THE POLITICS OF FINANCIAL POLICY
IN ARGENTINA AND CHILE:
LIBERALIZATION, CRISIS, AND RE-REGULATION

by

Laura A. Hastings

Submitted to the Department of Political Science
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ABSTRACT

This dissertation reexamines a moment in the 1970’s when Chile and Argentina both took initiatives to liberalize financial markets, under similar regime types and with similar histories of state-led lending and borrowing arrangements. It suggests that the similarities in these institutions and practices of bank regulation explain why, initially, the two countries witnessed strikingly similar policy developments under free market experiments: As financial market regulations were lifted, an explosion of speculative lending and borrowing ensued, and it was not long before the domestic banking systems in both countries collapsed. The variations in subsequent financial re-regulation in the early 1980’s then reveal why, after a few years, banking arrangements in Chile and Argentina looked quite distinct from either the era of state-controlled credit schemes or the free-market model.

This dissertation points to a recurrent cycle in financial policy in order to identify the point of policy divergence. After periods of deregulation, most countries are forced to follow a phase of re-regulation. Focusing on re-regulation, or the period of retrenchment, helps to identify the moment that financial policies begin to follow different paths.

What explains these variations? The patterns of bank re-regulation were shaped largely by the capacity of key financial actors in state and society to form coalitions with their peers. In Argentina, historical cleavages among bankers helped to establish which bankers would be adversaries in the new competitive environment. These splits then served to undermine economic policy, particularly at a moment of adversity and crisis. The private sector
ABSTRACT (continued)

conflicts obstructed the public tasks of implementing regulatory policy and monitoring bank activities. In Chile, with no previous experience of regional splits, the organization of the financial community remained cohesive, contributed in part by its smaller numbers. Chilean bankers permitted state leaders to gradually rebuild financial markets.

Thesis Supervisor: Dr. Jonathan Fox
Assistant Professor of Political Science
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# LIST OF ABBREVIATIONS

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<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ABIRA</td>
<td>Asociacion de Bancos del Interior de la Republica Argentina</td>
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<tr>
<td>ABRA</td>
<td>Asociacion de Bancos de la Republica Argentina, The Bank Association of the Republic of Argentina</td>
</tr>
<tr>
<td>ACIEL</td>
<td>Asociacion Coordinadora de Instituciones Empresarias Libres, Argentine Association of Free Enterprise Institutions</td>
</tr>
<tr>
<td>ADEBA</td>
<td>Asociacion de Bancos Argentinos, Association of Argentine Banks</td>
</tr>
<tr>
<td>AFP</td>
<td>Administradores de Fondos de Pension, Chilean pension fund system</td>
</tr>
<tr>
<td>BANADE</td>
<td>Banco Nacional de Desarrollo, Argentine Development Bank</td>
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<tr>
<td>BHC</td>
<td>Banco Hipotecario y Fomento de Chile, Mortgage and Development Bank of Chile</td>
</tr>
<tr>
<td>BIR</td>
<td>Banco Intercambio Regional, an Argentine bank from the Interior</td>
</tr>
<tr>
<td>CAL</td>
<td>Comision Legislativa, Argentine Legislative Advisory Commission</td>
</tr>
<tr>
<td>CGE</td>
<td>Confederacion General Economica, Argentine National Industry Confederation</td>
</tr>
<tr>
<td>CGT</td>
<td>Confederacion General del Trabajo, Argentine National Labor Confederation</td>
</tr>
<tr>
<td>CONADE</td>
<td>Argentine National Development Council</td>
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<tr>
<td>CONASE</td>
<td>Argentine National Security Council</td>
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CORFO  Corporacion de Fomento de la Produccion, Chilean state development agency

CORVI  Corporacion de la Vivienda, Chilean housing agency

CRAV  Compania Refineria de Azucar de Vina del Mar, a Chilean economic group

ENAMI  Empresa Nacional de Mineria, Chilean national mining company

GDP  Gross domestic product

IAPA  Trade Promotion Institute, Argentina

INDAP  Instituto de Desarrollo Agropecuario, Chilean agricultural agency

LIBOR  London inter-bank offer rate

ODEPLAN  Oficina de Planificacion, Chile’s office of national planning of the Presidency

SASETTRU  Argentine economic group

SBIF  Superintendencia de Bancos e Instituciones Financieras, Chilean bank and financial institution regulatory and oversight agency

SINAP  Chilean National Savings and Loan System

SOFOFA  Sociedad de Fomento Fabril, Society for Manufacturing Development, Chilean industrialists pressure group

SRA  Sociedad Rural Argentina, Argentine Rural Society

UCRI  Union Civica Radical Intrasigente, Argentine political party

UP  Unidad Popular, Popular Unity, Chilean political party
Chapter I.

EXPLAINING POLICY DIVERGENCE:
THE CASE OF FINANCIAL REFORM IN THE SOUTHERN CONE

This study seeks to explain divergence in government re-regulation of financial markets. It has become increasingly fashionable for countries to release their financial markets from state control. Yet, some countries do better than others with this "free market" experiment. How can we explain the differences in outcomes of this currently popular economic model to liberalize banking practices and institutions?

In the 1970's, the newly-installed military governments of Chile and Argentina embarked on sweeping reforms to open up the economy to private -- and international -- initiatives. After four decades of state-led policies of credit allocation, the liberalized domestic banking arrangements sought to transform how funds were solicited, collected, and supplied. Ten years later, however, after spectacular (and systemic) bank collapses, the Argentine and Chilean financial sectors -- and their relationship to the state -- looked quite distinct from each other. While Argentine policymakers had reimposed Central Bank direct controls on lending and borrowing operations and had regulated interest rates, in Chile, indirect regulatory mechanisms were preserving the appearance of a functioning
"free market". It is at the moment of re-regulation that Argentina and Chile financial policy and performance differ dramatically.

A key premise of this work argues that a "spiral staircase" phenomenon operates in financial policy reform. When markets are freed from restrictive measures, over time, government policy is often forced to revert back to a policy of reformed regulation, or to "re-regulate". Such cycles occur because financial reform often results in relaxing controls and vigilance in bank supervision. While this policy initially creates growth in the financial sector, it is often followed by waves of speculation, then a loss of confidence and instability among domestic banking structures. Such behavior is not unique to Latin America or to developing financial systems; deregulation of the U.S. savings and loan industry in the 1980's produced similar results.

Certainly the character of state intervention in finance will change qualitatively in countries undergoing this policy cycle. However, the state does not simply "pull out" of markets. While regulatory ties between state and banker are often held accountable for the sins of financial "repression", regulation also may help to moderate free market "indulgences". Re-regulation of financial markets is an important ingredient for sound banking under a liberalized regime. Thus the key to Chile's successful privatiza-
tion of credit markets is found, not in state abdication, but rather in a style of government-managed re-regulation of finance.

The financial reform projects in Argentina and Chile were shared attempts to redraw the boundary between state obligation and civil society's sphere of business. Since financial activities were opened up to participants beyond sovereign borders, the state found itself called upon to create and maintain credibility in its markets; in effect, to re-regulate domestic financial institutions and practices.

This dissertation argues that divergent patterns of bank re-regulation emerged in Chile and Argentina as a result of domestic financial sector organization. The process of regulatory reform evolved through a succession of policy alliances between private bankers and government officials; The character of these coalitions was shaped largely by the internal coherence of, or conflicts within, the banking sector. Intra-sector alliances and cooperation led to more successful arms-length bank regulation (Chile), while infighting within the banking community forced a return to state-led banking (Argentina).

In Argentina, over the span of the financial reform policy, splits within the national banking sector made the state's task of building a coalition more onerous, impeding effective re-regulation. The historically weak Argentine
Central Bank permitted these internecine disputes among banking groups. Factions within the Argentine armed forces also forged competing alliances with these two rival bank groups. At the moment of the bank collapse, state authorities resolved the adversarial style of bank regulation through nationalization of that sector.

Chilean bankers faced no such rivalries within their ranks. At the outset of the project, the united industry-bank organizations (grupos economicos) agreed to the new rules of the financial game. A few years later, confronting a collapsing financial sector, Chile’s relatively unified banking sector negotiated successfully with the state for a dramatic re-regulation of the system; the mechanisms of regulation in Chilean emerged as an arms-length consensual activity.

A. Statement of the Problem

Historically, arrangements between bankers and the state looked remarkably similar in Chile and Argentina. Beginning in the late 1930’s, government-led credit allocation systems guaranteed that states could retain key control over their development policies. International capital flows were carefully monitored. Bankers, in turn, secured profits through privileges and concessions that they obtained from their access to government.
The radical financial reforms implemented in both countries in the 1970's attempted to break these relationships. Among these newly-installed Southern Cone military-authoritarian regimes, there was broad consensus among the military, the middle class technocrats, and private economic groups to "open up" markets. The neoliberal policies sought to increase the amount of money circulating in the system; not through politically-conditional government grants, but rather through private, international capital markets -- through the banking system itself.

In both Chile and Argentina, this economic development policy appeared practically immune to theoretical critiques, societal challenges, or internal political conflicts. At these "moments of opportunity" (1973 in Chile and 1976 in Argentina), divergent political interests united on the need for change, temporarily overwhelming the vested interests attached to the old structure. The financial reforms (poised to take advantage of recently available international capital) radically transformed bank operations, bank organization, and the members of the banking community. Argentine and Chilean capitalists responded to the free market philosophy with zeal, and the financial markets became the axis of economic gain.¹

¹Stephan Haggard and Robert Kaufman have aptly called this movement "right-wing structuralism", differentiating it from the stabilization policies that aimed to correct balance of payment shortages and reduce spending. "The Politics of Stabilization and Structural Adjustment," in Jeffrey
Not all this activity was prudent. New financial agencies appeared overnight, advertising attractive interest rates and easy credit arrangements, only to close down in a cloak of debts and disappeared owners. Industrialists became financiers, closing factories and engaging in financial speculation with their revenues and with available credit.

Within a few years, the private banking systems of both countries collapsed: Argentina in April 1980; Chile, in January 1983. Both governments bailed out their nation’s top banks and assumed (temporary) state control of their assets. The Chilean state ended up owning 70 percent of the domestic banking sector.2

After the bank interventions, however, the two experiments took different paths. Distinctive patterns of financial regulation had appeared, and financial structures and policies had diverged markedly. Chile maintained a system of market-determined interest rates. Although Central Bank funds propped up insolvent banks, Chile retained the basic liberal reform tenets (a distanced relationship between public authority and private banker) to keep the banking system afloat.3 Argentina, on the other

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2In Argentina, the figure was lower, but nonetheless reached 25 percent.

hand, returned to an essentially nationalized banking system. By 1986, the activities of Chilean state agencies were accountable for only 20 percent the country's deposits and credits, while the Argentine state directly controlled nearly 65 percent of these operations. As economists Roberto Frenkel and Mario Damill commented, "In April 1982, the financial system barely resembled anything of the [free market] theories that provided the foundation for the liberalization experiment."

Since then, the observed economic performance of these two countries has also differed. In 1990, Chile emerged as the Latin American success story. If we define "success" in terms of achieving strong growth indicators, the Chilean experience is indeed compelling. Since 1985, Chile's capital markets have expanded, and its foreign debt has dropped, while Argentine financial development has stagnated."

This policy divergence is not simply a face-off,


The goals that both Chile and Argentina pursued were controversial, and failures of the reform were acute: disparities of income grew, and unspeakable human rights violations were committed. But, after 1985, the Chilean economy has reaped tangible benefits, measured by its export diversification and GNP growth. While a country's economic performance may be due to a myriad of factors, the market in lending and borrowing (state-owned or privatized) is an important ingredient to the long-term growth of an economy in the present international environment.
however, between Milton Friedman (Chile) and the London School (Argentina). The perception of Chile as a free market haven is misplaced. On closer observation, the organization of Chilean banking does not resemble the orthodox free market, "Chicago Boy" model. Beginning in 1982, the Chilean state bolstered the solvency of failing banks by first absorbing the non-performing loans, then liquidating selective banks, and subsequently reorganizing (and assuming management of) others. Almost a decade later, commercial banks continued to owe the Central Bank over one-quarter of their active portfolio. Presently, a state-promoted (but privately-run) pension plan requires all workers to "save" twelve percent of their salary. In 1990, the forced savings from this system comprised over 60 percent of the countries net deposits. While Chilean state monetary authorities did not nationalize the financial sector at a moment of bank collapse and crisis, neither were banks left altogether privatized."

In neither country do we witness the touted "liberalization" of financial markets, as originally conceived. The lessons of these two experiences speak to a success based on particular agreements between, and among, parts of the state and society. The problem remains to explain how and why Argentina and Chile responded differently subsequent to the

bankruptcy crises, and how these different patterns of re-regulation emerged.\(^7\)

B. Alternative Explanations

Few studies have tackled the problem of explaining divergent outcomes in re-regulation.\(^8\) Several approaches under-identify the theory, some over-determine the outcomes, while others mismatch the theory to the outcome.

1. Economic factors

Mainstream economists emphasize the priority of economic policy in explaining why the Chilean and Argentine financial reform experiments turned out differently. They point out that Argentina’s misaligned exchange rates, lack of policy perseverance, and inefficient or "incorrect"

\(^7\)Argentina and Chile have since returned to civilian rule; Argentina in 1983, Chile in 1990. The regime variable is thus held constant for the duration of the study.

policy implementation contributed to subsequent policy difficulties, forcing policy-makers to terminate the free market strategy. Others argue that the "sequencing" of policy implementation and the nature of financial regulatory mechanisms, which differed in the two countries, explain the variation in policy outcome."

The economics discipline forces more rigorous thinking about the economic trade-offs implicit in each policy package.¹⁰ This line of inquiry, however, tells us only part of the story. The political agenda may be driven by a kind of economic determinism (in our cases, previous poor economic performance and the subsequent outbreak of financial crises). Political responses, however, are not. Societies do not necessarily react to policies according to the costs and benefits that drive economists' calculations. Policies often turn out differently due to particular political arrangements.

Why, for example, under conditions of widespread


¹⁰Moreover, in both countries, the dialogue over political issues often employed economic "language", contributing to the dominance of economic explanations. See El Clarin, Buenos Aires, 1977, and El Mercurio, Santiago, 1976, various issues.
financial collapse, did the two credit markets and their bankers react differently? An Argentine policy that guaranteed private bank deposits did little to calm markets; it appears even less significant in light of Chile's outspoken rejection of this type of state protection. Chronic high inflation in Argentina itself explains little of regulatory policy outcome, since Argentine bankers responded in various ways to the rise in domestic prices. The different sequencing of policies is only a starting point for understanding why subsequent policy choices were made.\footnote{See Chapter 4 (Argentina) and 6 (Chile) for discussion of the effects of the guarantee of deposits, policy sequencing and banker responses. Most works that cite the lack of regulation and government supervision of private commercial activities do not help to differentiate between the outcome of financial reform in Argentina and Chile. Although regulatory action reveals why Chile and Argentina initially were unable to effectively monitor banks, it cannot explain the different responses subsequent to the bank collapses. Works on regulation range from M. Aglietta, \textit{A Theory of Capitalist Regulation: the US Experience}, New Left Books, London, 1979, to George Stigler, \textit{The Citizen and the State: Essays on Regulation}, University of Chicago Press, Chicago, 1975 (chapter 6), to G. Kolko, \textit{Railroads and Regulations, 1877-1916}, Princeton University Press, Princeton, 1965, pp. 1-2. The work of David Vogel, \textit{National Styles of Regulation: Environmental Policy in Great Britain and the United States}, Cornell University Press, Ithaca, 1986, is an important exception.}

2. International factors

International factors are commonly employed to explain domestic financial policy outcomes in Latin America. This approach argues simply that international financial flows such as loans and capital investment determined the political options available to Latin American bankers and policymakers during the liberalization drives. An alternative, Marxist-inspired view explores the economic and political power inequalities that persist between developing countries and the capitalist, industrialized regions and argues that the structural need for periphery countries to work within the international system steered financial reform in Chile
and Argentina toward particular outcomes.\textsuperscript{13}

Certainly the international component of our story figures prominently. Beginning in the late 1960's, the volume of lending to Latin America grew explosively. The emergence of the unregulated Eurocurrency market and the excess petrodollars (which needed to be recycled) presented banks with opportunities to embark on a transnational growth strategy. U.S. banks turned their efforts towards neighboring Latin America, countries whose growth records appeared promising.\textsuperscript{14}

Particular characteristics of the international economic system shaped and constrained the operation of finance in Chile and Argentina. The liberalization of the two Southern Cone financial markets encouraged foreign indebtedness. Private firms, public enterprises, and the national and regional governments became increasingly dependent on (and vulnerable to) the international financial


system. At the same time, the state was stripped of much of its control over these funds. A reliance on foreign financial capital created new political pressures from external actors -- governments, banks, and international agencies. Foreign capital decisions influenced Chilean and Argentine market actors.

An exclusive focus on factors which lie beyond the control of local actors, however, tends to obscure differences in policy outcomes. While international factors help to identify the similar constraints that Latin Americans faced, they do not explain most of the variations among subsequent decisions. Both countries faced comparable international pressures and policies, yet responded differently. Foreign capital alone cannot inform us of the political struggles that took place in Chile and Argentina, whose outcomes left groups with varying amounts of influence and committed to different types of alliances. Even the concept of "dependency" should be seen as a result of a particular national strategy rather than an inherent characteristic of the international system. Simply, this argument cannot account for variation among developing countries, the phenomenon that this study sets out to explore.¹⁵

¹⁵The amount of foreign-held bank debt, for example, itself is not a sufficient measure to determine how bankers will respond to a particular government policy. P. Vander- gast and P. H. Buttell have called for a "shift in the problematic underlying development studies" from identifying
International ideas about the development process, transmitted through transnational networks, may also influence outcome. Differing beliefs among Chilean and Argentine elite concerning the state's role in managing finance provide a plausible explanation of why the two countries' financial arrangements turned out differently: The "Chicago Boys" economic school dominated much of Chilean elite thinking, while this obsession with the "magic of the market" did not have the same following in Argentina.

In the late 1960's, economists and policymakers began to argue that the lack of dynamism in Latin American financial markets was due to excessive state regulation of banking practices. Economist Ronald I. McKinnon and the "Stanford School" described the misallocation of resources and inefficiencies in developing countries, coining the politically-loaded term "financial repression".16 The military governments which came to power in Chile and Argentina in the 1970's embraced this economic formula. In

"features of the development process that tend to cause Third World countries to be..alike" to considering what is driving the "variations in peripheral formations". "Marx, Weber and Development Sociology: Beyond the Impasse", World Development, June 1988, p. x.

Chile, these economic theories were "marketed" more effectively than in Argentina. "Neo-liberal monetarism" spread a powerful ideology, and it became a persuasive policy prescription. The Argentine elite, meanwhile, was not so beholden to one economic idea, nor to an institution which promoted it. The degree of allegiance towards the international free market model was less fervent and less uniform in Argentina and might serve to explain that country's policy "backsliding" as the economy soured.  

Policymakers' world views can play a critical role in taking initial decisions, interpreting outcomes and reaching new verdicts. Particularly in the area of finance, such beliefs can help to maintain public confidence in the stability of private lending and borrowing. Indeed, the job of convincing actors of the viability of the new financial reform was an ideological project, especially at the moment of a systemic banking collapse. Ideas can exert a significant influence on economic policy-making, in particular, in

producing this "confidence".18

Yet, despite the apparent attitudinal differences in Chile and Argentina, neither the nature (nor the degree) of enthusiasm for this economic vision explains the timing or content of critical policy shifts. Policy ideas are rarely sharply defined. Indeed, if Chile were so ideologically bound to the free market policy, why did the Chilean state take over the failing banks in 1983? Such a reverse argumentation simply underscores the problem with using elite economic ideology as a single explanatory variable; it is able to justify both state pull-back and state intervention. Indeed, what is so striking in these two cases is the similarity of policy goals and arguments to promote them.19


19Argentine policies persevered (as long as they did) because of the hegemony of the neo-monetarist idea. An Argentine industry consultant observed that, "we sat and watched because there was no other 'language' with which to dispute what was going on." Interview, Rodolfo Bogo. See List of Sources, Interviews, for full citation. For this view, see Hector Schamis, "Reconceptualizing Latin American Authoritarianism in the 1970s: From Bureaucratic-Authoritarianism to Neoconservatism", Comparative Politics, January 1991.
3. State-centered approaches

State-centered analyses address how -- and how well -- the state formulated and implemented its preferences. The differences in Chilean and Argentine bank policy emerged at a point of dramatic exercise of state power. The state, as a social institution with a unique capacity to mediate among classes and to impose authority (particularly pronounced in Third World states), is a key explanatory variable.20

At the outset, the Argentine and Chilean Central Banks possessed little data on their countries' banks and had few resources to gather them. In both countries, the bank watchdog agencies, or Superintendencias, were low prestige, run-down institutions. There were few funds allocated to carry out regulatory practices (visits to banks, data collection, analyses of bank records). Yet, after a few years of financial reform, the Chilean agency developed this regulatory capacity, while the Argentine office did not. The two states displayed varying technical and institutional capabilities to regulate the banking sectors at a time of financial opening.

Under military-led regimes, the armed forces emerged as another key state actor. The Argentine armed forces, split over the means to handle guerrilla groups and over the proper role of the state in economic development, remained

divided. The new institutional arrangements heightened political factionalism within the Argentine military and contributed to challenges to the structure of authoritarian rule. On the other hand, the commanding rule of Chile’s armed forces under Army commander Augusto Pinochet could explain the state’s ability to pursue a coherent, new regulatory strategy. Could strong military control and centralized decisionmaking explain why Chile’s bankers remained acquiescent while the state restructured the system?21

Theories of state autonomy and concepts state capacity do not provide much analytic leverage on our two cases, despite the descriptive appeal of the concept. State capacity is only too easily proved in a functional and self-referential way: The success of the Chilean state to impose effective regulation of the bank sector is itself the proof that sufficient state "capacity" existed. The term itself tells us little about how, over time, Chile strengthened its regulatory competence while Argentine remained mired in internecine conflicts. Moreover, the course of Chile’s

regulatory policy does not signal that Chile has a "strong state": There is no reason why the regime could not have nationalized the banking sector, as other strong states, like Mexico in 1982, have done.  

Moreover, at the moment of the bank crashes, the "relative autonomy" of the Argentine and Chilean states -- their capacity to deny political access to (and the preferences of) private groups -- cannot be readily ascertained. Both military regimes broadly implemented a policy of bank intervention, whose outcome did not necessarily contradict the interests of the bankers. The differences in these state regulatory policies cannot be evaluated according to their effect on the capitalist classes.

Most state-centered arguments are so loosely specified that the theories end up simply emphasizing the state's role in shaping political events rather than permitting critical comparative explanation. When this study looks at state policy, it will treat state capacity, or the ability of the state to regulate effectively, as the dependent, instead of the independent, variable.

4. Sectoral and interest group theories

Interest group approaches shed light on the role of the

\footnotetext{\textsuperscript{22}States also may have different capacities in different policy arenas, rendering the notion of "strength" trivial, or at least theoretically less powerful.}
private sector in public policy outcome. According to recent theories, rational actors compete for access to power or to economic resources using the most efficient means available. Bankers, in particular, are an influential and organized sector in capitalist political economies, capable of imposing their interests in political circles. 3

A simple causal argument that moves from the imputed preferences of bankers to policy outcome is not persuasive. In our cases, bankers expressed contradictory preferences over the course of the policy reforms: While they favored a financial sector free of state controls (and open to international markets) in anticipation of increased maneuverability at home and stronger alliances with financial centers abroad, bankers also wanted a guarantee of state intervention and protection to provide stability and confidence in the markets. Contradictions between the individual and the collective behavior of financial actors also tended to muddle strategies. The information necessary for optimal decisions is not customarily available in financial markets, as organizational theories observe. Speculative behavior and the "psychology of the mob" often are rational for the individual, but lead the market as a whole to respond

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irrationally. In practice, banker strategies under the new financial reforms were different: Some invested in state-led projects, while others speculated on international exchange markets.24

Private sector actions did influence public policy decisions. Yet, arguments that impute the preferences of the private sector either directly from economic situations or, post facto, from outcomes are misleading. During these years of dramatic policy swings, both Argentine and Chilean bankers had difficulties determining which action would promote their "interests". For example, the Buenos Aires-based banking association incorrectly identified its "true" interests at the outset of the liberalization measures, directing its energies to foiling foreign competitors, only to later perceive that its Argentine regional allies were taking over the market share. In Chile, the banking system appeared to profit from the state's regulatory stance, however, many Chilean conglomerates did not prosper from state policy after 1983. Chilean state monetary authorities dismembered many of the economic groups, forcing industries

and banks to be sold off. The structure of Chile’s financing changed dramatically as regulation took hold. In the rush toward financial opportunity, and in the crunch of financial debacle, bankers were not certain which strategy would get them ahead, or even of who was winning, and who was losing.²⁵

5. *Institutional approaches*

Institutional approaches argue instead that structures of financing within the private sector influence economic policies and their outcomes. Finance is understood as an institution with established norms and procedures. It operates according to formal and informal agreements that dictate behavior and procedures. The financial system may then be evaluated in terms of where and how industries get their financing (debt versus equity), and the pricing mechanism of capital (through banks, governments, or markets).²⁶

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²⁵Jeffrey Frieden, "Classes, Sectors, and Foreign Debt in Latin America", *Comparative Politics*, 21, #1, October 1988, suggests that the structure of asset holdings (liquid versus fixed) helps explain private sector reaction to government economic policies. Unfortunately few economic groups kept track of the composition of their holdings during this period. Interview, Domingo Giorgetti.

In Chile, the existence of private sector grupos economicos, which commanded most of the structure of financing industries, suggests that patterns of financing can affect public policy. These organizations comprised of extended families, who jointly owned commercial, financial and productive enterprises. Prior to the financial reforms, these grupos economicos were able to take advantage of, and maneuver around, state preferential credit policies to mobilize and allocate funds. After the reform in the 1970’s, many of the grupos improved these partnerships and some developed ties to international concerns.  

From a comparative perspective, however, the structure of financing in the larger Argentine firms was similar to that of Chile. By the 1960’s, many Argentines owned their own banks, forming similar grupos economicos as those traditional to the Chilean business community. The


27Maurice Zeitlin and R. E. Ratcliff, Landlords and Capitalists: The Dominant Class of Chile, Princeton University Press, Princeton, N.J., 1988, analyze Chilean grupos through the 1960’s. For discussion of economic groups, see Nathaniel Leff, "Industrial Organization and Entrepreneurship in the Developing Countries: The Economic Groups", Economic Development and Cultural Change, 1978. Unlike modern conglomerates in industrialized countries, the economic groups, or "grupos", shared management responsibility; there was no legal relationship between a parent company and its subsidiaries.

economic resources available to Chilean and Argentine economic organizations appear only too similar; the neomonetarist ideas that swept both countries appealed to the financial interests of both countries' elite. Policy outcome did not depend on a particular structural feature of the financial system based on capital, credit-based, or government-administered markets, as John Zysman would have it.

Nevertheless, there were important differences in the politics of these banking conglomerates. While the integrated organization that united finance and industry (the grupo económico) itself cannot illuminate the differences in these two countries' bank reforms, other organizational issues became critical to the policy outcome. Re-emergent cleavages between Argentine rural and urban bankers, rather than particular arrangements of financing, changed banker calculations. The capacity of key actors to form coalitions with state leaders was undermined by cleavages within the sector. This dissertation will argue that economic organization (in particular, conflicts within the organization) did indeed affect the nature of bankers' association with the government economic team and the ruling military.

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Desarrollo Económico, 1977, pp. x, identified these new "grupos".
C. The Argument: Intra-sectoral Organization

The following chapters examine the relationships among bankers and the alliances with the state in order to understand variations in policy reform in Argentina and Chile. Financial liberalization in these countries was more than a one-time policy choice towards a free market system. The policy brought about precipitous changes in the distribution of economic power and, thus, shifts in social organization and political authority. Regulatory change, breakdown, and reform are linked to evolving "cultures" of market capitalism; that is, the practices and structures that are built up around the system of capitalism. Actors who trigger these events together redefine (and battle over) the changing boundary between public and private.

An important alliance in the moment of banking reform is the agreement among actors to regulate (and supervise) the financial markets. The institutions of monetary regulation -- and the political alliances that kept the regulatory "rules of the game" in force -- provide the roadmap to track the shifts between state domain and private sector. In his work, The Great Transformation, Karl Polanyi argues that 19th century economic liberalism was enforced by regulatory institutions and practices. How groups have particular comparative economic advantages, in the end, has
to do with political struggles within these coalitions.²⁹

The alliances that the Chilean and Argentine states forged with banking groups was based on this **mutual** task to redraw responsibilities. Both state and non-state actors shaped economic policy. Policy alliances, then, cut across the boundary of state and society. Peter Katzenstein and Sylvia Maxfield have written on what they call "policy networks or policy currents", suggesting that the focus on the relative power of the state versus society in policy formation is misplaced. Over the course of the policy implementation, such a strategy demanded deliberate agreements between the state economic leaders and private, market actors.³⁰

The outcomes of this bargaining, I argue, depend on the cohesion of private sector groups in response to these policy initiatives. My research has revealed a key empirical finding; that splits within the banking sector in Argentina led to the loss of policy cohesion and its ultimate reversal. I suggest that a key variable in evaluating durability of these policy shifts is the relationships that


developed among bankers.

These splits, in turn, help to understand the puzzle of breakdown in state policy. The free market policies that the new regimes implemented needed private sector collaboration. When groups remained fighting amongst each other, this participation was harder for the state to command.31

The reemergence of old patterns in politics -- the persistence of feuds and of allegiances -- is part of the fabric of any society.32  Chapter Two asserts that cleavages between Provincial and Buenos Aires-based Argentine bankers, largely over export revenues, emerged already in the early 19th century. For much of Argentine’s post-war history, they remained muted by state policy. Strict government regulations on bank entry and on geographic lending suppressed open struggles among bankers for markets. By the mid-1970’s, these two groups had nevertheless developed a keen sense of their contending

31Peter Hall has written of the difficulties that President Francois Mitterand’s socialist government faced in the early 1980’s in reorganizing interest representation in various sectors of agriculture and business (so as to give more power to left-leaning associations, which supported the government). The Mitterand administration found that the resulting fractionalization and intensification of cleavages interfered with the successful implementation of government policies. See Peter Hall, "Pressure Groups and Pluralist Politics", in Peter Hall, et al., eds., Developments in French Politics, Macmillan, 1990.

interests as groups. Certainly the vacillating character of Argentine state policy, which alternately favored credit allocation to the rural groups and to the industrial sector, fomented these divisions.

In 19th and 20th century Chile, extended family enterprises ran their fiefdoms of agriculture, industrial, trade, and financial concerns. As Chapter Three recounts, no substantive rural and urban splits materialized. Strong state institutions directed the course of development policy in collaboration with these grupos economicos. As in Argentina, an increasingly contentious political climate arose over economic decisionmaking, however, contributing to the dramatic regime change and momentous shift in policy direction in the mid-1970’s.

With the financial opening, rivalries among banking groups resurfaced. Chapter Four details how Argentine financial actors became fixated on antagonisms between the Buenos Aires bankers, the foreign bankers, and the newer bankers from the Interior of the country. State officials arbitrated among -- and took bribes from -- combative banking groups, and patronage politics took over. The adversarial and coercive regulatory policy that emerged ultimately led the Argentine state to terminate its experiment in private lending and borrowing operations.

In Chile, the financial reform policy in 1975 initially led to a compact between state monetary authorities and
bankers similar to that in Argentina. Chapter Five contends that new ties with international groups were established with comparable ease, unlike in its neighboring country. Dissenting Chilean Central Bank functionaries were fired, and the armed forces' political - and economic - detachment from the private sector permitted the military regime to construct new policy coalitions with key groups. At a point of crisis in the banking sector, state regulatory institutions remained in place.

Chapter Six reviews and expands on the effects of the main explanatory variable, intra-sectoral organization, on banking practices and policy outcomes. It argues that the policy cooperation emerging from this intra-sectoral unity is key, in particular, to the success of market-led reforms.

The study concludes that the regulatory relationship established between the policymaking body (whether it be a military, a communist party, Parliament or Congress) and the financial sector helps to define the possibilities and parameters for market-led financing. As Eastern European countries race to profit from international lending opportunities through liberalization of markets, it would be well to remember that the forms of re-regulation are decisive factors in crafting financial systems.

At the outset of the liberalization programs in Chile and Argentina, the new policymakers seized upon a resurgent
economic doctrine that called for pulling the state out of the economy and in society. The decision was a result, in part, of identifying that the state had overextended itself: Out of a concern with the weakening of the state, the state could be revitalized by reducing (or concentrating) its office.\textsuperscript{33}

An economic policy that handed over critical accumulation duties to the private sector (through the free enterprise system) could transfer political fights over distribution to another arena. The impersonal, rational marketplace then carried the mantle of responsibility. By implementing free market reforms, Argentine and Chilean governments lost direct control over credit flows (and revenue from ownership of these assets).\textsuperscript{34}

At a moment of crisis in the stability of the banking

\textsuperscript{33}Market-oriented policies would subject the state to rational discipline, ridding the state of its inefficient and corrupt aspects. In the 1980's, the "new right" critique of the state and statecraft championed this view, ironically, in the context of the "crisis of democracy". See Samuel Huntington article in M. Crozier, Samuel Huntington, and J. Watanuki, The Crisis of Democracy, New York University Press, New York, 1975; Robert Nozick, Anarchy, State and Utopias, 1974, or Milton Friedman, Capitalism and Freedom, 1962.

\textsuperscript{34}In theory, the state would also be left with more political space to move into other domains, such as culture and education. Privatization is the "move away from provision of goods or services on a communal or subsidized basis to provision on a commercial basis" (Fred Hirsch, Social Limits to Growth, Harvard University Press, Cambridge, MA, 1978). Privatization is often confused with the related process of deregulation. In our cases, deregulation of the system of credit allocation had more profound effects.
sector, cooperation -- not coercion -- among parties turned out to be the most effective way of keeping liberalization on track. In Argentina, on the eve of a severe credit crunch (largely precipitated by the state macroeconomic policy), the government economic team found itself unable to craft a consensus with business groups, led by the newly powerful banking community. The alliance crafted between the state and banker was fragmented among various different banking groups. The compromises -- the "give and take" -- that would be necessary to maneuver through an economic crisis were not available.

While Argentine state authorities moved toward an adversarial style of bank regulation, Chile developed mechanisms of regulation based on consensus-building.\(^3\) The Chilean economic leaders, facing a similar financial crisis, negotiated with a financial community which remained cooperative, largely due to the absence of internal conflicts. State and business were able to reform banking policy within the original framework, to re-regulate financial markets.

Although banking practices in Argentina and Chile were transformed in one policy stroke, the longer term implications of liberalization suggest that this reform movement is a complex process of state and bankers reorganizing the

\(^3\)David Vogel introduces the concepts of conflictive and consensual regulation to describe national styles of regulation, in National Styles of Regulation, 1986.
institutions and operations of banking. How this regulatory relationship between policymaker and bank is crafted, and how bank reforms become institutionalized, are the focus of this study.
CHAPTER II:

THE HISTORY OF ARGENTINE STATE AND BANKER IN CREDIT ALLOCATION SCHEMES: SPLITS AND CYCLES

Markets are historically conditioned institutions. They do not automatically or spontaneously respond to a shift in state policy. Neither do economic rules and incentives alone shape the patterns of exchanges between state and banker. In 1976, although both the Argentine and Chilean banking sectors functioned as textbook cases of McKinnon and Shaw's "repressed finance", these countries' monetary arrangements were built, modified, and reinforced by different political exchanges. This chapter sets out the history of Argentina's political economy of banking. Chapter Three then details Chile's comparable developments in the institutions of lending and borrowing.

Economic and political differences between Buenos Aires-based and Interior elites emerged as the country was establishing its center of governance in the mid 19th century. Over the next 100 years, these cleavages remained essentially ossified in the structures and practices of banking, as governments developed selective credit arrangements and other financing programs. Meanwhile, in the 19th century, the government oscillated between policies to attract foreign credit, on one hand, and to promote state-led financing, on the other. These swings both reflected
and, after 1930, counterbalanced shifts in the international economic climate.

A. Emergence of State and Finance in Argentina, 1800-1946

In 19th century Argentina, the export trade dominated the country's business activities. British traders set up merchant houses in the port city of Buenos Aires to supply short term financing for the export of grain, hides, and dried meat. These foreign agencies operated without state regulation or administration, given the absence of a monetary system or a local financial infrastructure. The creation of local currency was tied to the quantity and price of Argentina's goods on the international market. A laissez-faire view prevailed among traders.¹

Increasingly, domestic financial institutions participated in the capital market. The Banco de Londres y Rio de la Plata (1863), the Banco de Italia (1872), the Banco Popular Argentina (1887) founded by cattle ranchers, and the Banco El Hogar Argentino (1889) competed with the Buenos Aires government-backed Banco Hipotecario (1872) and

the powerful Banco de la Provincia de Buenos Aires. Formerly called the Banco y Casa de Moneda, the state-run Banco de la Provincia de Buenos Aires issued its own gold-backed currency until 1856 (with the backing of the Argentine state), while accepting private deposits.

Six other Provincial banks (run by the regional governments) also solicited funds and, importantly, took out overseas loans. Each Province and, at times, each bank, competed with its own monetary emission and credit policy. The emergence of this strong regional banking system reflected and reinforced the ongoing struggle over which geographic faction would claim Argentine statehood. Although Argentina won its political independence from Spain in 1810, the country engaged in a bloody conflict for the next 42 years over Buenos Aires city or Interior rule. Only in 1853 did an Argentine constitution establish a Buenos Aires-based centralized government, although most of the legal details were not settled until 1880. The provincial governments continued to hold onto significant autonomy through control over currency and financial operations.²

By 1883, Argentina’s economy was relatively monetized. By 1880, banks were permitted to open branches throughout the Interior. The Banco Nacional became one of the largest

²The constitution was inspired by The United States’ Federalist Papers. See David Rock, Argentina 1516-1982: From Spanish Colonization to the Falklands War, University of California Press, Berkeley, 1985.
banking institutions. Mortgage banks, many located in the Provinces, also issued paper money. In 1881, Argentina agreed on a national monetary standard, and in 1883, the Banco Nacional made notes fully convertible to gold.

British commercial bank operations remained the dominant model for Argentine banking and provided the short term credits to facilitate trade.3 (Longer-term credits only became widely available with the advent of state development financing in the 1930's.) Non-bank financing handled the longer term mortgage cédulas (or certificates) and insurance policies. Financial deals relied on debt instruments (such as mortgage investments) rather than on equity (raising funds by selling issued capital of a company). These private financial institutions preferred to offer low risk loans to the national government or to the provinces; private credit most often went to large borrowers holding public works contracts.4

By the 1880's, financial activities with British commercial banks became a means by which Argentina's

3Vera Blinn Reber, British Mercantile Houses in Buenos Aires, 1810-1888, p. 145, argues that the presence of British mercantile houses provided essential credit and little repatriation, while creating and organizing trade. Italian, French, German, Dutch, Belgian and US foreign capital also flowed in.

4Since Argentina adopted the British organization of finance (short term loan instruments), the longer term French (Saint-Simon) "credit mobilier" financing lost out. See Charles Jones, "Commercial Banker and Mortgage Companies", in British Imperialism, p. 33.
landowners could acquire - and reinforce - their economic and political power. This ruling class was rich in land and poor in capital. Thus, they changed future assets (land) into liquid capital through the creation of a mortgage credit mechanism, thereby attracting money from abroad without losing ownership of their land. As a British merchant observed:

"[Cattle ranchers became rich] not by the sale of their crops and their live stock, but simply by the rapid rise in the value of land."

The use of land as the original source of capital for the financial market explains the longer-term source of wealth of Argentina’s landowning class. Only those who owned land could participate in Argentina’s financial market.⁶

By the late 19th century, ownership in more than one sector was common among the great landholders. They used their financial capital to expand their economic activities into commercial trading, signaling the emergence of the grupo economico. The business dynasty Bunge and Born, and the Capozzolo and Catena families distributed their capital to the agricultural, agro-industry, and mining sectors, then into manufacturing and merchandising, while controlling


⁶Some historians argue that the oligarchy used the pampa for political power and social prestige, preventing the growth of efficient domestic capitalism. See, Rodolfo Puiggros, Pueblo y oligarquia, Jorge Alvarez, Buenos Aires, 1965.
financial institutions."

These grupo families also dominated the political scene. The powerful business association, the Argentine Rural Society (SRA), represented their interests. The Rural Society was founded in 1866 by these self-described "modern" landowners. The estancieros, or cattle ranchers, championed the doctrine of classical liberalism, which encouraged individualism and free enterprise. Argentina had become well integrated into the international economic system through its exports of wool, cereal, and beef. Between 1860 and 1930, growth rates were unprecedented, comparable to those of European countries. The Rural Society argued that free trade, in particular, brought in revenue as well as a "civilizing, cosmopolitan influence". *

*Juan Carlos Korol and Mirium Trumper, in "Formacion y caracteristicas de la clase dominante argentina", (CEDES Working Paper), Buenos Aires, September 1980, sketch portraits of these early economic groups.

*High rates of immigration from England, Germany, and later Italy, provided an important source of labor as well as a domestic market. Carlos F. Diaz-Alejandro, Essays on the Economic History of the Argentine Republic, 1970, pp. XX, uses the staple theory of trade and growth to explain this great expansion. Many wealthy English, Scots, Irish and Germans moved to Argentina to ranch and export, creating early economic conglomerates. Italian immigrants made up the medium size farmers. The 1913 census found three quarters of the owners of industrial and commercial establishment to be foreign-born, of whom only five percent took Argentine citizenship. Jorge Sabato, La clase dominante en la Argentina moderna, 1988.

*Peter Smith, Politics and Beef in Argentina, Columbia University Press, New York, 1969, p. 48-50, writes that until 1940's, the SRA had the political field largely to (continued...)
This free enterprise conviction was held, however, in the name of a larger goal: progress. Since export-led growth was vulnerable to oscillations in external markets, the free marketeers posited that the state should also create conditions favorable to "progress". State-secured financing of economic activities such as railroad construction and even meat-packing were considered legitimate, "exceptional" areas. A tenuous balance existed between openness and protectionism.¹⁰

Beginning in 1871, a series of major debt crunches hit Argentina, when Britain, a major trading partner, cut loans to that country due to a UK financial panic. The short term loans from British financing were particularly disastrous to the Argentine creditors. Similar, severe (and perhaps inevitable) financial shocks occurred in 1889 and 1892. Again in 1913, the volume of loans dropped dramatically when the Bank of England executed a domestic policy change in interest rates. The Argentine government commonly took out new loans (refinancing existed debt) in order to pay the

interest and amortization on short-term loans, which made it particularly vulnerable to these crunches.\textsuperscript{11}

In 1891, the most famous such disaster led to the creation of an official bank, the Banco de la Nacion Argentina. In 1889, a panic had broken out when two British investors, the Baring brothers, were unable to raise cash. British loans came to a halt. The Argentine government was suddenly unable to make its payments on a foreign loan without further infusions of fresh credit. Argentine President Pelligrini, brought to power by the political upheaval from the 1980 crisis, described this moment:

The big banks had fallen: the entire Argentine Republic had nowhere to turn to get a single peso for its commercial needs. The Republic lacked an organ essential for its economic development: we needed to create a bank. We had searched for capital in any and all forms, offering all the enticements that we could. We even declared that if foreign capital were to establish banks under these conditions, that we would give them all the privileges that we could. In those sad and dark moments, everything was useless.\textsuperscript{12}

The idea that a state bank could protect industry from

\textsuperscript{11}David Rock, \textit{Argentina 1516-1982}, p. 147-8.

\textsuperscript{12}Printed in "La banca oficial en el sistema financiero argentino", \textit{Memoria, 1980}, ADEBA, 1981. My translations. The Baring crisis is a good example of the occasional irrational markets (the "bandwagon effect") in financial lending. The Argentine mortgage and national banks were closed in the aftermath of the crisis, and only reopened in 1904. The international system of monetary regulation, the Gold Standard, forced countries to depreciate their currencies when stocks of international reserves rose, a policy that penalized foreign investors -- and Argentina's capital needs.
the caprices of financial speculation took hold. The debate over protectionism took on new aspects; Argentines were fearful of dependency on Britain for capital and for sales of Argentina's few exports. Proposals to protect the sugar and wine industries and to further diversify exports were, however, counteracted by the continued strong free trade lobby.  

During these years of financial instability, a number of public banks with jurisdiction in the provinces, or the Interior of Argentina, were unable to pay back debts borrowed from international creditors. The Buenos Aires-based national government assumed the debts. In exchange, the Provincial banks agreed to hand over management of their accounts to the Capital government. These regional banks lost much of their independence in credit allocation decisions. The loss of economic autonomy and subsequent political power ended the open struggles between Buenos Aires and the Provinces, but divisions still existed.  

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14For a general discussion of splits between Argentine rural and urban groups, see Jerry Adelman, "Agricultural Credit in the Province of Buenos Aires, 1890-1914," Journal of Latin American Studies, volume 22, 1990. The 1904 bank reform centralized and strengthened the Banco de la Nacion role as national creditor: between 1905 and 1913, private sector loans from this institution tripled. Government expenditures, however, were small compared to the use of monetary instruments to satisfy wage and price demands. See Jeremy Adelman, Frontier Development: Land, Labor and Capital on the Wheatlands of Argentina and Canada, 1890-1940. Oxford University, forthcoming, pp. 1-14; and D.C. M. (continued...)

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The experiences and consequences of the 1929 Great Depression, when much of the world's commercial business dried up, were Argentina's bitter lessons in trade and monetary dependence, together with a weak central authority. Cycles of trade and financial "booms and busts" suggested that the free market could not assure stable, reliable sources of revenue for a growing economy.

In 1935, the Argentine government created a Central Bank to print, distribute and regulate money, and to supervise foreign and domestic bank activities. The newly-established Central Bank was administered by a board of representatives from private banks, and the principal instruments to regulate monetary policy were open market operations. The Bank fixed a legal reserve requirement for banks and supplied short term advances to banks and to the Treasury.¹⁵

The larger financiers and entrepreneurs in Argentina had actively sought the participation of the state in establishing this system. They complained of "instabilities and irregularities" in the financial markets. Textbooks and

¹⁴(...continued)

¹⁵Open market operations are Central Bank sales or purchases of marketable financial assets (usually long term) to influence the quantity of assets held by the banking system and thus to affect the volume of lending. 11 out of 12 Central Bank directors were from the private sector. See Laura Randall, An Economic History of Argentina, 1978.
news accounts identified the proper, "public character" of state intervention in credit operations, suggesting that the Central Bank legislation would "guard against the risks and inconveniences of the liberal system to the national economy", and would serve to avoid "tying up funds which should be available".¹⁶

The expectation that foreign participation would play a leading role in the Argentine economy, however, also largely shaped the Central Bank mandate. Since the mid 1800’s, foreign investors had been underwriting much of the financing for ports and railroad construction and communication systems. After 1904 this activity increased, and foreign investors often demanded loan guarantees (and political assurances for stability) from the Argentine government. The new Central Bank mandate served to guarantee the investments of foreign financial operations, establishing "public confidence and security" in the domestic monetary environment. A system of state deposit guarantees offering state insurance in case of bank losses, fashioned after the United States invention, was also set in place. The state and provincial banks then took on the responsibilities of receiving and distributing these credits.¹⁷

¹⁶Natalio Muratti, Elementos de Ciencia y Tecnica Bancarias, 1937.

¹⁷Also during this period, under Finance Minister Federico Pinedo, the government began to supervise the exchange rates and import licenses of the agricultural (continued...)

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The regulative powers of the state grew significantly in this period. The state continued to protect local groups from foreign interests, while at the same time soliciting external funds through a posture of economic orthodoxy. These apparently contradictory functions were mirrored by the private sector ambivalence over the intervention of the state in their business. Undoubtedly, Argentine rhetoric increasingly asserted the need for economic independence from Britain. Yet, how to best achieve this freedom was in dispute. On one hand, increased state surveillance of foreign activity and state tariff policies would guarantee this autonomy; yet, on the other, the free market policies would induce foreign capital and ensure profits for an Argentine private sector, whose export products were competitive on world markets. These contradictions in banker policy preferences were deeply imbedded by the time of the 1976 reforms.18

17(...continued)
sector. The government negotiated special trade agreements with Britain. These junta reguladoras sought to handle the persistent foreign exchange shortages and the decline of exports during the Depression and war periods.

18Jeremy Adelman makes the point that, between 1929 and 1943 Argentina chose economic orthodoxy and "stabilization" at a time when the international system was disposed toward easy credit. "[T]his trend flew in the face of changes elsewhere in Latin America - reflecting the possible, but forgone opportunity to follow the rest of the world in a clearly developmental direction.". "Development and Stabilization in Argentine Macroeconomic Policy, 1870-1950" draft copy, February 1992 conference at ILAS, pp. 28-29.
B. State Economic Management under Juan Peron, 1946-1955

Under the leadership of General Juan Peron, Argentine economic management was securely centralized under the state. Peron rose to power in 1946, as the Depression and two world wars had left Argentina diplomatically isolated and economically vulnerable, and as concerns about controlling the oscillating economy were reaching new heights. With unfortunate timing, the appeal of private international credit disappeared in Argentina just at a moment of expanding activity in foreign direct investment and trade. Peron's economic team argued that controlling the final use of credit would help to promote the domestic economy and encourage its independence from international trade and monetary oscillations.19

In banking policy, the Peron administration nationalized the Central Bank, and converted all money deposits in banks to public ownership. Its president Miguel Miranda could not count on bankers concurring with the government's expansionist vision of credit allocation. Thus, private banks were required to register their deposits with the state. In return, they were compensated for this "restric-

tion" in the amount of the financial and administrative costs involved in handling deposits. The British and other foreign bankers reduced their operations in Argentina, and banking gradually became a national (Argentine) endeavor, under the tutelage of the state. The volume of domestic loans rose, creating a credit boom in housing and construction. Credits alone reached 8.5 percent of GNP.20

Peron's administration increasingly used the Central Bank to organize and direct credit allocation. The Central Bank determined the amount of credit disbursed, its price, and those regions or sectors which would receive it. The autonomy of the Central Bank, written into its 1935 Constitution, was formally eliminated, although it had never exercised initiative in crafting monetary policy. As a department of the Ministry of Economy under the Executive, the Bank operated in concert with national economic directives. Its instrument to regulate the amount of money in circulation also became direct credit rationing. The state bank, Banco de la Nación, became the exclusive agent for the Central Bank, handling financial operations for the

20 Already by the 1920's, British merchant houses had lost their controlling hold over the Argentine economy, as British economic exporting activity had declined. Peron's policy did not quite constitute nationalization of the banking sector, since banks officially continued to disperse loans privately. Note that the origin of banker acquiescence to state-led financing in part rests with a guaranteed source of income for the banker.
government.\textsuperscript{21}

Nationalizing deposits permitted the state to direct the flow of credit to its priority sector: industry. Exchange rate controls channeled export sector earnings into designated funds, such as the Trade Promotion Institute (IAPA), which directed the buying and selling of exports. The \textit{Banco de Credito Industrial}, set up in 1944, carried out much of the medium and long term financing for industry. From mid-1946 to 1955, 80 percent of overall credits went to the manufacturing sector at favorable interest rates (set by the Central Bank authorities). The bank received capital for loans from the Central Bank's new "distribution" system (through forced loans from the Argentine banks) and from export profits from the IAPI.\textsuperscript{22}

In 1955, Peron was ousted from power by his armed forces. Although many institutions and policies were partially reformed or reversed after the leader's downfall, arrangements among groups, and with the state, were permanently altered. As part of Peron's policy of import

\textsuperscript{21}The \textit{Banco de la Nacion} however, continued to dominate the Central Bank, since it was founded earlier and maintained greater financial resources. See Frank Tamagno, \textit{Central Banking in Latin America}, 1965, p. 76.

\textsuperscript{22}The interruption of imports during World War II provided the impetus for the creation of the Industrial bank. In 1970 it was renamed \textit{Banco Nacional de Desarrollo}. David Rock, \textit{Argentina}, p. 276. The IAPI agency created a monopoly over foreign sales of cereals and meats to ensure the highest possible earning for exports. It was liquidated in 1957.
substitution industrialization, state-directed credits had helped to foster the small enterprise in Argentina. A new industrial class arose which depended on government, rather than on private banks, for financing. The demands of these urban groups were pitted against those of the larger agro-exporting groups in an urban-rural conflict.23

The number and size of state-owned sectors also increased under Peron's tutelage, not only in banking, but in transport and communications.24 Beginning in 1947, key areas of production such as oil, steel and petrochemicals were run by the state (as sectoral monopolies) through a National Directorate of Industry. The armed forces operated most of these large concerns. Legislation authorized the new military-operated enterprise, Fabricaciones Militares, to produce items needed for the "defense of the country" in those cases where private capital failed to "show sufficient

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23See Juan Carlos Portantiero, "La crisis de un regimen: una mirada retrospectiva", in Jose Nun (ed), Ensayos sobre la transicion democratica en la Argentina, Buenos Aires, 1987, who argues that the inclusion of middle and lower classes into the political economy made policymaking a "contested terrain": no one could exert exclusive control over the state.

24During his ten years in power, the national government also grew from 312,00 to 541,000 employees. Benjamin A. Most, Changing Authoritarian Rule and Public Policy in Argentina, 1930-1970, 1991, p. 133. The growth of the state was not exclusively a "Peronist" policy; his predecessors and successors also increased the state payrolls.
dynamism".25

Military engineers who ran these huge steel, mining, and machinery plants believed the military had a role in the nation’s progress, creating a visible "state interest" in economic development. They actively blocked the approval of private, competing projects, sitting on advisory boards in the Ministry of Economy and effectively vetoing private firm entry.26

Finally, the close, corporatist relations between worker and government nurtured by President Peron created a powerful, politicized labor movement capable of electing—and overthrowing—governments. The Argentine armed forces, already split by historic inter-service rivalry, became further divided over methods to oust such politicians, and, in turn, over the proper role of the state in economic development.27

C. The 1957 Financial Regime

In 1955, the Argentine armed forces overthrew the Peron


government in the *revolucion libertadora*, supported by the Church and landed oligarchy. These groups held that Peron's populist policies and state-subsidized credit to industry had impeded the growth of the country's strongest sector, agricultural exports. Under General Pedro E. Aramburu, this elite proclaimed a "restoration of the free market system".

For the next 20 years, Argentine economic policies displayed a "pendulum effect": Each new administration alternatively favored the agro-export sector then the domestic manufacturing sector, implementing policies to attract or to protect against foreign competition. A foreign exchange devaluation would favor the agricultural sector (increasing exports), while it hurt industry (raising the cost of imports, necessary for the manufacture of industrial goods). Those state policies that favored one private interest tended to be vetoed by the other.²⁸

1. *Liberal Rhetoric, Statist Reality*

The new Argentine leaders set out to reverse the centralized state control over financing that Peron had established. In 1957, and still under provisional military rule, the Argentine government passed a series of financial reform regulations that sought to give commercial banks more

control over deposits. Banks returned to the traditional fractional reserve system, and deposits were, once again, decentralized. Restrictions on bank entry were relaxed, and bank mergers and take-overs were permitted.  

In 1958, after the military government had lost both political and economic support, elections were held. The Union Civica Radical Intransigente (UCRI) candidate Arturo Frondizi was voted President. Frondizi’s highly visible program of industrial development (desarrollismo) tempered the burst of enthusiasm for laissez-faire economics. These policies restored much of the extensive state regulatory powers; however the government continued to build ties with international investment and foreign lending agencies.

Under Frondizi, the 1957 banking reform also remained intact. These laws were largely aimed at reorganizing and codifying Central Bank activities: The Central Bank was formally assigned broad powers of monetary operations and bank supervision. It held on to its 1935 tools (largely qualitative controls) and added selective (mostly quanti-

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29Rafael Olarra Jimenez, *Evolución Monetaria Argentina*, 1968, pp. 111-116. Fractional reserve banking is a Central Banking system that requires commercial banks to maintain a reserve of liquid assets (unloaned) in relation to their total asset portfolio. The amount is determined by the Central Bank in the interest of monetary and credit policy.

tative) credit controls inherited from the Peronist administration to carry out monetary management. It regulated the volume of bank credit and money emission, kept gold and foreign reserves in order, applied the resolutions from the Ministry of Economy in exchange rate policy, and oversaw compliance with bank laws. In 1957 Central Bank stock was also withdrawn from general public holding, and its operations were administered by representatives from other state banks, private banks and selected economic sectors.\(^{31}\)

State banks were given more specific mandates: The Banco de la Nacion continued to attend to agricultural credit, the Banco Industrial offered medium and long term financing to industry and mining, and the Banco Hipotecario Nacional financed urban and rural housing needs through the emission of mortgage bonds, and intermittently, through exchange rate financing. The Caja Nacional de Ahorra y Posta, a large savings banks attached to the postal system, invested in low-risk, public bonds. Each of the Provinces maintained its own official bank (some with mixed capital)

\(^{31}\)Adolfo Diz, "Money and Prices in Argentina, 1935-1962", in D. Meiselman, Varieties of Monetary Experience, p. 72. Central Bank money and credit policy remained closely coordinated with (or subservient to) the country's overall economic policies. Pedro Real, Central Bank president in the 1960s commented: "the Bank is, properly, always subject to the directives from the broader mandates coming from the Ministry of the Economy". Interview. (For full citation, see List of Sources, Interviews) See also, Tamagno, Central Banking, 1965, pp. 52-3; Muratti, Elementos de Ciencia y Tecnica Bancarias, p. 35.
and five municipalities created public banks.\textsuperscript{22}

2. Banking in the 1960's: Old Friends and New Opportunities

The 1957 Central Bank reforms were supported by groups who perceived they had been hurt by Peron's state-led credit allocation policies. Agro-exporting concerns and businesses with ties to foreign financing embraced the policies whose larger aim was to open domestic markets to private (and international) interests. Indeed, the 1957 banking reform officially gave private banks increased decisionmaking authority over credit allocation.

In practice, however, the Argentine state lost very little of its leverage in the area of finance. The Central Bank continued to direct bank operations: Minimum and maximum interest rates were set by the Central Bank depending on the loan category. The volume of credit available for dispersal remained fixed by Central Bank authorities. Minimum reserve requirements were highly differentiated according to the type of deposit and the geographic area and sector of lending. Indeed, most Central Bank employees were occupied with directly managing private bank activities: authorizing banks, checking the distribution of bank loans,

\textsuperscript{22}In 1973, the postal bank was renamed the \textit{Caja Nacional de Ahorra y Seguro}, reflecting its increased role in the insurance business, due to the effects of inflation on its savings accounts. Most of the provincial and municipal banks were founded between 1930 and 1960.
and carrying out bank inspections. These Central Bank functionaries regarded the banks and the banking operations as their "public charges".33

State intervention in financial markets is a common feature of most countries' political economies. Governments may set exchange rates, interest rates, and regulate market activities. Yet, in Argentina, the philosophy that financing was essentially a public service was both deeply entrenched in state credit policy and private bank behavior -- and vehemently rejected. On the one hand, people claimed that banks operated to benefit the public. They "manage deposits that do not belong to them". As the 1957 law suggested, the private banks were considered "agents" of the country's development, responsible for "maintaining liquidity of the portfolios and the orderly development of credit and correct loans for the service of the economy".34

Yet, Argentine banking operations, in contrast to most activities, were also associated with outright capitalist

33Interview, Pedro Real, former Vice President for Supervision, Central Bank. The policy was another expression of the, now, Janus-faced attitude towards how much control the state should exercise in banking. Its introductory preamble acclaims the theory of the free market mechanism in determining financial policy, yet, in the same document, individual Articles of the Law spell out specific Central Bank actions to allocate credit, both sectorally and geographically.

endeavors, established under 19th century British hegemony. Most traditional private bankers were engaged in financing the agro-export industry, which continued to profit from the free enterprise system. "Anything that violates the concept of a free market is unconstitutional", pronounced a spokesperson for Argentine Rural Society.35

The somewhat schizophrenic attitude emerged because, by the 1950s, the Argentine banker was reaping handsome profits under the increasingly state-led system. The Central Bank-mandated spreads (the difference between what the bank offered for deposits and what it charged for loans) and the fixed commissions that the Central Bank provided (or less publicly, those that borrowers provided) were a dependable source of income. Timely manipulation of regulations and enforcement enhanced these profits. The "public agent" philosophy served the pocketbooks of domestic Argentine bankers.

Actual lending functions were left to private banks.36 After receiving directives from the Central Bank regarding the geographical location and economic sector to which the funds should be allocated, it was the banker’s job to choose the individual credit recipient. Banks offered many of the government-subsidized loans to established creditors and to


public sector industries. Although the Central Bank also instructed bankers to provide credit to state-run companies through "forced" loans, credits to these enterprise were so attractive that additional funds found their way to this sector. Using their prerogative as "agent" of the state, banks chose clients based on commissions, of which some were outright bribes. Family and friends also received their share. Credit ratings on potential customers were not carried out.

Banking might not have been a highly profitable business, but it was prestigious. With no formal schooling, sons of established merchants, industrialists and landowners began as trainees in a bank, and ended their careers as directors. The banker regarded his service of disbursing credit as a privilege - "like granting a patent". "People ran banks like their own personal estancias".3

These capital groups also exercised relatively little direct influence on politics compared to the productive sector organizations. Rivalries between such groups as the conservative lobby group, the Association of Free Enterprise Institutions, ACIEL, and the Peronist-led industry grouping,

CGE, split banker interests. Even within the ACIEL, which was dominated by banks and export-import firms, frequent infighting over such issues as wage increases or government credits hindered coordinated action.

Despite its contradictory signals, the 1957 reform did create new incentives for credit creation, exposing bankers to the potential financial gains in a free-market system. A discernible "blip" in financial activity occurred between 1960-1968. The 116 commercial banks, 80 financial companies and 424 credit companies operating in Argentina began to experiment with new types of lending transactions. 38

For example, the Treasury sold its first government securities in September 1959. In December 1960, the floating mortgage certificate appeared, a new, private sector instrument. The private cooperative bank, a source of savings and financing for the small and medium-size business in the Interior, began to expand rapidly. Between 1959 and 1961, the stock market expanded, allowing firms to obtain long term, equity capital for a few short years. And, nonbank finance companies (which financed consumer goods purchases) also mushroomed. 39

38 Ernesto Feldman and Juan Sommer, Crisis Financiera y Endeudamiento externo en la Argentina, Centro de Economía Transnacional, Buenos Aires, 1986, p. 18-21.

39 Diaz-Alejandro, Exchange Rate Devaluation in a Semi-Industrialized Country: The Experience of Argentina, 1955-1961, pp. 161-2. The rise of these operations created a momentary increase in the steady decline in financing as a (continued...)

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Several banks under new ownership were particularly resourceful. A few were located in the Provinces. In 1965, the Banco Intercambio Regional (BIR), newly acquired by Rafael Trosso, began to grow in the Province of Corrientes. The Banco de los Andes began to purchase vineyards in the region of Mendoza. The two brothers who ran the Perez Companc economic group, specializing in petroleum products, bought the Banco Rio in 1961. New finance agencies, financieras, sprung up to handle new financial transactions.

New sources of foreign financing also became available during the 1960’s, in part as a response to the 1958 election of Arturo Frondizi. The administration’s well-received desarrollismo policies incorporated friendly direct foreign investment regulations, and it openly cooperated with the United States in diplomatic policy. Between 1959 and 1961 a total of $344 million was invested. European investment totaled more than 40 percent of foreign investment between 1958 and 1965. Although most of this capital had pulled out or was repatriated by 1963 due to the expiration of favorable investment clauses, the funds helped to orient the domestic financial markets toward the international client.”

35(...continued)
percentage of the country’s growth (GNP) that had begun in the early 1950s.

"Both in the form of direct investment and credit, this money was largely directed to specific projects in the (continued...)"
3. Decline of Formal Banking Structures

In the 1960's, bankers were offered opportunities to earn profits through new credit instruments, the money market, and international operations. The 1960's also marked a critical shift in the source of firm financing away from external, formal, credit and toward informal credit transactions and supplier credits. Until 1958, the primary boost to industrial credit was subsidized from state coffers. After Peron's overthrow, however, this government credit at real negative rates increasingly lost its relevance in the firm's financial books. In response to the new agro-exporting coalition in power, the Central Bank passed a series of regulations that reversed the decade-long partiality towards financing industry. It restricted the availability of state-provided bank credit to industry, forcing those firms to look for new ways to access funds.

The main source of subsidized credit - the official bank - steadily dropped its participation in industrial credit. Several external credit accounts, monopolized by

\[40\] (...continued)

\[41\] Most domestic Argentine industry do not disclose financial information about firm activities (excepting the relatively few listed on the stock market). The following analysis is based on largely impressionistic data.
the state banks until 1959, were taken over by private banks. Official banks had less control over where the funds would go. The three official banks, Banco Hipotecario Nacional, Banco Industrial, and Banco de la Nacion, saw spectacular volume losses in their participation in industrial loans. The volume of state bank assets dropped from 80 percent in 1955 to 50 percent in 1960."

The subsidized interest rates also lost importance to the firm because, in practice, many loans were not transacted at these official rates. Due to extra commissions collected by banks (often in the form of bribes), and the institutional spreads between assets and liabilities and compulsory deposits, bank credits were not as cheap as the published figures. Secondly, firms often contracted credits from their suppliers. Between 1958 and 1964, supplier and trade credit accounted for 60 to 70 percent of all external financing. Finally, the larger national firms went directly to foreign suppliers for loans. The huge Perez Companc company received foreign loans for its petroleum production; Alpargatas developed a vertically-integrated textile company, and Techint borrowed and bought (through military ties) from the national steel industry. These credits, whether local or foreign, carried their own interest rates

"Recall, in addition, that the absolute size of the market in real terms was diminishing. See Feldman and Sommer, Crisis Financiera, 1986.
and conditions."

In search of alternatives to state-provided or supplier and trade credits, the Argentine borrower turned to informal financing in the private, credit markets. The grey market of financieras offered an instrument called a bank acceptance, a private IOU. Financial institutions would then transfer them to investors. These acceptances were, in most cases, emitted without the endorsement of a financial institution. The loans were taken out at market interest rates, since they were not subject to any controls. Interest rates varied between a range of 30 to 40 percent for the most "qualified" firms to 400 percent for financially weak firms or for marginal operations. By 1970, they represented 40 percent of interest-yielding deposits of the banking system."

Non-bank financial companies, which were less closely


regulated, also grew rapidly in the early 1960s." Between 1955 and 1965, the percentage of bank credit dropped from 50 percent of total financial liabilities to 20 percent. Credit cooperatives, postal savings banks, investment funds, even insurance companies supplied short term financing to firms. These financial companies readily attracted deposits because they were not subject to the (10 percent) interest rate ceilings that the Central Bank fixed for commercial banks. One study estimated that the non-banking participation in obtaining sight (or demand) deposits rose from 12.34 percent in 1955 to 35.56 in 1965."

Another external source of financing, stock sales, virtually did not exist. The Argentine stock market was a venerable institution, founded in 1854. However, the volume of its trading in private shares and its participation in raising capital had declined steadily since its founding. Between 1960 and 1962, the value of transactions, in constant prices, was less than in the year 1930. In 1961,

"Capital Markets in Latin America: General Survey, 1970, Chapter 5; Mallon and Sourrouille, Economic Policymaking, 1975, p. 144; Diaz-Alejandro estimates that some 10 percent of the money supply was attracted to these companies, with the rural sector providing much of these funds, in Exchange Rate Devaluation in a Semi-Industrialized Country, p. 162.

"In 1968, these financieras were placed under stricter Central Bank supervision. Samuel Itzcovitch, "Los intermediarios financieros extrabancarios en la Republica Argentina", 1966, cited in Jose Carlos Jaime, "La Banca Comercial Argentina - Su Evolucion y Perspectivas", working paper, 1967.
the placing of stock represented about 11 percent of gross domestic private investment."

The underground economy became an accepted way of doing business. The cheque volador, or "flying check" became a common means to buy goods and services without cash. An undated or postdated check served as a demand or promissory note, and they were often passed on to third parties (at a discount). Checks written on overseas accounts circulated widely and served numerous purposes. Anyone with capital saved in dollar-denominated accounts abroad. By 1960, even the housekeeper kept her earnings in dollars."

Firms also used tax evasion as a means of capital investment. Diaz-Alejandro estimated that, between 1950 and 1960, 16 percent of all capital for investment came from firms avoiding the payment of taxes to the government. As a

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"Deltic Panamerica, El mercado de capitales en Argentina, 1968, pp. 51-52. In 1971, La Comision Nacional de Valores (the Stock Commission) wrote in the Annual Report: "Most (firms) act without a preconceived plan or without any justification" which leads to "ignorance as to how to use this capital market as a financial source". Cited in Jorge Schvarzer, "Dinamica Empresaria y Desarrollo Economico", CISEA, 1980, p. 14fn. Catherine M. Conaghan suggests that the absence of the stock market as a financial instrument reflects the unwillingness of firms to give up ownership of family-run businesses. "Latin American Capitalists in the 1980’s", XVI International Congress, LASA, April 4-6, 1991. Government competition with the private sector for the funds was also a factor.

"Review of the River Plate, 10 January 1970, p. 9; 22 January, 1965, p. 65. See Adolfo Canitrot, La disciplina como objetivo de la politica economica; un ensayo sobre el programa economico del gobierno argentino desde 1976. Estudios CEDES, 1979; and Interview, Adolfo Canitrot."
banker recalled, "illicit activities – contraband, under and over-invoicing, tax evasion – were accepted practices in the name of "getting by" in a system that didn't work." 49

By 1960, self-financing had emerged as another standard method to obtain credit. This internal generation of funds within industrial firms reflected a situation of growing financial disintermediation. Between 1950 and 1955, self-financing comprised thirty percent of total sources of funds in Argentina; at the end of 1960, this figure had risen to fifty percent. 50

4. The Return of the Grupo and of the Regional Bank

As Argentine firms looked for ways to obtain financing, the grupo economico organization, often based in the Interior of the country, reemerged as a viable institutional alternative. An organization of several distinct


50Oscar Altimir, Horacio Santamaria, Juan Sourrouille, "los instrumentos de la promocion industrial en la posguerra", Desarrollo Economico, April-June 1966, p. 142. In "Estructura financiera y concentracion bancaria: El caso argentino," Economica, January-April 1971, Ernesto Feldman and Samuel Itzcovitch compare this figure to the less developed countries of Ecuador, Paraguay and Bolivia, where self-financing is 70 percent of total funds.
businesses under joint management and financing, the grupo reduced many of the business risks in an uncertain, or unstable, economic environment. After 1955, as state-directed credit to industry declined, banks increasingly allocated loans based on the ability of the creditor firm to provide the bank additional business (in the form of deposits). Banks had an interest in the profitability of the creditor company because of a financial share in its ownership.\textsuperscript{51}

In 19th century Argentina, ownership in more than one sector was common among the great landholders. Since most banks did not voluntarily lend to industry (preferring the low-risk, government-contracted packages or mortgage arrangements with land-holders), an "insider" banking arrangement was decisive to the success of a big business empire. When a group of investors, or a family, controlled a bank, it gained access to the savings of the depositors. Raising money through affiliated insurance companies was also common. These financial institutions were managed as subsidiaries of the business interests.

After 1940, state-led credit allocation policies and extensive government regulations curbed the process of

\textsuperscript{51}This practice, regarded with apprehension in the United States, was noted in \textit{Business Latin America}, 2 February, 1977. In the United States and Europe, capitalistic enterprises also evolved out of family business. Most became incorporated in order to have wider financing choices, such as stock markets. In Argentina and Chile, such advantages were not available.
integration between finance and industry. Under Peron, the 1946 bank nationalizations gave the state greater control over the distribution of credit. As the Argentine government began to promote industrial development and reorganize credit incentives, these largely agricultural-based concerns lost their commanding position in the economy. Although relatively few firms (financial or productive) were outright taken over by the state, nationalized bank deposits and restrictions on lending and borrowing (geographic and sectoral) hindered the grupo ability to spread operations and ownership.\textsuperscript{52}

After the reforms of the post-Peronist regime (which suspended the automatic access to industrial credit), the organization of the grupo once again prospered. Like their 19th century predecessors, firms which integrated a bank into their operations in the 1960’s found this internal credit system an "added safeguard" in business, compensating for the "distorted state of finance". As in the 19th century, the top executives of companies were members of the family that owned the conglomerate. A number of grupos emerged out of the thriving Provinces of Corrientes, Tucuman

\textsuperscript{52}In 1950, 137 out of 268 companies listed on the stock exchange appeared to be family-controlled, while in 1966, 1,378 out of 4,187 corporate executives listed on the exchange had a family member also listed with the company. Paul E. Lewis, \textit{The Crisis of Argentine Capitalism}, 1990, p. 76, does not, however, regard this as a decline, citing these figures instead as evidence of a "high level of family control" into the 1960s.
and Mendoza.  

In the 1960’s, the grupo economico structure began to prosper from two new ventures: supplying goods and services to state enterprises and engaging in business with international concerns. Firms whose operations were based largely on contracts with the Argentine state grew substantially in the post-war years. From 1945 to 1970, the Argentine economy as a whole performed relatively erratically, while the percentage of GNP used for state projects rose continuously. For example, the conglomerate SASETGU delivered most of its textile and foodstuff products to the Peronist governments.

The larger Argentine conglomerates also began to branch out to neighboring Brazil, Peru, Uruguay and Paraguay. The group Bunge and Born had extensive agro-food activities in Brazil, and Alpargatas was a principle textile producer in Brazil. The internationalization of the grupo created new ties with foreign companies and foreign governments.

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53Interview, Javier Gamboa, president, Alpargatas. In 1966, a list of corporations and their executive boards from the Buenos Aires stock exchange suggested that "interlocking family directorates" was again the norm. In 1967, traditional Buenos Aires banks complained about being "usurped by new entrants". La Nacion, date, 1967.

54For comparative data, see Business Latin America, (date.)

55Multinational operations also moved into Argentina; between 1957 and 1966, the number of foreign firms rose from 14 to 50. See Laura Randall, An Economic History of Argentina, 1978, p. 236.
In sum, the rise of self-financing and new forms of extra-bank credit for firm financing meant that official commercial bank credit -- and thus subsidized interest rates -- quantitatively held less importance in the structure of liabilities of a firm. Beginning in 1960, national grupos had greater resources, both domestic and foreign. Firms and banks became less interested in maintaining the state-controlled structure of financing. Increasingly, they chose to short cut the labyrinth of officialdom by bribery, blackmarketeering, informal banking or self-financing. While the experimentation "blip" in financial activity in the early 1960's did not provide enough new capital for industry, it did give bankers a taste of the possibilities for "opening up" in finance.

D. The Military versus Peronism Pendulum: Prelude to Change

1. The Intellectual Backdrop to Change

The overthrow of Peron in 1955 had set off a volatile political cycle of rule. Military-run governments, which were largely perceived as temporary arrangements, alternated with populist leaders, whom the power elite held to be unacceptable. From the fall of the first Peronist government in 1955 to the military coup in 1976, eleven presidents, five of them military, took office. Amidst this
political instability, the country continued to experience secular decline in its economic performance. A new model of economic development began to emerge which argued that liberalizing financial markets could solve a range of development issues. As economist Raymond Goldsmith wrote in early 1970:

"After a generation in which economic analysis was unduly influenced by the famous simile of the "veil of money", it has become clear since the 1950's that money, and not only money but also other financial institutions, "matter" in the sense that the course of real economic development may be considerably influenced, even if it is not basically determined, by a country's financial structure and activities."\(^5\)

According to these analyses, exchange of funds between savers and borrowers increased the possibilities for growth. In the post-war period, a detailed web of state financial regulations had flourished in developing countries, producing a situation of "financial repression". Direct controls on money creation and on credit allocation impeded the "natural" development of exchange and creation of money.

The theory of financial repression advanced the neoclassical premise that the market and the price mechanism most efficiently allocated resources. When the state interferes with these signals, the public is unable to

predict future movements. These uncertain expectations are particularly detrimental to the operation of financial markets. Arbitrary (state-directed) movement in interest rates, for example, deters savings and investment. The openly subsidized interest rates offer a negative real yield on deposits. The public has no incentive to save under these conditions. The dearth of varied financial instruments (stocks, bonds, and trusts) and institutions (Central Bank, credit agencies, commercial banks) is a sign of "financial repression" and can lead to monetary instability.\textsuperscript{57}

In the 1960's, Argentine economists began to use the literature on development economics to identify and critically gauge financial repression in Argentina.\textsuperscript{58}

According to its leading proponents, financial repression in Argentina was caused by excessive state regulation of a poorly developed financial market. State controls over


\textsuperscript{58}The economist profession emerged in Argentina in the 1960's. Jose Maria Dagnino Pastore writes of the movement to separate the careers of accountants and economists: The 1960 creation of economic research institutes and professional annual meetings established an institutionalized communication among economists, in "Los Economistas en el Gobierno Argentino", in Pastore, \textit{Cronicas Economicas, Argentina, 1969-1988}, 1988, pp. 1-5. Raymond W. Goldsmith, \textit{El desarrollo financiero y el crecimiento economico en el America Latino}, CEMLA, Mexico, 1962, was read widely.
nominal interest rates (legal ceilings on deposit and borrowing rates), accompanied by high rates of inflation, and by government absorption of the little available credit (the state taking away part of the credit supply for itself) created low financial savings and investment. The uncertainty created by these non-economic decisions impeded the growth of financial intermediation.

"Demonetization", "segmentation", and " politicization" were the key indictments against the Argentine system, signaling the negative consequences of Argentine Central Bank control of credit allocation. The volume of bank transactions (M2) as a percentage of Argentina's economic output (GNP) -- the level of monetization -- had been steadily dropping since the early 1950s. Between 1948 and 1967, the country witnessed a net decline of 4.3 percent in real volume of financial assets, compared to an average positive growth of 7.4 percent for other developing countries. While the average ratio of financial assets to GNP for other developing countries in 1967 was 11.1, Argentina listed a meager 4.96. Scholars, bankers, and businessmen alike saw these (much publicized) figures as indicators of a stagnant sector and a misguided profession."

59 The bank association ADEBA wrote that state financial transactions were eliminating the function of the private banker. ADEBA, Memoria, 1974. For ratio figures, see Raymond W. Goldsmith, "The Development of Financial Institutions during the Post-war Period." BNLOR, 1971. p. 147. Frank Tamagna, Central Banking in Latin America, 1965, p. 13. (continued...)
Meanwhile, the number of banks and branch offices had risen in Argentina. Between 1957 and 1976, gross entry of banks rose 77 percent, while the net growth reached 30 percent. In 1975, most analysts held that Argentina did not need 689 banks, and that 3,300 branch offices was far too many. Banks, unable to compete on interest rate terms, appeared to be using a strategy of branch office openings, or surcursalismo, to attract clients. The capital and manpower costs of extra branch offices also reduced profits. It became increasingly clear that the sector was being run inefficiently. With exasperation, an economist wrote: "The country cannot subsidize the small entity that has little solvency, that segments the financial market and does not produce wealth." 59

The increase in the number of bank branches had not led to greater diversification of financial institutions. Private bank holdings were still concentrated — out of 24 domestic, private commercial banks, six held 77.6 percent of the country’s deposits. Commercial bank deposits, in

59 (...continued)
Argentine economists also documented a decline in official bank activity, a slight decrease in bank concentration, and a small increase in the participation of Interior banks in the post 1957 financial sector. See ADEBA, Memoria, 1974-5 for Interior versus Capital banks.

current and term accounts, made up the bulk of the structure. A preponderance of short-term monetary assets (less than three months) was available, reaching 75 percent of total financial assets by the 1970's. The participation of official banks remained high: In 1975, official banks held 56 percent of deposits and 71 percent of loans.  

The studies, carried out by Central Bank officials as well as private research economists, illustrated the specific failures of the state-led system to finance industry. The Central Bank allocated either too much, or too little credit to economic sectors. Government development banks raised and channeled funds with little thought to the real financial costs. Traditional clients had greater access to the state-rationed, subsidized credit, regardless of their return on their investment, since they had established contacts with certain banks. Thus, different groups received different terms on loans. Real interest rates oscillated between -60 percent and +15 percent, demonstrating the separation between the official and the informal markets. This market usually offered short term instruments to the borrower.

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\textsuperscript{61} Feldman and Sommer, \textit{Crisis Financiera}, 1986, p. 39. The percentage distribution of foreign banks in deposits also rose precipitously.

\textsuperscript{62} Feldman and Sommer, p. 36. Financial companies bridged the informal and official credit markets by placing their own (high interest, extra-bank) deposits with the commercial banking system. See also Alieto Aldo Guadagni, \textit{La} (continued...)

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This call to release finance from state control also conveyed a (perhaps indirect) concern for equity in the markets. In general, large and foreign enterprises had better access to greater sources of financing. Under "repressed finance", the situation was further aggravated: The large firm used the "organized" market (under Central Bank control), whose interest rates are held below equilibrium levels. Small domestic firms or rural borrowers, meanwhile, were driven into the hands of the "unorganized" market, moneylenders and commission agents in the non-bank money market who demanded "equilibrium", or higher, rates for loans. The free credit market would eliminate the segmentation of the market, permitting the small firm access to financing. Finally, selective state regulation of financial activities privileged certain groups in society. According to this view, financing in developing countries was based on contacts (knowing the right bank director) and corruption (inappropriately close relations with the government), rather than on Prices.  

A generalized impatience with the system of personal

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62(...continued)


63Mallon and Sourrouille, Economic Policymaking, 1975, p. 131, suggest this point.

"These economists failed to see that lending and borrowing deals in industrialized countries often rely on such criteria. The recent US savings and loan episodes revealed the extent of these practices."
preference in credit allocation prevailed. After the 1977 financial reform, an Argentine economist wrote what every citizen knew: "When it came to bankers, it was more important to have good contacts at official levels than to improve the quality of the services that they offered." Not only privileges, but corruption was perceived as a consequence of the state assuming control over credit allocation.\(^5\)

The recommendation was simple: Eliminate state interference in banking and its protectionist policies to permit savers and investors to better "see" the true price of money. In particular, supply and demand conditions for credit and by monetary policy would determine the level of real interest rates. Liberalizing and strengthening the domestic capital markets would "automatically" decontrol the rest of the economy.\(^6\)

2. Policy Shifts, and the Emergence of New Bank Lobbies

During this period, Argentine governments changed so rapidly that few policies remained intact. In 1962,

\(^5\)Juan Carlos de Pablo commentary "Tormenta de Verano?" in Carta Politica, February 1977, p. 73.

\(^6\)Shaw and McKinnon prescribed little else in their works; their contribution lay in diagnosing the problem. High, real interest rates affect economic growth and investment through indirect (Shaw) or direct (McKinnon) transmission.
Frondizi was overthrown by the army (on grounds that he refused to annul the 1962 congressional elections in which the Peronists had made gains). In 1963, candidate Arturo Illia was elected (in a vote which excluded Peronist participation), only to be deposed in a military coup in June 1966.

The military made several attempts to rationalize the Argentine economy. In 1967, under the auspices of yet another government led by General Juan Carlos Ongania, a sweeping stabilization project was implemented. Although the policy called for "the restructuring of Argentine capitalism", the banking sector experienced little structural change. Financial markets felt a slight stimulation as a result of credit loosening. These credit lines, largely for housing and personal consumption, benefitted the middle and upper classes. Financial societies (financieras), prohibited from operating checking accounts, gained the most. Their participation in loans jumped from 7.5 percent in 1967 to 11.6 percent in 1969."

This "opening up" lasted until October 1970, when, 

under General Roberto Levingston, Economics Minister Aldo Ferrer announced a new "Argentinization" program. In response to the perceived failures of the military's liberal economic programs, the new economic team intended to redistribute bank credit to favor locally-owned enterprises. The Central Bank reduced the requisite level of bank reserves for those loans which banks offered to Argentine firms (although a differentiated reserve requirement was not a new policy tool). All new loans had to be given to firms which operated with a majority of national capital.

Private capital groups vigorously opposed the "Argentinization" project. The new set of laws generated a new cohesion to the interests of "big capital". Groups such as the Argentine Rural Society and the Industrial Union, many of which had established ties with international concerns, lobbied together under an umbrella lobby group, The Asociacion Coordinadora de Instituciones Empresarias Libres, ACIEL.

A new bank lobby, the Association of Argentine Banks, (ADEBA), was also established in response to these economic policies. The new members of ADEBA broke off from the

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"In 1969, the military regime had been shaken by several days of rioting and armed resistance, begun in the industrial center of Cordoba. After the "cordobazo", General Ongania stepped down, his credibility shaken.

"For the first time since 1946, the Peronist Confederation (CGE) (the populist worker union legalized in 1958) found itself appointed to positions on the Central Bank and other state banks."
existing bank group, the Association of Bankers of the
Republic of Argentina (ABRA) because they objected to the
ABRA’s joint representation with foreign bank branches in
Argentina. This type of proposal to separate the foreign
and the national bank lobbies had been circulating in the
financial sector since 1967. In 1970, when issues of
nationalization (under Economic Minister Ferrer) again
arose, the high-society, Buenos Aires-based banking
community believed that the interests of the foreign and
domestic banking communities had irrevocably diverged.
Under ADEBA’s first president, Roberto Bullrich, of the
Banco Galicia, the new bank lobby not only excluded the
foreign banks, but kept national bank membership exclusive.
Bankers from the Interior of Argentina, already represented
by the Asociacion de Bancos del Interior de la Republic
Argentina, ABIRA, were not admitted. As a group, the banks
in the newly-formed ADEBA were economically influential:
The 13 founding banks represented the deposits of 70 percent
of all private national capital in Argentina. They
exercised a new willingness to engage in political battles
over credit policy.\footnote{This number drops to 40\% if foreign
capital is included, and down to 20\% if state-owned banks are counted
towards the total. See ADEBA, Memoria, 1973. Also,
interviews, Adolfo Díz, Carlos García Martínez.}

Meanwhile, union organizations, student groups, and
guerrilla movements increasingly demanded reforms and
civilian rule. In 1973, ruling General Alejandro Lanusse lifted the ban on Peronist candidates for the upcoming elections, and, predictably, the peronist Hector Campora was elected. A few months later, Campora quietly left office, and Juan Peron and his Justicialista party returned to power.\footnote{See Daniel Muchnik, De Gelbard a Martinez de Hoz: el tabagén económico, 1978, pp. 310-311 for discussion of this period.}

Under the new Peron administration, national priorities were once again shifted. The Pacto Social sought to increase wages and employment through regulation of trade and exchange rates and subsidized credit to industry. Economics Minister Jose Ber Gelbard sought to activate the economy through a huge credit expansion. Bankers saw all deposits in Argentine banks once again placed under the property of the state.

Most types of financial institutions were able to profit from an economic plan to stimulate the economy and to provide more direct regulation of banking. The Central Bank closely monitored entry of new banks into the systems, and several foreign-owned banks were nationalized, keeping competition down.\footnote{Only a small sector of the market was eligible to offer these operations. See Review of the River Plate? Chase Manhattan’s Banco Argentino de Comercio, Morgan Guaranty Trust’s Banco Frances, and First National City Bank’s Banco Argentino del Atlántico were taken over by the state, and Spain’s Banco Central de España lost its Banco Popular (continued...)} Under a nationalized system, bankers
were ensured steady profits from the Central Bank-regulated spreads and commissions. While the newly-formed Argentine Banking Association (ADEBA) complained of the "profound and substantial change in banking operations", their Annual Report added that "from the point of view of services and of loans that are offered to the public and its clients, there are no differences with the earlier set-up."

The administration also introduced policies to promote more financial intermediation. In early 1975, the Peronist economic team liberated a few, select interest rates in the Argentine domestic market. It offered a new fixed term certificate of deposit, which was transferable at a free interest rate. The advent of an inflationary explosion in 1975, however, undermined the impact of the banking reforms, crippling the financial sector as a whole. In 1971, the government had emitted indexed bonds, adjusted to inflation. This new instrument financed the public sector. But the 1973 rise in oil prices forced the government to spend its foreign reserves and to accumulate a huge payments deficit. The explosion of US dollars on the black market created an expansion of credit and inflation, out of the control of the

"(...)continued"

Argentino. The Foreign Investment Law of 1973 forbade any foreigner from purchasing any Argentine enterprise considered "vital to national security", which included those in the banking and insurance sectors.

ADEBA Memoria, 1974. p. 72. This time, the policy switch was pro forma, given that the banks had little formal autonomy under the 1957 financial regime.
Central Bank. By 1974 consumer prices had risen almost 25 percent. A political breakdown between the right and left wings of the Peronist movement led to escalating terrorism and instability.

In November 1974, Peron died, leaving the government in the inexperienced hands of his wife, Isabel Peron. Her new Economic Minister, Celestino Rodrigo, mandated a 38 percent salary boost, followed by another 80 percent increase, which created an inflationary explosion. By the end of 1975, prices had risen 180 percent. In March 1976, the annual inflation reached 2,300 percent. Fixed gross investment was down 16.7 percent from the year earlier. The rate of price increases became divorced from the market of financial assets.74

3. A Society Ripe for Change

The political economy setting was ripe for the 1977 dramatic policy shift. By 1976, the implicit bargain between banker and the government was breaking down. Although bankers had learned to profit from state-run credit systems, and they did fear increased competition from outsiders, they were willing to see a change. The

74Feldman and Sommer, Crisis Financiera, 1986, suggest that the dramatic price increases of the 1960s and early 1970s were more devastating to financial transactions than the depressed nominal interest rates. p. 17.
agreement that states protect banks from (foreign) competitive pressures (inherited from the trade dependence with Britain), which had historically battled with the "free enterprise" belief, was becoming obsolete. State credit policies, mishandled by a series of corrupt or inept administrations, no longer appeared to favor the capitalist classes. Moreover, the experimentation in financial openings in the 1960's had led some banks to anticipate windfall gains from a liberalization drive. Many bankers believed that foreign credit opportunities, and a redistribution of funds away from state-led projects, would improve banker prospects.75

On March 24, 1976, the Argentine military, for the second time in a decade, rolled its tanks down the main boulevard of Buenos Aires.76 On April 2, 1976, General Jorge Videla solemnly proclaimed "the final closing of one historical cycle and the beginning of another", and his newly appointed Economics Minister, Jose Alfredo Martinez de Hoz presented his "Programa de recuperacion, saneamiento y expansion y la economia", whose outlines had been in preparation for almost a year.

This chapter sets up the argument that key historical

75Agro-export interests and rural landowners had witnessed a slow decline in their fortunes since the 1940's and were anxious to improve their situation.

76President Isabel Peron had asked for military "assistance", (outright intervention) already one year prior to the coup. Interviews, Mallea-Gill, Fichera.
factors influenced the outcome of Argentina's financial reforms in 1977. The rural and urban cleavage, which was an underlying factor in 19th century struggles over financial resources and political power, would reemerge in the 1970's as a result of the changes brought on by the liberalization policies. An historical ambivalence over the state role in financing development persisted, forged on one hand, from profitable trade and capital exchanges with Britain and the United States, and on the other, by effective state protection from foreign economic penetration. The policy shift in 1977 actively rejected state participation in finance, yet it did not itself change entrenched bankers' practices. As Chapter 4 will describe, the persistent historic fear of foreign "penetration and invasion" led to lobbying which modified the final policy. Buenos Aires bankers and their regional counterparts, each accustomed to state protection of their markets, were quick to turn to state leaders for support and special treatment.
CHAPTER III.

THE HISTORY OF CHILEAN STATE AND BANKER
IN CREDIT ALLOCATION SCHEMES: SOLIDARITY AND CONSENSUS

Argentina and Chile faced markedly similar experiences in the development of their financial markets. By examining the historical parallels in state-led financing and banker practices, the differences which do emerge are highlighted. In the 19th century, Chile’s landowning and banking classes remained small and cohesive, in contrast to the regional splits marking Argentine national development. In the late 1920’s and early 1930’s, both countries faced political turmoil and sought solutions in corporatism and state intervention in the economy. But, unlike Argentina, in which a succession of political formulas failed to achieve consensus and instead produced an arena of confrontation, Chile reached a broad consensus over a multi-party system. The dominant landowning and newer middle classes worked together with the succession of government officials. The rift that emerged between polity and society (and which led to the military takeover in 1973) was profound, but it did not comprise splits within the banking sector.
A. State Incentives, International Uncertainties

1. Export-led Financing

Chilean financial activity originated largely in the export of primary goods, as in Argentina. Beginning in the early 19th century, British trading companies worked with private merchant banks and state officials to handle the financing, transport and marketing of Chile's agricultural and mining exports.¹

The state apparatus financed itself with the customs duties collected from the booming nitrate export business. Chilean authorities took even more initiatives than their Argentine counterparts to encourage the exploitation and export of the country's natural riches. They offered incentives to foreign mining and domestic landowning interests: The Foreign Ministry secured disputed territory in the North for mining companies, and the state mortgage bank, the Caja de Credito Hipotecario, created in 1855, furnished subsidized capital (by purchasing the landowners' mortgages) to upgrade irrigation facilities.²


²Chile declared war on Bolivia and Peru in the War of the Pacific (1879-1883) to annex the world's source of nitrates in the Atacama desert. Tom E Davis, "Economic Development of Chile," in Mario Zanartu S. J. and John J Kennedy, eds. The Overall Development of Chile, University
By mid-century, Chilean governments had the revenues to adjust the price (and purpose) of credit for their larger clients. But private sources of financing grew up alongside the state apparatus. By 1860, private merchant banks, largely free from state control, were busy handling the export business: issuing bank-notes and operating as the institutional center for the insurance, transport and distribution services. By 1891, twenty-seven banks operated in Chile. Santiago, and the neighboring port of Valparaíso, were the undisputed centers of commerce and politics. No regional threats to this centralized power emerged.3

The well-being of the Chilean economy depended on the exporting business, and on the credit that foreign traders extended. With pressure from its primary business partner, Britain, to keep taxes low (and trade open), Chile grew increasingly dependent on the vagaries of the international market. A domestic credit crunch in London in 1876 set off a two year economic crisis in Chile. The foreign-owned nitrate export industry, which, from 1880, pumped huge revenues into the Chilean state coffers, was destroyed by the invention of synthetic nitrates in the First World War.

3In 1890, President Balmaceda proposed nationalizing banks, a scheme which suggests early state ambitions in credit allocation. The nationalization threat might have led to Balmaceda's overthrow in 1891. See Julio Cesar Jobet, Ensayo Critico del Desarrollo Economico-Social de Chile, 1951, cited in Aníbal Pinto, Chile, una economía difícil, Fondo de Cultura Económica, Mexico, 1964, pp. 60-66.
In times of international crises, or during shifts in world demand of Chilean products, the entire economy collapsed, until an upturn or a new market emerged. Chile was perhaps even more dependent than Argentina on these export lines. 

2. Emergence of State Monetary Control: Central Banking

In 1925, the U.S.-led Kemmerer Commission arrived at the request of Chile to put the country on the gold standard and to set up a Central Bank and bank monitoring agencies. The Chilean Central Bank was organized as a semi-public institution, with joint ownership by government, commercial banks, and the general public. Shares were divided among the private banks in proportion to their paid-in capital, and among other private shareholders. Legislation granted the Central Bank the sole right to print currency and monitor its volume and distribution through commercial banks through the rediscount mechanism. Private banks were assigned minimum capital requirements and complied with

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'State revenues doubled in every decade from 1880 through to World War I, with 97 percent coming from taxes on foreign commerce. By 1920, trade with the United States had increased with the opening of the Panama Canal.

ratios between reserves and other assets and liabilities. The supervisory agency, a separate institution, was charged with examining banks and regulating their operations.\(^6\)

Chile's authorities soon began to manipulate the recently established Central Bank and monetary reforms.\(^7\) In 1935, the Central Bank set interest rate controls for bank deposits. (For most years until 1965, the maximum legal interest rate was less than inflation.) Low bank lending rates were matched by low nominal interest rates paid to depositors. It was feasible to fix interest rates institutionally (without relationship to the money supply) in the absence of a significant capital market.\(^8\)

The Central Bank also set relatively high reserve requirements for the commercial bank, inhibiting bank lending. It began to levy direct controls on particular

\(^6\)Out of a total of fifteen members on the Central Bank's policymaking Board of Directors, four were appointed by the state, four were selected from Congress, three were nominated by private national and foreign banks, and four by other business and labor groups. This corresponded to the formula proposed by the Kemmerer Commission, and was similar to Argentina's bank structure, which followed ten years later.

\(^7\)In 1928, under military rule led by Colonel Carlos Ibanez (1924-1932), an Institute of Industrial Credit was created, using revenue from the newly created social security banks, but its resources were small.

\(^8\)See Table 2, Annual Interest Rates. As in Argentina, taxes (and other charges applied to loan transactions) increased the effective cost of borrowing, but it still remained below the real cost of capital. With inflation rising, few people held on to unindexed financial assets. See Chile: A Country in Transition, A World Bank Country Study, 1979, p. 46.
kinds of credit expansion by classifying the type of assets which could be counted toward the reserve requirement, an important step towards preferential credit allocation. In 1935, a preferential loan rate was applied to wheat credits, and by 1937, this policy applied to all agricultural loans.

3. The Grupo Economico

Chile's private business groups actively welcomed public control over the monetary unit and the money supply, anticipating greater price stability (and credit availability) in domestic markets. Most large enterprises, however, had already reduced their exposure to the vagaries of Chile's credit markets by creating ties with financial institutions.⁹

The grupo economico, also present in Argentina, dominated the Chilean economic structure. These economic groups brought together productive and financial enterprises under one organizational roof. In an environment in which capital, management and information were not readily available, the economic group accumulated and allocated these resources. As in Argentina, in-house banks also offered financial advice to the firms, and through their

⁹See Augustin Ross, Chile 1851-1910: Sixty years of Monetary and Financial Questions and of Banking Problems, Impresa Inglesa Westcott & Co., Valparaiso, Chile, 1910, for a contemporary banker's account.
understanding of firm operations, signaled new opportunities for mergers, associations, or investment linkages with other industries and banks.\textsuperscript{10}

In Chile, firms within a grupo shared management responsibility; rarely did a legal relationship exist between a parent company and its subsidiaries. Interlocking ownerships and investments were common. Mining, banking, and landowning interests had become interwoven, and a small number of (extended) families owned and managed activities in these diverse sectors. In 1922, 77 percent of large enterprise proprietors owned businesses in areas outside the sector of which their firm represented.\textsuperscript{11}

One such example was the Edwards family, which was conceived in the early 19th century by an English ship's physician's marriage to a Chilean woman. Augustin Edwards Ossandon opened the Banco de Edwards in 1856, and his son Augustin Edwards MaClure invested in railroads, newspapers, and the copper and nitrate export business. He established partnerships with British firms, and, in 1905, his family conglomerate orchestrated a merger of several insurance

\textsuperscript{10}For a general description of these organizations, see Nathaniel Leff, "Industrial Organization and Entrepreneurship in the Developing Countries: The Economic Groups", Economic Development and Cultural Change, 1978.

\textsuperscript{11}See Henry W. Kirsch, Industrial Development in a Traditional Society, University Presses of Florida, Miami, 1977, p. 73. This data was calculated from Bolsa disclosures from 151 owners of Chilean enterprises whose stock was traded.
companies to form the Consolidated Chilean Investment company. By the 1920's, the family had further diversified its holdings, owning controlling shares and Directorships on the Boards of 12 companies, ranging from sugar refining, beer production and textile manufacturing. Much of its operations were carried out together with the British bank, Banco Anglo Sud-Americano. The grandson became a powerful senator and helped to direct state policies in the family's interests.\(^{12}\)

Membership on the powerful agricultural or business lobby groups, Sociedad Nacional de Agricultural (SNA) or the Sociedad de Fomento y Fabril (SOFOFA), also emerged as an inside track to influence government policymaking. Founded in 1883, the SOFOFA grew to over one thousand members by 1920. The organization became a voice for business in the state bureaucracy, boasting a voting membership on the Central Bank and other state boards.\(^{13}\)

B. The State-led Model: Uncontested

Chilean exports had only just recovered from the


\(^{13}\)Kirsch, *Industrial Development*, p. 129-133.
collapse of the nitrate market when the Great Depression set in. Between 1929 and 1932, Chile's exports fell 88 percent. The country was, once again, thrown into economic and political turmoil, and the military government, led by Colonel Carlos Ibanez, resigned in 1932.\textsuperscript{14}

1. CORFO and Industrial Credit

In 1939, Pedro Aguirre Cerda was elected on a leftist coalition platform, uniting the Radical, Communist and Socialist parties to form the Popular Front.\textsuperscript{15} The Aguirre Cerda administration set out to speed up Chile's industrialization process. Chile's private financial system (banks of issue and deposit, savings and loan associations, brokerage houses, and a stock exchange) did not provide enough capital for a major industrialization drive: The major intermediary, commercial banks, offered mostly short term loans (under 90 days) to a select number of large agricultural and mining family enterprises, steering clear of the riskier, longer-term industrial loans, and the privately-run Santiago stock

\textsuperscript{14}This brief period of military rule in Chile left the armed forces discredited and humiliated and led them to eschew political involvement until 1973. See Frederick Nunn, \textit{The Military in Chilean History. Essays on Civil-Military Relations, 1810-1973}, University of New Mexico Press, Albuquerque, 1976.

\textsuperscript{15}For treatment of this administration, see Paul W. Drake, \textit{Socialism and Populism in Chile, 1932-1952}, University of Illinois Press, Urbana, 1978, pp. 98-142.
market, a venerable institution established in 1893, was, like its Argentine counterpart, little more than a social meeting place for the few members who traded among themselves.

The Popular Front government established a state development agency to provide the longer term financing that the private banks had been unable (and unwilling) to offer to the fledgling Chilean industrial sector. Over the course of the next thirty years, the Corporacion de Fomento de la Produccion (CORFO) functioned as financier, investor, and entrepreneur for the state; extending credit at reduced interest rates, making direct investments, and guaranteeing outside loans to enterprises, both public and private. Representatives from each Ministry, the Central Bank, the state banks, and the private sector sat on its Board of Directors.16

In its original mandate, CORFO funds were to be drawn from state contributions. Taxes and foreign exchange from the country’s export base, copper, were essential. When copper revenues dropped, the Central Bank extended credit to CORFO. The agency received an average of about 5–6 percent of the national budget. It also dispensed its own revenues

16While the socialist government originally intended such a state agency to improve the lot of the poor, the desire to accelerate domestic production soon created a very different organization (witnessed first by the composition of its Directorship). See Paul Drake, Socialism and Populism in Chile, pp.
earned from interest on its loans and from sales of stocks on equity investments.\textsuperscript{17}

As CORFO expanded, and as international support for state-led development agencies grew, foreign credit supplemented its sources of financing.\textsuperscript{18} Between 1950 and 1964, the average amount of foreign credit hovered around one-fourth of CORFO's total disbursements. In 1949, external credits to CORFO reached a high of two-thirds of total investments.\textsuperscript{19}

CORFO emerged as the central state mechanism to implement preferential loans. CORFO investment decisions were based on a general import substitution criterion, ranked according to the value of the product's imports and to the potential foreign exchange savings. With CORFO assistance, domestic-oriented industry became the most important growth sector. By 1957, CORFO controlled at least 30 percent of aggregate investment in machinery and equipment, more than one quarter of public investment, and 15 percent of gross domestic investment. Although the


\textsuperscript{18}The United Nations-sponsored Economic Commission on Latin America (ECLA), founded in 1946, promoted the use of state policy tools such as taxation, tariffs, and credit subsidies to encourage the development of domestic industry. Raul Prebisch, \textit{The Economic Development of Latin America and Its Principle Problems}. United Nations, New York. 1950.

\textsuperscript{19}Markos Mamalakis, "An analysis," p. x.
Argentine state also became involved in the business of credit allocation through an industrial bank and by nationalizing bank deposits, no development bank took the lead in financing.\textsuperscript{20}

2. Economic Exchanges under Coalition Governments

By the mid-1930's, Chile boasted a highly developed electoral system. The country's political groups had organized over 30 parties. Analysts heralded such "democratic" diversity as a political role model, for it provided representation for middle and working classes. Conservatives in Chile tolerated the communists and the union, while the left-wing parties participated in electoral politics.\textsuperscript{21}

The diversity, however, also mandated that no single party was able to win more than 25 percent of the Chilean vote in a presidential election. Over the next 35 years, Presidents came to office on coalition platforms and, in


order to pass legislation, were forced to build alliances (mostly short-lived) with opposing parties. Such arrangements led to a politics of increasing betrayal, accommodation, and back-room bargaining. After one party won an election with another party's support, it would turn to a third party to gain support for policies. To solve these distributional deadlocks, the volume of state participation in the economy increased secularly. This stalemate suggested an analogous deadlock to that in Argentina, in which periodic elections of Peronist candidates led to their repeated ouster by the Argentine military. The political game in Chile, however, was less volatile, leading to coalition, rather than stop-go, politics.**

3. International support

Foreign academics and international agencies also supported the enhanced role of the Argentine and Chilean

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**Economic measures were passed piecemeal in response to the demands of particular groups. Passage, or longer-term implementation of economic policies was often blocked. For example, in 1952, under increasing inflation and slow growth, the (now democratically-elected) General Carlos Ibáñez imposed Chile's first major economic austerity program. It was quickly disbanded in the face of massive strikes. The divisions impeded the emergence of an overall policy vision for state-directed credit allocation. For accounts of this political stalemate, see Peter S. Cleave, Bureaucratic Politics and Administration in Chile, University of California Press, 1974; and Arturo Valenzuela, The Breakdown of Democratic Regimes: Chile, The Johns Hopkins University Press, Baltimore and London, 1978.
states in guiding the course of economic development. In
the post-war period, economists began to argue that the
market economy was not self-propelling and suggested that
the "invisible hand" needed help. Out of the devastating
economic shortages of the Depression and the war years
emerged a new policy solution: import substitution
industrialization. The Economic Commission on Latin America
(ECLA), a United Nations-sponsored research institute,
argued that the patterns of trade between developing
countries and northern industrialized Europe had created
structural limitations to economic growth for Latin America.
To avoid a dependency on imports, developing countries
should use policy tools such as taxation, tariffs and
subsidies to encourage the development of domestic
industry.²³

In finance, development economists prescribed state
promotion of certain forms of savings and borrowing. They
advocated direct state subsidies - in the form of credit -
to stimulate desirable investments, arguing that a big
capital accumulation drive would lift developing countries
into self-sustained growth. In post-war Argentina and
Chile, the banking systems became increasingly regulated --
or run -- by state monetary authorities and institutions.

²³See Raul Prebisch, The Economic Development of Latin
America and Its Principle Problems, United Nations, New
York, 1950.
C. **Strengthening Preferential Credits**

The populist rule of Carlos Ibanez (1952-1958), the conservative Jorge Alessandri government (1958-1964), the U.S. government's "Alliance for Progress" favorite, Eduardo Frei (1964-1970), and the socialist Salvador Allende (1970-1793), all augmented the system of state credit allocation. The state bank and state agencies (such as CORFO) increasingly carried out domestic and foreign credit operations, regardless of the political party in office.²⁴

1. **The Alessandri Administration**

In Chile's 1958 presidential elections, the businessman candidate Jorge Alessandri was elected on an economic platform that emphasized price stability over redistributive policies. The Alessandri administration received renewed foreign capital, and it instructed the Central Bank to pay interest on savings accounts in foreign currency to encourage foreign currency-denominated loans and deposits in the banking system.²⁵

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²⁵By the end of 1959, foreign currency accounts amounted to 12 percent of the money supply. The increment in foreign currency loans in 1959 amounted to one-third of
While the Alessandri administration created new incentives to attract foreign credit, it also added new features to the system of state-led credit allocation. Monthly credit quotas for individual banks, set in 1953, were frequently raised to meet sudden credit demands. In 1958, the Central Bank augmented the program of explicit selective credit controls, offering differential rediscount rates to commercial banks (agricultural credits were favored). Quantitative credit controls remained in place.\textsuperscript{26}

Rarely was enough of the subsidized credit available to potential borrowers. And, access to credit in an inflationary economy under fixed interest rates was, in effect, a direct subsidy to the borrower. State-owned enterprises and large firms with ties to private financial institutions (the grupos economicos) received much of this government-provided money.

During the Alessandri administration, CORFO grew into a relatively autonomous public agency, both from the executive branch and from the private sector. By 1965, CORFO extended credit both for working and investment capital and, in doing total bank credits outstanding. Introducing indexed savings accounts (an instrument that varied the interest rate to reflect changes in the real cost of money) also stimulated overall savings. Chile: A Country in Transition, 1979, pp. 46-47.

\textsuperscript{26}If a bank exceeded these quotas, it was denied access to the rediscount window. Interview, Sergio Malbran. (See List of Sources; Interviews, for full citation.)
so, established its own subsidized interest rates for industry clients. CORFO had also spread into activities beyond credit allocation; it was a partial owner of forty-six firms and held interest in ninety concerns from a range of sectors. These direct (equity) investment were often the result of CORFO acquiring bankrupt firms that had formerly received CORFO financing.  

The Banco del Estado de Chile, established in 1953 by the merger of three separately-administered state banks, acted both as a commercial bank and as an agent of the government, providing credit facilities in areas the government sought to foster. In 1966, the Banco del Estado activity accounted for some 40 percent of commercial banking loans to industry.  

As the culture of state-directed banking deepened, the banker profession, as in Argentina, became one of "gift-giving". Under the state regulated system, private bankers

27When manufacturing productivity dropped after 1940, CORFO undertook major direct investments in energy and heavy industry, starting up the steel works, coal, the sugar refineries, and copper processing industries. Arturo Valenzuela describes the independence of many of Chile's state agencies from day-to-day political demands, in "Political Constraints," in Arturo Valenzuela and J. Samuel Valenzuela, eds. Chile: Politics and Society, p. 18.

28Jacques R. Stunzi, "Banking and financing considerations: Financing in Chile," Thomas A. Gannon, Doing Business in Latin America, American Management Association, New York, 1968. p. 68. This state bank shared with CORFO the responsibilities of long-term industrial financing, although it offered more agricultural credits than the country average. Its Directorate included representatives of private economic sectors.
were ensured steady profits from Central Bank commissions, and bank failures were rare, if not impossible. Bankers remained an important figure in society because they were in charge of distributing credit; they remained, however, essentially powerless to decide who received it. "After following the instructions from authorities, we were supposed to make our loan decisions based on when the request arrived," recalled a banker. "We didn’t solicit clients, we just lent on friends’ recommendations."^{29}

The Central Bank regulations and state credit allocation schemes essentially eliminated the practice of private banking. While the individual banker acted as a collection agent for the Central Bank, bank owners (or majority shareholders) took initiatives to set -- and interpret -- state credit controls. Public credit institutions (CORFO, the Central Bank, state banks) were managed largely by representatives of Chile’s grupos economicos. A majority of the Central Bank’s Board of Directors were elected from the private sector; CORFO and the Banco de Estado also had private sector representation.^{30}

Moreover, shareholders of Chile’s banks also had controlling interests in the country’s industrial, commercial, and agricultural operations. Legal arrangements

^{29}Interviews, Sergio Malbran, Leon Dobry.

^{30}Tamagno, *Central Banking in Latin America*. 103
permitted banks to invest in these companies. Banking representatives then served on the Boards of Directors of numerous different companies. By 1960, these "finance capitalists", as Maurice Zeitlin and Richard Ratcliff have identified them, belonged to a handful of extended families ("kinecon groups").\(^{31}\) Out of the twenty economic groups that had emerged in Chile in the 1960's, three groups dominated in terms of the number and size of the enterprises that they controlled: the Agustin Edwards group, which ran the daily newspaper and controlled Banco Edwards, the Eliodoro Matte group, which owned the bank BICE, and a newer group called the "Piranhas", the Banco Hipotecario y Fomento de Chile (BHC), owned jointly by Javier Vial, Fernando Larrain and Ricardo Claro.\(^{32}\)

Since government regulation of financing had the effect of limiting competition and minimizing the risks in banking, these businessmen (who sat on state agency boards or became elected officials) did not necessarily oppose state-led credit arrangements.\(^{33}\) The system of government-subsidized

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\(^{31}\)Zeitlin and Ratcliff. Landlords & Capitalists, 1988, pp. 138-139. Their research was carried out in the late 1960's.

\(^{32}\)In 1970, this group bought the important Banco de Chile, as well as other firms and services. Philip J. O'Brien, Chile, The Pinochet Decade: The Rise and Fall of the Chicago Boys, Latin American Bureau, London, 1983, p. 72.

domestic credit generally favored the larger banks; those that received the Central Bank directed lines of credit generally belonged to these conglomerates. These banks then supplied their producer partners with financing.

The assets of commercial banks were concentrated: the six largest banks held 77.6 percent of the deposits and provided more than four-fifths of the private commercial banking credit. The private, commercial Banco de Chile itself held 30 percent of the deposits in domestic commercial banks, and its share of assets in these banks remained over 40 percent. The bank held principal stockholdings in 13 of the top 37 non-financial corporations. The bank was one of the only banks with a large number of stockholders, although two of the more powerful Chilean families exerted controlling management.34

As the Alessandri administration came to a close, Chile's financial system was comprised of institutions specialized according to their type of operation: the 24 domestic, privately owned commercial banks carried out short term (under one year), mostly unindexed operations; the two small mortgage credit banks offered long term, indexed credit directed toward agricultural or real estate loans, and the national savings and loan system (SINAP), with its 21 associations, financed construction and housing purchases

34Zeitlin and Ratcliff, Landlords and Capitalists, 1988, p. 119-121.
(long term). The leading bank, the state Banco del Estado, carried out both commercial and investment banking, with preferential credit lines for industry and agriculture, and shared with SINAP a monopoly over medium term, indexed deposits. State agencies such as CORFO, CORVI (Corporacion de la Vivienda, founded in 19xx), INDAP (Institute de Desarrollo Agropecuario, founded in 1962), and ENAMI (Empresa Nacional de Mineria, founded in 19xx) increasingly granted medium and long term credits to targeted sectors. While Chile's financial sector was considerably smaller than Argentina's, its banks functioned in a similar fashion.\textsuperscript{35}

Foreign bank access to Chile's markets was far less than in Argentina, limited to four foreign bank branches. None had assets or deposits exceeding those of any of the six largest privately owned Chilean banks. (This, also in part due to international banks' lack of interest.) Officially, Chilean banks had no direct lines of credit with international banks. The Central Bank handled all such financing.\textsuperscript{36}

\textsuperscript{35}CORFO, ENAMI, CORVI, and INDAP credits were rarely counted in financial system credit distribution tables, although they were major suppliers.

\textsuperscript{36}The foreign banks were subsidiaries of: Citibank, Bank of London and Southern America, Bank of Brazil and the Banco-Italian Bank of South America.
2. The Frei Administration: Financial Housecleaning

In the early 1960's, the rise of the Christian Democrat party set the stage for a series of dramatic policy reforms and produced an increase in popular political activity, somewhat analogous to the effect of Peronist policies on the Argentine political scene. The Christian Democratic party leaders used impassioned rhetoric to garner popular support for their new political strategy of a "third way" between Marxism and free market liberalism. With U.S. government financial backing, the campaign brought out the electoral vote: over one-half of eligible voters cast a ballot for the first time in 1964. The movement catalyzed worker, peasant, and the professional classes' demands that the political system deliver reforms.

The Christian Democratic crusade also fractured the historical agreements between private capitalists and state authorities concerning control over economic decisionmaking. The clarion call to "make policy more efficient" meant that private groups gradually lost an inside ear -- and voice -- in economic policymaking. As a Chilean remarked at the time, "We've all felt we had a finger in the pie. Everyone had the feeling that he was doing something direct. Everyone knew a senator, or was the cousin of a judge. Everyone was near power; power was a personal thing. Now power is
getting to be very abstract."37

In the 1964 presidential election, the Christian Democratic candidate, Eduardo Frei, won the Presidency on a platform to stimulate growth and to carry out redistributive policies without systemic (or socialist) change.38 The Frei administration introduced ambitious constitutional reforms to reorganize economic policymaking, and it promised to "democratize" the process of credit distribution by making credit available to a greater number of enterprises. A newly created Office of National Planning of the Presidency (ODEPLAN) and the informal Economic Committee were set up to orchestrate economic policy -- excluding, for the first time in Chile's history, the formal participation of private sector groups. The Frei administration also passed legislation to increase Chilean ownership and


38For a description of this "Program of the Revolution in Liberty" that attempted to break the political stalemate between the rising socialist workers movement and the hardening political right, see Arpad von Lazar and Luis Quiroz Varela, "Chilean Christian Democracy: Lessons in the Politics of Reform Management," Inter-American Economic Affairs, 21, no. 4, Spring, 1968.
control of the copper industry and to redistribute arable land among farmers.39

Over the course of the six year administration, many of the Central Bank reorganization measures were never voted into legislation by the Congress. But these key reforms -- and their real or potential effects -- sent signals that Chilean state authorities were relocating the boundary between the public and the private domains. A precedent for confiscating foreign private ownership and private property had been set. Moreover, the possibility grew imminent that private interest group input into policy would be altogether removed.

Until the introduction of the Frei administration reforms, privileged sectors had been assured inside access to public sector decisionmaking centers. In Congress, the economic elite exerted leverage to stop legislation that threatened its interests. As long as the ability to control the state apparatus was preserved, the powerful economic groups favored (or acquiesced to) the expansion of the state credit programs. The loss of participation in policy formulation placed such state economic intervention in a new

light.

In the area of finance, the Frei administration moved to disengage the Central Bank from both executive branch and private sector influence, groups which regularly pressured the institution to finance credit expansions. In 1965, all Central Bank direct credits to the public were eliminated. Legislation to remove all representatives of private industry from the Board of Directors was submitted (although the proposal never passed, due to pressure in Congress from private groups). The Central Bank improved the quality of its monetary statistics, publishing daily (instead of monthly) figures. It began regulating the money supply, not according to "ad hoc measures", but to a "formula which included the demand for money". Central Bank technocrats began to publish research articles on policy issues in the Bank's monthly journal.40

The Central Bank shake-up also sought to centralize the management and control of monetary aggregates under one state bureau, and through one set of guidelines.41 The Bank raised the overall reserve requirement on commercial banks, forcing banks to rely increasingly on Central Bank rediscouts. Preferential interest rates (through softer


41Interview, Antonio Mollo. I am grateful to Sr. Mollo for access to his papers on this period.
rediscount terms) were then fixed for a range of priority uses, such as loans to newly established firms or for export credits. The Central Bank narrowed interest rate differentials (among types of loans, or geographic destinations), while strengthening quantitative controls on credit.

The administration also took steps to extend credit to more users. Through selective credit controls, banks were specifically instructed to increase the proportion of their total loan portfolio to small enterprises. A Central Bank program entitled "Credit lines according to a cash budget", encouraged the smaller firm to develop in-house financial accounting and planning skills. The enterprise would qualify for a guaranteed loan if it submitted an annual budget to a commercial bank. While the purpose of the program was to eliminate enterprise uncertainties in financial matters, it also strengthened Central Bank control over credit allocation.⁴²

These institutional reforms to streamline the public credit system attained only marginal success. The direction of state financing, however, was clear: As the Frei presidency drew to a close in 1970, public sector institutions (the Central Bank, Banco del Estado, the savings and loan associations, and agencies such as CORFO, CORVI, ENAMI, and

⁴²Firms were also required to pay suppliers with cash and to commit one half of their profits to increasing working capital. See Enrique Rudloff Wachtel, Administracion de las lineas de credito según presupuesto de caja, Universidad de Chile, Department of Administration, Santiago, 1973.
INDAP) granted almost all medium and long-term credits in national and foreign accounts. In short term accounts, the Banco del Estado granted 52 percent of credits and collected 46 percent of deposits."

Meanwhile, as in Argentina, another, parallel financial system had emerged in Chile. Since 1940, self-financing, inter-industry loans (loans between firms, producers and suppliers) and informal channels of finance had grown precipitously. In 1960, non-bank financing, informal activities, or supplier credits comprised 34 percent of all loans to the private sector, compared to 21 percent in 1950, and 3 percent in 1940.""

Fearful of losing control of capital flows, the Frei administration sought to bring private financial transactions back into the legal market. The Central Bank raised the credit ceilings to positive real levels for the first time in years. Since interest rate ceilings had resulted in subsidized credit for a few borrowers (acknowledged as the large and established conglomerates), higher interest rates could provide greater access to credit. The administration also introduced indexed savings accounts. By encouraging

"By the end of 1969, the International Monetary Fund calculated that about 90 percent of bank credit operations were subject to quantitative guidelines. IMF Report SM/70/109, cited in Chile: A Country in Transition, 1979, p. 48. See also, Banco Central, Boletín Mensual, September 1971.

the growth of savings, and the movement of funds, in the formal market, the state monetary authorities also hoped to increase state revenue through taxation on financial profits. In 1965, development banks were legally permitted to specialize in long term financing for investment projects. (No such banks actually opened for business, however, in part because CORFO already granted such credits.)

The Frei administration openly appealed to U.S. and European governments and private corporations to expedite its reform efforts. In 1965, it implemented a well-publicized stabilization program in the attempt to control inflation and increase confidence in the Chilean economy. Foreign capital transfers to finance public and private investment did increase markedly. These foreign funds offered the Chilean state officials a new freedom from domestic pressures to underwrite programs.


But, despite Frei administration reforms, the government selective credit facilities fell short of their goals. State funds (distributed through CORFO, the Central Bank, or the Banco del Estado) were overshadowed by the increasing volume of financial transactions in the informal sector. For example, many firm savings went directly back into the family enterprises, rather than through the banking system. The "parallel" market of private finance companies and unregulated brokers extended credit to Chilean borrowers. The larger firms were able to afford this credit, offered at higher rates. Lending activity in the private sector shifted increasingly to nonbank financial intermediaries, either through the informal sector or directly through suppliers. By 1971, almost one half of all loans to the private sector originated in non-bank institutions. Policy changes that increased bank interest rates were thus only marginally decisive in allocating resources.4

Moreover, funds allocated by state agencies rarely reached their mark. Monies borrowed under selective credit programs were subsequently reinvested in the rapidly growing parallel market. Many credits were diverted by the original

borrowers to other (unregulated) uses, such as suppliers
credit or consumer loans. The overall investment levels in
targeted sectors were not necessarily boosted by state
credit subsidies."

Thus, local private grupos maneuvered relatively easily
around preferential state credit policies. In addition to
informal sources of finance, grupo firms had options to
negotiate loans directly from international banks through
their affiliated banks. Many had established ties with
foreign capital through trade and direct investment arrange-
ments and, in the post-war period, saw renewed opportunities
for credit from foreign partners, independently of the
state. Those same grupos not only enjoyed access to finan-
cing from the affiliated bank, but they also drew funds from
their own enterprises. They often had larger retained
earnings. The networks of inter-conglomerate financing in
the grupo meant that state credit facilities became
increasingly dispensable."

"Fuenzalida and Undurraga, El credito y su
distribucion, 1968.

"An institutional forum for contacts with foreign
companies was the Comite Interamericano del Comercio y la
Produccion (CICYP). This US-based association opened an
office in Chile in 1953 and brought together local enter-
prises and foreign businesses. CICYP financed the 1967
convention which established guidelines for the "Chicago
Boy" program in 1974. See David Francis Cusack, "The
Politics of Chilean Private Enterprise under Christian
Democracy", Ph.D dissertation, University of Denver, 1970,
pp. 80-86.
3. Allende Administration: Modifications on the Model

By the end of the 1960's, neither the Chilean nor the Argentine economies had "taken off". In the highly-charged 1970 presidential election, the socialist party candidate Salvador Allende was voted into office by a coalition of leftist parties. His Unidad Popular platform promised to "replace the current economic structure" by socializing the means of production in Chile.\(^5^0\) To this end, industrial firms were taken over by the state development agency (CORFO), the agrarian reform was sped up, and the remaining foreign-run copper mines were outright expropriated. No new legislation was necessary to carry out the nationalizations. CORFO already commanded sufficient legal tools, which, until then, had been largely unused.\(^5^1\)

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\(^5^0\)From the opening line of the Allende economic program. See El Mercurio, Breve historia de la Unidad Popular, Santiago, 1974. Goals included redistributing income toward the working class and the poor and introducing major changes to the structure of the economy in order to break the traditional business class control over production and credit. See Ian Roxborough, Philip O'Brien, Jackie Roddick, Chile: The State and Revolution, Holmes and Meier, New York, 1977, pp. 52-69.

\(^5^1\)A 1933 decree permitted firms to be brought under state control, if in the public interest. The Allende administration reforms altered the degree of activity - and not the function - of agencies. By 1973, 35 percent of agricultural land had transferred ownership, and CORFO became a giant state depository for the companies that had been interceded, bought, or nationalized. See Alejandro Foxley, Redistributive effects of government programmes: The Chilean Case, Pergamon Press, Oxford and New York, 1979, p. 9.
In December 1970, the Allende administration announced that it would nationalize Chile's banking sector (an even more radical reform than the Argentine 1973 nationalization of deposits).\textsuperscript{52} CORFO was authorized to buy shares from private bank stockholders (which customarily comprised only a handful of affiliated business partners) to gain majority ownership of the financial institutions. The development agency also took control over banks where infractions -- financial or labor -- could be proved. CORFO then designated new members for the banks' Board of Directors.\textsuperscript{53}

Foreign bank branch offices operating in Chile, which had accounted for only a small percentage of total banking activity, were bought out. Savings and loan associations were placed under the supervision of their central office, which in turn was placed in the hands of the state. The insurance companies were left untouched. By 1972, the state controlled the majority of the 21 commercial banks, or 95

\textsuperscript{52}The election of the socialist leader had brought on a sudden withdrawal of local savings deposits, and a reversal of funds from abroad. Stephany Griffith-Jones argues that, by 1972, cuts in U.S. bank and international financial agency loans were compensated by West European, Japanese and socialist country credits. The Role of Finance in the Transition to Socialism. Allanheld, Osman Publishers, Totawa, N.J., 1981, p. 163. On the other hand, Stallings argues that the credit contraction irrevocably damaged industry. Barbara Stallings, Class Conflict and Economic Development. 1978, p. 134.

percent of the country's investments and deposits.\textsuperscript{54}

The private bank expropriations, which dislodged the large property-owning groups, created only a ripple of opposition. (This, in contrast to the open conflicts in response to the take-over of industrial firms.\textsuperscript{55}) The capitalist class remained relatively sanguine in the face of nationalizations for a number of reasons. As evidenced earlier, government control of credit allocation did not substantively affect the operations of the established economic groups. The first two years of rapid domestic sales during the Allende administration gave most economic groups sufficient inter-firm funds. Many grupos retained access to sources of private international capital. More fundamentally, the Allende bank expropriations were, in some sense, only paper transactions, since lending and borrowing arrangements under the previous two administrations had been increasingly carried out under state control. Bankers were accustomed to government intervention; they transferred credit to their clients through informal channels. An

\textsuperscript{54}CORFO paid the stockholders well; some, even in dollars. Only one bank owner refused to sell his shares. Interviews, Antonio Mollo, Leon Dobry. (See List of Sources; Interviews, for complete citation.) See also Alfonzo Inostroza, "Nationalization of the Banking System," pp. 287-289, 293.

industrialist recalled: "We didn’t use their [state-provided] credit much anyway. We hadn’t been participating in their programs."\(^{56}\)

The recently nationalized banks also continued to lend a portion of funds to the economic groups, often at terms more favorable than in previous administrations. While private banks were once considered the instrument of grupos (to acquire credit at negative rates), public banks under the Allende administration ended up offering funds at even better rates to these same conglomerates. Interest rate ceilings were lowered. The rate structure became more differentiated according to sector and types of loans; the Central Bank assigned each bank its own area and sector distribution. State-directed, subsidized credit did help the small Chilean firm to prosper. Yet, this net transfer of funds from the public sector (banks owned by the state) to the private sector (recipients of the credit) also depleted state finances.\(^{57}\)

Selective credit policies (already a complex network of regulations under the Frei administration) continued as a

\(^{56}\)Interviews, Ernesto Ayala, Rodolfo May Muller. The specter of declining foreign investments – and the prospect of a longer term weakening of the economic groups’ power positions – was real, however.

\(^{57}\)Griffith-Jones notes that, had the real cost of credit been positive, the state, through its banking sector, might have earned a profit and eased its fiscal deficit, in The Role of Finance, pp. 167-8. In 1972, the average real rate of interest was -12 percent.
major tool for directing resource allocation under Allende. No set limits, however, were established on the expansion of either sectoral or overall credit. The economic team was preoccupied with administering structural reforms, and few paid attention to the task of coordinating the independent credit authorizations that emerged out of the Central Bank, the Ministry of Finance, CORFO, and the Banco del Estado. The Banco del Estado even began to distribute merchandise, tractors, and seeds directly to its customers.  

Opposition to the Allende administration policies grew from both the political Left and the Right. As in Argentina, where the guerrilla movement which had emerged out of Peronist teachings, left the party, Chilean leftist underground movements began to disassociate themselves from Allende, believing the administration to be moving too slowly on structural reforms. A mid-term election in March 1972 fueled the infighting within the Unidad Popular coalition. Sabotage from the large industrialists also frustrated many government initiatives: The strategy of massive strikes by industry and union organizations began in earnest in October, 1972. By 1973, growth of the Chilean

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58Interview, Julio Barriga, general manager of the Banco del Estado. Monetary authorities also assumed that inflation would disappear with the structural reforms. Stephany Griffith-Jones, The Role of Finance, p. 151.

59For the tactics of conservative groups, see Ian Roxborough, Philip O’Brien and Jackie Roddick, Chile: The State and Revolution, Holmes and Meier Publishers, New York, 1977, pp. 103-22.
economy had stalled. Worker strikes had closed down much of Santiago. Inflation was nearing 1000 percent annually, a balance of payment crisis loomed, and the government had amassed a fiscal deficit close to 25 percent of GDP.\textsuperscript{60}

In September 1973, the Chilean armed forces stormed the Presidential palace and formed a provisional military junta; a year and a half later, its economic team imposed a dramatic free market financial reform. As in Argentina, Chile's mediocre economic performance was diagnosed as a matter of excess state control over the economy and society. Its champions argued that the pattern of credit allocation was being set according to political imperatives rather than measures of "rates of return" and "equilibrium points".\textsuperscript{61}

This comprehensive world view had been well marketed in Chile. In 1955, an academic exchange program between the departments of economics at the University of Chicago and the Universidad Catolica in Santiago was launched to train a generation of Chilean bankers and policymakers in U.S.

\textsuperscript{60}See Table 1, Selected Macroeconomic Indicators. For contrasting assessments of the Allende administration, see Paul E. Sigmund, The Overthrow of Allende and the Politics of Chile, Pittsburgh University Press, Pittsburgh, 1977; and Barbara Stallings, Class Conflict and Economic Development in Chile, 1958-1973, Stanford University Press, Stanford, CA, 1978, pp. 137-153.

monetarist economics. Chilean business associations were solicited to help finance the new University exchange, but they viewed the Chicago School economic theories with suspicion. The Edwards group, the foremost economic group in the 1960’s, alone gave key political and financial support.\textsuperscript{62} By 1970, the Universidad Católica had emerged as an influential institution to promulgate the market liberalization theories. A group of right wing economists emerged from its graduates to prepare Pinochet’s program.\textsuperscript{63}

Once the free market policies were introduced, most business organizations and bankers embraced them. Most, however, did not actively advocate a radical policy switch to open up financial markets, since state-led banking provided adequate profits in a risk-free environment. The right wing "alessandrista" business group in particularly was opposed to the project. These dissenting groups, however, had no alternative vision (other than the

\\textsuperscript{62}As the owner of the newspaper, \textit{El Mercurio}, the Edwards group went to lengths to promote the new venture. Interview, Domingo Santa María.

\textsuperscript{63}Some students went to the United States to receive degrees; most attended classes at the Universidad Católica taught by visiting professors Arnold Harberger and Milton Friedman. Its academic programs, public lectures, and publications were financed by U.S. government grants and the University of Chicago. The 1970 Alessandri presidential campaign also brought together these future "Chicago Boys". See Juan Gabriel Valdes, \textit{La Escuela de Chicago: Operacion Chile}, Editorial Zeta S.A., Buenos Aires, 1989, pp. 196, 294, 304.
interventionist policies of the past) to offer to Pinochet. "We accepted liberalization, not for university reasons, but because we were sick of the tramites [red tape procedures] of government meddling," explained a business leader. Bankers also came to view the recent bank nationalizations and centralized credit facilities as political and economic failures. Because the memory of the 1970-1973 socialist experiment, "it was natural to want to do everything opposite from what Allende represented". What better argument for a new policy than the collapse of its perceived antithesis?""  

This chapter has pointed to the striking similarities in the historical experience of Chile and Argentina with state-led financing. Nevertheless, important differences emerge, which would affect the course of the financial reforms in the 1970's. First, no Interior-Capital cleavage developed in Chile. This, due to the absence of a political struggle over centralized (Santiago) rule and to the dominance of the grupo economico, whose investments in agriculture and industry tended to mute any conflicts of interest among regions of Chile. Thus, the years between

"Interviews, Rodolfo May, Hernan Felipe Errazuriz, Ernesto Ayala. See Arriagada Pinochet: The Politics of Power, p. 30, suggesting that some of these perceptions might have been due to an excellent publicity job by the economic team technocrats and the press. Attempts to protest the dismantling of the state were also subject to military repression; after the president of the wheat growers association voiced complaints in 1982, he was arrested and thrown out of the country.
the Popular Front victory in 1938 and the overthrow of the socialist president Allende were marked by consensus-building and relative political stability among elites. Strategic government agencies worked well with the cohesive business elite. Although this consensus began to break down in the late 1960's, no history of splits among the financial sector emerged.

After 1973, Chile's new military-led regime rejected the 40 year-old model of Chilean credit policies, but it did not face competing factions of bankers over the state's role in shaping economic outcome. In Argentina, on the other hand, the free market model tended to further confuse the issue of how state policy and state institutions should mediate among banker groups and regulate financial activities.
Chapter IV:

ARGENTINA: BANKER SPLITS AND THE POLITICS OF BOOM AND BUST

One week after establishing military rule in April, 1976, Argentina’s Executive Junta swore in Economics Minister Jose A. Martinez de Hoz and his new economics team. Just over a year later, in June, 1977, an ambitious financial reform law was implemented. The ensuing explosion of financial activity was characterized by increasingly risky lending and borrowing operations in an environment of lax government regulation. Argentina’s government economic team implemented an IMF-approved monetary policy, which led steadily to the overvaluation of the currency. After a few years, the banking sector was in ruins, and the collapse of financial activity in 1980 left the economy paralyzed.

Until its own bank collapse a few years later, Chile’s financial policy took a strikingly similar course. In Argentina, however, conflicts within international and domestic banking communities, were undermining compacts among bankers and the state. Over the course of the bank experiment, these splits within the financial community inhibited consensus over the fragile bank policies. A few years after the generalized bankruptcies, the free market policies were scrapped in favor of direct state control of
financial instruments. In Chile, while the laissez-faire policies were modified, they remained essentially intact.

This chapter traces the shifts in strategies of the Argentine private groups, state monetary authorities, and military officers over the course of the new financial policy. As debates emerged over such issues as the deposit guarantee, foreign bank branches, and rural cooperative banks, so developed conflicts between foreign and national banking and subsequently between Buenos Aires and Interior bankers. These splits within the banking community undermined the cooperation necessary for policy implementation.

In early 1980, when the Argentine domestic banks began to struggle under non-performing loans, an Interior bank, the Banco BIR, was not granted additional funds to carry over its debts. Buenos Aires bankers refused to help out their colleague through short-term transactions on the mesa de dinero -- even after a (private) appeal from the Central Bank. After the Central Bank announced the closure of the Banco BIR, the deposits of the other two leading Interior banks Los Andes and Oddone began to flee. Within days, even the leading Buenos Aires banks were losing deposits. The Central Bank’s new regulatory policies were incapable of setting the financial sector back on track, and themselves exacerbated splits within the banking community.
The "Law of Financial Intermediaries" was a component of the newly-installed military government's comprehensive economic liberalization program, heralded as El Proceso de Reorganización Nacional. Under the aegis of its economic "tsar", Jose Alfredo Martínez de Hoz, the Argentine state proposed to change the model of accumulation and growth that had characterized the evolution of the Argentine economy since the 1930s. The policies that favored high protection, import substitution, and heavily controlled financial systems would be reversed.

The package comprised five areas: 1) a wage policy; 2) a price policy (both of which aimed to eliminate administrative and quantitative controls), 3) schemes to reduce the size and function of the state, 4) steps to open up the economy to international goods and capital (reducing trade barriers), and 5) a reform of the financial sector. Argentina's new economic team promised that any sector that was internationally competitive -- industrial or agricultural -- would survive and prosper under the new policy regime.¹

According to the plan's architects, domestic finance was a critical building block to construct the new Argentine

¹The reform package comprised short-term rescue operations (stabilization) as well as longer term policies. It also partly deregulated labor markets. See Jorge Schvarzer, La Política Económica de Martínez de Hoz, Ediciones Hyspamerica, Buenos Aires, 1986, for these policies.
society. By permitting banks to set interest rates competitively and to develop new financial instruments, private savings and borrowing would be encouraged, displacing the state role in allocating credit. If the state lowered its overall participation in the economy, investors could better "see" the true price of money.

The creation of a strong domestic financial sector—and the profit opportunities from stable, internal sources of funds—was designed to attract trade and capital from abroad as well. External sources of money would provide Argentina with new resources for economic growth. International capital inflows would also help adjust the disequilibria in the country's balance of payments current account, adding funds that exports were unable to provide. The immediate objective of the financial reform, however, was to create the instruments to "monetize" the economy. Financial intermediation (the process of transferring savings from one source into credit for another) would strengthen the demand for money.  

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3It was then argued that such private sector expansion would simultaneously slow down the rhythm of monetary expansion, or inflation. Foreign currency inflows also sustained Argentina's exchange and tariff policies in the face of trade disequilibria. See Adolfo Canitrot, La (continued...)
Argentine state monetary leaders and their military bosses understood the usefulness of the "free market" strategy. They envisioned that the policy package would not only transform the structure of the Argentine economy, but would alter deeply imbedded social and political alliances. The policy changes could hurt a range of interest groups, from agro-exporters to state employees. If, however, financial instruments - and not a state - determined this "rearrangement" of resources, then technocratic and dispassionate economic acts - rather that people - could be held accountable for the results.³

The political component of the economic policy was also explicit. There was widespread belief that democratic forms

³(…continued)
disciplina como objetivo de la politica economica: un ensayo sobre el program economico del gobierno argentino desde 1976. Estudios CEDES, 1979, p. 33. It is not clear whether this boon from the financial policy was anticipated. Interview, Juan Sommer. (See List of Sources for full citation.)

'Various state agencies differed over where this boundary between state and society should be drawn. In 1975, the future Minister of Finance Martinez de Hoz portrayed economic development as a joint effort between the state and private activity (CICYP Conference, 1975). After the military coup, Commander in Chief of the Navy and member of the ruling military Junta Admiral Emilio Massera also spoke enthusiastically of a state responsibility to bring about "social togetherness" and "cultural transformations". (Buenos Aires Herald, 10 June, 1976, p. 9; 6 April, 1977, p. 9; 9 May, 1977, p. 9. David Rock, Argentina, describes this point of view it as "military populism", p. 369.) Central Bank president Adolfo Diz, on the other hand, subscribed to the neo-classical monetarist position regarding the role of the state in economic development: a distanced and indirect operation of a few fiscal and monetary levers.
of government had been the brakes holding back economic expansion; the statist arrangements and particularist policies (that had presumably emerged over the course of democratic regimes) had blocked private initiative. An authoritarian government could sweep away these rent-seeking outgrowths. The market, functioning without restrictions, would be an efficient instrument for disciplining social relations and for regulating the behavior of workers and politicians without resorting to violence. Interior Minister General Albano Harguindeguy spoke of the "creative and realistic alternatives" that the free market system offered for governing the country.\footnote{Interview, Noticias Idea, September 1979. Adolfo Canitrot, Orden social y monetarismo, Vol 4. No. 7, Estudios CEDES, Buenos Aires, (no date). Oscar Oszlak, et al, ed., "Proceso", crisis y transicion democratica (Vol 2). CEAL, Buenos Aires, 1984, p. 13, differentiates the 1976 military experiment from that of the 1960's by the use of the economy as a means to carry out a project, and not merely an end in itself.}

By mid-1977, the declared "revolution" was underway: The financial reforms brought about a true and sudden redistribution of power. The new sources of authority emerged both from the existing economic base and from new political actors. These policies that reduced credit restrictions and released real interest rates were embraced readily by most groups. From the agro-industry sector, to corner shopkeepers, to the Peronist-led unions, all greeted the policy shift as a potential remedy for Argentina’s
protracted financial disorders.

The "free market" financial reform laws themselves also led to changes in the structure of the banking community. The "Law of Financial Institutions", passed in June 1977, altered the rules over bank entry, bank regulations and financial instruments. Interest rates for savings and deposits were no longer set by the Central Bank authorities. Financial institutions returned to a system of decentralized deposits, which permitted commercial banks to solicit and manage their own funds. Banks were free to allocate credit where (and to whom) they wished, at whatever rates.

The law also sought to "rationalize", or streamline, the many (and diverse) financial institutions that had sprung up in the Argentine system. A recent entry in the credit market, consumer credit associations, was abolished.6 These agencies, which provided short term credit to individuals, were run by small-time business people. They represented less than three percent of the market, yet they were numerous and difficult to control. The new Economics Ministry considered them "glaringly limited in their activities and thus unsuitable for the system in general", and they were given one year to convert

6Out of 725 financial institutions, 70 were consumer credit companies. They also employed 10 percent of bank workers.
into banks or cooperatives."

The financiera, which had been operating since the
early 1960's in Argentina's informal sector, was
legalized.¹ One intent of the policy reforms was to bring
these informal (or grey) transactions back into the formal
market. These "fly-by-night" credit companies were legally
converted into legitimate financial agencies or commercial
banks. (The commercial bank was still the only financial
institution permitted to deal in foreign exchange and to
accept checking accounts.)

To foster an initial confidence in the fledgling "free
market" banking system, the Central Bank extended the system
of government guarantees for all national currency deposits
received by a financial entity. Since 1935, depositors had
received guarantees on their savings from either the federal
or the provincial governments. Originally fashioned after
the U.S. system, bank credits were not guaranteed. In 1946,
this backing was broadened to include all financial transac-
tions. But, by this time, the close Argentine state super-
vision (nationalization of deposits) had tempered the
essential purpose of the insurance.

¹Carta Politica, February 1977, p. 75; "Exposicion de Motivos", Ministry of Economy, (notification of the details
of the 1977 Law of Financial Institutions to the Executive

²See Adrian C. Guissarri, "La Argentina Informal",
draft, Instituto de Estudios Contemporaneos, Buenos Aires,
In practice, then, the 1977 guarantee legislation marked a significant increase in the level of the government insurance. Formerly, parallel market activities such as bills of exchange did not receive government guarantees. Under the new bill, such transactions, which did not change in nature, instantly became secured by the state. At the outset, the state provided a total safety net -- a 100 percent guarantee -- on all deposits. A state insurance program would transmit a sense of security to all depositors. However, the short term nature of this guarantee was explicit: As the reforms took hold, the percentage of guaranteed deposits would be gradually reduced.⁹

Argentina's monetary authorities set a reserve requirement of 45 percent for all deposits; this relatively high level was chosen on account of the country's high inflation.¹⁰ As a rule, Central banks set reserve requirements for banks in order to reduce money creation (which is a source of inflation). Commercial banks are then instructed to keep a certain percentage of their capital assets inactive, or in reserve. However, the reserve

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⁹Fernandez, "The Expectations Management Approach to Stabilization". Financial institutions accepted bills of exchange contracts on behalf of a customer who needed credit. They had always operated at relatively free interest rates.

¹⁰The reserve requirement is made up of that part of commercial bank assets which must be kept in cash and in specified accounts. Formerly, Argentine banks had to hold on to 100 per-cent of their assets.
requirement also adversely affects the bank's profitability. Banks often pass on these losses to the savers and borrowers in the form of an increase in spreads. In an environment of high inflation, where high reserves are exacted, as in Argentina, such policies could be pernicious. Expensive credit could not be avoided.\textsuperscript{11}

Argentina's monetary authorities came up with a novel solution to neutralize the effect of the inflationary tax on bank reserves and to prevent wide spreads between borrowing and lending rates: the monetary regulation account. In exchange for restricting banks to loaning only 55 percent of their deposits, the Central Bank program compensated banks: It paid interest to the banks on those reserves it held, but only against \textit{time} deposits. In the absence of this reimbursement, and in the face of inflation, banks would have profited from current accounts but would have faced enormous losses from interest-based, or time deposits. Banks would have stopped offering these kinds of operations (or would increase spreads to make up for their losses), hurting the overall monetization of the economy. The central objective of the financial reform would have been blocked.\textsuperscript{12}

\textsuperscript{11}Note that, in theory, in the face of international competition, banks should not be able to demand any wider spreads. In practice, such forces are rarely determining.

\textsuperscript{12}The innovator of the \textit{cuenta regulation monetaria}, Ricardo Arriazu, has written at length about this program, (continued...
With the exception of this somewhat complicated reimbursement device, Argentine commercial banks faced fewer, and more flexible restrictions on initial entry, branch openings, and minimum capital requirements. Both regional banks and the Buenos Aires banks had the opportunity to expand into each other's regions. Competition, and not Central Bank regulations, would determine the proper behavior for (and the proper number of) banks. Banks were required to maintain other technical positions regarding the relation of fixed assets to net wealth (with a maximum of 1:1), the relation of financial liabilities in Argentine currency to net wealth (with a maximum of 25 times), and the different credit risks (with limits for individual loans at 10 percent).¹³

The consequences of failing to maintain these standards would "lead to strong punitive charges", according to Article Z of the Law. The Central Bank was assigned the exclusive rights to supervise financial institutions with broad descriptive powers to discipline banks. specific

¹²(...continued)

¹³Initially, minimum capital levels were differentiated by the type of institution and its geographical location, and financial institutions were granted several years of leniency to reach the stipulated capital amounts. Feldman and Sommer, Crisis Financiera, p. 47.
instruments, however, were not enumerated. The new regime's monetary authorities also went to great lengths to emphasize that the new directives were broad and flexible. The idea behind the new regulations was to "avoid a rigid structure in lawmaker" and to "permit commercial banks to carry out all and any operations that are not expressly prohibited, in contrast to the method of enumerating everything that is authorized as previous laws have adopted".¹⁴

The effect of the Law of Financial Intermediaries was dramatic. Bankers, creditors, and investors witnessed a financial opening which the country had seen only in the 1850's. As new lending and borrowing arrangements emerged (and new opportunities for foreign credit presented themselves), many bankers, particularly the entrenched Buenos Aires bankers, became fearful of the new competition.

B. Emerging Splits over the Financial Reform

The Financial Reform Law was officially drafted by team of five civilians (Central Bankers, private ADEBA-affiliated bankers, and economists) and three military officers. The issues raised over the course of drafting the reform (and

¹⁴"Exposicion de Motivos" (Ministry of Economy correspondence to the Executive military Junta), February 1977, p. 8. As this chapter details, since regulations on bank practices (and publication of appropriate Central Bank disciplinary actions) were not established explicitly, Argentine bankers took advantage of legal loopholes to carry out speculative (and destabilizing) operations.
their resolution) reflected both the dominance of the ADEBA-member banks in political economy, and the re-emergence of splits among banking groups.\footnote{The customarily vociferous unions were quiescent during most of the financial reform. After the coup, the union organization CGT was abolished, strikes were banned, and thousands of union leaders, politicians, and workers were arrested. The industry organization, CGE, was closed in July, 1977, when it voiced opposition to the military regime's policies.}

1. The Players

Initially, the Argentine private sector appeared to enjoy access to public decision making. Euphoric over the regime change, it met frequently with Minister Martinez de Hoz and military leaders. They believed that the free market philosophy -- which circumscribed state power in the economy -- had shifted the political boundaries away from the state and toward societal initiatives.\footnote{For example, Martinez de Hoz lunched weekly with a private sector organization of business people concerned with balancing Christian values with the free market, the Asociacion Cristiana de Dirigentes de Empresa (ACDE) founded in the 1960's. Interviews, Emilio Von Pehborgh. Press reports also recorded this sensation of empowerment. But, while groups met frequently with the economic team, most found their concerns ignored as the exchange rate policy turned against its interests. Evidence suggests that many groups managed to garner benefits from government policies but remained virtually powerless to modify them. Julio J. Nogues, The Nature of Argentina's Policy Reforms during 1976-1981, World Bank Staff Working Papers Number 765, Washington, DC. 1986.}
enthusiastic over the new financial order. Indeed, their newly-formed bank lobby, ADEBA, had helped to craft the 1977 reform. Already in May, 1976, the bank association ADEBA had offered to the advisory group (established to draft the law) an "Outline for a Banking System in the Service of Country and Community" that closely resembled the final document. The bank advisory group deliberated on the final text for thirty-seven days, having been handed a draft text of the Law prepared by bankers, ADEBA economists and Central Bank president Adolfo Diz.\textsuperscript{17}

While some bankers might have regretted relinquishing the economically secure position maintained under the state-allocated credit regime, most envisioned the development of a more dynamic financial system with higher interest rates (profits), more lending and borrowing, and increased funds moving into the system. Their spokesmen advocated even greater discretion over the rate of profit (the spreads between lending and borrowing rates) and the bankers' use of deposits.\textsuperscript{18}

\textsuperscript{17}In addition to the bank reform, the Association called for labor discipline in order "for the most efficient use of human resources" to take advantage of the "stupendous technological changes in modern banking". See Memoria, ADEBA, 1977. Interviews, Luis Garcia Martinez, ADEBA economist; Adolfo Diz, Central Bank president.

\textsuperscript{18}Publications such as Noticias IDEA, of the Institute for the Development of Executives in Argentina (IDEA), were wildly supportive of the Law. (see issues September, October, 1977). In private, bankers were more fearful of the possibilities of instability and personal loss.
These bankers were not willing, however, to lose the state's economic security net in return for these freedoms. Shortly after the draft reform law was made public, the banking community actively solicited both monetary authorities and military officials to safeguard their position in the new economic system. Bankers mounted extensive lobby efforts to ensure control of the newly-forming financial system, focusing on issues of foreign bank regulation and bank entry.

Another player in the financial reform game was Argentina's armed forces. Certainly, this institution was equipped historically with the legitimacy for political rule, having successfully removed various different social and political groups from power -- in 1930, 1943, 1955, 1962, and again in 1963. It was beholden to no one social group.¹⁹ The armed forces also had institutional mechanisms for rule already in place. The "Revolutionary Council", set up in 1955 under General Aramburu, and the National Security Council (CONASE), created in 1966 under General Juan Carlos Ongania, had formalized military access to policymaking. Finally, since 1940, the military had

¹⁹Alain Rouquie has written: "[The] intervention of the military is, if not legitimate, at least legitimated by large sectors of public opinion. ... Not only the Peronist, whether of the right or the left, reach out to the military, but even the orthodox Communist party and almost all the sectors of the nonviolent extreme left long for an alliance with "patriotic and progressive officers" or an improbably "Nasserist" revolution." Alain Rouquie, The Military and the State in Latin America, 1989, p. 275.
participated actively in Argentina’s industrial development. Its ownership and management of a number of industries, from steel to foodstuff, meant it had an interest and a means of control over the state fiscal spending.\textsuperscript{20}

Despite these advantages, the military’s political rule created tensions and rekindled rivalries within the Argentine armed forces.\textsuperscript{21} During the previous military regime led by the charismatic General Ongania (1966–1973), the army had shouldered the blame for policies which it did not authorize, or understand. In 1976, as the military took over political rule for a second time, the institution mandated a three-person junta, represented by each of three services. In order to make political rule less personalistic, each service would have \textbf{direct} and \textbf{equal} participation in governing the country.\textsuperscript{22}

A division that did not reflect true power differen-


\textsuperscript{22}"Direct" referred to the military participation in making laws; "equal" sought to avoid a concentration of power by one man or service. For the military’s internal debates, see Andres M. Fontana, "Political Decision-making by a Military Corporation: Argentina, 1976–1983", PhD dissertation, The University of Texas, Austin, 1987, pp. 45-54.
tials among the services exacerbated the already existing power struggles. Each branch of the armed forces received Ministries under its supervision. The army took the Interior and the Labor Ministries, the navy led the Foreign Relations and Social Welfare Ministries, and the air force put their men in the Defense and Justice Ministries. Military officers were also placed in a variety of administrative posts in the Provinces, in the pension fund agency, and even in the World Cup soccer organizing committee. These appointments created little "fiefdoms", or ministerial jurisdictions for the armed services.\textsuperscript{23}

The military became sensitive to the demands of lobby groups, who ranged from cooperative banks to industrialists to the influential (Peronist-associated) newspaper, \textit{Clarin}. The services openly cultivated a social consensus with the public over policies. The military-run Legislative Advisory Commission (CAL) was set up to deliberate on, and approve, all executive laws. As policies were promulgated, CAL held consultative interviews with bankers, economists, policy leaders, and military officers. The military officers had no training in economics or finance, and they acted largely

\textsuperscript{23} Civilians were appointed to the Economic Ministries. The economic team found itself repeatedly meeting with each military service to explain policies. See \textit{Buenos Aires Herald}, 7 September 1976, p. 9 on divisions. See also, Schlaudeman, "", in Hans Binnendyk, ed., \textit{Authoritarian Regimes in Transition}, Department of State Publications, 1987. The counterterrorism, or "dirty war", was also largely decentralized, as each army district conducted its own campaign.

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as a "rubber stamp" body. But through this forum, controversial issues were thrust into open debate. And, on certain issues the military took an active stance, pressuring the economic team.24

Over time, factions within the armed forces deepened over the appropriate course for repressing guerrilla activity, transitions to civilian rule, and economic policy.25 Many of the familiar splits between "nationalists" and "liberals" reappeared, but personal gain also played a significant role. The air force, having never before been given a commanding political position, was least interested in handing over power to civilians, while the navy under Commander Eduardo Massera wanted to create a new political party, led by Massera himself.26

By 1979, with the problems of subversion largely over, the military began to turn its attention to economy policy.

24Interviews, Vice Admiral Leopoldo Suarez del Cerro, Antonio Crespi, military officers; and Ricardo Arriazu, economist and Central Bank consultant. Lucio Geller, in Analisis de una situacion de relaciones de fuerzas: Argentina 1976-1981, suggests that the military had the economic policy in place from the beginning, but Fontana, in "Political Decision-making", p. 55fn. argues otherwise. My interviews confirm this latter position: Interviews with Francisco Mezzadri, Colonel Mallea-Gil, and Fichera, members of the Chief of Staff of the Presidency. See also, Buenos Aires Herald, 24 August, 1976 p. 8, in which an editorial questions the "extent to which [the military leaders] want to apply the market economy philosophy".


26The army was split over the transition issue. See Business Latin America, 8 November, 1978, and The Buenos Aires Herald, February 14, 1978.
As the armed forces developed institutional interests in particular economic activities (the armaments industry, infrastructure development, even the fishing industry), the participation of the military in the economy increased. A new elite emerged among both retired and active duty military officers who held public office in the new regime. As they became more engaged in running state enterprises and initiating ambitious public work projects, military officers appropriated larger budgets and took on increasing paternalist or populist views toward its constituency, particularly on issues of wage policy and unemployment. With little interest in the details of financing, the military also had little fear bankrupting their projects. Corruption in contracts was the norm. As a member of the economic team complained, "we could not touch the public industrial sector." 27

At the outset of the policy experiment, however, civilians had a relatively free hand to run the country's financial policy. The Economics Ministry, its Departments, 

27Interviews, former Treasury Minister Juan Alemann; former Secretary of Commerce Alejandro Estrada; Luis Garcia Martinez. In an interview, economist Debra Georgi claimed that the military controlled 80 percent of government spending. The air force refused to let the Economics Ministry privatize Austral airlines, which it ran, and the navy profited from operating parts of the fishing sector. The military had unrestricted access to public funds for its atomic energy research and industry during the 1976 regime. On this latter issue, see Hebe M. C. Vessuri, "O Inventamos O Erramos: The Power of Science in Latin America", World Development, Volume 18, No. 11, 1990, p. 1545. See also, Argentina’s navy magazine, Gaceta Marinera, November 1977.
and the Central Bank were handed over to civilian command, and these players were key actors in policy formation. Economics Minister Jose Alfredo Martinez de Hoz brought to the job an enormous prestige and presence. A descendant of an old estanciero, or landowning family, Martinez de Hoz had been president both of the National Grain Board and of the largest, private steel company, Acindar. He had served under a previous military regime.\footnote{Martinez de Hoz’s short lived experience in the Economics Ministry in 1963 (aborted due to public reaction to policies) convinced him of the political advantage of letting the economy carry out the dirty work. He also was a member of a closed, "lodge-type" political organization whose members included prominent military officers, including President Videla. Anonymous interviews.}

Martinez de Hoz’s economic team was similarly elitist, conveying the same confident, dogmatic style in its work. While the policymakers were not identified with any school of teaching, as were the "Chicago Boys" in Chile, most had studied abroad, learning first-hand of the new formulation of monetarism that aggressively adopted the principles of classic political liberalism. Central Bank head Adolfo Diz, in particular, brought the international mystique from a career with the Bank of International Settlements in Geneva. Finally, these men were the few civilians who maintained close ties to the military Junta, This technical knowledge gave the economic team power and authority, as well as an
insulation from both military and private group pressure.\textsuperscript{29}

2. The Issues in the Contest

Despite this policymaking freedom, state officials continued to rely on private sector cooperation to implement the financial policy. As the debates over the operation of foreign banks, the guarantee of deposits, and the fate of cooperative banks progressed, they revealed the emergence of cleavages between banking groups. New, previously unaccredited financial entities and Interior banks intimidated the established Buenos Aires banking community. Central Bank functionaries, unaccustomed to the free market policies, failed to regulate bankers and became embroiled in fights among these new groups. The armed forces also became increasingly involved with crafting financial policy and split over its liberal tenets. The outcome of the policy debates surrounding the new financial law suggested that

\textsuperscript{29}Over time, however, the Argentine military grew to resent the power that the "hot-shot" Economics Ministry generated. Abroad, the economic team received better treatment than did military leaders: Foreign governments refused to receive General Videla, while Martinez de Hoz met frequently with these political leaders. Soon, the new military elite tried to reassert its official prerogatives at home, seeking to amend (and block implementation of) particular policies. Gradually a "climate of discontent" over Martinez de Hoz and his aides built up. While other factors, such as competing calls for help from bankers, also triggered the military into action, a formal, institutional grounds for hostility between these two groups arose. Interviews with military officers and members of the economic team, active during the 1976-1983 regime.
splits within the banking community over turf would hinder effective implementation and control over policy.

a. Foreign and Interior Banks

The private, national banks geared up early for battle against foreign banks. They feared that the foreign bank would take over the Argentine market; that it would "substitute for national banking" rather than play a "complementary" role.\(^{30}\) The national banks lobbied successfully to pass regulations that would increase the percentage of national ownership required for an entity to be Argentine, which effectively restricted foreign bank operations in the country. While national banks won this engagement, the victory distracted them from seeing a new market intruder: the banks from the interior provinces of Argentina.

In private correspondence with the military Executive Junta, the private national Banco Rio del Plata argued eloquently, and at length, to restrict foreign banks. In particular, it lobbied for stricter bookkeeping to keep track of national versus foreign ownership of a bank corporation, arguing that the location of a home office was insufficient documentation of nationality. Instead, the make-up of the Board of Directors, the portfolio, and the

\(^{30}\) Banco Rio del Plata, memo, unpublished, no date. p. 34.
degree of connections to other companies should be disclosed, detailing exactly what was considered "Argentine". It restricted the business of their competitors:

"[Foreign bank] activities are beneficial to promote foreign trade and business with its home country, and to channel investment and external financing... [They] should be admitted into the country principally as a vehicle for channeling external savings for investment - not as an instrument for raising internal savings."\(^{31}\)

The established Buenos Aires banking community was particularly anxious to avoid losing any market share under the new financial regime. Led by the Banco Italia and the Banco Galicia, the bank organization, ADEBA, fought actively to limit foreign banks. The association presented a proposal to prohibit foreign banks from collecting any local deposits (which was not adopted), and led an active press campaign to inform the public of the true nature of stock ownership in a bank. "The life of the lamb will be short, if it is not afraid of the wolf", they cautioned.\(^{32}\)

The newspaper *La Opinion* suggested that foreign banks do not necessarily perform better: "In order to carry out a banking service, there are no special secrets, nor patents, nor unknown techniques", it reported. National banks had all the necessary abilities. But the argument to circum-

\(^{31}\)Correspondence from the private, national bank, *El Banco Rio*, pp. 34, 12.

scribe foreign banking went further. In an interview with two anonymous bankers (lending the issue and arguments more drama), the newspaper quotes its interviewee:

"While freedom of competition is a desirable principle, this is not possible between the national and the foreign bank because the difference in strengths is so great. Foreign banks deal primarily with the multinational industries. They have guarantees from their home offices. The power differential is enormous."  

The banking sector did not, however, view this issue unanimously. A few voices in the financial community rose in favor of permitting foreign banks to operate freely in Argentina. More accustomed to competitive forces, the financiera owner suggested that, since more than 70 percent of financial activities and 50 percent of Argentina’s GNP were in the hands of the state, only the foreign bank could force the Argentine banking system to return to the "free market" economy. An Interior bank president contended that foreign competition could only improve the bank’s performance. But these newer (and weaker) financial institutions had few working ties with the government economic team or with the established banking community. Their opinions carried little weight. 

The final version of the 1977 Law regarding foreign banks was revised significantly from the original September

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33La Opinion, date, 1977.

1976 document. In order that a bank be considered "national", the new regulations reduced the maximum amounts of external participation permitted from 50 to 30 percent. Foreign-owned firms were prohibited from setting up any financial institution other than a commercial or an investment bank. And, the opening of foreign bank branches was restricted. As an ADEBA banker commented, "It's not just the origin of capital, rather we must consider in whose hands lies the power of decision."\textsuperscript{35} Indeed, the Commission (regretfully) acknowledged this successful show of political lobbying in their final report: the decision to change the percentage determining the qualification of foreign versus national was a "wholly political decision", they wrote.\textsuperscript{36}

A largely unnoticed Article in the financial reform law gave preferential treatment to another type of bank: Argentine banks from the interior of the country. The Ministry of Economy emphasized that the regulations and requirements did not establish "unequal treatment". National banks were permitted to open branches within the national territory without prior authorization, in accor-


\textsuperscript{36}Report on the Commission, written by Benedicto Bianchi, February 1977. The commission conceded that investment laws and restrictions on expansion were justified.
dance with the loosening of Central Bank regulations. At the same time, however, the law permitted the Central Bank to "establish differential regulations and requirements that take into account the diversity of characteristics of all banks". This imprecise but significant concession to the Interior banks permitted these banks to maintain lower reserve requirements and to remain eligible for larger Central Bank compensations.\(^{37}\)

The traditional banking community stood opposed to this modification. In the "Report to the Commission", its members noted minor areas of disagreement with the final version of the Law, regretting that it did not contain an "explicit, written, legal sanction against discriminatory regulations on liquidity and solvency based on regional distinctions." One of its authors recalled that "our hands were tied when it came to these changes in the Law".\(^{38}\)

Who favored this exception? The regional bank lobby, Asociacion de Bancos del Interior de la Republica Argentina, ABIRA, was (quietly) opposed to the entire 1977 liberalization drive. In particular, they feared the relaxation of regulations on bank branch openings: The Buenos Aires banks would move into the rural areas and wipe out their base of operation. This bank association, however, carried very

\(^{37}\) Chapters I, II, Title 3.

\(^{38}\) Report on the Commission, Benedicto Bianchi, date. Interview, Benedicto Bianchi.
little political weight in the banking community. After several fruitless meetings with the Commission and with Economics Minister Martinez de Hoz, the regional bank association likely found a sympathetic ear with the military.  

The role of the military in this modification to give Interior banks preferential treatment was likely decisive. In particular, the Argentine navy under Eduardo Massera lobbied hard for the banks in the Provinces. The concession to regional banks, however, evoked none of the political or emotional response of the foreign bank issue. It passed quietly.

b. **Cooperatives: The Military Coerces**

A more heated campaign during the drafting of the bank reform concerned the fate of the cooperative bank. On this issue, the Buenos Aires banking lobby admitted defeat, albeit, again, a small one. State monetary authorities and commercial banks sought to eliminate the cooperative bank. The final version of the Law, however, permitted these banks to operate under highly restricted conditions. The Ministry of Economy offered an awkward explanation for the policy accommodation: "due to reasons of expediency and equal

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treatment". In this battle, pressure from the military contributed to the outcome.⁴⁰

Cooperative banks were founded in 1950 as a local initiative to finance the individual rural creditor. They quickly grew into a major source of savings for the worker and financing for the smaller enterprises. Between 1958 and 1966 cooperative banks grew from 100 entities to over 1,000. The Communist party adopted the cooperative bank as a symbolic - and financial - ally. Publicly, the bank was labeled a "stronghold of communist activity" "infiltrated by the traditional Communist Party", reflecting the fear that public figures held for the communist movement, although no more than 10 percent of the cooperatives were run by the Party. Privately, the traditional elite feared the rapid expansion of the cooperative bank in the rural areas. By 1966, they accounted for nearly 50 percent of total formal loans by commercial banks.⁴¹

In 1966, liquidity restrictions were imposed to curtail the cooperative bank expansion, which forced more than two-


thirds of the banks to close by 1969. In 1976, monetary authorities felt that, as part of the overall streamlining of the Argentine banking system, cooperative banks should be, on principle, outright phased out. They cited cases of bad administration and improprieties in the locally-run cooperatives."

The Argentine military institution, for its part, identified with the populist aspect of cooperative banking. The military legislative body (CAL) entertained numerous visits from advocates of the cooperative, who argued that "finance is a true public service". The military actively lobbied with monetary authorities to keep the cooperative banking system alive: Treasury Secretary Juan Alemann received daily visits and veiled threats from high-level military representatives to his office. Military officers argued that the small and medium firm (and worker) would be "defenseless" without its credit. The navy openly defended these banks as a sanctuary for the poor and the humble, the "everyday man"."

In the final version of the financial reform law, cooperatives were prohibited from collecting deposits, which

"Interview, Benedicto Bianchi, Commission head.

"A disgruntled state monetary official noted that, with regard to some economic policies, "The military [in charge from 1976 to 1983] acted more like a salvation army than like the sidestepping, Prussian army with a high hat." Interviews, Jose Carlos Jaime, Juan Alemann, Secretary of the Treasury under Martinez de Hoz. See also, La Opinion, 1 December, 1976, p. 12.
had comprised more than 70 percent of its funds. A number were converted into cooperative banks, although through this conversion, they lost much of their competitive advantage as the small, neighborhood business. Whatever its ultimate effect, however, the mixed decision on cooperative banks was an early sign of the military’s ability to flex its muscles in financial policy matters and the Buenos Aires banking centers’ desire to reduce competition."

The settlements reached on the financial reform law reveal the close working ties with the established Buenos Aires banking community and the state economic apparatus; alliances and attitudes built through years of a close state relationship with private financial agents. But the initial debates surrounding the proposed decrees also were an indication of the upcoming shifts in the banking community and suggest the ambivalence over the project within the Central Bank and among the restless military state leaders.

c. Deposit Guarantee: A Must

On the other hand, a Central Bank guarantee of deposits faced little opposition. Although observers believed the guarantee to be political tool, its rationale was straightforward: Since official and foreign banks had greater

"Interview, Juan Alemann; La Opinion, 1 December, 1976, p. 12."
support either from the state or from overseas central offices, the government guarantee would offer a "level playing field" to all banks until the public could form a judgment about the comparative risks of national, foreign and official banks. The plan could also protect the small saver. Institutional investors and large firms had a better understanding of markets and access to information to evaluate risks than did the individual Argentine saver. Over time, as such expertise and information would become accessible, the guarantee could be reduced or withdrawn.45

In retrospect, however, the guarantee of deposits in an environment of freely determined interest rates built in contradictory incentives in the Argentine lending and borrowing system. On one hand, the deposit guarantee sought to foster confidence and stability in the markets. Yet, reassured by the state security net, depositors tended to choose the highest interest rate for their savings without regard for the quality of the bank's portfolios, encouraging speculative behavior and creating instability in markets. However obvious the incongruity, everyone agreed on the political and ideological importance of permitting banks "to

45Despite plans to gradually reduce the guarantee, depositors still received 90 percent of a total deposit in November 1979. See La Nacion, date. The Argentine press (censored by the military regime in much of their reporting) initially championed the financial policy, citing the "small saver" case. The guarantee would stimulate greater competition among intermediaries. Interviews, Guillermo Walter Klein, Juan Sommer.
start out at the same point." In the 1977 law, the deposit guarantee system was reinstated."

Indeed, at the time of the policy announcement, the issue did not create controversy. Banks were in favor of the guarantee: Traditional and new banks, national and, even, foreign banks, supported the policy that permitted all banks to take greater risks, to operate with less liquid portfolios, and to increase overall bank profitability. The ADEBA spokesperson announced that the association was "comfortable" with the guarantee. The smaller banks, many from the interior of Argentina, had feared being swallowed up by the larger Buenos Aires banks, given their more modest capital base and deposit potential. The guarantee made the services of these lower profile banks as attractive (and secure) as the city banks. Finance companies, which had handled the uninsured, parallel market "acceptances" in the 1960's and 1970's, were, in particular, pleased to discover that these instruments were also guaranteed."

Economists agreed that a short term guarantee could

""The guarantee was regarded as "untouchable", politically. Interview, Ricardo Lagos, bank consultant.

""The acceptances were now called "certificates of deposits at fixed rates". Foreign banks would not benefit from such a collateral, but they raised no objections. In the Commission's final report, the bank insurance issue was not even mentioned. Only when banks began to fail in 1980, did everyone claim to have been initially opposed to this particular Article. Interviews, Estela Sosa, Central Bank functionary, Manuel Sacerdote, Bank of Boston, Diego Estevez, former Ministry of Economy."
steady the markets, and that the Argentine financial sector, which was accustomed to a central bank-directed (and thus a state-guaranteed) system, required some kind of insurance provision to instill confidence in the market system. Keeping in mind the 1929 United States crash (for which the deposit guarantee was originally created), they argued that the guarantee would reduce the public's propensity to pull out its deposits in moments when the public confidence about the solvency and liquidity of an institution could deteriorate."

Certainly the option of no guarantee, of offering no security to depositors in the event of temporary dislocations, would have been hard to justify. Yet, there was little discussion over what the deposit insurance could actually do. In 1979, as the market began to expand, this one legal provision was treated as a panacea to cure all potential problems with the Argentine banking sector. The guarantee was considered the principle instrument to alleviate the exaggerated expectations and speculative behavior of the Argentine investor. After the 1980 bank collapse (treated at length in the following section), the government guarantee was also held responsible for the

"J. A. Piekarz, TITLE, 1981; Ricardo Arriazu, Ambito Financiero, 22 May, 1980, p. 1. Frequent references to the 1929-1933 U.S. bank failures, and to the domino effect of one insolvent financial company bringing down the entire system are made."
widespread risk-taking.\footnote{Roque Fernandez, "La Crisis Financiera Argentina: 1980-1982", Desarrollo Económico, April-June 1983, p. 80. The role of the deposit guarantee in the financial crisis is discussed in the following section.}

In subsequent years, the armed forces was accused of having pressured the economic team to incorporate a guarantee in the financial package. Historically, important elements of the armed forces, attending to Argentina's national, industrial interests, had been suspicious of financial capital and its links to the outside world.\footnote{Guillermo O'Donnell, Bureaucratic Authoritarianism: Argentina, 1966-1973, in Comparative Perspective, 1988, pp. 54-57. O'Donnell also refers to an historical antagonism between the military institution and finance capital in the 1966 regime.}

Many observers believed, moreover, that the military tribunal (CAL) and military officers pushed through an amendment to guarantee the survival of the smaller, national banks over the objections of the monetary authorities. Indeed, the original draft text of the Law of Financial Institutions did not include a deposit guarantee clause.\footnote{Bankers were convinced that the military forced this guarantee on the economic team: Juan Ocampo, then President of the Banco de la Nacion; Luis Garcia Martinez, Martinez de Hoz's advisor; Francisco Mezzadri, the military Junta's advisor. In La Política Económica de Martínez de Hoz, p. 99, Jorge Schvarzer refers to the "long battle by members of the economic team to eliminate the guarantees" which eventually broke under the "political pressure in the center of power", a reference, no doubt, to the military.}

Yet the military was likely \textbf{not} instrumental in the eventual banking insurance provision. The President of the
civilian commission that supervised passage of the bill recalled that the military support was divided; while the air force actively championed the guarantee, the army remained neutral, and the navy contested its inclusion. A member of the military tribunal (CAL) recollected that the military had no need to lobby for the bank collateral program since, by the time the CAL received drafts of the bill, the deposit guarantee provision was already present.\(^{52}\)

Indeed, Central Bank president Adolfo Diz and other members of the bank commission affirm that they supported the guarantee condition from the outset on the grounds that the Argentine system needed temporary confidence-building measures. Banking habits in Argentina were "tied to folklores": Depositors were drawn to the prestige of traditional banking families; and, in turn, these private bankers were unlikely to loan to the small borrower. Those old-fashioned customs had to be discarded with the help of state measures.\(^{53}\)

The military was likely accused of the deposit guarantee "blunder" because by 1980, the military had

\(^{52}\)Interviews, Jose Carlos Jaime, General Leopoldo A. Suarez del Cerro.

\(^{53}\)Diz admitted that the argument that the guarantee would assist small banks and small depositors was simply a device to ensure passage of the provision. Interviews, Roberto Sola, of the Fiscalia Nacional de Investigaciones Administrativas, Adolfo Diz, Jose Carlos Jaime, and Benedicto Bianchi.
meddled in several other important financial decisions and had blocked a number of "free market" edicts.54 A more likely culprit in the 1980 bank failures, if less directly perhaps, was the marked lack of Central Bank supervision of the new, largely unfamiliar bank practices. Before that situation developed, however, the banking community faced more battles within their ranks.

C. The Operation of Banking under the New Regime

The financial reform decree passed into law in February of 1977, and the decentralization of deposits officially went into effect on June 1, 1977. The reforms were a critical legal turning point for banking practices, changing financial operations, financial organization, and the financial community. Banking practices, long held under control by state regulations, did change, but not in ways expected by the authorities. Bankers continued to lend to familiar customers, using the conventional short-term instruments. The level of financial speculation, however, did rise dramatically, a level which ultimately led to the collapse of the banking structure.

54Moreover, even later on, it became politically easy to blame the military.
1. **Financial Institutions**

Under the financial reform law, Argentine banks, previously restricted geographically or sectorally by Central Bank guidelines, were free to expand and solicit deposits and grant loans as they wished. Banks operated on a fractional reserve system, although bank reserve requirements fell only bit-by-bit, resting at 30-40 percent until 1980.\(^{55}\) Interior banks, previously restricted to operating in their region, could now solicit deposits in the Buenos Aires capital. While the activity of foreign banks was circumscribed, any Argentine bank could raise money abroad. Export and import transactions, which had required Central Bank paperwork, were now carried out by private banks.\(^{56}\)

The foreign bank was cautious in setting up domestic operations and did not create competitive pressures for the Buenos Aires bank. Foreign capital was welcome, but restrictions on entry for foreign-owned financial insti-

\(^{55}\)The Argentine Central Bank’s *cuenta regulacion monetaria* compensated banks for the high reserve requirement and the high inflation rate, setting up a Central Bank "account" that essentially subsidized bank loans. Reserve requirements were substantially lowered in January 1980, two months before that country’s state financial interventions.

\(^{56}\)For descriptions of the policies, see Schwarzer, *La Politica Economica de Martinez de Hoz*; and Alfredo Gutierrez Girault, "Dimensiones del Sistema Financiero Argentino", in Juan Carlos Casas (ed), *Saneamiento de Bancos: Estudios de Crisis Financieras en la Argentina, Colombia, Chile, Espana, EE.UU., Italia y Uruguay*, Ediciones El Cronista Comercial, 1989.
tutions kept out many new banks from abroad. The seventeen foreign branches in 1977 grew to twenty-six by 1980.

The commercial bank now became the most attractive financial intermediary. Authorization for commercial bank and branch openings was relaxed, and other types of financial companies were discouraged. Stripped of their ability to accept deposits, most credit companies, cooperatives, and some savings and loans institutions converted to commercial banks. One year after the financial reform was implemented, the number of commercial banks had jumped from 119 to 157. A year later, the number had increased another 40 percent.

[Insert Table 4.1 Number of banks]

The number of financieras also grew initially. The financieras, which had operated previously in the black market were able to pass into the legal market. The 79 finance houses in 1977 rose to 138 in 1978, then leveled off in 1979 to 142. Many financieras took advantage of permissive bank entry authorizations and transformed into banking institutions. These "new" banks had few ties to the traditional elite. They also brought into the credit markets the experience with black market transactions and, together with banks, energetically sought funds from abroad. These seasoned financiers were some of the more inventive
risk-takers in the market.

Banks from the regions outside of Buenos Aires, the Interior, grew most rapidly. They took advantage of the favorable Central Bank terms on reserve requirements, passed with little fanfare in the 1977 reform law. The regional banks embarked on highly visible public relations strategies and carried out innovative lending and borrowing operations. The rift between these new, "upstart" banks -- both the former finance houses and the non-Buenos Aires banks -- and the traditional banks began to take shape.

The number of bank branches rose dramatically. Bank offices were a visible -- if expensive -- way to attract more clients. Competition for money occurred primarily over rates of interest on deposits, but branch services such as more rapid check deposits, specialty accounts, and longer banking hours were also popular. The "Baby Bank" for children and the "Joan of Arc Bank" for women lured new customers through specially tailored accounts. More useful was the service permitting Buenos Aires-based firms to pay their workers in the provinces out of regional accounts. The Interior banks were most resourceful with these promotions.57

Banks introduced different instruments to carry out

57 Interviews, Anibal Salatino; Gregorini. Recall (Chapter 2) that economists had predicted that the strategy of attracting customers through increasing the number of bank branches would end as long as there were competitive interest rates, which now proved incorrect.
financial transactions. The certificate of deposit bank acceptance, circulating since the 1960's in the informal market, passed into the formal sector. New mechanisms such as longer term loans and indexed rates would offer more opportunities for savings and lending. Most banks, however, did not take advantage of these new instruments, due to lingering suspicions over the long term, or due to the presence of informal agreements about loan renewals. Instead, most banks manipulated their interest rates to attract (largely short-term) deposits. 58

Interest rate ceilings on deposits and loans were progressively eliminated. The intent behind this policy was to let the market determine the rate, a figure to be higher than the previously subsidized rate. Yet, interest rates among competing banks stayed above world rates, more expensive than presumably warranted by the market signals. Rates also fluctuated daily, without any real "economic" reason. 59

Most bankers had little idea how to arrive at a "market-determined" interest rate. After a few months, the

58 Business Latin America, (12-27-77) simply concluded "banking habits are slow to change". Julio Ramos, editor of the financial daily, Ambito Financiero, wrote "In our peculiar land, nobody invests in anything for more than 30 days", 19 May, 1980, p. 1.

59 Argentina's bank lending rates in 1980 were 26 percent, compared to the international Libor rate of 13.9 percent (in real terms). Public sector demands and high bank reserve requirements contributed to the high interest rates.
Central Bank instituted a *tasa testigo*. The annual effective interest rate, calculated from a weighted ratio of various leading rates, was to be "used as a guide" by banks. In the absence of better information flows, the Central bank also began daily to publish various interest rates to serve as a basis of operation for floating and indexed rates. By 1978, interest rates were not reflecting the supply of (and demand for) money that economists calculated. Neither bankers nor monetary authorities, however, were overly concerned about the high rates, or the unusual specialty accounts. High interest rates created the illusion of a dynamic market. Together with the liberal banking regulations, the attractive interest rates also brought in foreign capital.

2. *Monetary Policy and Performance*

Argentina's progressively overvalued exchange rate also brought in foreign capital. Financial policy followed an IMF-sanctioned stabilization path, according to the theory of "the monetary view of the balance of payments".60 One of its most important policy instruments was manipulation of

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60A good account of this policy is found in: Jose Maria Dagnino Pastore, "Assessment of an Anti-Inflationary Experiment: Argentina in 1979-81", in Nicolas Ardito Bartletta, Mario I. Blejer, Luis Landau, eds., *Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay: Applications of the Monetary Approach to the Balance of Payments*, 1983, pp. 21-38.
the exchange rate. The framework was based on the assumption that a country's economy should be in equilibrium with external movements. After liberalizing trade and capital flows, preannouncing the growth rates of a few key variables would help to stabilize the economy. By progressively moving the exchange rate, the monetary authorities could affect the level of the expansion of the monetary base. The high inflation and interest rates would decrease in line with a certain declining rate of devaluation. 61 Beginning in January 1979, Argentine monetary authorities preannounced the path of the exchange rate to get prices in line with international levels. The schedule, or tablita, devalued the currency monthly at a diminishing rate (enabling economic agents to predict future exchanges). The domestic inflation was supposed to meet the external rate by March 1981. But the effects of the experiment did not meet expectations. The crawling peg devaluations appeared not to affect wages and non-tradable goods, so the domestic inflation rate stayed higher than predicted.

Thus, the overvaluation of the currency in an open, "free market" economy -- together with the spiralling

61 The Central Bank would then play only a minimal role, largely in internal operations. Some point out that anti-inflationary policy took precedence over other economic reforms, such as finance. See Carlos Rodriguez, "The Argentine Stabilization Plan of December 20th", World Development 10, 1982, pp. 226–238. The consequence of this policy (an overvalued currency) was, however, not in conflict with the goals of the financial reform.
interest rates --created a sharp rise in the volume of foreign capital. Capital flows were freed in Argentina at the outset of the program, and in January 1979, banks were exempted from having to hold in reserve the margin of 20 percent of foreign funds. The sudden increase in foreign capital inflows had a dramatic effect on the Argentine economy. Credit as a percentage of GNP rose from below 10 percent in 1976 to 23 percent by 1980. Assets of the financial system (as a percentage of GNP) grew from 17.8 percent in 1970 to 48.9 percent in 1980.62

Financial investors (both foreign and domestic) made money effortlessly by playing with the (predictable) exchange markets. The delusion of wealth created, what has been called, the period of *la plata dulce*, or "sweet money", in which speculative financial opportunities arose from interest rate differentials and exchange rate changes. By purchasing and depositing pesos (in a local bank), the investor could withdraw, then reconvert, them to dollars and reap the lower peso depreciation rate.63

62The strong peso also brought in a rise in imports, mostly luxury consumer goods, and foreign travel. Vittorio Corbo, Jaime de Melo, James Tybout, "What went wrong with the Recent Reforms in the Southern Cone", *Economic Development and Cultural Change*, 1986. For discussion of rise of external indebtedness, see Feldman and Sommer, *Crisis Financiera*.

63This practice of financial arbitrage became known as the *bicicleta*, the bicycle. Aldo Ferrer, "El monetarismo en Argentina y Chile", *Ambito Financiero*, 22 August 1980, estimated that between 1977 and 1979 in Argentina, profits of (continued...)
At the same time, the lack of convergence between expected and real values of the exchange rate created expectations of a devaluation. Already by 1979, international capital, attracted by a favorable environment, could began to ease off, finding other markets in which to invest. Meanwhile, borrowers accumulated debt, in particular, foreign debt. The government financed its deficit increasingly by this foreign borrowing and investment in government bonds.  

Between 1977 and 1980, economic data careened up and down: The GDP growth rate bounced from over 6 percent in 1977 and 1979, to sharply negative rates in 1978 and 1980. Real interest rates (adjusted for exchange rate and price changes) moved from sharply positive to negative at each quarter. Trade and current account surpluses were high in 1978, but dropped sharply in late 1979. Inflation dropped from a pre-reform high of 444 percent in 1976 down to 176 percent in 1977, but it never fell below 100 percent.  

(...continued)

$1.2 million were made in speculating on this interest rate differential. Former Central Banker Pedro Real commented: "With a fixed exchange rate that moved predictably, people could carry out financial 'speculation', ironically, with security." Interview.


The currency overvaluation negatively affected agricultural and industry exports. Each devaluation would then have severe effects on bank (and firm) external debt. See Adolfo Canitrot, La disciplina como objetivo de la (continued...)"
3. Bank Practices: Inventive or Irregular?

The Argentine banking sector exploded with activity. After years of low-risk (and protected) business, banking became the career for the young and ambitious. Overnight, banks moved from a dusty, back room to a bustling office in the middle of the financial district. Most bankers began to engage in highly irregular lending and borrowing practices. In particular, the newer, upstart banks launched into high-profile, service-oriented banking activity, soliciting a new kind of customer. Their activities changed the image of the Argentine banker. With every finance company that opened, another would disappear. "Normally, banks are the staid, conservative institutions in society. Not so in Argentina, where they became boutiques, offering a little of everything; and here today, gone tomorrow."  

The upturn in banking, however, was not without its troughs. Soon, the staid, old-boy network of banking became a highly unstable profession. Argentine financial institu-

65(...continued) politica economica, 1979, p. 34. See also, R. Arriazu, A. M. Leone, R. H. Lopez Murphy, "Policias Macroeconomicas y endeudamiento privado", in Carlos Massad, Roberto Zahler, Deuda Interna y Estabilidad Financiera. Volume II: Estudios de casos, 1988.

66Interviews, Lorenzo Sigaut, Carlos Helbling, Carlos Etcheverrigaray.
tions faced difficult macro-economic conditions: Between 1977 and 1980, the exchange rate and import-export business fluctuated erratically. But lending and borrowing practices themselves placed bankers in risky positions. Credit was often poorly assigned, largely because few banks had systems to assess the credit worthiness of the borrower. (In turn, Argentine firms were unaccustomed - and often unwilling - to show the state of their books.) Banks also concentrated their lending portfolio in one borrower or sector, out of ignorance or laziness. When the business or the sector faced financial difficulties and was unable to pay interest or principle on the loan, the lending bank confronted its own financial shortcomings. But, instead of writing off these nonperforming loans as losses, banks financed their new resource commitments (debts) by attracting new deposits at higher rates.  

Banks owned by larger business concerns (grupos economicos) were not alone in this practice. Any bank whose portfolio was comprised of one major loan could become "captive" of that debtor. The established Banco Ganadero failed in 1981, largely because it concentrated its loans in the meatpacking industry, which lost its international markets in 1980. The portfolio of the Banco Credito Argentino, which had specialized in financing construction

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and housing, lost its value when the real estate market dropped in 1980.

Due to the 19th century tradition of British banking and Argentina’s more recent experience with an inflationary economy, most deposits were accepted in short term accounts. Depositors preferred to shift their (non-indexed) savings in response to the rapidly rising interest rates. Meanwhile, most loans were taken out on longer term contracts. Thus banks negotiated long-term loans, while they were able to attract only short-term deposits, creating a potentially dangerous situation of a temporary run on deposits with no loan payments due.

In order to balance their assets and liabilities accounts at the end of a working day, banks resorted to creative (and often illegal) financial arrangements. A financial manager of a firm recalled receiving a "proposal" from the firm’s bank that he deposit the firm’s salary with that bank over the weekend -- at outrageously favorable rates. The bank needed to cover up "a balance sheet error." 69

The inter-bank market was also active, as banks scrambled to cover their account balances or to raise cash. The mesa de dinero, or "money desk" handled these financial

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68See Chapter 2 for this legacy of short-term accounts.

69Interview, Salatino Anibal, SADESA, a leather exporting company.
transactions. Acceptances in the mesa were not counted as part of banks’ reserve requirements. Under Central Bank approval, this call money was transacted in under seven days.

"If you weren’t a traditional bank, you couldn’t get money easily. You had to keep yourself covered. The place to go was the mesa de dinero, where anything was possible. If a firm needed a loan, it could take months to get through normal channels; not so, in the mesa de dinero."  

The Banco de la Nacion de Argentina, the state bank, was not above "creative accounting" with these operations. The state banks (Banco de la Nacion, Banco Hipotecario, Banco de la Provincia, and each of the Provincial government’s banks) managed the financial accounts of public enterprises and bankrupt firms. The Banco de la Nacion, newly placed under the leadership Juan M. Ocampo, descendant of a prestigious banking family, embarked on an innovative banking strategy to attract more than the savings of state enterprises, "enlarging the orbit of its activities". The bank saw, in particular, spectacular international growth, of which capital grew from five to 50 percent of total assets between 1977 and 1980.

70 Interview, anonymous.

71 A particularly high number were acquired between 1973 and 1976; see Boletin Mensual, Banco Central, March 1977.

72 Among other deals, it granted credits (in US dollars) to the Argentine military-run steel company, and its London affiliate participated in a syndicated loan to the Bank of (continued...)

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The Banco de la Nacion philosophy of privatizing its own public operations led to a strategy of releasing funds that customarily had circulated between the state bank and state-owned industry into the private sector. The Banco de la Nacion transferred these funds for state enterprises to private banks by way of the mesa de dinero. These banks, acting as intermediaries, then received substantial commissions for handling the subsequent transactions to state-owned industries. The private banks who carried out these operations faced no risk; they simply took funds from the state bank at one rate, and loaned it back (usually to a state enterprise) at a higher interest rate.

The Banco de la Nacion practice became a public scandal when it was revealed that, in one case, this "private" bank had been none other than the Banco Ganadero, owned by the president of the Banco de la Nacion's father, Narcisso Ocampo. When the discovery was publicized, the Ministry of Economy and the Central Bank publicly admonished its state bank, but dismissed the allegations, taking no action. Juan Ocampo defended his actions, arguing that "in this system, everyone tries to get preferential treatment."

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72(...continued)
Uruguay in July 1978. Ambito Financiero, 9 December, 1980, p. 42. "The bank was a sleeping elephant when I took over, having operated under state "dirigismo". I strove to get it to run like a commercial bank." Interview, Juan Ocampo.

73Interview, Juan M. Ocampo. Ocampo described the expose as a "campaign led by the interior banks,". He (continued...)
Banks actively sought loopholes in the new government regulations, a strategy to which they had been accustomed since the 1950’s. For example, they would comply with a $5 million minimum asset requirement by purchasing real estate (or any high risk asset) and merely assessing it at $5 million. Other banks resorted to outright fraud to run their business. The Banco de los Andes, whose subsidiary companies had bought up many of the vineyards in the region of Mendoza, used these wineries to fabricate credit. Loan officers offered money at favorable rates, which many small farmers accepted. But the bank recorded a larger amount of credit on the books. The bank, or rather, its owner, pocketed the difference between these two figures. Yet another scheme was to fabricate export and import activity in order to receive from the Central Bank advance payments.74

a. The Economic explanation

Improper behavior by a few banker aventurosos does not

72(...continued)
signalled another case of paranoia towards these new regionally-based banks. The story was followed by a right-wing, nationalistic magazine, Cabildo, various issues, 15 July, 1980 through 12 August, 1981.

"This pre-financing scam was discovered when the Banco Alas suddenly became the number one bank in export accounts, which, upon closer investigation, were found to be non existent. Ambito Financiero, date; Interviews, Carlos Casas, Carlos Etcheviguerray, anonymous.

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appear to adequately explain this speculative activity. Instead, observers generally assert that banks were responding to "market signals" -- to a structure of (incorrect) incentives set before them. Economists suggest that high interest rates, which fed the financial boom, persisted due to a "speculative euphoria" after the period of financial repression. Other economists have argued that the government deposit insurance encouraged this irresponsible behavior. Rentseekers took advantage of the free guarantee. After the bank crashes, Central Bankers Diz and Jaime argued that the deposit guarantee was incorrectly understood as a continuation of state support for lending and borrowing, rather than regarded as a simple monetary concept, as in the United States.  

Economist Roberto Alemann (who had a brief stint as Economic Minister under the military regime in 1981), placed all the blame for the crisis on the mishandled deposit insurance. Writing in 1982:

"Operating [under the system of the official guarantee], all the interest rates that financial

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75For this view, see Ambito Financiero, 9 December, 1980, p. 46. Most analysts also reject this view: Schwarzer, La Política Económica de Martinez de Hoz.

76The debate over why interest rates remained high is lively; see Guillermo Calvo, "Fractured Liberalism: Argentina under Martinez de Hoz.", Economic Development and Cultural Change, 1986. Firm behavior itself also accounted for high rates. Most national firms did not cut back on their demand for credit in response to the high price of funds, as any "market" actor should. Also, Interviews, Adolfo Diz and Jose Carlos Jaime.
institutions pay and collect tend to rise, and they stiffle productive activity. The interest rates did not decline substantially because there were always financial institutions ready to pay high rates with an official guarantee... The emerging distortion of official guarantees on deposits conveys an ethical connotation as well. The official guarantee facilitates spurious business, because certain financiers, without scruples, can divert funds of the depositors for personal transactions, or even defraud the company and abscond from justice... The Central Bank has suffered from this concept [of abusing the guarantee] with losses in the billions."

Another line of reasoning advances the belief that the monetary *tablita* policy sent confusing signals to investors. The increasingly large spreads between peso and dollar borrowing costs led the economic agent to "shift their attention from the traditional objective of maximizing operating earnings to exploiting the various arbitrage possibilities that arose". Moreover, bankers complained that the monetary officials sent contradictory and cryptic communiques, appearing to allow themselves the option to change their policy direction: "Many ambiguities shrouded the [*tablita* exchange rate] announcements. Declarations were often vague about the future."


"Vittorio Corbo, et al., "What went wrong with the Recent Reforms", pp. 621, 623. See also *El Cronista Comercial*, date."
Argentine speculative behavior, however, likely hearthens back to historical, and more political, origins. Financial actors were interpreting these (economic) incentives through the lens of one hundred years of state-led preferential treatment. These relationships and practices did not disappear overnight. With little experience handling free market instruments, banks used the variable interest rate as the principle means to attract deposits. Bankers, depositors, and subsequently, the press were obsessed with these interest rates, and later with the sustainability of the exchange rate. Financial newspapers wrote special columns about each interest rate movement, printing hundreds of rates daily. Individual banks competed with competitor banks located around the corner for the depositor’s money. Banks could raise their advertised interest rates on deposits up to two times daily, in response to a shift from a competitor. Depositors would then transfer their savings from one bank to another, creating a volatile financial market. This frenetic competition then exacerbated the antagonisms between established Buenos Aires bankers and the new, Interior bankers.

The deposit guarantee argument also less convincing from a comparative perspective, since other countries provide such deposit guarantee programs without experiencing "stifled productive activity" or ethical improprieties among
bankers. The deposit guarantee concept was abused by financial actors (who placed funds in banks regardless of the risks they presented). Yet the guarantee provision also became the "whipping boy" for all the problems of the financial sector during the 1977-1980 period. In this way, the politics of why the financial speculation and bust occurred could be explained by a simple malfunction of a Central Bank instrument.

b. Permissive Bank Regulation

The Argentina Central Bank initially failed to implement meaningful financial regulatory policies to accompany the bank reforms. It failed to exact enough information from banks to adequately evaluate the status of the portfolios (liquidity levels, solvency positions) or to inform these banks how delinquent portfolios would be handled. Few banks understood the design of the law, and fewer bothered to inquire. They exploited regulatory loopholes, as they had done since the 1940's.

With inadequate Central Bank supervision of bank lending and borrowing practices, banks, in the scramble for more business, themselves had little incentive to follow prudent banking rules. The consequences were decisive: Banks lent out more funds than they should have, and, under deteriorating economic conditions, found themselves unable
to continue operating.\textsuperscript{79}

After the liberalization policy was put in place, disagreements within the Central Bank over its role in the new system also contributed to the, often subversive, circumvention of regulatory policy. The new responsibilities of the Central Bank represented a profound institutional change for that agency. In redrawing the boundaries of the state in financial markets, the ambiguities over the state position with regard to "free banking" created a confusion. How much should the Central Bank do to control its bankers?\textsuperscript{80}

In 1976, when the bank association ADEBA stated its recommendations for the banking reform, it included a list of new regulatory procedures: "Maintain strict criteria on bank solvency, and penalties for not keeping minimal capital requirements". The document characterized "the relationship between the Central Bank and the banks" as one of "control and cooperation", further stipulating that "the Central Bank principle mission will be to become the scrupulous investi-


\textsuperscript{80}Legislation also gave to the Central Bank official autonomy from the Ministry of Economy, but freedom of policy initiative depended more on personality than on law. Regulatory enforcement was never the business of the Ministry.
gator to detect infractions." As the free market banking took off, however, private bankers became increasingly less interested in regulation, absorbed with the speculative game against other banks. International bankers, as an able competitor in the free market, also estimated that they could profit from the absence of regulation.

Indeed, while the Central Bank was a well regarded state institution, led by a charismatic bankers, it had little authority, and its 1977 charter was vague. Conflicts and rivalries within the Central Bank compounded its difficulties. The 1977 Financial Reform law granted the Central Bank latitude in handling situations of bank failures;

"...great flexibility in matters of bank regulation in order to facilitate the adoption of particular measures that the management of the monetary conjuncture requires...[The system] will rely on the experience of the Central Bank in these matters [of regulatory action] and in interpreting any form of application necessary." The concept of "intervention", however, did not appear in the Articles.

For their part, state monetary authorities waxed eloquent about the virtues of "self-regulation". The free


"Ministry of Economy official notification to the Executive military Junta of the details of the Law of Financial Institutions, p. 18.

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market euphoria itself obfuscated the need for regulating banks. It was explicit Central Bank policy not to interfere with, or regulate, the financial sector. It regarded the cycles of deflation and bankruptcy as "cleansing". In policy statements, Argentina's Central Bank president frequently likened banks to corner grocery stores, businesses that simply go bankrupt if they mismanage affairs."

"Freedom with Responsibility" became the popular Central Bank phrase as the financial reform took off. In a 1978 conference for financial companies, Central Bank Vice President of bank supervision Christian J. Zimmerman spoke at length about this philosophy:

"The Central Bank has no interest in changing into the police. It hopes that its regulations are understood and accepted in letter and in spirit, and it plans to continue to produce broad and flexible regulations that permit the exercise of individual responsibility. The responsibility is a fundamental element of the development of the system and should be exercised by the authorities and by you [bankers] like a true obsession, in order that the competition that approaches, and which we are going to stimulate in all the operations, be really a healthy and loyal competition. This will be beneficial for the system in general and for the citizens, who will see in practice that freedom is worthy of being defended with all its arms.""

"Interview, Manuel Sacerdote, banker; El Ambito Financiero, December 14, 1977. In an interview, former Argentine Central Bank president Adolfo Diz likened banking to "farming".

As the pace of financial activity accelerated, neither the Central Bank nor the Finance Ministry gave state regulation serious consideration. Electrified by the radical transformation under their direction, Central Bank directors spoke confidently about the smooth operation of the financial system. When, around 1978, Central Bank head Adolfo Diz was told that the Central Bank supervisory agency was understaffed (and that employees were leaving for higher paying jobs in the private sector), he was said to retort "when the problem gets ten times as bad, come to me again."\textsuperscript{85}

In the meanwhile, these Central Bank supervisory functionaries (who were assigned to carry out bank inspections) underwent dislocating changes in their work. Under the liberalization measures, the Bank managed monetary and credit policy through indirect mechanisms, leaving the private banks with (the more important) decisions, such as credit allocation, branch openings, and service pricing. These Central Bank employees, who had previously managed the financing of entire regions and sectors of the Argentine economy, now found themselves assigned the task of checking the accounting books of banks. The "old guard" Central Bank workers not only lost prestige. Their deeply embedded ideas about how the banking system ought to be run -- that finance belonged to the public sphere -- were discarded by young,

\textsuperscript{85}Interview, Julio Gonzalez del Solar.
foreign-educated policymakers. These Central Bank employees were ambivalent about their supervisory tasks.⁶⁶

Banks, in turn, were supposed to provide information to the supervisory agency. But the regulations were unclear (few bankers understood how to fill out the forms), and the process was unmanageable. As one former Argentine Central Banker commented, "We just couldn’t keep up. Suddenly, we had three times the number of institutions to keep track of. And we had never created the measures to supervise them." Private bankers helped to exploit this Central Bank lethargy. One Argentine bank alone hired away six bank Central Bank supervisory agents in its own employ (a sophisticated bribe).⁶⁷

Although regulatory enforcement was lax, the Central Bank continued to guide financial operations: The *tasa testigo* sought to direct interest rate movements, and the *cuenta regulacion monetaria* adjusted the amount of capital available to banks. And, to most observers, the state

⁶⁶Foreign educated Central Bankers received scholarships for study abroad in 1973; most returned to directorship positions in 1977. Other Central Bank employees, displeased with the loss of direct control over credit allocation, might have practiced sabotage: failing to penalize (or stop) improper bank practices. This non-compliance was not overly orchestrated; laxness also arose from top Central bank directives and the resulting confusion over what entailed "free banking". Interviews, Jose Luis Machinea, Juan Sommer, Central Bank directors; Estela Sola, Central Bank functionary; Ricardo Arriazu, Central bank consultant.

⁶⁷Interview, Anonymous BIR bank employee. The bank was the *Banco Intercambio Regional*, BIR.
guarantee on bank deposits represented "a vestige of state obligation in financial matters". Yet, ironically, without adequate regulatory measures and supervision, these state levers could not effectively "oblige" banks to do anything.\textsuperscript{88}

Perhaps, at the outset, policymakers did not correctly perceive the importance of regulatory oversight under a free banking system. The don of finance, Raymond Goldsmith, had reinforced that view, writing in 1968 that, in practice, regulatory instruments were used so "sparingly" that financial institutions essentially operated in their self-interest, as private management dictated. In 1979, Central Bank Vice President of bank supervision admitted the government's oversight: "We were wrong; we admit it with all frankness, and the regulations modifying this document have already been approved".\textsuperscript{89}

Those who did argue for state monitoring of bank activity had few institutional resources. It was neither

\textsuperscript{88} Interview, Domingo Stamati, private banker.

\textsuperscript{89} Christian J. Zimmerman, "La reforma financiera y el cambio de estructuras", in La Gestion financiera ante el cambio de estructuras en la economia Argentina, Convencion nacional de Ejecutivos de Finanzas, 1979, p. 83. Also, Raymond Goldsmith, Financial Institutions, Random House, N.Y., 1968. The theory of regulation is unclear about how troubled banks ought to be treated. The literature disagrees overs which factors should be considered to signal danger: the numbers of banks, the bank capital ratio, or the types of bank assets. Thomas Mayer and James S. Duesenberry, Money, Banking and the Economy, Norton Press, NY. 1987, p. 47.
easy nor a speedy process to reform regulatory practices. The Central Bank and its supervisory agency encountered predictable institutional "lags" in setting up these oversight procedures. Supervisors had to be hired and trained, the questionnaire forms printed, the process put in motion. At the outset of the reform program, the (free) bank insurance was provided with no examination of the banks' loan portfolios to determine risk. No systematic procedures for monitoring the banks were set up until January 1980.

D. Splits in the Argentine Banking Community

In retrospect, the initial decision not to regulate the financial community was a miscalculation. The subsequent inability to reregulate banks, however, lay in the banks' refusal to cooperate with state monetary authorities. The banking sector, a group critical to forging an agreement over the new rules of the game, was split by internal disputes between Interior and Capital actors. Throughout the experiment, the Argentine private sector remained uneasy over the intentions of state monetary authorities. In the midst of intra-bank rivalries, bankers did not trust the Central Bank to remain impartial. They feared that the state would "take sides" in the fight over turf. Thus banker splits can help to understand the puzzle of breakdown
in Argentina's financial policy.

The 1977 bank reform was sure to redistribute economic power from entrenched industrial groups into the hands of the financial sector. As the legislation was being crafted, Buenos Aires-based bankers also worked hard -- and succeeded -- in keeping international bankers from moving in on the free-market hunting ground. But in its anxiety over losing out to the foreigners, this elite group overlooked other competitors.

Who were these new rivals? Many of these new bankers had begun as small time brokers in illegal or informal financieras that had sprung up in the 1960's and early 1970's: Under the financial reform law, these finance agencies could register as commercial banks and compete with the established Buenos Aires banking groups. Bankers from the Interior of Argentina (whose jurisdiction had not previously reached the Federal Capital) also presented a competitive threat.

These financial newcomers brought about a split in the Argentine banking community. The superior services and competitive interest rates that they offered hurt both the pride (and, potentially, the pocketbook) of the staid, traditional financial institutions. These entrenched, politically well-positioned bankers were not ready to accept the competition that came along with liberalization. They strove actively to eliminate these newcomers.
As the banking community divided, it became increasingly unable to negotiate with state monetary authorities. While the distrust between Buenos Aires and Interior bankers mirrored an historical cleavage between urban and rural groups in Argentina, it also set off a new constellation of rifts between industrial and financial groups, divisions which cut across rather unconventional lines. Rather than sectorally divided, the struggles erupted generally between established capitalists and the "newer" entrants.90

Argentina's newer financial institutions competed effectively with the established Buenos Aires banks by offering attractive interest rates. Toward the end of 1979, some of this lending was mostly "distress" borrowing. But, a careful look at interest rate trends suggests that for much of this period, official banks were in the lead in setting rates (due to bank compensation procedures). Everyone, new and old alike, played the game of interest rate "one-upmanship".91

The client base of the newer banks was often different from that of the traditional banks. Buenos Aires banks

90Another difficulty in defining "new" banks emerges when traditional banks were bought up by these newer entrants. The Tucuman-based (a northern region of Argentina) Banco Financiero, a new bank, purchased an old Buenos Aires bank, the Banco Credito Argentino.

91Ambito Financiero, date. The Banco de la Provincia de Buenos Aires was a leader in setting rates.
remained reluctant to provide financing for any but the prime and habitual borrower. Thus the smaller and newer industries, sometimes less creditworthy, and often located outside of Buenos Aires, turned to the new banks for loans. But these borrowers were not representative of one economic sector. They included the fishing industry, textiles, food processing or farming industries. 92

The new banks did introduce little-known marketing strategies into the business, and they extended attractive services to customers. The Banco Intercambio Regional (BIR) had opened more than seventy branches by 1978. The bank was the first to offer a convenient credit card and rapid check cashing. New banks like BIR completed financial transactions between the Capital and the Interior in a record time of under three days. In interviews, manufacturing firms recalled that they began to use the Interior bank to pay workers in the Provinces because of these prompt services.

The logotypes of these upstart banks became prominent on street corners, in advertising, and even at political occasions. In a grand public relations splash, BIR opened a New York City branch in 1977, and an office (not a bank branch) in Washington DC in August, 1978. Its president, Rafael Trozzo, even organized several conferences on bank marketing, drawing resentment -- and clients -- from the

92 This could explain why, as the banks began to founder, no organized political support for these new banks emerged from industry.
traditional banks.\textsuperscript{93}

Did a competitive threat really exist? Rough data on the participation of different bank types tabulated according to deposits and loans suggest that, while both Interior and Capital private banks were increasing their market share relative to state banks, the out-of-town bankers were making small gains. Data on overall gains in the financial sector confirm that the entire finance sector was making huge profits during this period.

[Insert Table 4.3, Interior/Capital banks]

Most newer banks did grow very rapidly after passage of the financial reform measures. In January 1980, three of the top five private, national banks measured in terms of deposits were former interior banks or finance houses. Moreover, the press coverage and high profile look that they garnered angered the established banks, who feared that their rivals might cut into their market share.\textsuperscript{94}

The profits that banks earned were not always the result of standard market operations or of sectoral lending decisions. True; the traditional Banco de Galicia lost its

\textsuperscript{93}The press duly noted the location of the Washington, DC office near the White House, although its only activity was to house an exhibition of Argentine products. Diplomats and businessmen were on hand for the grand opening. \textit{Confirmado}, August 24, 1978.

\textsuperscript{94}\textit{Ambito Financiero} cite.
market share in the post-1977 climate due to overly conservative lending and borrowing practices, the Banco Credito Argentino lent most of its capital to the booming construction industry (which collapsed with the economic downturn in 1980), and Banco BIR likely grew to be the largest Argentine banks (in terms of deposits) through its effective marketing strategies. But the market was too volatile to respond to long-term economic practices.

Financial opportunities (and profits) came largely in the form of overnight financial deals on the mesa de dinero or speculation on the exchange market. In these few years of free banking, bankers made profits, not on loans, but on a range of speculative deals, relying on fortuna rather than any formula. "In the frenzied state of banking, one good market deal could hurl a little-known financiera into the 'number one' position. And, of course, vice-versa."95

Over the course of carrying out high-risk operations, Argentine bankers would often, at the end of the day find themselves "in the red" -- that is, their accounting books (assets and liability columns) would not balance. All banks resorted to inter-bank lending, or to the mesa de dinero, to help each other out through overnight loans to each other. The Buenos Aires banks had easier access to these short-term funds. They extended them selectively, offering inter-bank loans to fellow banks; avoiding the need to carry out

95Interview, Jorge Schvarzer.
unauthorized maneuvers. Again, this preferential lending practice was a sign of the animosity towards the newer bankers.

Perhaps the most important distinction between the two Argentine banking groupings was membership in the Asociacion de Bancos Argentinos (ADEBA). At the founding of ADEBA in 1970 (spurred by a disagreement with the existing bank lobby, the Asociacion de Bancos de la Republica de Argentina (ABRA), over its open-door policy toward foreign banks), only the most prestigious Buenos Aires banks were admitted. Notably, the well-established interior banks were absent from the ADEBA roster: This omission, despite the fact that the Association's stated objective was to develop the private, national bank. The owners (and thus, presidents) of the Interior banks did not "belong".96

After the 1977 liberalizations, the membership policy of ADEBA was modified. In the spirit of the financial opening (and fearful of an invasion of foreign banks), ADEBA admitted a number of new Argentine banks to their club. The Banco Internacional and Banco Unido de Inversion, members of the economic group, SASETRU, joined. [ANOTHER ONE] But ADEBA steadfastly refused to admit the leading new banks: Banco Oddone, the Banco de los Andes, or BIR, because "they knew these banks were different... and their Presidents were

96Interviews, William Chapman, Dagnino Pastore. From the ADEBA roster, it is clear that affiliation with an industry group was also not a prerequisite.
not like them." 9

The organizational distinction between old and new banks became obscured -- and this, in part due to ADEBA's own strategic error: its fixation on the idea of the foreign bank invasion. By 1979, ADEBA's mistake was apparent. The presence of the newcomers in the bank association created a set of new tensions and exacerbated those in the banking community.

The actions of the ADEBA gave the regional/class conflict an institutional base. In preparing the financial reform law in 1977, ADEBA had played an active role, developing close working ties to the state economic team and the Central Bank. This policy relationship, cemented by their success in rewriting legislation to keep out foreign bank competition, gave them the perception of "exclusive rights" to an alliance with the government. The financieras and the Interior banks did not enjoy the same privileges.

By 1978, ADEBA was publicly condemning the practices of Interior banks and financier-turned bankers - the fabricated loans, the overleveraged portfolios, the high deposit interest rates (labeling them adventurosos, what might be called the "junk bond crowd"). ADEBA statements denouncing the "unethical behavior of the new banks" were carried in

9ADEBA members spoke of the "grave social consequences" that could emerge when "anybody could enter the financial system". The presence of the foreign bank grew, but not dramatically. Interviews, Alejandro Reynal, Luis Garcia Martinez.
the press, and its repercussions rippled through the banking community. The traditional bankers remarked on the lack of preparation and background of the newcomers (no antecedente bancario); this, while most established bank owners had no more formal training and perhaps less experience in the free market than did their competitors.\textsuperscript{98}

Established banks also publicly complained that the financial market strategies of their new competitors were highly risky and often illegal. Accounts of fraudulent financial operations such as those carried out by the Banco de los Andes, an Interior bank, served to justify this claim. Yet most bank portfolios, including those of the official banks, likely reflected similar poor lending choices, risky investments, and their own fabricated loans.\textsuperscript{99}

In retrospect, it is worth remembering that the BIRs and the Oddones had started up their banking operations under the previous financial setup in the 1960's. It was not the "free-market", nor the liberalization policies alone which created these banks. Rafael Trozzo acquired the BIR in 1965 and followed a strategy of developing associations with credit cooperatives in the interior of Argentina.

\textsuperscript{98}Interview, Carlos Etcheverrigary.

\textsuperscript{99}The illegal dealings of traditional banks were left largely undiscovered by Central Bank authorities, a vestige of discrete state preference for these well-placed bankers. Interviews, Ricardo Lagos, Dagnino Pastore.
Indeed, the bank grew initially because it was not directed from Buenos Aires. In ten years, the BIR had 50 branch offices -- all before 1977. In the 1970's, many of these Interior banks and finance companies grew and prospered under the very system that castigated them.

E. The Collapse of the Experiment

As long as the economic pie was expanding, the growing Buenos Aires banker resentment toward its Provincial neighbor had little policy effect. But, as economic conditions began to deteriorate, and bank portfolios became overleveraged, the rifts within the Argentine bank community affected the ability of the state to keep the policy together.

1. Deterioration of the Economy

As 1980 approached, the mood in the Argentine marketplace was resigned. People found solace in speculation and in the purchase of cheap imports. But, these financial money-making maneuvers also produced a conviction that stimulating finance was, in general, not productive. The disparaging designation, patria financiera, symbolized the unregulated growth of the financial system, the activities on the mesa de dinero and, subsequently, the breakdown of
the economy. The term also referred to the idea that activities previously belonging to the regulated, public sector had been moved into unscrupulous, private hands. Even official banks were being run by private bankers.

Meanwhile, the monetary policy of "crawling peg" devaluations did not keep up with the Argentina’s rate of inflation, and the currency became increasingly overvalued. The relatively expensive peso left domestic industries with few markets. Imports were so cheap that firms supplying the internal market were no longer competitive. The export sector saw the most dramatic shifts. Activities that had been profitable before the tablita had been set up were squeezed by 1980.

Firms were slow to make adjustments in their business strategies in response to the changing exchange rate environment. Some entrepreneurs temporarily switched over to the importing business to take advantage of the low prices, subsidizing their own failing businesses. Others focused on financial activities to offset operating losses. This tactic explains, in part, why industrial groups did not protest the financial policies. "Any firm with access to credit, especially dollars, could create a substantial cash flow for itself simply by expanding its nominal borrowing at a rate sufficient to keep its real debt constant." These opportunities for "non-operating" earnings led firms to assume risky financial structures. It also set the stage
for huge losses.\textsuperscript{100}

The widening spread between the internal and the external cost of credit (both for exchange rate and risk factors) had, up until 1980, led to massive capital inflows. But this speculative capital could just as easily be reversed, and could breed further uncertainty in the markets. By the end of 1979, the Argentine exchange rate was severely out of line with productivity, costs, and domestic prices. A devaluation would have cost the economy dearly to pay back the more expensive, dollar-denominated debt. The economic team chose instead to reestablish the external equilibrium (that the monetary theory dictated) through further increases in the interest rates: It chose a recession. In January, 1980, the economic team increased rates through the sale of Treasury bills and a one point increase in the reserve requirement. The combination of macroeconomic policies and a misguided exchange rate program had left the currencies overvalued; the subsequent tightening of international credit spelled disaster for Argentina.\textsuperscript{101}

\textsuperscript{100}Corbo, de Melo, Tybout, "What went wrong with the Recent Reforms in the Southern Cone", 1986, p. 634. Rodriguez, Cuadernos de Economia, 1983. Interviews, Gregorini. Other businesses chose to indebted themselves, believing, it seems, that the reform would shortly be reversed, or that interest rates would stay low.

\textsuperscript{101}This rate had been reduced to 33 percent by November 1978.
2. Bank Interventions: The BIR and Market Chaos

In January 1980, a prospective new owner of the Banco Intercambio Regional discovered through an outside auditor that the bank's accounting books were in desperate shape. He went to the newly-appointed Central Bank Vice President Alejandro Reynal to request short term help in paying these arrears. The Central Bank agreed to extend $200 million to the bank, but the bank required additional outside funds.\(^\text{102}\)

Central Banker Reynal first approached Juan Ocampo of the Banco de la Nacion to request short-term funds. Ocampo was incensed. Since 1976, his bank had been run with the belief that state enterprises had to be run efficiently and profitably -- like a commercial bank. Ocampo felt it was not his "mandate" to bail out a poorly managed bank, take on bad loans, and subsidize the private sector. The development bank, BANADE, also refused. These official state banks (managed by bankers of the traditional private sector) refused to carry over the BIR's debts.

Reynal then met several times with the directors of the high-profile bank association, ADEBA. The acrimony and resentment that ADEBA expressed towards these new bankers

\(^\text{102}\)One account of the BIR debacle is given by this new owner, Raul Pinero Pacheco, \textit{La De-Generacion del 80}, El Cid Editor, Buenos Aires, 1981. Other accounts, Interviews, Alejandro Reynal, Guillermo Walter Klein, Juan Ocampo, Mariano Grondona.
was acute: These bankers believed that if the Central Bank had to close down the BIR, it would confirm the view that "some types are born and bred to be bankers" and justify accusations that only certain types of people, respected by the community, should be bankers. ADEBA bankers refused to help out the Central Bank in its attempt to keep the BIR from collapsing by extending short-term transactions on the mesa de dinero. "They relished the opportunity to watch their enemy go under".\footnote{103}

The Central Bank had no legal powers to compel ADEBA bankers to help out, or to force its authorized agent, the Banco de la Nación or BANADE to comply. Nor did it have any legal instruments to bail out the BIR itself. Its charter did not mention the term "intervene", and consequently, any Central Bank actions taken toward BIR were officially unauthorized. The intervention required the Central Bank to write new, accompanying laws to guarantee legal propriety, but this, only after the fact.\footnote{104}

\footnote{103}Interview, Jose Maria Dagnino Pastore. Economics Minister Martinez de Hoz was vacationing (hunting) in Africa and his right hand man, Guillermo Walter Klein was recuperating from an attempted assassination. Reynal had replaced Christian Zimmerman in December 1979, who had resigned suddenly to take a position with the international agency in Washington, DC.

\footnote{104}Reynal argued, "There was no legal way to help the BIR alone. It would have been a political decision not to liquidate." Reynal also claimed he circumvented the legal route because the judicial system was too costly and slow. Interview, Alejandro Reynal: "Informe financiera", FIEL, May 1980, p. 12. Conjuntura Argentina, Fundacion para el Estudio de los Problemas Argentinos, 3 December, 1980, p. 10.
On Friday, March 28, Economics Minister Martinez de Hoz agreed to revoke the authorization of the BIR to function as a financial institution. The Central Bank announced the closing on grounds of insolvency, excessive defaulted loans, and loss of deposits due to a deterioration in confidence by other financial entities.¹⁰⁵

Buenos Aires bankers were happy to see this Provincial upstart go under. Soon, however, their own banks started to succumb to runs by their own depositors. When the announcement circulated of the demise of the Banco Intercambio Regional, it become clear that the credit situation was built on a fragile structure; that the "gangrene had spread" to other banks. The cannibalism began: Any bank that had emerged during the recent reforms (the "new" banks) experienced speculative bank runs. Worse yet, as soon as a bank or financiera became number one in rankings of deposits, it immediately suffered a bank run and subsequently collapsed. Even those banks that were technically profitable (and whose credit portfolio looked sound) lost their credibility and, forthwith, their deposits. Those that had been more ambitious, saw the most rapid decimation. The Banco Oddone, a finance house-turned bank (whose flamboyant owner had speculated in real estate) and the Banco de los Andes (whose well-publicized expansion in the Mendoza region had caused a stir), experienced sudden and huge withdrawals immediately.

¹⁰⁵FIEL, "Informe financiero", April, 1980.
after the BIR closed.¹⁰⁶

Funds quickly moved into official banks, foreign bank branches, and the traditional banks, in the belief that these institutions offered greater security. Even though the operation of the state-managed Banco de la Provincia had been equally as outrageous -- in particular, boosting interest rates on deposits as a way to raise cash for nonperforming loans -- it experienced no bank runs.

On April 25, the Central Bank stepped in and took over three other financial intermediaries. The loss in savings became more significant. The deposits of four intervened banks -- BIR, Los Andes, Oddone and Internacional -- accounted for 10 percent of all those nationally. As the financial situation began to look increasingly fragile, the exchange rate rule began to lose its credibility, the accumulated capital (and foreign exchange) headed for more secure investment sites in other countries.

The Argentine Central Bank did take action: The government gave advances to financial institutions to help them weather the run on deposits. In one month, the "Circular 1051" granted advances of more than $2 billion, or 27 percent of Argentina's monetary base. The Central Bank also immediately boosted the deposit insurance back up to

¹⁰⁶According to its own 1978 Annual Report, the BIR had increased deposits by 708 percent and loans by 328 percent in that year, Noticias IDEA, June 1978; FIEL, "Informe financiero", May 1980, p. 11. Interview, Diego Estevez.
100 percent, which had been reduced in November. At that time, the Central Bank had passed a new set of regulatory measures - greater control, more information on stock sales and transfer of ownership of banks.\textsuperscript{107}

Due to the conflicts within the banking community, the public capital infusions and government decrees did little to allay market fears. In an atmosphere of apprehension and mutual maligning, bankers assumed that the Central Bank was taking sides in the struggle between established and new banks. Indeed, the Central Bank was not perceived as an impartial institution. The regulations issued in the ensuing months were roundly criticized by all bank factions as contradictory, complicated, and incomplete. The Central Bank was accused of producing little data from the intervened banks to justify their executive actions. The private sector argued that it was not given explicit, formal understanding of what the financial regulation entailed; the press complained of "being kept in the dark", bankers whined that the Central Bank kept documents so that intervened banks were unable to defend themselves.\textsuperscript{108}


\textsuperscript{108}Noticias IDEA, date; \textit{Ambito Financiero}, 6 November, 1980, p. 2; "Informe financiera", \textit{FIEL}, May, 1980; In March, 1981, the Central Bank had still released no figures from the last two quarters of 1980 on the GNP or balance of payments; "Informe financiera", \textit{FIEL}, March 1981, p. 5. As Jorge Schvarzer commented: "Before 1980, there was no (continued...)
Historically, states have successfully bailed out failing banks in conditions of market decline without generating long-term political crises. The Central Bank measures could have been sufficient to create the conditions for a recuperation of the system. Credibility in government rescues and confidence in private financial agents could have calmed the rumor-mongering and speculation that undermines the business of banking. Instead, the expectation grew that the policy of exchange rate preannouncements (and currency overvaluation) would be terminated. Between March and May 1980, international reserves dropped $1.5 billion, as short-term speculative dollars fled the country. Investors bought up the dollars that the Central bank pumped into the system, and promptly took them out of the country. Capital flight out of Argentina rose dramatically, when word circulated that an average of 20 percent of credits were in arrears.

By mid-1980, as the traditional banks began to

108(...continued)
supervision; after 1980, there was no accountability". Interview. Some observers held it ironic that an economic policy that held rational expectations critical to the behavior of financial actors should offer so little information. On the other hand, if the Central Bank had revealed data, it likely would have created even greater negative expectations, not a welcome alternative.

collapse, foreign investors were permitted to open one month accounts. $700 million was deposited in Argentina. In February 1981, there were more bankruptcies, a sudden devaluation and $2 billion more in capital flight.\textsuperscript{110} A roller coaster of high wheeling deals and rumors generated an unstable credit environment. A mood of chaos and uncertainty prevailed. Confidence in the financial markets was never reinstilled. The political decision to close an Interior bank, the Banco Intercambio Regional, precipitated transformations because it opened up conflicts and set off vendettas against old and new enemies within the banks, the Central Bank, and the military.

[Insert Table 4.4, Liquidations of Financial Organizations]

3. \textit{Intra-Agency Conflicts}

Were the Central Bank and the military officers actually involved in mediating this conflict among private bankers? The collapse of the Banco Intercambio Regional signaled the culmination of the conflict that had been brewing between new and traditional bankers. Conflicts within the newly organized Central Bank over its attitude towards these feuding banks created much of the lack of credibility and confidence in the markets.

\begin{footnote}{\textsuperscript{110}Girault, "La Crisis Financiera Argentina", p. 32.}\end{footnote}
In April 1980, the Central Bank had announced the new system to compensate for losses in deposits by offering a rediscount to banks, the Circular 1051. Yet at the same time, the Central Bank declared the right to exclude any particular institution from using this loan. Most bankers did not know how to respond. Should they approach the officials for this rediscount, revealing the true state of the books, only to be refused the advance, and subsequently intervened? In August 1980, the rumor circulated that the Central Bank could intervene a bank merely for the purpose of analyzing its balances. Many bankers, fearful of an impending bank run, began to request the liquidation of their banks. Only in August 1980 did a Central Bank circular "ratify" its interventions post facto.111

As the interventions proceeded, observers held that the Argentine Central Bank was closing banks with impunity, in an ad hoc fashion; indeed that vendettas against certain bankers and banks were being served. It appeared as though those banks which had circumvented the state bank policy "suggestions", or those which had taken away market shares from some Central Bank crony, were treated more harshly than a neighboring bank whose balance sheets (capital ratio, profitability) looked similarly risky. Many believed that the Central Bank was responding to the splits within the

111El Ambito Financiero, 13 August, 1980, p. 4. This ratification was codified in CB law 22.267.
banking sector, favoring one bank over the other. Which banking group was receiving favors was itself in dispute. Indeed, whether such preferential treatment existed is less important than the perception. The effect was to extend the splits within the banking sector over to the domain of government policy.112

By 1980, the Central Bank had the reputation for playing favorites: Some bankers were convinced that the Banco Ganadero would have fallen (before its 1981 demise) if it had not had its "friends in the Central Bank Board of Directors", a suspicion encouraged by the Banco de la Nacion-Banco Ganadero scandal, which essentially had involved a state subsidy to a traditional bank. At the same time, Reynal was accused of foul play because he was the nephew of the head of the Bank of Boston's Argentine branch. It was common knowledge that Central Bank functionaries could be readily bribed (due perhaps to the regulators' ambivalence).

112See the leading finance daily newspaper, Ambito Financiero, April 21. 1980, page 1 for this view. The Central Bank leadership received the brunt of investor anger. Under the "charming" Central Bank leadership that flaunted technical know-how and overseas educations, the general view held that the Bank "deceived the public into believing that everything was in order". "They created an overblown picture of the powers of the Central Bank, and when the time came to do something, they were incapable." Interviews, members of the economic team; Guillermo Walter Klein, Dagnino Pastore. Zimmerman, who was Central bank Vice President until January 1980, appeared to have ignored the piles of files stacked up behind his desk on delinquent banks. Interview, Alejandro Reynal.
Conflicts within the Central Bank over the new policy direction (and its implementation) contributed to the incomplete observance of financial regulations. Some functionaries held grudges against the elitist Buenos Aires bankers, and were known to favor the Interior banker push for greater market share. Others had a distaste for the "provincial" banker who flaunted 40 years of Central Bank control over bank activity. Without a trained or highly motivated administrative corps, the efforts to oversee banks were easily sabotaged by widespread lack of bank compliance, evasion and bribery.

The military services, witnessing this ambivalence, found the Central Bank responsive to regulatory arm-twisting. The military pressured Central Bank functionaries to grant "exceptions" and privileges to particular banks. General Suarez Mason reportedly asked a public bank official repeatedly for special favors regarding a loan. A smaller bank, the Banco Ambrosia, was the particular interest of Navy Commander Eduardo Massera, whose office reportedly telephoned a Central bank employee daily to "inquire" about government authorizations for that bank. Indeed, bankers readily admitted that they gave loans to military officers, both in a personal and institutional capacity, and that officers were given positions on the Board of Directors.¹¹³

¹¹³Anonymous Interviews. Financial directives were often made by telephone. Ambito Financiero also hints of military (continued...)

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By 1980, military meddling in finance was readily acknowledged. The military relationship with the Martinez de Hoz team had soured; this relationship worsened when the economic team decided to devalue the currency in late 1980, and the military (like other interest groups) lost substantial assets. Many had invested in industries and had personally become highly indebted.

The military was widely believed to have interceded in defense of certain banking groups and to have lobbied to destroy others. Officers in the air force had interests in the Banco Greco, while certain navy commanders owned assets in the Banco Oddone. The newspaper, La Nacion recounted in March that the precarious situation of the Banco Intercambio Regional had been apparent already in mid-1979, but the state monetary authorities chose not to take action after pressure from the military. General Suarez Mason openly supported the bank. Other reports concluded that the Central Bank did not make the decision to close BIR, rather the military Junta did, with Interior Minister Harguindeguy in the lead. Said one banker involved in the closure, "the Central Bank closed the BIR improperly; without warning, and with a military hand". The military was itself split in its policy preferences: Air Force Commander Graffini was reported to have insisted that Martinez de Hoz not help BIR

\[113\](...continued)

influences in Central Bank decisions; various issues, 1980.

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with any bail-out, demanding that the Central Bank not give
the BIR "a second chance".114

Other (anecdotal) evidence suggests that, by 1980, the
military carried a somewhat exaggerated perception of the
control that it held over individual banks and bank policy.
Interior Minister Harguindeguy, who was active in directing
bank policy, was reported to have indicated in a policy
meeting his distaste for Mr. Seitz, of the economic group
SASETTRU (which soon went bankrupt) and his support for the
gруппос Capozzolo and Tornquist.115

With unfortunate timing, the Argentine military was
planning to execute a change of political leadership in
1981. The new rotating President of the Junta, chosen in
October 1980, would take over in March, 1981. At first, the
choice of military leader was in dispute; then, once
appointed, the designated president General Roberto Eduardo
Viola remained vague about his economic policy plans. The
selection of Viola, however, was intended to signal policy
continuity. The indecision of political authority at this
juncture only accelerated the deterioration of confidence in
the banking system. Already in July 1980, market observers

114La Nacion, 30 March, 1980, p. 2, section 3. See also
Ambito Financiero, 6 May, 1980; Anonymous Interviews.
Interviews referred to BIR president Trozzo's close
relations with the military and its involvement in financing
for Navy construction. "Trozzo made sure that there were
lots of different interests and lobbies to keep BIR from
going under". Anonymous interview.

115Two anonymous Interviews.
expected a change of the economic cabinet and of the exchange rate system. Long term credit evaporated.

When Viola began his five year term, he appointed Lorenzo Sigaut as Economics Minister to form a new economic team. Sigaut and his economic team had a difficult inheritance. The Central Bank could no longer make foreign exchange available for private external debt servicing. The administration received open pressure from business and from foreign bankers. While the basic characteristics of the Argentine economic model were unaltered, expectations had shifted dramatically. Indeed, Sigaut implemented a series of strong devaluations: X percent in March 1981, then another 30 percent in April. The relative price of the dollar rose 248 percent in the commercial market and 437 in the financial markets. The business sector, indebted in dollar currency (from the favorable interest rate differential), was ruined.

To protect Argentine companies (banks and businesses) from these devaluations, the economic team instituted various exchange rate insurance and credit subsidy programs. They permitted firms to transfer most of the capital losses acquired from the devaluation through a seguro de cambio program. This exchange rate guarantee scheme essentially transformed private business debt into public debt. Despite this open subsidy to bankers and business alike, confidence
in markets remained low.\textsuperscript{116}

4. The End of the Experiment

On July 2, 1982, the newly appointed president of the Central Bank, Domingo Cavallo, passed a "counter" banking reform to return the financial system back to centralized state management, reminiscent of the 1973-1977 structure. Financial institutions were required to keep almost one hundred percent of their reserve requirements. New controls governing interest rates, minimum term deposits, and official guarantees were also legislated. Cavallo ordered financial institutions to carry out a wholesale corporate-debt rescheduling for sixty months at negative real interest rates. In turn, the Central Bank funded this operation by rediscounting it through a "consolidated loan", or a Bono Nacional de Consolidacion Economico Financiera. Industry was able to refinance 50 percent of its debt.\textsuperscript{117}

The Central Bank absorbed the private, domestic and external debts, essentially running as a loss-making intermediary for the commercial banks and their nonperforming assets. By liquidating the debt, firms lost their

\textsuperscript{116}The President (and several advisors to the) Central Bank resigned over the seguro de cambio policy. Interviews, former Central Bank president Name Gomez, advisor Ricardo Lagos.

\textsuperscript{117}Juan Carlos Casas, ed., Sareamiento de Bancos, 1989; and Fernandez, "La Crisis Financiera Argentina", 1983.
financial obligations, but savers also lost their savings. Investors were not anxious to place more funds into the local Argentine financial system. The public lost faith in public bonds and in the Argentine currency.\textsuperscript{118}

Bank collapses are difficult moments in any government, as the case of Chile will underscore. But, while most observers had anticipated some sort of denouement to the frenzied banking practices by late 1979, the magnitude and duration of the financial crisis caught everyone by surprise. The bank closings created a crisis of accumulation, in the sense that the mechanisms of capitalism were unable to function. Banks were unwilling to extend credit, investors dared not to save, and industry no longer could hold off its debts. Between April 1980 and the following March, 62 institutions were intervened or liquidated, representing 20 percent of total deposits.\textsuperscript{119}

The bank collapse also spawned a crisis of government, breaking the Martinez de Hoz mystique and forcing a change in public policy and in its leadership. It then helped to bring on a regime crisis. Economic instability eroded people's confidence in the state to rule effectively. New channels of access to political authority were generated, as Argentines realized that the breakdown of the whole system

\textsuperscript{118}This was the first time that a non-Peronist government had carried out such a shift in the rules of the economic game.

\textsuperscript{119} ABRA, Memoria, 1980.
was possible. Finally, the bank run revealed an looming crisis of society. The behavior of economic - and political - actors did not appear consistent or rational, if evaluated according to these groups' "interests".  

This chapter argues that the inability to reregulate banking was due to a failed contract between banker and the state. State regulation of the banking sector broke down because bankers, fighting among themselves, lost confidence in the impartiality of state monetary authorities. Banker cleavages obstructed the public tasks of implementing regulatory policy. The state needed its leading bankers to help administer the policy; this cooperation was unavailable when the sector itself was split.

120As Guillermo O’Donnell has written, Argentina’s history of so much failure and "squandered potential", leads the country to resort to frustrated and bitter blame, creating a culture of "recrimination". Guillermo O’Donnell, Bureaucratic Authoritarianism: Argentina, 1966-1973, 1988, p. 323. Other observers might view the situation as one in which the actions of society were not consistent with the "reproduction of social relations".
CHAPTER V:

CHILE: BOOM AND BUST AND BANKER QUIESCENCE

On September 11, 1973, the Chilean armed forces stormed the Presidential palace and formed a provisional military junta.¹ Nine months after the military coup, General Augusto Pinochet consolidated his power within the military ranks and declared himself Supreme Chief of the Nation. Five months later, a new decree gave Pinochet the title of President of the Republic. Only then did Pinochet turn his attention to crafting an economic program: One month later, in April, 1975, the Programa de Recuperacion Economica was presented.²

¹The armed takeover was more brutal than that of Argentina. President Allende lost his life, and human rights groups estimate that 1500 people died in the first week of the coup. See Commission on Human Rights, Informe sobre la situacion de los derechos humanos en Chile, Organization of American States, Washington DC, 1985. The junta took over the university, and suspended all political organization. Trade union activity was banned in December and the political parties were eliminated in 1977.

The sweeping economic reforms under Chile's military-authoritarian regime and the ensuing financial boom and bust exhibited many similar features with that of Argentina. Banks operated in a relatively free market environment and were authorized to enter most credit markets with a range of instruments. The economic team implemented similar exchange rate policies to bring prices to international levels.

As in Argentina, banking practices took longer to change than did the ideas behind the reorganization. After a lifetime of government control over credit allocation, bankers initially understood little about responding to "market signals" or evaluating risks. A frenzied, speculative fever took hold, as most financial actors engaged in high risk lending and borrowing schemes. This activity became increasingly rational as the market destabilized. Indeed, state agencies sanctioned this behavior through the preferential sale of banks and the explicit absence of banking regulation and oversight.

However, the absence of any internal disputes within the Chilean banking community, in particular at the critical moment as Chilean banks were collapsing, was in striking contrast to the experience in Argentina. The Chilean Central Bank was able to introduce interventionist policies to bolster the solvency of failing banks. It bought up bad loans on 100 year maturities and absorbed other non-performing loans and promised state guarantees on deposits,
while the Supervision and Oversight agency selectively liquidated banks. In 1983, The Central Bank subsequently assumed management of the commercial banks, and put selected bank presidents and bank managers in jail. By 1984, state-appointed regulators were reorganizing these banks, and all Chilean employees were required to "save" twelve percent of their salary in privately-run pension funds.

These policies were interventionist credit schemes, with preferential treatment for some; not the hands-off, free market model most had envisioned. Nevertheless, it represents quite a different arrangement than Chile before the reforms in 1975, and from its Argentine neighbor. As one banker explained, "we considered ourselves one big family; a tragedy in one house, was a tragedy for us all". The following Chapter demonstrates the importance of this consensus by tracing the progress of Chile’s financial liberalization policy and the evolution of the alliances between state monetary authorities and private sector capitalists.

A. Setting the Stage for Reform

In the months preceding the announcement of the financial reform package in April 1975, newly-appointed Economic Minister Fernando Leniz passed policies to free
interest rates and sell off the nationalized banks. The newly set-up finance houses and privatized banks emerged as the critical building blocks in the reconstruction of the country's financial base.

The financiera emerged as an early product of the new, yet undefined, economic environment. Beginning in May 1974, financieras were authorized to lend money with no interest rate restrictions and with lower capital requirements; this, to introduce competition to the commercial banks. Twenty-one new agencies sprung up in under a year. Between 1974 and 1977, activity in the secondary financial market flourished. Commercial banks found themselves unable to compete with the financiera, since banks had to comply with interest rate ceilings, and in 1975, the three largest national banks recorded losses.

Under the new regime, Chilean banks were also quickly privatized. All banks, save one, had been bought out by the Allende government and were now provisionally managed by military officers. The agency CORFO (also led by a military officer) was charged with reselling the stock of the

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3In 1973, Leniz was backed by a heterogeneous group of supporters of Allende's overthrow: landowners, industrial groups, professionals, and even some workers. Over time, the "Chicago Boy" views became increasingly attractive. See Thomas Moulian and Pilar Vergara, "Politicas de estabilizacion y comportamientos sociales: la experiencia chilena 1973-1978", Apuntes CIEPLAN, No. 22, 1979, pp. 23-25, which describe this short-lived coalition. Also, Interviews, Roberto Kelly, Rolando Ramos.

recently nationalized banks on a basis of "public bidding".

Few persons (or firms), however, had the capital to buy the bank shares. Beginning in late 1975, the government selectively "sold" banks -- on credit -- to interested buyers, or, as the Vice President of CORFO recounted, to "groups most likely to prosper under the new regime." Participants were selected based on criteria of previous business experience, reputation, and social connections. Between 1975 and 1978, most banks were sold not only on credit, but below their asset value.\footnote{Interview, Lieutenant Colonel (Rt) Luis Danus Covian, former CORFO official. His decisions were largely "personal": most buyers took five to eight years to pay off the credit. The public sector was prohibited from buying stock in private banks. Fernando Dahse, \textit{Mapa de la Extrema Riqueza: Los Grupos Economicos y el Proceso de Concentracion de Capitales}, Editorial Aconcagua, Santiago, 1980, pp. 175-179. \textit{Fortune} Magazine estimated that assets that Javier Vial's economic group acquired from CORFO in 1975 were, in 1981, worth eight times what he originally paid. November 2, 1981, p. 142. That in a few years, several of these banks went bankrupt reflected unexpected changes in interest rates and speculation, rather than their original net worth.} 

CORFO officials, who essentially remained under Finance Ministry direction, also indirectly sanctioned the increased concentration in bank ownership. The original decree stipulated that only 1.5 percent of the total shares could be sold to an individual and 3 percent per firm. Interested owners soon found housekeepers, brothers -- or holding companies -- to purchase the percentage of bank capital maximum, accumulating controlling portions in the banks shares. A number of new owners also used credits from the
purchased banks to buy the shares.  

By 1976, it became clear that the unregulated market of finance agencies was destabilizing. Several financieras had contracted risky loans to stay afloat and had lost creditor funds. In January 1977, higher minimum capital requirements were set for these private investment companies, which were then also required to register with the Central Bank authorities. Commercial banks regained their advantages, offering customers current accounts, longer term instruments, external trade operations, as well as a greater prestige. 

The short-lived experiment in free banking, however, created the foundation for new entrants into the commercial banking system. (The Chilean banking community was particularly open to newcomers, since many of Chile's bankers had been forcibly retired when Allende nationalized the banks.) The May 1974 reform measures had permitted financieras to operate without putting up existing capital. At the outset, the finance house proprietors, many of whom had previously run exchange agencies or businesses, prospered in the new

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"This ownership limit was rescinded after January, 1978. Interviews, Mario Corbo, Oscar Gonzalaz, Claudio Skarneta. Personal correspondence, Sergio de la Cuadra to Roberto Kelly. See, also Rolf Luders, comments, in Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay, A World Bank symposium, Washington, DC, 1983, p. 63-64.

"See Superintendencia de Bancos e Instituciones Financieras (SBIF), Informacion financiera, February 1977.
environment: They had foreign contacts, they were comfortable with new financial instruments, and they were willing to take risks. Then, as the conditions for financiera operations tightened, the recently-authorized financiera owners used their collateral to buy majority shares in auctioned-off banks.¹

Thus, the financieras helped to secure the fortunes of a new capitalist player, who had emerged in the 1960’s. In 1968, financier Manuel Cruzat (holding a degree in administration from Harvard University) joined as consultant to the group of Ricardo Claro, Fernando Larrain and Javier Vial. After the 1974 coup, his economic group (now jointly owned with his brother in law, Fernando Larrain) started up a finance agency. In 1978, the finance house was converted to the Banco de Santiago, and by 1983, the bank had become the second largest private, national bank in Chile.

The newly-established financiers, many of whom created new economic groups, were the most aggressive seekers of the privatizing bank shares. CORFO officials were aware of such practices, but recognized that, due to the scarcity of available credit, concentrated ownership would facilitate the rapid bank sales. These privatized banks were necessary for the next phase in Chile’s financial history: the

¹Existing banks also opened up financiera branches (to take advantage of the favorable operating conditions and to raise cash). See Ricardo Lagos, "La Burguesia Emergente", in Chile-America, Nos. 72-73, July-September 1981, Rome, pp. 86-88. Also, Interview, Julio Salas.
"Program of Economic Recovery".

The decision to adopt the sweeping free market policies rested primarily with President Pinochet. Until 1973, a relatively cloistered Chilean armed forces had stayed out of electoral politics and economic decisionmaking. The military's historical obedience to elected civilian rule and its constitutionalist ideology offered few models for its tenure as political ruler. This insulated and hierarchical structure of the military gave Pinochet both the freedom and the institutional basis to exert his personal authority.9

Augusto Pinochet most likely chose the "Chicago Boy" economic team to run the country's economic policy due to the transformative nature of the project. As a military man, Pinochet was attracted to the profoundly authoritarian concept of the world that this liberal vision incorporated. The opportunity to change old structures -- to smash the traditional powers of business and labor, absent the meddling of political parties -- was appealing.10

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9The military had refrained from political participation for four decades after the 1928-1932 military rule of Carlos Ibanez: Military caudillismo led to a loss of civilian support (and respect) for the armed forces. See Alain Joxe, Las fuerzas armadas en el sistema politico de Chile, Editorial Universitaria, Santiago, 1970. Although the military subscribed to national security and counterinsurgency doctrines, it had few mechanisms to set its principles into political action. See Augusto Varas and Felipe Aguero, "El desarrollo doctrinario de la fuerzas chilenas", Documento de Trabajo, FLACSO, Santiago, 1978.


(continued...)
As in Argentina, once the policy direction was approved, civilian authorities took over its implementation. The number of civilians in Pinochet's Cabinet was even higher than in Argentina: in 1980, it comprised all of the economics ministries, ODEPLAN, the Ministers of Interior, Agriculture, Mining, Labor and Education. Advisors to, and members of, the leading grupos economicos took positions in economic ministries, and, over the years, government officials retired to jobs in banks and grupo businesses.11

By April 1975, a year and a half after the coup, this group of university economists and bankers were directing economic policy, ready to impose the first "economic shock" measure. The "Chicago Boy" economists were so enamored with the possibility of constructing a free economy in Chile that they regarded the absence of a free political system as a necessary, short-term evil. Their technical know-how commanded a distanced respect from the military and a collegial regard from private sector groups.12

10(...continued)
Adolfo Canitrot, La disciplina como objetivo de la politica economica: un ensayo sobre el programa economico del gobierno argentino desde 1976, Vol 2, No. 6, Estudios CEDES, Buenos Aires, 1979, has written persuasively on the political advantages of the neoliberal project in Argentina.

11Jorge Cauas, Jose Pinera, Pablo Baraona and Sergio de Castro were a few of the more important government officials to return to the business world after their terms as Ministers.

12For theoretical discussion of the development of military-civilian links, see Manuel Antonio Garretton, The (continued...
B. The New Financial Regime

The new team of "Chicago Boy" economists was appointed in April 1975. Finance Minister Jorge Cauas soon introduced a major economic program to address Chile's foreign exchange and fiscal crisis. A few weeks later, the government announced a package of banking reforms directed at letting the market determine the allocation of funds. The sweeping financial reform measures permitted enterprising grupos economicos in Chile to expand; most with little attention to risk and longer term stability.\textsuperscript{13}

1. The Financial Reform Law

Under the new financial regime, few explicit restrictions were set on bank activities. In September 1975, interest rates were freed for commercial banks. These banks were authorized to extend 1 to 3 year credits (three month term loans had been the standard); later even this restriction was eliminated. Export and import transactions, which had required Central Bank paperwork, were carried out

\textsuperscript{12}(...continued)


\textsuperscript{13}See the excellent work by Pilar Vergara, \textit{Auge y caida del neoliberalismo den Chile}, FLACSO, Santiago, 1985.
without state approval.\footnote{For most of the period, January 1977 to April 1982, the policies were executed by the charismatic Finance Minister Sergio de Castro. For description of other programs: reforms in the fiscal sector (cuts in government expenditures), prices, and tariff reductions, see Patricio Meller, \textit{Los Chicago boys y el modelo economico chileno: 1973-1983}, Apuntes CIEPLAN No. 43, Santiago, January 1984; and Ernesto Tironi, \textit{El modelo neoliberal chileno y su implantacion}, Documento de Trabajo No. 1, Centro de Estudios del Desarrollo (CED), Santiago, December, 1982.}

The complicated web of regulations concerning geographic and sector lending was dismantled; by late 1975, state-targeted credit lines were removed, and, in May 1976, quantitative credit controls were lifted. In its place, commercial banks operated on a fractional reserve system. In contrast to the Argentine policy, the Chilean economic team officially rescinded the state guarantee for financial deposits in 1975. (Although this policy shift was hailed as a dramatic symbol of the state's abdication of participation in the business of banking, in practice the Central Bank continued to bail out struggling banks and compensate their depositors.) In 1979, international capital flows were liberated, and commercial banks were authorized to accept foreign deposits.\footnote{See Jose Pablo Arellano, "De la liberalizacion a la intervencion: el mercado de capitales en Chile, 1974-83", \textit{Coleccion Estudios CIEPLAN} No. 11, December 1983, pp 5-49.}
The organization of the Central Bank underwent radical changes. The Central Bank’s Board of Directors, formerly comprised of representatives from banks and business groups, was disbanded. Central Bank functionaries who had been hired in the Allende administration were summarily fired. Obscure functionaries, many of whom had worked in the Research Department, became the managers of entire divisions. The Superintendencia de Bancos e Instituciones (SBIF) also received expanded authority to monitor all financial bodies, although, as in Argentina, neither its organizational structure, personnel, or funding changed.¹⁶

The Banco del Estado, the only publicly owned commercial and development banking institution, lost its monopoly access to government accounts in 1978, and its participation in the overall financial system dropped. Although it continued to offer longer-term loans to large companies or state-targeted projects, the bank could no longer grant blanket credits to state-owned firms. SINAP, the state-run savings and loan institution, announced its bankruptcy in early 1977.¹⁷

¹⁶Interviews, Alejandro Yung, Daniel Tapia.

¹⁷Interviews, Julio Barriga, Hector Espinoza. SBIF, Informacion financiera, March, 1979. Under the new regime, the forestry and horticultural (especially fruit exports) industries were priorities sectors; although they did not receive subsidized credits; see Oscar Munoz, "El Estado y los Empresarios: Experiencias Comparadas y sus Implicancias para Chile," Coleccion Estudios CIEPLAN no. 25, December, 1988, pp.39-42.
Soon after the reforms were implemented, foreign banks converged on the Chilean market; by 1981, sixteen new banks had opened branches in Santiago. A handful of national banks, both former regional banks and converted financieras, were established, raising the number of private banks from 18 in 1973, to 27 in 1981.\footnote{See Table 4, Structure of Financial System.}

[Insert Table 5.2 Assets/Liabilities]

More significant, perhaps, were the changes in volume of financial business: the financial market grew two times faster than the country's GNP, and the volume of credit to the private sector increased by more than 1,000 percent. By 1982, the private domestic banks controlled 68 percent of the markets; the Banco del Estado, 18 percent; and finance companies about 1 percent. A bank consultant remarked, "The private bankers were the true pioneers of the economic project".\footnote{Interview, Mario Corbo; See Tables 5 and 6, for structure of assets and liabilities and rates of growth of GDP by sector. See also, Sebastian Edwards, and Alejandra Cox Edwards, \textit{Monetarism and Liberalization: The Chilean Experience}, Ballinger Publishers, Cambridge, MA, 1987, p. 56. According to SBIF head, Mauricio Larrain, M2 over GDP rose from 9.3 percent in 1974 to 25.7 percent in 1982, in "How the 1981-83 Chilean Banking Crisis Was Handled," p. 5.}
2. The grupo economico: changed and prosperous

Chile's grupo organization was especially suited to take advantage of the changed economic environment. The revolutionary changes in the composition (and practices) of the international banking industry provided Chilean bankers with new opportunities for foreign borrowing. Since foreign credits were no longer channeled through the Central Bank, bankers could solicit these international funds directly. Existing ties between Chilean financial grupos and international concerns gave the domestic financial sector a new commanding position in the Chilean political economy. Chile's private external debt tripled between the end of 1979 and the end of 1981.20

Ironically, it was the grupo's traditional financing arrangements that also enjoyed an edge under the new conditions. In the past, in an environment of restricted but cheap credit, it had made sense to shift funds within

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one organizational group, as was the grupo practice. In conditions of free and expensive credit, however, owners were expected to obtain funds at the lowest cost, at whatever source. Economic groups nonetheless retained the practices of intra-enterprise lending; the "money desks", or mesas de dinero, of finance companies and banks participated in this market. Bank managers received pressure from grupo bank owners to extend loans to the bank owner’s affiliated businesses. Industry often held large amounts of its own bank credit.\textsuperscript{21}

Most bankers, however, also considered these "incestuous" loans to be a smart business strategy under the new financial regime. First, extending loans to a firm which was legally connected to the same lending institution both reduced transaction costs and appeared less risky. The bank had access to more accurate financial and production figures of an affiliated company. The bank also had personal experience with the credibility of the borrower. What better way to keep track of funds than to keep them in the same economic group? The grupo enterprises were often in better economic health than their industrial counterparts:

\textsuperscript{21}Interviews, Oscar Gonzalez, Ernesto Illanes. During these years, bank debt generally comprised of grupo projects in construction, real estate, and consumer credit. These personal loans reflected both increased consumption and speculation in exchange markets. SBIF, Informacion financiera, 1979.
"Today, the economic group is treated as the problem. But at the time, to be a grupo was considered an advantage. While the spirit of the law might not have permitted portfolios of "related" loans, lending to these firms was a better business decision; they simply were the better clients."

Despite its perceived merits, this financing strategy provided no self-imposed credit ceiling under market conditions of excess capital and lax regulation. By 1981, growth of the grupo was no longer supplemented by, but rather depended on, funds from the banks or finance companies that the conglomerate controlled. Indeed, owning a bank provided a firm with access to funds. A banker commented, "When someone bought a bank, they were actually buying the vaults". The grupo's subsequent expansion strategy rested on the grupo-controlled bank extending more credit.

Several high-profile economic groups emerged from Chile's uncharted territory. Manuel Cruzat Infante and Javier Vial Castillo led the two largest grupos. Cruzat, together with Fernando Larrain, owned the Banco de Santiago, 26 different investment and real estate companies, and five other finance and insurance companies, as well as forestry, construction, industrial and trade companies. The Banco de Santiago entered on an arrangement with New York's Citibank

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22 Interview, Juan Andres Fontaine.

23 Interview, Julio Salas, who recalled this comment by Leon Dobry, banker.
to receive bank training courses and new, computerized equipment. It was also the first Chilean bank to offer separate banking services according to loan types and special personal credit services along the Citibank model.\textsuperscript{24}

Javier Vial, heading the BHC group (thus called for its ownership of the Banco Hipotecario de Chile) owned almost 30 percent of the shares in the Banco de Chile and exercised controlling ownership in seven other banks and financieras and assorted industries. These new conglomerates handled not only combined industry and bank assets, but, increasingly, foreign and national capital. By 1979, Chilean economic groups controlled 80 percent of banking sector equity, compared to 40 percent in 1970. Five financial conglomerates controlled 53 percent of the capital of the largest 250 Chilean enterprises.\textsuperscript{25}

\textsuperscript{24}The consumer loan made its debut in these banks. During this period, Chilean banks were organized in two separate divisions for local and foreign operations, so the full extent of indebtedness of a particular firm/client was never realized. Interviews, Ernesto Illanes,Jose Mena Valencia, Juan Andres Fontaine.

\textsuperscript{25}Fernando Dahse, \textit{Mapa de la Extrema Riqueza}, 1980. In private correspondence with the author, Rolf Luders suggests this figure may overstate the relative importance of the grupo. Due to its pyramid structure, grupo assets and equities might have been doubly counted, Also, interview, Francisco Silva, banker with a foreign branch bank.
3. Speculative Banking practices — with few conflicts

The management of these new grupos was distinctive from that of the pre-reform forerunners. Groups of entrepreneurs, rather than families, formed the nucleus of the groups. These businessmen hired trained economists, lawyers and engineers (rather than promoting their friends' sons) to run their companies. The new bankers also actively solicited clients. The conservative, family-oriented lending of the established economic groups gave way to aggressive, highly risky, international operations. "These new businessmen were sophisticated pacesetters, they spoke English, and, as American bankers preferred, their companies (or assets) looked large," recalled a Chilean banker.26

The grupo strategy, as in Argentina, was based on extending more credit to cover bad loans. