6

Central Bank Reform in Latin America: Will Independence Guarantee Low Inflation?

*John F. Normand**

Since 1989 several Latin American countries have proposed independent central banks as mechanisms for controlling persistently high inflation. This paper examines the questions of political economy surrounding such proposals, with particular emphasis on how four factors—regime type, electoral timing, prevailing economic conditions and the populace's inflation intolerance—contribute to the eventual success or failure of newly autonomous central banks. Case studies on reform efforts in Chile, Argentina, Mexico, and Venezuela suggest that central bank autonomy is more likely to guard price stability when implemented after a period of broader structural reform and inflation stabilization. Attempts to create legally independent central banks in the absence of popular or governmental commitment to price stability may damage institutional credibility in the long run. These conclusions hold potential applicability for other emerging market economies considering similar central bank reform proposals.

A prevailing perspective among policymakers is that low inflation is an essential feature for an efficient market economy and that independent central banks are the best means to achieve this goal.

**M.P.A. Candidate, Woodrow Wilson School of Public & International Affairs, Princeton University; B.A., Georgetown University.*

While this belief has guided monetary policy among industrialized countries for decades, the idea of central bank autonomy has only recently gained currency in the developing world. In Latin America the trend toward establishing independent central banks is particularly pronounced, with countries such as Chile, Argentina, and Mexico having recently passed legislation ceding exclusive control over monetary policy to their central banks. Yet despite the momentum toward central bank independence, it remains unclear whether such institutions hold the key to eliminating high inflation in Latin America or other emerging market economies. Most research on the political economy of central bank independence focuses only on industrialized countries and pays little attention to the political context in which central bank reforms are initiated in developing countries.

This paper attempts to illuminate the political dimension by examining several questions of political economy which surround proposals for central bank independence as a means of institutionalizing price stability. Given the high incidence of inflation-prone countries in Latin America, this study focuses on four countries which have recently undertaken central bank reform in the region: Chile, Argentina, Mexico, and Venezuela. Four factors are found to influence the eventual success or failure of newly autonomous central banks. The first factor, "regime type," refers to the orientation of the government proposing economic reform as either authoritarian, dominant party, or democratic. The second factor, "electoral timing," tests the hypothesis that central bank reforms are proposed near the end of a chief executive's term when the ruling party's loss of power is imminent. "Prevailing economic conditions," the third factor, refers to the overall macroeconomic climate—especially the inflation rate—at the time of the reform proposal, and tests the claim that central banks are best able to maintain long-term price stability if the government has already lowered inflation to a reasonable level. Finally, "inflationary memory" refers to the collective intolerance of inflation among the populace, which political leaders may harness to generate support for an autonomous central bank.

Three criteria are used for judging a reform attempt as either successful or unsuccessful. First is the willingness of the government to cede monetary authority exclusively to the central bank through legislative reform. Several provisions of reform legislation

are examined, including those concerning authority over monetary policy, term lengths for governors, and conditions for removing governors from office. The second criterion for assessing success is the ability of the new central bank to maintain price stability, as measured by inflation patterns following the promulgation of central bank reform legislation. The third criterion is the management of policy conflicts between the chief executive and the central bank.

The political patterns that emerge from analyzing country experiences in Latin America are somewhat incomplete given the information constraints imposed by the recent timing of reforms. Still, country experiences to date provide evidence to support the following propositions:

(1) Legal independence is not an automatic predictor of low inflation in developing countries given the relative youth of central banks in those countries and the lesser attention paid to the rule of law.

(2) The current move by high-inflation countries toward autonomous central banks reflects a shift in political culture as embodied in an intolerance of inflation. Legal autonomy is also a stability guarantee to investors and the financial community, which are both politically well-connected interest groups.

(3) Successful autonomy plans have been implemented only after price stability has been achieved and are an attempt to limit the policy options of successor governments. Regime type may facilitate reform in some cases, but it is not a necessary condition.

(4) Finally, the ultimate success of a central bank in achieving price stability rests on its credibility with consumers, business, labor, and finance. How a government transfers credibility to a newly independent central bank is crucial to overall success. These conclusions, discussed later, hold important policy implications both for countries on the verge of reform consolidation and for those designing a reform program that includes overhauls of the financial sector.

The Inadequacy of Legal Independence Alone

Several theories have been offered to explain why independent central banks are more likely to promote price stability than nonindependent ones. The prevailing notion holds that political leaders will use the influence over central banks in order to increase the money supply, stimulate economic growth, and thus win

popular support to guarantee reelection. An independent central bank (i.e., one which cannot be forced to lend directly to the central government or to public sector enterprises) insulates the economy from the political-business cycle because it can resist executive manipulation of monetary policy. The inability of politicians to exercise restraint over inflationary monetary expansion in order to garner popular support has been offered as the most compelling argument for central bank independence (Volcker and Mancera 1991).

Several recent studies support the hypothesis that countries whose central banks exhibit the highest degree of legal independence also demonstrate the lowest rate of inflation (Bade and Parkin 1988; Alesina 1988, 1989; Grilli, Vitorio, and Masciandaro 1989). Cukierman, Webb, and Neyapti (1992) have found that while legal central bank independence is a good predictor of low inflation in industrialized countries, it is not a good predictor in developing countries.

The notion that indices of legal independence hold less predictability for inflation stability in developing countries should come as little surprise given the methodological assumptions inherent in these indices. Most indices are based on written bank charters and specifically exclude considerations of how the law is applied in practice. Given this methodology, these analyses hold less explanatory power in countries exhibiting a high disparity between legal theory and practice—that is, in countries where the rule of law may not be explicitly recognized as a fundamental governing principle. This disparity is particularly pronounced under authoritarian regimes where most political decision making may be concentrated in a small group of political actors or, as likely, in countries undergoing structural economic transformation where power relationships may be in flux. In such cases, ranking the independence of central banks should take into account alternative nonlegal factors such as the presence of a strong central bank president, the competence of the central bank staff, or turnover rate of the central bank governors (Cukierman, Webb, Nepaypti 1992, 361).

As Maxfield (1994) notes, rather than rely on the rule of law, central banks in developing countries instead react to the financial needs of government officials and the private sector financial market. The more robust the financial markets, the greater incen-

tive financiers have to protect their interests by pressuring the central bank and government officials toward price stability. Similarly, the more developed the financial markets, the less dependent the government is on central bank financing and the more likely that it will tolerate an independent central bank.

While Maxfield's hypothesis may explain why countries find themselves more likely to support continued central bank independence and price stability over the short run, her explanation does not clarify the motivations pushing governments to propose alternative central bank arrangements. Should we conclude that only countries with well-developed financial markets would have relatively independent central banks to protect financial interests? Numerous other countries, such as Brazil, Venezuela, and Peru, have active and well-developed financial sectors, a growing share of industrial production in GNP and thus a growing class of industrialists, yet exhibit no more penchant for price stability than Nicaragua or Zambia. Clearly, a more complicated dynamic than financial sector incentives is needed to explain the effectiveness of central banks.

The case studies which follow illustrate some of the additional factors such as regime type, inflationary memory, electoral timing and prevailing macroeconomic conditions that also contribute to the eventual success or failure of a country in establishing an autonomous, inflation-fighting central bank. Table I provides summary statistics on inflation and central bank autonomy indices on Argentina, Chile, Mexico, and Venezuela—the four countries that this paper will use to examine the conditions under which central bank autonomy is most likely to guard price stability.

Case Studies in Successful Central-Bank Reform: Chile and Argentina

Chile

Chile's central bank as reorganized in 1989 is arguably the most legally independent in the developing world. It is forbidden by constitutional amendment from printing any new money to cover a fiscal shortfall except in wartime. Its five governors are appointed for periods of ten years, with staggered departures every two years, thus giving them the ability to outlast two presidential administra-

Table I: Summary Statistics on Inflation and Central Bank Independence in Selected Latin American Countries
(Percentage change over previous year in consumer price index)

	1960s avg	1970s avg	1980s avg	'90	'91	'92	'93	Independence Index	Turnover Rate
Argentina	23.5	132.9	565.6	2314	171.7	24.9	10.6	.40	.92
Chile	30.4	174.5	21.37	26	21.8	15.4	12.7	.46	.46
Mexico	2.7	14.7	69.1	26.7	22.7	15.5	9.8	.34	.15
Venezuela	1.7	6.6	23.05	40.8	34.2	31.4	38.1	.43	.30

Source: Inflation rates from *International Financial Statistics*; independence index and turnover rates from Cukierman, Webb, and Neyapti (1992). A score of 1 on the independence index indicates maximum independence while 0 indicates minimal independence. Turnover rates indicates average number of governor turnovers per year, 1950–89.

tions. Governors cannot be removed for any reason by the chief executive or the Congress (Marshall 1991; Fontaine 1989).

Such an arrangement represented an abrupt about-face for the Banco Central de Chile, which previously could assert little institutional autonomy and acted as a virtual checking account for government deficit financing. Prior to reform, its governing board consisted of members appointed by Chile's president, the national banks, and private sector representatives from industry and agriculture.[1] Since the 1940s it had been responsible either directly or indirectly for financing the state industrial holding company CORFO and encouraged other commercial banks to do the same. Other organizations involved in agricultural or regional development were similarly authorized to solicit funds from the central bank.[2] This habit continued in subsequent years and peaked when Salvador Allende's Marxist government came to power in 1970. Consistent with its socialist agenda, the Allende regime authorized an enormous increase in social services and salaries which compounded demands on the central bank for additional government financing. The result was not surprising: inflation shot up from 20 percent at the beginning of Allende's term in 1970 to over 350 percent at the time of the coup d'état in 1973 and averaged nearly 175 percent annually for the remainder of the decade (See Table 1).

Upon seizing power in a 1973 coup, General Augusto Pinochet undertook several steps, including central bank reform, to reverse the economy's inflationary trend. Attempting to reverse what he considered the profligacy and disorder generated by the Allende administration, Pinochet installed a core group of economic advisors trained at the University of Chicago who proceeded to implement what has been called a "radical experiment with neo-conservative economics" (Foxley 1983). The Pinochet government followed several years of inflation stabilization with a 1980 constitutional amendment prohibiting the central bank from printing money to cover fiscal deficits. In 1989 he strengthened these reforms by proposing to make the central bank fully independent of the executive branch and Finance Ministry by lengthening the terms of office of the governors and giving the central bank direct control over monetary and exchange rate policy. The measure was easily implemented through executive decree and became law in 1989.

