4-28-2006

The Paradox of Neoliberalism: A Critique of the Washington Consensus in the Age of Globalization

Benjamin G. Griffith
Connecticut College, bggri@conncoll.edu

The Paradox of Neoliberalism

A Critique of the Washington Consensus in the Age of Globalization

Benjamin Griffith

April 28th, 2006

Connecticut College, Honors Thesis

Contents

Chapter One

Introduction

In the age of globalization, the puzzle of economic development has become more complicated. Conventional paths to economic growth have become even riskier. In the last 25 years, technological advancement and the liberalization of international trade policy seem to have compressed both space and time. In this smaller and faster world, instability spreads more easily. As transnational capital has become increasingly mobile and powerful, policy makers traditionally responsible for maintaining financial and political stability are finding themselves less and less in control of the rapidly changing world system.[1] Recent changes to the political economic system have forced academics and policymakers to think about old problems in new ways.

Many theorists have postulated that Neoliberal reforms are a prerequisite for long-term, stable growth. Countries of the less-developed world are said to require Neoliberal economic policies in order to curb inflation and to make up for deficiencies in domestic savings by attracting foreign capital. Given the average domestic savings rates throughout much of the developing world, it would be hard to argue that foreign investment is unnecessary. Yet at the same time, Neoliberal reforms have brought tremendous social and economic costs, especially to those in the middle and lower classes. Critics argue that Neoliberalism diminishes national policy autonomy and is too costly for those members of society who are least capable of bearing the burden. Nevertheless, in the last quarter century, the ultimate vision of Western-style individualism seems to have taken hold, as democracies and liberal economies are propagated all over the world.

---

[1] William I. Robinson, *Transnational Conflicts: Central America, Social Change, and Globalization* (New York: Verso, 2003), 11.

In this context of globalization and liberalization, many Latin American nations made the conversion from authoritarian governments to democratic ones during the 1980s and 1990s. Yet the stability of these governments was shaken in the mid 1990s, as international financial crises spread to Latin America, and elected governments were toppled by popular dissent. While these democratic regimes were not replaced by dictatorship as they had been 25 years earlier, the failure of elected leaders to survive their terms was the result of their inability to manage instability in the new world system. Not all of these democratic governments were destabilized by crisis. Why were some governments unable to outlast financial crisis while others emerged unscathed? Why did potentially destabilizing economic or political conditions create financial instability in some countries and not in others? These are the principal questions that this work will attempt to answer. In order to do so, it is first necessary to describe the complex relationship between political and economic instability.

Simply put, governments and markets form the link between political and economic instability. Instability that results from changes in economic or political conditions can therefore spread back and forth between the economy and the political system. Instability in the economy can spread to the political situation via the weaknesses of government, and that political instability can further impact economic conditions through markets. The result is a circular pattern of increasing instability with four prominent phases. Despite the given numbering scheme, this pattern is circular and need not begin or end with any particular phase. In the first phase, economic instability becomes an issue when economic expectations are not met, and therefore a negative discrepancy occurs between what citizens feel entitled to and what they actually receive.

This "relative deprivation,"[2] creates tensions among the populace which may or may not generate national instability. If the feeling of relative deprivation occurs among a group of elites, then the political ramifications can be dire. In the second phase, the reigning regime has the opportunity to address the unmet expectations of its citizens. If the government is unable to successfully address a relative deprivation through institutional support or coercive control, then political instability or violence is likely to occur. In the third phase, the outcome of political instability is determined in a contest between elites loyal to the reigning regime versus elites supportive of dissident movements. In an effectively functioning democratic system, this contest can occur through a constitutionally sanctioned process, whereas disillusioned citizens of ineffective or exclusive governments may resort to political violence. In the fourth phase, the international financial community reacts to the political situation through the valuation of monetary instruments in capital markets. A negative perception of investment opportunities will adversely affect the financial resources of the country undergoing instability, thereby compounding the crisis. In any of the four identified phases, it is possible for a country to end the debilitating cycle of instability. However, when governments are incapable of effectively addressing instability, and when the international financial community negatively perceives a countries financial profile, a downward spiral of simultaneous political and economic instability can ensue.

In order to further explore the relationship between economic and political instability, a comparative case framework will be established. The series of financial and economic crises that swept through the developing world in the 1990s will facilitate a comparison of states and markets during crisis periods. Case studies will be developed

[2] Ted Robert Gurr, *Why Men Rebel* (Princeton: Princeton University Press, 1970), 15.

for Argentina and Chile, and a comparative analysis will be done between Latin America and East Asia. Whereas similar political and economic conditions were experienced among Latin American states during the 1990's, the long-run outcomes varied. In East Asia, liberalizing reforms were conducted differently, and under very different social and political conditions. In many cases, these reforms were much more successful in East Asia than in Latin America. By comparing international examples of success and failure, it is the purpose of this study to identify sets of conditions and policy reforms that would enable developing countries to enjoy the benefits of globalization. Whereas Neoliberalism has become the hegemonic ideology of adjustment to the global economy, the efficacy of Neoliberal reforms will be the focus of this study. An analysis of these cases may provide unique insight into the relationship between economic and political instability, and may provide an answer to the main question of this study: How can Neoliberal reforms be modified to have more positive outcomes in the developing world?

This study eventually seeks to address the recent political backlash against globalization and to discuss the efficacy of Neoliberalism. It will ultimately be shown that Neoliberalism and globalization are beneficial to developing countries in the long-run, so long as they are carried out in accordance with a careful consideration of the political, economic, and social reality of the reforming country. Globalization can have a positive effect on the developing world if liberalizing reforms are adapted to work in specific political and economic contexts.

It is important to note that for the purposes of this work, a positive outcome of reform is defined as an improvement in the economic wellbeing of the citizens of a nation, measured primarily in terms of GDP per capita, the percentage of citizens living in poverty, and some measure of the distribution of wealth. Neoliberal reforms necessarily entail short-run costs, and can potentially bring long-run costs that outweigh the benefits of reform if the process is not carried out effectively. The two most important determinants of the long-run outcome of the liberalization process are the degree to which the economy is controlled by the state prior to the implementation of reforms and the openness of the political system. More market dependency on the state implies a more costly transition to open markets. An open political system is most vulnerable to political instability that results from the short-run costs that occurs during the reform process. Conversely, a closed political system may only institute reforms biased in favor of the interests of the ruling elite. The ensuing political instability can bring further economic costs that create a disastrous cycle of crisis, a cycle represented by the causal model of this study.

Long-term destabilization, stagnation, and the ensuing anti-globalization movement, are indicative of a two-part failure of the key actors in the reform process. Both international financial institutions and national governments have failed to address the importance of the political, economic, and social conditions of reforming countries. Potential weaknesses in the markets and governments of reforming countries must be addressed by a reform package in order to ensure the long-run net-benefit of the plan. In light of complicating conditions, careful reform planning is necessary to make the reform process worth the cost. There are ways in which Neoliberal reform can be instituted, while minimizing the social costs and the resulting political backlash. However, in the current world order, a so called ‘Washington Consensus’ of seemingly standardized macroeconomic policy reforms are prescribed by powerful international financial institutions such as the IMF, the World Bank, and the U.S. Treasury Department. These policy reforms include: the privatization and deregulation of state owned enterprises, financial market and trade liberalization, and the general minimization of the role of the state in the economy. This study seeks to identify practical policy modifications that should be made to the Washington Consensus so that globalization will lead to more positive outcomes in the developing world. The developing world needs more globalization, but reforms must be adapted to the political and economic context of each country in order to minimize the costs and to eliminate the roots of the political backlash that currently stalls the process.

Chapter Two

Review of the Literature

Introduction

The following literature review attempts to provide an understanding of the competing arguments on the key topics that this work addresses. These are contentious issues that have sparked controversies within their respective fields. The purpose of this literature review is to provide a clear theoretical framework for the principal arguments of this work. Furthermore, this review will summarize the divergent opinions of various authors on the theoretical underpinnings of the main argument of this work: that globalization can have a positive effect on the developing world if liberalizing reforms are adapted to work in specific political and economic contexts. While many have written about the causes and effects of economic and political instability, these theories will be reassessed within the context of globalization. The following questions provide the structure of the literature review. How has the context of globalization and Neoliberalism impacted global stability in the last twenty-five years? Why do men rebel? What determines whether a regime will survive or collapse once political dissidence has formed? Finally, how does political instability impact the economy of the host nation?

The Context: Globalization and Neoliberalism

The cases of instability that form the basis of this study have occurred in the context of globalization. In his book, <u>Transnational Conflict</u>, William Robinson develops a useful vocabulary for describing the fundamental aspects of globalization. Robinson writes that in the last twenty-five years, a fundamental shift has occurred in which the old world economy has disappeared and a new global economic system has emerged. The world economic system of past epochs was one in which each country developed its own circuits of accumulation and production that were ultimately connected via international commodity and capital markets. In the economy of today, the production process itself has been globalized. Transnational capital now commands the production process without regard for national political boundaries.[3] Globalization is therefore a process of integration, wherein all the economies of the world are unified to form a single mode of production. Increases in trade and financial flows have occurred in the past, a process Robinson terms *internationalization*. However, what differentiates the recent phenomenon is the globalization of the production process, which Robinson terms *transnationalization*.[4] In this new epoch, transnational capital has gained a new-found dominance in its relation with labor. Robinson argues that globalization has integrated national social classes into one international class system in which the dominance of elites is solidified by their connection to transnational capital. The nation-state has begun to break down as the central locus of class and group relations.[5]

Robinson asserts that the nation-state has further lost its importance in regulating capital, and transnational institutions are rising to fill the void. International institutions are created collectively by various nation-states in order to address cross-border issues. Many international institutions currently present distinct gradations of "state-ness," but they are beginning to shed their connection to the nation-state apparatus to varying degrees. Supranational economic and political institutions, which Robinson refers to as transnational states, have risen to advance the emergent hegemony of the transnational

[3] (Robinson 2003, 13)
[4] (Robinson 2003, 13-14)
[5] (Robinson 2003, 31)

capitalist class.[6] This process is taking place in international forums, economic and political. These forums include the IMF, the World Bank and the WTO, the various political groupings of wealthy nations such as the G8 and G22, and the old formal political forums such as the UN and the EU.[7] In the context of the growing importance of evolving transnational organizations, Robinson writes, "the function of the nation-state is shifting from the formulation of national policies to the administration of policies formulated by a transnational elite operating through supranational institutions."[8] The growing power of transnational capital and supranational institutions in markets and governments has altered the relationship between economic and political instability. The consequences of this process of globalization are central to this study.

In addition to globalization, the ideological rise of Neoliberalism in the last twenty-five years has played a key role in shaping the relationship between economic and political instability. In his book, States and the Reemergence of Global Finance, Eric Helleiner describes the rise of Neoliberalism as a dominant economic ideology. Beginning in the 1970's, an ideological shift took place in which the popularity of Keynesian embedded liberalism lost popularity and the Neoliberal ideas of Milton Friedman and Friedrich Hayek were increasingly promoted by intellectual networks. Keynesianism promoted international trade and "productive" capital flows while explicitly controlling short-term "unproductive" capital flows. Keynesianism generally prescribes a greater degree of government intervention in markets than does Neoliberalism, which promotes the perfect mobility of capital. By the end of the 1970's it had become clear that Neoliberalism was gaining clout within academia and

---

[6] (Robinson 2003, 43)
[7] (Robinson 2003, 44)
[8] (Robinson 2003, 44)

international institutions. Additionally, economic stagnation in the 1970s and 1980s created an intellectual climate conducive to alternative economic paradigms.[9]

Neoliberal policies are often collectively referred to as the 'Washington Consensus', signaling the importance of the U.S. Treasury Department in the promotion of Neoliberalism around the world. Helleiner illustrates the consistency between Neoliberalism and US economic interests, which meant that changes in name at the US Treasury Department from the "nationalist Secretary John Connally to the "Neoliberal" Secretary George Shultz, led to no change in the administration's position on capital movements."[10] Helleiner argues that liberal theory had gained prevalence starting as early as the 1960s, when the birth of the Euromarkets provided the means to circumvent the capital controls of Bretton Woods. The clear turning point in the ideological shift came alongside clear examples of failure on behalf of embedded liberal policies, exemplified by the u-turn in French economic policy under the government of Francois Mitterrand in 1983. The central purpose of Neoliberal reform is to slow inflation and to improve the financial position of the state.[11] The Neoliberal model rests on the premise that investment is the most important stimulus for economic growth, and despite the name, it is more closely linked to Classical models than to the embedded liberalism of the Second World War era.[12] By the 1980's a precedent had been established connecting the failure to adopt Neoliberal reforms with potentially rapid and destructive financial destabilization.[13]

---

[9] Eric Helleiner, *States and the Reemergence of Global Finance* (Ithaca: The Cornell University Press, 1994), 15-16.
[10] (Helleiner 1994, 119)
[11] (Helleiner 1994, 15)
[12] (Helleiner 1994, 15)
[13] (Helleiner 1994, 162)

Geoffrey Garret contests the popular view that the international financial community has come to play a dominant role in global politics in the new era of globalization and Neoliberalism. In his chapter entitled, *Global Markets and National Politics,* Garret argues against the common belief that, "where states were once the masters of markets, now it is the markets which, on many crucial issues, are the masters over the governments of states."[14] Garret uses an empirical analysis of the OECD countries to challenge the claim that the multinationalization of the production process is the defining characteristic of globalization. For Garret, the most politically significant aspect of globalization has been the integration of financial markets. Garret further refutes the notion that the increasing power of financial markets has eroded national policy autonomy, arguing that governments have not been forced to engage in a "policy race to the Neoliberal bottom."[15] Garret hypothesizes that national governments will continue to play an important role in the economy by providing certain collective goods that even pro-market economists support. Such collective goods range from the accumulation of human and physical capital and the maintenance of social stability in times of market uncertainty. Furthermore, Garret postulates that governments can be powerful advocates for the Neoliberal policies that others argue limit government autonomy.[16] "There is no evidence that the financial markets attach interest-rate premiums to the expansion of the public sector."[17] While Garret views the integration of financial markets as the most consequential aspect of globalization and Neoliberalism, he also sees financial markets as being fundamentally disinterested in the affairs of national

[14] Geoffrey Garret, "Global Markets and National Politics: Collision Course or Virtuous Cycle," in *Exploration and Contestation in the Study of World Politics* (Cambridge: The MIT Press, 2000), 147.
[15] (Garret 2000, 183)
[16] (Garret 2000, 183)
[17] (Garret 2000, 183)

governments, so long as they do not directly infringe upon returns to investment. Garret paints a picture of the modern era of globalization as one wherein Neoliberalism achieves a sort of compromise with the embedded liberalism of old.[18]

The purpose and effect of Neoliberal reform policies are illustrated in the piece, *Economic Reforms in New Democracies: A Social-Democratic Approach*, by Luiz Carlos Bresser Pereira, Jose Maria Maravall, and Adam Przeworski. Whereas Garret draws his conclusions on the impact of Neoliberalism and globalization from a study of the OECD countries, Pereira, Maravall, and Przeworski highlight the effect of Neoliberal reforms on the developing world. In times of crisis, Neoliberal reform is often seen as necessary in order to restore the purchasing power of wages in the context of hyper-inflation and to attract much-needed foreign capital.[19] Financial crisis often serves as the impetus to economic reforms, yet in the short-run, reforms can deepen or even prolong the crisis. Furthermore, Neoliberal reforms have been seen to have severe short-run economic costs, costs felt especially by the lowest classes of society.[20] Pereira, Maravall, and Przeworski argue that in order to be carried out effectively Neoliberal stabilization programs must involve a transitional reduction of demand, due to the combined effect of reduced public spending, increased taxation, and high interest rates.[21] In addition, policy reforms such as tariff eradication, antimonopoly measures, and privatization can simultaneously increase unemployment and decrease the government revenue needed to provide social services. Such contractionary measures are collectively termed an "austerity package," and can

---

[18] (Garret 2000, 184)

[19] Eduardo A. Gamarra, "Market Oriented Reforms and Democratization in Latin America: Challenges of the 1990s," in *Latin American Political Economy in the Age of Neoliberal Reform* (New Brunswick: Transaction Publishers, 1994), 9.

[20] Luiz Carlos Bresser Pereira and Jose Maria Maravall and Adam Przeworski, "Economic Reforms in New Democracies: A Social-Democratic Approach," in *Democracy Markets, and Structural Reform in Latin America* (New Brunswick: Transaction Publishers, 1993) 183.

[21] (Pereira, Maravall, Przeworski 1993, 184)

bring severely negative economic conditions to a country already in crisis. That Neoliberal policies often have a negative short-run impact on economic growth will not be new information for anyone with a background in economics. Indeed, if unemployment does not drastically increase alongside Neoliberal reforms then this can be taken as a sign of the failure of their implementation. As Pereira, Maravall, and Przeworski point out, "reform programs are, thus, caught between the faith of those who foresee their ultimate effects and the skepticism of those who experience only their immediate consequences."[22] The political and economic issues surrounding Neoliberal reform are key elements of the context within which the crises of this study occurred.

Of these competing arguments on the efficacy and nature of Neoliberalism, there are aspects of truth in all of them. The work of Pereira, Maravall, and Przeworski more effectively address the political issues relevant to reform in the developing world, whereas Garret's theories more accurately describe the effect of reforms in industrialized nations. The argument of this work is partially based on the assertion of Pereira, Maravall, and Przeworski that liberalizing reforms usually have negative short run effects that can endanger the political support for reforms.

The Impetus to Political Violence

In order to understand the destabilizing potential that the reform process has for developing countries, it is necessary to identify the kinds of conditions that lead citizens to rebel against their government. The cause of rebellion has long been a subject of study in political discourse. In his book, <u>Foreign Investment and Political Conflict in</u>

[22] (Pereira, Maravall, Przeworski 1993, 184)

Developing Countries, John M. Rothgeb, Jr. compiles the history of deprivation-based theories that attempt to describe the root of rebellion. The idea that human beings respond through dissident behavior to a perceived failure of the system to provide certain goods has been common to political theory since John Locke. "When the people are made miserable, and find themselves exposed to the ill-usage of arbitrary power… it is not to be wondered that they should rouse themselves and endeavor to put the rule into such hands which may secure to them the ends for which government was at first erected."[23] Since Locke, most political theorists have furthered the notion that governments exist to provide certain basic "necessities" to citizens. A failure to do so constitutes a "deprivation," which justifies and inspires political change.

Rothgeb writes that deprivation-based theories are built on the notion that when economic, social, or political conditions become bad enough, it is natural to desire political change.[24] Within this large group of deprivation-based theories, there are several specific types. Absolute deprivation is a theory that sees political conflict as a result of extreme poverty and the stagnation of economic growth. This theory suggests that there is a universal level of human tolerance for poor economic conditions, but when economic conditions become bad enough, dissident behavior becomes a natural response to a failure of the system.[25] Political deprivation theory states that government repression creates rebellion by limiting the ability of citizens to voice grievances within the system. According to this theory, when politically active members of society perceive civil disobedience as being more efficacious than legal participation in achieving a desired

[23] John Locke, *Second Treatise of Civil Government* (Chicago: Henry Regency Co., 1955), 187-188.
[24] John M. Rothgeb, Jr. *Foreign Investment and Political Conflict in Developing Countries* (Westport: Praeger Publishers, 1996), 19.
[25] (Rothgeb, Jr. 1996, 13)

outcome, than political violence will be the result.[26] A third theory, labeled relative deprivation, states that inequality in the distribution of income is what leads to rebellion. This version of relative deprivation theory is a class-based analysis, implying that political violence is the result of inequalities that are perceived to be unjust or undeserved.[27]

Ted Gurr uses the term "relative deprivation," but with a distinct meaning from that of the old theories which bear its name. In his seminal work, Why Men Rebel, Gurr argues that it is the failure of economic and social conditions to meet expectations that brings men to rebel. For Gurr, a "relative deprivation" occurs when citizens do not perceive economic and social conditions to meet their expectations, and they are therefore denied of something for which they feel entitled. Gurr describes relative deprivation as, "the term used to denote the tension that develops from a discrepancy between the "ought" and the "is" of collective value satisfaction."[28] Relative deprivations occur when societal conditions create a divergence between expectations and reality. The result is discontent, anger, and frustration, which Gurr sees as an impulse to action. This frustration will have political ramifications to the degree that citizens perceive violence against political actors as justified and potentially useful in improving their value positions.[29]

Gurr argues that there is no particular threshold for poor economic conditions, below which rebellion is guaranteed. Rather, this threshold can be seen as the constantly evolving expectations of the citizenry. If people do not expect more than they have, no

[26] (Rothgeb, Jr. 1996, 19)
[27] (Rothgeb, Jr. 1996, 15)
[28] (Gurr 1970, 13)
[29] (Gurr 1970, 319)

matter how poorly they live, they will not rise up in rebellion. This assertion is based on empirical evidence gathered through psychological testing. Gurr asserts that relative deprivations are most likely to lead to organized political violence, and therefore likely to cause political change, when the deprivation occurs on the part of the economic or political elite. Otherwise, frustrations caused by relative deprivations will merely result in political turmoil: "unorganized political violence with substantial popular support."[30] In addition, when the wealthy, educated, and well-connected feel as though the system does not further their interests, they will be more inclined to try to bring about an extra-systemic change. Gurr goes on to assert that the potential for political violence is determined by the scope and intensity of the discontent which results from the deprivation. The potential for political violence is further amplified to the extent to which errors are committed on the part of the government which result in even more depriving conditions.[31] Therefore, Ted Gurr's analysis highlights two key determinants of the magnitude of violent dissent: deprivations between expectation and reality in social and economic conditions, and the perceived ability of the government to alleviate these depriving conditions.

In his book, The Economics of Political Violence, Dipak K. Gupta incorporates the theory of relative deprivation postulated by Gurr into a broader theory of collective rebellious behavior. Gupta reaffirms Gurr's principal thesis that participation in dissident political movements is determined by "personal frustration caused by an individual's inability to attain something he feels is rightfully his."[32] Yet, Gupta takes the theory a

---

[30] (Gurr 1970, 11)
[31] (Gurr 1970, 319)
[32] Dipak K. Gupta. *The Economics of Political Violence: The Effect of Political Instability on Economic Growth* (New York: Praeger Publishers, 1990), 251.

step further by arguing that there are two main categories of frustration: individual and group. While individual frustration may lead men to take rebellious action against the state, frustration associated with membership in a particular group is what motivates men to participate in collective rebellion. Gupta argues that the degree to which popular and organized political violence occurs is determined by the "pursuit of group utility."[33]

The passion with which an individual will pursue his or her group utility is a product of two key factors: the closeness of the association with the group, and the intensity of the frustration. Gupta labels the former as ideology and the latter as a product of economic and social conditions, although the two are typically linked. When these two elements of group utility are linked, such as when unemployment is perceived to be a product of membership in a particular group, then the passion of group utility can be intense. Gupta identifies two kinds of group identities: ascriptive and adoptive. Membership to an ascriptive group is involuntary and includes such categories as race, language, and religion. Adoptive group membership is voluntary and includes interest groups, clubs, and social groups of similar preferences. Frustration will be more intense when it is linked to an ascriptive membership as it is not a product of choice and it is generally not reversible.[34] Discrimination based on race or economic class will therefore lead to a group unity that lends itself to popular and organized participation in collective rebellion. This sense of group unity can be filtered and molded by the opposition group into an ideology. Gupta writes that the meshing of preferences between that of the individual and of an ideologically oriented group, especially within the elite, will result in widespread political violence. Gupta agrees with Gurr that a universal threshold of

---

[33] (Gupta 1990, 251)
[34] (Gupta 1990, 252)

tolerance for poor economic conditions does not exist. However, Gupta points out that poor economic conditions will have the effect of lowering the opportunity cost of participation in rebellious movements. For example, unemployed workers are much more likely to spend a day conspiring and protesting than are employed workers. In order to participate, it is necessary for the individual to forego a short-run gain for the sake of the larger entity, group, or nation. This is more likely to occur as that foregone short-run gain decreases.[35] Both Gurr and Gupta assert that participation in rebellious behavior is generally rational, based on an individual cost-benefit analysis. Gurr and Gupta agree that participation in dissident movements is determined by frustrations that are a product of relative deprivation. However, Gupta goes a step further in detailing how the kind of aggressive behavior that an individual is likely to engage in will depend on the degree to which the frustration is perceived as resulting from individual or group conditions. Gupta writes that unemployment and poverty do not cause political turmoil without the presence of a group identity. Group identity can be shaped by elites of the opposition in order to promote participation in violent political dissidence. If frustration is linked to a collective ideology, then it has the potential to significantly undermine political stability.[36] Gupta and Gurr provide a framework for understanding the causes of rebellious behavior and the determinants of the form this rebellion will take.

---

[35] (Gupta 1990, 255)
[36] (Gupta 1990, 256)

Political Conflict: Authority vs. Opposition

The ability of governments to contain political conflict within institutionally justified or legal frameworks is central to this study. The first step that a government can take to minimize the destabilizing effect of economic crisis is to allow political challengers within to address their concerns within constitutional frameworks. Bruce Bueno De Mesquita, James D. Morrow, Randolph M. Siverson, and William C. Smith describe the political mechanisms that minimize instability before it becomes violent. In their chapter entitled, *Political Institutions, Political Survival, and Policy Success,* De Mesquita, Morrow, Siverson, and Smith deny that the ability of a leader to repress dissidence is the ultimate cause of stability. These authors attempt to explain how seemingly small policy failures can result in the collapse of a ruling regime, whereas in other examples, seemingly endless blunders have little or no effect on the ability of a regime to remain in office. De Mesquita, Morrow, Siverson, and Smith highlight two deep-seated political institutions that determine political stability: the size of the *selectorate* and the size of the *winning coalition.*[37] By the selectorate, they mean those people with the institutionally guaranteed right to take part in the selection of leaders. By the winning coalition, they mean the portion of the selectorate whose support is vital for the incumbent government to remain in office.[38] Politicians attract and maintain a winning coalition by distributing things of value, public and private. Private goods include special privileges, employment in government jobs, access to graft and bribes,

[37] Bruce Bueno de Mesquita and James D. Morrow and Randolph M. Siverson and Alastair Smith, "Political Institutions, Political Survival, and Policy Success," in *Governing for Prosperity* (New Haven: Yale University Press, 2000), 60.
[38] (Bueno de Mesquita, Morrow, Siverson, and Smith 2000, 60)

favorable tax or contractual terms, and judicial and other forms of favoritism. In the developing world, the distribution of private goods may be less regulated, and may therefore play a larger role in the decision making process of the selectorate.[39] Public goods affect the welfare of everyone in the state and can include the provision of national security, general economic growth, and the amount of generally distributed state resources.[40] De Mesquita, Morrow, Siverson, and Smith argue that political legitimacy is undermined when the incumbent fails to divide the benefit from government revenue and public policy in order to reward the winning coalition, and when credibility problems arise surrounding the future distribution of goods.[41] Without providing the necessary quantity of goods, political leaders may lose cohesion within the winning coalition, and a struggle between the winning coalition and the opposition may spill over into unsanctioned, violent political conflict.

