

**PATTERNS OF INSTITUTIONAL CHANGE AND  
EXTERNAL COMPETITIVENESS IN NEOLIBERAL AND  
DEPENDENT POLITICAL ECONOMIES.  
THE CASES OF CHILE AND ESTONIA**

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Submitted to  
Central European University  
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In partial fulfilment of the requirements for the degree of Master of Arts in  
Political Science

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Budapest, Hungary  
(2011)

*"plus ça change, plus c'est la même chose"*

(Jean-Baptiste Alphonse Karr, 1849)

## ABSTRACT

This research studies the ways neoliberal and dependent political economies change their institutions to enhance competitiveness in the face of growing external vulnerability and processes of deindustrialization. The study draws on the identification of two research gaps: 1) the lack of systematic study of policy and institutional change in emerging political economies; 2) the neglect in the mainstream approaches to capitalist diversity of institutional change in political economies that show predominantly liberal institutions.

In order to fill these gaps this research proposes an analytical framework based in the notion of institutional hierarchy, and its exploratory application to study the patterns of institutional change in policies affecting external competitiveness. Two case studies are conducted, Chile and Estonia. These countries have been selected on the basis that they present important similarities in the adoption of a radical neoliberal path, as well as analogous vulnerabilities with respect to external downturns in economic activity and loss of competitiveness. The research concentrates on exchange rate regimes and industrial policies, studying on how these policies are set in a track and how they change in certain tuning points highlighting the sources, agents and modes of change.

The research shows that in order to maintain the stability of a neoliberal track in a dependency context, political agents engage in constant processes of change or *adjustment*. On the other hand, while exchange rates tend to change towards the liberal end, industrial policies show a tendency to change towards an increasing embeddedness, reflecting the higher hierarchy attributed to the former. In the context of an increasing loss of competitiveness and growth of non-tradable sectors such as finance and real estate, the capacity of agents seeking higher degrees of embeddedness is tied to the extent this hierarchy can be sustained over time.

*I would like to thank my supervisor Dorothee Bohle for her constant support and  
encouragement*

*This effort would have not been possible without the love and understanding of Malú*

*You are the real 'shinning star'*

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## LIST OF ABBREVIATIONS

BOE	Bank of Estonia
CBA	Currency Board Arrangement
CBC	Central Bank of Chile
ECLAC	Economic Commission for Latin America and the Caribbean (english for CEPAL, Comisión Económica para América Latina y el Caribe)
CIEPLAN	Corporación de Estudios para Latinoamérica
CLP	Chilean Peso
ECE	East Central Europe
EEK	Estonian Kroon
EMU	European Monetary Union
ER	Exchange Rate
EU	European Union
FDI	Foreign Direct Investment
FSU	Former Soviet Union
FX	Foreign Exchange
IMF	International Monetary Fund
ISI	Import Substituting Industrialization
LAC	Latin America
NER	Nominal Exchange Rate
RER	Real Exchange Rate
SME(s)	Small and Medium Enterprise(s)
VoC	Varieties of Capitalism



## INTRODUCTION

During the 1980s and 1990s radical liberalization processes took place in emerging political economies such as those of Latin America (LAC) and East Central Europe (ECE). In both regions these processes meant a recalibration of the role of the polity in the regulation of the economy that manifested in a decreased influence of the state in the provision of public goods and services and in the regulation of market relations.

The character of the transitions, the initial policy choices and the ways policies and institutions have been modified since then have had diverse implications for the post-transition political and economic dynamics giving rise to more or less stable patterns of development (cf. Bohle and Greskovits 2007a, 2007b). As a result, some countries have managed to re-embed the market forces in new forms of social and political regulation. In others, as is the case of countries like Chile in LAC and the Baltic States in ECE, the liberalization processes assumed a re-foundational neoliberal character that generated a pattern of development marked by a radical pursue of market reforms and the minimization of the role of the state.

Although regarded as successful in their transition processes and economic performance, political economies that followed this developmental pattern have been particularly sensitive to external turbulences. Adjustments to these shocks have generated acute social and economic downturns. They have, furthermore, undermined these countries' industrial base accentuating patterns of capital concentration and specialization in resource and/or labour intensive low-wage low-productivity sectors, putting a strain on these political economies ability to develop in a context of enhanced external pressures, economic volatility and increasing social exclusion.

Due to the external fragility and lack of active public policies to cope with external competitiveness, economic crises put a particular stress on the sustainability of neoliberal and dependent political economies. At the same time, economic crises can constitute an important driver of institutional and policy transformations, opening a window for changes in directions that permit a better regulation of the economy, increasing competitiveness and diminishing external vulnerability. Yet, countries that have followed these development strategies seem to persist in their chosen path, reaffirming their compromise to neoliberal policies after each crisis takes place.

Several questions arise from the described situation. *What mechanisms are behind this institutional persistence? Does it show the constitution of particular 'models of capitalism'? Does the observed institutional stability imply no change at all?*

The emerging literature on capitalist diversity in the east and the south that followed the adoption of market reforms in ECE and LAC has advanced a great deal in observing the variety of economic and social models that these political economies have given rise. Moreover, the initial concern of establishing the *models of capitalism* that were emerging in these regions (Kornai, Haggard, and Kaufman 2001, 2) has given place to a research more centred on tracing their transition paths, understood as processes setting patterns of development with distinctive performances (Bruszt and Greskovits 2009, 412). The accumulation of this literature has helped understanding the specificities of these developing region's capitalist institutional arrangements (Nölke and Vliegenthart 2009; Schneider 2009), including the study of the emergence of institutions and their structural couplings (Buchen 2005, 22ff; Schneider and Karcher 2010), the role of the state and other internal and external actors in their shaping (Bohle and Greskovits 2007b; Bruszt and Greskovits 2009), the institutional legacies affecting future institutional choices (Feldmann 2006, 842ff; Bohle and Greskovits 2007a, 444) and their performances in terms of patterned socioeconomic outcomes

(Bohle and Greskovits 2007a). Nonetheless, these works have not yet answered the question of what are the mechanisms that explain the persistence and reinforcement of the observed patterns and in what way the processes of institutional change help in their consolidation.

On the other hand, the debates on institutional change in advanced capitalist political economies have developed substantial analytical tools such as to understand modes of incremental change with transformative consequences (Streeck and Thelen 2005b) and the political settings and agents of change associated with them (Mahoney and Thelen 2010). Notwithstanding, they have not successfully shed light on the specific problems of how liberal institutions change. Indeed, the main point of controversy has been how the model of Coordinated Market Economy (CME) as represented by Germany in the original Varieties of Capitalism (VoC) version, changes in the face of the pressures of liberalization imposed by globalization (Streeck and Thelen 2005b, 2ff; Hall and Soskice 2001a, 54ff; Hall 2008, 64-66). The debate is, in this sense, focused on the issue of whether CMEs persist or whether they change enough to consider they no longer represent this formulation, but without this meaning a convergence to Liberal Market Economies (LME).

In this way, the literature has not paid enough attention to the specific mechanisms of change presented in economies with liberal institutional arrangements. They appear thus as a sort of meta-model that is not affected by the pressures of change affecting the 'less pure' mixed or coordinated models (Peck and Theodore 2007, 755ff; cf. also Goodin 2003).<sup>1</sup> What is more, the debates on changing CMEs have concentrated in endogenous change and have largely neglected the role of external agents and steep shocks, two major important drivers of change in non-advanced political economies (cf. for example Bohle and Greskovits 2007a).

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<sup>1</sup> Studies on institutional change in the U.S., the 'LME *par excellence*' can be found in Hacker in Streeck and Thelen (2005a).

Several new puzzles arise from these concerns: *How and in what direction do liberal institutions change? Do they present particular mechanisms of change in dependent political economies? Can steep and incremental change be combined in a common framework?*

The purpose of this research is to explore the mechanisms driving institutional change in policy domains that affect external competitiveness in neoliberal and dependent political economies. In order to attain this, the study explores two policy domains, exchange rate regimes and industrial policy, in two political economies from LAC and ECE: Chile and Estonia. The patterns of change of the two policy domains are analyzed from the moment of the transition understood as a critical juncture until they reach a point of maturity (cf. Mahoney 2001, 10-11). A deep examination is made on how these paths are set, how they persist in the context of turning points (political and economic), and the sources, agents and types of change involved.

The thesis shows that far from remaining stable, neoliberal and dependent political economies are crossed by different processes of change. The trajectories of the two policy domains analyzed combine steep transformation, path dependency and gradual change. The sources of change are diverse, ranging from learning processes, shifts in the balance of power and the politics of coalition formation. On the other hand, external sources do play a major role in the observed processes of change given the dependent character of the selected cases. The outcome of these processes is a patterned developmental path that is actively defended and steered by social groups interested in its continuity.

The thesis is structured in the following sequence. The first chapter explains the methodology of the study, presents the case studies and a brief outline of the plan of analysis. The second chapter gives an overview of the main theoretical underpinnings regarding institutional and policy change in the literature on capitalist diversity. The aim is to construct a theoretical framework that allows the integration of the discussions on institutional change.

The third and fourth chapters develop the case studies of Chile and Estonia. Both chapters are organized in order to present the critical juncture setting the initial path, the trajectory of change through different turning points, the main reasons why change did or did not occur and the outcome of the path. Each chapter is followed by a short conclusion drawing on the cases' lessons and their future prospects in terms of institutional change and external competitiveness. The thesis concludes highlighting the observed processes of change and how do these integrate into the discussions on institutional change and capitalist diversity.

## **CHAPTER 1. METHODOLOGY**

The present study aims to understand the processes of institutional change that generate and reinforce specific policy frameworks in the field of external competitiveness. Its intention is to recognize the interdependent character of these processes and their interplay at different levels of analysis, as well as their political nature. In order to tackle this, the study draws on a qualitative exploratory study resting on the tradition of historical institutionalism and the utilization of case studies as a research technique.

This study echoes two of the characteristics of contemporary historical institutional analyses (Pierson and Skocpol 2002, 695): 1) a focus on "big, substantive questions" of public interest such as the sustainability of an extreme neoliberal development path in dependent political economies, and 2) the analysis of how institutional configurations change with attention to critical junctures and long-term processes. In the context of the exposed purposes, historical institutionalism provides grounds for tracing transformations in time, specifying historical sequences and studying the combined effects of institutions and processes (Pierson and Skocpol 2002, 693).

Following Pierson and Skocpol (2002), the investigation of patterns and processes requires a careful examination of the contexts and the history of the mechanisms behind them. Qualitative research is indeed, the best way of attaining these considerations, since it provides tools that improve analytical leverage by facilitating detailed contextual and case knowledge (Brady, D. Collier, and Seawright 2004, 10; McKeown 2004, 145). Case studies are especially suitable for this purpose, given that they provide close knowledge of the cultural, historical and political contexts in which historical processes take place, allowing for a better identification of historical causal mechanisms (Munck 2004, 112; McKeown 2004, 145). In this context, case building becomes a heuristic device that provides grounds for the

clarification of theoretical relationships, helping in the construction of hypothesis that can be tested in other cases (McKeown 2004, 157; 167; Munck 2004, 112). In this sense, "analytically oriented historical case studies" (Rueschemeyer 2003, 319) provide an important basis to investigate long sequences of historical developments offering "a large number of theoretically relevant observations that rule out or suggest the revision of a whole series of propositions" (Rueschemeyer 2003, 311; cf. also Pierson and Skocpol 2002, 697).

Given that this research intends to advance in a field of research that has not yet been explored by existing studies (cf. Peck and Theodore 2007, 755ff), it assumes an exploratory character. This means that the investigation does not allow for a systematic comparison between the cases in the sense of giving light of the "impact of factors that differ across cases" (Rueschemeyer 2003, 322). Instead it will offer novel insights and provide new hypothesis about the processes of institutional change in general, and how they operate in neoliberal and dependent political economies in particular.

Following Falleti and Lynch (2009, 1157) the analysis will consider the starting and endpoints of different institutional layers that affect directly the policy domains under study i.e. different policies that interact with the exchange rate and the industrial policy in affecting competitiveness. The division of the process in institutional layers that bear different starting and ending points will help addressing the interactions between processes moving at different speeds that condition the patterns of institutional change beyond the occurrence of certain specific junctures (cf. Falleti and Lynch 2009, 1157-8; also more generally Pierson 2003).

### **1.1 *Policy areas and the direction of change***

This research is concerned with the institutions that rule the relations of domestic economic agents with the external economy and that constitute a crucial determinant for the

competitiveness of the political economy. It will focus on two such policies or set of policies: the exchange rate (ER) regime and the industrial policy.

The ER constitutes a fundamental relative price in the economy (Frenkel and Rapetti 2010, 10). At a micro level, producers use it to calculate the costs of imported supplies as well as their gains in local currency per exported unit. In this sense, the competitiveness of the export sector is largely influenced by the ER regime. At a macro level, it also affects the behaviour of key indicators such as the balance of payments and the rate of economic growth. Furthermore, it has an important influence on other economic policy objectives such as price stability, and domestic financial stability (Frenkel and Rapetti 2010, 10). In this sense, it affects domestic and external economic agents' prospects of the performance of the economy.

On the other hand, industrial policies define the economic agents' expectations for the return from the investment in existing and/o new economic sectors by providing a regulatory framework, a common set of public goods (infrastructure, access to markets, a general level of training and education, etc.), targeted incentives and/or direct subsidies, among others. In terms of competitiveness, industrial policies are responsible for the development of comparative advantages enhancing the ability of companies to compete, identify niches and/or establish new markets in the international markets.

Both policy domains will be operationalized in order to be able to identify the direction of institutional change.

### **1.1.1 Exchange rate regime**

The ER can be formally defined either as "the relative price between domestic traded and non-traded goods or as the relative price between similar bundles of goods traded abroad and domestically" (Frenkel and Rapetti 2010, 9). The exchange rate *regime*, on the other hand, refers to the set of policies that govern the real exchange rate (RER) through the impact on the nominal exchange rate (NER). It includes the definition about how it is calculated, and



defines the actions that are expected from the government and other public bodies (e.g. the central bank) in order to comply with the established rule i.e. defines the degree of intervention in the foreign exchange (FX) market and other relevant domestic variables. In this sense, it sets expectations about the degree of commitment of the authorities in the determination of the NER (Frenkel and Rapetti 2010, 11).

There are two extreme exchange rate regimes that constitute a minimal degree of intervention from the government. The first is a pure floating ER where the definition of the NER is left exclusively to the forces of the market i.e. it depends entirely on the transactions private and public agents develop with FX. The other liberal pole is represented by a fix ER, particularly the one that supposes the adoption of a foreign currency "giving up the sovereign right of issuing its own currency" (Frenkel and Rapetti 2010, 11). In this case, the government not only has no decision whatsoever regarding the NER, but what is more, a foreign authority makes that decision. A fix ER grants lesser degree of government intervention given that in addition it binds monetary and fiscal policies. This is particularly important in the case of economic shocks where under floating ER regimes, monetary policy and fiscal policy can be used, while with fixed ER (especially regimes guaranteeing full convertibility) the burden of adjustments falls on domestic relative prices and the real economy (OECD 2000, 78). Furthermore, pure floating ER regimes are in practice difficult to find, given that governments reserve themselves the possibility to intervene when they find it strictly necessary.

Between these two extremes there is a wide range of possibilities countries can adopt that reflect diverse degrees of government discretion in their definition and enforcement. The more 'interventionist' regime is multiple ER that in practice entails the active management of different regimes at the same time.

Exchange rate regime	Examples	Description	Degree of government discretion
<i>Fixed</i>	"Dollarization" ("euroization")	A country stops issuing its own currency and adopts a common currency with other nations or one issued by some other country.	-
	Currency board	Explicit legislative commitment to fix the NER at certain parity. The authority guarantees full convertibility of FX.	
	Adjustable peg	Authorities commit to defend a particular parity, but reserve the right to change it under certain circumstances.	
<i>Managed</i>	Crawling peg Formula-variant	Authorities pre-commit the future path of the ER given the expectations of evolution of the economy.	
	Crawling peg Decision-variant	Authorities peg the local currency to a foreign currency –or to a basket of currencies– but adjust the rate gradually over time in a series of small corrections.	
	ER bands or Crawling bands	Authorities set margins for ER flotation and intervene when it hits the margins. The margins can be adjusted gradually over time following some rule.	
	Multiple exchange rates	Authorities impose restrictions on FX transactions. Different regimes and/or parities are devised according to the type of agents and operations.	+
<i>Floating</i>	Managed floating	Authorities are not committed to defend any particular rate, but nevertheless intervene in the FX market at their discretion.	
	Pure floating	Commitment of the monetary authority not to intervene in the market, leaving the NER to be determined by the FX market.	-

**Figure 1. Exchange rate regimes and degree of government intervention**

Source: author's elaboration based on Frenkel and Rapetti (2010, 11-13).

The relation of the exchange rate regime to other policy sectors considered here refers mainly to what is called the *policy trilemma of an open economy*.<sup>2</sup> Policymakers are confronted with three related policy decisions: i) the stabilization of the exchange rate, ii) enjoying free international capital mobility, and iii) the utilization of monetary policy for domestic purposes. The trilemma dictates that only two of the three can be simultaneously consistent; policymakers have thus to decide which one of them to give up. In this sense,

<sup>2</sup> Cf. Obstfeld Maurice, Jay C. Shambaugh and Alan M. Taylor. 2005. "The Trilemma in History: Tradeoffs Among Exchange Rates, Monetary Policies, and Capital Mobility" in *The Review of Economics and Statistics*, 87 (3): 423-438.

policy decisions regarding the control of prices and the capital account have a direct impact in the decisions about the ER regime. Additionally, given the effects of public spending in the aggregate demand i.e. in the evolution of prices, fiscal policy is also considered to be a policy domain that affects the performance of the ER regime.


### **1.1.2 Industrial Policy**

In a general way, industrial policy can be defined as the set of government interventions directed to promote particular patterns of industrialization (cf. Kosacoff and Ramos 1999, 38). It includes market regulation that supposes the setting of common standards, enhancing and supervision of competition, and the availability of information; it also affects the cost and availability of the factors of production such as capital (by regulating financial markets), labour (providing an educational and skills formation system) and technology, and affects indirect production costs (e.g. through taxes and subsidies) (cf. Kosacoff and Ramos 1999, 50)

The poles of industrial policy are given by the view about how comparative advantages emerge. On the one hand, comparative advantages are said to be natural. In this sense, the invisible hand of the market selects the competitive sectors and any government intervention would only hinder private actors to pursue them and provoke inefficiencies. On the other, they are said not to be natural but constructed. In this case economic institutions are seen to actively affect economic agents' decisions. Given that comparative advantages are not natural, but generated by a certain institutional framework, active state intervention is crucial to foster them. These visions also differ in the assumptions they make about how economic markets function and the capacity of governments to overcome market failure (Kosacoff and Ramos 45).

Three alternative visions of industrial policy arise from these considerations (Lall in Kosacoff and Ramos 45): the neoclassical vision, the facilitating or "market-friendly" and the

structuralist or developmentalist (see figure 2). In the first, all markets are considered to be perfect, thus any intervention presupposes distortions to the most efficient allocation of resources. The second believes that markets suffer recurrent failures often due to high transaction costs, especially in emerging economies. Thus, interventions that do not hinder the market mechanisms but correct them are desirable. Here there is an -often explicit- idea that government failures are always worse than market failures, therefore intervention should be minimal and narrowed to 'levelling the playfield' for economic agents. Conversely, the third standpoint expresses that government intervention is necessary to foster industrialization and development. Given that each sector has its own characteristics and market failures affect them differently, selectivity of state interventions is crucial (Kosacoff and Ramos 45-6).

Industrial policy regime	Examples	Description	Degree of government discretion
<i>Neoclassical:</i> No market intervention or only to protect market competition	Neutral state a/  'Regulatory state' b/	Industrial policy reduced to market regulations. The role of industrial policy is expected to be played by other policy domains i.e. liberalization and international integration.  The state assumes an active role in supervising market competition i.e. by establishing anti-trust agencies and other supervisory bodies.	- 
<i>"Market friendly":</i> Tackle market imperfections though functional interventions	Microeconomic policies a/  Horizontal promotion c/	The role of industrial policy is to reduce costs i.e. flexibility of labor markets, reduction of taxes, and other business support measures  Rests on the recognition of recurrent market failures that can be specific to certain sectors (i.e. SMEs). Provision of an array of public measures understood as a common infrastructure that levels the playfield, but does not privilege any sector in particular.	
<i>Developmentalist:</i> Actively induce a pattern of industrialization through selective interventions	'Flexible developmental state' d/  'Bureaucratic developmental state' d/	Mediate global connections (build local networks around global capital, help local innovations get global), flexible state structure, embedded in professional networks and foreign capital  Strategic use of protectionism, selective subsidies, embedded in domestic capital, importance of state bureaucracy	+

**Figure 2. Industrial policy regimes and government intervention**

Source: author's elaboration based on diverse sources. a/ Kosacoff and Ramos (1999); b/ Muñoz, O. 1992. "El Estado Regulador" en *Después de las privatizaciones. hacia el estado regulador*, ed. O. Muñoz, Santiago: DOLMEN. c/ Román (2003); d/ O'Riain, S. 2000. "The Flexible Developmental State: Globalization, Information Technology, and the Celtic Tiger." *Politics and Society*. 28 (2): 157-193.