The success of Chile's central bank has been evident in recent years. From a strictly legal perspective, the Chilean central bank charter contains the key strengths of the most respected independent central banks in industrialized countries: exclusive control over monetary policy, long tenures for governors exceeding those of the chief executive, and freedom from arbitrary dismissal by the chief executive. In practice, the past five years of autonomy have witnessed few heated contests of will between the chief executive and the central bank. Further, annual inflation has fallen to single digits for the first time in 30 years. The Chilean central bank reforms have even been cited by other governments in the region as models for autonomy.

Explaining both the policy shift in Chile and the success thus far in maintaining price stability requires analysis of the political context of reform. The electoral timing of the policy proposal is the first key element in explaining why Pinochet, who had achieved de facto monetary autonomy through constitutional amendment in 1980, would propose central bank autonomy in 1989. In 1988, after fifteen years as chief executive, Pinochet proposed a plebiscite on his administration under which a "yes" vote would sustain his rule for eight additional years while a "no" vote would automatically trigger a presidential election in 1989 in which opposition candidates would be allowed to run. Pinochet lost this referendum, and

by 1989 it was clear that the Chilean electorate would vote Pinochet out of office. Faced with imminent demise, Pinochet initiated a series of provisions to ensure his stamp on Chilean politics and policy-making would endure through the subsequent regime (Herrara and Graham 1994, 250–53). The Pinochet government's proposal called not only for a more autonomous central bank, but also gave Pinochet himself the power to appoint all five incoming governors, a power which would allow *pinochistas* to control monetary policy through the year 2000. Pinochet's move to grant autonomy thus can be seen as an attempt to institutionalize his own policy preferences for monetary stability well after he or his advisors had left office and to ensure that his successor would not retreat from the program that had brought strong growth to Chile in recent years.

Chile's authoritarian political structure further facilitated such a bold policy move in the face of opposition. The 1989 proposal by Pinochet was hotly contested among both economists and political leaders. Patricio Aylwin, who defeated Pinochet in the 1989 election, opposed the idea, arguing that it would create a central bank even more powerful than the German Bundesbank or the U.S. Federal Reserve.[3] Chilean economists also questioned the soundness of creating a "superbanco." However, as has been noted with respect to other structural adjustment reforms in Chile, the Pinochet regime had no need to "sell" the reform proposal to the public given its exclusive hold on power (Herrera and Graham 1994). As a dictator writing the terms of his own departure from office, Pinochet had the luxury of writing in provisions which may not have been possible in a more decentralized political context.

This is not to say that Pinochet completely disregarded public opinion. After significant opposition from Aylwin's newly elected government, Pinochet did concede on his earlier demand to appoint all central bank board members by allowing Aylwin to appoint two members and agreeing on a joint appointment for board president. Further, Pinochet could still garner some measure of public sympathy for his proposal given the country's inflationary history. As in other countries which had experienced hyperinflation, such as Germany after World War I, Chileans could still recall the hyperinflation of the Allende years. This public intolerance of inflation lent some justification to Pinochet's policy prescription, even if implemented under a repressive regime. A public consen-

sus on the need for price stability, while not necessary for passing legislation in an authoritarian context, could nonetheless be seen as a way to establish institutional legitimacy for the central bank's role in policy-making during the post-Pinochet years. Therefore, the combination of previous hyperinflation, a strong government committed to anti-inflationary policies, and constitutional prohibitions against deficit financing have all contributed to the record of price stability and instituuional credibility that the Chilean central bank enjoys today.

Argentina

In contrast to Chile, which undertook structural adjustment under authoritarian rule, Argentina's reforms progressed under democratic regimes, which have held power since the country's military rulers stepped down in 1983. When Carlos Menem was elected President in 1989, the Argentine economy had reached the apex of its inflationary struggle. Inflation had averaged over 500 percent annually throughout the 1980s and had surpassed 3000 percent by Menem's inauguration. The policies of the Banco de Argentina were a leading source of such price instability. Like other Latin American central banks, the Banco de Argentina subsidized state enterprises and absorbed internal and external public debt throughout the 1980s.[4] By some estimates the central bank had been responsible for nearly $68 billion in losses during the 1980s, an amount equal to Argentina's entire foreign debt or one year of national income (World Bank 1993). The central bank had been forced to lend to other financial institutions with no expectation of repayment and had been pressured to issue treasury bills which it could not cover. Numerous financial demands on the central bank and the lack of alternative financing mechanisms in Argentina left the central bank with a continual need to print money or issue financial liabilities to cover the numerous debts it had assumed. The resulting hyperinflation of the late 1980s was therefore not surprising.

Given the central bank's historically lax supervision of monetary growth, its reform was a fundamental component of any long-term stabilization plan. Upon taking office in 1989, Menem proposed to legally limit the chief executive's influence over monetary policy. The Law of Convertibility was inacted to peg the peso to the U.S. dollar and prohibit the central bank from printing money unless it were backed by foreign-currency reserves, gold, or a limited

quantity of government bonds (World Bank 1986). Two years later, President Menem proposed to render the central bank fully autonomous by giving it exclusive control over the peso, restricting government borrowing from the bank, and removing extraneous responsibilities not directly related to price and exchange rate stability.

Argentina's success with maintaining price stability in recent years has indeed been remarkable. From a high of over 3000 percent in 1989, annual inflation fell to less than eleven percent in 1993 and to single digits in 1994. Further, Argentina's Law of Convertibility has created a monetary regime that extends beyond traditional notions of central bank autonomy and further insulates policy-making from executive pressures. By creating a currency board, the Law of Convertibility restricts the ability of the chief executive to manipulate monetary policy for political gain. At the same time the currency board reduces the discretion of central bankers who might be sympathetic to the chief executive's agenda. Such a system has the additional advantage of creating confidence in the fiscal solvency of the country since reserves must cover the monetary base. This feature can be credited for helping the Argentine peso avoid speculative attacks in the wake of the Mexican peso devaluation of December 1994.

That Argentina has replicated Chile's price stability is particularly interesting given the decidedly different political context under which these two central bank reform efforts were undertaken. Unlike Pinochet who enjoyed dictatorial powers in Chile, Menem faced the challenge of implementing economic reforms within a democratic political structure of more diffuse power relations. Imposing institutional reforms by executive fiat was therefore not a policy option as in Chile. Given that central bank reforms were proposed early in Menem's term, it does not appear that electoral timing played as important a role in influencing the reform effort as it did in Chile.

Lacking the institutional authority or the electoral motivations of Pinochet, Menem thus availed himself of the remaining political resource in Argentina, growing Argentine intolerance for inflation. Menem assumed the presidency in 1989 at a critical juncture when successive stabilization plans had failed and inflation had topped 3000 percent annually. The effects of such a crisis on political culture and interest-group alignments proved profound. Economic crises, such as the one Argentina experienced during the

hyperinflation years of the 1980s, can redirect policymakers out of their traditional modus operandi, realign interest groups that would otherwise oppose drastic policy reform, and create new coalitions to pressure government action (Williamson 1994). Argentina's inflationary crisis of 1989, more acute than Chile's inflationary struggle of the 1970s, required central bank reform measures more drastic and deep-rooted than those implemented in Chile. To break the inflationary expectations of the public, the government had to implement a policy that would prove its resolve to monetary stability and establish the long-term credibility needed to maintain low inflation. Given these exigencies, the Menem administration pushed for a Law of Convertibility, which until that time was the most drastic legal measure by a Latin American government to impose monetary discipline on a central bank. By the time full central bank autonomy was legally established two years later, the Menem administration had not only proven its commitment to price stability, but had imposed a legal safeguard against expansionary monetary policy. Having established its commitment to follow anti-inflationary policies through the convertibility law, Menem's administration could more easily establish a credible central bank capable of sustaining low inflation in subsequent years.

Crises of Credibility: Central Bank Reforms in Mexico and Venezuela

Mexico and Venezuela serve as useful counterweights to the Argentine and Chilean cases of central bank reform. Both countries have witnessed extreme fluctuations in their economic fortunes over the past decade. Venezuela, praised until the 1980s for its record of high growth with low inflation, was blacklisted in 1994 by international investors due to President Rafael Caldera's decision to re-institute capital and foreign exchange controls, nationalize several banks, and impose price controls on numerous consumer goods. Mexico, considered in the early 1990s to be a model policy reformer among emerging market economies, found itself, in 1995, saddled with a fiscal austerity plan, capital flight, and rising inflation following the December 1994 peso devaluation. The following sections explore how central bank policy has contributed to abrupt increases in inflation in both countries.

Mexico

By Latin American standards, the Bank of Mexico prior to the 1980s was a relatively autonomous, inflation-fighting central bank. Given the institutional structure of the bank prior to reform in the 1990s, this should indeed seem surprising. Before central bank reform in 1993, the Bank of Mexico set no legal limits on government borrowing from its coffers. Further, the Bank shared decision making on monetary and exchange-rate policy with the Ministry of Finance and the Ministry of Budget and Planning, and it relied heavily on them to resist expansionary pressures from political officials. Despite the potential for abuse of monetary policy under such an arrangement, the Bank in fact presided over a period of relative price stability through much of the 1950s through 1970s (Maxfield 1994).

During the 1980s, however, exogenous economic shocks eroded this commitment to an anti-inflationary monetary policy. Higher international interest rates and lower oil export prices dealt a double blow to the balance of payments and increased the need to seek alternative financing through the central bank. Faced with a growing balance of payments crisis, a lack of financing alternatives, and a host of emerging collapses among commercial banks, then-President José Lopez Portillo nationalized the private banking system, including the Bank of Mexico, which was placed under the Ministry of Finance. With no legal limits to restrain government borrowing from the central bank, the government moved to monetize its deficit. This resulted in inflation that reached as high as 150 percent in 1988 at the election of President Carlos Salinas de Gortari.

Though inflation stabilization was a key feature of Salinas's overall economic-reform agenda, his early initiatives such as the Pact for Economic Solidarity, which bound business, government, and labor to accept price and wage restraints, made no mention of instituting an autonomous central bank. While the issue had been broached by several leading policymakers, including Banco de Mexico Governor Miguel Mancera, a serious proposal to implement such a plan was not floated until 1993. In May 1993 Salinas proposed a constitutional amendment to free the central bank from the Ministry of Finance, under which it had been subordinated since the bank nationalization of 1982. The PRI-controlled Con-

gress approved the amendment in December 1993, and it took effect in April 1994. The amendment established price stability as the main and exclusive priority of the central bank and limited the amount that the Bank of Mexico could lend to the federal government to 1.5 percent of the federal budget. To further insulate governors from executive influence, the amendment set the term of the governor at eight years (exceeding the President's by two years) and staggered terms of deputy governors to avoid presidential board packing.

Until December 1994 it appeared that Mexico's central bank reform was an unqualified success. The liberation of the central bank from the Ministry of Finance and the extension of governors terms to eight years were fundamental reforms, although the staggering of terms still maintained some opportunities for executive influence.[5] In practice the central bank also performed quite well until the December 1994 devaluation. By 1993 inflation had fallen to single digits for the first time in two decades and had remained at this level for almost two years.

That the newly independent central bank had established an initially credible track record was not unexpected given that the reform process in Mexico reflected several aspects of successful reform in Chile and Argentina. Like Pinochet in Chile, Salinas was well-positioned to institutionalize low inflation policies by leveraging his tremendous power as chief executive in a dominant party state. Moreover, Salinas could capitalize on the accumulated intolerance of inflation in Mexico. Through the Pact for Economic Solidarity, Salinas had not only lowered inflation to single digits for the first time in two decades, but also forged societal consensus on the maladies of inflation and the need for restraint on the government's temptation to practice populist policies which the budget could not finance (Kaufman 1994).

Yet despite these factors that argued in favor of a strong inflation-fighting central bank, Mexico found itself on the brink of an inflationary crisis in December 1994 following the peso devaluation. Why did the same factors such as electoral timing or regime type, which favored successful central bank reform in Chile, or the presence of strong anti-inflationary sentiments, which supported drastic institutional reform in Argentina, not also lead to sustainable low inflation in Mexico following the creation of an independent central bank in 1994?

Undoubtedly, some of the inflationary tendencies touched off by the December 1994 devaluation could be attributed to overly pesimistic predictions about the state of the Mexican economy. When investors hold overly pessimistic expectations and fear a devaluation, they will try to convert peso holdings into dollars, which weakens demand for pesos and precipitates a fall in the peso's value. Thus, fears alone of a devaluation may give rise to the devaluation itself and the concomitant inflationary pressures due to rising import prices.

This overcompensation of the market notwithstanding, Mexico's monetary crisis was also attributable to the central bank's monetary policies in the eight months preceeding the December 1994 devaluation. Beginning in March 1994, when Mexico entered the thick of presidential campaigning, the central bank increased the money supply by over 20 percent (IMF 1995), presumably with the intention of boosting the PRI's chances of victory in the upcoming elections. Further, the central bank did not release information on the low level of foreign reserves until after the presidential election, for fear that doing so would force an earlier devaluation and weaken the PRI's electoral prospects. Such policies suggest that, despite its independent legal status, the Bank of Mexico was not as insulated from executive influence as originally purported. The Bank of Mexico has indeed suffered a severe blow to its institutional credibility. As the case of Venezuela will illustrate next, such a crisis of credibility has long-run consequences that are not easily overcome.

Venezuela

Like many central banks in Latin America, the Banco de Venezuela exhibited few characteristics of legal autonomy. Prior to reform efforts in 1992, it did not exercise exclusive control over formulating monetary policy but instead shared some responsibilities with the government. During conflicts with the executive branch, the central bank did not always have the final word. In one notable incident the government actually sought and obtained a ruling from the Venzuelan Supreme Court ruling to reverse a central bank decision to lift interest rate ceilings. Yet despite these legal deficiencies, Venezuela maintained a remarkably low inflation rate until the 1980s. Hausman (1990) attributes this to the "fiscal deficit aversion" of Venezuelan policymakers whose tendencies to run deficits were

proscribed until the 1980s by legal requirements for a balanced budget and limits on public credit expansion.

This strong anti-inflationary record collapsed in the 1980s when Venezuela confronted the structural adjustment crisis that had plagued other Latin American countries. According to Naim (1993), the complacency of oil-led growth disguised structural imbalances in the Venezuelan economy which had been developing over years and later precipitated the inflation and fiscal crisis of the 1980s.[6] Successive stabilization plans had failed, and by the late 1980s the state was facing virtual fiscal insolvency.

In 1989 Venezuelans elected Carlos Andres Perez as President. Although he campaigned on a populist platform, once in office Perez espoused the same deficit reduction and trade liberalization policies of other neoconservative leaders such as President Salinas of Mexico. Perez's reforms were immensely unpopular both among the public (who rioted following a bus-fare increase in 1989, leaving 60 people dead) and the military. Two failed military coups in 1992 and corruption charges were enough to drive Perez from office later that year, but not before the Venezuelan Congress passed legislation giving the central bank control over monetary policy and a floating exchange rate. Perez appointed a new six-person board headed by Ruth de Krivoy, a strong proponent of monetary conservatism, whose five-year term would outlast the chief executive's by one year. However, by stipulating that the president and directors could be removed for a variety of reasons such as "failure to perform the responsibilities of the position," the new law preserved opportunities for governmental interference in monetary policy-making (*Financial Times,* June 23, 1993).

As restructured in 1992, the Banco de Venezuela could not be considered as successful in maintaining price stability or resisting executive pressures as central banks in Chile or Argentina. In practice, the bank has been unable to preserve low inflation, which rose from 31 percent in 1992 to over 100 percent in 1994. Moreover, the 1992 reform legislation still maintains provisions for unseating governors, a problem that has hindered the bank's ability to resist executive pressures to manipulate monetary policy for political gain. For example, in April 1994 central bank president Krivoy and half the central bank board resigned after newly-elected President Rafael Caldera pressured the bank to lower interest rates. She and her three colleagues have since been replaced, thus giving *calderistas* a majority on the central bank board.

The failure of Venezuela's central bank to assert its position as an inflation-fighting force once legally liberated from the executive branch raises several concerns about the essential preconditions for successful central bank reform. Comparisons to Chile, Argentina, and Mexico yield some insights. As in Chile and Mexico, central bank reform in Venezuela was proposed near the end of tenure for a chief executive who had initiated significant policy reform in his country. His efforts can thus reasonably be interpreted as an attempt to institutionalize reforms under his administration and thereby prohibit his successor from retrenching. However, Venezuela's regime type and prevailing economic conditions further complicated the reform process. Unlike Pinochet or Salinas, who as chief executives in dominant or one-party systems could successfully manage their departures from office, Perez was not empowered to do likewise. The Venezuelan president enjoyed few of the broad institutional powers afforded by the Mexican or Chilean presidencies or the political capital controlled by their respective party apparatus. With less lawmaking discretion than either Salinas or Pinochet, Perez could not push through extensive central bank reform easily. Instead of proposing to further lengthen governors' terms or to prohibit the chief executive from unseating governors, Perez settled for more modest measures. Electoral position may have provided the opportunity for reform, but regime type did not guarantee the creation of a strong central bank to consolidate reform.

Venezuela also differed from Argentina and Chile in terms of the prevailing economic conditions at the time when central bank reform was proposed. In 1992 when central bank autonomy was first proposed by Perez, inflation still hovered around 30 percent annually. By contrast, Argentina and Chile's inflation rates were under 20 percent and were declining. Both the Argentine and Chilean governments had not only proven capable of lowering inflation, but had also shown a commitment to policies over a sustained period which kept inflation at low levels. Only after having established this credibility as inflation fighters could the Chilean and Argentine governments then transfer such powers to a central bank which would lock in these reforms. Venezuela's central bank lacked the benefit of such a "credibility transfer." Furthermore, President Perez was ousted from office before he could lower inflation significantly and begin the process of consolidation with some measure of credibility.

Venezuela's experience highlights the notion that legal central bank reform is a necessary but not sufficient condition for institutionalized reform consolidation. Equally important are bank legitimacy and credibility. Legitimacy refers to the notion that policymakers and the public alike acknowledge the importance of price stability and designate the central bank as the most appropriate guarantor of this policy. Credibility flows from legitimacy in that the actions of a central bank will not be taken seriously by the financial community or labor leaders unless those actions are seen as being within its legitimate mandate.

As rational expectations adherents have argued, the credibility of central bank actions are indeed critical for price stability. According to these theories, inflation is partly determined by the expectations of the government and of the public as each tries to forecast the other's move and act strategically in response. If the public expects the monetary authority to run an inflationary policy, producers will seek higher prices, labor will demand higher wages and investors will ask for higher interest rates. Inflation's impact is compounded by expectations, which further complicate the stabilization process. Given the importance of expectations, governments try to promote institutional changes such as increasing central bank autonomy that, in addition to exercising tangible control over monetary policy, also alter the psychological elements of inflation by reducing inflationary expectations. According to inertial inflation theorists, a government that seriously espouses low inflation should support central bank independence in an attempt to influence long-term expectations.

Part of the Bank of Venezuela's weakness is that it lacked sufficient credibility to either influence expectations or resist pressures from the chief executive. The mere promulgation of a new central bank charter was insufficient to influence expectations among consumers or financiers without a commitment from the government to cut the fiscal deficit. Thus inflation persisted despite central bank reforms. Further, the resignation of the central bank governors demonstrated that despite legal reform, the chief executive still influenced monetary policy in Venezuela. Though the resignations of Krivoy and her colleagues were voluntary, a major personnel change in the central bank was rumored from the time Caldera assumed office. Given these limitations, the outcome of Venezuela's experiment with central bank autonomy are not unexpected.

Conclusions and Policy Implications

The experiences of Mexico and Venezuela with inflation stabilization illustrate that policy reform is not always a linear process. Countries that may at one point undertake significant structural overhauls may find their efforts reversed by an administration that does not share their policy preferences or by external developments which jolt a fragile policy infrastructure. Having traversed the political minefield of inflation stabilization, IMF conditionality, and deficit reduction in the 1980s, Latin American countries are finding that an additional obstacle remains, reform consolidation. The notion that policy reforms cannot be self-sustaining without complementary institutional arrangements has proven painfully true in both Venezuela and Mexico.

