimentos in Rio de Janeiro. He was part of the team behind the Real Plan.

Miguel Mancera was the longest serving Banxico's Director General. He oversaw the transition from a completely dependent institution towards a formally independent one. He entered the bank in 1958 and climbed the ranks of the organization up to being appointed in 1982 as Director General. He retired in 1998 as Governor.

Carlos Ominami was Minister of the Economy (1990-1992) during the government of Patricio Aylwin. He was elected Senator in 1993 and reelected until 2009. He participated in the transition team from the military government to the democratically elected government.

Andre Lara-Resende is an Adjunct Senior Research Scholar at the School of International and Public Affairs, Columbia University. He is a founding partner of Instituto de Estudos em Política Econômica da Casa das Garças and a member of the board of directors of the International Advisory Board of Itaú-Unibanco. He thought economics at PUC-Rio de Janeiro, was a member of the board of directors of the Central Bank of Brazil and President of BNDES. He was part of the teams behind the Cruzado and Real Plans.

Jaime Ruíz-Tagle is a sociologist. He was director of the Labour Economics Program and Head of the Office of Forecasting Studies at the Ministry of Planning. He has been involved in social security issues since the 1980s.

Alfonso Serrano Spoerer was the Under-Secretary of Social Protection from 1976 to 1985 being an important member of the team in charge of shepherding the reform from the conception up to its completion. He was later nominated (in 1985) as Vice-President of the Chilean Central Bank and after the reform that granted independence to the institution he was chosen as a Member of the Board of Directors after the reform.

Licínio Velasco Jr was the Chief of the Department of Privatization Services of the BNDES in 1999 and worked on that department since at least the late 1980s. He entered the bank through one of its subsidiaries in the 1970s and made his career in the BNDES bureaucracy; during the 1990s he completed a Master's degree in Political Science at the *Instituto Universitário de*

Pesquisas do Rio de Janeiro – IUPERJ (Institute for Advanced Research of Rio de Janeiro) where he also completed a Ph.D in political science in the early 2000s.

Joaquín Vial is member of the Board of Directors of Chilean Central Bank. He has been the Chief Economist of the global Trends Unit of the Economic Research Department at BBVA (a bank); He was Chief Macroeconomic Adviser to the Minister of Finance (1992-1994) and Head (1997-2000) of the *Dirección Nacional de Presupuesto* – Diprés (National Budget Directorate).