## 1.2 Cases

The selection of cases has followed the requirements of the qualitative method, i.e. it has been theoretical (cf. Brady, D. Collier, and Seawright 2004), trying to find political economies that share a neoliberal and dependent political economy and where liberalization processes were implemented by a critical juncture. The regions of ECE and LAC offered a good universe where to find the best cases, given the coincidence of changes of political system and liberalization. Two cases were selected, Chile and Estonia, which represent the most extreme patterns of neoliberal development (Bohle and Greskovits 2007a) in LAC and ECE respectively. Both countries engaged in acute liberalization processes under critical junctures generated by particular economic and political conditions in the 1970s and 1990s, respectively, which implied a drastic shift from previous strong *dirigiste* economic models assumed after the World War II. While Estonia was under the Central Command Soviet economy, Chile adopted an ISI model characterized by strong state intervention that radicalized over time.

Both countries experienced growth averages of more than 7%<sup>3</sup> for more than a decade catching the attention of scholars and policy analysts from all over the world, being regarded as examples for other developing countries<sup>4</sup>. At the same time, both have been submitted to the fluctuations of the international economy and have been especially susceptible to external crises and capital movements, loosing their industrial capacity with the consequence of a loss of external competitiveness.

Nowadays Chile and Estonia face severe challenges in terms of competitiveness. In the case of Chile, it is due to its enduring dependency on copper revenues that has not wither away despite important diversification in the past two decades, and more recently, the

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<sup>3</sup> Further historical data can be found in the annex.

<sup>4</sup> Indeed they have both received the denominations of *tigers* (or *jaguar* in the case of Chile), a nickname restricted to high growth economies. Estonia has also been called the 'Baltic shining star' or 'the little country that could' while the Chilean case has been labelled "the Chilean miracle".

emergence of *Dutch disease* symptoms. As for Estonia, it is because of its extreme dependence on capital inflows and external economic fluctuations, and an economic structure that biases investment towards non-tradable sectors, especially financial intermediation and real estate. As it will be seen, both situations are directly related to the neoliberal policy choices that these countries have made, and their processes of institutionalization.

Beyond these similarities, important -interrelated- differences have to be acknowledged: above all, these resort to politics, including political cultures, historical patterns of political mobilisation and cleavage formation, national-identity questions, and the character of the critical junctures.

In the case of *Chile*, an early independence from Spain in 1810 induced the formation of a state with a rather independent and efficient state bureaucracy that led to the emergence of middle classes from the late 1800s and especially during the 20th century with the expansion of the state under the ISI model. On the other hand, the development of the mining sector since the independence days and of the state's promoted industry under ISI, induced the formation of a politically mobilised working class represented by a centralized union federation (CUT) closely linked to left-wing political organizations. At the same time, business groups organized in '*gremios*' were important actors representing sectorial interests. The critical juncture -a reactionary military *coup d'etat* in 1973- is indeed directly related to the radicalization of the class struggle and the lags between political and economic democratization (cf. Ffrench-Davis 2003, 28-30) and can be read mainly as a capitalist re-foundation (cf. Diaz and Martínez 1996).

In spite of this 'accident', Chile constitutes one of the democracies with longer tradition of stability in LAC and enjoys a stable and developed western-like party system as well as a presidential system with high agenda-setting powers studded with a number of veto points (cf. Aninat, Londregan, Navia, and Vial 2008). The return to democracy in 1990 with

the restoration of the old political parties and cleavages and regular elections since then is a demonstration of it.

*Estonia* on the other hand, was under tsarist Russia until the First World War and fell under foreign domination again during the Second World War, after the invasion of the Germans first and the Red Army afterwards. The short period of independence in the interwar saw the emergence of some national institutions such as the Estonian parliament or '*Riigikogu*', the Bank of Estonia (BOE) and three political constitutions, the last dating from 1938 with a strong autocratic and corporatist flavour (Lauristin and Vihalemm 1997, 101).

After the World War II Estonia became part of the Former Soviet Union (FSU). Together with the suppression of national political institutions, it was subject to a large industrialization process, particularly in heavy industry, mining and energy sectors, and the importation of Russian speaking workforce that settled especially in the industrial regions close to the Russian border. Although the life standard was in average higher than in other Soviet republics, political activity and civil society organizations were suppressed as well as national symbols and costumes. The resistance movement emerged thus, mainly on the cultural field as a way to maintain folk traditions (Lauristin and Vihalemm 1997, 74-75).

The critical juncture -independence from the FSU- implied then, a simultaneous effort to form a new democracy, build a market economy and construct a nation. Given the history of occupation, an important driver of the process was the need to leave behind the Soviet past and reaffirm the national sovereignty in all fields. As a consequence, the political economy shows low degrees of organization, both at the level of employers and workers, and ethnic politics has undermined the capacity of the party system to constitute under a classic socioeconomic cleavage leading to high under-institutionalization and instability.

### **1.3 Plan of analysis**

To analyze the patterns of change of the exchange rate and industrial policy in both countries this study will follow the following plan:

- i. Review of the critical juncture and the way exchange rate regimes and industrial policies were set in a particular track (1973-1975 for Chile; 1989-1992 for Estonia). This will include the main political actors and their orientations, and an account of how alternatives were dismissed.
- ii. Analysis of the direction of change that arises from different economic and political turning points that present a possibility of diversion from the path, with the respective sources and agents of change. Emphasis will be made in the mechanisms that helped in the reproduction of the paths.
- iii. Analysis of the modes of change illustrated by each trajectory, highlighting the main factors that explain the patterns of stability and change of the exchange rate regimes and industrial policies.



## **CHAPTER 2.**

### **TOWARDS AN INTEGRATED FRAMEWORK FOR UNDERSTANDING INSTITUTIONAL CHANGE IN CONTEMPORARY CAPITALISM**

The development of institutional theory in the last decades has allowed comparative political economy to advance significantly in understanding the varied ways in which capitalist relations can be codified producing a diversity of modes of economic governance or *varieties of capitalisms* with distinctive performances in different socioeconomic outcomes (cf. Crouch and Streeck 1997; also Hall and Soskice 2001b; Boyer and Saillard 2001b; Amable 2004; also for non advanced political economies Bohle and Greskovits 2007a).

In their different variants (Streeck 2010, 17-23) these studies have generated a new wave of research that allowed the dismissal of the theories that predicted an inevitable convergence towards the free-market industrial type of capitalism and have showed the manifold institutional foundations of contemporary political economies.

However, the literature on institutions, and especially the one working on capitalist diversity, has most of the time emphasized institutional stability over change and continuity over discontinuity. This "conservative bias" shows that the development of conceptual and analytical tools for understanding stasis has not been matched by equal efforts for understanding change (Streeck and Thelen 2005b, 16).

One of the main problems with respect to the appraisal of institutional change is said to lie in the very definition of institutions that makes them too rigid (Streeck and Thelen 2005b, 16; Mahoney and Thelen 2010, 4-7). Change is only possible either as a small adjustment that reflects the stability of certain models or institutional configurations, or as a steep transformation that entails a breakdown and replacement of old institutional arrangements.

In opposition to this, scholars have increasingly started to claim the existence of processes of gradual change with transformative consequences (Streeck and Thelen 2005a, 2; for a general account cf. Pierson 2003). According to them, the liberalization processes in advanced political economies have transformed institutions not in an abrupt manner, but rather as a long-run incremental process. Moreover, the outcomes of these processes are not always of continuity with the previous institutional arrangements; they can generate discontinuities with the previous rules by radically changing the social relations and the economic performance that previous institutions were responsible for (Streeck and Thelen 2005b, 8-9).

Furthermore, by loosening the definition of institutions and allowing imperfect compliance with the prescribed rules to play a major role in institutional change, these approaches have also opened a window to include economic policy, and public policy in general, in the analytical framework of institutional change.

Although these new insights to institutional change have permitted to widen the analytical leverage of institutional theory to understand current processes of adjustment and change, they have left several gaps in their way. First, explaining how liberalization processes lead the way of institutional change has conduced to focus on institutional change in what VoC calls Coordinated Market Economies (CMEs), i.e. political economies that rely on modes of economic governance different than free markets -e.g. networks, hierarchies, etc. In this sense, it leaves opened the question of what is the effect of this overarching and encompassing process on political economies that already rely greatly on market arrangements (cf. Peck and Theodore 2007, 755ff). Is liberalization the same under the two institutional settings or are there other processes in operation, perhaps following the opposite direction?

On the other hand, gradual liberalization seems to be a pervasive change path in most advanced political economies, but not necessarily outside the capitalist core. Indeed, in many cases and especially in those of LAC and ECE, the break with the post-war order was often abrupt and big transformations took place at the time liberalization pressures were being internalized. Is then institutional change in non-advanced political economies necessarily of the breakdown and replacement type or are there also processes of gradual but transformative change?<sup>5</sup>

The study of processes of institutional change in dependent political economies constitutes a prominent contribution to answer both questions. On the one hand, the liberalization process took place in an abrupt way, most of the time imposed by external or internal agents in the context of radical societal transformations preceded by critical junctures (Haggard and Kaufman 1992; Kornai, Haggard, and Kaufman 2001; Baer 2000). On the other hand, initial policy choices and institutions after the transition have been undergoing a process of consolidation that can be said to be closer to the type of incremental or gradual change in many cases (Falleti 2009; Bohle and Greskovits 2007a). Conversely, the legacies of old institutional traditions and practices generate further mechanisms of change (Bruszt and Greskovits 2009; Bohle and Greskovits 2007a), while external pressures play a decisive role in shaping policy choices (Stallings 1992).

This chapter will discuss the main theories of institutional change in the capitalist diversity framework. Firstly, a brief clarification of how the notion of institutions is used will be done, followed by some caveats to take into consideration when treating exchange rate regimes and industrial policy as institutions. The next points discuss the sources and agents of change stressing the particular conditions of dependent political economies. Afterwards, an attempt is made to combine theories of disruptive change and path dependency with theories

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<sup>5</sup> For an interesting attempt cf. Falleti (2009).

of incremental change -continuous and discontinuous. Finally a reference will be made to the direction of change.

## **2.1 *On institutions and policies***

Although it is not the intention of this study to deepen into the concept of institutions, given the relation between how it is defined and the way institutional change is conceived (Streeck and Thelen 2005b, x; Amable and Palombarini 2009, 127-8) a brief clarification will be necessary to understand the reach of the idea of institutional change here presented. This will allow, furthermore, to understand in what sense economic policies can be regarded as institutions and thus how far is it possible to use theories of institutional change to understand policy change.

Although definitions of what an institution is abound, a common frame to put them in relation with each other has been offered by Hall and Taylor (1996). Synthesizing the three approaches to institutions presented by the authors, rational choice, sociological and historical, it may be said that institutions constitute the building blocks of social life. They set a network of expectations for the coordination of social agents' interests and/or practices in different societal domains. They serve as action templates for routinely driven social exchanges but also as rules of the game and parameters that can be taken in consideration when engaging in strategic behaviour and rational decision-making.

In either case, as Streeck and Thelen point out, what is decisive about institutions is the possibility that a third party enforces compliance and sanctions deviance from the rules they prescribe (Streeck and Thelen 2005b, 11). The latter emphasizes the distributional character of institutions, i.e. they constitute a compromise solution for problems arising from the conflict between different interests and worldviews that are best represented by different sets of rules (Amable and Palombarini 2009, 130). Conflict is thus "institutionalized" when

rules decide between conflicting alternatives, generating winners and losers. The crucial points are, then, the legitimacy of rules and the extent to which social and economic actors conform to them.<sup>6</sup>

Although public policies do not seem to comply with the 'stickiness' and stability characteristics of institutions, different authors claim that they can be treated as such as long as they stabilize collective expectations that are enforced by a third party (Streeck and Thelen 2005b, 12; Pierson 2004, 35). Furthermore, as Pierson (2004, 165) points out, in modern societies public policies are the institutions that most affect the ordinary citizens' and the political actors' behaviours. This is especially true, following Streeck and Thelen, if institutions are understood as regimes (2005b, 12-13), i.e., if the possibility of imperfect compliance is considered as characteristic of any institutional dynamic. What becomes critical, then, is not only what the rule prescribes, but how rule takers perform it and the legitimacy of this performance given its embeddedness "in a societal context of supportive third parties" (Streeck and Thelen 2005b, 13). In this sense, economic policies that i) set expectations for economic agents' to pursue their interests and coordinate their actions, and ii) whose compliance is subject to public scrutiny -including sanctions for deviance and in some cases even law enforcement-, can be treated as institutions (cf. Pierson 2004, 35).

### **2.1.2 Exchange rate regimes and industrial policy as institutions**

Economic policies can be treated as institutions, but not all policies are institutions. The key is third-party enforcement. The case is easier to make for industrial policies which in general are regulated by law, and thus, can be enforced by specific regulations e.g. those

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<sup>6</sup> "The political struggle is a cognitive struggle 'for the power to impose the legitimate vision of the social world' (Bourdieu in Amable and Palombarini 2009, 130).

regarding the allocation of subsidies, or by more general dispositions regulating state transparency e.g. embezzlement of public funds.

In the case of exchange rate regimes, although they do stabilize economic agents' expectations with regard to external prices, these are usually enforced not by a third party but by the same concerned actors using mechanisms such as pressures and lobby and/or inflicting "reputational costs" to the defecting authorities (Frenkel and Rapetti 2010, 5). In this sense, they tend to resemble more a voluntarily agreed contract or a convention between private parties (cf. Streeck and Thelen 2005b, 11). It is necessary, then, to qualify the extent to which the chosen policy domains can be treated as institutions, especially exchange rate regimes.

First, following Streeck and Thelen's idea that rule makers and rule takers are not always perfectly defined in terms of their roles,<sup>7</sup> and that "[y]oung' institutions require elaboration of their meaning in practice, by a sequence of decisions on the part of rule makers as well as rule takers" (2005b, 30), it may be claimed that the policy areas hereby studied can be considered as institutions-in-their-process-of-consolidation. This is the can be considered as embedded in a process of policy development (Pierson 2004, 165-166), or more specifically a process of institutional building in emerging market economies following certain critical junctures.

In fact, as it will be seen, the character of the developmental paths followed by Chile and Estonia suggest that an important part of the changes observed might be understood as systematic attempts of certain groups to institutionalize the policies they regard as relevant. This can be observed especially in the case of the ER regime were the establishment of an independent Central Bank and the autonomization of certain policy decisions from the discretionary power of governments become central. In this sense, once policies are in place

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<sup>7</sup> They express that rule makers and rule takers are not always identifiable as opposite roles, and this certainly obscures the related enforcement practices. For example, they state that in a limit case, both rule takers and rule makers can be the same (Streeck and Thelen 2005b, 13). In this sense, the author's express, what is important is that their "relations and interactions (...) are crucial for the content and the evolution of the regime as such" (Streeck and Thelen 2005b, 13)

their institutionalization implies setting an enforcing third party. Institutionalization of these policy areas, including the creation of new public bodies in charge of their regulation (e.g. central banks, promotion agencies, etc.) can thus be regarded as forming part of the same processes of institutional change.

Finally, the inexistence of rigid and formal enforcement mechanisms does not mean that they cannot be accounted as institutions. On the contrary, it constitutes a characteristic of some institutions that endows the process of change with particular features (cf. for example Mahoney and Thelen 2010, 15ff). In this way, what is crucial is that we can establish a line between rule makers and rule takers, which is a key to understand "the content and the evolution of a regime as such" (Streeck and Thelen 2005b, 13).

## **2.3 On institutional and policy change**

### **2.3.1 Sources and agents of change**

In the previous points it has been highlighted as features of institutions that they represent interests and/or worldviews, are stabilized thanks to political compromises and are enforced by third parties, and leave space for non-compliance. These three elements also underline the ways by which institutions can change, namely, the diffusion of ideas, the exercise of power by different interest groups, and way they function. This research will be focused on two such sources: 1) shifts in the balance of power and 2) the way institutions work (cf. Mahoney and Thelen 2010, 9-10).<sup>8</sup>

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<sup>8</sup> Although this study does not refer explicitly to the role of ideas as a source of institutional change, it will be touched in terms of power relations. In this sense, the possibility of *policy learning* -"the deliberate attempt to adjust the goals or techniques of policy in response to past experience and new information" (1993)-, is codified in terms of the ability of ideas to modify the balance of power. See for example in Amable and Palombarini (2009, 130-1) the notion of the 'political battle as a battle of ideas'.

In order for these sources to actually trigger a change process, they need to be "activated" by certain political agents willing or not to generate change<sup>9</sup>. In this sense, distributional struggles and coalition politics always play a central role either by modifying the power to change institutions or their enactment. Two types of agents of change will be considered here: interest groups -including economic actors and their preferences- and political leaders or institutional entrepreneurs. While the first struggle to embedd -and maintain- their interests in institutions, the latter try to gain -or remain- in power using institutional change in an instrumental way to get support from different coalitional bases.<sup>10</sup>

Shifts in the balance of power allow new factions, social groups or coalitions to be able to modify the rules of a specific domain or various institutional domains in varied degrees, embedding their interests in institutions or balancing them with existing ones, thus changing the relative distribution between winners and losers. Also policymakers can get support from new groups or coalitions to undertake certain reforms that are resisted by the existing support base or dominant coalition. The degrees of freedom by which interest groups and/or political actors can engage in the formation of new coalitions and gain support will depend on the set of political institutions and the number of veto points in place.

On the other hand, imperfect compliance can produce a type of change that arises from the distance that is left between what the rule prescribes and how the actors enact it (Streeck and Thelen 2005b, 10ff; Mahoney and Thelen 2010, 14). In this way, institutional change does not only account for the replacement of one institution with another one -new or old-, but also to the modification of how the rule is interpreted and enacted i.e. by a change in

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<sup>9</sup> As Mahoney and Thelen argue "institutional change need not emerge from actors with transformative motives. Rather, institutional change can be an unintended by-product that grows out of distributional struggles in which no party explicitly sought the changes that eventually occurred" (2010, 23)

<sup>10</sup> Cf. on the latter Amable and Palombarini (2009, 156).



the "spirit" of the rule without having to change "the word of the rule" (Mahoney and Thelen 2010, 13).<sup>11</sup>

In this case, change depends on the properties of institutions defining the degree of interpretation left to rule takers i.e. their specific characteristics regarding compliance and enforcement. Here the characteristics of the enforcing third party become relevant. While policies in-their-process-of-institutionalization are easier to interpret, changing those that have clearly identified enforcing third parties and punishments for non-compliance is harder.

Related to the way institutions work is also a third element that constitutes a source of change as well but that is subordinated to the other two: institutional coupling or complementarity. In this study we will understand this as the functional relationship between two institutions that makes that the political support -or enactment- of one institution be closely related to that of other related institutions.<sup>12</sup> In this sense, two institutions are more functional -*complementary*- for the maintenance of certain interests or practices. Thus, a shift in one institution can generate by complementarity, a shift in another (cf. also Mahoney and Thelen 2010, 9).

### 2.3.2 Sources and agents of change in dependent political economies

East-Central Europe (ECE) and Latin America (LAC) share a similar position in the global context, namely, that of a dependency<sup>13</sup> on the flows of FDI to the financial and real sectors. This situation creates political economies that are characterized by the central role *hierarchical* relations exerted by external agents play in coordinating the main domestic

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<sup>11</sup> Logically, it can be said that a change in the "word of the rule" i.e. the actual codification of certain interest or worldview or goal, does not necessarily provoke change allowing for another source of 'change within stability'. This will be developed further in the discussion in institutional hierarchy.

<sup>12</sup> The functionality here mentioned should not be confounded with the *functionalistic* claim that two institutions need one another, or that only certain combination of institutions produce efficient outcomes as in VoC's idea (cf. Hall and Soskice 2001a, 17-21). It has to be understood in strict political and practical terms.

<sup>13</sup> Following Bruszt and Greskovits (2009), dependent development situations can be understood as "clusters of developmental constraints and enabling factors" (412) that are "rooted in the unequal distribution of resources, roles, and opportunities" (428) in the international division of labour.

economic activities and agents (cf. Nölke and Vliegenthart 2009; Schneider 2009). Thus external sources and agents of change play a crucial role in shaping institutions and policies.

Following Stallings (1992), we will distinguish three mechanisms that, acting from the external environment, influence institutional and policy change, mainly through their effects in the balance of power: markets, linkage and leverage. The first is related to the structural and institutional characteristics of the economy, i.e. the degree of openness and vulnerability to external shocks, mainly from trade and finance. International market forces help in the "selection" of dynamic economic sectors, as well as the diffusion of ups and downs and major economic crisis through different channels.

Linkage refers to the relationships between domestic and external interest groups through different means. The more direct links between them are the business relations external and internal economic groups engage in. Here, the relevant domestic actors are those oriented towards the international market, i.e. the export and financial sectors. According to the author, the networks of interests can also cover political, ideological and cultural aspects (i.e. the imitation of international patterns of consumption). Structural factors are again important in this respect. For example, actors in an open economy are likely to have more interest in enhancing the links with external actors than actors in a close economy.

External interests groups or actors can also be active in the promotion and support of what Jacoby calls "minority traditions" (Jacoby 2006, 629). These constitute coalitions between insiders and outsiders with different degrees of scopes, that are able to change the internal balance of power: strengthening internal actors already committed to the external group's interests, winning new groups of support, and/or preventing neutral groups from blocking reforms (Jacoby 2006, 629).

A third way by which external factors can influence domestic politics is simply by exerting leverage. For example, by directly imposing institutions bypassing local groups and

institutions (Jacoby 2006). They can also impose hegemonic ideas or political leadership through conditionality, promises of reward or threats of punishment for carrying out (or not) certain policies, etc. (Stallings 1992, 55).

### 2.3.3 Types of institutional change

Streeck and Thelen (2005) offered a useful matrix that classifies different forms of institutional change according to two criteria: whether the process is incremental or abrupt, and whether the result is continuity or discontinuity.

		<i>Result of change</i>	
		Continuity	Discontinuity
<i>Process of change</i>	Incremental	Reproduction by adaptation	Gradual transformation
	Abrupt	Survival and return	Breakdown and replacement

**Figure 3. Types of institutional change: processes and results**

Source: Streeck and Thelen (2005b, 9)

The following points will be dedicated to describe these different types of change, integrating them into a common framework.

#### 2.3.3.1. Breakdown and replacement

This type of change characterized by an abrupt process and a discontinuous outcome has been analyzed as a combination of a critical juncture and a subsequent path dependent process (cf. D. Collier and R. B. Collier 1991; Mahoney 2001).

A critical juncture constitutes "a period of significant change (...) which is hypothesized to produce distinct legacies" (D. Collier and R. B. Collier 1991, 29). Critical junctures present a major turning point that sets in motion a process of institutional

development in which specific causal mechanisms<sup>14</sup> create path dependency over long time spans. Following Mahoney, what is 'critical' about this junctures as opposed to other historical turning points is that in these moments a particular option is selected among several alternatives, and once it is chosen "it becomes progressively more difficult to return to the initial point when multiple alternatives were still available" (Mahoney 2001, 7).

Critical junctures are then important to understand the possibility of a major shift in the balance of power, allowing for an important change in the dominant groups. These can be understood as periods of extraordinary politics where the room of manoeuvre is wide, and where actors can set in motion long-term political projects. Transformative agents such as social movements or reformist elites are commonly found.

Initial decisions matter in that they help narrowing the subsequent path, illustrating the relative openness of the initial stages of the process *vis-à-vis* the later stages (Pierson 2004, 51). Nevertheless, the reduction of alternatives that occurs in the critical juncture means the setting of a political economy in a specific path, but not the a priori drawing of that path. In this sense, it depends on the alternatives and strategies pursued by different political actors in certain turning points. At the same time, there is no complete openness at each subsequent turning point but a *positive feedback* dynamic that illustrates i) that the "costs" of switching from one alternative to another increase over time, and ii) that sequence and timing are crucial to understand the differentiated outcomes of the critical juncture itself and those from the subsequent turning points that reinforce or divert the original paths (Pierson 2004, 19).

Reinforcement of, or diversion from an existing path can occur at points where new conditions generate a disruption or overwhelm the mechanisms of reproduction of institutions

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<sup>14</sup> Following Stinchcombe, Mahoney (2001, 8) refers to two ways institutions can "endure" over time (cf. also Pierson 2004, 46). *Constant causes* refer to those factors that reproduce a given outcome -an institution in this case- repeatedly over time. In this sense, a common set of factors works to produce and reproduce the institution. Conversely, *historical causes* can be identified when there is a separation between the factors that produces the outcome -the institution- and the ones that work in their reproduction. In this case the original causes do not intervene in the subsequent path. Path dependent analysis are related to the specification of historical causes, this is, "structures and institutions endure in the absence of the processes that initially led to their establishment" (Mahoney 2001, 8)

(Pierson 2004, 52). Two such decision points can be identified: economic crises (Boyer and Saillard 2001a, 43-44; Gourevitch 1986) and political crises (Amable and Palombarini 2009, 138). As Gourevitch stresses, in "hard times" a political choice is made among conflicting policy proposals (1986, 17). In this sense, the relative openness of the political game in periods of crisis makes corrections of the path possible.<sup>15</sup>

### 2.3.3.2. Incremental institutional change

On the side of incremental change, two approaches stand: reproduction by adaptation and gradual transformation. The first of them is represented by scholars working on the VoC tradition (Hall 2008; Hall and Soskice 2001a). These authors describe change as processes of adjustment directed to recreate previous comparative advantages, reinforcing over time the two pure models of market economies, liberal and coordinated (Hall and Soskice 2001a, 63).<sup>16</sup> Pressures for change come from external events<sup>17</sup> and the agents of change are firms that seek to maintain and reinforce the institutional comparative advantages in their favour. Thus, while the process is incremental, the result is the continuity or maintenance of a model.

In the past few years VoC approaches have widened their view arguing that models of capitalism change within certain limits or "institutional ecologies built up gradually over time" (Hall 2008, 80), thus allowing diverse "*institutionally conditioned adjustment trajectories*" (Hall 2008, 41 italics added) within the same type of capitalism. According to Hall (2008, 80) partisan politics play a major role in defining these trajectories.

The second approach highlights the discontinuous result of incremental processes of change (Streeck and Thelen 2005b; Mahoney and Thelen 2010). According to these authors, actors reinterpret and transform the meaning of institutions from below, generating processes

<sup>15</sup> Accordingly, when both conditions coincide, another critical juncture is likely to emerge (cf. D. Collier and R. B. Collier 1991, 30).

<sup>16</sup> Given the way change is conceived, non-pure, hybrid or mixed models, are expected to converge to either one or the other pole. Cf. Goodin (2003).

<sup>17</sup> E.g. changes in international regimes, structural developments of the economy, and "unintended" effects of the operation of existing institutions (Hall 2008, 52) or changing technologies, products and tastes (Hall and Soskice 2001a, 62).

of change that introduce institutional discontinuities and the possibility of diverting paths. These theories emphasize the openness of institutions to transformation, the gaps between what formal institutions prescribe and their actual enactment by social actors, and the distributional conflicts around their re-specification and modification.

Following the types of incremental change proposed by Streeck and Thelen, Mahoney and Thelen organize them according to the characteristics of institutions -i.e. the degree of enforceability and interpretation- and the political context -the number of veto points (Mahoney and Thelen 2010, 18).

The following matrixes represent the characteristics of the four types of gradual change and their likelihood depending on the characteristics of institutions and the political context:

	<i>Displacement</i>	<i>Layering</i>	<i>Drift</i>	<i>Conversion</i>
Removal of old rules	Yes	No	No	No
Neglect of old rules	-	No	Yes	No
Changed impact/enactment of old rules	-	No	Yes	Yes
Introduction of new rules	Yes	Yes	No	No

**Figure 4. Types of gradual institutional change**

Source: Mahoney and Thelen (2010, 16)

		<i>Characteristics of the institutions</i> (Level of discretion in Interpretation/Enforcement)	
		Low	High
<i>Characteristics of the political context</i> (Veto possibilities)	Strong	Layering	Drift
	Weak	Displacement	Conversion

**Figure 5. Types of incremental gradual change by characteristics of the institutions and the political context**

Source: Mahoney and Thelen (2010, 19).

#### 2.3.4. A common framework: the role of institutional hierarchies

So far two opposite ways of understanding the process of change, abrupt or incremental, have been presented. In the case of the latter, two possible results were discussed, continuity or discontinuity. They will be called transformation, adjustment and shift, respectively, to facilitate the presentation.<sup>18</sup>

The question that emerges here is if there is any possibility of merging these three modes of institutional change into a single framework that allows the understanding of the conditions under which one or the other can arise, without losing parsimony. It is claimed here that it is possible to integrate the three modes of change by adding a third dimension to Mahoney and Thelen's 2x2 entries: institutional hierarchy (cf. Amable 2004, 66-73).

According to Amable, in a substantive sense hierarchy refers to the distributional struggles that define the power of the dominant groups and/or represent the interest of political leaders. If institutions define who gets what, and dominant groups are said to be so because institutions favour them, institutional hierarchy relates to those rules that are more important in maintaining the dominant groups' (leaders/parties in power) hegemony. At the same time, if institutions are defined as compromises of interests, institutional hierarchy also relates to those rules that help maintaining a political compromise (Amable and Palombarini 2009, 135).

In this sense, it is possible to expect that change will be more difficult or will be implemented more cautiously in domains where the most powerful socioeconomic and political groups have vested interests or where political compromises are difficult to obtain. In the opposite way, it would be expected that those areas in which the dominant groups have little interest and/or this interest is widely shared are easier to change (Amable 2004, 68). The definition of institutional hierarchy is thus made with specific reference to a certain socio-

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<sup>18</sup> I agree with Streeck and Thelen in that the fourth cell of their table, the one represented by a process of abrupt change with continuity does not offer heuristic interest for the purposes of this study.

political equilibrium and a specific dominant bloc, and it is contingent to it (Amable 2004, 69). Changes in the institutional structure of the economy can then be related to political changes i.e. accommodations of the dominant bloc or factions of it, and/or changes in the electoral bases supporting certain political leaders/parties.

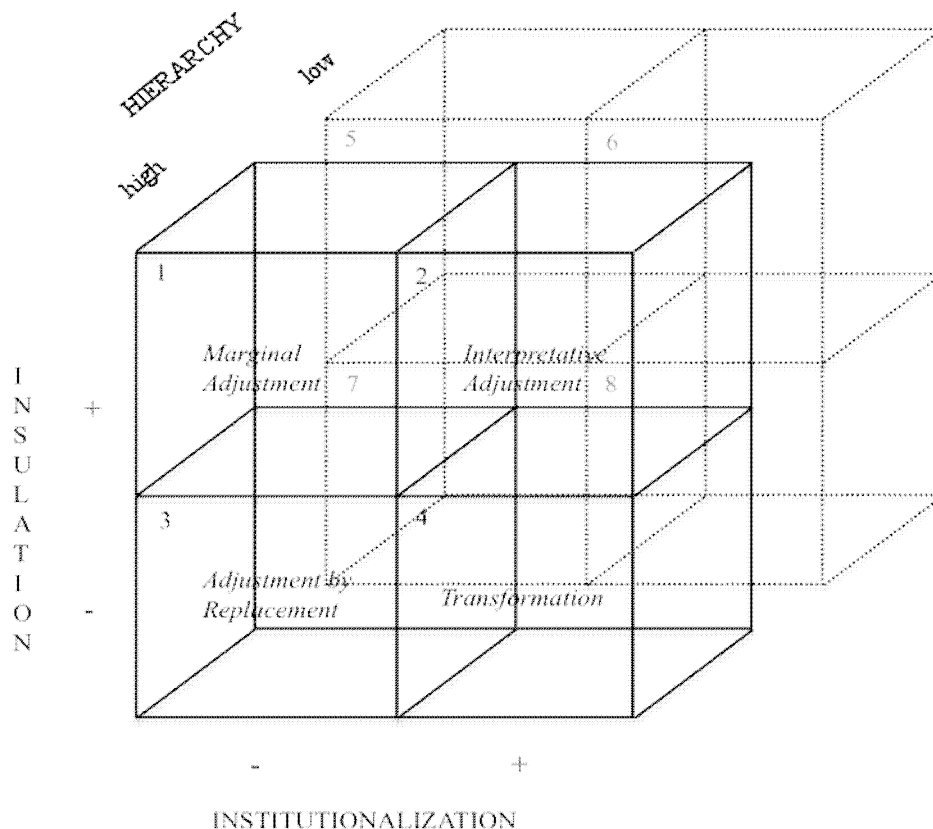
The introduction of the notion of hierarchy generates four new modes of institutional change in addition to the four mentioned above (see figure 7). These have been moved to the 'low hierarchy' part of the figure. To adapt Mahoney and Thelen's framework to a process of institutionalization as the one this study is interested in, two dimensions of characteristics of the institutions and political context have been translated as 'degree of institutionalization of policies' and 'insulation of dominant groups from social pressures/political competition'.<sup>19</sup>

In the new high-hierarchy boxes the upper part represents institutional change in high hierarchy institutions and high insulation of dominant groups. Here we encounter processes of incremental change with continuity that will be called *adjustment* (boxes 1 and 2). Two such processes can be distinguished. In the case of policies with higher degrees of institutionalization (box 1), there is *marginal adjustment*, this is, the accommodation of parameters, specific codes or policy instruments to maintain the same institution or its overarching goals. Here the dominant bloc maintains its composition and correlation of forces or political leaders increase their chance to be reelected. Conversely, with low levels of institutionalization, adjustment is *interpretative*. Interpretative adjustment can be used by a faction of the dominant groups to adapt the institutions and 'upgrade' their privileged position.

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<sup>19</sup> Following the notion of hierarchy here proposed, it makes sense to focus on the dominant groups as agents of change. As formulated by Joan Nelson, *insulation* refers to the degree of autonomy of policymakers in reforming institutions. Here the relationship between insulation and veto points is interpreted in the following way: while high veto points reflect an obstacle for reform from the point of view of agents with transformative purposes, high insulation from social pressures/political competition allows dominant groups to maintain in power by small institutional adjustments without transformative consequences. On the contrary, while low veto points allows more degrees of freedom for reform, so does low insulation inducing dominant groups to form coalitions and broaden the basis of support for the institutions of their interest. Cf. Nelson, Joan. 1993. "The Politics of Economic Transformation: Is Third World Experience Relevant in Eastern Europe?" *World Politics* 45 (3): 433-463.





**Figure 6. Integrated framework of institutional change**

On the lower part of the 'high-hierarchy' side of the figure (boxes 3 and 4), represented by low degrees of insulation, two types of change are likely. In high-institutionalized policies, there is *adjustment by replacement* (box 3), characterized by a re-accommodation of the dominant bloc and/or political leaders in power. Their need to accommodate can be met by parliamentary discussion, consultations with different social actors, etc. in order to broaden the basis of support. The result is a modification of political coalitions or compromises of interests (or both) to support the new institutions, while still maintaining the overall goals. The last box (4), where low insulation and low institutionalization combine with high hierarchy, there is *transformation* itself, this is, widespread openness to societal change with a new dominant bloc coming into scene.

The adoption of the concept of hierarchy has at least four advantages. First, it helps understanding why certain institutions can be more prone to change than others. Thus it creates the following relation: the higher an institution is in the hierarchy, the harder it is to change it. However, once certain sources of change trigger a transformative process, a modification of the whole developmental path is more likely to occur. On the contrary, while lower hierarchy institutions are easier to change, they are at the same time less decisive. In this sense, their impact on the broader institutional setting will depend in their capacity to provoke a shift in the balance of power -or enactment- to change higher hierarchy institutions by *complementarity*.

Second, it allows identifying the winners and the losers of change with respect to the overall societal situation. Indeed, as Mahoney and Thelen express, one of the consequences of adopting a loose concept of institutions and the possibility of imperfect compliance is that it "complicates assessments about which actors are advantaged or disadvantaged" (Mahoney and Thelen 2010, 22). With the new framework it becomes clear that while certain actors can have momentary conquests, as far as they don't reach the top of the pyramid, the political economy is likely to stay in the same developmental track.<sup>20</sup>

Third, it allows comprehending better the idea of institutional resiliency. In fact, the possibility of contestation over the meaning of institutions together with the idea that some institutions are more important for the dominant bloc or for political leaders to stay in power, offers a view of *stability as a continuous and necessary process of adjustment*. As Mahoney and Thelen put it: "Those who benefit from existing arrangements may have an objective preference for continuity but ensuring such continuity requires the ongoing mobilization of political support as well as, often, active efforts to resolve institutional ambiguities in their favour" (2010, 9).

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<sup>20</sup> This idea was already suggested by the *régulation* theory, that argued that political economies have institutions that act as 'pilots' of a certain institutional regime defining its character and the dominant bloc or winner groups associated to it (cf. Boyer and Saillard 2001b).

In this sense, the idea of hierarchy makes relative the importance of institutions in the sense that in a certain context, what can be relevant to maintain the dominant bloc in power is not necessarily the institutions themselves but the goal or function they fulfil. Thus, changing institutions does not necessarily mean changing the overarching goals of those institutions or their distributive performance (cf. Hall 1993).

Finally, hierarchy allows considering the possible linkages between processes of change. For example, dominant groups can disregard change in some institutions as far as they do not threaten the stability of the top of the hierarchy. A modification, however, can generate a chain of reactions on other institutional domains and institutional layers that end affecting the institutions on top, either by a change in the balance of power, by challenging their actual meaning, or by complementarity. The latter highlights the idea of social actors working in the fringes of institutions to change their meaning, and that of limited rationality in the strategies devised to defend or redesign hierarchical institutions, and is coherent with a view of a political economy that while extremely 'solid', can without notice 'melt into air'.<sup>21</sup>

### **2.3.5. The direction of change: between liberal and embedded capitalism**

The Polanyian notion of the double movement gives a way to conceptualize the direction of change. According to this formulation the dynamics of capitalist development and institution building is conceived as consisting of a consecutive *dis-embedding and re-embedding* of market relations into broader societal ties (Polanyi 2001).

In the first movement of liberalization, the economy is differentiated as a separate subsystem with its own logic -the logic of free markets- and is made autonomous from the influences of political decisions or societal bonds. However, these attempts to build a market society i.e. where socially and politically mediated relations of exchange are transformed into valuable goods and services, implies the dislocation of the societal substrata in which the

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<sup>21</sup> Karl Marx and Friedrich Engels (1848). *The Communist Manifesto*.

economy is embedded and to which its outcomes are directed using political power. The liberalization processes trigger thus a spontaneous countermovement of re-embedding of markets in networks of social relations and political institutions. In relation to this, it would be expected that radical liberalization processes be followed by countermeasures aimed to regain control over an increasingly autonomous economic sphere.

Following Ruggie (in Bohle and Greskovits 2007a, 445) two types of capitalism emerge from this distinction, a liberal and an embedded one, differing in the extent the economy is regulated by the state. Disregarding the fact that because they are *public*, public policies are all to a certain degree regulated by the state, they can be analyzed according to the degree of active state intervention they embody. This study will use these two notions to characterize the direction of institutional change.

Liberalization has indeed been the main driving force of the processes of institutional change in advanced political economies being pursued both by governments and business in order to accommodate economic institutions to the growing pressures of external markets (Streeck and Thelen 2005b, 4). In this sense, the common external constraint to liberalize is said to be, paraphrasing Streeck (2010) a commonality of capitalisms.

Nevertheless, global liberalization trends may not produce the same liberalization responses in all political economies. Already liberal countries may accommodate differently, perhaps by an embedding countermovement. In fact, as Streeck and Thelen emphasize, "in study liberalization as a direction of institutional change, we should expect also to observe changes in institutions intended to reembed the very same market relations that liberalization sets free from traditional social constraints" (2005b, 4). This seems particularly relevant in the case of early liberalizers, especially those who have already started to exhaust the possible combinations of liberal institutions.

### CHAPTER 3.

#### CHILE, A LIBERAL ECOLOGY WITH INCREMENTAL EMBEDDEDNESS

The Chilean case shows the increasing search for the institutionalization of a liberal compromise at the top of the institutional hierarchy, while allowing degrees of freedom in the lower ends showing the capacity of dominant groups to constantly *adjust* institutions and incorporate new factions in order to maintain their power.

The critical juncture is represented by a military takeover in 1973 followed by a dictatorship that managed to *transform* an ISI pattern of development for a radical neoliberal experiment thanks to the alliance made with a technocratic elite and the consent of the business sector. The trajectory of change of this model was steered by the stabilization goal in the top of the institutional hierarchy. While a fixed ER regime was initially set for stabilization purposes, industrial policy was identified with the previous pattern of development, and thus eradicated from the dominant group's concern.

Three turning points were key to stabilize the path: a deep financial crisis in 1982-83 and successive social turmoil that obliged the government to forge a new alliance in order to recompose its basis of support; the return to democracy in 1990 that brought a centre-left coalition into power; and the political and economic context surrounding the Asian crisis (1997-98) that allowed to seal a broad liberal consensus.

The unfolding consequences of the latter turning point would produce diverging paths in both policy domains. In the case of the ER, after a short heterodox period, it consolidated the liberal path. On the other hand, it served to foster the discontents with the bad results of past industrial policies, triggering a process that could be considered as a first attempt to re-embed industrial policy.

The result after 25 years of development of a *liberal institutional ecology* was the consolidation of the liberal hierarchy in the macroeconomic policy i.e. the stabilization goal

ruling the rest of the policy instruments and an ER regime away from the competitiveness goal. Conversely, after an incremental process that included *layering* and the *conversion* of old institutions, industrial policy appeared to approach the embedded pole for the first time. The challenges remain for the diversification of the highly concentrated resource-intensive export sector that this trajectory has yielded, using a set of industrial policies that starts to contradict the existing neoliberal consensus.

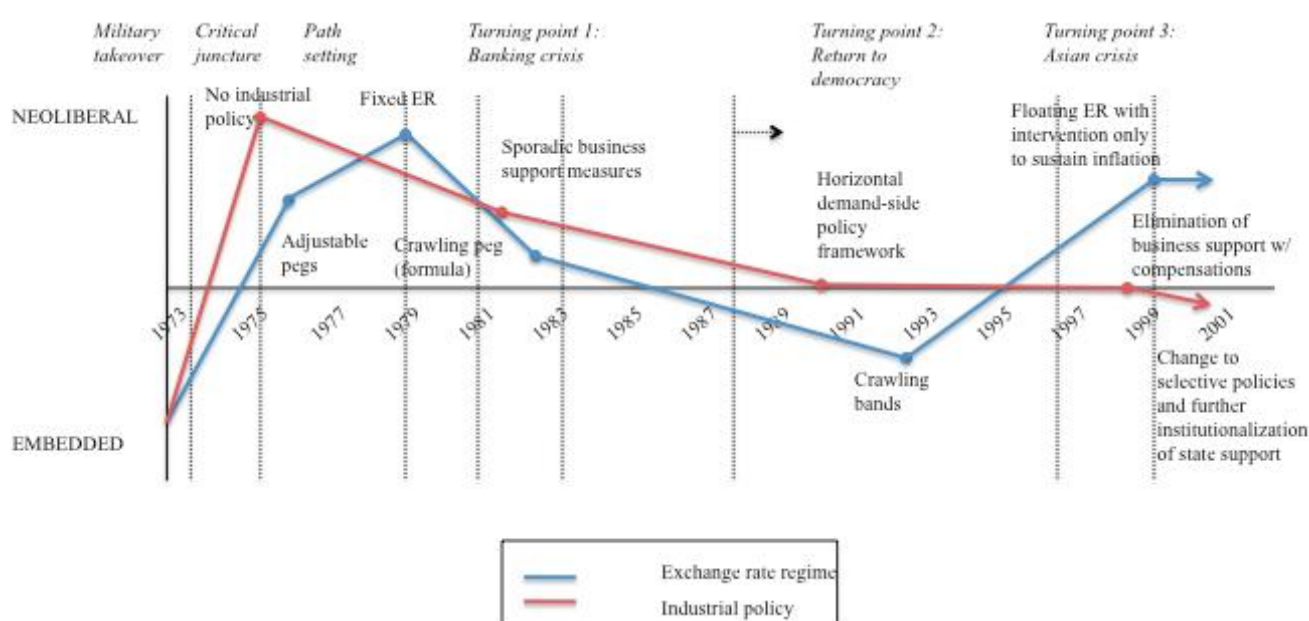


Figure 7. The Chilean neoliberal path: A liberal ecology with incremental embeddedness

### 3.1 Critical juncture: a military takeover and capitalist re-foundation (1973-1975)

In September 1973 the elected government of socialist Salvador Allende's was overthrown by a Military Junta aimed to restore private property and institutional stability in the country. Until then, the model of development in Chile had been characterized by an Import Substituting Industrialization (ISI) strategy that relied heavily in the active role of the state in the promotion of industrialization. The latter included the provision a wide array of

basic infrastructure (roads, ports, airports) and public services (telephone, electricity, etc.), the formation of qualified human capital (through a network of state universities and training institutes), the direct participation of the state as a producer in strategic areas (mining, heavy industry, etc.) (Agosín 2001, 122-23). Additionally, a multiple ER regime was utilized with an explicit goal of benefiting domestic producers and discouraging capital outflows (Ffrench-Davis 2003, 156-162).

The strategy, however, was not as successful as in other Latin American countries. While state intervention was not enough to boost an effective and diversified export industry, growth lagged behind the region's best performers, the structure of exports was highly concentrated in mining activities especially copper, and inflation was so persistent to be conceived by Albert Hirschman as a sort of substitute of a civil war<sup>22</sup> (cf. Fourcade-Gourinchas and Babb 2002, 543; for an overview of the period cf. Ffrench-Davis 2003, ch. 1). The Allende administration radicalized state intervention with massive expropriations, nationalization of natural resources, land reform, price regulation and an increase in wages. The process of polarization that had started at the beginning of the century with the increasing mobilization of the working class and its gradual economic integration was exacerbated, and a climate of economic paralysation, class struggle, and institutional chaos installed. In this context, two thirds of the political spectrum -including the centre Christian Democrats and the conservative right- together with the majority of the business sector supported the military takeover.

The critical juncture extended through 1973 to 1975. The positions of the actors this period resorted to historical cleavages and class relations. The Navy, historically closer to the economic and conservative elite, was named in charge of the Ministry of Finance. The Air

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<sup>22</sup>Among the reasons Babb mentions the small size of Chile's internal market that made ISI policies more difficult to achieve, but especially the incapacity of the state to control social conflict. On the other hand, inflation averaged almost 30% per year between 1940 and 1970 and rose to a 600% in 1973 (Fourcade-Gourinchas and Babb 2002, 542-3).

Force, on the other hand, with a middle class extraction and a corporatist background, enrolled a Christian Democrat closely related with the structuralist thinking of ECLAC, as advisor and later on the Ministry of Economy and Production.

On the other hand, the business sector or '*gremios*' while closer to the right and fervent opponents of Allende, were recognized for a more nationalistic view traditional of right wing conservative parties in Chile and associated with a state-corporatist tradition, especially the stratum of medium enterprises producing for the internal market that had benefited from the ISI policies. On the other side of the civilian support was the radical liberal view represented by the 'Chicago Boys'.<sup>23</sup>

All of them shared a common overarching i.e. the restoration of private property and the rapid solution of high inflation and chronic public deficits through a process of liberalization and stabilization, but a specific economic strategy was missing (Diaz and Martínez 1996, 81; cf. also Valdes 2008). Thus, during this period economic policies with divergent goals were carried out reflecting the different -and conflicting- military factions in the government as well as of the supporting civilians. For example, while adjustment policies were severe, with immediate price liberalization and a deep adjustment and restructuration of the public sector to eliminate the public deficit (Edwards 1983, 5-6)<sup>24</sup>, the parameters affecting the external sector were devised in order to allow a smooth adjustment to the new economic conditions (Edwards 1983; Agosín 2001, 109).

The functioning of the economy would be the source triggering a change in the balance of power. A steep downturn in economic output between 1974-75 and the reactivation

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<sup>23</sup> In the late 50's the U.S. government International Cooperation Administration (ICA) promoted an agreement between the University of Chicago and the Universidad Católica de Chile to conduct an exchange program of students and scholars between both schools. The program was part of a broader project by the U.S. government intended to eradicate the pervasive structuralist economic ideologies in Latin America. The "Chicago Boys" remained in the academic world until they were called to be protagonists of the neoliberal experiment. In 1972 they were incentivated to write a comprehensive set of principles and economic proposals to oppose Allende's socialist government. The compilation called *El Ladrillo* [*The Brick*] was made available for the *Junta* members since the first day of the military government and its proposals enacted in the subsequent years.

<sup>24</sup> The measures included a mass privatization process of previously expropriated enterprises but also of state-owned companies, large decreases of public employment and sharp cuts in public spending.



of inflationary pressures in 1975 opened the door for the "Chicago Boys" to step in decisively in the process. Their comprehensive program of radical reforms and national political project captivated the members of the *Junta* that were convinced of the necessity to undertake a more profound capitalist and national re-foundation led by the Military Commander in Chief General Pinochet. This also supposed the necessity to configure the basis of support for the regime.

Under this background, Pinochet granted the "Chicago Boys" a majoritarian composition in the cabinet in 1975. In this way, the military actors allied with this new technocratic faction to lead the new dominant group, dismissing the sector of big business habituated to protectionism and state clientelism and the more corporatist factions of the Armed Forces from the initial pact.<sup>25</sup> The context of economic crisis and the fears of backlash and popular unrest associated with left forces was, indeed, determinant in making business sectors more docile in accepting the new power configuration (Diaz and Martínez 1996, 86).

The opportunity could not be better to transform the country into a monetarist laboratory (Ffrench-Davis 1983, 9; cf. also Valdes 2008): state intervention was highly discredited and the trauma of the Allende socialist experience was still fresh; the authoritarian and repressive context ensured the insulation of the government from the influence of parties and other pressure groups; finally, the encompassing reform program offered a "longer-lasting source of legitimacy than that which could be provided by a simple program of 'pacification'" (Diaz and Martínez 1996, 85).

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<sup>25</sup> Fourcade-Gourinchas and Babb (2002, 548) argue, on the contrary, that a handful of the most influential businessmen that engaged actively in the overthrow of the Allende government, were also closely related with the Chicago doctrine of the new technocracy even helping in its diffusion throughout certain groups of the business sector.

### **3.2 Path setting (1975-1979)**

With no political opposition and a government ready to embrace the re-foundational idea, the process took a new face. Economic policy followed the full-fledged implementation of the "monetary approach to balance of payments",<sup>26</sup> as elaborated by Chicago prominent economists Harberger and Friedman, recognized by their "militant stance against inflation" (Fourcade-Gourinchas and Babb 2002, 539). Stabilization policy focused then on the utilization of the ER as the main adjustment mechanism (Ffrench-Davis 1983, 15; Edwards 1983, 7; cf. also Fourcade-Gourinchas and Babb 2002, 545).

The ER was substantially and recurrently revaluated to generate a marked change in the expectations of inflation. Although inflation fell importantly, it continued to be higher than the international rate. Thus, in 1979 the ER was fixed to the US dollar producing a reduction of inflation to one digit, but accelerating the real appreciation pressures that had been growing during the process.

The program was complemented with the acceleration of the initially gradual liberalization program. In 1979 the reduction of tariffs reached a flat 10% -after an average of 100% in 1973- and a complete liberalization of the capital account was accomplished as a part of a comprehensive program of liberalization aimed to produce the conditions of a free-market economy as proposed by monetarist approaches.

The strong appreciation of the RER and the tight monetary policies combined with the steep reduction in tariffs and liberalization of import restrictions induced a loss of competitiveness in the industry with massive bankruptcies especially in the tradable sector. At the same time, there was a small initial boom of non-traditional exports in the primary sector, an important increase in imports and non-tradable sectors, but overall, the emergence of a

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<sup>26</sup> In general terms it proposed that under a closed free-market economy, inflation would be the result only of monetary expansion, thus recommending a conservative management of monetary policy. The open-economy version, applied in Chile from 1979, argued that inflation responded to the variations in international prices plus the ER; thus a fix ER would rapidly lead to an equalization of internal and external rates of inflation (Ffrench-Davis 1983, 15-16; Frenkel and Rapetti 2010, 27-28).

financial sector associated with bank re-privatizations and financial reforms (Agosín 2001, 110).<sup>27</sup> As a result, the process had induced a re-composition of the business sector that permitted the formation of the new source of societal support the *Junta* was looking for.

### **3.3 Turning points: pragmatism, heterodoxy and democracy**

#### **3.3.1 The first crisis of the model and the pragmatist consensus (1982-1983)**

The adjustment process linked to the ER managed to control the inflation at the expense of economic growth and an important external imbalance. A combination of high interest rates, decreased government spending and a depressed export sector led to a downturn in economic activity by the end of 1980.

On the other hand, balance of payment deficits had been accumulating due to the increasing appreciation of the ER and the subsequent adjustments in the productive sector. An amorphous financial sector characterized by a pattern of short-term loans and high levels of external leverage grew from 1975 thanks to the low levels of internal saving, favourable interest rate spreads and new facilities for financial transactions. A massive influx of foreign capital, especially after 1979 aggravated the current account deficit making it unsustainable by 1981. The subsequent massive capital outflows after an increase of international interest rates triggered a massive failure of the banking and financial sector.

Analysts discussed three responses for the first crisis of the neoliberal experiment. Two of them responded to a division among the advocates of the model that can be expressed in terms of dogmatism versus pragmatism (cf. Wisecarver 1983; also Fontaine 1983). While the first claimed for the completion of the liberalization process and the maintenance of the ER regime (Wisecarver *ibid*, 93; 105; 132), liberal pragmatists favoured

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<sup>27</sup> For the formation of the new financial groups cf. Díaz and Martínez (1996, 87-94).

some government discretion and more active management of economic policies in instances of economic crises (cf. Fontaine 1983). The opposite sidewalk, represented by the Christian Democrat opposition and the recently founded CIEPLAN<sup>28</sup>, advocated for a developmentalist alternative<sup>29</sup>.

The aggravation of the capital outflows, the sharp increase in current account deficit and an imminent banking crisis turned the balance of power in favour of the pragmatist solution, forcing the government to drop its "neutrality", devaluating the Chilean peso (CLP) and subsequently rescuing the banking system in 1983. Moreover it was constrained to agree IMF conditions to receive emergency funds in the face of the loss of international reserves to cope with the emerging debt-crisis.

The pragmatic turn was felt immediately in economic policy. An ER regime of crawling bands according to a PPP rule<sup>30</sup> was adopted instead of the fix ER, with the explicit objective of keeping a depreciated real exchange rate to promote external competitiveness (Frenkel and Rapetti 2010, 34; Morandé L. and Tapia G. 2002, 68).

The latter constituted a necessary concession of the military government to the old big business base for the maintenance of its maintenance in power in the face of growing social unrest, reconstitution of the political opposition and increasing discontent by the '*gremios*' that suffered the consequences of an economic crisis they did not feel part of (Díaz and Martínez 1996, 95). On the other hand, the government's financial sector support base that

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<sup>28</sup> Christian democrats were opposition to the Allende government and initially approved the military intervention when the political and economic situation radicalized in 1973 hoping that, according to the Chilean constitution, power would have been given back. They broke with the dictatorship leaving the cabinet in 1975 and becoming the main opposition group from within the country as they were not persecuted as were the socialist and communist party (Díaz and Martínez 1996, 82; 85). In 1976 a group of young economists close to the Christian Democratic party founded CIEPLAN (*Corporación de Estudios para Latinoamérica*). This would become the main opposition in the field of ideas.

<sup>29</sup> Among others they proposed: anti-cyclical management of public spending, selective protection and promotion for domestic production; and increment in public investment and promotion of SME's; a competitive exchange rate at the service of the external balance and the promotion of exports, and a progressive monetary policy in line with long term investment plans (Ffrench-Davis 1983, 24; Foxley 1982, 167-170).

<sup>30</sup> The ER would be adjusted on a monthly basis according to the previous month's inflation minus an estimate of external inflation (Frenkel and Rapetti 2010, 34).

had gone bankrupt with the crisis shared interests with the business sector in pressing for a bailout of the banking system and of the debtor companies. This sealed the new compromise of an overall neoliberal regime with some strategic concessions to the business sector.

Although the new ER regime could in theory imply a risk of inflation, two sources acted as further supports for change: the functioning of markets and external leverage. On the one hand, the deepness of the fall in output left the government with a wide range of manoeuvre to satisfy business interests without threatening the stabilization goal. On the other hand, the conditionality program of the IMF that included the maintenance of fiscal surpluses and international reserves and a focus on economic growth imposed important constraints. Indeed, the government had little other options to finance the high public and private debt generated with the bailout process given hostility of the international community towards the military regime.<sup>31</sup> Thus, while the inflation target would not be threatened, the government could adjust the ER regime to combine stabilization with economic growth widening its support base.

### 3.3.2 The return to democracy (1988-199?)

According to the Constitution of 1980 that was passed under the military government (Díaz and Martínez 1996, 16-8), a plebiscite was to be held in 1988 asking the population whether the military regime should extend for another eight years or whether democratic elections should be held instead. The regime was democratically expelled from power in 1988 and a new majority came to power in 1990 after the first democratic elections in 17 years<sup>32</sup>.

The transition to democracy generated several uncertainties both in the international community and the business sector (Weyland 1999, 69). The new centre-left majority (the *Concertación de Partidos por la Democracia* or *Concertación*) grouped in the same coalition

<sup>31</sup> Fourcade-Gourinchas and Babb (2002, 548) remind that multilateral organizations and even the Paris Club were reluctant to lend to Chile because of the dictatorship's human rights abuses. The IMF, point the authors, was literally "Chile's lender of last resort".

<sup>32</sup> Cf. Martínez y Díaz for an overview of the process, especially pp. 18-40

parties coming from such diverse traditions as the Socialist Party -that represented the most extreme pro-government faction under the Allende administration- and the Christian Democrats. All of them had been active opposition to the military regime and fervent critics of the economic model. Furthermore, many CIEPLAN thinkers were candidates for key appointments in the new economic team, thus generating fears of backlash (cf. Fazio y Parada 2010, cap 1).

The business sector, on the other hand, had openly accepted the neoliberal reforms after the liberal consensus in 1984. In addition, from 1985 a strategic and selective new wave of privatizations was carried out by the military government, reinforcing the basis of support for the model (Díaz and Martínez 1996, 98).<sup>33</sup> Moreover, the rapid growth of economic activity experienced since 1985 led by the expansion of the export sector, with non-traditional producers rocketing, increasing FDI flows, no inflationary pressures in the horizon and the perspectives of democratization, had granted widespread international support for the neoliberal reforms.

In this context, after taking office in 1990 the new authorities rushed to ratify the economic model inherited from the dictatorship and its main macroeconomic policies, ensuring continuity and institutional stability (Fazio and Parada 2010, ch. 1). Some analysts expected that the backlash would be produced after an initial transition period. In effect, while the moment of returning to democracy presented several obstacles, further elections (1994 first and 1998 afterwards) were seen as a way to enhance the *Concertación's* power and thus enact the model they had promoted previously (cf. Weyland 1999, 89). Two explanations served to feed these expectations.

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<sup>33</sup> A good research on the links between the process of privatization of the mid-1980s and the main economic interests and business groups in the Chilean economy, as well as their political links through right-wing parties can be found in Monckeberg, María O. 2001. *El saqueo de los grupos económicos al Estado de Chile*, Santiago: Ediciones B.

First, there were several institutional constraints left by the authoritarian constitution of 1980. The most important was the existence of a number of authoritarian veto points, also known as "undemocratic enclaves" (Aninat, Londregan, Navia, and Vial 2008, 172) that included unelected senators and the autonomy of the armed forces, among others. Many of them would not be eliminated until late 2005. Additionally, the electoral system created incentives for the party system to conflate on two stable coalitions that discouraged the poles of the political continuum. Indeed, although maintaining around 7% of the votes throughout the years of democracy, the leftist parties were excluded from representation in the congress (Aninat, Londregan, Navia, and Vial 2008, 172).

Second, analysts refer to a "hangover from the civil strife" (Aninat, Londregan, Navia, and Vial 2008, 157) that would have affected the political dynamics in the early nineties. This meant that the main political actors tried to avoid conflict and engaged in what was further called 'the politics of consensus'.

While in 1994 and again in 1998 the *Concertación* did win again the elections, instead of back lashing the new governments deepened and institutionalized many of the attributes of the model. Without negating the former explanations, we put forward other two interrelated ones that help explaining the liberal turn of the *Concertación* as part of the political economy of narrowing the set of future alternatives to a liberal ecology.

The first underscores a change of interests of many supporters of developmentalism after the success of the liberal pragmatic compromise of the 1980s, leaded by a process of learning from the domestic past experiences and those of other Latin American countries (cf. Weyland 1999, 69; Meller 1996, 332). Many '*concertacionistas*' embraced a milder version of the liberal pragmatic wing by adding a degree of social responsibility to the free-market option, thus changing their initial productivist bias for a social policy one.<sup>34</sup> This internal

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<sup>34</sup> This accomodation of a -majoritarian- faction of the old developmentalist groups bear similar characteristics with the processes in other countries that embraced a neoliberal model during the time. Cf. for example

conversion was part of the strategies by which dominant groups managed to co-opt potential threats to the liberal track. The new pact was sealed by the negotiations surrounding the tax reform in the early 1990s: while the business sector -represented by the political right- gave room to increase taxes, the actual reform was far from what had been previously proposed by the *Concertación* (cf. Fazio and Parada 2010, ch. 2). On the other hand, the improvement of the tax base allowed the converted 'concertacionistas' to pursue the new social policy goal without disturbing macroeconomic balances (cf. Weyland 1999, 81ff; Torres 2011).

Additionally a more strategic adoption of the model can also be explained by external the leverage. In the context of economic success of the military government, and the successive external recognition and approval of the neoliberal reforms and their performance, achieving economic stability was crucial for democratic consolidation (Weyland 1999, 71), and as an optional extra, for the consolidation of the new coalition in power. In this sense, an open adoption of the neoliberal model by the new administration -as it actually occurred- would prevent authoritarian backlashes, and at the same time, would open the confidence from investors and the international community (cf. Weyland 1999, 70).

### 3.3.3 A short heterodox interlude (1991-1994)

On the eve of the transition to democracy, the Central Bank of Chile (CBC) was made officially independent in 1989 with the main goal being the control of prices. After the return to democracy the stabilization goal of the CBC was clearly confirmed adopting an innovative mechanism of *quasi* inflation targeting<sup>35</sup>. In relation to the 'policy trilemma' it also had to choose between maintaining the ER regime of crawling bands or allow free capital mobility. The choice was important given the context of international movement of capital towards emerging economies at the beginning of the 1990s. Given the inherited ER regime and the

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Fourcade-Gourinchas and Babb (2002) for the case of Mexico and France. For the case of France see also Levy (in Streeck and Thelen 2005a)

<sup>35</sup> Annual announcements of the subsequent year's inflation target (De Gregorio, Tokman, and Valdés 2005, 11)



impression that most of the capital flows were short-term driven, the preferred solution was to introduce barriers to capital mobility. In 1991 the CBC introduced the '*encaje*', a non-remunerative reserve requirement for capital flows. The '*encaje*' managed successfully to reduce short-term capital flows while still allowing large amounts of FDI enter the country expanding importantly the rate of investment (for an overview cf. Ffrench-Davis 2003, ch 10). The climax of the instrument was its key role in isolating the Chilean economy from the turmoil caused by the Mexican crisis and its contagion to other LAC economies in 1994-95.

In a short period between 1991 and 1994, and against the odds, the democratic government had combined the macroeconomic goal of reducing the rate of inflation with an important expansion of fiscal spending -under a tacit rule of a surplus balance-, the competitiveness of the exchange rate, and the control of capital flows. Thus, without breaking with the path traced by pragmatist liberal policies this period represented the possibility of an *interpretative adjustment* and a redirection of the path towards a greater embeddedness as illustrated by the controls to capital flows and the active management of the ER.

Nevertheless, soon it would become clear that these heterodox consequences were not in the agenda of the government nor of the CBC (cf. Morandé L. and Tapia G. 2002, 67) and that they had been mostly driven by a change in the external conditions and not as a pursued policy. Indeed, during the previous period (1985-1990) relatively low levels of capital inflows as well as important productive gaps did not threaten with inflation and thus did not pressure the ER bands despite the real depreciation. Under the same policy framework, however, the reduction of the productive gaps and the need to control inflation made monetary policy particularly restrictive. The latter fed even more the already important capital inflows of the early nineties. The CBC was thus constrained to actively sustain the lower end of the band to keep the inherited competitiveness goal while at the same time increasing the interest rate to tackle the higher-hierarchy price stability goal. As Morandé and Tapia emphasize (2002, 67;

cf. also De Gregorio, Tokman, and Valdés 2005, 9), this cocktail of policies was condemned to be ended soon, and in favour of the higher-hierarchy stabilization goal as it demonstrated when both goals contradicted each other.

The heterodox interlude lasted as far as small appreciations of the RER served to sustain the anti-inflationary policies while still preserving the support for the export sector.<sup>36</sup> In the eve of the Asian crisis, however, the scenario changed. A second shock of important capital flows materialized in 1995-1996 reinforced the imbalances. When the Asian crisis busted in 1997 the main fear of the CBC was that massive capital outflows leading to a rapid depreciation of the CLP in the context of an overheated domestic demand would threaten the inflation target for that year (Céspedes, Goldfajn, Lowe, and Valdés 2005, 22; Morandé L. and Tapia G. 2002, 70). An attempt to maintain both targets alive -by tightening the bands and rising the '*encaje*' to defend the ER against depreciation- proved impossible after successive waves of speculative attacks following the Russian crisis, convincing the CBC that intervention was no longer possible (Céspedes, Goldfajn, Lowe, and Valdés 2005, 24).

With the support of the *liberal spectrum* (dogmatists and pragmatists alike, plus the by-now majoritarian liberal wing of the *Concertación*) that blamed the "not very orthodox policies" (Morandé L. and Tapia G. 2002, 71 my translation) of the downturn in 1998-99, the CBC enjoyed an ample base to announce a set of modifications: i) a replacement of crawling peg for a floating ER regime that left open the capacity to intervene only under special circumstances (i.e. when depreciation threatened inflation); ii) the introduction of a "full-fledged inflation targeting framework" (De Gregorio, Tokman, and Valdés 2005, 11ff) based on an annual target inflation band of 2-4 per cent; iii) elimination of controls to capital flows in 2000; the implementation in 2001 of a structural balance fiscal policy plus a 1% fiscal surplus goal.

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<sup>36</sup> At the same time the CBC intervened to sustain the lower end of the band, it was successively widened thus producing a softer appreciation (Ffrench-Davis 2003, 371).

This combination of *replacement* and *marginal adjustments* at the top implied the consolidation of the stabilization goal i.e. the maturation point of the liberal track established in 1975, by the institutionalization of a coherent set of liberal policy institutions supported by an important majority of the political class as well as the business sector.

### **3.4 Industrial policy: incremental embeddedness in a liberal environment**

Contrary to what happened in the case of the ER, strongly influenced by the hierarchy established around the inflation target, industrial policy underwent a gradual and transformative pattern of change from the lower part of the hierarchy. While the policy debate concentrated in the macro and the industrial policy seemed to vanish away under the aegis of the liberal consensus, an incremental process of learning and institutional consolidation was occurring in the fringes.

#### **3.4.1 From neoclassical policies to a business friendly environment (1973-2000)**

The neoliberal path started in 1975 implied an explicit rejection and disdain of the tradition of state intervention and industrial policy (Edwards 1983, 3; VVAA 1992, 184). Nevertheless, between 1973 and 1975 some developments were possible thanks to the open space left by the critical juncture and the accommodating forces inside the Junta, when corporatist elements were still alive. Although small, these experiences would gain importance and come to the forefront of the export strategy later on.

The most important to be mentioned was the foundation in 1976 of *Fundación Chile* thanks to the support of a Christian Democrat Minister of Production that resigned in 1975 after the 'Chicago takeover'. This institution owned in equal parts by the state and ITT Corporation was supposed to foster venture and risk capital, and promote innovation and

technology transfer in the country (UNCTAD 2006, 10). Its biggest success was the experience with the development of the salmon industry in the early 1980s.<sup>37</sup>

A second stage implying greater government intervention, although still under a strong neoclassical environment followed the crisis of 1982-83. Indeed, the necessity to promote growth at all costs, the constraints imposed by the IMF agreement and the reconfiguration of the business support base of the government, gave place to implement different microeconomic policies in order to foster the export sector. Among them, subsidies for the importation of intermediate goods, FDI attraction policies linked to the refinance of public debt, certain protections to sectors competing with imports, and a general increase in tariffs plus some specific over-tariffs in certain sectors in order to shelter local producers (Agosín 2001, 120ff). Although dispersed, these instruments were evaluated as "undoubtedly useful" (Agosín 2001, 120) to stimulate the export sector.

The return to democracy gave promotion policies a new spurt and certain coherence under a pragmatic liberal ideology. In fact, there was an important degree of agreement inside the new democratic government of the necessity to implement policies directed to promote SMEs (Román 2003). However, the new framework was to be constrained by higher-hierarchy policies, especially liberalization and trade integration. The importance of this policy for the new democratic government was rapidly reaffirmed with the launching of a policy of "reciprocal openness" that led to the signing of numerous trade and commerce agreements in the successive years with concomitant decrease in tariffs to 11% in 1991 and again to 6% in 1999 (Ffrench-Davis 2003, 280ff).

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<sup>37</sup> With the background of previous -unsuccessful- attempts by public and private bodies to develop this industry (UNCTAD 2006, 5) in the early 1980s *Fundación Chile* created *Salmones Antartica*, a firm dedicated to plant salmon crops using technology imported from Norway and Scotland, demonstrating the commercial viability of large-scale production of salmon in Chile (UNCTAD 2006, 1). The rapid growth of the company stimulated private interest and led to the expansion of the industry. Domestic and foreign capital started to invest largely in the second half of the 1980s (UNCTAD 2006, 1). In 1993 the country became the second world exporter of salmon (UNCTAD 2006, 29). Between 1990 and 2002 salmon production grew about 17-fold and its share in the global production of farmed salmon increased from about 10% to 35% (UNCTAD 2006, 26).

These policies demonstrated to be incompatible with the instruments in place. For example, two of them, the subsidies for the import of intermediary goods -of widespread use- and other sectorial subsidies had to be dismantled after the government signed the agreements of the Uruguay round of the WTO (cf. Agosin 2001, 120; 126). The new battery of instruments had to be strictly on the liberal side of the policy choices.

The key proposition behind the new scheme was the implementation of demand-side subsidies (cf. Muñoz Gomá 2001, 49) based on a system of horizontal "matching grants" (Román 2003, 40) where the state would only provide the funding, while private parties would be in charge of the intermediation and the provision of services to the client firms. The promotion framework was strictly designed to prevent any kind of sectorial preference, aiming for a neutral involvement of the state (Muñoz Gomá 2009, 13).

The new policies were settled using institutional infrastructure inherited from the dictatorship and the old state promotion agencies that had been crucial in the ISI period. These structures had been kept at a survival level during the military government, but had not been dismantled. Two such institutions were the main pillars of the strategy: CORFO (Corporation of Promotion) that was endowed with several new financial instruments to match specific types and sizes of enterprises, and SENCE (National Service of Training and Employment) under which the new training policy was to be implemented.

### **3.4.2 From market friendly to increasing government intervention**

In the years following the Asian crisis, policymakers showed a growing concern for the low rates of growth that the country was showing (an average of 2,2% between 1999-2002 after the 7% of the nineties) (Muñoz Gomá 2001, 29-30). Additionally, the horizontal and demand-oriented oriented promotion instruments were not having the expected results: despite the efforts SMEs decreased their participation in sales, employment and credits allocated by the banking system (Román 2003, 61). This created an environment favourable

for a dialogue process between the government, academia and the business sector (Muñoz Gomá 2009, 45), from where a consensus grew on the necessity to actively support the increase in value added and productivity in the main export sectors.

Moreover, the case of the salmon industry that had grown from scratch in the 1980 thanks to the active participation of the state through *Fundación Chile*, was an example of the importance of developing public-private cooperation programs and the devise of selective policies embedded in local networks (Muñoz Gomá 2009, 45)<sup>38</sup>.

While the macro discussion was concerned about narrowing the liberal ecology, the micro debate was undergoing important changes. In the early 2000s the Minister of Finance proposed the establishment of a national innovation fund financed by a royalty on the extraction of copper -a measure largely demanded by non-liberal analysts (Fazio and Parada 2010, 73-74). Although the project faced the opposition of the corporate sector, and was rejected at first, an agreement was reached and it was implemented in 2005 under the form of a tax on copper sales. The same year the authority created the National Fund of Innovation for Competitiveness (*Fondo Nacional de Innovación para la Competitividad*).

Parallel to this, the National Council of Innovation for Competitiveness was founded, a consultancy board under mandate of the presidency that should give concrete policy recommendations for a National policy of innovation and competitiveness, indicating the role of the state. One of the recommendations was to support the development of strategic clusters and institutional modernization for a National innovation system.

In 2008 the report by the advisory board recommended the promotion of eight clustered productive sectors, delineating specific targets and the institutional responsibilities to meet them. In 2009 the law creating the National Fund of Innovation for Competitiveness was passed, establishing an institutional framework and the funding for the new innovation

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<sup>38</sup> Cf. other successful experiences of industry and technology development by *Fundación Chile* in UNCTAD (2006, 10; fn5).

policy. Although the selected sectors were concentrated in high resource-based (e.g. salmon and other foodstuff, mining, etc.) and sectors with high development in liberal-like economies (e.g. financial services, transportation and communications), judging the new positioning of the role of the state in actively and systematically fostering the development of these industries represented an attempt to cross the line towards an incipient embeddedness.

### **3.5 Conclusions on Chile**

Chile shows a pattern of development that has been here called a *liberal ecology*. It is characterized by a constant search for the right liberal adjustment under an accommodating dominant bloc. This means that while the institutional hierarchy remains stable, with marginal adjustments undergoing at the top -in this case the introduction and further enhancement of the inflation-targeting framework- the rest of the policy domains can change in a higher degree to fit in the best way the hierarchical goal and the need to negotiate new bases of support.

Shifts in the balance of power have been the main determinants of the trajectory of change: i.e. social turmoil, the electoral victory of an adversary political group or the political edge granted by the learning from previous policy experiences. External sources have exerted some degree of influence, especially under the forms of informal coalitions (in the path setting period), external market forces (in economic crises) and different degrees of leverage (IMF conditions in 1982, positive expectations in 1990). On the other hand, interpretation had an important role in the quasi-*interpretative adjustment* episode of the ER in the mid 1990s - benefiting from an under-institutionalized policy framework- and in the case of industrial policy, allowing for the conversion of previous state promotion agencies.

In the case of the ER, the trajectory shows a mode of change close to what has been here called *adjustment by replacement*. Each of the three turning points analyzed present

important pressures that illustrate the need of the dominant bloc to enlarge the base of support for liberal policies. In this sense, dominant groups have not only accommodated, but also incorporated new interests as has been shown by the sequence of changes in the ER. Widespread support for the liberal track in the political and technocratic elite, as well as, some degree of *policy learning* allowed the replacement of a fixed ER for a floating ER.

On the other hand, industrial policy shows a pattern of change closer to a combination of *layering* and *conversion*. The subordinated position in the institutional hierarchy offered a room of manoeuvre for more embedded views. The very dynamic of constant adjustment at the top of the hierarchy and the consequent re-accommodation of dominant groups, made them overlook the developments in this area. The incorporation of new layers to the institutional framework together with the conversion of old ones accounts for a process of incremental embeddedness within a neoliberal pattern. This trajectory also benefited from the unfolding of certain initial policy choices (i.e. Fundación Chile, the maintenance of CORFO and SENCE, etc.).

Regarding competitiveness, although the neoliberal path initiated in 1975 underscored export-led growth and external openness, in practice the ER has always been subsumed to the hierarchy of stabilization policies. During most of the time the ER has been used with stabilization purposes, undermining its ability to deliver external competitiveness. The opposite situation, in turn, has been possible only in moments when inflation remained controlled for different motives: external leverage, the necessity to re-build internal coalitions, the economic dynamic itself, among others.

The incremental embeddedness of industrial policies could be seen as a threat to the neoliberal path and a possible opening of the liberal institutional ecology. Following the thesis on institutional hierarchy, this will depend in the ability of loser sectors to mobilize support and/or the degree of incompatibility of the floating ER with a more interventionist



state. These actors can be found in the few developmentalist factions that are left after the liberal turn of the *Concertación*, and in the business sectors that have suffered from the ER appreciation during these decades. At the same time, it will depend on the ability of the agents defending current institutions, mostly the banking sector benefiting from the tight control of inflation and integration to the world financial markets, and export sectors isolated from the effects of an appreciated ER (i.e. mining and other commodities producers benefiting from a boom in international prices).

## CHAPTER 4.

### ESTONIA, POSITIVE FEEDBACKS TO A TIGHT NEOLIBERAL PATH

Estonia shows a development of the neoliberal path where liberal institutions managed to remain largely uncontested and thus only *marginally adjusted*. This was possible due to the positive feedback yielded by a mix of institutional deadlocks, ethnic politics, an under-institutionalized political system and created external interests.

The early institutionalization of the main liberal institutions in the context of a critical juncture presented by independence from the Soviet Union tilted the balance of power towards the political groups presenting the more nationalistic proposals. Radical neoliberal reforms were framed, under this context, as a way to cut with the Soviet past. The creation of the Currency Board Arrangement (CBA) at the top of institutional hierarchy and its identification with the nation building process gave a strong support for neoliberal policies. It also helped to generate a coherent set of *complementary* institutions around it (e.g. conservative fiscal policies), and to disdain any form of state intervention in industrial policy.

While the under-institutionalization of the political system -including a lack of political culture- hindered the formation of a socioeconomic cleavage to contest the neoliberal reforms, the main point of reference for policymakers to maintain the liberal trajectory was the international community -and the prospects of EU/EMU accession- and the external business community that benefited from the economic environment created by the CBA.

Three turning points can be identified that sustained the liberal arrangements: an early banking crisis (1992-94) that coincided with the track setting period and was marked by the commitment to the neoliberal path; the combined effects of the Asian and Russian crises in 1997-98, and the recent global financial crisis in the face of EMU accession (2007-10).

The result of almost 20 years of neoliberal development was the locking in a tight neoliberal track that produced *positive feedback* for the maintenance of the liberal institutions.

The challenges ahead are not small considering the new conditions that EMU accession will impose to a domestic industry already in foreign hands and an overall loss of competitiveness of the export sector.

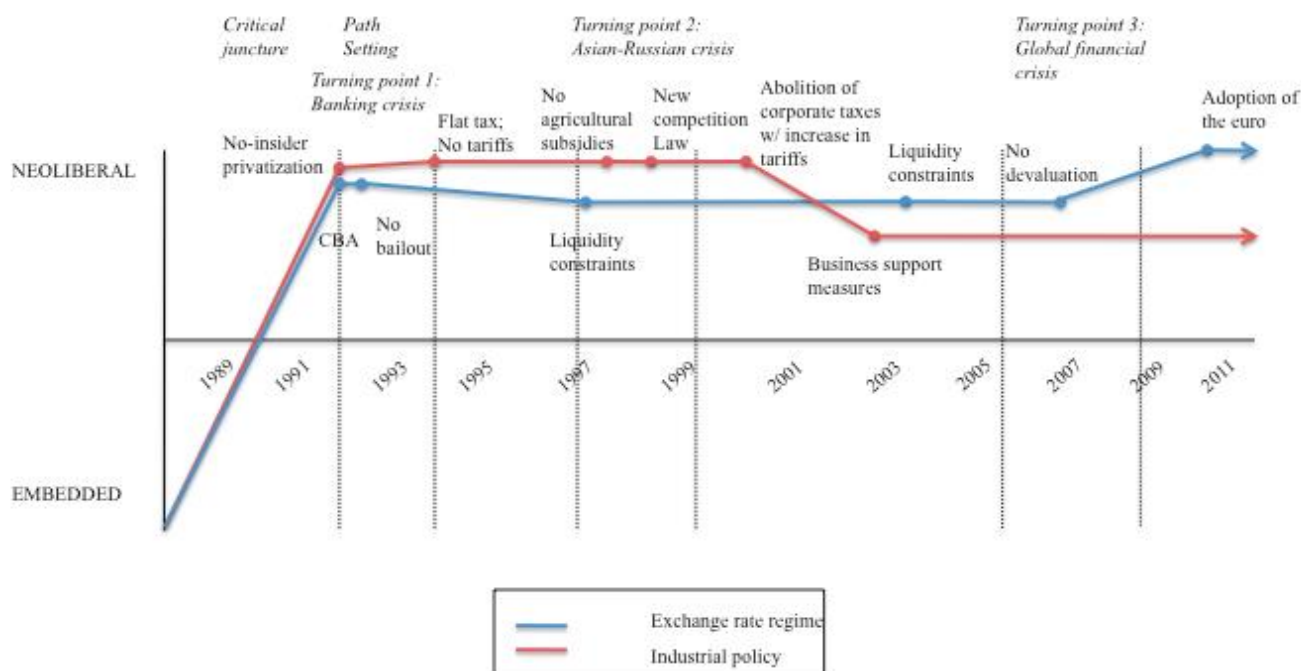


Figure 8. The Estonian neoliberal path: Positive feedback to a tight neoliberal path

#### 4.1 Critical juncture: Triple transition and the national question (1987-1991)

In August 1991 Estonia declared its independence from the former Soviet Union (FSU). The advances had already started in the late 1980s with Gorbachev's *perestroika* and *glasnot* reforms that gave the impulse for a movement seeking greater economic independence for Estonia. This movement gained momentum with the Singing revolution (1988-89) that catalyzed a widespread process of mobilization against Russian occupation. In the economic field, the elaboration of the IME, a proposal for a *self-managed Estonia* -as the

acronym speaks - that drew the possibility of a free-market economy in the country within the FSU was an important antecedent of the later reforms.<sup>39</sup>

Following these events in 1989 the FSU passed the Soviet Law on Economic Independence that granted some degree of autonomy to Estonia and the other Baltic states. The possibility to start a limited process of privatizations and price liberalizations were part of the gains. Under this framework the Bank of Estonia was re-established in 1990. Although it only functioned as the Tallinn subsidiary of the Soviet state bank -the *Gosbank*-, not having any formal role other than financial intermediation in the region, the Bank officials would play an important role in the future monetary reform after the independence. Moreover, during 1990 and 1991 the government enacted a gradual price liberalization cutting different subsidies (alcohol, foodstuffs, energy, transport and telecommunications), started the privatization of small enterprises and nationalized and modernized the tax system.

The soviet breakdown led to a widespread economic crisis in the soviet republics leading to a loss of export markets and dysfunctions in the payments system (Knöbl, Sutt, and Zavoiceo 2002, 9). In Estonia, industrial and agricultural production fell by 36-46% and inflation soared from 300% 1991 in the middle of price liberalizations to 940% next year in the context of the collapse of the Soviet economy (Smith 2002, 116). Simultaneous processes of price liberalization across the FSU and loose monetary policy by soviet authorities further deteriorated the situation, increasing the price of imports and the cost of energy leading to massive shortages of fuel and food (Smith 2002, 69).

The combination of dependence on soviet monetary policies, rise in inflation brought by widespread price liberalizations in the FSU, and local shortage of roubles, was unsustainable. In this context the exit of the crisis required abandoning the rouble zone,

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<sup>39</sup> Also called the 'four-man proposal', two of the signatories were Edgar Savisaar and Siim Kallas, further leader of the left-wing Popular Front and Governor of the Bank of Estonia respectively. Both would play key roles in the transition period and the setting of the neoliberal path the former as the main opposition of the chosen path, the latter as one of the main supporters.

establishing a national currency and a monetary policy *in tune* with the country's economic conditions (Erixon 2010, 19; Smith 2002, 116).<sup>40</sup>

The success of the economic reforms became thus closely entrenched with the necessity of political autonomy. The combination of economic crisis and the need (and will) of independence from the FSU created a particular scenario for the economic reforms to take place. In a short period of time the country had to address the challenge of a triple transition to a market economy, to a democratic political regime and to a nation state (Offe in Lauristin and Vihalemm 1997, 77-78). Under this scenario the new economic institutions became not only rules of the game for economic actors, but also important symbols of national unity and pride. Indeed, the adoption of autonomous financial institutions had to be pursued in parallel to the sovereignty question of establishing a border with Russia and achieve the withdrawal of Soviet troops still occupying Estonian soil (Smith 2002, 68).

In August 1991 Estonia declared the independence from the Soviet Union. This meant, however, that the economic situation became even more critical. The constituent assembly following the declaration of independence faced with the options of restoration of the previous political institutions or the declaration of a new 'Third Republic'. Two groups were the main actors: the first represented mainly by the Pro Patria (*Isamaa*) movement and other radical nationalist movements, called for a complete abolition of the soviet period and legacy, appealing to the national sentiment symbolized by the short period of independence in the interwar years. The second alternative was represented by the Popular Front that reunited former communist leaders that were in charge at the time of independence, who called for the foundation of a new republic laying on the soviet legacy. While the former entailed widespread neoliberal reforms as a means to cut with the Soviet past, the latter constituted a

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<sup>40</sup> Such a reform had been part of the IEM proposal four years earlier, but this proposal did not suggest an exact design of Estonia's new monetary order (Erixon 2010, 19).

middle way between a liberal market economy and a soviet style economy, i.e. a “‘socially oriented’ market economy along Nordic lines” (Smith 2002, 72).

The crucial issue was, nevertheless, the stance on the 'ethnic question' that could be summarized in the decision of granting or not citizenship rights to the Russian minority that had settled during the Soviet period and that accounted for about a 30% of the Estonian population. While the nationalists argued the necessity of a tight citizenship law that prevented Soviet settlers to take over either the growing domestic economy given that they controlled an important share of the industry, or the political process given their share in the total population. The Popular Front on the other hand, had a more integrationist stance towards the -now- Russian-speaking minority.

Given the scenario unleashed by the achievement of independence and the sentiments against the soviet occupation -that heavily affected the 'ethnic question'-, the balance of power inclined to the side of those who advocated a citizenship law restricted to Estonian ethnics and who framed the economic issues in a more nationalistic way. Indeed, as Smith argues, “[w]ith independent statehood restored, radical nationalists were able to tap the rich vein of popular resentment against Soviet-era settlers” (Smith 2002 74). Indeed, the presence of Russian troops that prolonged until August 1994 was the main public concern in the initial years of independence (Lauristin and Vihalemm 1997, 112).

So crucial was the nationalistic issue that it provoked a break in the Popular Front and a faction went to support the radical nationalistic standpoint. While the country was preparing for the first democratic elections of parliament in 1992, the provisional government of the ex-Popular Front Mart Vahi underwent several economic reforms closely related to the ethnic question: an acceleration of the privatizations that included a modification of the law on the restoration of property passed in 1991 and the restoration of the national currency, the Kroon (EEK) in 1992. The latter, in turn, was possible thanks to a stand-by agreement with the IMF

that required the liberalization of all consumer goods, freezing wages and the replacement of earnings-related pensions with flat benefits (Lauristin and Vihalemm 1997, 103).

Under this scenario, the first elections of president of the Republic were won by Lennart Meri<sup>41</sup>, against the candidate representing the more integrative citizenship law (Lauristin and Vihalemm 1997, 101). This would mark the future political faith. In fact, the new president had an important role in calling elections and appointing new prime ministers in the period of political instability and executive change during the 1990s.

In 1992 the election of Pro-Patria Mart Laar as the first Prime Minister illustrates the importance of the nationalist cleavage after the independence. Laar's government represented the younger generation of Estonians willing to radically cut ties with the old regime, as reflected in the composition of the government: young people, relatively "untainted" by associations with the former regime, non-party westward oriented technocratic experts, and *émigré* Estonians (Smith 2002, 83).

## **4.2 Path setting (1992-1994)**

With widespread expectations of change, Laar engaged in an acute neoliberal reform program with a nationalist flavour. In this context the establishment of a monetary order was central not only from economic reasons but also from national building ones (cf. Erixon 2010, 16). Apart from the symbolic effects, the implementation of new economic institutions under a nation building process implied that the new currency and the rest of institutions had to gain credibility and transparency in the eyes of the international community and especially external investors and economic agents (Bank of Estonia 1999, 4). In this sense monetary stability was

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<sup>41</sup> As the new Foreign Minister in 1991, Lennart Meri, later the President of Estonia, had recruited a new breed of civil servants that took a liberal view on Estonia's external economic policy. Some of them were assigned to lead the new External Economic Policy Department that was responsible for preparing trade policy reforms. This department also became the centre of reform. (Erixon 36)

seen as a precondition for successful reforms in other areas of economic policy (Bank of Estonia 1999, 3).

In the first quarter of 1992, the discussions on the monetary reform intensified and the search for a new arrangement became, in words of Erixon (2010, 21), more or less desperate as inflation skyrocketed and output crashed. The deterioration in government's budget in the absence of internal and external sources of financing, moreover, led to increasing pressures against the BOE to loose credit restrictions for state and private enterprises as well as commercial banks that were going through important economic distress (Knöbl, Sutt, and Zavoico 2002, 11). So critical was the situation that the government of the City of Tartu established its own currency to cope with rouble shortages, being rapidly suppressed by the BOE (Erixon 2010, 21).

The officials occupying high positions in the BOE were of great importance in delineating the new monetary regime (Knöbl, Sutt, and Zavoico 2002, 6). Led by Siim Kallas, they had developed pro-market orientations in contrast with the position of the former communist *nomenklatura* at the foundation of the bank in 1990 (Erixon 2010, 16). The new regime would also be strongly influenced by the recent experience of hyperinflation. Indeed, cutting down inflation was an important component of the economic agents' expectations and would grant the confidence and credibility the bank was looking for (cf. Erixon 2010, 19).

These elements, as Erixon rightly points, do not explain why Estonia established a Currency Board Arrangement (CBA) (Erixon 2010, 19). Two additional elements that shifted the balance of power will be discussed here: policy diffusion from successful experiences and the influence of the international community, in this case represented in the figure of neoliberal reform advocator and post-communist advisor Jeffrey Sachs.

On the first issue, the Argentinian experience of taping inflation with a CBA was fresh. This country had recently adopted a CBA and despite the important problems this



country had in the past curbing soaring prices, the CBA was considered as an effective and successful mechanism in restoring price stability and credibility in little time (Knöbl, Sutt, and Zavoico 2002, fn23).

The second element acted perhaps even stronger in favor of the CBA. As Erixon states, the influence of Jeffrey Sachs and his former student Ardo Hansson, who was advising Estonia on transitions policies, was crucial to support Kallas' views (Erixon 2010, 21).

In the moment of greater distress posed by the independence from FSU and the Soviet collapse in spring 1992, Jeffrey Sachs visited Tallinn to meet with Kallas and other government officials. The meeting, moreover, coincided with an IMF team that was negotiating a stand-by agreement with the government. When in Tallinn, and although his previous reserves, Sachs suggested to Kallas that Estonia should introduce a CBA and he outlined the details of the proposal in a memorandum (Erixon 2010 21).

Sachs' proposal had two major positive effects in the eyes of Kallas (Erixon 2010 22): first, its political economy effects that fostered discipline in economic policy by constraining discretion. Second, the similarity of the CBA with the gold standard. According to Erixon (2010, 22), Kallas was already focused on a currency reform when he assumed the position of Governor of the BOE in September 1991, and his preferences for an ER regime followed closely the Estonian stability experience under a gold standard in 1927-1933 (cf. also Knöbl, Sutt, and Zavoico 2002, 7).

Further endorsement of the mechanism by the IMF -after initial reserves- contributed to sealing the decision in favour of the CBA (Erixon 2010 22). In fact, this institution helped designing the austerity package needed to support the new monetary regime that included achieving a balance budget (from a 5% GDP deficit in 1992), and an increase in VAT (from 10% to 18%) among others (Knöbl, Sutt, and Zavoico 2002, 16-17).

Estonia implemented the CBA in June 1992. Its main dispositions were contained in the "Law on Security of the Kroon" and established that (Bank of Estonia 1999, 6): i) the EEK had to be fully secured by Estonia's gold and convertible FX reserves; ii) the ER would be determined with respect to the German Mark and the BOE had no right to devalue the EEK; iii) the BOE had to guarantee unconditional current account convertibility of the EEK; and iv) a change in the amount of EEK in circulation was possible only if there was corresponding change in the BOE's gold and/or FX reserves. A further agreement with the IMF in 1994 would establish the formal elimination of all restrictions to foreign capital on current transactions and related payments (Bank of Estonia 1999, 19; Knöbl, Sutt, and Zavoiceo 2002, 7).

The exact parity was explicitly set at an undervaluated level of 8 EEK per 1 Deutsche Mark, with the intention of promoting exports and protecting domestic producers from imports (Smith 2002, 120). And despite Jeffrey Sachs' proposal, convertibility was not made mandatory for broad money due to considerations of excessive constraints over the banking system and lack of enough international reserves (Knöbl, Sutt, and Zavoiceo 2002, 13).

In retrospective, the implementation of national financial institutions as the main building blocks of an independent Estonian State, and thus, strongly correlated with the rejection of Soviet communism and Russian occupation, had two main consequences that would generate positive feedbacks in subsequent turning points. First, and related with the critical juncture and setting of the neoliberal path, it helped insulating the initial reformers from the pressures from social groups. In fact, as pointed by Smith, the exhortation of the independence movements and the hope that the new Estonia would bring "a bright future" (Smith 2002, 81) making people more receptive to radical reforms despite the hardships provoked by the Soviet collapse and the first period of independent life. It also helped

framing the economic reforms in nationalistic terms generating a breeding ground for movements that proposed a steep break with the Soviet past (Smith 2002, 117).

Second, this initial insulation created the conditions to generate institutional lock-ins that would make a change in the direction of the path harder, either by a change in the balance of power or by interpretation. In fact the new constitution of independent Estonia promulgated in 1992 established that the government was obliged to maintain a balanced budget and the provision could only be modified with a two-thirds majority vote in parliament (Smith 2002, 118). Also, the ER parity was set by a law-like decree, requiring the parliament's consent for a change (Bank of Estonia 1999, 6). Additionally, the fiscal surplus arrangement that was supported by the IMF agreement in 1992 would bind the future electoral promises (Smith 2002, 96). Additionally the concern for establishing a good business environment for foreign investment as the main economic goal, and the shaping of the new institutions with the prospects of EU/EMU accession would become the main drivers for *adjustment*.<sup>42</sup>

### **4.3 Turning points: recurrent financial crises**

#### **4.3.1 An early banking crisis in the midst of the path setting process (1992-1994)**

The establishment of a sound banking sector was key to sustain the emerging private sector that followed the liberalization of prices and the privatization process. Policies licensing new banks were extremely loose<sup>43</sup> generating a rapid growth of the sector with "[l]ittle thought (...) to the implications of this policy for banking safety and supervision"

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<sup>42</sup> It is interesting to note that many of the westwards integration targets that were part of the technocratic elite's projects were not so embedded, at least in 1990s, in the sentiments of the population. For example, while in the eyes of the analysts EU accession constituted "the graduation of Estonia as a Western and modern country, politically far away from its recent past as a small part of the Soviet Union" (Erixon 2010, 39), the population remained suspicious about the consequences it would bring (Smith 2002, 107). As a matter of fact, even after the positive avis was obtained from the European Commission, support for EU entry stood at only 40% in 1997, with 35% of the people still undecided, falling to 26% and 60% respectively in the next year (Smith 2002, 107).

<sup>43</sup> According to the OECD, the minimum capital requirement for the establishment of a bank was equivalent to USD 40 000 and its restrictive effect was furthermore eroded by the hyperinflation of 1991-92 (OECD 2000, fn 45).

(Fleming, Chu, and Bakker 1996, 4). Although the mushrooming of commercial banks started in 1990, the neoliberal orientation of the reform leaders gave a further spurt. Indeed, in their view the bigger the number of banks the easier would be the generation of the competition needed to pull commercial interest rates down and facilitate the capital that the new businesses needed (Fleming, Chu, and Bakker 1996, 4). From five state banks in 1987, the total number of banks went to 43 in 1992 (25 new banks, 14 branches of the Agriculture Bank, and other 4 state banks) (Fleming, Chu, and Bakker 1996, 4).

According to the OECD (2000, 105) the banks created between 1990 and 1992 exploited the loose supervisory rules in order to generate rapid private gains. They rapidly engaged in excessive lending, high interest rates and corporate practices that "bordered illegality" (OECD 2000, 107). These elements together with a widespread mismanagement resulting in poor quality loan books, low capacity for risk management in the context of a rapid change in the macroeconomic environment constituted the "ingredients" of the future banking failure (OECD 2000, 105).

In early 1992 and before the CBA was in place, two large Russian banks froze the assets of Estonian banks that were held in Moscow<sup>44</sup> triggering important liquidity problems and producing a chain of failures (Fleming, Chu, and Bakker 1996, 8). Three Banks were mainly affected in Estonia, one of them, the Savings Bank, holding over 85 % of the household savings at the time (Fleming, Chu, and Bakker 1996, 8). The attitude of the BOE was selective: it protected only the banks whose difficulties were considered related to the lax policies of the BOE in the previous years. This decision was taken explicitly "by the desire to minimize disruptions to public confidence during the introduction of Estonia's new currency (the kroon) planned for June, 1992" (Fleming, Chu, and Bakker 1996, 8).

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<sup>44</sup> Before independence, most of the financial resources collected by local branches of the Soviet state banks were sent back to the main headquarters of each bank in Moscow. In early 1992, the Moscow offices of the Vnesheconombank and the Savings Bank froze all assets belonging to non-Russian banks causing problems throughout the former Soviet republics (Fleming, Chu, and Bakker 1996, 8).

The BOE took over the ownership of the Savings Bank, while the other two banks involved, the NESB and UBB, continued to operate normally assuming that the liquidity problems were temporary, and did not take particular measures to back their liabilities (Fleming, Chu, and Bakker 1996, 8). The liquidity problems were exacerbated, however, with the implementation of the CBA, making it impossible for the commercial banks to get new credits to back their loan portfolio, triggering a crisis in the banking system at the end of 1992 (Fleming, Chu, and Bakker 1996, 9): payments began to slow down and banks started to freeze enterprises accounts, including state enterprises, hoping that this would force the government to bail them out.

The attitudes of the newly appointed authorities were highly influenced by the political and economic conditions of the path-setting context under way i.e. the identification of economic institutions with the national building process and the necessity to provide a stable investment environment to foreign capital. Hence, preceded by Prime Minister Laar and BOE Governor Kallas authorities announced very quickly that no bail-outs would be provided. Although the CBA did allow the BOE to provide credit in a banking crisis, authorities decided not to stand for a large scale intervention that would have inflationary consequences and would threaten the recently adopted monetary arrangements and their credibility (Fleming, Chu, and Bakker 1996, 14; Smith 2002, 119).

The BOE placed a moratorium on the failed banks, whose assets accounted for about 40% of total Estonian banking system (Fleming, Chu, and Bakker 1996, 9). Many banks were delicensed after reviewing the licensing policy and others were restructured and/or merged. Additionally in 1993 the bank introduced guaranteed Credit Default Swaps with the aim of encouraging domestic interbank market and providing potential collateral (Bank of Estonia 1999, 8)<sup>45</sup>

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<sup>45</sup> According to the BOE the utilization of this instrument was not widespread and it practically disappeared with the introduction of stronger capital reserve requirements in 1996 (Bank of Estonia 1999, 8).

After the crisis had passed by mid-1993, the number of banks had decreased from 43 to 23. The Bank of Estonia also began to strengthen prudential supervision and regulation, passing a new Law on Credit Institutions and implementing international accounting standards (Fleming, Chu, and Bakker 1996, 14; OECD 2000, 106). A new wave of failures in 1994 induced the creation of a new banking law that included increased capital requirements, presentation of financial statements based on international accounting standards, audit of annual accounts to be carried out only by international auditing firms, and provision for increased competition (OECD 2000, 106-107).

According to Fleming, Chu and Bakker, given the small size of banking intermediation relative to Estonia's real sector and an output still declining, the episode did not generate great economic strains or political consequences (Knöbl, Sutt, and Zavoico 2002, 19). Nevertheless, it did contribute to enhance the positive feedbacks on the neoliberal path. On the one hand, it reduced the margin of interpretation of the recently adopted monetary arrangements: a no bailout could be expected in the future. Additionally, it helped creating expectations that authorities would favour the stability of the chosen institutions and 'favour' foreign capital,<sup>46</sup> which would anchor external interests to the future developments of the banking and financial sector.

#### **4.3.2 The Asian-Russian crisis and the political system (1997-1999)**

After a strong export performance in 1995 and 1996 -in part thanks to depreciated value at which the EEK was initially set- increased investor's confidence on the Estonian economy (OECD 2000, 108). The year 1997 showed an exceptional growth of 10.4%, the highest in Europe for that year, increasing the concerns of overheating (Sutela 2001, 55). At the same time, macroeconomic imbalances were accumulating: current account deficit

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<sup>46</sup> After the crisis passed, the blame was directed towards the weaknesses in bank regulation and supervision that created incentives for corrupt practices and risk-prone actions in banks (Fleming, Chu, and Bakker 1996, 26). In this way, and in the word of the analysts, the prospective that foreign banks took over the domestic banking industry represented a way of strengthening banking discipline (Fleming, Chu, and Bakker 1996, 26).

exceeded 14% in spring<sup>47</sup>, while bank credit increased around 80-90% and the production of financial services another 30% (Bank of Estonia 1999, 14; Sutela 2001, 55). Moreover, the recently opened Tallinn Stock Exchange (1996) was in a rally with financial flows to the country at an "all-time high" (Sutela 2001, 55) and stock prices doubling in a few months (OECD 2000, 69).

With the events occurred in Asia, creditors started to shed doubts about Estonian payment capacity (cf. Sutela 2001, 55) and the authorities decided to undertake measures to cool down the economy. The BOE responded tightening the conditions for credit, increasing the capital adequacy ratio and the minimum liquidity requirements and implementing a reserve requirement to cover net liabilities and restrain short-term capital inflows (OECD 2000, 69), while the fiscal balance was transformed into fiscal surplus reaching a 5% and a 2% of GDP in the third and fourth quarter of the year respectively (Bank of Estonia 1999, 14). Moreover, the government of Estonia announced the creation of a Stabilisation Reserve Fund (SRF) where fiscal surpluses would be deposited in order to reduce domestic demand and sustain the confidence of foreign investors in the economic policy framework (Bank of Estonia 1999, 14).<sup>48</sup>

In the context of increasing liquidity requirements, interest rates started to go up while the stock exchange plummeted.<sup>49</sup> The authorities argued that this evolution constituted the adequate correction of the economy given the CBA, and not a crisis of confidence in the Estonian economy, reinsuring their compromise with the CBA and announcing further contractive measures (i.e. increase reserve requirements, increase fiscal surpluses) for the next year (Sutela 2001, 56).

<sup>47</sup> According to Aslund, the rule of thumb is that a deficit larger than 4-5 % of GDP is dangerous (2010, 19).

<sup>48</sup> The SRF was used to withdraw liquidity from banks by transferring public savings abroad and to sterilise money proceeding from some large privatisations. In March 1999 the balance on the SRF amounted to 3.5 per cent of projected GDP for the year (OECD 2000, 99)

<sup>49</sup> By the end of 1997 the Tallinn lost nearly three-quarters of its value and the losses were concentrated in the banking sector (OECD 2000, 104).

In the meanwhile, however, the Asian crisis had produced a deceleration of growth in Europe. The start of the Russian crisis in 1998 on the other hand, with the CIS being destination of 21% of Estonian exports especially of food manufactures, fishing and agriculture products (Sutela 2001, 50), added a further strain on the economy. With increasing detrimental conditions in 1998 and a fiscal budget that had been calculated with prospects of higher economic growth, the targeted fiscal surplus went to an increasing fiscal deficit that reached 5% in the fourth quarter. As a result, and despite the balances of previous years, a stand-by agreement with the IMF had to be signed in November of 1998, and the desired cool down (6,6% of growth in 1998) had gone to a rapid a downturn of -0,3% in 1999.

This seemed a perfect setting for backlash of the neoliberal path. Indeed, the impact of the crisis in the agricultural sector increased the "vociferousness of the rural lobby" (Smith 103-4) that had been the main sector in opposition of the liberal reforms. On the other hand, the elections of 1995 had brought back into power the Popular Front with an important social agenda in sight, including increasing pensions, reducing unemployment, and the protection of the agricultural sector (Smith 2002, 94-95). The government indeed devised a package of subsidies to farmers, and an increase in 10% tariffs to non-EU imports. However, these would be banned by the constitutional court for passing over the parliament (Smith 2002 104).

The inability of left-wing political parties to generate a credible opposition to the neoliberal path and act as agents of change can be understood in the context of an under-institutionalized political system given the pervasive ethnic divide driving domestic politics.<sup>50</sup> According to O'Dwyer and Kovalčík an under-institutionalized political system insulates the political competition from social pressures, "attenuat[ing] the public's voice in policymaking" and weakening "vertical accountability between government and voters" (2007, 5).

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<sup>50</sup> Following Kitschelt the presence of multiple social divides in the electorate "frustrate[s] the development of a left-right spectrum structured by a dominant socio-economic cleavage" (in O'Dwyer and Kovalčík 2007, 10). In this sense the underinstitutionalization of Estonia's political system is directly related to the ethnic question.



Smith describes several features of the under-institutionalized character of Estonian party system: after independence political parties constituted little more than small popular movements, often grouping around one or more prominent leaders (Smith 2002, 79-80); the multi-party proportional system facilitated a "mushrooming of parties and electoral platforms" (Smith 2002, 81); in addition, the modifications made between 1994-1998 to stabilize governments and coalitions, made it difficult for parties to channel electoral demands (Smith 2002, 117).

Two consequences emanated for the ability of opposition groups in Estonia to change the direction of the neoliberal path. First, it made it difficult to create a coherent and credible opposition. In fact, as pointed by O'Dwyer and Kovalčík (2007, 10), in the case of Estonia the perception that parties related to the old *nomenklatura* i.e. those at the left of the spectrum, were "overly compliant towards Russian-speaking settlers" (2007, 15) prevented the consolidation of an opposition on pure socioeconomic grounds.

On the other hand, without clear constituencies, "opposition parties are less resistant to cooptation by the government" (O'Dwyer and Kovalčík 2007, 15), fragmenting opposition vote and hindering cooperation. Indeed as Smith (2002, 116) underscores, the inability of the different Estonian governments to complete their term in office is tightly related to the many internal differences of the multiparty coalitions that sustained them.

Additionally, public debate over the policy alternatives to face the crisis was scarce. Indeed, as Smith highlights, the advancements in institutional reforms were not followed by the democratization of the political culture and civil society was not well organized (2002, 67).<sup>51</sup> Thus, the analyses of the consequences of the crisis tightened the support for the monetary arrangement. Although the CBA was said to "limit the scope for responses to external shocks" (Bank of Estonia 1999, 19), to allow a too rapid transmission of external

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<sup>51</sup> This was a legacy of Estonian politics during the Soviet period. As Lauristin and Vihalemm emphasize, until the 1980s the political contestation movement was rather small, in comparison to, for example, cultural manifestations of resistance (1997, 74-5).

shocks to the real sector (Eamets, Varblane, and Sõstra 2003, 13) and to play a pro-cyclical role in the downturn of the economic activity (Sutela 2001, 48; OECD 2000, 73), analysts underscored instead its capacity to "build up a stable and reliable investment climate" (Bank of Estonia 1999, 19).

At the same time, even though the recession had showed the vulnerability of small and open Estonian economy to external shocks and international economic fluctuations (Eamets, Varblane, and Sõstra 2003, 8), the Russian crisis had created a window of opportunity for Estonian producers to upgrade and increase their productivity. In fact, the closing of the eastern market led to a relatively fast reallocation of trade towards the West, mainly to Finland and Sweden. Moreover, although several banks failed and manufacturing firms went into bankruptcy, the low stock prices of the remaining -more efficient- ones allowed foreign investors to acquire major shares (Eamets, Varblane, and Sõstra 2003, 6). Ultimately, this would create pervasive external interests in the maintenance of the economic policies. For example, about 85% of the Estonian banking sector, 90% of the leasing and 30% of the insurance market became concentrated into two major foreign-controlled financial groups (OECD 2000, 106)

This result was directly related to the positive feedbacks generated around the neoliberal institutions. Thus, while ethnic politics shifted the balance of power towards political groups proposing a more radical break with the Soviet past, insulating radical nationalist to impose their neoliberal program, the under-institutionalization of the political system made the maintenance of the initial reforms possible despite the economic turbulences. Additionally it would create a new source of positive feedback: external economic agents interested in the maintenance of the economic policy framework.

### 4.3.3 Global financial crisis and EMU accession (2007-2010)

During 2000-07 Estonia showed an outstanding rate of growth diminishing unemployment and rapidly converging towards EU income levels (OECD 2009, 20). After 2005 however, the economy started to show signs of overheating again: increasing macroeconomic imbalances that reflected rising inflation and wages, and threatening current account deficits (OECD 2009, 20).

In this context the BOE tried to use the instruments in its hands. Unwanted inflation pressures would in fact, hinder the much-expected EMU accession in spite of the fulfilling of the fiscal and exchange rate parts of the Maastricht criteria. In 2005 the CBA raised the minimum reserve requirements and tightened the capital adequacy ratios, i.e. the same measures that it had used under the Asian-Russian crisis (Deroose, Flores, Giudice, and Turrini 2010, 5). The trend, however, reflected deeper institutional determinants such as the compromises generated around the CBA and the strong incentives these generated for portfolio capital flows.

In 2002 Estonia's current account deficit was already of double digits, and by 2007 it reached 18% of GDP (Åslund 2010, 41). The high rates of growth were mostly fed by a rapid foreign-financed credit boom, with an expansion of the total credit volume of 95% (Åslund 2010, 18). At the same time, the foreign-owned bank sector had promoted the indebtedness in FX, reaching more than half of domestic loans (Åslund 2010, 19) while foreign debt rose up to 114% of GDP (Åslund 2010, 41). On the other hand, credit growth went mostly to consumption, feeding the growth of the non-tradable sector especially finance intermediation and real estate (Raagmaa 2010, 57). In fact, in 2008 the financial sector accounted for 24% of Estonian GDP while construction was between 8-10% (Åslund 2010, 59). Additionally, high capital flows under a CBA, led to high monetization and accordingly, an upward turn in the inflation trend -that would reach two digits in 2008.

The bust of the housing bubble in the U.S. and its contagion effects arrived to Estonia, as could be predicted, through the financial channel. Increased credit restrictions due to international lack of liquidity made foreign owners of the major local banks tighten back the conditions for successive credits and started to slow down their lending (Åslund 2010, 25). As a consequence, housing prices plummeted together with investment and private consumption (Åslund 2010, 25) leading to a downturn that had major consequences in Estonia's small and overheated economy. Analysts labelled the fall of 15,6% in the first quarter of 2009 "epic" (Erixon 2010, 2).

Following Erixon (2010, 3), three explanations were available for this "sudden stop" (Åslund 2010, 26):

- i. The Baltic economies had undergone a typical process of overheating and needed a dose of contractive measures such as the ones utilized in the Asian-Russian crisis to return to equilibrium.
- ii. After the completion of economic reforms, EU accession and outstanding rates of growth, political leaders had grown "complacent" (Erixon 2010, 3), relaxing its initial compromise to maintain sound economic policies and neglecting the need to improve competitiveness (cf. for example Deroose, Flores, Giudice, and Turrini 2010, 4).
- iii. The neoliberal path followed by Estonia had inherent shortcomings. These were illustrated by the excessive faith in free markets and openness to foreign capital that led to a "hot air economic growth" (Erixon 2010, 3) without a strategic industrial policy to promote export growth. Furthermore, it was the very institutional framework surrounding the CBA that made it difficult to control the growing imbalances (e.g. the openness to capital flows -reinforced

by adoption of the EU regulations- and the impossibility to use monetary policy) (Raagmaa 2010, 67).

While analysts advocating the second and third explanations pointed the need to drop the monetary arrangement, policymakers were more inclined towards the first (cf. Kuokštis and Vilpišauskas 2010, 3). In fact, with the crisis already in course they insisted in the goal of adopting the euro putting in place the necessary policies to comply with the Maastricht criteria (Åslund 2010, 107). This policy choice was widely backed by public opinion and domestic analysts, and enjoyed important external supporters. Among them Kuokštis and Vilpišauskas (2010, 6-7) mention two: the Swedish government and the EU. The Swedish government was concerned about the problems a devaluation of the EEK would bring to the Swedish banks controlling almost the entire banking system and a great part of the financial intermediation business. Devaluation would erode their positions and oblige the Swedish government to bail them with Swedish taxpayer money. The EU commission, on the other hand, feared that a deep devaluation in one EU country would produce a collapse in the other Baltics causing a domino effect on the rest of the ECE region.

In this context, in February of 2009 the Bank signed a precautionary agreement with the Swedish Central Bank that allowed it to borrow up to 10 billion Swedish kronor against EEK in order to ensure liquidity in case of massive capital outflow (OECD 2009, 22). This move implied, in practice, the confirmation of the CBA and the adoption of measures to restore the equilibrium using internal devaluation to foster external adjustment (cf. for example Deroose, Flores, Giudice, and Turrini 2010, 7). Subsequently, and with the goal of EMU accession in sight, the government started an austerity package to keep the deficit below 3% of GDP (OECD 2009, 23). Budget cuts amounted to 9% of GDP with massive layoffs and rocketing unemployment. It also undertook other measures to increase revenue such as

postponing the reduction of the income tax rate and increasing the VAT base (OECD 2009, 23), which would in turn further enhance the contractive measures of the crisis.

According to Åslund (2010, 41) a rapid return to growth in 2010 convinced the public that in spite of the hardships, the decision to stick to the CBA maintaining fiscal surpluses and support market reforms was right. In fact, thanks to the decrease in inflation provoked by the recession, the maintenance of the ER parity and the ability to maintain low levels of fiscal deficits, the EU Commission announced the acceptance of Estonia to the Eurozone in 2011.

These events show the reach of the positive feedbacks to the neoliberal institutions, as enhanced by the external environment. In this case, after the effects of ethnic politics and an under-institutionalized political system, the EU membership and the later perspective of EMU accession have been strong factors to maintain economic policy framework (OECD 2000, 103; Deroose, Flores, Giudice, and Turrini 2010, 7-8). This was further reinforced by the generation of strong business interests -i.e. foreign banks and financial institutions- after the Asian crisis, and their growing relevance in determining the dynamics of the Estonian economy.

#### **4.4 *Waves of industrial restructuring under neoclassical orientations***

Industrial policy in Estonia is also heavily marked by the nationalistic cleavage generating an aversion to the Soviet past in the form of a disdain for state intervention and selectiveness. The policy has followed a neoclassical orientation that privileges clarity, credibility and non-discriminatory rules (Sutela 2001, 19).

According to Tiits (2007, 332), the expectation of the authorities was that fast privatization and external liberalization would produce massive capital flows increasing the rate of investment and productivity and fostering external competitiveness (Tiits 2007, 332).

Three waves of industrial policy can be identified under these orientations: privatization, liberalization and EU accession. Most of the positive industrial policy measures were taken after 2000 in the face of EU accession prospects. Before that, industrial policy was constrained to other higher-hierarchy policies shaping the competitiveness of Estonian industry such as privatization and liberalization policies. The three waves also show distinct outcomes in terms of industry promotion and restructuring. We will address these as well as the outcomes of the overall trajectory.

#### **4.4.1 Privatization and FDI**

Privatization started early during the critical juncture period with the privatization of small enterprises favouring mostly insiders i.e. existing managers and employees. After the creation of the Estonian Privatization Agency (EPA) in 1992, however, insiders lose all privileges in acquiring enterprises. A modified privatization law was yielded in 1993 broadening the base of potential buyers to including foreign investors in the process (OECD 2000, 25). The decision not to favour insiders was directly related to the fact that large enterprises and a good part of the industry were in a large proportion in hands of the Russian speaking population (OECD 2000, 132).

The country adopted the Treuhand model<sup>52</sup> for the privatization of large enterprises and a voucher system for smaller enterprises with no restrictions to foreign capital. Most privatisations were carried out in 1994 and apart from a few strategic enterprises (e.g. in the energy sector) by 1995 the process was almost completed (OECD 2000, 126). While insiders were not given a preferential treatment, they were able to participate in the bids in equal conditions (OECD 2000, 132).

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<sup>52</sup> The “Treuhandanstalt” (Treuhand) model was the method of privatization utilized in East Germany. It consisted in setting an international tender where the enterprise would be sold to the best bid. In addition to the price offered, other criteria were considered. Potential buyers also had to submit plans setting out their business strategy, the proposed investment and expected employment. (OECD 2000, 126)

Nevertheless, despite the search for neutrality in practice the process favoured the flows of FDI to the country and was in a high degree responsible of the structure of the industry by the end of the 1990s (cf. Sutela 2001, 19; Tiits 2007, 332). Indeed, according to the OECD (2000, 127) the better access to external capital in the context of a small domestic financial system gave external agents a clear advantage, and as follows, they acquired an important share of the privatised companies (OECD 2000, 126). As a result, by 1997 the companies controlled by foreign capital already accounted for one third of Estonian output and generated over 50% of exports (Sutela 2001, 19).

#### **4.4.2 Liberalization and international integration**

Together with privatizations, an important and widespread liberalization process took place since the beginning of the 1990s. Estonia followed a unilateral policy of tariff elimination during 1992-1993, signed a free trade agreement with the EU in 1995 and by 1998 was accepted to the WTO.

Several adjustments followed this rapid external opening in order to establish a good business environment to attract investors. Among them, the establishment of a flat tax on corporate and personal income in 1994 -that included the elimination of previous tax benefits for foreign investors-, and a new competition law in 1998 following EU directives. Corporate taxes would be further eliminated in 2000. According to Sutela (2001, 19) policymakers openly avoided tax holidays, free trade zones and other such selective instruments.

Unlike the case of other developing countries, the process of international integration in Estonia did not produce adjustments in terms of further liberalization.<sup>53</sup> On the contrary, as duties and other regulations were already low, many of them had to be increased in the process of adopting the respective EU and WTO agreements. For example, in the context of

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<sup>53</sup> For example, Estonia had no transitional period in its agreement with the EU, applying no duties to industrial goods including all agricultural and fisheries goods (OECD 2000, 191).



EU accession it was necessary to implement custom tariffs to third countries in order to align Estonian borders with those of the EU (OECD 2000, 219). Interestingly, these measures would not affect most of Estonian trade partners (EU members and the other Baltic states). In addition some tariffs were increased in line with WTO agreements in order to compensate for lower fiscal revenue after the elimination of corporate taxes (OECD 2000, 85-86). The latter marks contrasts with the previously mentioned negative of the constitutional court to grant protections to foodstuff and agriculture producers in the face of the Russian crisis. In this sense, it clearly shows that the sources of change did not come from the domestic environment -given the insulation of dominant groups from social pressures- but from external factors.

As a result during the 1990s the Estonian export capacity specialized in low technology and resource-intensive activities industries (Tiits, Kattel, and Kalvet 2006, 58). The most important competitive advantages were at this stage the low price of production inputs, especially labour and energy (Tiits 2007, 332). In this way, at the beginning of the 2000s the export structure was mostly concentrated in wood processing activities (including furniture, printing and paper industries), that were responsible for productivity and income growth (Tiits, Kattel, and Kalvet 2006, 6). Additionally low value-adding enterprises were developed as part of the Scandinavian information technology and electronic clusters (Tiits, Kattel, and Kalvet 2006, 6). This industry was based mainly on subcontracting activities between local and foreign companies, especially in the case of the production of machinery and electrical equipment (Tiits, Kattel, and Kalvet 2006, 6).

As wages started to grow especially in the mid' 2000s, the 'low-cost producer' competitive advantage would not last for long as companies started to reduce their operations in the country to find a new low cost producer in the global value chain (Raagmaa 2010, 69).

Within Estonia this manifested in a movement of the production facilities of labour-intensive industries to the geographic peripheries (Raagmaa 2010, 69).

#### **4.4.3 Towards a market friendly environment under EU accession**

Pre-accession to the EU was an important factor inducing the adoption of some business support measures. Although it did not put the same pressure on all sectors, as Tiits Kattel and Kalvet (2006, 60) emphasize, "all industries are (...) forced to make significant investments into the modernisation or innovation of their products, working environment, production processes as well as waste management and the like in order to meet the terms imposed by the European Union".

Similar to what occurred in the case of liberalization policies, EU accession implied that Estonia had to introduce more pragmatic policies in terms of promotion of exports and thus a small correction away from the liberal end. Industrial policy developments in this sense, were almost exclusively restricted to the arrival of EU funds under specific projects, and were fostered by the adoption of the *acquis communautaire* and other EU policies (Tiits, Kattel, and Kalvet 2006, 59).

Under this impulse several developments took place (Kuusk and Jürgenson 2008, 2). First, in 2002 was elaborated the document "Enterprising Estonia - National Policy for the Development of SMEs in Estonia in 2001-2006" with the aim of favouring enterprising spirit, create new jobs and improve the competitiveness of Estonian businesses. Second, a strategy for the development of R&D called "Knowledge-based Estonia" was outlined.

The latter was considered the "most important research, development and innovation (RD&I) policy" in Estonia (Kuusk and Jürgenson 2008, 2). It was based on a national consensus on the importance of Research and Development, establishing strategic goals and courses of action in order to strengthen the knowledge base of the Estonian economy and increase competitiveness. The strategy also identified key areas for business support such as

user-friendly information technologies, biotechnology, and materials' technologies (Kuusk and Jürgenson 2008, 2).

These developments were also reflected in the Estonian National Development Plan (NDP) that served as a basis for the distribution of the EU structural funds through the years 2004 and 2006. Under this framework the government enacted diverse grant schemes (for start-up businesses, training, contracting consultancies, developing infrastructure and R&D) in addition to loan programs and guarantees to overcome collateral problems. Two public bodies were created to manage these instruments: Enterprise Estonia (EE) and the Credit and Export Guarantee Fund (KredEx) (Kuusk and Jürgenson 2008, 2-3; OECD 2009, 142).

As a consequence R&D as a share of the GDP has increased reaching 1.14% in 2006 that according to analysts is appropriate for the level of GDP of Estonia, but still half of the OECD average (OECD 2009, 131).

Despite the process of upgrading of Estonian legal framework to EU regulations has been the main driver for the establishment of promotion policies (Tiits, Kattel, and Kalvet 2006, 59) the package of 'business friendly measures' implemented did not have a substantive affect on steering the development of Estonian industry towards higher value added industries. Instead, FDI concentrated during the period on non-tradable sectors especially financial and real estate. As shown by Raagmaa (2010, 68) the cumulative stock of FDI between 2001 and 2008 went mainly to financial intermediation (32,9%) and real estate (27,5%) while manufacturing received a meagre 14,4% of the total. Thus, instead of promoting investment in higher value added industries, capital flows and the business friendly environment strategy set by the authorities have contributed to decrease the relative importance of middle- and high-technology value added in Estonian industry as well as generating a "financing pattern of the current account deficit [centred in] portfolio investments" (OECD 2000, 108).

On the other hand, market concentration has increased<sup>54</sup> rising concomitantly the dependency on large foreign-owned enterprises<sup>55</sup> and producing concerning social and geographical inequalities. Thus while GDP has grown 416% in the Tallinn region, it has done so by about a half (only 247%) in north-eastern region (industrial and mining), while unemployment has also been the double in the former region and it has lost a quarter of its population (Raagmaa 2010, 77-78; 89; cf. also OECD 2000, 141).

#### **4.5 Conclusion on Estonia**

Estonia shows a pattern of change of *positive feedback* to the neoliberal institutions. Three interconnected elements generated these feedbacks with the outcome of hindering domestic sources of change and favouring adjustments taking into consideration external interests. First, the characteristics of the transition period and the emerging ethnic political cleavages; second, the effects of an under-institutionalized political system on the political dynamics of the years following the market reforms; third, the importance of external factors including foreign business interests, in moulding Estonian institutions and generating expectations for their maintenance.

The context of a triple transition in the critical juncture and the importance of nation building determined the emergence of a pattern of political competition highly influenced by the ethnic question and the importance of political leaders as agents of change. The installation of the CBA at the top of institutional hierarchy was facilitated by the identification of the neoliberal reforms with the national independence. The setting of important institutional lock-ins in this period combined with the under-institutionalization of

<sup>54</sup> According to Tiits, the Swedish investments account for approximately a half of Estonia's inward FDI position (2007, 331)

<sup>55</sup> Sutela (2001, 42) exemplifies this with the case of a Finnish-owned electronics subcontractor that in the early 2000s was responsible for as much as 28,5 per cent of total Estonian exports. The downturn of their main customers - Nordic mobile phone companies- lead to a major stop in further expansion plans and a massive loss of jobs.

the political system, especially the party system, and the lack of a democratic culture, hindered the formation of a structured political opposition that could credibly threaten the path. In addition, the creation of external business interests and the initiation of the EU accession process successively supported and gave legitimacy to the initial policy choices.

The balance of power has remained stable given the institutional lock-ins generated at the beginning of the process, when the ethnic base of political competition insulated policymakers to carry the neoliberal reforms and successively shielded them from political competition. External sources have been a determinant driver of small adjustments, especially external influences (e.g. in the path setting period to establish the CBA) and leverage (e.g. to maintain the CBA under the global financial crisis). Interpretation, on the other hand, has been restricted thanks to the early institutionalization of the CBA and the rest of neoliberal reforms.

The ER reflects what has been called *marginal adjustment*. With high degrees of institutionalization since the beginning of the path i.e. parliamentary approval and high quorums needed for change, plus important degrees of insulation from domestic pressures, minor adjustments have been made to the institutional environment built around the CBA - e.g. new instruments for the BOE to constrain liquidity, a stabilization fund to sustain fiscal surpluses-. These have been done mainly to meet external agents' expectations -especially foreign business- of stability and high returns.

In the case of industrial policy a process of layering has been carried out, especially after EU accession. This, however, has remained highly constrained by the complementarities emanating from the institutional hierarchy i.e. the constraints on public spending.

This international orientation and the idea of creating a good environment for investment has been the main responsible of locking the Estonian political economy into a tight neoliberal path highly dependent on external agents and the fluctuations of the

international markets, or as Sutela puts it, "the development pattern of lacking markets" (2001, 51). The latter has strongly biased the development of the financial and real estate sector as opposed to the manufacturing sector, especially after the country started losing its edge as the lower stitch on the commodity chain for the production of low value added products.

Recent adoption of the euro represents the culmination of the process of international integration and it is marked by the necessity that the country starts focusing on industrial upgrade to be able to compete with its western partners. Conversely, while increasing awareness of the Estonian economy losing external competitiveness has started to induce proposals of more active engagement of the state in industrial upgrading, the dominance of a radical stabilization goal and its incompatibility with larger forms of state intervention has left no room for increasing embeddedness through industrial policy.

## GENERAL CONCLUSIONS

The present study has addressed the patterns of institutional change and external competitiveness in two emerging and neoliberal political economies, Chile and Estonia. The concrete features of each case have been highlighted in the conclusions of the respective chapters. Following the research concerns this investigation has posed, the final conclusions will draw on two issues: first, it will review the characteristics of the neoliberal patterns of institutional change here analyzed; second, it will reflect on the challenges neoliberal and dependent political economies face in terms of external competitiveness.

The analytical framework of an integrated theory of institutional change has highlighted the role of institutional hierarchy to understand the different possible modes of change. In the context of neoliberal and dependent political economies, this has allowed to understand the processes of institutional development and change triggered by critical junctures and stabilized through successive political and/or economic turning points.

As has been showed, in the context of an encompassing international pressure towards liberalization, neoliberal institutions do not remain unmodified, but are subject to constant modifications. The processes of change underlying these modifications can be understood in the context of the hierarchies dominant groups embedd in the institutional framework. The latter establishes a set of propositions regarding the expected strategies these groups and/or political leaders will enact in order to maintain their institutional advantages represented in these institutions. In a general fashion, the processes of change occurring in high-hierarchy institutions have been called *adjustment*.

Processes of institutional change by adjustment are characterised by the ability of the dominant groups and/or political leaders to maintain the institutional hierarchy over time. This can be achieved by i) *marginal adjustments*, this is, the modification of the parameters of

institutions and/or their complementary structures, ii) *interpretative adjustments* i.e. the further interpretation or institutionalization of policies by certain factions of the dominant bloc that become thus hegemonic, and iii) *adjustment by replacement*, i.e. by important accommodations in the power relations and the formation of new coalitions including new interests that do not contradict -in the eyes of the dominant groups- their interests.

We can account for some specific mechanisms by which neoliberal economies have succeed in maintaining their track, as illustrated by the cases of Chile and Estonia here analyzed. Two of them will be highlighted: early institutionalization and the ability of groups of defending hierarchical goals while having flexibility to give up lower-hierarchy institutions. The first is widely shown by the Estonian case where the early institutionalization and strict definition of characteristics of the institutions at the higher end of the hierarchy, i.e. the CBA and its complementary arrangements. This narrowed the possibility for change either by a shift in the balance of power or by changing the interpretation of the rules. On the other hand, it generated deadlocks that in the context of a particular critical juncture and a political setting marked by an ethnic divide, isolated them from political competition. The pressures for change, then, came from external forces that were interested in maintaining these arrangements, and thus, were reflected in marginal adjustments.

The second is illustrated by the Chilean path, especially in the first two turning points where the dominant groups had to accept concessions to other groups i.e. subsidies to the business sector, an increased tax base for redistribution to political adversaries in power, in order to maintain the stabilization goal on the top of the hierarchy.

While in the former case the early institutionalization allowed to maintain the liberal path through positive feedbacks that hindered the possibility to develop a more embedded industrial policy, in the latter the relative flexibility of the path generated a liberal ecology, or



a constant search for the right compromises to stabilize the liberal path. This also generated more room of manoeuvre to change lower hierarchy institutions i.e. industrial policy, in an increasing embedding direction.

Regarding the absence of a credible political alternative to the liberal track in both paths, the main factors appear to be the weakness and/or conversion of oppositions (e.g. by a pragmatic turn as in the case of Chile), and the fact that the more contentious movements are left out of the legal political playfield (e.g. political left in Chile, Russian ethnics in Estonia). Moreover, the creation of institutional deadlocks reflecting path dependent constitutional processes in both countries shortened the room of manoeuvre of opposition political groups to establish the political competition around a contestation of the high-hierarchy institutions.

In relation to the 'non advanced' character of Chile and Estonia's political economies, two important sources of institutional change are the leverage exerted by external agents and the formation of informal coalitions between insiders and outsiders that conduce political economies to certain forms of international integration. While these external sources may not necessarily produce further liberalization, as the Estonian case shows, they can exert diverse degrees of leverage that act as obstacles for a change towards the embeddedding direction. These forms of leverage vary from setting conditions for loans or integration agreements (as in the case of both Chile and Estonia with the IMF and the WTO, and especially the case of Estonia with the EU), to other *softer* forms of coercion such as generating certain expectations with respect to institutional change and stability (for example, the case of Chile in the return to democracy).

The two cases under study show the importance that a liberal environment places to institutions regulating the stability of prices (i.e. the control of inflation) as the main driver of the economic agent's expectations, and to the creation of a stable environment for investment (especially foreign). Although they underline openness and export led-growth, given the

position dependent political economies have in the international division of labour, they are foster instead the development of the non-tradable sector especially banking, finance intermediation and real estate, resource based industries and labour intensive industries. Thus, the net effect of the neoliberal paths observed has been a gradual loss of external competitiveness coming from constant external shocks.

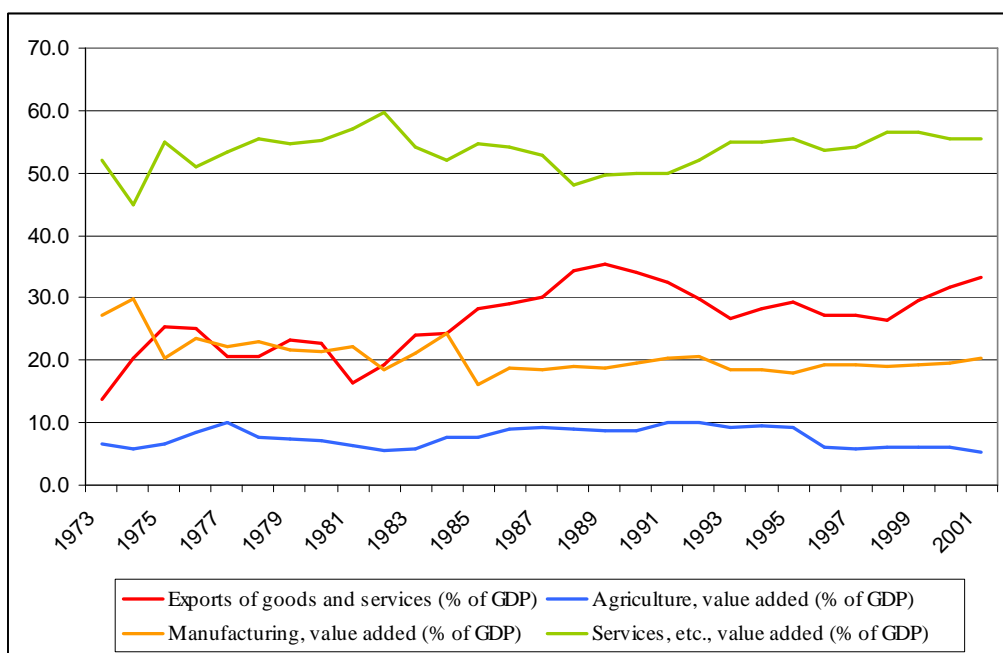
This paradox becomes more evident with time, when the pursuance of the liberal track starts to be incompatible with the development of higher value-added industries. The challenge for these political economies will be in the ability of loser sectors to promote new coalitions favouring a shift in the direction of change. As has been discussed, although small embryos of this can be observed both in Chile and Estonia, both the domestic and the external sources of change remain dormant.

## ANNEX

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<i>GDP</i>																													
GDP growth (annual %)	-4.9	2.5	-11.4	3.4	8.7	7.5	8.7	8.1	4.7	-10.3	-3.8	8.0	7.1	5.6	6.6	7.3	10.6	3.7	8.0	12.3	7.0	5.7	10.6	7.4	6.6	3.2	-0.8	4.5	3.4
GDP per capita growth (annual %)	-6.5	0.8	-12.7	1.9	7.2	6.0	7.2	6.6	3.2	-11.7	-5.3	6.2	5.4	3.9	4.8	5.5	8.7	1.9	6.0	10.2	5.1	3.9	8.8	5.8	5.1	1.9	-2.0	3.2	2.2
<i>Prices</i>																													
Real effective exchange rate index (2005 = 100)								171.9	204.0	182.6	150.4	148.8	121.9	104.2	95.8	89.7	92.0	88.0	91.8	97.0	99.0	102.5	108.6	111.2	119.4	117.2	111.6	110.7	100.0
Inflation, consumer prices (annual %) <sup>a</sup>	352.7	504.7	374.7	212.0	92.0	40.1	33.4	35.1	19.7	9.9	27.3	19.9	30.7	19.5	19.9	14.7	17.0	26.0	21.8	15.4	12.7	11.4	8.2	7.4	6.1	5.1	3.3	3.8	3.6
<i>External sector</i>																													
Current account balance (% of GDP)			-6.8	1.5	-4.1	-7.1	-5.7	-7.1	-14.5	-9.5	-5.6	-11.0	-8.6	-6.7	-3.5	-0.9	-2.4	-1.5	-0.3	-2.2	-5.4	-2.9	-1.9	-4.1	-4.4	-4.9	0.1	-1.2	-1.6
Exports of goods and services (% of GDP)	13.7	20.4	25.4	25.1	20.6	20.6	23.3	22.8	16.4	19.4	24.0	24.2	28.1	29.1	30.1	34.2	35.4	34.0	32.4	29.8	26.6	28.2	29.3	27.3	27.1	26.3	29.6	31.6	33.3
Foreign direct investment, net inflows (% of GDP)			0.7	0.0	0.2	1.2	1.2	0.8	1.2	1.6	0.7	0.4	0.9	1.8	4.3	3.9	4.5	2.1	2.3	2.1	2.2	4.7	4.1	6.4	6.4	5.8	12.0	6.5	6.1
<i>Production</i>																													
Agriculture, value added (% of GDP)	6.7	5.8	6.6	8.5	10.0	7.8	7.4	7.3	6.3	5.5	5.9	7.5	7.6	9.0	9.2	8.9	8.7	8.7	9.9	9.9	9.2	9.4	9.2	6.0	5.9	6.1	6.2	6.1	5.4
Industry, value added (% of GDP)	41.2	49.3	38.4	40.5	36.7	36.8	37.9	37.4	36.6	34.7	39.9	40.5	37.6	37.0	38.0	43.1	41.8	41.5	40.1	38.1	35.8	35.6	35.3	40.2	40.0	37.5	37.3	38.4	39.1
Manufacturing, value added (% of GDP)	27.3	29.9	20.4	23.6	23.1	22.9	21.6	21.5	22.3	18.5	21.2	24.2	16.2	18.7	18.4	18.9	18.9	19.6	20.5	20.5	18.5	18.4	18.1	19.4	19.2	18.9	19.2	19.5	20.3
Services, etc., value added (% of GDP)	52.1	45.0	55.0	51.0	53.3	55.4	54.7	55.3	57.1	59.8	54.2	52.0	54.8	54.0	52.8	48.0	49.5	49.8	50.0	52.0	55.0	55.0	55.5	53.7	54.1	56.4	56.5	55.5	55.5

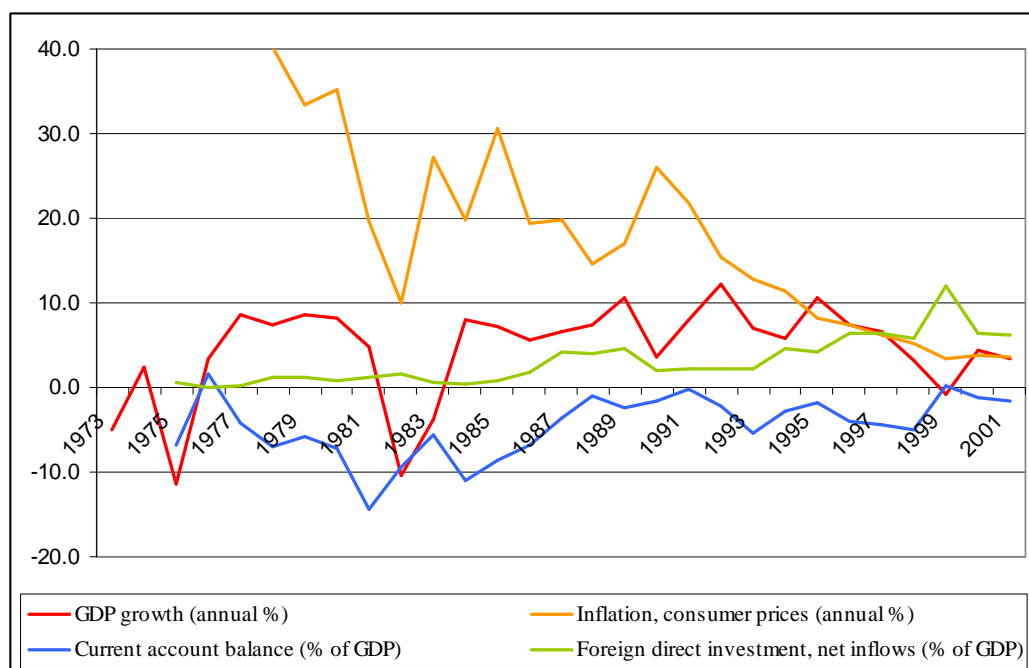
**Figure 9. Chile, selected economic indicators 1973-2001**

Source: World Development Indicators (WDI), World Bank. a/ Central Bank of Chile



**Figure 10. Chile, evolution of production and exports (1973-2001)**

Source: World Development Indicators (WDI), World Bank



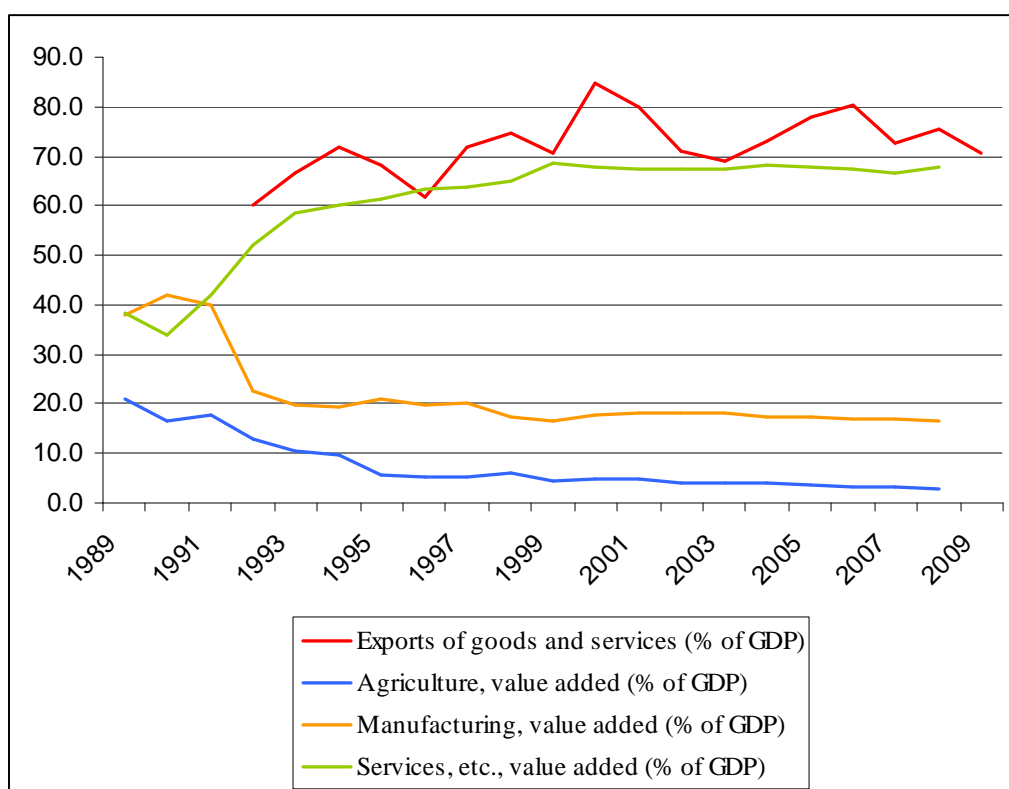
**Figure 11. Chile, Evolution of selected macroeconomic indicators (1973-2001)**

Source: World Development Indicators (WDI), World Bank

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<i>GDP</i>																					
GDP growth (annual %)	3.1	-7.1	-8.0	-21.2	-5.7	-1.6	5.0	5.0	10.8	5.4	-0.1	9.6	7.7	8.0	7.2	8.3	10.2	11.2	7.1	-5.1	-14.1
GDP per capita growth (annual %)	2.7	-7.1	-7.5	-19.7	-3.3	0.4	6.9	6.5	12.1	6.4	0.6	10.0	8.1	8.4	7.6	8.6	10.4	11.4	7.3	-5.1	-14.1
<i>Prices</i>																					
Real effective exchange rate index (%) /a								9.7	3.3	10.4	7.3	-3.8	2.0	1.9	1.7	1.3	1.1	0.4	2.9	4.7	1.6
Inflation, consumer prices (annual %)					89.8	47.7	28.8	23.1	10.6	8.2	3.3	4.0	5.7	3.6	1.3	3.0	4.1	4.4	6.6	10.4	-0.1
<i>External sector</i>																					
Current account balance (% of GDP)				0.9	0.6	-4.2	-3.6	-8.4	-11.1	-8.5	-5.2	-5.3	-5.2	-10.6	-11.3	-11.4	-10.0	-15.6	-17.4	-10.0	4.7
Exports of goods and services (% of GDP)				60.3	66.6	71.8	68.1	61.9	71.7	74.6	70.4	84.6	79.8	70.9	69.2	73.1	77.7	80.1	72.8	75.6	70.6
Foreign direct investment, net inflows (% of GDP)				2.1	4.2	5.4	4.6	3.2	5.3	10.4	5.3	6.8	8.7	3.9	9.3	8.0	21.2	10.8	12.8	7.4	9.2
<i>Production</i>																					
Agriculture, value added (% of GDP)	21.0	16.6	17.9	13.1	10.3	9.6	5.8	5.4	5.2	6.0	4.4	4.8	4.7	4.2	4.0	3.9	3.5	3.2	3.4	2.9	
Industry, value added (% of GDP)	40.6	49.7	40.1	34.7	31.0	30.2	32.9	31.1	30.9	29.0	26.9	27.5	28.1	28.3	28.5	27.9	28.6	29.3	30.0	29.1	
Manufacturing, value added (% of GDP)	37.9	42.1	40.1	22.8	19.6	19.2	21.0	19.7	20.1	17.5	16.7	17.7	18.3	18.1	18.1	17.4	17.2	17.0	16.9	16.7	
Services, etc., value added (% of GDP)	38.4	33.7	42.0	52.2	58.7	60.2	61.2	63.4	63.9	64.9	68.7	67.6	67.2	67.5	67.5	68.2	67.9	67.5	66.6	68.0	

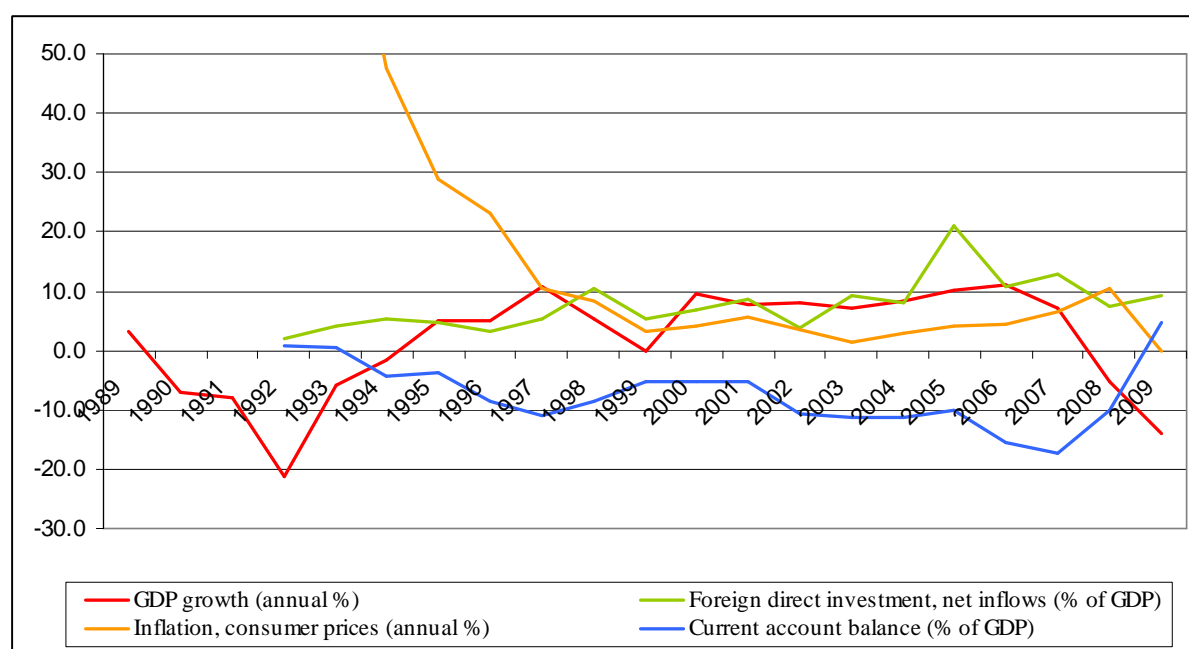
**Figure 12. Estonia, selected economic indicators 1989-2009**

Source: World Development Indicators (WDI), World Bank. a/ Bank of Estonia



**Figure 13. Estonia, evolution of production and exports (1989-2009)**

Source: World Development Indicators (WDI), World Bank



**Figure 14. Estonia, Evolution of selected macroeconomic indicators (1989-2009)**

Source: World Development Indicators (WDI), World Bank

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