Once political conflict has exacerbated legal frameworks, political violence occurs between the government and the dissident movement. In another section of his work, <u>Why Men Rebel</u>, Ted Gurr establishes that when political violence occurs, the ability of the government to minimize participation in extra-systemic dissidence will determine the result of the political conflict. Gurr highlights two basic elements that determine the ability of the government to remain in power. The actualization of discontent in the form of political violence is modified by the institutional support and coercive control of the ruling regime.[42] The magnitude of political violence is minimized

---

[39] Eduardo A. Gamarra, "*Crafting Political Support for Stabilization: Political Pacts and the New Economic Policy in Bolivia,"* in *Democracy Markets, and Structural Reform in Latin America* (New Brunswick: Transaction Publishers, 1993), 117.
[40] (Bueno de Mesquita, Morrow, Siverson, and Smith 2000, 64)
[41] (Bueno de Mesquita, Morrow, Siverson, and Smith 2000, 65)
[42] (Gurr 1970, 319)

to the degree to which the government is capable of providing institutional support for, or coercively controlling its citizens. Conversely, the ability of dissidents to achieve organizational support and coercive control will also determine their ability to change the political system. Therefore, if dissidents have widespread social support and a high degree of coercive capacity compared with the regime, then they may be capable of displacing the ruling authority. Coups typically occur and political concessions are most readily granted by elites when the balance of social control and support favors the opposition. If the balance of power between the authority and the opposition is relatively equal, then political violence is likely to be protracted and intense.[43]

In his work, The Economics of Political Violence, Dipak K. Gupta expands upon Gurr's support and control framework for understanding violent political conflict. Gupta writes that the authority can maintain stability by modifying or even harnessing the feelings of collective frustration by maintaining legitimacy. For Gupta, legitimacy is maintained in three ways. Legitimacy can be maintained in times of conflict by providing economic and political opportunities, and by lowering the cost of involuntary group membership. The third way in which legitimacy can be achieved is by raising the cost of dissident political activities by enforcing coercive measures.[44] These three mechanisms fit neatly within Gurr's description of institutional support and coercive control. Gurr and Gupta both view political conflict as a "carrot and stick combat" between the authority and the opposition over the political participation of key members of society. However, Gupta also underscores the importance the ability of the regime to adjust to address the problem by displacing the political blame for the deprivation, or by

---

[43] (Gurr 1970, 321)
[44] (Gupta 1990, 252)

rebalancing value expectations with value capabilities. Authoritarian regimes, for example, have less structural conduciveness to political change and therefore will suffer less frequent but more violent political conflicts.[45] Gupta argues further that regimes that lack structural conduciveness to change may enhance feelings of group schism within society by making group divisions more pronounced or by establishing a zero-sum game mentality between groups.[46]

The theories of Gurr and Gupta suggest that during periods of economic deprivation, the survivability of the government is determined by the ability of the government to address and eliminate the initial deprivation. So long as the net-benefit of living under the current regime is perceived by members of the society to be greater than any viable alternative, the current regime remains in power. This style of analysis emphasizes the importance of economic over political conditions. However, Minxin Pei and Ariel David Adesnik refute this emphasis in their article entitled, "Why Recessions Don't Start Revolutions." Pei and Adesnik propose that crisis-ridden regimes collapse mainly because of internal political stresses.[47] Pei and Adesnik base these claims on an empirical study of severe economic crises in Asia and Latin America since the Second World War. Of 93 economic crises analyzed, those that resulted in direct regime collapse were rare. Pei and Adesnik argue that in these rare cases of immediate regime collapse, the ultimate determinant of whether a regime survived or collapsed was the degree of internal cohesion among the ruling elite prior to the crisis.[48] "When economic difficulties widen rifts within a country's leadership and undermine the authority of government, the

[45] (Gupta 1990, 84)
[46] (Gupta 1990, 253)
[47] Minxin Pei and Ariel David Adesnik, "Why Recessions Don't Start Revolutions." *Foreign Policy* No. 118 (Spring 2000), 149.
[48] (Pei and Adesnik 2000, 140)

survival of the regime is unlikely."[49] Therefore, the most important determinant of the political response to economic crisis is not the size and scope of the frustration that results from the crisis, but the ability of the ruling elite to remain unified. Furthermore, the most important economic aspect of the crisis is the way in which it affects the well-being of members of the elite. A mild recession, when combined with strife among the ruling elite, can bring about rapid and violent regime change. In contrast to deprivation theorists such as Gurr and Gupta, Pei and Adesnik write that, "political institutions determine regime survival."[50]

The potential policy ramifications of political change are outlined in Jonathan Hartlyn and Samuel A. Morley's piece, entitled *Political Regimes and Economic Performance in Latin America*. Regime change need not lead to any substantive policy change as it can merely be a transfer of power from one group of elites to another with similar preferences. Hartlyn and Morley argue that when regime change does bring about significant modifications of policy, the consequences may be most immediately visible in terms of political liberties and respect for human rights.[51] Regime changes may also lead to changes in the way policies are determined, which may or may not in turn lead to changes in the substance of the policies themselves. Finally, regime changes can bring about significant economic and social policy modifications that have important distributional consequences. In the developing world especially, regime changes "have often been associated with abrupt, pendular shifts in economic policies."[52]

---

[49] (Pei and Adesnik 2000, 141)
[50] (Pei and Adesnik 2000, 149)
[51] Jonathan Hartlyn and Samuel A. Morley, Political Regimes and Economic Performance in Latin America, in *Latin American Political Economy: Financial Crisis and Political Change* (Boulder: Westview Press, 1986), 18.
[52] (Hartlyn and Morley 1986, 19)

The Economic Impact of Political Instability and Change

There has been a great deal of research devoted to the study of the economic impact of political change. Economic ramifications of political change are seen on domestic and foreign markets. In another chapter of his work, The Economics of Political Violence, Dipak K. Gupta describes the economic impact of political instability on domestic markets, which he sees as several fold. Most fundamentally, all transactions imply a contract between two entities, and all contracts require trust. The lack of continuity of legal frameworks protecting such transactions undermines this trust. Conflict between groups in society further diminishes interpersonal trust. Inconsistent economic policies, as a result of constant or violent political changes, can further undermine confidence in markets. Additional uncertainty about the future undermines consumer and investor confidence in markets clamoring for predictability of the future. [53] The lack of confidence in future economic conditions results in decreased rates of consumption and investment as citizens resort to "hoarding." Hoarding involves hiding money under the proverbial mattress or sending money to safe havens in foreign financial markets. The hoarding of money that would have been used for consumption decreases aggregate demand. Hoarding has the effect of constricting the money supply, creating a downward multiplier that forces the economy to settle for a lower level of income and employment.[54] The resulting constricted money supply will lead to increased interest

[53] (Gupta 1990, 179)
[54] (Gupta 1990, 181)

rates, which may not have the impact of stimulating investment, as economic institutions often fail to function normally in times of political crisis. Furthermore, this politically-motivated reduction in the money supply will render government monetary policy largely ineffective.[55] Aggregate supply may also be negatively affected via labor and capital markets. In times of political violence, the production process may be interfered with physically and directly. Politically motivated strikes may cripple the economy. Frightened workers may fail to show up for work. A large segment of the labor force may leave work to fight, and possibly to be killed. Troop movement can disrupt agricultural production. Fighting between groups or acts of sabotage can destroy capital goods, such as factories, railways, and networks of electricity and water. The effect of all of these potential outcomes of political instability is to decrease aggregate supply and aggregate demand, decreasing output, employment, and incomes and potentially increasing prices.

Gupta writes that the decrease in economic growth shown to occur in times of political instability is likely to decrease government revenue generated from taxes. Taxable incomes will decrease and the ability of government officials to collect taxes may diminish as well. However, in spite of this dwindling tax revenue, authorities may be compelled to spend more on the military and other pacification programs.[56] Coinciding increases in spending and decreases in revenue will increase the government deficit, and may lead to spiraling debt to be felt by future generations long after the political situation has calmed. In sum, an economy torn by violent political conflict will be characterized by low incomes, high unemployment, inflation and debt. "However, the

[55] (Gupta 1990, 182)
[56] (Gupta 1990, 184)

extent to which this extremely gloomy prognosis will materialize will depend on the magnitude of external assistance, especially by a superpower, or the nation's capacity to finance its debts through the sale of its natural resources…"[57] Injections of foreign currency can cushion the shock, but the political and economic circumstances required for such an injection are generally the exception rather than the rule.

In his book, The Political Economy of Emerging Markets, Javier Santiso describes the probable market reaction to political instability from the point of view of the banking community. Given the importance of international investors and international financial institutions, this perspective is useful to understand how the perceptions of the financial community are likely to impact economic conditions of the country in crisis. Santiso highlights the importance of maintaining investor confidence in order to preserve stability. Confidence is necessary in order to uphold investors' loyalty, to minimize the influence of their voice, and at all costs, to avoid their exit. Exit on behalf of foreign investors involves the devaluation of assets and illiquidity, whereas the voice of foreign investors implies the loss of policy autonomy. The rules established by the international financial community for developing world governments are conventions that change according to the macroeconomic, social and political perceptions of emerging market analysts.[58] Noncompliance brings capital flight, illiquidity, and spiraling debt. As currency speculators have become increasingly capable of moving money around the globe more or less instantaneously, the potential for massive capital flight acts as the ultimate discipline on governments. Political "irresponsibility," a term used to describe governments closing markets to foreigners or exercising deficit spending, creates a lack

---

[57] (Gupta 1990, 185)

[58] Javier Santiso, *The Political Economy of Emerging Markets*, (New York: Palgrave MacMillan, 2003), 18.

of confidence on the part of the international financial community that will bring further illiquidity, restricting investment and economic growth.[59] The key players in the game of confidence include rating agencies, government officials, international organizations, and media corporations. Fund managers emphasize the importance of investor relations and the timely release of financial and economic data. Periods of political turnover are associated with a significant increase in the spread on emerging market debt securities over the US Treasuries Bills, signaling investors' fears that political instability will negatively impact rates of return.[60] In addition to political instability, the lack of transparency can make financial instability even more pronounced, and in times of crisis, international contagion can spread based on a lack of confidence in emerging market economies in general. Whereas a lack of transparency and political stability will necessarily impede returns to investment, it is natural that foreign investors enforce these ideals through the threat of their voice and their exit. Santiso writes that transparency of information and the stability of governments is thereby reinforced in the long-run by the rent maximizing behaviors of world financiers.[61]

In her chapter entitled *Emerging Market Makers: The Power of Institutional Investors,* Mary Ann Haley provides a counterpoint to Santiso's perspective. Haley illustrates inefficiencies that arise as the international financial community becomes more and more powerful in emerging market economies. She argues that the ability of international investors and financial institutions to impact a country economically is dependent on the degree to which the economy has opened up to flows of foreign capital. The purpose of opening one's financial markets is to attract foreign investment and to

[59] (Santiso 2003, 18)
[60] (Santiso 2003, 147)
[61] (Santiso 2003, 148)

retain the approval of international financial institutions such as the World Bank and the IMF. Haley writes, "The most effective means of attracting capital into developing countries has shifted rapidly from pledging allegiance to one of the cold war rivals to marketing the nation-state to the world's financiers."[62] Developing nations market themselves to foreign capital by establishing "pro-market," Neoliberal policies. Once Neoliberal reforms have been instituted, foreign investors enter the market, and by the strength of their position in relatively small, emerging markets, they gain incredible power in determining the valuation of assets. Haley argues that the prices of monetary assets on emerging market are no longer determined by the movements of the invisible hand, but by the visible hands of foreign investors.[63] Haley agrees with Santiso that the preferences of these foreign institutional investors thus become a guide for countries in need of capital. However, unlike Santiso, Haley argues that these preferences are not necessarily beneficial to a country in political transition. In the developing world, inefficient financial markets empower money managers who value stability and growth over political democratization.[64] The ramifications of the market response to political instability in the developing world are incredibly important to this study.

[62] Mary Ann Haley, "Emerging Market Makers: The Power of Institutional Investors," *Financial Globalization and Democracy in Emerging Markets* (New York: Palgrave, 2001), 74.
[63] (Haley 2001, 74)
[64] (Haley 2001, 74)

Chapter Three

Theory & Methodology

Introduction to the Model

The following model of political and economic instability will be used to structure the analysis of the Argentine and Chilean crises of the late 1990's. It will be shown how instability or underperformance in the economy may result in political instability, and vice versa. This model is designed to reflect the context of globalization and Neoliberal economic policies which have fundamentally altered the relationship between political and economic stability.

Instability is communicable between the economy and the political system on two levels. At the individual level, instability can spread between politics and economics via the participation of citizens in political violence. The amount of civilian participation in political violence is determined by individual frustration that is the result of economic conditions. In turn, this political violence affects economic conditions. At the institutional level, instability can spread via states and markets. Shifts in the political power of the state impact the distribution and quantity of economic values distributed in the market. These economic values in turn shape the distribution of political power. Therefore, instability that results from economic or political change can spread back and forth between the economy and the political system. Instability in the economy can spread to the political system via the weakness of government relative to dissident movements. Political instability impacts economic conditions by influencing the confidence of market actors.

Individuals

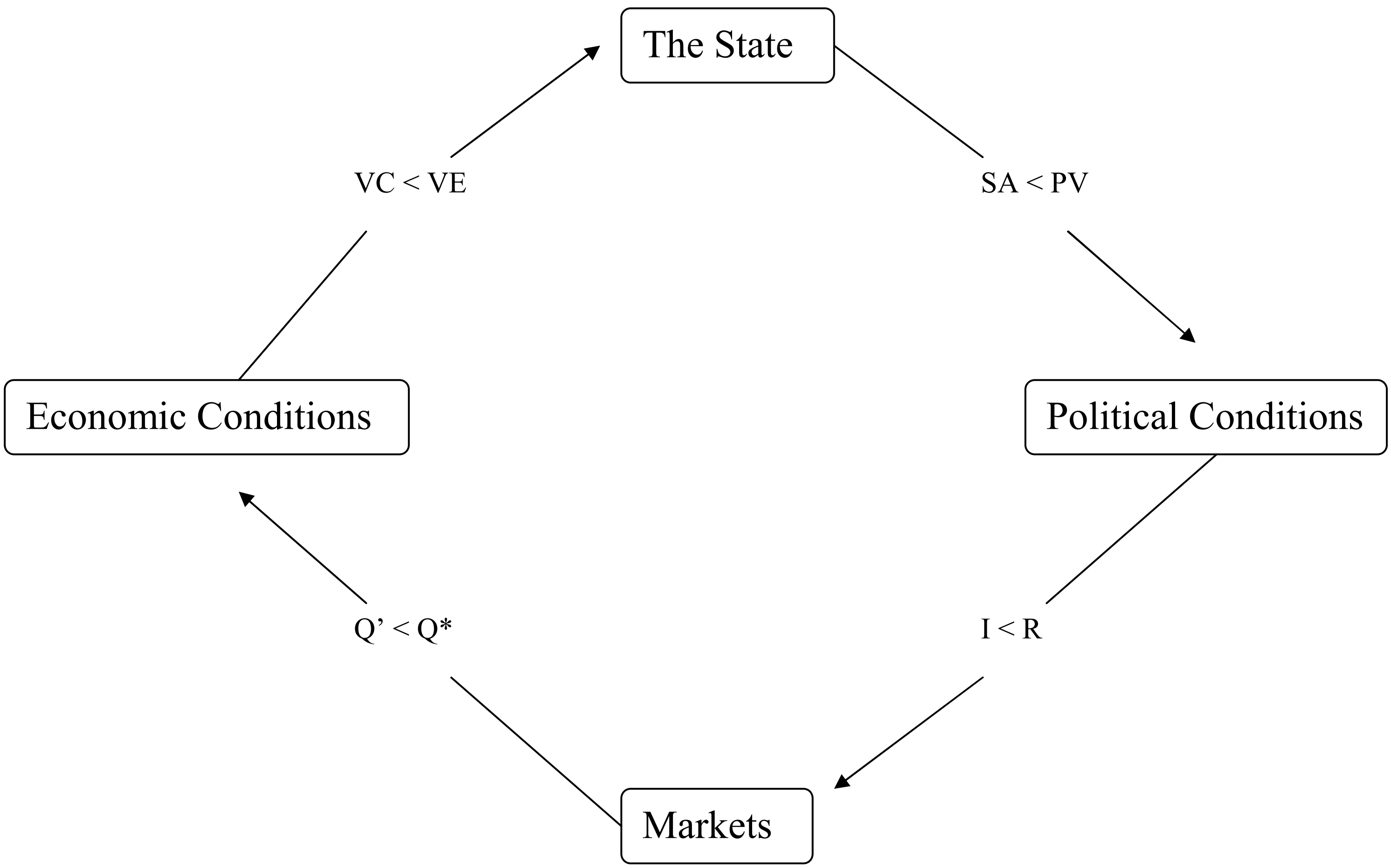
Economic Frustration $\longleftrightarrow$ Political Violence

Institutions

The State $\longleftrightarrow$ Markets

By compiling these two bilateral cause and effect relationships, it is shown that instability can spread between the economy and the political system through a four stage process. This process may begin with any of the four stages, yet in the context of globalization and Neoliberal reform, instability often appears to begin within economic conditions. The model functions as follows: if the value of private and public goods obtained by citizens is less than the expected value, then the resulting civil frustration affects the hegemony of the state. If the ability of the state to remedy this frustration is less than the relative deprivation felt by citizens, then a change will occur in political conditions. If the political conditions are perceived by investors and consumers to impact their financial position, then the value of goods, services, and financial instruments will be affected on markets. If a change in market values occurs, then shifts in factor inputs will affect economic conditions. Through these cause and effect relationships, a political or economic change can impact the entire system.

Economic and Political Instability



Economic Conditions = The conditions affecting the generation and distribution of wealth as they are perceived by individual citizens.
VE = The expectations of citizens as to their capacity to obtain things of value.
VC = The actual capacity of citizens to obtain things of value.

The State = The governing regime and the formal institutions that establish the rules of the political system.
SA = The ability of the state to remedy or to control the expression of frustration in the form of political violence.
PV = The strength of dissident movements that engage in collective acts of political violence against the state.

Political Conditions = The conditions affecting the distribution of political power as they are perceived by individual citizens.
I = The perception of market actors as to the future rate of return on investments within the host country.
R = The perception of market actors as to the amount of risk associated with investments in the host country.

Markets = Forums in which economic and financial actors establish the price of things of value.
Q' = The output, income, employment, and relative value of the currency of the host country.
Q* = The theoretical, potential value of these economic and financial variables within the host country.

Elaboration on the Model

Although instability often appears to begin with economic conditions, this model is circular and need not begin or end with any particular phase. In the first phase, economic instability becomes an issue when economic expectations are not met, and therefore a negative discrepancy occurs between what citizens felt entitled to and what they actually received. This "relative deprivation,"[65] creates tension among the populace which may lend itself to participation in collective acts of political violence. If this feeling of relative deprivation occurs among a group of elites, then the political ramifications can be dire. In this phase, the political culture of the country experiencing instability is especially important. In certain countries, extremely harsh economic conditions may not drive citizens to express frustrations in the form of collective acts taken against the government or the regime. The attitude towards revolt, or the willingness of citizens to challenge the institutional structure, plays a vital role in determining the level of individual participation in collective acts of dissidence. To the degree to which the government has established legitimacy and enjoys the trust of the people, dissidence can be undercut before it becomes a serious threat to stability. This first phase of the model draws upon the "relative deprivation" theory postulated by Ted Gurr and further developed by Dipak Gupta in order to identify the kinds of economic conditions that bring citizens to rebel.[66]

In the second phase, the reigning regime has the opportunity to address the unmet expectations of its citizens. The ability of the state to remedy the frustrations of citizens

[65] (Gurr 1970, 15)
[66] (Gurr 1970) and (Gupta 1990).

is determined by the degree to which an institutional structure has been put in place that is capable of responding effectively to the potential crisis. Formal institutions of government must respond, either by distributing public goods to redress material needs or by controlling the actions of potential dissidents. The flexibility of governing institutions is also an important element. Constitutional structures that allow for the replacement of a government without the destruction of the regime are better equipped to survive periods of instability. If the government is unable to successfully address a relative deprivation through institutional support, coercive control, or fluid adjustment, then widespread political violence may occur. The theories of Bueno De Mesquita, Morrow, Siverson, and Smith were especially useful in this phase for describing the determinants of the capacity of the state to respond to frustration.[67]

In the third phase, the outcome of political instability is determined in a contest between those loyal to the reigning regime versus those supportive of dissident movements. In an effectively functioning democratic system, this contest may occur through a constitutionally sanctioned process, whereas disillusioned citizens of ineffective or exclusive governments may resort to political violence. As political violence intensifies, a critical tipping point occurs when a change of government or the destruction of the regime become viable options in the minds of key political actors. Mounting political violence in the street may be the most visible element of instability, but behind closed doors, politicians pressure key leaders to either fix the problem or step down, depending on their interests. The government is toppled when the support of enough business and political leaders is lost. When the loss of support of key actors renders the president incapable of governing, then the president will either resign or face

[67] (Mesquita, Morrow, Siverson, and Smith 2000)

more coercive pressure from the military. In this phase, the theories of Jonathan Hartlyn and Samuel A. Morley were especially useful to describe the potential policy ramifications of political instability and change.[68]

In the fourth phase, economic actors react to changes in the political situation via their participation in markets. Political conditions may affect domestic markets by influencing the supply or demand for goods and services, but in the context of globalization and the liberalization of financial markets, the participation of the international financial community has become increasingly important in determining the market reaction to political change. The international financial community reacts to the political situation through the valuation of monetary instruments in markets. A negative perception of investment opportunities will adversely affect the financial resources of the country undergoing instability, thereby compounding the crisis. A devaluation of the goods, services, and the currency of the host country will impact economic conditions, thereby completing the circular orientation of the model. In any of the four identified phases, it is possible for a country to end the debilitating cycle of instability. However, when governments are incapable of effectively addressing instability, and when the international financial community negatively perceives a countries financial profile, a downward spiral of simultaneous political and economic instability can ensue. In this fourth phase the writings of Dipak Gupta were especially useful for describing the impact of political change on the domestic economy whereas Javier Santiso and Mary Ann Haley were utilized to describe the impact via international financial markets.[69]

---

[68] (Hartlyn and Morley 1986)
[69] (Santiso 2003) and (Haley 2001)

According to this model, the degree to which economic instability will spread to the political system is determined by the ability of formal and informal institutions within society to facilitate the maintenance of social order when a collective frustration occurs among the populace. In concordance with the empirircal findings of Pei and Adesnick, this model is largely based on the notion that political stability will remain so long as the state is capable of maintaining order through the use of one or more of several possible mechanisms. As the principle formal institution, the state can attempt to maintain order in one or more of three ways: by providing institutional support to the effected populace, coercively controlling discontents, or fluidly adjusting to the problem.[70] Governments with the ability to employ any or all of these mechanisms effectively will be more effective at managing economic crisis and may avoid the political ramifications of economic instability. Authoritarian governments may be able to ensure stability through economic crisis by coercively controlling dissident movements. More democratic governments may remain stable by providing institutional support, minimizing the impact of the crisis on the lives of its citizens, or by fluidly adjusting to shift the political blame of the crisis or to correct underlying policy failures. Conversely, there are examples of both forms of government which have failed to employ these mechanisms effectively, and were subsequently toppled. Negative economic conditions begin to threaten the state when they directly impact the capacity of the state to maintain order.

Informal institutions also play a role in transmitting the impact of economic conditions to the political environment. Social norms and conventions, such as the

[70] (Gurr 1970, 15) and (Carlos H. Acuña and William C. Smith, "The Political Economy of Structural Adjustment: The Logic of Support and Opposition to Neoliberal Reform" in *Latin American Political Economy in the Age of Neoliberal Reform: Theoretical and Comparative Perspectives for the 1990's* (New Brunswick: Transaction Publishers, 1994), 20.

propensity to save money or consume goods, can have a tremendous impact on the breadth and severity of instability.[71] The degree to which political change will impact the economy is further determined by the efficacy of economic policies instituted by the newly appointed political actors, the ability of international financial institutions to address market instability, and the international banking community's perception of the political situation.[72] Economies in which there are policies viewed by the international community as financially irresponsible may be especially vulnerable during times of instability. Economies in which Neoliberal reforms have been successfully instituted in the past may not be pressured by IFI's to introduce austerity measures and may maintain the confidence of international investors throughout crisis. The consequences of a failure to maintain the confidence of international markets in periods of political instability can be devastating. Capital flight, currency collapse, and spiraling debt can have long-lasting effects on a countries economic conditions. In turn, these deteriorating economic conditions further augment the frustrations of the people. Therefore, a circular relationship is established in which instability can be self-perpetuating as it spreads back and forth between the state and financial markets.

Methodology

It is important to note that for the purposes of this work, a positive outcome of reform is defined as an improvement in the economic wellbeing of the citizens of the nation, measured primarily in terms of GDP per capita, the percentage of citizens living

[71] C. Mantzavinos, *Individuals, Institutions, and Markets*, (New York: The Cambridge University Press, 2001), 249.
[72] (Garrett 2000, 151)

in poverty, and some measure of wealth distribution. This definition of success is derived from the fact that stable, long-run economic growth can be the most effective means of eradicating poverty. Elevated, sustained economic growth rates are a necessary, but not a sufficient condition for the improvement of standards of living in the developing world. While economic growth is not the entire solution, it is a very important part. Studies of the economic experience of Latin America in the 20th century suggest that, "…without economic growth, it is virtually impossible to make lasting improvements in the welfare of the poorest sectors."[73] The achievement of sustained, equitable economic growth will serve as the definition of success throughout the remainder of this study.

In order to assess the determinants of success or failure within Latin America, I will develop case studies for Argentina and Chile. Whereas similar exogenous shocks were experienced in these states during the 1990's, the long-term political and economic outcomes varied. In the case of Argentina in 1999, the devaluation of Brazil's Real, combined with plummeting global commodity prices, brought on an economic crisis that led to tremendous political instability, concluding only upon a change of government.[74] In Chile during the same period, the near financial standstill in Asia and the ensuing drop in copper prices did not have an equally tumultuous impact on the economy or the political environment.[75] Apparent similarities of institutions and political economic conditions between Argentina and Chile bring more credence to the claim that the discrepancy of outcomes can be explained by identifiable policy differences. These two

---

[73] La Corporación Andina de Fomento. Publicaciones. "Reflexiones para Retomar el Crecimiento," (Caracas: La Corporación Andina de Fomento, 2004), 15.
[74] Yahoo! International Finance Center. "Argentina." Yahoo! International Finance Center. Available from http://biz.yahoo.com/ifc/ar.html; Internet; accessed 13 April 2005.
[75] Yahoo! International Finance Center. "Chile." Yahoo! International Finance Center. Available from http://biz.yahoo.com/ifc/cl.html; Internet; accessed 13 April 2005.

case studies may provide unique insights into the relationship between economic and political instability and an answer to the main question of this study: How can Neoliberal reforms be modified to have more positive outcomes in the developing world?

Chapter Four

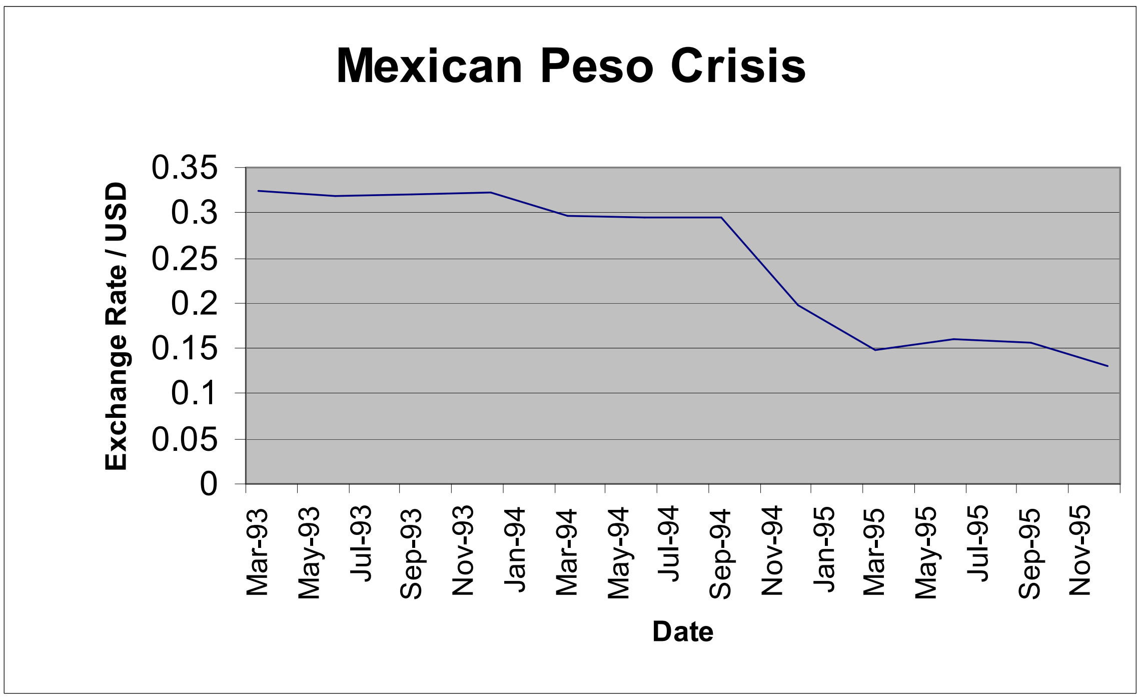
International Financial Crises

Introduction

Following the deregulation and liberalization of capital markets over the last twenty years, currency crises struck Mexico, East Asia, Russia, and Brazil between 1994 and 1999. These international currency crises established a context of defensive economic policy amidst widespread fears of contagion in Latin America and other emerging markets. These international financial crises had several consequences relevant to the Argentinean, Chilean, and East Asian case studies. First, the negative effects of open capital flows shaped the perception of citizens towards market liberalization, and therefore influenced the political environment within which Neoliberal reforms were attempted. Second, the crises forced policymakers to reevaluate their regulation of capital flows and currency fluctuations. Third, and perhaps most importantly, this first round of crises noticeably influenced the behaviors and attitudes of the international money centers towards emerging markets. I will address the specific ways in which these crises affected the individual cases of Argentina and Chile in their respective chapters.

The Mexican Peso Crisis

The Mexican Peso Crisis of 1994 had immediate ramifications in other emerging markets, most notably in Argentina. The crisis began in the last quarter of 1994 as a result of mostly endogenous factors. The Zapatista peasant rebellion in southern Mexico negatively affected the confidence of domestic and foreign investors. Yet more importantly, increased domestic credit from official development banks drove down the relative value of the Peso. Furthermore, as capital flowed excessively from the state into the private sector, the Central Bank lost the currency reserves that guaranteed the stability of the Peso.[76] Domestic imbalances were augmented by the herding instincts of large institutional investors, urged by analysts who viewed the Peso as being overvalued by as much as 20%. Foreign investors fled en mass in late 1994, and the Peso collapsed against the dollar, devaluing by more than 300% over the span of the next year and a half. The currency crisis was only ended when a bail out loan was organized by President Bill Clinton to the tune of $50 billion.[77]



Source: "Global Macroeconomic Figures." Bloomberg *2005.*

The aftershocks of the crisis were felt throughout Latin America in 1995. Despite the bail out organized by the NAFTA-bound U.S., many other emerging market

[76] Valeriano F. Garcia, *Black December: Banking Instability, The Mexican Crisis and its Effects on Argentina* (Washington DC: The International Bank for Reconstruction and Development, 1997), 24.
[77] (Garcia 1997, 25)

economies suffered reduced rates of capital inflows, higher interest rates, and reduced growth rates as a result of the crisis. The "Tequila Effect," as it was known in the southern Cone, hurt Argentina especially due to the perception of the international financial community that Argentina's currency managing regimes suffered similar problems.[78] Despite the perception, Argentina's currency regime was distinct, being managed by a currency board using an automatic adjustment rule. This rule generally exposed the Argentine Peso to more volatility but provided the opportunity to let of some steam in times of serious confidence crisis. Although Argentina did not suffer from over expansionary monetary policy, current fiscal expenditures had increased substantially in the final quarters of 1994, seriously deteriorating the state's fiscal accounts. Furthermore, there was a fear on the part of international investors leading up to the crisis that the Argentine government would repeat the 1991 forced swap of sovereign bonds for longer-term time deposits.[79]

The immediate impact of the resulting loss of investor confidence was two fold: a domestic run on banks in favor of cash, and an international run on the Peso in favor of the US dollar and other strong currencies. An increased cash to deposit ratio and capital flight each have the effect of significantly constricting the money supply. In the case of Argentina, the decrease in the demand for money was the initial cause of the devaluation rather than the increase in the supply of money as was the case in the Mexican crisis. In both cases, the lack of an official lender of last resort to anchor confidence in the currency board was a primary factor in the devaluation. Argentina lacked the intervention of the US, and consequently suffered more debilitating long-run economic

[78] (Garcia 1997, 27)
[79] (Garcia 1997, 28)

costs. Following a crisis, currency regimes have two main options: to deflate the money supply or to devalue the currency. In countries where wages and prices are relatively sticky, the result of a deflation of the money supply is long-run unemployment. In the 1995 crisis, Argentina chose to deflate the money supply rather than to devalue the Peso, and resulting rates of unemployment surged as high as 18% at the turn of the millennium.[80]

The East Asian Crisis

The East Asian Crisis of 1997-1998 had a tremendously destabilizing impact on the region and long-term economic consequences that were felt far beyond. Prior to the crisis, the East Asian economies had benefited from growth in the private sector led by deregulation and high rates of investment, largely domestic, coinciding with relatively low rates of inflation. The Asian Tigers of Hong Kong, Singapore, South Korea, and Taiwan had become the often cited examples of the benefits of opening up to foreign capital inflows. The deregulation of the East Asian financial markets occurred in the environment of pressure from the Wall Street-US Treasury-IMF complex, with little regard given to the need for the sequencing of reforms or for regulations designed to minimize the negative impact of speculative movements. In East Asia, as in Mexico before it, the mobility of capital was given "priority over all other considerations" by

[80] (Garcia 1997, 31)

foreign and national financial policy makers.[81] The crisis began in Thailand in the summer of 1997 and quickly spread to Indonesia, Malaysia, and South Korea.

The countries affected had robust fundamentals leading up to the crisis, including strong GDP growth, low unemployment, low inflation and budgets balanced with the help of relatively large domestic savings rates. However, the countries hardest hit by the crisis were institutionally unprepared for the potentially destabilizing short-term capital flows entering and exiting their emerging economies. All of the countries in question suffered from poorly regulated private banks and the widespread perception in the business community of minimal risk.[82] Coming off of decades of impressive economic growth, businesses became overzealous in their pursuit of growth. Financial institutions of the private sector, and increasingly foreign capital inflows from the major money centers, were all too willing to lend. These factors led to the overexposure of the East Asian economies to short-term foreign investment. The countries least exposed to such capital flows suffered the least. China, Hong Kong, Taiwan, and Singapore all minimized their exposure, yet for different reasons. China maintained strict capital account controls and regulations of international trade. Hong Kong had a history of disciplined openness, with a currency tied to the dollar through a currency board arrangement. Taiwan benefited from consistent economic growth fueled by exceptional rates of domestic savings which minimized the importance of short-run foreign investment in the economy. Singapore also benefited from consistent growth with minimal inflation and large rates of domestic savings.

---

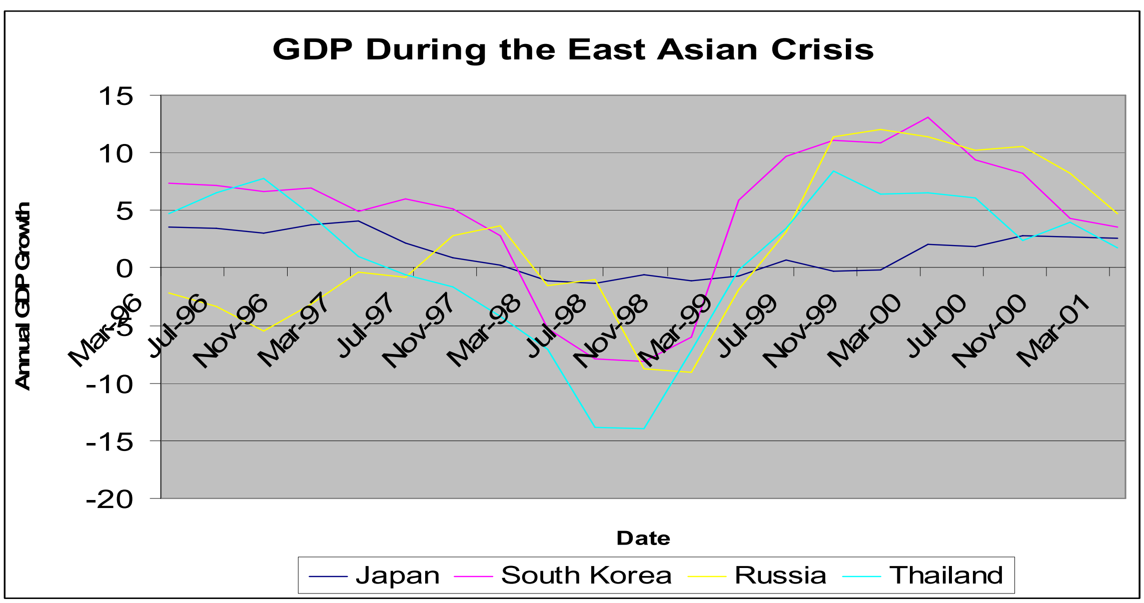
[81] Padma Desai, *Financial Crisis, Contagion, and Containment: From Asia to Argentina* (Princeton: Princeton University Press, 2003), 96.
[82] (Desai 2003, 86)

These crisis-immune economies also benefited from large foreign exchange reserves unaffected by short-term inflows. China maintained large enough reserves to pay for 6 months of imports, and in Singapore short-term debt as a percentage of foreign exchange reserves made up a miniscule 2%.[83] Most important for those economies that emerged unscathed from the crisis was the degree to which their foreign debt was held in long-term vs. short term notes. Singapore's foreign debt as a percentage of GDP prior to the crisis was a stable 10%, with only 17% of this debt being held in short-term notes. On the other hand, Thailand's debt to GDP ratio was 50%, and 57% of this debt was short-term. Similar degrees of foreign indebtedness were experienced in the other crisis-prone countries of Indonesia, Malaysia, and South Korea.[84] In these countries, the foreign debt played a critical role in the economy, as it facilitated increases in private sector lending and the money supply. In 1996, foreign debt amounted to as much as 25% of bank loans to the private sector. In the case of Singapore, only 2% of bank loans were provided by short-term foreign capital. Even a relatively mild slow-down of foreign capital inflows would have significantly undermined the ability of the crisis-prone economies to remain afloat.

The crisis was set in motion in Thailand and the other crisis-prone economies as highly leveraged local banks borrowed short-term from abroad and lent long-term to questionable ventures in real estate and emerging businesses. These potentially destabilizing underpinnings were brought to fruition by the mass exodus of foreign capital from the international money centers of New York, London, and Tokyo.[85] Both South Korean and Thai companies missed payments on foreign debt as early as January

[83] (Desai 2003, 92)
[84] (Desai 2003, 92)
[85] (Desai 2003, 95)

of ’97, prompting fears of further corporate failures to service massive foreign debt. In January, the South Korean chaebol, Hanbo, declared bankruptcy under the weight of $6 billion in debt. Local policy makers issued directives to contain the damage. The central banks of Thailand and Malaysia established limits on real estate credits and capped the fraction of loans that could be secured by stocks and bonds, but these measures were too little too late. In May of 1997, the Baht was hit by a massive speculative attack, forcing the Bank of Thailand to spend nearly $10 billion in defense of the currency, nearly wasting all of its foreign currency reserves. The Thai central bank insisted on the sustainability of the currency peg right up until the July 2nd, 1997 decision to float the Baht, which tumbled by 18% overnight.[86] By October of 1997, all of the crisis-prone countries had been hit, and the Malaysian and Thai currencies had depreciated against the dollar by more than 50%. Negative outcomes were not isolated to financial markets, as GDP for most East Asian nations plummeted in 1998.



Source: “Global Macroeconomic Figures.” Bloomberg *2005.*

[86] (Desai 2003, 120)

Tremors were felt around the world. The confidence of Wall Street and the other money centers in emerging markets had been shattered. Although stock prices fell especially in East Asian and Latin American exchanges, the American markets were no exception. The Dow Jones fell 554.26 points, one of the largest intra-day point losses in history.[87] Over-indebtedness was a major concern for much of Asia and Latin America, one that came to the forefront of investors minds in the wake of the Asian crisis. As international investors began to worry about the risks of investing in heavily indebted entities, foreign portfolio investment became more squeamish and speculative currency attacks intensified around the world.

The Ruple and Real Crises

The liberal market transition of the Russian economy following the collapse of the Soviet Union succeeded in liberalizing trade and rationalizing financial markets. Liberal reforms were implemented despite the fractured political climate and institutional vacuum left by the Communist dictatorship. Although successful in decreasing the rate of inflation to single digit levels, the reforms prolonged a transitional recession with steep economic and human costs. The shock therapy instituted by the technocratic reform team, led by the IMF, was increasingly met with opposition by left-leaning Russian lawmakers. Amidst the ongoing confrontation, which threatened to freeze the process entirely by 1998, Boris Yeltsin attempted to maintain the financial health of the federal

[87] (Desai 2003, 121)

government, which was still a key employer in the Russian economy.[88] Unable to raise adequate tax revenue, and prohibited by the IMF from borrowing from the Russian Central Bank, Yeltsin turned to foreign capital markets, which were unwilling to loan in the long-term given the emerging market scares of the time. Short-term foreign debt soon exceeded the foreign exchange resources available to finance a sudden withdrawal. Russian private banks also borrowed heavily from foreign markets, unrestricted by government regulation, and by 1997 foreign liabilities as a percentage of their assets had increased to 17%.[89]

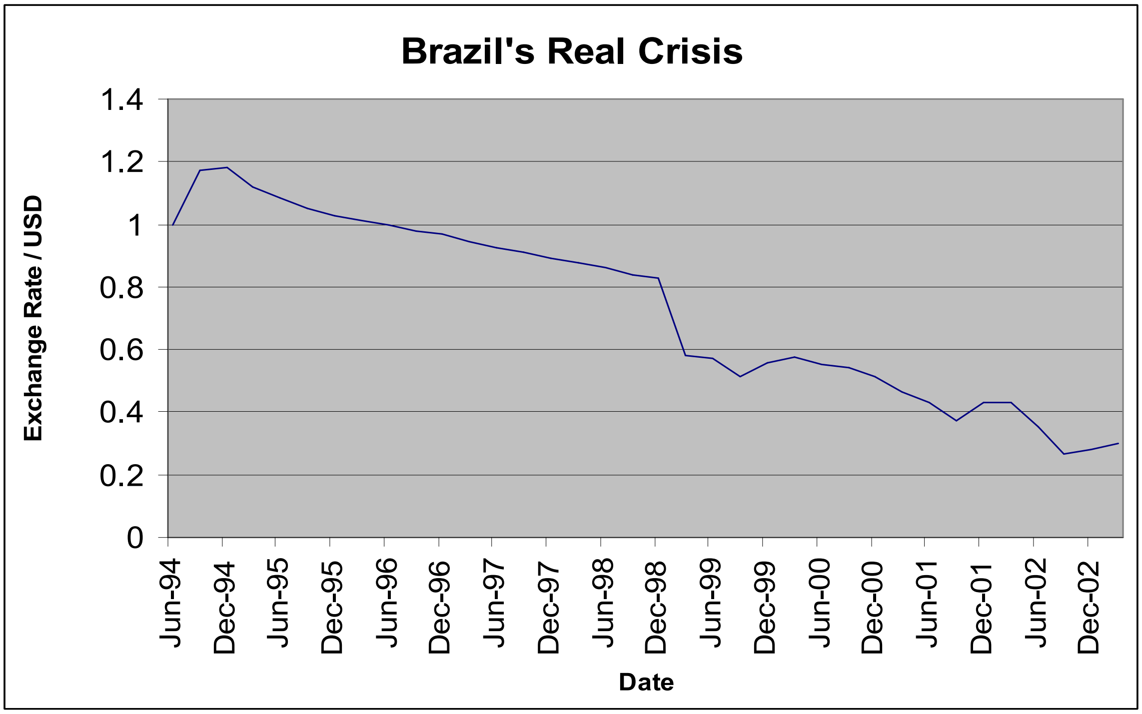
Within this context of endogenous fiscal weakness, the Russian economy was subjected to two major exogenous shocks. The first shock was the East Asian Financial Crisis which severely limited the supply of credit, dramatically increasing the interest rate for loans available to emerging market countries. The second shock came with the dramatic decrease in oil and nonferrous metal commodity prices on international markets, two of Russia's primary sources of foreign exchange earnings. The price of oil declined from $23 dollars a barrel in mid-1997 to $11 a barrel a year later.[90] A souring trade balance combined with soaring interest costs on Russia's sovereign debt, pulling the current account into the red by $5 billion by mid-1998. Fearing an impending devaluation of the Ruple, non-resident lenders of short-term capital pulled out of Russia despite the hike of the central bank interest rate to an incredible 150%. As Russian households began to by foreign currencies, capital flight became unrestrainable, and nearly $5 billion dollars of an IMF bail-out loan used to defend the currency disappeared in two weeks. The ensuing default of the Russian sovereign debt worsened the situation

[88] (Desai 2003, 141)
[89] (Desai 2003, 143)
[90] (Desai 2003, 144)

as Russian commercial banks were faced with rising interest rates on their foreign liabilities and disappearing domestic assets. Under pressure from the US Treasury, the IMF pushed the Russian federal government to provide 20% cash payments to all investors, forcing Russia to generate the cash via inflationary domestic economic policies.[91]

Financial crisis spread to Latin America as investors reacted to the East Asian crisis by pulling out of the Brazilian Real in 1997. Brazilian president, Fernando Henrique Cardoso responded with a Neoliberal stabilization plan designed to stave downward pressure on the Real. Under his guise, the Central Bank's overnight lending rate was increased to 43.5%, and government expenditures were at once cut by 2.5%. These drastic and immediate reforms had partial success until the following year, when contagion from the Russian Ruple crisis further undermined investor confidence in emerging markets outside of Asia. Further fiscal tightening and increased interest rates failed to curb capital flight out of Brazil of $1 billion per day.[92] The Brazilian government spent in excess of $40 billion of their foreign exchange reserves in a desperate attempt to defend the currency. As capital continued to exit the economy, Brazil turned to the IMF in 1998 in hopes of ending the balance of payments crisis. Despite the support of the IMF, Brazil's managed devaluation or "Real Plan" of 1994 was hastened when the Real was allowed to float freely on January 18th, 1999, and subsequently fell from 1.32 to the dollar to 2.14 to the dollar in less than two weeks.

[91] (Desai 2003, 146)
[92] (Desai 2003, 162)



Source: "Global Macroeconomic Figures." Bloomberg *2005.*

The IMF responded by imposing even stricter fiscal targets in the midst of the economic decline.[93] Weakness in the current account became an even greater problem dragging down the Real as central bank lacked effective control over other elements of the public sector. As had been a major problem in Russia, the non-financial public sector in Brazil maintained a lax policy on balancing their budgets, refusing to accept the necessary spending cuts.[94]

The crisis of the Brazilian Real was similar to the East Asian and Russian crises except that Brazil faced a relatively positive economic outlook prior to the crisis, as inflation had declined since the adoption of the "Real Plan" in 1994 and real GDP had increased to a relatively stable 3.2% by 1997. Although Brazil was also severely

[93] (Desai 2003, 162)
[94] (Desai 2003, 167)

dependent on short-term foreign loans, the crisis was not as lengthy or as damaging because it occurred in a time of long-run economic growth. The prices of Brazilian exports on world markets, although held flat by shrinking global demand, were not diminished to the degree that oil and metals had for Russia. Furthermore, Brazil's exports became more competitive versus Argentinean and other producers. The amount of Brazil's foreign debt and the extent of the speculative attacks were more of an issue than were the unavailability of foreign exchange earnings that had plagued East Asia and Russia. GDP growth rebounded into the black by 1999, and by 2000 it had once again surpassed 4%, while inflation remained relatively low at 7%.[95]

The most painful element of the crisis was a result of the IMF-designed austerity measures designed to facilitate repayment of debt, and unemployment shot up to 7.1% in 1999 amid steep reductions in government social spending. The devaluation of the Real further undermined Brazil's current account, and Brazil's debt as a percentage of GDP increased from 25% in 1997 to 47% in 2001.[96] The Real devalued an additional 30% in 2001 as concerns about Argentine default spread to Brazil, requiring five consecutive interest rate increases of 375 basis points by the central bank. Brazilian devaluation hampered the Argentine export sector as Brazil's similar products became relatively cheaper overnight. The loss of demand for Argentine exports crippled the ability of the Argentine government to acquire foreign exchange. The lack of foreign exchange reserves would become the ultimate factor threatening the Argentine currency peg up until the collapse of 2001.[97]

[95] (Desai 2003, 165)
[96] (Desai 2003, 170)
[97] (Desai 2003, 170)

Conclusions

An analysis of these cases of international financial crisis yields practical policy recommendations to Neoliberal reform. The following conclusions will be presented in more detail in the "Comparative Analysis" chapter. First, the social disposition towards high rates of domestic savings provides stability during reform periods as local capital is less likely to rapidly exit the domestic market. Second, the liberalization of capital markets should be done slowly so as to allow the markets to develop and to minimize potentially painful valuation corrections. Successful reforms in Taiwan and Singapore were pursued gradually over the course of many years of economic growth. Third, there are a series of financial techniques that reforming governments can employ in order to prepare for Neoliberal reform. These defenses against potential crisis include the accumulation of large amounts of foreign currency reserves, and the minimization of foreign debt, especially that held in short-term notes. Finally, the efficiency of the formal institutions of the reforming state must be taken into account when assessing the relative risk of reform.

Chapter Five

The Argentine Case

Introduction

The Argentine Crisis of the 1990's is an important case of political and economic instability for this study. Financial and economic instability resulted in the collapse of the Fernando de la Rua government in 2001. In order to discuss the crisis in depth, a brief history of Argentina's political economy will be given. Two important variables will be highlighted in the period leading up to the crisis: the degree to which the economy had undergone market liberating reforms prior to the crisis, and the degree to which the political decision making process was inclusive. The ultimate goal of this section will be to use the Argentina case in order to discuss the efficacy of the stabilization policies implemented by the government and international financial institutions.

History

Export-led growth, driven by inflows of foreign capital and substantial natural resource wealth, led to long-run economic expansion in the decades leading up to the end of the 19th century. Yet the overwhelming dependency of the Argentine economy on primary commodity exports left the nation vulnerable to the massive shock of plummeting foreign demand during the Great Depression and the First and Second World Wars. In 1930, the armed forces intervened, overthrowing the liberal Radical Party government, ushering in over a decade of conservative rule.[98] Throughout the 1930s, the Argentine state practiced regular intervention in the economy in order to transfer capital

[98] The Economist. "Argentina: History in Brief." Available from http://www.economist.com/countries/Argentina/profile.cfm?folder=History%20in%20brief; Internet; accessed 1 Aug. 2000.

from agriculture into the emerging industrial sector. The state practiced New Deal-style regulation of the economy, including the implementation of an income tax and foreign exchange controls, and the Argentine Central Bank was established in 1935. During this period, the conflict between elites whose livelihoods were based on the production of agricultural commodities such as beef and wheat clashed with the emerging urban bourgeoisie of the industrializing cities. Pampean conservatives, tied to the successful beef and grain industries, came into conflict with the liberals of the industrial economy. During the interwar period, the urban working class doubled in size to one million.[99] The rapidly changing class structure disrupted the balance of power in the Argentine political economy. The frequency of strikes and other demonstrations symbolized the rising power of organized labor. When it became apparent that conservative elites planned to rig the upcoming presidential election, the armed forces carried out a coup on June 4th, of 1943.

A young Colonel, Juan Domingo Peron rose in the ranks of the military government as a charismatic leader, helped by the mass mobilization of organized labor. Peron successfully welded the interests of the rising working class and the industrial entrepreneurs, creating a populist political movement to support his 1946 election to the presidency.[100] Coherence between these two, often conflicted, groups was facilitated by the Fordist notion popular among industrial entrepreneurs of the time that the interests of business were inextricably bound to those of the workers. Peron instituted economic policies based on import substitution industrialization through which growth in the industrial sector was fed by domestic demand and subsidized credit and protected from

---

[99] William C. Smith, *Authoritarianism and the Crisis of the Argentine Political Economy* (Stanford: Stanford University Press, 1991), 24.
[100] (Smith 1991, 26)

foreign competition. By redistributing incomes and widening internal markets, Peron's strategies had achieved 25-29% GDP growth from 1946-1948, but by the late 1940's, stagnant rural output and costly imports began to pull down the economy. Although the Peron government realized significant benefits to wages and working conditions, by the early 1950's the Argentine economy had reached the limit of Peron's inward-looking growth model. As a result, inflation began to creep above 30% by the early 1950's, and many segments of the urban elite that stood to benefit from growth in exports began to demand a return to participation in world markets, dividing Peron's political coalition. Following the removal of Juan Peron from office by the military in 1955, Argentina was plunged into a prolonged epoch of political and economic instability. Although Peronismo officially fell in 1955, it would remain the strongest political force in Argentina, as the memory of the charismatic populist lived on in the memory of the working class.[101]

The 1950's saw a return to the global market, as Argentina opened to foreign investment and multinational corporations in the hope of stimulating growth in the historically profitable sectors of the economy. For the 1950s and '60s, the result would be violent stop and go cycles of growth and high inflation on which the fate of the two main parties, the Peronistas and the Radicals, was determined. Pendular political swings were caused by the distributional consequences of this volatile period of subsequent booms and busts.[102]

Perhaps the boldest economic reforms yet imposed in Argentina began in the late 1960s under Economic Minister Adalberto Kreiger Vasena of President Juan Carlos

---

[101] (Smith 1991, 32)
[102] (Smith 1991, 43)

Onganía government. Kreiger implemented the denationalization of industries, the reduction of barriers to trade and the strict encouragement of increased efficiency in pursuit of an international comparative advantage in trade. The Keynesian free-market reforms of Kreiger required significant state intervention and brought substantial social costs to certain sectors of the economy and to the state. Wages decreased as profits soared in all sectors of the economy, with the exception of agriculture.[103] Resistance to the strictly imposed reforms of the Onganía regime grew among working class members of less-incorporated labor movements. The *Cordobazo*, a powerful anti-regime uprising, began in the 1960's in response to the political stalemate between Onganía and *colaboranista* labor leaders, in which little was done to minimize the costs of reform on the working class. The *Cordobazo* was a period marked by increasing militancy and well organized labor strikes that undermined the legitimacy of the increasingly authoritarian Onganía regime. In the late 1960's, dissidence was radicalized following the traditions of Peronismo and Marxism among university students and intellectuals. The military became increasingly concerned by the weak Onganía regime and rising Marxist movements. In 1970, a Military Junta replaced President Onganía with a centrist General Roberto Marcelo Levingston.[104] The radical left continued to undermine the authoritarian regime, and Juan Peron briefly returned to the presidency in 1973, only to die the next year. Claiming the threat of communist revolution, a conservative military Junta, supported by powerful economic interests, overthrew Peron's third-wife Isabel from the presidency in 1976.

[103] (Smith 1991, 79)
[104] (Smith 1991, 231)

General Jorge Videla came to power with the expressed intent of destroying the perceived threat of communism and transforming the Argentine economy. The military Junta practiced state repression and terrorism on a tremendous scale in order to eliminate political opponents, torturing and murdering thousands. Official estimates of the "disappeared" victims of the "Guerra Sucia," or dirty war, surpass 8,960, while other estimates are as high as 20,000.[105] The Junta imposed Neoliberal economic reforms based on the opening of the economy to the world market and the strict adherence to the law of comparative advantage. In the early 1980's, a painful economic recession tested the coherence of the military regime, which responded by imposing even more austere reforms. In a desperate political move to shift public tensions away from the economy, the armed forces invaded the British controlled Faulkland islands (Islas Malvinas) in 1982. The invasion failed as the British retook the islands several months later, further discrediting the military Junta. The short-lived war brought spiraling national debt and near financial insolvency to be felt by future democratic governments.[106] The inability of the military state to rule itself eventually brought the downfall of the authoritarian regime, more so than the mild resurgence of civil politics and in 1983 Argentina returned to civilian rule.[107]

President Raul Alfonsin of the Radical Party replaced the military Junta through democratic elections in 1983. The Alfonsin government sought to maintain stability in a nascent democracy by more or less maintaining the economic system inherited from the Junta while eradicating or reforming praetorian institutions. Alfonsin's government attempted to maintain legitimacy strictly by providing an end to political repression and

[105] (Smith 1991, 233)
[106] ("Argentina: History in Brief." 2005)
[107] (Smith 1991, 266)

promoting human rights. However, the regime was unable and seemingly uninterested in curbing ever-increasing inflation. Weak stabilization plans were not obeyed by all elements of the government, and state banks maintained an expansionary monetary policy that further increased the price level. Inflation led to capital flight as the US government discontinued its already lukewarm support as a potential lender of last resort for the Alfonsin regime in 1987.[108] The political emphasis of the Radical Party under Alfonsin failed to recognize the importance of economic issues of price stability and investor confidence. A new currency, the Austral, failed to ensure the confidence of currency markets. The Alfonsin regime's attempts to end inflation before the 1989 election were unsuccessful, as currency controls and price freezes reduced government revenue and failed to reduce inflation as they were largely ignored and a black market emerged in price controlled goods. Alfonsin was replaced by Carlos Saul Menem of the Peronistas in the 1989 election. Menem engaged the inherited problem of massive hyperinflation head on, personally declaring the need to transform Argentine capitalism. The reforms initially had tremendous social costs, unemployment and income inequality surged as real GDP finished the decade down 26%. However, reforms had real success in the following year, returning Argentina to positive GDP growth, significantly reducing inflation, and bringing back foreign capital.[109] The successes were enough to guarantee victory for the Peronistas in the mid-term elections of 1991. However, the longer-term benefits of reform would soon be undermined by exogenous economic shocks.

[108] (Smith 1991, 86)
[109] (Smith 1991, 89)

Liberal Reform Prior to the Crisis

The instability of the late 1990's is directly linked to the depth and political impact of Neoliberal reforms in the Argentine political economy. In order to discuss the Argentine instability of the late 1990's it is necessary to address the quantity and quality of Neoliberal reforms implemented before the crisis period. The degree to which the state exerts control over the economy is an important variable determining the impact of the crisis as the state is forced to relinquish control to balance fiscal accounts and to receive the approval of international financial institutions. In Argentina, there were three main periods of reform in the 20th century: the Keynesian free-market reforms of Kreiger in the late 1960's, the rapid and forced reforms of the "New Political Economy" under the Junta of the 1970's, and the reforms of Carlos Menem under the strain of hyperinflation in the late 1980's and early 90's.

In the late 1960's, the liberalizing reforms of Onganía's economic minister, Krieger, were moderate when compared to future reforms. The reforms were designed to curb inflation through Argentina's volatile economic cycles. Krieger posited a compromised, Keynesian version of liberalizing reforms, in which the state consistently intervened to limit the cost of reform. The reforms involved the denationalization of industries, the reduction in barriers of trade, intended to foster growth in the most efficient industries which were disproportionately owned by foreign interests. Kreiger's reforms led to an initial rate of growth fostered by inflows of foreign investment, as GDP growth shifted from -7.2 percent in 1966 to 21.4 percent in 1969. By 1969, the Argentine cost of living was also reduced to a historic low. The effects of the liberal policy reforms were partially the result of the particular adeptness of Kreiger's policies in returning growth and the purchasing power of wages while garnering the endorsement of international financial institutions and foreign bankers. Yet Krieger's reforms were ultimately undermined by the political ramifications of distributional consequences. Kreiger had promised that the reforms would not amount to the transfer of wealth from one sector to another, whereas the logical effects of his economic policies meant the transfer of wealth from industries protected by the state to industries connected to foreign markets.[110] Disillusioned rural elites began to articulate a concern that their interests were being subordinated to that of the urban and financial sectors. Argentina's economic elite was divided by the distributional consequences of Krieger's reforms, forcing Onganía to make significant policy compromises in order to maintain his ever-eroding domestic support.[111] Krieger's reforms came to an end, despite their general success, due to political conflict and the resulting Cordobazo.[112]

Upon the acquisition of power by the military Junta of 1976, a doctrine of classical liberal orthodoxy was imposed, involving the forced opening of the economy to international competition. The new economic minister, Jose Martinez de Hoz, rejected the Onganía reforms as insufficiently orthodox and proposed a "full test" of market theory espoused by University of Chicago economists and increasingly the IMF.[113] Martinez de Hoz rapidly eliminated subsidies designed to foster development in industrial sectors which were seen as unfairly biased against the interests of the Pampean

---

[110] (Smith 1991, 98)
[111] (Smith 1991, 75)
[112] Adolfo Canitrot, "Crisis and Transformation of the Argentine State (1978-1992)" in *Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia, Brazil, Chile, and Mexico.* (New Brunswick: Transaction Publishers, 1994), 76.
[113] (Smith 1991, 234)

elite. The transformation of the Argentine economy was further carried out by the elimination of administrative controls and the wholesale of state owned enterprises untouched by Krieger. Wages were effectively reduced to about 40% to that of the five year average. Export taxes on agricultural and livestock products were at once eradicated, and tariffs were progressively phased out by 50%. State expenditure was greatly reduced by imposing sizable cut-backs in social welfare spending on health, education, and housing. Overall, these policies were designed to achieve rapid deflation and long-run stabilization of prices following IMF-type prescriptions.[114] The already deep recession was to be prolonged in order to eliminate inflation and to "rationalize" the productive structure of the Argentine economy. Argentina's public and private debt skyrocketed during this period, and would plague later democratic regimes.

The most important series of reforms came under the government of Carlos Saul Menem in response to the hyperinflation of Alfonsin. After running on a fairly ambiguous platform of economic reforms, Menem set out to eliminate inflation through an economic austerity program. Menem's reforms immediately spurred a "hyperrecession," entailing huge social costs while failing to reduce inflation.[115] The curtailment of public-sector investments and the sale of inefficient publicly owned industries reduced aggregate demand, prolonging the recession despite drastically lowered interest rates. This ineffective first round of Neoliberal reform had dramatic distributional consequences. By the end of the 1980's, the share of national income going to the top 10% increased to 46%, whereas the extremely poor grew to as much as 40% of metropolitan Buenos Aires. As stagnation persisted into the 1990s, threatening

[114] (Smith 1991, 236)
[115] (Smith 1991, 300)

the unity of Menem's Peronista political support, Menem instated Domingo Felipe Cavallo as the new Economic Minister with the expressed intent of taking reforms even further. Menem's presidency seems to be the exception to the rule that economic policies in Argentina have been largely subordinated to political movements, as Menem was able to retain support for his stabilization programs despite internal political strife in the Peronista party. Reforms were perceived to be necessary by nearly the entire political spectrum in the context of massive hyperinflation and negative GDP growth.

Upon assuming the economic ministry seat, Cavallo's economic team benefited from the large foreign currency reserves that were the result of the effect of currency devaluations on the current account, which dramatically increased exports and decreased imports. Cavallo's plans to reform Argentine capitalism, known as the "Cavallazo," included two main elements: the harsh treatment of organized labor, and the Peso Convertibility Plan. Both of these strategies were legalized by congress. Congress passed a bill making it illegal to participate in strikes in certain sectors of the economy deemed to be critical to Argentine recovery. The value of the Peso was supported by law at a one to one ratio with the US dollar. The controversial Convertibility Plan included 11 main points. First and foremost was the redefinition of the state and its role in the economy. The Plan called for significant cuts in the public deficit vis-a-vis government spending cuts and the sale of deficit ridden state owned enterprises. The state's capacity to regulate was restricted and a number of central administrative jobs were cut. A stand-by agreement was arranged with the IMF, providing access to IMF credits and the US "Brady Plan," securing a higher credit rating and lower interest rates from foreign banks. Many tax exemptions were eliminated and value-added taxes were increased. The other main points of the Convertibility Plan were intended to decrease prices and improve production efficiency. Further entry into the world economy allowed imports to act as a ceiling on domestic prices. Legislation was passed limiting the compensation of occupational accidents and salaries were linked to productivity.

Further legislation limited the clout of unions and strengthened the bargaining power of employers. Finally, the retirement system was overhauled, privatizing the pension system to eliminate the public debt occasioned by the bankruptcy of the major pension funds.[116] Each of these policies had the effect of lowering prices. By the end of the year, Cavallo's Convertibility Plan reduced growth in consumer prices from 27% to 3%, and one year interest rates fell from 44% to 22%.[117] The large currency reserves enjoyed by Cavallo's team allowed the Central Bank to guarantee the currency peg, cementing investor confidence. As foreign capital flows returned to Argentina, economic growth finally rebounded, legitimizing the Menem government in time for the 1991 mid-term elections in which the Peronists widened their majority in congress.[118] The control exercised over unions returned price flexibility to the Argentine economy. Deals were brokered with the capitalists of other industrial sectors in which tax breaks were granted in exchange for carefully coordinated price reductions. The Convertibility Plan, successfully brought back foreign capital, fostering a 9% GDP growth rate by 1992.[119] Despite the initial success of Menem's reforms, the failure to deepen fiscal

[116] Carlos H. Acuña, "Politics and Economics in the Argentina of the Nineties (Or, Why the Future No Longer Is What It Used to Be)," in *Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia, Brazil, Chile, and Mexico* (New Brunswick: Transaction Publishers, 1994), 47.
[117] (Acuña 1994, 45)
[118] (Canitrot 1994, 89)
[119] (Acuña 1994, 48)

reforms left the economy vulnerable to a series of exogenous shocks in the mid and late 1990's.[120]

Political Environment of Reform Periods

In order to discuss the efficacy of Neoliberal reform during the crisis period of the late 1990's, it is necessary to address the political environment during past reform periods. The liberal economic reforms of the Onganía and Junta regimes occurred under bureaucratic authoritarian systems, while the reforms of Carlos Menem occurred under the guise of a nascent democracy. Furthermore, the most recent round of reforms was executed by a Peronist regime, a party symbolic of populism and working-class interests.

The economic reforms of 1967-69 and 1976 occurred under a political environment of bureaucratic authoritarianism, characterized by the exclusion of working-class interests from the decision making process. In each case, although to varying degrees, there was a perception among the political and economic elite of a threat to the existing social order in the form of leftist reform or even communist revolution. In both cases, the bureaucratic authoritarian state came about in response to this perceived threat and with the ostensible goal of the "normalization" of the economy through a series of liberal reforms, which subsequently benefited those elites connected to transnational capital.[121] During each period of reform, elites coercively controlled the decisive weight of institutions to suppress effective political democracy and to promote a pattern of capital accumulation biased in favor of oligopolistic units of private capital. In this

[120] ("Argentina: History in Brief." 2005)
[121] Guillermo O'Donnell, *Bureaucratic Authoritarianism* (Berkeley: The University of California Press, 1988), 31.

environment, the "normalization" of the economy was pursued to further the interests of the ruling regime, whose monopoly of the connection to foreign capital further augmented and justified their local domination of economic and political resources.[122]

A social order based on class exclusion became necessary in the eyes of the ruling elite benefiting from it, not for their own gain, but in pursuit of what had become the ultimate rhetorical goal, the liberal transformation of the economy. In pursuit of this goal, class rhetoric was suppressed and the economic reform process was depoliticized, separating the link between the political interests and the distributional consequences of the reforms. Not surprisingly, the economic reforms of Krieger and Martinez de Hoz, achieved their intended purpose of decreasing wages and salaries of lower-middle sectors, while increasing profits and salaries of upper-middle sectors across the board.[123] The one noted exception occurred in the more Keynesian minded reforms of Krieger, in which industrial production was favored over the interests of the Pampean bourgeoisie and agriculture was the one sector of the economy to experience decreasing profits. During the reforms of the Junta regime, profits in agriculture increased more than any other sector.[124]

Following the collapse of the Junta, there was a genuine pursuit on the part of the elected Alfonsín government to democratize the institutions long-marked by authoritarianism. The political influence of the Junta elite and the threat of a military coup remained major concerns for the Alfonsín and Menem regimes. Democratization would require two processes: the subordination of the military to civil government and the elimination of the corporatist collusion of the Argentine economy through a transition

---

[122] (O'Donnell 1988, 32)
[123] (O'Donnell 1988, 123, 267, 285)
[124] (O'Donnell 1988, 124, 285)

to a true open-market economy.[125] The former was somewhat successfully pursued by the "human rights government" of Alfonsín, while the latter became the primary goal of the economic reforms of Carlos Menem. The Alfonsín government successfully responded to the political crisis of democratic consolidation by destroying the old institutional framework of corporatism. Several of the institutions of the Argentine government remained firmly in control of the military, and had to be fully dismantled before democracy could be fully pursued. However, the economic policy of the Alfonsín government suffered remarkable failure. In an attempt to produce economic growth despite a bloated and deficit-based public sector, the Alfonsín government pursued inflationary monetary policy, which resulted in massive hyperinflation and impoverishment by the end of his term in 1989. Leading up to the elections of 1989, Argentina's price level grew by an astounding 4,924 percent.[126] Carlos Saul Menem ran in the presidential elections of 1989 as a Peronista, on a simple platform of ending the economic crisis triggered by the failure of the Radical party under Alfonsín.

Once in office, Menem led the third major push in Argentine history to liberalize the economy, pushing through a series of sweeping reforms. Himself a Peronista, Menem dismantled what remained of the neomercantilist state that had been instituted by the original Peronismo. That Menem was willing to execute neoliberal reforms historically associated with the upper echelons of the bourgeoisie is explained by the extent of the hyperinflation and impoverishment in Argentina when he took office, and the international demonstrative factors that delegitimized any other option. In the context of hyperinflation, Menem's avowed goal of *salariazo* (slang for a large increase in

---

[125] Carlos H. Waisman "Argentina: Capitalism and Democracy," in *Democracy in Developing Countries: Latin America* (Boulder: Lynne Rienner Publishers, Inc., 1999), 97.
[126] (Waisman 1999, 98)

wages), was best achieved in real terms by restoring the purchasing power of wages through the eradication of inflation. The spectacular global failure of communism and state led-development in Latin America and the apparent successes of economic liberalization in Chile served as crucial cognitive mechanisms reinforcing the perceived validity of Neoliberalism, not only among Argentine elites.[127] These factors led Menem to pursue a path of radical economic liberalization, which would have striking and seemingly counterintuitive political consequences.

The Peronista coalition now consisted of the lower classes faithful to the rhetoric of Peronismo and the economic elite who expected to benefit from Menem's reforms, while the Radical party captured the majority of the middle class. This shaky alliance of political poles was cohesive under the threat of further economic crisis, yet as the memory of the late 1980s receded and economic liberalization prolonged unemployment, public opinion began to clamor for "active employment policies."[128]

At the opposite pole, there was a push by economic elites to subordinate labor in pursuit of further reforms to prevent crisis and maximize profits. The Menem government in particular cracked down significantly on the power of unions, outlawing strikes in particular sectors of the economy.[129] This was an especially egregious law for many Argentines who associated organized demonstrations and protests with Peronismo.

[127] (Waisman 1999, 105)
[128] (Waisman 1999, 102)
[129] (Acuña 1994, 52)

The Argentine Crisis

The Fernando de La Rua government inherited this polarized political discourse amidst a slowdown in economic growth. A relatively conservative member of the Union Civica Radical, de La Rua continued many of the economic policies of his Peronista predecessor. In 1998, Fernando de la Rua was positioned to replace Carlos Saul Menem as the president of Argentina. He would inherit a currency pegged one to one with the US dollar and an economy seemingly on the mend. The economy had weathered several damaging exogenous shocks, including the Mexican Peso Crisis and the East Asian Emerging Markets Crisis, and seemed to be rebounding. GDP growth had been positive since the 1995 "Tequila Effect," and capital inflows were on the upswing by 1998.[130] However, a third external shock in late 1998 and 1999 changed de la Rua's fate, as a steep devaluation in Brazil's Real significantly undermined the competitiveness of Argentina's agricultural exports. Argentina's export earnings fell by 10% in the second half of 1998. GDP fell by 3.5% in 1999, and a further 1% in 2000. Unemployment achieved a staggering 15%.[131]

De la Rua's recovery strategy was to close a widening gap between government expenditures and revenues by increasing taxes and pushing through tough public-spending cuts in the hopes of boosting the confidence of foreign investors. In 2000, Argentina's financial instability and mounting debt forced Economy Minister José Luis Machinea to try to rapidly eliminate debt and reassure the markets about the stability of

[130] Christina Daseking, *Lessons from the Crisis in Argentina* (Washington DC: International Monetary Fund, 2004), 5.
[131] The Economist. "Another President Caught in Argentina's Economic Trap." Available from http://www.economist.com/displaystory.cfm?story_id=387306; Internet; accessed 5 Oct. 2000.

the Peso. The Argentine government desperately tried to avoid default and capital flight by stopping payment on domestic liabilities, canceling or suspending state spending wherever possible. In May of 2000, the government announced it would cut spending by $938 million. In addition, the fuel tax was heightened in order to increase revenue.

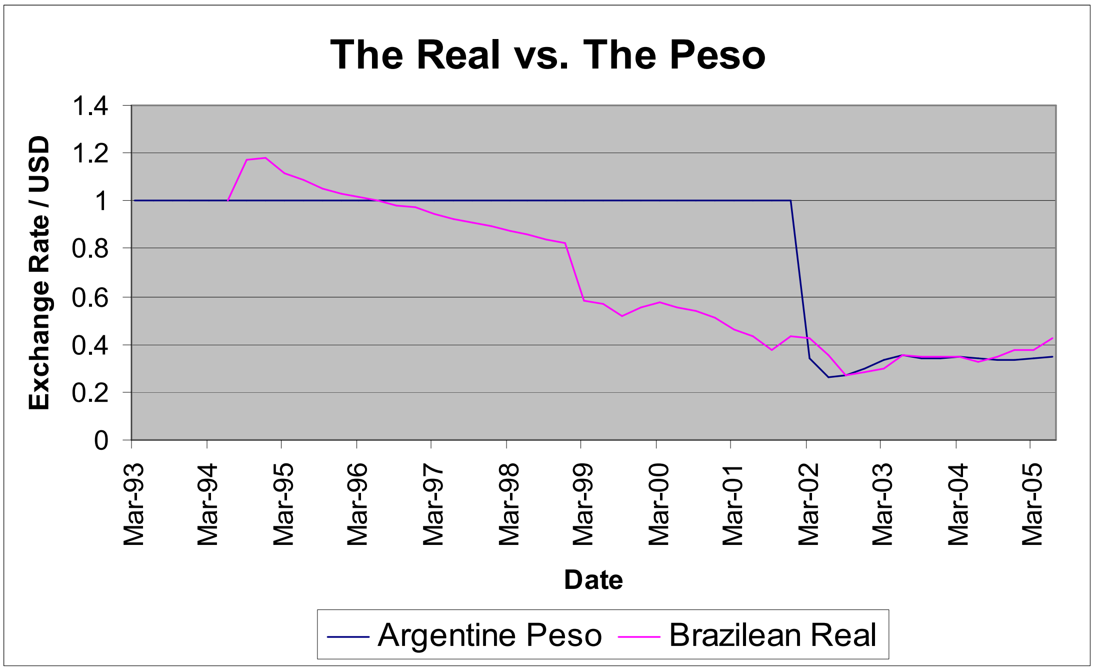
On May 29th 2000, 20,000 marched to protest the simultaneous increase in taxes and decrease in services. The only event to give the Argentine stock market a significant rebound that year was the announcement of a $40 billion financial aid package from the IMF.[132] The contractionary policy move slowed growth and failed to lure foreign investors, as interest rates actually rose. The spread between the Argentine sovereign debt and US Treasury Bills rose above 750 basis points in the early months of 2000, signaling a persistent lack of investor confidence in light of emerging market crisis in Russia and Brazil.[133] Creeping economic misfortune and the strictly pegged currency brought sharp deflationary pressure on the Argentine economy in 2000.

The value and volume of Argentina's exports continued to decline, as Brazil's Real further devalued by 30% in 2001 in response to investor's fears that Argentina would default on its sovereign debt. At the same time, the U.S. dot com bubble burst, and the recession engulfed U.S. economy further diminished demand for Argentine exports and for the Peso. The declining Real made Argentine exports relatively more expensive on world markets, decreasing the quantity demanded and severely hampering Argentina's primary source of foreign currency reserves. Argentina was hit especially hard by the devaluation of the Brazilean Real, and by 2001, de la Rua's government

---

[132] Reuters. "Timeline: Argentina's Financial Crisis." Fox News. Available from http://www.foxnews.com/story/0,2933,40274,00.html; Internet; accessed 6 December 2001.
[133] (Daseking 2004, 23)

seemed trapped between two equally painful alternatives: to abandon the currency peg and devalue, or to default on it's $132 billion in public debt.



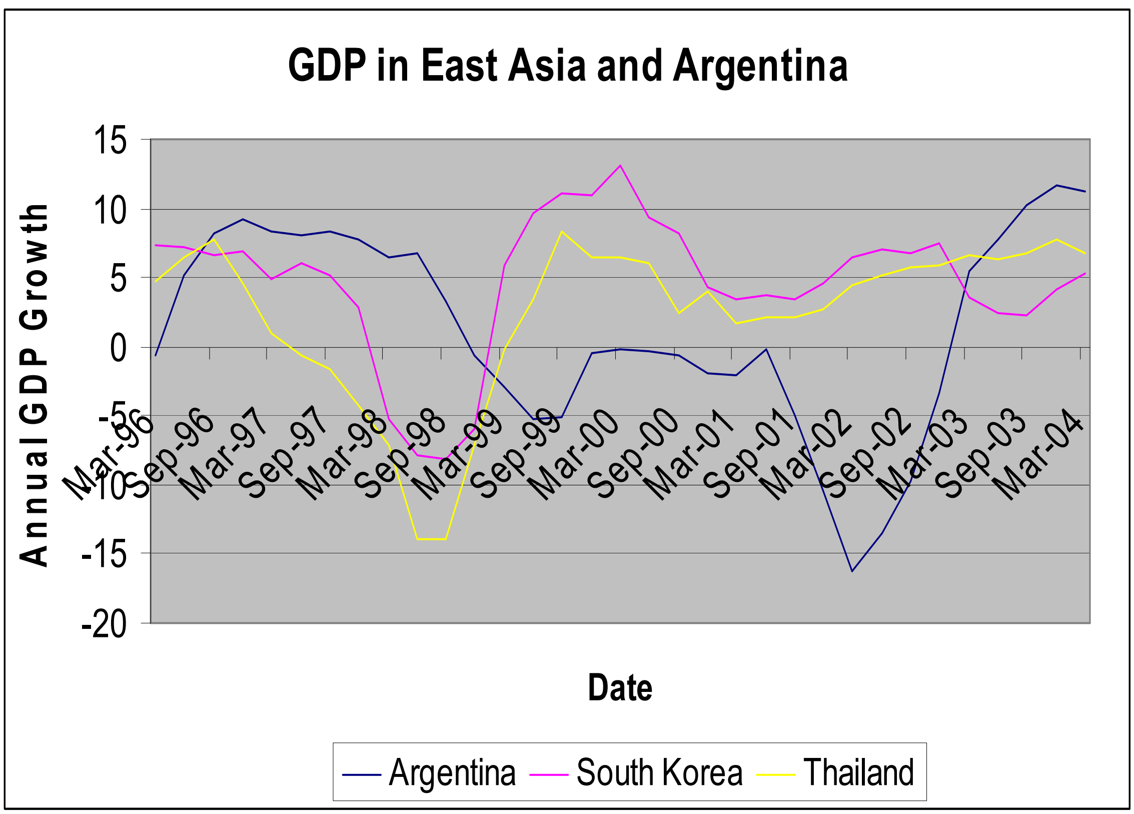
Source: "Global Macroeconomic Figures." Bloomberg 2005.

Foreign exchange is critical both to service foreign debt denominated in foreign currency and to defend the pegged Peso against speculative attacks by currency traders. The lack of foreign exchange, rather than insurmountable debt, became the greatest weakness of the Argentine financial outlook.[134]

In March of 2001, Economy Minister Machinea resigned, and Ricardo Lopez Murphy replaced him, only to announce a $4.45 billion austerity program with significant cuts in spending on education. Lopez Murphy resigned on March 19th. The next day, de la Rua called for a national unity government and appointed successful and tough former

[134] (Desai 2003, 170)

Economy Minister, Domingo Cavallo to replace Lopez Murphy. Cavallo attempted to shield Argentine markets and industries by launching a tariff on financial transactions and increased tariffs to shield local firms. Cavallo's Competitiveness Plan modified the currency peg and enacted a debt swap of $30 billion, but these moves signaled weakness to international investors. Things turned worse when Cavallo dipped his hands in the currency board, switching the peg to a weighted average of 50% dollars, 50% euros, which brought a 4% improvement on terms of trade to Argentine exporters. However, the change led to fears of further devaluation, and a run on Argentine banks caused the loss of $8 billion in July of 2001. The run on the banks caused a credit crunch, and GDP fell further from 6% to 12% year on year. [135]



Source: "Global Macroeconomic Figures." *<u>Bloomberg</u> 2005.*

[135] The Economist. 2001. "Down and Almost Out in Buenos Aires." Nov. 1.

By this time, it had become clear that the currency peg was a liability. The peg forced contractionary monetary and fiscal policy throughout a period of economic stagnation and declining demand. At the same time, the removal of the peg in the context of currency devaluation in several other emerging market economies would have significantly undermined investor confidence and possibly provoked speculative attacks. The government repeatedly attempted to restructure the public debt without scaring away investors, launching a market-based, voluntary debt swap in June of 2001. Argentina was forced on July 10th to pay the highest interest rates in five years on its short-term debt, and to raise money for the now increasingly expensive debt servicing, the federal government announced that the provinces would have to immediately slash all deficits to zero, and eliminate any debt. Later that month the economy was brought to a near standstill by a massive strike in protest to the spending cuts and the failure of provincial governments to pay public sector wages. Unemployed or unpaid protestors, known as 'piqueteros,' took to the streets of Buenos Aires. Despite this and later debt swaps, Argentina's credit risk rating hit new record highs, and capital both foreign and domestic began streaming out of the country.[136] In a last ditch effort to end capital flight, Cavallo announced the sweeping restrictions on withdrawals and fund transfers abroad that would bring violent street protests.

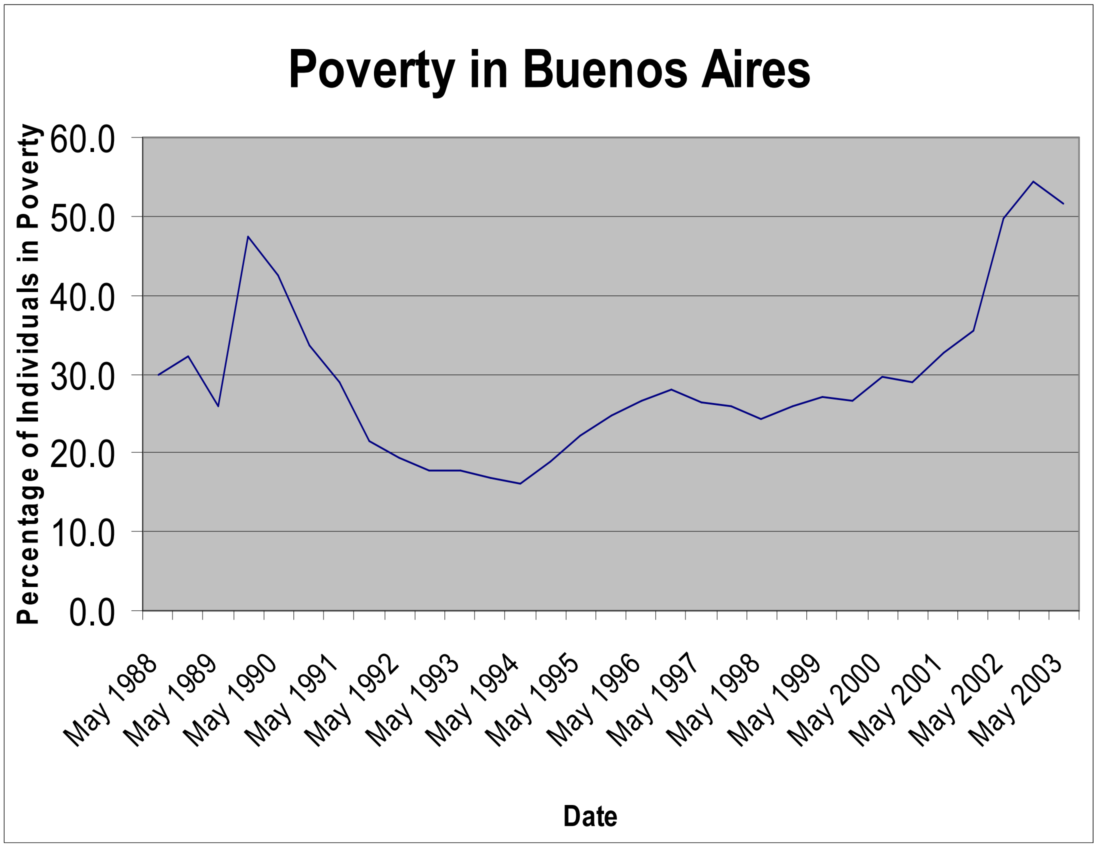
In November of 2001, the authorities made further efforts to restructure debt domestically, exchanging peso and dollar denominated bonds for domestic guaranteed loans with an interest payment grace period until April of 2002. The crisis fell into free fall in late November, triggered by a further domestic run on banks. In the final three

[136] ("Timeline: Argentina's Financial Crisis." 2001)

days of November, 6% of the deposit base of Argentine banks was withdrawn, and the authorities responded with draconian controls on banking and foreign exchange transactions.[137] Authorities extended controls to include a limit on withdrawals of 250 pesos from individual bank accounts in what would be known as “el corralito.” Banks were prohibited from granting loans on pesos and foreign exchange controls were placed on traveling expenses and cross-border money transfers. Civilians responded to el corralito with street protests and riots. On December 13th, a 24 hour general strike was held protesting the banking restrictions and the delayed payout of state pension funds. On December 20th, at least 25 people were killed during violent street protests and rioting, and President Fernando de la Rua resigned. Economic activity collapsed in late 2001, as industrial production fell by 18% almost overnight. Tax revenue plummeted by 17%, further undermining the governments already deteriorating fiscal outlook. On December 23rd, the interim President Adolfo Rodriguez Saa declared the default of government debt and called presidential elections within 60 days. [138] By 2002, GDP per capita had bottomed out at $10,690 measured in purchasing power parity, and the percentage of porteños living in poverty increased temporarily above 50%.[139]

---

[137] (Daseking 2004, 37)
[138] (Daseking 2004, 37)
[139] The Economist. “Backgrounders: Argentina.” Available from http://www.economist.com/research/backgrounders/displayBackgrounder.cfm?bg=1022218; Internet; accessed 1 Nov 2005.



Source: "Global Macroeconomic Figures." Bloomberg 2005.

Conclusion

Argentina's economic reforms of the early nineties were undermined by regional inconsistencies, leaving the economy greatly indebted and vulnerable to the exogenous shocks of the late 1990s. The Argentine case demonstrates that some political environments may not be conducive to liberalizing economic reforms. Argentina's reforms did not enjoy the political support necessary to make them viable, thereby rendering monetary and fiscal adjustments ineffective and undermining the currency peg. Menem's government lacked the kind of common political front necessary to ensure policy consistency. In the relatively decentralized Argentine government, Argentina's economic policy makers did not enjoy the authority to formulate a unified monetary and fiscal policy capable of defending the currency peg and solidifying Argentina's financial position. Argentina is a clear example of the dangers of indebtedness and the importance of maintaining the confidence of the international financial community. Investor confidence is best maintained by consistency and transparency. While Argentina's various Economic Ministers attempted to minimize the sovereign debt in the form of short-term notes, the drastic measures taken to restructure the government debt during the throngs of crisis further undermined investor confidence in the Peso. In conclusion, the Argentine case highlights the importance of certain political prerequisites for reform such as a degree of centralization. Other important policy implications of this case include the consistency and transparency of policies, the minimization of debt, and the accumulation of a stability fund and currency reserves.

Chapter Six

The Chilean Case

Introduction

The economic performance and political outcomes of Chile in the late 1990s provides a useful comparison to the Argentine case. During this period, Chile experienced similar external economic shocks, and the political climate was, while not identical, very similar. Although Chile experienced a mild economic slowdown, financial and political stability were more or less maintained. Unlike Argentina, Chile remains a Latin American success story for free-market economic reforms and democratic governance. In order to discuss the crisis period in depth, a brief history of Chilean political economy will be given. Two important variables will be highlighted in the period leading up to the crisis: the degree to which the economy had undergone market liberating reforms prior to the crisis and the degree to which the political decision making process was inclusive. Ultimately, I will use the Chilean case as a counterpoint to the Argentine case in order to draw conclusions about the efficacy of the Neoliberal stabilization policies.

History

Chile's geographic position along the ocean and plentiful natural resource endowment provided the impetus for export-led economic growth in the 19th century. Minerals such as copper, along with organic nitrates such as guano, remained staples of the Chilean economy. By the mid-19th century, Chile had established significant trade contacts with the British Empire, and Chile had become known for maintaining governance in Western European style, marked by a powerful central legislature. During the late 19th century, the power of the Chilean Congress increased dramatically. The invention of synthetic nitrates in the 1920s brought economic slowdown and political upheaval to what had been a prosperous and stable 19th century. In 1920, Arturo Alessandri took office in the context of increasing calls from the Left for a more active presidency who would provide a stable hand in the economy's transition away from nitrates. The idea of an active president was met with stiff opposition from conservatives who controlled Congress. In 1924, a group of young military officers staged a coup. Alessandri was forced to resign, and control of the government was taken over by a military junta. It would be the first time since Chile's independence that the military would control the national government.[140]

Within the military authority, incongruity soon arose as more conservative senior officials disagreed with the reformist agenda of the young officers who carried out the coup. Alessandri was asked to return to the presidency by senior military officials in January of 1925. Out of the deal, a new constitution was established in which presidential powers were actually increased. Alessandri did not return to office, and in 1927, Alessandri's ineffective successor was replaced democratically by Colonel Carlos Ibanez, himself one of the young military officers responsible for the coup of 1924. Ibanez led reforms to curb the power of the traditional political parties, yet his political capital ran dry during the catastrophic economic effects in Chile of the American

[140] Arturo Valenzuela, "Chile: Origins and Consolidation of a Latin American Democracy," in *Democracy in Developing Countries: Latin America* (Boulder: Lynne Rienner Publishers, Inc., 1999), 199.

depression.[141] Support for Ibanez's reforms among agricultural and mining elites dwindled as commodity prices fell. Chile's exports dropped to a fifth of their former value almost overnight. Unrest mounted in the streets as unemployment surged and real wages plummeted.[142] A brief period of political instability ensued in which a 90 day "Socialist Republic" was established by a civil-military political coalition.

As the socialist coalition failed to yield results to a demanding public, Arturo Alessandri returned to power in 1932 to restore economic growth. In this second term, Alessandri brought the country out of the depression with transformative austerity measures designed to shift the economy away from dependency on the traditional export commodities. The success of president Alessandri reaffirmed Chile's belief in democratic values as they were being challenged in Europe and in neighboring countries. In 1938, the Radical Pedro Aguirre Cerda was elected president with the support of a broad coalition which included the centrist Popular Front and the Marxist left. Despite stiff opposition from the right, Cerda expanded Chile's social-welfare policies, encouraging the growth of unions and promoting import substitution industrialization to further diminish the impact of export prices. Although, Chile's economic elites strongly objected to collective bargaining at the workplace, they began to accept the legitimacy of working class interests in democratic political institutions.[143] By 1952, the growing popularity of the Chilean Communist Party began to worry the Socialists, Radicals, and conservatives alike. Newly-elected president Gabriel Gonzalez Videla outlawed membership in the Communist Party, sending many of its leaders to detention camps. As the traditional parties struggled to produce a platform that appealed to the rapidly

[141] (Valenzuela 1999, 200)
[142] (Valenzuela 1999, 200)
[143] (Valenzuela 1999, 209)

changing class dynamics of Chile's population, Ibanez returned to power in late 1952 on an anti-party platform, only to struggle without the support of the main parties. In order to regain support from the center-right, Ibanez was forced to shift once populist programs into a severe austerity plan in which wages and salaries temporarily declined. By the end of the 1950's, Chilean politics became increasingly polarized, defying one hundred years of moderation and compromise in Chile's democracy. In 1958, Arturo Alessandri's son and conservative businessman, Jorge Alessandri edged out Socialist Salvador Allende by only 2.7% of the vote.[144]

The politics of Chile up to this time were marked by regular fluctuations in popularity for the Left driven by calls for real wage increases. As true majorities were impossible to achieve, Chile's presidents invariably turned to building broad governing coalitions of the center and whichever segment of the political spectrum, the left or the right, currently enjoyed popular sentiment. Between presidential elections, these coalitions quickly broke down as economic conditions changed and as real policy decisions had to be made. While a picture is painted of a polarized and excessively competitive political landscape, Chilean politics prior to the 1970's was marked by a relatively high level of compromise and a strong respect for the principles of democracy in key institutions which served to moderate disagreements.

In the early 1970's, popular discontent and political polarization grew as economic austerity measures failed to temper inflation and spur real wage growth. As discontent escalated, fears among the center and right of the growing clout of the extreme left began to breakdown compromises across party lines. Fear of the left led traditionally extreme right parties to join the center in backing Eduardo Frei of the Christian Democrat

[144] (Valenzuela 1999, 201)

party. Frei enjoyed massive financial assistance from the United States, and the Christian Democrats instigated far-reaching economic reforms. However, these reforms failed to ensure the tacit agreement with the parties of the extreme right, and Frei's popularity and effectiveness diminished. As the ruling coalition of the center right splintered, and amidst growing popular cries for the restoration of real wages, the Left backed Salvador Allende. This time, Allende enjoyed the broad support of his Popular Unity coalition which united the moderate and extreme left. In the elections of 1970, Allende received the most votes with only 36.2% of the electorate. The Christian Democrats had failed to develop a dominant coalition representing the moderate center, and Salvador Allende went head to head against the rightist Jorge Alessandri. Allende defeated Alessandri by merely 1.3% of the vote.[145]

Allende's election brought an extreme reaction domestically and in Washington by those who saw Allende as potentially pro-Moscow. Political pressure from Washington surged leading up to the election of 1970 as the government of Richard Nixon invested millions of dollars in the Christian Democrat party. Allende's UP coalition believed, just as the US supported Christian Democrat party had before him, that state resources and power should be used to redistribute wealth and stimulate the Chilean economy in order to bring about an increase in the real wage. Allende's self declared "Socialist Revolution" called for a more aggressive redistribution than had been pursued by past regimes, and expansionary monetary and fiscal policy brought increasing inflation. Furthermore, private businesses were brought under state control, undermining a legal system founded on private property and alienating Chile's corporate sector. As outright expropriation further impacted the profitability of small businesses, this move by

[145] (Valenzuela 1999, 218)

Allende also alienated much of Chile's middle and working class. The Union Popular attempted to broaden its coalition in the face of "sabotage, subversion, and foreign intrigue," but centrist political groups advocated for narrower group stakes.[146] Traditionally apolitical institutions, such as the courts, were pulled into the increasingly polarized debate, thereby losing there important role in moderating political struggle. In addition, military officials began to vocalize their political opinions, and politics became increasingly confrontational. The middle ground was further undermined by US policymakers, who aimed to destroy the perceived legitimacy of leftism, associated at the time with Communist Russia, by crippling the Chilean economy and bolstering the anti-democratic opposition. Despite the ineffective state of democracy during the increasingly polarized partisan conflicts of the early 1970's, most Chileans remained in favor of democratic policies as surveys taken weeks prior to the military coup suggest.[147]

In 1973, the Chilean military staged a violent coup, bringing to power only the third undemocratic government in Chile's post-independence history. The military junta did not merely aim to replace a failed democratic government with another more successful one, but rather, to transform Chilean society and to attack the perceived threat of Communist subversives. The legitimacy of the Pinochet regime, as was also the case during the Argentine junta, was precipitated by the perceived threat of Leftist revolution. The leaders of the various branches of the military that made up the Junta immediately sought to destroy the traditional political parties responsible for the rise to power of Salvador Allende. The Junta's expressed goal was to "cleanse" society of all those "unpatriotic," or anyone opposed to it's political and economic vision of radical,

[146] (Valenzuela 1999, 219)
[147] (Valenzuela 1999, 220)

conservative change.[148] Military units were brought in to working and middle class neighborhoods to "clean up," or eliminate those associated with the parties of the Left. Thousands of party leaders, trade-union officials and political activists were arrested, exiled, tortured and killed. While the official count of those killed by the junta regime number 2,279, it is much more likely that in excess of 3,000 were killed by the state through politically motivated disappearances.[149] Under military dictatorship, political stability was ensured through a combination of coercive control and institutional support, as military officials were given benefits unheard of during previous civil governments in exchange for their support or complacency. General Augusto Pinochet of the Chilean army rose as the most politically astute of the military leaders. Pinochet gave the secret police, or DINA, ever increasing powers to silence opposition. DINA became infamous for carrying out a series of high profile assassinations of vocal critics of Pinochet both at home and abroad. The only remaining opposition to General Pinochet by 1975 was Admiral Gustavo Leigh Guzmán, the commander of naval forces. Pinochet strengthened his grip on Chilean politics by leading a power play with the two other heads of military branches to forcibly and illegally remove Leigh from office in what has been called, a "coup within a coup."[150] Leigh's removal from the scene formalized Pinochet's unilateral authority, effectively transforming the junta regime into a government of one.

Pinochet used this opportunity to enact widespread Neoliberal economic reforms. Led by Milton Friedman, the IMF was called in to advise the process of rationalizing the trade and fiscal accounts, privatizing state owned enterprises, and opening up to international trade. The macroeconomic reforms did not immediately yield positive

---

[148] (Valenzuela 1999, 222)
[149] (Valenzuela 1999, 223)
[150] (Valenzuela 1999, 225)

results on inflation, instead the poverty rate greatly increased as Pinochet cut spending on health, welfare, and education. A moderate revival in economic growth, combined with Pinochet's often-exploited monopoly on the use of force allowed him to maintain control throughout the 1970's. Chile's traditional political parties were unable to reassert their political voice despite the extremely costly reform process, until 1982 brought a significant decline in the Chilean economy. Pinochet's economic policies prior to 1983 did not facilitate easy adjustments to market fluctuations, and Chile's foreign debt began to spiral out of control.[151] GDP declined by 14.3% in 1982 alone. Unemployment, which had yet to recover from Pinochet's reforms which wiped out noncompetitive industries, surged above 30% by the end of 1982.[152] The percentage of Chileans living in poverty had doubled since the coup of 1973, increased to more than 38% in 1983. Widespread protests became uncontrollable through the regimes traditional methods of selective political violence and intimidation.[153] Massive unemployment and violent repression drove labor leaders to launch a resurgence of party politics. Influential voices from the right began to warn that if Pinochet did not speed up his proposed schedule for the return to democracy, than Chile could become ungovernable. Pinochet responded by declaring a plebiscite, yes or no vote, on his mandate to govern the country for 1988. The revival of radical opposition to the economic interests represented by Pinochet, namely the Communist Party, was hampered by the fear and negative connotation that Chileans had developed for confrontational politics. While the surviving members of the Communist Party continued to oppose any deal brokered with General Pinochet, most

[151] Pilar Vergara, "Market Economy, Social Welfare, and Democratic Consolidation in Chile," *Democracy, Markets, and Structural Reform in Latin America* (New Brunswick: Transaction Publishers, 1994), 239.
[152] (Valenzuela 1999, 227)
[153] (Vergara 1994, 245)

Chileans by this point simply wanted a non-violent return to democracy. By 1987, it had become clear to most of the traditional political parties that acknowledging Pinochet's own sponsored plebiscite on military rule was their best shot at restoring democracy. There was a pull to the center from both sides of the political spectrum, in which both left and right revived Chile's long established tradition of compromise in order to end military rule. The now unified parties launched a massive grassroots campaign to counter the use of fear and intimidation on the part of the junta. In 1988, 97% of registered Chileans showed up to vote. The opposition parties won a surprise victory, winning by a margin of 12% over General Pinochet.[154] A massive national and international campaign to ensure fairness and democratic processes provided resources to monitor the election.

The opposition leadership that emerged victorious from the plebiscite now faced the dilemma of how to dismantle the praetorian aspects of Chile's political institutions without provoking renewed military intervention in politics. A compromise was reached between the opposition, military leaders, and rightist politicians in which the 1980 constitution established under Pinochet was maintained in exchange for 54 amendments designed to eliminate the more egregiously undemocratic elements. On July 30th, 1989, the new constitution was ratified by an astounding 85.7% margin. In December, Patricio Aylwin of the Christian Democrat party defeated Pinochet's former minister of finance, restoring to democracy for the first time in 16 years.[155]

The Christian Democrats formed a broad coalition of centrist parties dedicated to the revival of democracy, known as the concertación. While Pinochet had been removed from the head of government, he remained head of the armed forces until 1998, and many

---

[154] (Valenzuela 1999, 229)
[155] (Valenzuela 1999, 232)

of his economic policies were maintained by subsequent democratic governments. Pinochet's radical austerity programs had brought increased poverty and unemployment, while the more flexible reforms of the post 1983 period began to yield some benefits to efficiency of tax collection, and the Chilean current account was balanced. Many Chileans desired increased spending on basic services. However, they were able to witness the economic benefits of the open market reforms implemented under Pinochet prior to the transition to democracy. Upon taking office in 1989, President Aylwin expanded the Neoliberal reforms enacted under the reign of the junta. The leaders of the concertación affirmed that a free market economy was not incompatible with greater social equality.[156] The political environment of cooperation and the looming threat of a return to dictatorship, epitomized by General Pinochet's position as head of the armed forces, facilitated the reform process despite its perceived costs.[157]

By 1991, Chile's fiscal accounts had been rationalized, and tax collection made more efficient. The financial groundwork had been laid for a revival of social spending, which was increased by 20% over the final days of the military junta. While inequality remained high in Chile, increased spending on education and health made a significant dent in poverty in the early 1990's.[158] The breadth and depth of freemarket reforms achieved by Pinochet and later democratic governments set the stage for export-led growth fed by massive inflows of foreign capital. From 1991 to 1997, Chile enjoyed average GDP growth rates in excess of 7%, and per capita real income increased by more than 50%. The percentage of Chileans living in poverty fell from 39% in 1990 to 23% in 1996. Significant cohesion within the political parties also allowed president Aylwin to

[156] (Vergara 1994, 239)
[157] (Valenzuela 1999, 232)
[158] (Valenzuela 1999, 233)

address the demands for official accounts of the human rights abuses committed under military rule, and despite the maintenance of certain non-democratic elements in the Chilean government. The negative memory of dictatorship provided Aylwin and his predecessor Eduardo Frei with a unique opportunity to pursue costly reforms without radical political backlash.[159]

Chile's growing economic stability and prosperity, and the acclaimed successes of president Aylwin allowed the centrist coalition of the Christian Democrat party to win the 1993 presidential election to replace Aylwin. Christian Democrat Eduardo Frei Ruiz Tagle garnered an impressive 58.1% of the vote, as the more leftist parties of the concertación gained seats in the congressional contest. The Frei administration generally continued the successful economic policies of the Aylwin regime. Chile's fiscal responsibility continued to provide record levels of foreign direct investment, while further diminishing inflation, and restoring the relative value of wages. Frei continued his predecessors popular tradition of massive government expenditures designed to improve infrastructure and human capital in order to support growth in the private sector.[160] It would not be until the East Asian crisis of 1997-98 that Chile experienced an economic downturn.

Neoliberal Reform prior to the Crisis Period

Prior to the 1970's, Chile's economic policy remained largely dominated by the import substitution industrialization. Yet Chile was one of the first developing countries

[159] (Valenzuela 1999, 233)
[160] (Valenzuela 1999, 235)

in which Neoliberalism was seriously adopted as an economic stabilizer. Upon coming to power, Pinochet was heavily pressured, both by conservative business leaders domestically, and by international financial institutions, especially the IMF, to adopt Neoliberal reforms as a way to minimize inflation and bring export-led economic growth. Pinochet's rise to power coincided with the rise of Neoliberalism as the dominant economic doctrine of IFI's and the US Treasury department. Following the coup of 1973, General Pinochet's intended transformation of Chilean society came to be largely defined by a series of sweeping Neoliberal reforms. General Pinochet greatly reduced the ability of the state to intervene in the economy, privatizing and deregulating state owned enterprises, severely restricting public spending on social programs in order to balance fiscal accounts, and generally enforcing strict adherence to the rule of comparative advantage in trade. These macroeconomic reforms were enacted, at times, virtually overnight under the unequivocal authority of the junta regime. External shocks diminished prices of crucial export commodities at the same time as contractionary macroeconomic policies reduced aggregate demand and social safety nets.

The result was massive increases in the rates of unemployment and poverty. From 1970 to 1980, unemployment increased from 5.9% to 16.9%, peaking at 31.3% in the recession and debt crisis of 1983. Despite the high social cost, Pinochet's reforms were markedly successful at curbing inflation, and between 1970 and 1983 inflation fell from 36.1% to 12.9%. This occurred at a time when many Latin American countries were experiencing massive hyperinflation.[161] While Pinochet was politically capable of ignoring or eliminating left-leaning opposition to his costly orthodox reforms prior to 1983, the debt crisis of that year brought a severe economic downturn that brought calls

[161] (Vergara 1994, 240)

from all segments of society for changes to be made to the reform policies. The liberalizing reforms undertaken after the 1983 crisis were specifically designed to fluidly adjust to market fluctuations. It was this second round of macroeconomic reforms that paved the way for significant growth and minimal inflation that would last until well after Pinochet's departure from office.[162] The privatization of the health sector was one of the most dramatic changes enacted by Pinochet, which at once eliminated the ability of many Chileans to access health services in order to help balance the states fiscal accounts. Such reforms were responsible for massive increases in inequality, as family incomes decreased under Pinochet's 16 year reign in all but the wealthiest 20% of households.[163] The effects of Pinochet's austerity program, combined with the recession of 1983 were enough to provoke a revival of civil politics despite the tremendous threat of state repression, torture and execution. At the end of the Pinochet regime, the percentage of Chileans living in extreme poverty had increased from 17% to 38%. The illiteracy rate, once one of the lowest in the Western Hemisphere, had increased to 6%.[164] As opportunities eroded in the formal sector, there was a massive expansion of the informal economy which diminished government revenue. By 1988, only 45% of working Chileans contributed to the social security system.[165]

Despite the tremendous costs, the Pinochet regime established structural conditions that facilitated growth and stability under later governments. In contrast to the economic conditions encountered by neighboring nascent democracies, Chile's new democratic government entered the scene after the benefits of Neoliberal reform had

[162] (Vergara 1994, 241)
[163] (Vergara 1994, 243)
[164] (Vergara 1994, 244)
[165] (Vergara 1994, 245)

already begun to materialize. Furthermore, macroeconomic imbalances were under control, and increased administrative efficiency had begun to provide increased tax revenue. The liberalization of foreign trade had gone especially well in the post 1983 period, as high prices for Chile's staple agricultural and mining commodities fueled economic growth. Chile was naturally competitive in a few key export commodities, such as copper. The process of diversifying into other industries by transferring capital accumulated in naturally competitive industries into newly developing industries. Because the Neoliberal reforms undertaken following the 1983 crisis were broadly seen as responsible for the successful economic recovery, Aylwin's democratic government came to power with an established consensus in favor of the Neoliberal view of the proper function of the state in the market.[166] Under the Aylwin regime, Chile's general export orientation was maintained. In an effort to further reap the benefits of globalization, Aylwin reduced tariffs and joined free trade agreements with other Latin American countries. New incentives were established encouraging productive flows of long-term, foreign direct investment. The positive momentum of Chile's economy hastened under democratic rule, as industrial production increased by more than 5% in 1991. Chile's export sector was especially vibrant, and the trade balance rose to a surplus of $500 million. Foreign direct investment continued to surge, and unemployment fell further to 6%. The Neoliberal reforms of Aylwin's democratic regime were distinct from those of General Pinochet, in that massive amounts of social spending was used to generate improvements to human capital, and social safety nets were extended to those most impoverished. While the center left was a dominant force in post-Pinochet Chile, conservative economic elites remained a disproportionately large force in Chile's

[166] (Vergara 1994, 247)

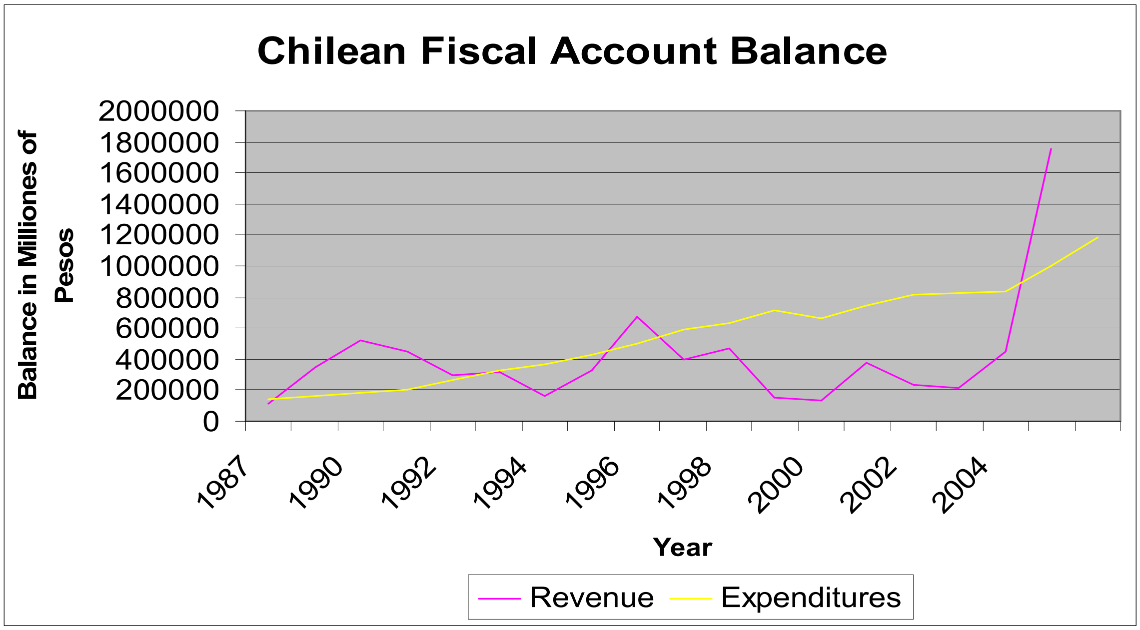
primarily but not entirely democratic politics. This balance ensured that the necessary macroeconomic reforms would be pursued without ignoring the social costs that could be potentially destabilizing. Leftist elements of Aylwin's concertacion were instrumental in a push to repeal some of the more repressive aspects of the military regime labor policies, which when combined with a decline in inflation from 27% to 18%, led to an increase in the average real wage by 6% in 1991.[167] It should be noted that participants in the informal sector did not benefit from newly adopted labor legislation such as the minimum wage, working condition regulations and spending on temporary social safety nets. However, as unemployment rapidly decreased it can be inferred that more workers from the informal sector were returning to jobs in the formal economy.

One of the first major reforms enacted under democratic government was a series of improvements to the efficiency of tax collection in 1990. Aylwin hoped to continue to improve administrative efficiency and to include more workers in the process in order to provide more government revenue to be distributed in the form of social spending. Aylwin's reforms provided a significant increase in government revenue, amounting to 2% of GNP in 1991, which enabled dramatic increases in government expenditures on health, housing, education, and infrastructure without negatively impacting the fiscal account which would bring inflation, debt, and discourage foreign investment. Between 1989 and 1995, government social spending rose by 50% in real terms.[168] The Fondo de Solidaridad e Inversion Social was a particularly innovative social program funded with resources gained from improved tax collection methods. The Fondo was designed to

[167] (Vergara 1994, 249)
[168] Timothy R. Scully, "Chile: The Political Underpinnings of Economic Liberalization," in *Constructing Democratic Governance: Latin America and the Carribean in the 1990's* (Baltimore: The Johns Hopkins University Press, 1996), 101.

target the absolute poorest communities and to bring those who turned to the informal sector during the austerity programs of Pinochet back into the formal economy. Social policies of the democratic governments that followed Pinochet were primarily focused on improving human capital and infrastructure to improve competitiveness. As a result, the distribution of income was made more equitable during the course of the Neoliberal reforms pursued by the new democracies. The percentage of income going to the wealthiest quintile fell from 59.9% in 1989 to 54.7% in 1991, and the poverty rate fell from 40% to 28% in the same year.[169] Chile's favorable factor endowments and institutional tradition of democratic values set the stage for successful reforms. Furthermore, the effective leaders that emerged with the collapse of military rule successfully recognized that under a democratic government, economic growth would have to be coupled with a measure of equity, and the social costs of further Neoliberal reforms would have to be managed. Yet despite this successful push for equity and government expenditures on human capital, positive fiscal account balances were more or less maintained throughout the reform period.

[169] (Scully 1996, 102)



Source: "Global Macroeconomic Figures." *__Bloomberg__* *2005.*

The Concertación alliance that continued under President Eduardo Frei was uniquely positioned to follow the economic liberalization of General Pinochet and President Aylwin while simultaneously working to improve social indicators.[170]

Political Environment during Reform Periods

Between 1973 and 1989, the Military Junta ruled Chile through a combination of coercive control over the political opposition and institutionalized support of loyal groups, especially within the military. The Neoliberal reforms achieved under the rule of the military junta were facilitated by Pinochet's personal, highly coercive domination of politics through institutionalized authoritarianism.[171] The political decision making process was controlled by Pinochet's personal advisors and economic managers that

[170] (Scully 1996, 109)
[171] (Vergara 1994, 239)

keenly represented the interests of Chilean elites and foreign capitalists. The Junta's transformative economic model was the reverse of the import substitution industrialization model used during the 1960's and '70's, and was named, the "New Model of Outward Development."[172] According to this model, market principles were established as the absolute governing force of the Chilean economy, as Pinochet himself was the absolute governing authority in Chilean politics. The business organizations and middle class professional groups that had played a vital role in the fall of the Union Popular of Salvador Allende were not given access to the decision making process that guided the reforms of the junta.[173] Instead, excluded middle income groups remained loyal to the regime because they viewed the military as the only viable alternative to the leftist radicalism that had evolved out of the democratic system. Although similar to the bureaucratic authoritarianism experienced by Argentina from 1976 to 1982, Pinochet's military government achieved a greater degree of centralized authority. In turn, this control enabled him to broaden and deepen Neoliberal reforms to a greater degree.

The military regime institutionalized its authority by establishing formal rules that justified and solidified the authority of the military over other groups. Where legal rules could not be adjusted to suit Pinochet, they were simply thrown out or ignored. Judicial protection could not be sought, and the population was encouraged to report and denounce any "disloyal" individuals.[174] By 1980, absolute authority was further concentrated under the personal figure of General Pinochet through the elimination of adversaries within the military and the adoption of a new constitution. Under military

[172] Manuel Antonio Garreton, "The Political Evolution of the Chilean Military Regime and Problems in the Transition to Democracy," in *Transitions from Authoritarian Rule, Prospects for Democracy* (Baltimore: Johns Hopkins University Press, 1986), 102.
[173] (Garreton 1986, 103)
[174] (Garreton 1986, 104)

dictatorship, the political decision making process was highly exclusive. The right to participate in the limited economic policy debate of this first reform period was extended only to the politically loyal members of the military and to the conservative economic advisers that supported the transformative macroeconomic vision of Pinochet and the IMF.[175]

Following the plebiscite of 1989, Chile underwent a process of redemocratization in which long-established democratic norms were revived.[176] Chile's transition back to consensus-based politics was facilitated by the surviving memory among many Chileans, especially the leaders of the old traditional parties, of democratic institutions and values. However, despite the stunning resurgence of democracy in the early 1990's, major elements of the 1980 constitution that ran counter to democratic principles remained. Most blatantly, General Pinochet remained the head of the armed forces until 1998. Special privileges for the military were maintained, including the critical direct appointments allowed military officials in the otherwise elected national legislature. The military enjoyed tutelary powers in politics, and the president did not posses the power to of appointment and removal of the heads of the various branches of the armed forces which would fully subordinate the military to the civil government. The extremely high defense budget was maintained at or above the level of the last year of dictatorship. The military intelligence agency, DINA, which played a dominant role in the political repression and human rights abuses committed under Pinochet, remained under the guise of Pinochet.[177] The most meaningfully undemocratic aspects of the post-dictatorship governments were the heavily biased electoral formula and the presence of the Pinochet-

---

[175] (Garreton 1986, 109)
[176] (Scully 1996, 99)
[177] (Scully 1996, 107)

designated members of the senate, which continued to affect the policies of an otherwise fully representative government.[178]

The undemocratic elements that remained in Chile's political decision making process facilitated the further implementation of macroeconomic Neoliberal reforms in two ways. One, the fear of resumed military rule provided an incentive for political parties with divergent opinions to compromise on maintaining the current path of export-led, open-market economics. Two, the political and economic interests represented by the military's disproportionate political voice were largely from the right, and supported the continuation the macro reforms pursued under Pinochet. The legacy and threat of military rule led to compromise and the political coherence of the Concertación that facilitated broader and deeper economic reforms.[179] At the same time, the relatively more inclusive decision making processes achieved under presidents Aylwin and Frei facilitated the broadening of reforms and allowed middle and working class interests to play a bigger role, so long as they were more or less inline with the law of comparative advantage and economic efficiency. Furthermore, political openness ensured that social spending would be used to improve human capital and to pursue a more equitable distribution of wealth.

The Crisis Period

The East Asian Crisis of the late 1990's tested Chile's reputation as a model of free-market economic reform and democratization. The East Asian Crisis threatened

[178] (Scully 1996, 108)
[179] (Scully 1996, 109)

Chile's economy in much the same way as Argentina's. Much of Chile's export commodities were destined for Asian markets, and Chile's economy remained dependent on the inflow of foreign capital that had poured in following the economic liberalization of Pinochet. While Chile had dramatically lowered the percentage of export revenue generated from copper in the two decades prior to the crisis, by the mid nineties copper still comprised 45% of export earnings.[180] Chile's export-led growth and shifting trading patterns made it especially vulnerable to declining Asian demand. The search for new markets of the Aylwin and Frei administrations, shifted more and more of Chile's exports from the US and Europe to the rapidly growing economies of East Asia, where raw materials such as copper were in heavy demand. In 1997, 33% of Chile's $17 billion of exports were destined for East Asia. In Chile, the potential economic ramifications of the East Asian Crisis were catastrophic. From June of 1997 until May of 1998, the average world price of copper fell dramatically from $1.19 a pound to 75 cents. Chile's dependency on copper exports meant that a one cent reduction in the price of copper would mean a loss of export revenue for Chile of $65 million.[181] The already negative current account took a turn for the worse, and Chile's exchange rate came under significant pressure. GDP turned sour by the end of 1997, bottoming out at -4% annual growth in the third quarter of 1998. Unemployment nearly doubled in 1998, temporarily surging above 10%.[182]

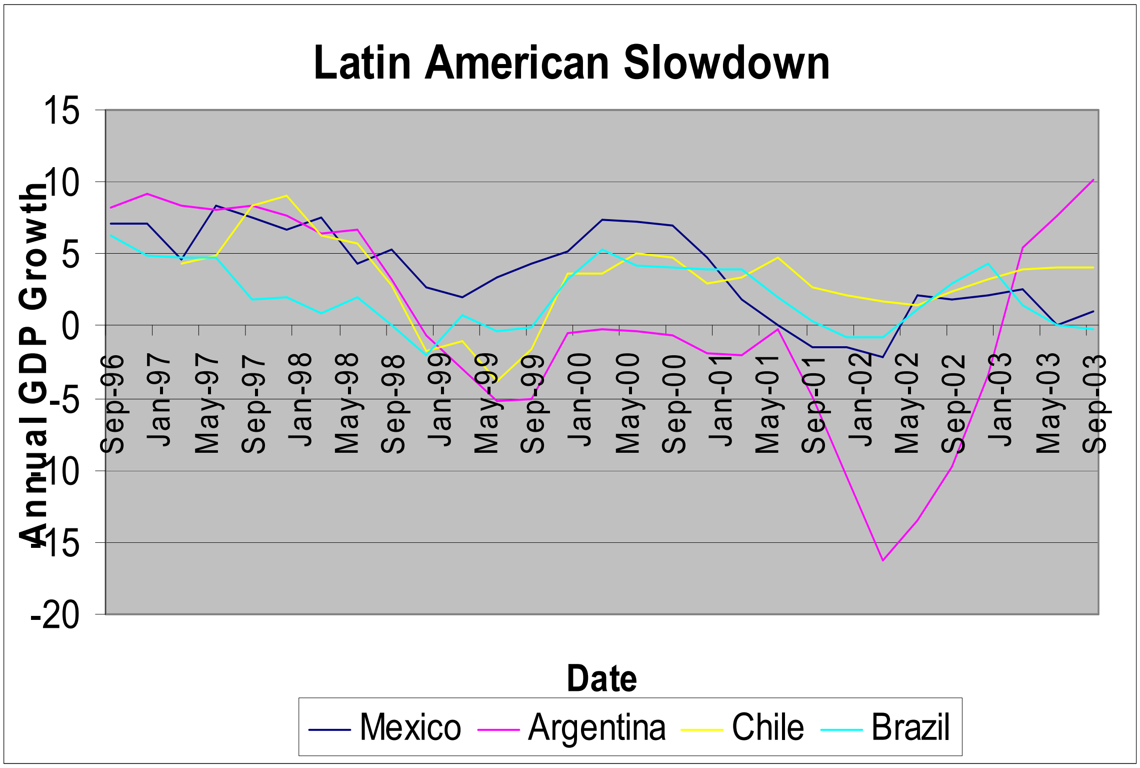
---

[180] Miguel Basch and Eduardo Engel, "Temporary Shocks and Stabilization Mechanisms: The Chilean Case," *External Shocks and Stabilization Mechanisms* (Washington DC: The Interamerican Development Bank, 1993), 25.
[181] The Economist. "Chile: All Good Things Must Slow Down." Available from http://www.economist.com/displaystory.cfm?story_id=115187; Internet; accessed 5 March 1998.
[182] Bloomberg. Global Macroeconomic Figures: Chile. 2005.

The political ramifications of the 1998 economic downturn were minimal, and fiscal account balances were maintained. Discontent was especially mild from the Left, as massive increases in social spending, particularly on health and education gained President Eduardo Frei political capital with Chile's Left-leaning organizations. Furthermore, the memory and political vestiges of conservative dictatorship in the legislature made center-left groups less quick to express discontent with the economic performance of Frei's center-left Concertación government. Criticisms for Frei's economic policy came from the Right, particularly from supporters of General Pinochet, who stressed that the democratic governments of Aylwin and Frei had eroded Chile's "international competitiveness and fiscal virtue."[183] Conservative critics further claimed that the government should have more aggressively tightened fiscal spending to lower inflation, rather than relying on the strength of the Peso to bolster spending on social programs. Concerns over political and economic instability intensified as capital flight and political violence arose in neighboring Argentina in 1999.

Yet the recession was short-lived in Chile. By 1999 GDP returned to a positive 4% growth rate, and unemployment gradually began to decline.[184] Chile's GDP growth rate remained one of the most stable throughout Latin America.

[183] ("Chile: All Good Things Must Slow Down." 1998)
[184] Bloomberg. Global Macroeconomic Figures: Chile. 2005.

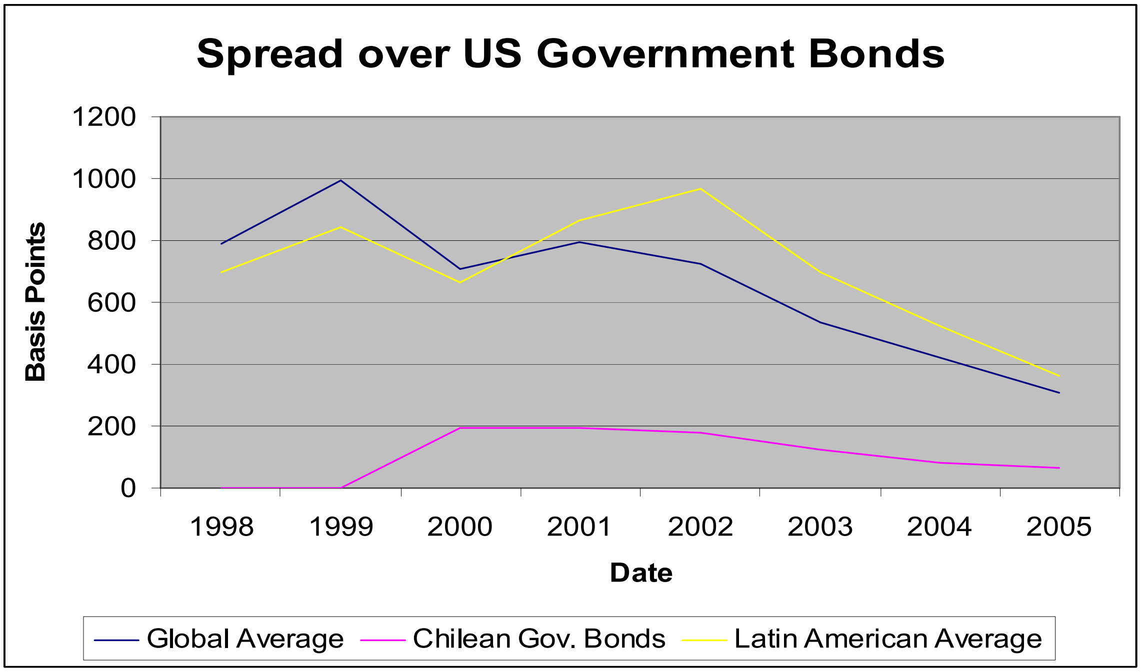


Source: "Global Macroeconomic Figures." *__Bloomberg__ 2005.*

The impressive recovery of the East Asian economies, combined with Chile's fiscal responsibility throughout the recession brought renewed demand and foreign investment. Chile was perhaps the best prepared of any country in the region for an exogenous economic shock. During the crisis, Chile benefited greatly from its well organized budgetary institutions, consistent fiscal surpluses since the fall of Pinochet, and tight banking supervision.[185] Chile also benefited from a shock absorber, as gains from high copper prices had gone into a stabilization fund known as the FEC that by 1997 was valued at $1.85 billion. This money, combined with Chile's other exchange reserves, defended investor confidence in the Peso despite the plummeting price of copper. Chile's liabilities were also comprised predominantly of long term notes, as Chile placed a tax on

[185] ("Chile: All Good Things Must Slow Down." 1998)

inflows discouraging so called "hot money." Capital inflows were generally maintained throughout the crisis. Chile's government not only survived the crisis, but its reputation as a model of economic reform also outlived the crisis. If anything, the East Asian Crisis solidified the reputation of Chile as one of the safest investments in the region.



Source: "Global Macroeconomic Figures." <u>*Bloomberg*</u> *2005.*

The elected governments of Frei and Lagos continued to serve out their terms, and Chile's GDP per capita has continued to grow, reaching an estimated $11,300 in purchasing power parity by 2005.[186]

Conclusion

[186] The Economist. "Country Backgrounders: Chile." Available from http://www.economist.com/research/backgrounders/displayBackgrounder.cfm?bg=884616; Internet; accessed 1 Nov. 2005.

Chile serves as a relative success story for free-market reform. Part of Chile's success was due to non-replicable informal institutions and economic and political conditions. However, Chile's success was also due to more classical economic prescriptions such as the maintenance of positive fiscal and current account balances, the minimization of debt, and the accumulation of hefty foreign currency reserves. In addition, Chile owes much of its policy success to more unorthodox policies, such as the Capital Inflow Tax and the Copper Stabilization Fund. This unconventional mix of economic wisdoms, employed in a favorable set of political and economic conditions, enabled Neoliberal reforms to have a dramatically positive effect on the wellbeing of the Chilean people and to outlive potential instability.

Chapter Seven

Comparative Analysis

Argentina and Chile

Introduction

The economic and political conditions in Argentina and Chile were relatively similar in the early 1990's. Both countries were transitioning to democracy and were implementing Neoliberal economic reforms. In the early nineties, Argentina and Chile were seen as the darlings of free-market reforms, as both nations experienced relatively high levels of economic growth. Liberalizing reforms put each country into closer trade relations with the rest of the world, especially with South East Asia. However, the East Asian Crisis of 1997-98 affected the two countries differently. This exogenous shock resulted in a recessionary period that climaxed with the collapse of the de la Rua government in Argentina, whereas Chile merely experienced a short economic downturn. It is the purpose of this section to determine why such different outcomes occurred in seemingly similar countries and to draw practical policy implications from the comparison. This analysis will use the structure established by the causal model given in Chapter Three, which mirrors the cyclical nature of political and economic instability.

Underlying Social and Economic Conditions

One important distinction between Argentina and Chile relevant to this phase of the analysis is that of informal institutions. While variables in this phase of the model are impossible to quantify, they nonetheless have a very meaningful impact on the development of political instability. Political culture is an especially relevant example of these unquantifiable variables for the purposes of this comparison. The political culture of a country determines the demands that citizens will place on the state and the propensity of citizens to rebel when frustrations occur. Relative to Chile, Argentinean political culture seems to facilitate instability by both of these measures. Argentine history since independence has witnessed significantly more examples of rebellion against the state than does that of Chile. Since the 1930's, Argentina has experienced five major unconstitutional regime changes, whereas Chile has had only one.[187] While insurrections cannot be entirely blamed on cultural differences, the history seems to bring credence to the idea that Argentineans have had a greater propensity to rebel than have Chileans in recent history. Indeed, Argentina did not develop a sense of national identity until well after independence was achieved. Unlike Chile, the Argentine state was not fully consolidated until the mid 19th century, and a transient Gaucho identity survived long after that. As Nicolas Shumway illustrates, "In no sense was the area [Argentina] unified by geography, politics, economics, or a particular vision of national destiny. What cities existed were in reality isolated towns and missions connected by poor or nonexistent roads and dreadfully slow land travel."[188]

In more recent times, there is evidence to suggest that Argentine citizens place greater demands on the government to directly provide public goods, especially under poor economic conditions. When asked in the 1995 Latinobarometro poll whether the government should give priority to diminishing inflation or increasing the rate of employment, 70% of Argentines chose to increase employment, whereas only 55% of Chileans said the same.[189] This discrepancy is easily explained by the difference in the national rates of unemployment aforementioned, yet the political ramification of this

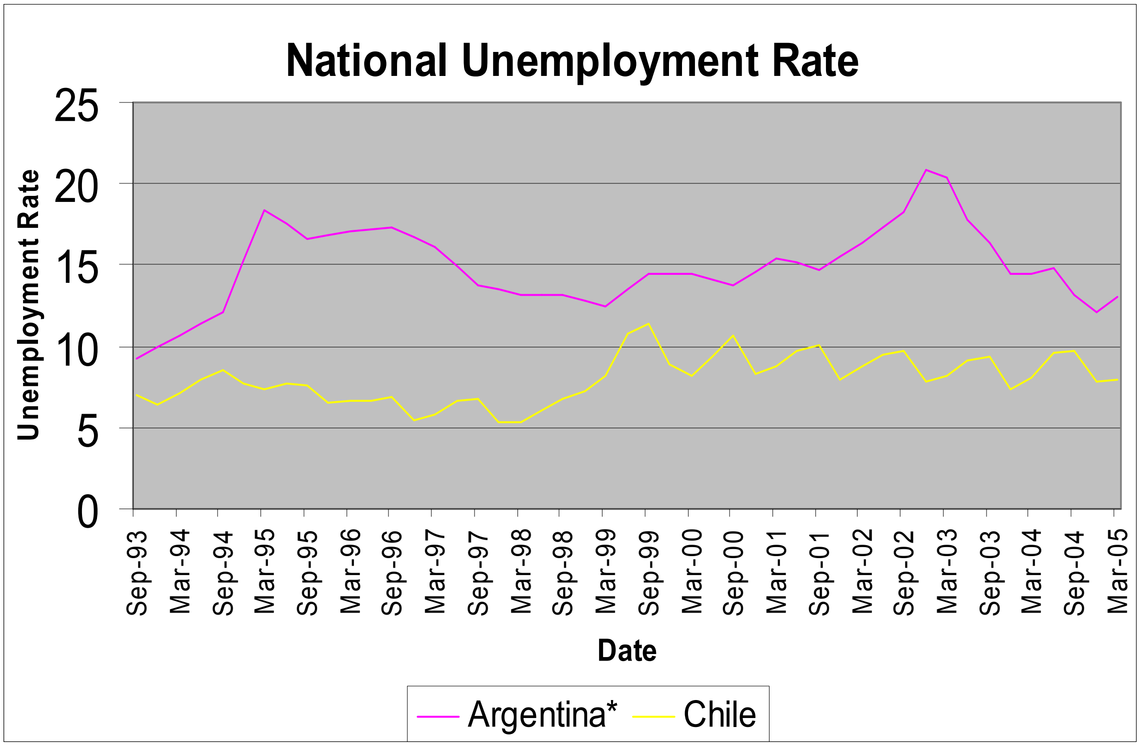
[187] ("Timeline: Argentina." 2005) and ("Timeline: Chile." 2005)
[188] Nicolas Shumway, *The Invention of Argentina* (Berkeley: University of California Press, 1991), 9.
[189] ("Informe de Prensa. Latinobarometro." 1995, 7)

discrepancy is significant. By the mid-nineties, Argentine citizens were not only fed up with the performance of the economy, but they were turning to the government to provide the employment that the market had failed to provide. The political culture of Argentina during the crisis period facilitated instability, and necessitated a greater state capacity to minimize citizens' frustrations with economic conditions.

In some respects, the economic conditions in Argentina and Chile were very similar leading up to the crises of the late 1990s. Since democratization, the two economies experienced impressive rates of growth. At 1991 prices, the GDP index for 1994 was 122.6 in Argentina and 127.0 in Chile. Both countries successfully implemented tight fiscal and monetary policies that brought down inflation to moderate levels by 1994: 3.9% in Argentina and 8.9% in Chile.[190] Yet by other measures, the two economies were responding to reform quite differently. Perhaps the most striking contrast between the two countries for the pre-crisis period was evident in the level of unemployment. In 1995, Argentina's national rate of unemployment was 34.7%, while in Chile, unemployment had declined to 7.3%. The trade balance was another conditional difference between the two countries for this period. In 1995, the value of Chilean exports outweighed imports by 9.4%, whereas Argentina experienced a negative trade balance in which imports outweighed exports by 12%.[191] A glimpse at the historical decline of inflation in Chile during this period suggests that Chilean monetary and fiscal authorities pursued deflationary policies less aggressively than their counterparts in Argentina, allowing the rate of inflation to decline more gradually.

---

[190] Roberto Frenkel, "Real Exchange Rate and Employment in Argentina, Brazil, Chile, and Mexico," *El Centro de Estudios de Estado y Sociedad: La Universidad de Buenos Aires* (2004): 36, 37.
[191] (Frenkel 2004, 36-37)



Source: "Global Macroeconomic Figures." *<u>Bloomberg</u> 2005.*

The level of economic well-being experienced by citizens was very different between the two nations in the mid 1990s. The perception of average citizens as to the success or failure of Neoliberal economics and political democracy is extremely important for this analysis, as this perception largely determines the level of political support for continued reform. A survey done in 1995 by the Chilean non-governmental organization, Latinobarometro, suggests that Chileans perceived more significant improvements to their standards of living in the previous five years than did Argentineans. When asked if the quality of their education had increased significantly in the last five years, 38% of Chileans responded positively, whereas only 12% of Argentineans shared that sentiment. 47% of Chileans said that the quality of their housing had improved, whereas only 24% of Argentineans said the same.[192] The responses to the same question in regards to the quality of health were less distinct, but again, more Chileans responded positively. Chileans also expressed a substantially more positive outlook in regards to their ability to improve their own lives. When asked if they believed that they had greater opportunities to improve their standard of living than did their parents, 58% of Chileans answered yes while only 39% of Argentines said the same.[193]

These figures suggest that by the mid 1990s, Chilean citizens had begun to experience the benefits of market liberalizing reforms to a much greater degree than had Argentineans. This point is extremely important for the comparative analysis in two ways: one, on the level of policy making and two, in regards to the likelihood of average citizens to rebel. The benefits of liberalization had been experienced in Chile, resulting in a greater political support for the direction that policy makers had taken. Therefore, where these benefits were experienced, policy makers would be more likely to continue to broaden and deepen liberalizing economic reforms. Argentinean policy makers were therefore, relatively more compelled to roll back on reforms. The second important implication is that economic expectations of long-run growth under the current system had been elevated in Chile such that short-run negative outcomes would be less likely to result in frustration or participation in acts of dissidence. Therefore, an economic downturn in Chile was less likely to produce political instability than if the same were to occur in Argentina. Chile happened to have begun Neoliberal reforms earlier than Argentina under an authoritarian regime, and the benefits had begun to materialize by the

---

[192] Latinobarometro. "Informe de Prensa: Latinobarometro." Santiago: Latinobarometro. 1995. Available from http://www.latinobarometro.org/index.php?id=66; Internet; accessed 26 Feb. 2005. 16.
[193] ("Informe de Prensa: Latinobarometro." 1995, 17)

time the policy making process was democratized. While this particular example of reform timing seems to have worked effectively, it is not the only way to reform, nor is it the most socially or politically desirable. That inflation was reduced more gradually in Chile was however, a conscious policy decision with demonstrably positive effects.

The policy implications of this phase of the analysis are twofold: reforms must be given time to work before they are abandoned. Reforms can be given time to work in one of three ways: by controlling the reaction of citizens to potential short-run negative outcomes, by temporarily supporting citizens through the short-run costs, or by pacing reforms more gradually. The second possible method is clearly more socially and politically desirable than the first, but it assumes that the government has the resources to minimize potentially massive individual economic costs through price subsidies or other safety nets. Furthermore, such government intervention designed to minimize the individual costs of reform could undermine the very economic objectives attempted by the reforms, such as fiscal balance and the reduction of inflation. The ultimate implication of this phase of the analysis is that the timing of reforms is extremely important. Reforms must be paced appropriately in order for reforms to be politically and economically sustainable. Rapid reform, or so called "Shock Therapy," may be so politically and economically destabilizing that it risks undermining the entire reform process.

The Relative Capacity of the State

Given the demands citizens place upon the state to provide public goods, and the propensity of citizens to rebel if these demands are not met, it is the capacity of the state to resolve citizens' frustrations that ultimately determines the political outcome of instability. The capacity of the state to address frustrations is a product of the states ability to coercively control dissidence or to support frustrated citizens through institutions. The ability of the state to remedy frustrations before they become destabilizing is determined by the institutional structure and the amount of resources available to the state. The Chilean government had a greater capacity to resolve frustrations by each of these measures. The Chilean democratic governments of the Concertación coalition were relatively effective at deciding on and executing policies in a timely manner. Presidents Aylwin and Frei enjoyed widespread support in parliament from the center and left, and the mutual threat of renewed military control strengthened bonds between political parties and facilitated cooperation. Argentina's relatively less centralized executive branch experienced calls from parliament for exemptions from policies designed to stabilize state spending and monetary policy. The Argentine federal government could not regulate the excessive spending of the provinces; nor could it end the practice of bailing the provinces out of payment obligations.[194]

Chile's post-authoritarian governments returned to democratic principles more easily, developing an institutional structure that facilitated the efficient government response to instability. Chile's government was also more capable of dealing with an economic downturn in that it had greater access to resources. The administrative reforms

[194] (Desai 2003, 182)

launched by President Aylwin in 1990 successfully improved the efficiency of the tax collection system. Within the year, these reforms increased government revenue by as much as 2% of GNP. This money was then used to bolster social programs, the bulk of which were aimed at improving human capital, but money was also spent on safety net insurance policies.[195] Government revenue also increased from the state copper company and royalties from foreign production in other key export commodities. As copper prices were high and oil prices were relatively low, the Chilean government was able to use export earnings to increase the funding destined for the Copper Stabilization Fund (FEC). This Fund will be discussed in greater detail in later sections. The external balance of trade and the internal efficiency of administration provided the Chilean state with the resources necessary to soften the effect of an exogenous shock on the livelihood of Chilean citizens.

On the other hand, the Argentine government lacked the administrative efficacy and resources necessary to react to the crisis. Tax evasion in Argentina reduced government revenue by an estimated $35 billion a year during the 1990's.[196] The superior financial position of the Chilean state is further evidenced by its fiscal account balances relative to that of Argentina throughout the period of crisis. The Argentine fiscal balance had deteriorated steadily since 1993, and in 1997 alone the federal budget deficit was close to 2% of GDP.[197] In Chile, central government expenditures were relatively in line with average revenues for the 1990s, and the government achieved a

[195] (Scully 1996, 101)
[196] (Desai 2003, 183)
[197] (Desai 2003, 178)

sizable surplus in 1995 of more than 177 billion Chilean Pesos.[198] Chile's government was better positioned to deal with the potential political ramifications of economic shocks due to an impressive institutional structure and the availability of state resources. Argentina's institutional structure and lack of state resources created conditions in which an external financial shock could limit the states capacity to function so drastically so as to render the executive incapable of governing. Competition among the parties further undermined the ability of the Argentine executive to make quick decisions in the months preceding the collapse of the Peso. Carlos Menem was unable to broaden and deepen stabilization reforms to the same degree of Chilean democratic presidents as competition between the Peronistas and the Radicals limited the ability of the government to react quickly to changing economic conditions.

The policy implication of this point of the analysis is that reforms must be properly sequenced in order to minimize potentially destabilizing costs or reform rollback. The most obvious element of this implication is that there are certain prerequisites for Neoliberal reform to function properly. These necessary preconditions are not entirely financial. This important point directly pertains to the expressed policies of the IMF and other international financial institutions which are known to view the political ramifications of their actions as "not their problem."[199]

As the Chile case demonstrates, Neoliberal reforms function best under governments that are capable of compiling the proper mix of support, control, and adjustment. Before reforms are attempted, the correct institutional structure must be established and the adequate state resources must be gathered in preparation for

[198] El Banco Central de Chile. Base de Datos Económicos. Available from http://si2.bcentral.cl/Basededatoseconomicos/951_portada.asp?idioma=E; Internet; accessed Feb. 26 2005.
[199] From the documentary film, "Life and Debt" produced and directed by Stephanie Black (2001).

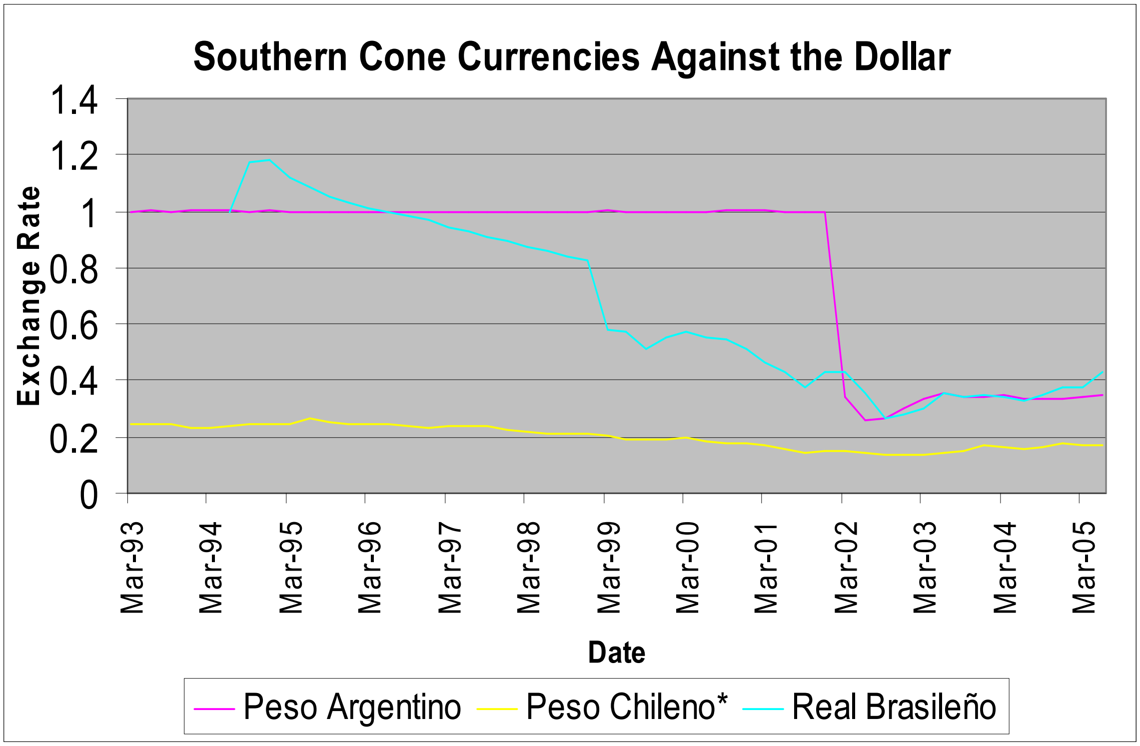
exogenous shocks and other potential setbacks. The second, less obvious element of this implication is that reforms must be sequenced in the proper order for instability to be minimized. For example, in Chile, the reformation of the tax system implemented by Pinochet and Aylwin was so important because it provided the necessary funding to underwrite a degree of stability throughout later reforms. A certain amount of control on the part of the federal government also seems to be a necessary prerequisite, without which the efficacy of reforms can be undermined by provincial governments or opposing political parties. Furthermore, the proper sequencing of reforms may vary from country to country depending on the underlying social, economic, and political conditions. The ultimate implication of this phase of the analysis is that liberalizing reforms must be properly sequenced, and that some of the prerequisites are political.

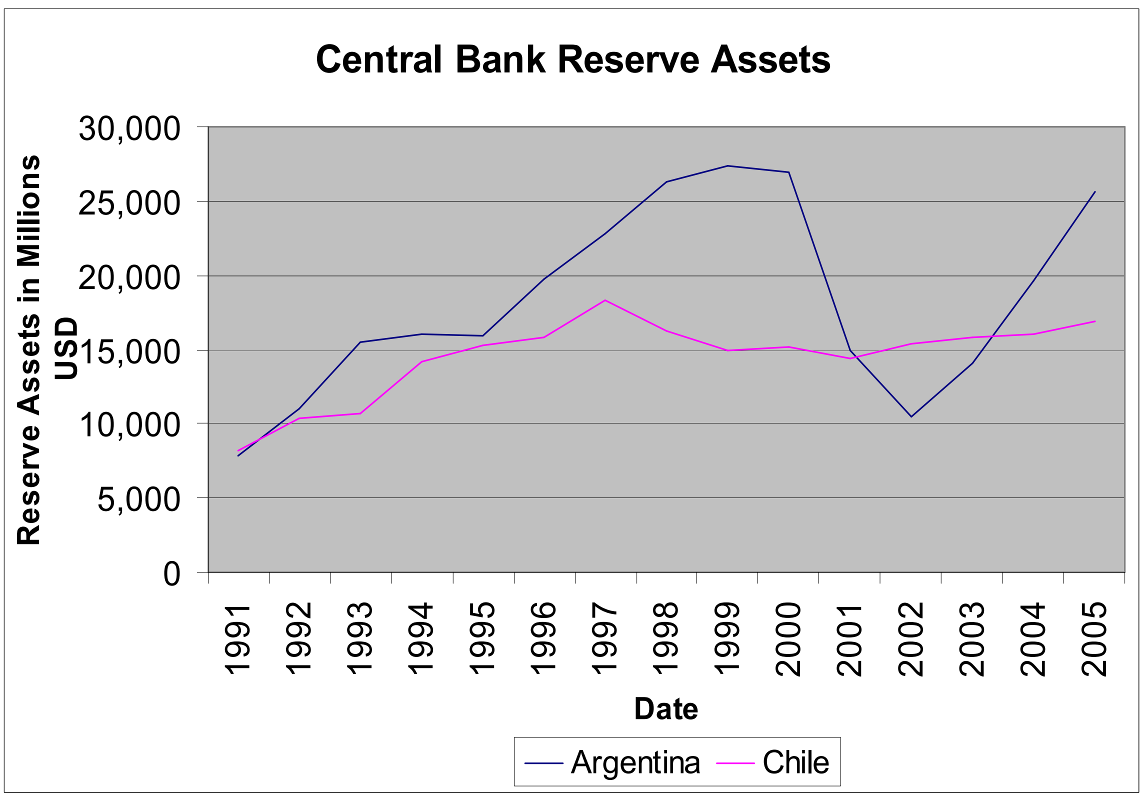
The Reaction of Markets

At this point in the analysis it should be reiterated that the causal model of instability put forth in this study need not necessarily start with any given phase. If the cycle of instability always began with economic conditions than many discrepancies between countries that occurred in later phases could be due in large part to success or failure in previous phases. For instance in this comparison, it is true that part of Chile's relative success in maintaining market stability is due to the fact that Chile did not experience the same amount of political or economic instability as did Argentina. However, part of Chile's market stability is also due to key financial mechanisms that function irrespective of the presence or absence of economic and political instability. As instability can begin or end in any of the given phases, successful policies are just as necessary in each phase.

Under similar economic conditions, Chile and Argentina employed very different financial mechanisms that led to their respective success or failure. Argentina's financial policies rested on a currency pegged to the U.S. dollar. Elemental to the failure of Argentina's currency peg was the rising debt that the Argentine government, banking industry, and business community were burdened with in dollar denominated notes. By 1999, Argentina's foreign debt had surged above 50% of the value of GDP.[200] By this point, a devaluation of the Peso would have greatly increased the real value of that debt and made repayment impossible, triggering further currency devaluations. The failure of the Argentine financial system lay in that investor confidence was tied to the rigidity of the Peso, when the currency's value had become out of sink with economic conditions. As Brazil's flexible Real began to decline, investor worries about the unsustainable overvaluation of the Argentine currency expressed via the increased frequency and vigor of speculative attacks, which began to drain Argentina's currency reserves.

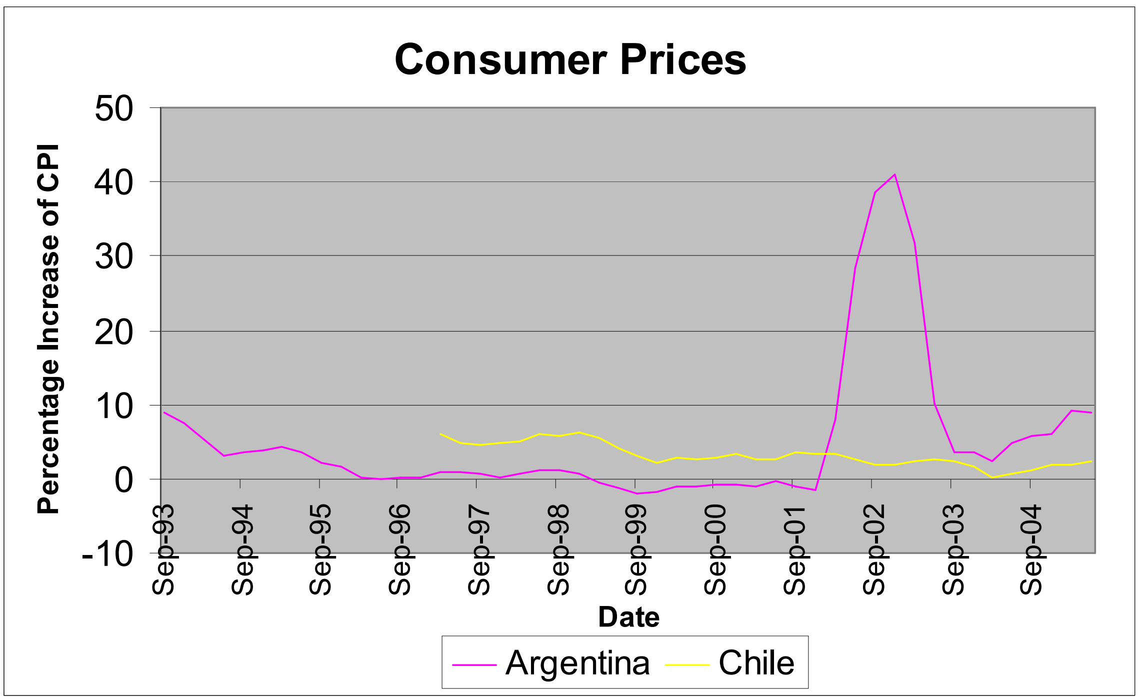
[200] (Desai 2003, 179)





Source: "Global Macroeconomic Figures." <u>*Bloomberg*</u> *2005.*

The inflexibility of the currency ultimately led to the massive erosion of investor confidence which brought unavoidable capital flight and devaluation, forcing rapid government spending cuts and a default on public debt. By 2001, capital flight in Argentina produced an enormous increase in consumer prices. This temporary bout of hyperinflation not only evidences the failure of Argentine financial stabilization policies, but it also represents how this failure impacted the well-being of individual Argentines.



Source: "Global Macroeconomic Figures." *__Bloomberg__ 2005.*

Chile employed a unique mix of heterodox and Neoliberal reforms. As markets were opened up to foreign capital, the government maintained tight restrictions on fiscal spending and the central bank imposed gradual deflationary monetary policy. Banking regulation and the privatization of the pension system were both executed with a great deal of success, thereby contributing to savings and investment while minimizing government liabilities and thereby providing stability to the overall system. Chile did not peg the Peso to the US dollar or another strong currency, but rather allowed the currency to float within a predetermined but flexible range before intervening with foreign currency reserves. The Central Bank's foreign currency reserves and the revenue from the Copper Stabilization Fund were instrumental in defending the value of the currency. Chile's pro-market policies were so successful that not only was capital flight avoided, but foreign investment actually increased during the period. Foreign direct investment increased especially, hitting a three year peak of $11 billion US in 1999.[201] The steady increase of foreign investment throughout the recession is undeniable evidence for the relative success of Chile's mechanisms of financial stability.

In addition to these important financial stabilizers, Chile pioneered two particular financial mechanisms that were instrumental in its successful maintenance of stability through the recession of 1998-99: the Copper Stabilization Fund and the capital inflow tax. The Copper Stabilization Fund was established in 1985 in an attempt to stabilize fiscal revenues by requiring savings of commodity receipts during boom times. The concept was simple; save during the good times to make it through the bad times. The fund played a large part in ensuring government savings, especially during the late 1980's when copper prices were high, and by 1997 the value of the fund peaked at $3.9 billion US.[202] The savings rules of the Fund were automatic, requiring a given rate of savings unless the law is changed. The Fund helped deflect political demands for government spending, especially during the transition to democracy. While the surplus savings generated by the Copper Stabilization Fund were not enough to single handedly diffract

[201] (Base de Datos Económicos 2005)
[202] Guillermo Perry. "Can Fiscal Rules Help Reduce Macroeconomic Volatility in LAC?" (Washington DC: The International Bank for Reconstruction and Development, 2002), 16.

the fiscal costs of the economic downturn of 1998 and 99, the reserves absorbed a great deal of the potential shortfall.[203] In addition to the CSF, the Central Bank of Chile had consistently increased the foreign currency reserve as another potential shock absorber. Perhaps even more importantly, Chile's reserves boosted investor confidence throughout the period and contributed to the increase of capital inflows and the reduction of interest payments on national debt, even in spite of the recession and currency collapse in neighboring Argentina.

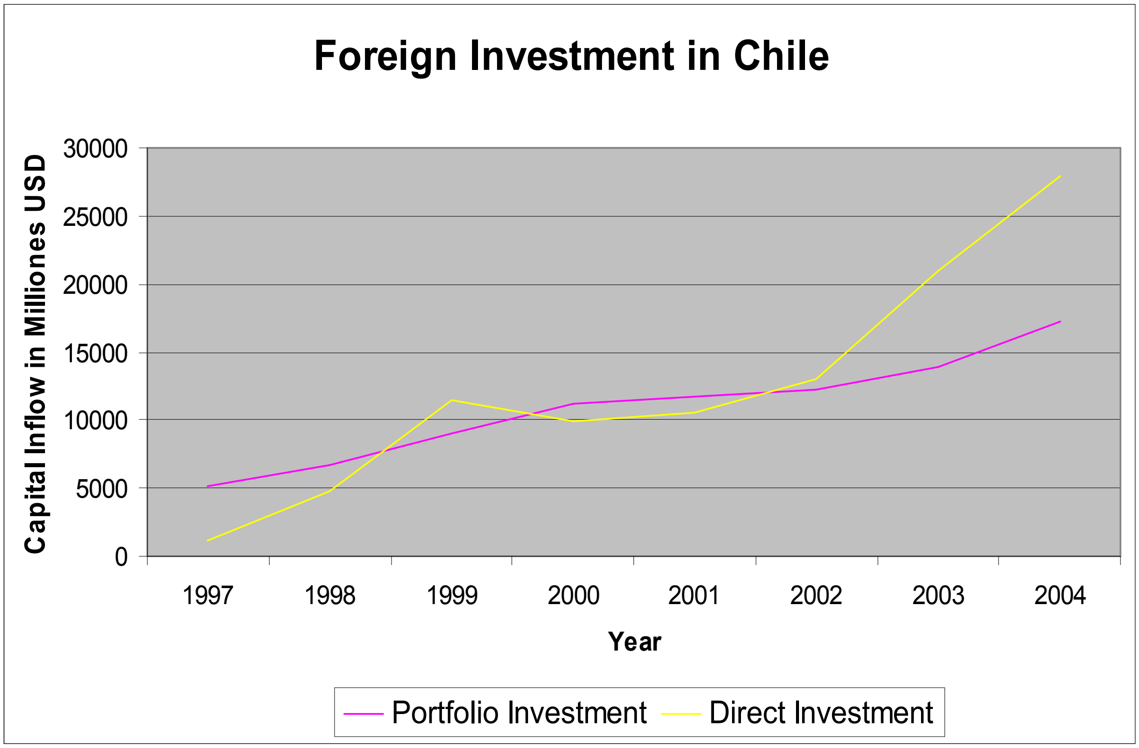
The capital inflow tax is another, more heterodox method employed by the Chilean government that contributed to the maintenance of financial stability. The tax evolved to minimize the potentially destabilizing impact of short-term capital flows. International investors often attempt to maximize rates of return in emerging market economies with high risk premiums, while simultaneously minimizing risk exposure by playing extremely short-term positions. The result is asset price volatility that hinders economic growth and can be, as was the case in South East Asia, dangerously destabilizing. Economies whose debt is held largely in short-term notes are particularly susceptible to financial instability, as changing investor sentiments can produce rapid capital outflows and rising interest rates that can make debt servicing impossible, such as was the case in Argentina. Since 1992, Chile has actively discouraged short-term capital inflows by effectively taxing capital based on the duration of its stay in the country. It does so by requiring that 30% of all non-equity capital entering the country must be deposited within the central bank for one year. In essence, this becomes a tax on inflows that proportionally offsets gains with the remaining 70%, especially for investments with short durations. In addition, the Chilean government limits the ability of local banks to

[203] (Perry 2002, 17)

receive financing from international capital markets to those banks that receive a credit rating greater than or equal to that of Chilean sovereign debt securities. Finally, all foreign capital inflows greater than $10,000 must stay in the country for at least one year.[204] The first and third regulations restrict short-term capital flows and the second regulation ensures that all capital flows entering Chile go through financially sound, responsible entities. The overall impact of the capital inflow tax, according to a variety of assessments, has been to shift the duration of foreign investments towards longer-term maturities without reducing the overall inflow of foreign capital into Chile.[205] The capital inflow tax also impacts the perception of investors, making Chile a less risky investment for longer term investors. The general increase of portfolio investment in Chile, despite the absence of hedge funds, evidences the success of the capital inflow tax. Despite the regulations, portfolio investment in Chile topped $10 billion US in 2000 and has continued to rise.[206]

---

[204] The Economist. "Of Take-Offs and Tempests: Can Capital Controls Stop Poor Countries Crashing?" Available from http://www.economist.com/displaystory.cfm?story_id=371608; Internet; accessed 1 Nov. 2005.
[205] (Desai 2003, 254)
[206] (Base de Datos Económicos 2005)

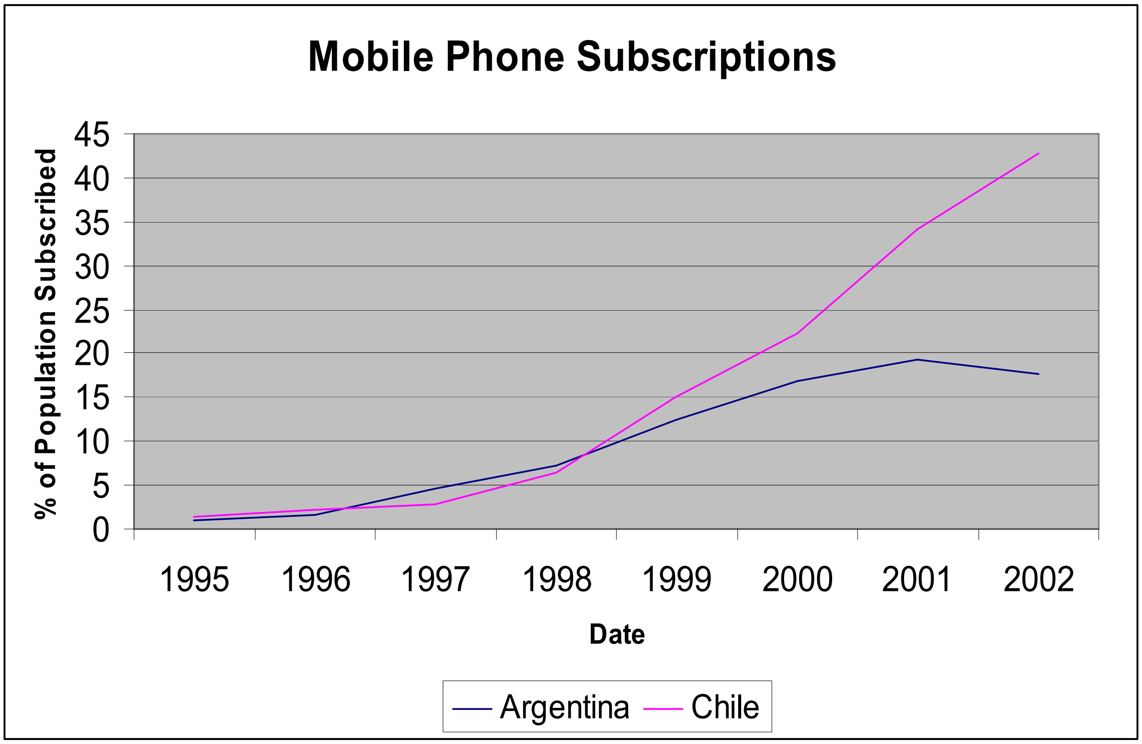


Source: "Global Macroeconomic Figures." *Bloomberg* *2005.*

There are several clear policy implications from this phase of the analysis in regards to financial management. First, stability must be facilitated by balancing fiscal accounts and through anti-inflationary monetary policy. It is important to maintain the flexibility of the currency, but central bank intervention may be useful if the currency surpasses a set range. Also, the transparency and certainty with which policy makers address and deal with international investors can help to solidify investor confidence. In addition to these more obvious implications of the comparison, the government should maintain foreign currency reserves, garnered through commodity export receipts during boom times when possible, in order to defend the currency and the fiscal balance during potential crises. Finally, potentially destabilizing short-term capital flows should be discouraged when a country can afford to do so. In these ways, the market impact of political or economic instability can be avoided.

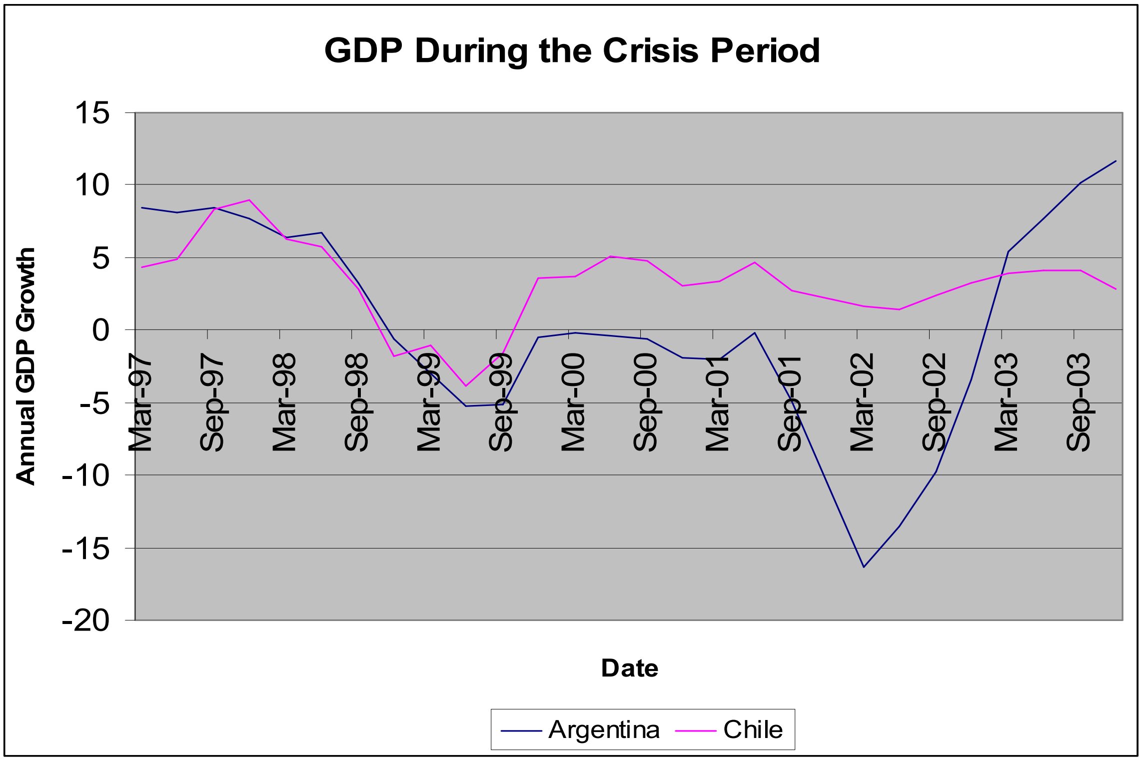
Market Instability and Domestic Economic Conditions

The cycle of instability is potentially completed by this final phase, when the price setting function of the markets impacts domestic economic conditions. In general, the more open an economy is to international financial markets, the more of an impact confidence crises can have on the domestic economy. In instances where financial instability stems from the irresponsible financial actions of the state, the greater the role of the state in the economy the more the economy will be affected by financial instability. When the markets have been opened up to international trade and capital, and where the state still plays a major role in the economy, the economic impact of unsustainable or irresponsible fiscal or monetary policy can be catastrophic. The state may be forced to look inward to rapidly raise money and cut costs, as any sign of default or devaluation of assets held by foreign investors would bring massive capital flight. Government cost cutting can have a significantly detrimental impact on the economic conditions experienced by average citizens. That the financial crisis had a very real impact on the lifestyles of average Argentineans is given credence by the number of mobile phone subscriptions made during the period. Mobile phone subscriptions have increased over time, almost universally for the past 15 years. A significant drop is significant because it implies that people were forced to cancel or drop their phone plans, and this is not a sacrifice easily made. Mobile phone subscriptions decreased in Argentina in 2001, while in Chile, the number of subscriptions continued its steady increase. Such frustration can be extremely politically destabilizing, thereby completing the cycle of instability.



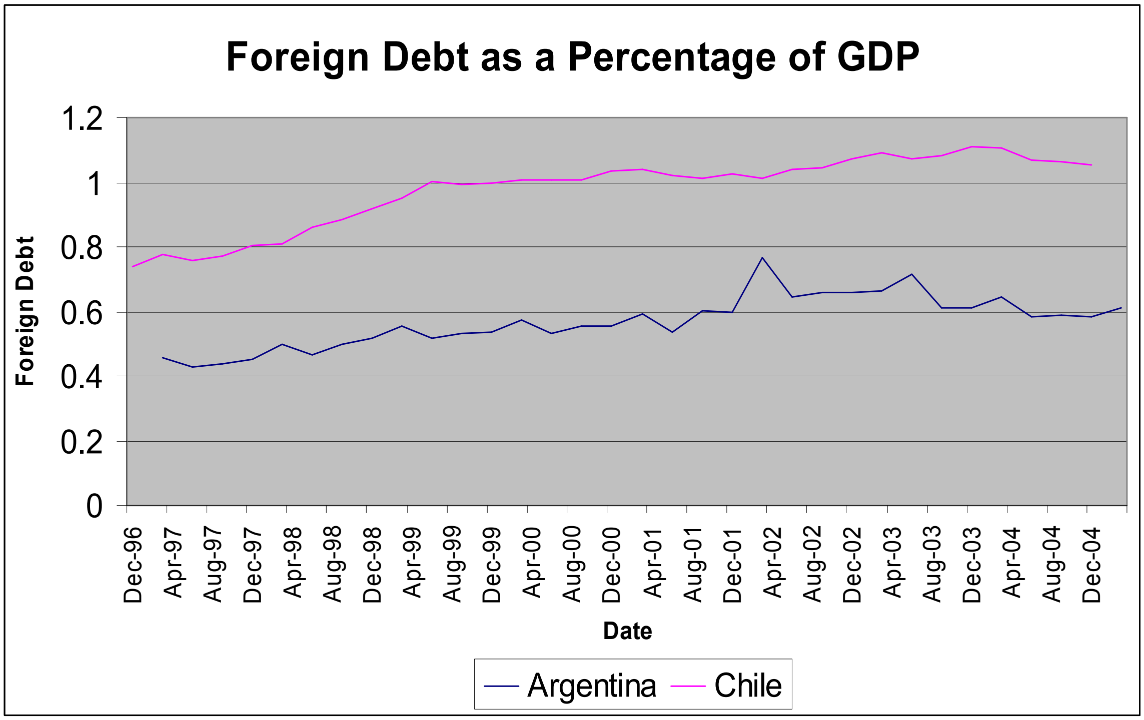
Source: "Global Macroeconomic Figures." *Bloomberg* *2005.*

Throughout the incredibly instable period of 2000 to 2002, both Argentina and Chile experienced economic recessions. The economic downturn in Argentina, however, was significantly deeper and longer lasting.



Source: "Global Macroeconomic Figures." Bloomberg 2005.

During this period, the Argentine government was forced to cut spending and raise taxes in a series of last ditch efforts to avoid default or devaluation. It was these spending cuts and banking restrictions that ultimately produced enough political instability to topple the government. The excessive spending and debt accumulated by the provincial governments forced these destabilizing cuts. The failure of the Argentine state run pension fund to make payments was also instrumental in the extension of market instability to the pockets of average Argentine citizens. Foreign debt as a percentage of GDP exceeded 100% as Argentina's financial position rapidly worsened. In Chile, fiscal accounts were not burdened with provincial debt, nor was the privatized pension system costly to the federal government.



Source: "Global Macroeconomic Figures." Bloomberg *2005.*

The policy implication of this phase of the analysis is that countries opening up their financial markets need to be extremely cognizant of increasing debt, and the potential that external capital shocks can impact the capacity of citizens to meet their own economic expectations. State workers generally expect to get paid and receive pension fund payments. Therefore, the actual capacity of citizens to obtain things of value will clearly fall short of their expectations if the government is forced to suspend payments. In turn, the frustration felt by citizens will be especially strong and directed at the government when the state is forced to rapidly cut spending. The potential for market instability to impact underlying economic conditions is heightened by the degree to which the government plays a role in the economy, employing workers and managing pension funds. In countries where capital markets have been liberalized but in which the government still experiences routine budget shortfalls, the potential for economic and political crisis can be enormous. Fiscal account reforms and privatizations should come before market liberalization. In addition, government liabilities should be made as flexible as possible, and policy makers should inform citizens as soon as possible about unplanned spending changes in order to minimize expectations shortfalls. The ultimate policy implication of this phase is not only that fiscal accounts must be balanced throughout reforms, but also that the flexibility and transparency of policies is of the utmost importance.

Conclusion

This analysis has shown that while the success of Chile is in part the non-replicable product of social and cultural phenomena or factor endowments, Chile's success was due, in part, to conscious policy decisions. Some of the discrepancy in political and economic outcomes between Chile and Argentina was a product of differing informal institutions, such as political culture, and therefore this aspect of the comparison does not yield practical policy applications. The underlying economic conditions throughout the reform period clearly facilitated the reform process. This suggests that countries should attempt major adjustments during periods of growth rather than during the crises that usually spur their hurried inception. It is worth reiterating that the successful policies employed in Chile were derived from a mixture of seemingly incompatible schools of thought.

While not all of the causes of Chile's success are replicable, some of the lessons learned by the relative success of Chile provide useful policy recommendations. The practical policy recommendations of this analysis include: the incorporation of an analysis of the political ramifications into the reform process, the centralization of authority to the degree that economic policy makers will be capable of defending national interests such as the currency and the fiscal account, the pacing and sequencing of reforms, the preservation of fiscal account balances throughout the course of reform, the maintenance of large foreign currency reserves as an insurance policy against financial instability, the minimization of short-term capital flows, and the flexibility and transparency of policy making.

Chapter Eight

Conclusion

In the age of globalization, the rules of the world system have changed. National economies must adjust or face long-run stagnation. So far, there have been clear winners and losers. The aim of this study was to explore the historical examples of success and failure in order to see what it takes to benefit from globalization. It was the purpose of this study to identify a winning policy strategy for the developing world.

The successes achieved by Chile and several South East Asian states were due to an unconventional mix of economic wisdoms. While belonging to different economic and political doctrines, the policies employed by the Chilean fiscal and monetary authorities were complementary in the pursuit of stable economic growth. These policies represented a successful compromise in the typical academic struggle between the Post-Keynesians and the Neoliberals. Unfortunately, the positive outcomes achieved in Chile, Taiwan, and Singapore may not easily be replicated under different economic and political conditions. Successful adjustment to the global economy is in part the non-replicable product of social and cultural phenomena, and economic and political conditions.

A particular set of social, political, and economic conditions can be especially beneficial, even necessary for the reform process. In terms of social conditions, informal institutions that reinforce cooperation, moderation, and stability seem to facilitate reform. States in which there is a political culture of dissidence are more likely to roll back on reforms as citizens express their frustrations through collective political action. Cultures with an above average propensity to save are also better protected from potential crisis, as domestic savings are generally less mobile and less subject to erosions of confidence during crises. Extremely high rates of domestic savings played an important role in the maintenance of stability in Taiwan and Singapore throughout the East Asian Crisis.

Politically, a democracy dominated by a strong coalition of parties seems to be the best system in which to attempt reforms. Dictatorships clearly enjoy the ability to control or ignore citizens during the costly transition to liberalization, but a closed decision making process will inevitably produce one sided reforms benefiting the economic interests of the elite. Where this has occurred it has reinforced the notion that Neoliberalism only benefits the rich. Democracies are much more capable of delivering the kinds of deregulation that can allow lower classes to enjoy the benefits of capital inflows and access to foreign markets. However, the presence of a strong opposition party to capitalize on the frustrations caused by adjustment can terminate reforms before they are given the chance to work. Strong democratic coalitions seem to provide the proper mix of stability and equity.

The economic conditions that facilitate the reform process are much more easily identifiable. Reforming economies benefit from high export prices and low import prices, especially for relatively inelastic goods such as petroleum and food. Export revenues are important during liberalization because they generate political support for reforms and because they provide the currency reserves necessary to defend against speculative attacks. Recessions or financial crises often provide the impetus to Neoliberal reforms, yet the reform process would be much more effective if conducted during periods of economic growth.

While social, political, and economic conditions are very important to the reform process, favorable conditions are not a free ticket to prosperity. Where there has been success, it has been the result of conscious policy decisions. As such, there are several policy lessons to be learned from this study. First and foremost, successful reform requires thoughtful and interdisciplinary analysis. Success or failure will not be determined entirely by the financials, but by underlying social, political, and economic conditions as well. Second, the pacing and sequencing of reforms must be designed to minimize the short-run costs and to hasten the arrival of the long-run benefits. The timing of reforms must also take domestic politics into consideration, as the failure to do so will result in the rollback of reforms. Third, there are orthodox and heterodox financial mechanisms that can be employed to stabilize the reform process. Reforms should not be attempted without the necessary currency reserves that can be used to defend against speculative attacks. Debt minimization is another very important financial requisite. Short-term capital flows should be discouraged, especially during the reform process in which the domestic economy is especially exposed to exogenous shocks. Fourth, reform policies must be consistent and transparent in order to maintain the confidence of investors whose potential for exit poses the greatest danger to reforming economies.

Further study of the political economy of globalization is needed. A regional comparison between Latin America and East Asia could provide a useful counterpoint to the examples of success and failure at the state level that have been analyzed in this study. A regional analysis could shed light on the efficacy of a state assisted transition to the market and the effect of informal institutions on the reform process. It would be interesting to study the long-run effects of reform role back in the developing world. Over the next few years, Latin America will become the focal point of the debate over

Neoliberalism and globalization as leftist nationalism rises in protest to the Washington Consensus. Hugo Chavez, Evo Morales, and Ollanta Humala embody the political backlash to globalization. Whether these experiments in "21st century socialism" succeed or fail will likely determine the direction of global economic policy as it is applied to the developing world.

The paradox of Neoliberalism is that, if not managed properly, the negative short-run and distributive effects of Neoliberal reforms will endanger the political viability of the reform process itself. Neoliberal reforms typically generate negative short-run outcomes and can render the state vulnerable to exogenous shocks during the course of reform. The occurrence of a financial crisis in a liberalizing economy begs the question: were negative outcomes a product of the Neoliberal reform itself or of the insufficiency of the reforms achieved? Proponents of the latter view have used the occurrence of financial crises in reforming countries as evidence of a need for further reform, whereas proponents of the former view have used the same crises as evidence of the general failure of Neoliberal policies. Neither of these views provides a solution to the paradox. Instead, where Neoliberalism has failed to generate positive outcomes it has been the result either of unfavorable social, political, or economic conditions, or of clear policy failures. The standard reforms prescribed by the Washington Consensus must be modified to heed the policy lessons of the past.

Chapter Nine

Bibliography

Acuña, Carlos H. 1994. Politics and Economics in the Argentina of the Nineties (Or, Why the Future No Longer Is What It Used to Be). In *Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia, Brazil, Chile, and Mexico.* Eds. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. New Brunswick, NJ: Transaction Publishers.

Acuña, Carlos H., and Smith, William C. 1994. The Political Economy of Structural Adjustment: The Logic of Support and Opposition to Neoliberal Reform. In *Latin American Political Economy in the Age of Neoliberal Reform: Theoretical and Comparative Perspectives for the 1990's.* Eds. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. New Brunswick, NJ: Transaction Publishers.

"Another President Caught in Argentina's Economic Trap." *The Economist* 5 Oct. 2000. Available from http://www.economist.com/displaystory.cfm?story_id=387306; Internet; accessed 1 Nov. 2005.

"Argentina: History in Brief." *The Economist* 1 Aug. 2000. Available from http://www.economist.com/countries/Argentina/profile.cfm?folder=History%20in%20brief; Internet; accessed 1 Nov. 2005.

"Argentina." *Yahoo! International Finance Center* 13 April 2005. Available from http://biz.yahoo.com/ifc/ar.html; Internet; accessed 13 April 2005.

"Backgrounders: Argentina." *The Economist* 1 Nov. 2005. Available from http://www.economist.com/research/backgrounders/displayBackgrounder.cfm?bg=1022218; Internet; accessed 1 Nov 2005.

Basch, Miguel and Eduardo Engel. 1993. Temporary Shocks and Stabilization Mechanisms: The Chilean Case. In *External Shocks and Stabilization Mechanisms.* Eds. Eduardo Engel and Patricio Meller. Washington, DC: The Interamerican Development Bank.

Base de Datos Económicos. El Banco Central de Chile [database on-line], 2005. Available from http://si2.bcentral.cl/Basededatoseconomicos/951_portada.asp?idioma=E; Internet; accessed 26 Feb. 2006.

Bueno de Mesquita, Bruce, James D. Morrow, Randolph M. Siverson, and Alastair Smith. 2000. Political Institutions, Political Survival, and Policy Success. In *Governing for Prosperity.* Eds. Bruce Bueno de Mesquita and Hilton L. Root. New Haven, CT: Yale University Press.

Canitrot, Adolfo. 1994. Crisis and Transformation of the Argentine State (1978-1992). In *Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia,Brazil, Chile, and Mexico.* Eds. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. New Brunswick, NJ: Transaction Publishers.

"Chile: All Good Things Must Slow Down." The Economist 5 March 1998. Available from http://www.economist.com/displaystory.cfm?story_id=115187; Internet; accessed 1 Nov 2005.

"Chile." Yahoo! International Finance Center. 13 April 2005. Available from http://biz.yahoo.com/ifc/cl.html; Internet; accessed 1 Nov 2005.

"Country Backgrounders: Chile." The Economist 1 Nov. 2005. Available from http://www.economist.com/research/backgrounders/displayBackgrounder.cfm?bg=884616; Internet; accessed 1 Nov 2005.

La Corporación Andina de Fomento. 2004. Reflexiones para Retomar el Crecimiento. Caracas, DF: La Corporación Andina de Fomento.

Daseking, Christina. 2004. *Lessons from the Crisis in Argentina.* Washington, DC: International Monetary Fund.

Desai, Padma. 2003. *Financial Crisis, Contagion, and Containment: From Asia to Argentina*. Princeton, NJ: Princeton University Press.

"Down and Almost Out in Buenos Aires." *The Economist* 1 Nov. 2001.

Frenkel, Roberto. "Real Exchange Rate and Employment in Argentina, Brazil, Chile, and Mexico." El Centro de Estudios de Estado y Sociedad: La Universidad de Buenos Aires (2004).

Gamarra, Eduardo A. 1993. Crafting Political Support for Stabilization: Political Pacts and the New Economic Policy in Bolivia. In *Democracy Markets, and Structural Reform in Latin America.* Eds. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. New Brunswick, NJ: Transaction Publishers.

Gamarra, Eduardo A. 1994. Market Oriented Reforms and Democratization in Latin America: Challenges of the 1990s. In *Latin American Political Economy in the Age of Neoliberal Reform.* Eds. William C. Smith, Carlos H Acuna and Eduardo A. Gamarra. New Brunswick: Transaction Publishers.

Garcia, Valeriano F. 1997. *Black December: Banking Instability, The Mexican Crisis and its Effects on Argentina*. Washington, DC: The International Bank for Reconstruction and Development.

Garreton, Manuel Antonio. 1986. The Political Evolution of the Chilean Military Regime and Problems in the Transition to Democracy. In *Transitions from Authoritarian Rule, Prospects for Democracy.* Eds. Guillermo O'Donnell, Philippe C. Schmitter, and Laurence Whitehead. Baltimore, MD: Johns Hopkins University Press.

Garrett, Geoffrey. 2000. Global Markets and National Politics: Collision Course or Virtuous Cycle. In *Exploration and Contestation in the Study of World Politics.* Eds. Peter J. Katzenstein, Robert O. Keohane, and Stephen D. Krasner. . Cambridge, MA: The MIT Press.

"Global Macroeconomic Figures: Chile." *Bloomberg* 2005.

Gupta, Dipak K. 1990. *The Economics of Political Violence: The Effect of Political Instability on Economic Growth*. New York, NY: Praeger Publishers.

Gurr, Ted Robert. 1970. *Why Men Rebel.* Princeton, NJ: Princeton University Press.

Haley, Mary Ann. 2001. Emerging Market Makers: The Power of Institutional Investors. In *Financial Globalization and Democracy in Emerging Markets.* Ed. Leslie Elliott Armijo. New York, NY: Palgrave.

Hartlyn, Jonathan, and Morley, Samuel A. 1986. Political Regimes and Economic Performance in Latin America. In *Latin American Political Economy: Financial Crisis and Political Change*. Eds. Jonathan Hartlyn and Samuel A. Morley. Boulder, CO: Westview Press.

Helleiner, Eric. 1994. *States and the Reemergence of Global Finance*. Ithaca, NY: The Cornell University Press.

"Informe de Prensa: Latinobarometro." *Latinobarometro*. 1995. Available from http://www.latinobarometro.org/index.php?id=66; Internet; accessed 26 Feb 2006.

Locke, John. 1955. *Second Treatise of Civil Government*. Chicago, IL: Henry Regency Co.

Mantzavinos. C. 2001. *Individuals, Institutions, and Markets*. New York, NY: The Cambridge University Press.

O'Donnell, Guillermo. 1988. *Bureaucratic Authoritarianism*. Berkeley, CA: The University of California Press. 1988.

"Of Take-Offs and Tempests: Can Capital Controls Stop Poor Countries Crashing?" *The Economist* 12 March 1998. Available from http://www.economist.com/displaystory.cfm?story_id=371608; Internet; accessed 1 Nov 2005.

Pei, Minxin, and Ariel David Adesnik. "Why Recessions Don't Start Revolutions." *Foreign Policy* No. 118 (Spring 2000), 138-151. Carnegie Endowment for International Peace. JSTOR Online Archive.

Pereira, Luiz Carlos Bresser, Jose Maria Maravall, and Adam Przeworski. 1993. Economic Reforms in New Democracies: A Social-Democratic Approach. In

Democracy Markets, and Structural Reform in Latin America. Eds. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. New Brunswick, NJ: Transaction Publishers.

Perry, Guillermo. 2002. "Can Fiscal Rules Help Reduce Macroeconomic Volatility in LAC?" Washington DC: The International Bank for Reconstruction and Development.

La Corporación Andina de Fomento. 2004. *Reflexiones para Retomar el Crecimiento.* Caracas: La Corporación Andina de Fomento.

Robinson, William I. 2003. *Transnational Conflicts: Central America, Social Change, and Globalization*. New York, NY: Verso.

Rothgeb Jr., John M. 1996. *Foreign Investment and Political Conflict in Developing Countries.* Westport, CT: Praeger Publishers.

Santiso, Javier. 2003. *The Political Economy of Emerging Markets*. New York, NY: Palgrave MacMillan.

Scully, Timothy R. 1996. Chile: The Political Underpinnings of Economic Liberalization. In *Constructing Democratic Governance: Latin America and the Carribean in the 1990's.* Eds. Jorge I. Dominguez, and Abraham F. Lowenthal. Baltimore, MD: The Johns Hopkins University Press.

Shumway, Nicolas. 1991. *The Invention of Argentina*. Berkeley, CA: University of California Press.

Smith, William C. 1991. *Authoritarianism and the Crisis of the Argentine Political Economy*. Stanford, CA: Stanford University Press.

"Timeline: Argentina." *BBC* 2006. Available from http://news.bbc.co.uk/1/hi/world/americas/country_profiles/1196005.stm; Internet; accessed 26 Feb 2006.

"Timeline: Argentina's Financial Crisis." *Reuters* 6 December 2001. Available from http://www.foxnews.com/story/0,2933,40274,00.html; Internet; accessed 26 Feb 2006.

"Timeline: Chile." *BBC* 2006. Available from http://news.bbc.co.uk/1/hi/world/americas/country_profiles/1222905.stm; Internet; accessed 26 Feb 2006.

Valenzuela, Arturo. 1999. Chile: Origins and Consolidation of a Latin American Democracy. In *Democracy in Developing Countries: Latin America.* Eds. Larry Diamond, Jonathan Hartlyn, Juan J. Linz, and Seymour Martin Lipset. Boulder, CO: Lynne Rienner Publishers, Inc.

Vergara, Pilar. 1994. Market Economy, Social Welfare, and Democratic Consolidation in Chile. In *Democracy, Markets, and Structural Reform in Latin America.* Eds. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. New Brunswick, NJ: Transaction Publishers.

Waisman, Carlos H. 1999. Argentina: Capitalism and Democracy. In *Democracy in Developing Countries: Latin America.* Eds. Larry Diamond, Jonathan Hartlyn, Juan J. Linz, and Seymour Martin Lipset. Boulder, CO: Lynne Rienner Publishers, Inc.