At the same time, it is clear that institutional reforms that lack political commitment are equally dangerous. Disingenuous attempts at central bank reform by one administration may in fact inhibit the ability of policymakers to establish sustainable reforms in the future by reducing the credibility of bank actions. Such is the challenge faced by the central banks of Venezuela and Mexico.

Given the need for consolidation mechanisms and the potential loss of credibility from half-hearted attempts, policymakers undertaking central bank reforms in Eastern Europe, the former Soviet Union, or elsewhere in Latin America would be well-advised to look toward the experiences of Argentina, Chile, Mexico, and Venezuela. A review of both the theoretical literature and case studies in Latin America yields several conclusions about the relationship between autonomy and price stability and about the political conditions under which central bank autonomy can be an effective means of reform consolidation. First, legal independence is not an automatic predictor of low inflation in developing countries given the relative youth of central banks as institutions in these countries and the lesser weight placed on adherence to the rule of law. Thus, an explanation of central bank behavior must delve more deeply into nonlegal measures of independence and the political context of reform efforts.

Second, even though legal measures of central bank independence are a poor predictor of price stability in developing countries, many governments are nonetheless moving to make their central banks legally independent of the executive branch. This move should not be viewed cynically as a token gesture toward

autonomy that will be disregarded when convenient. Rather, the cases of Chile and Argentina illustrate that this policy shift reflects an evolving consensus among policymakers that price stability is a reasonable, if not essential, policy goal. Further, the experiences of the countries studied suggest that reform-minded governments should strengthen institutions to accomplish this end. Intolerance of inflation is becoming an increasingly embedded notion in the political culture of formerly high-inflation countries in Latin America. This changing political culture acts to both encourage policy reform and lend credibility to institutions established to preserve anti-inflationary interests. In addition, public proposals for legal central bank independence also signal investors that the value of their assets will not be eroded by excessively inflationary monetary policies, a critical assurance in an age of increasing capital mobility.

Third, successful reform efforts have been implemented by outgoing regimes which attempted to consolidate broader structural reforms before leaving office. While regime type may have facilitated policy reform in Mexico and Chile, it is not clear that such a structure is a precondition of reform everywhere. In Argentina for example, President Menem successfully levereged the public's intolerance of inflation to create an independent monetary regime even though he lacked the broad executive powers of Pinochet or Salinas. However, a more in-depth test of the regime type hypothesis will require examining future reform efforts by additional countries with democratic political structures. Lacking absolute presidential powers to push through reform, those leaders will need to use other means of building societal consensus, such as capitalizing on an inflationary crisis or a strong public aversion to inflation. This tactic is particularly important in the emerging democracies of Eastern Europe and the former Soviet Union.

Fourth, successful central bank reform has been a preventive measure to preclude backsliding once inflation has been stabilized rather than a remedial measure to subdue hyperinflation. Legal central bank autonomy is not in itself a sufficient measure for curing inflation. As the case of Venezuela illustrates, mere legal reform without a true government commitment to fiscal stability will prove unsuccessful in the absence of government commitment to deficit reduction. Indeed, it may hinder the credibility of future reform efforts.

Finally, a central bank's long-term effectiveness in consolidating price stabilization hinges on its credibility. Legal charters granting autonomy are critical in this process, but they are not sufficient, especially in countries where the chief executive is unaccustomed to restrictions on the exercise of power. The best, in fact primordial, condition for bank credibility is *inflation stabilization prior to bank independence.* Credibility can also be created by a strong leader committed to price stability (Menem or Pinochet), a sustained period of low inflation (Chile), or an appeal to anti-inflationary sentiments among the populace (Chile and Argentina). Without such credibility, attempts to make central banks legally autonomous will prove unsuccessful at securing long-range price stability and reform consolidation.

Notes

[1]The potential for conflict of interest is evident from the board's composition. See Marshall (1989, 41).

[2]CORFO (Corporación de Fomento de la Producción), founded in 1939, was partially financed through commercial bank loans made at only a 2 percent annual rate, payable over 50 years. Banks were encouraged to extend such generous terms by the central bank, which counted these loans against the branch banks' reserve requirements owed to the central bank. The effect was the same as if CORFO had been subsidized directly by the central bank. For a discussion of the relations among CORFO, the central bank, and the industrial sector, see Marshall (1991).

[3]Aylwin's claim was partly motivated by the belief that General Pinochet was planning to hand over too little power to the successor government. See "Chile Plans to Create Strong Central Bank," *New York Times*, October 23, 1989, p. D14.

[4]For example, the Central Bank routinely covered capital and foreign exchange losses, as well as the outstanding debt from banks liquidated in the financial crisis earlier in the 1980s. See World Bank (1993).

[5]The deputy governor's terms are structured so that by the fourth year of a six-year administration, the President will have appointed three of the five sitting governors, giving him a majority on policy decisions, should he choose to exercise it. In contrast, the U.S. President can name only two of the seven Federal Reserve members during a single four-year term.

[6]According to Moises Naim, Minister of Industry during the 1980s, policymakers' complacency with oil-led growth-led policymakers to ignore the importance of coordinating or at least monitoring other indicators such as the exchange rate, interest rates, trade policy, or industrial policy. The result was rigid policy framework ill-suited to cope with external shocks such as the second oil crisis of the 1970s. See Naim (1993).

References

Alesina, Alberto. 1988. Macroeconomics and politics. *NBER Maccroeconomic Annual 1988.* Cambridge: NBER.

———. 1989. Politics and business cycles in industrial democracies. *Economic Policy* (April): 55–98.

———, and Lawrence Summers. Central bank independence and macroeconomic performance: Some comparative evidence. *Journal of Money, Credit and Banking* (May): 151–62.

Castello-Branco, Marta, and Mark Swinburne. 1992. Central bank independence. *Finance and Development* 29 (March):19.

Codevilla, Angelo. 1993. Is Pinochet the model? *Foreign Affairs* (November).

Collyns, Charles. 1983. *Alternatives to the central bank in the developing world.* Washington, D.C.: International Monetary Fund.

Cross, Sam. 1994. Following the Bundesbank:The spread of Central bank independence. *Foreign Affairs* (March).

Cukierman, Alex. 1992 *Central bank strategy, Credibility and independence.* Boston: MIT.

Cukierman, Alex, Steven Webb, and Belin Neyapti. 1992. Measuring the independence of central banks and its effect on policy outcomes. *World Bank Economic Review* 6 (September): 353–98.

Downes, Patrick, and Reza Vaez-Zadeh, eds. 1991. *The evolving role of central banks.* Washington, D.C.: International Montary Fund.

Fontaine, Juan Andrés. 1989. Banco central: Autonomía para cauteler la estabilidad. *Cuadernos de Economía* 77 (April): 65–74.

Foxley, Alexandro. 1983. *Latin American experiments in neo-conservative economics.* Berkeley: University of California Press.

Financial Times, various issues, 1989–90.

Grilli, Vittorio, Donato Masciandaro, and Guido Tabellini. Political and monetary institutions and public financial policies in the industrial countries. *Economic Policy* 13 (October): 341–92.

Haggard, Stephan, and Steven Webb. 1994. *Voting for reform: Democracy, political liberalization and economic adjustment.* New York: Oxford University Press.

Haggard, Stephan, and Robert Kaufman, eds. 1992. *The politics of economic adjustment*, Princeton: Princeton University Press.

Hausman, Ricardo. 1990. Venezuela. In *Latin American adjustment: How much has happened?* ed. John Williamson. Washington, D.C.: Institute for International Economics.

Herrera, Genaro Arriagada, and Carol Graham. 1994. Chile: Sustaining adjustment during democratic transition. In Stephan Haggard and Steven

Webb, *Voting for reform: Democracy, political liberalization and economic adjustment.* New York: Oxford University Press.

International Monetary Fund. 1967. *Central bank legislation.* Vols. 1 and 2. Washington: International Monetary Fund.

International Monetary Fund. 1995. *International financial statistics.* Washington, D.C.: IMF.

International Monetary Fund. 1992. *World economic outlook.* Washington, D.C.: IMF.

Kaufman, Robert, Carlos Bazdresch, and Blanca Heredia. 1994. Mexico: Radical reform in a dominant party system. In Stephan Haggard and Steven Webb, *Voting for reform: Democracy, political liberalization and economic adjustment.* New York: Oxford University Press.

Márquez, Javier. 1983. La banca en México: 1830–1983. *El Trimestre Económico* 50, no. 200 (October–December): 1873–1914.

Marshall, Jorge. 1989. Independencia o autonomía del banco central? *Cuadernos de Economía* 77 (April): 41.

Marshall, Jorge. 1991. Políticas monetarias seguidas en Chile desde la creación del banco central. *Cuadernos de Economía* (April): 29–54.

Maxfield, Sylvia. 1994. Financial incentives and central bank authority in industrializing nations. *World Politics* 46 (July): 556–88.

Morris, Felipe. 1990. *Latin America's banking system in the 1980s.* Washington, D.C.: The World Bank.

Naim, Moises. 1993. *Paper tigers and minotaurs: The politics of Venezuela's economic reforms,* Washington, D.C.: Carnegie Endowment.

New York Times, various issues, 1989–94.

Pollard, Patricia. 1993. Central bank independence and economic performance. *Federal Reserve Bank of St. Louis Review* 75, no. 4 (July): 21.

Rosende, Franciso, and Luis Oscar Herrera. 1991. Teoria y política monetaria:elementos para el analysis. *Cuadernos de Economía* 83 (April): 55–93..

Toniolo, Gianni, ed. 1988. *Central banks' independence in historical percpective.* Berlin: Walter de Gruyter.

Volcker, Paul, and Miguel Mancera. 1991. *Perspectives on the role of a central bank.* Washington, D.C.: International Monetary Fund.

Williamson, John. 1994. The political conditions for economic reforms. In *The Political Economy of Policy Reforms.* Washington, D.C.: Institute for International Economics.

World Bank. 1993. *Argentina : From insolvency to growth,* Washington: World Bank.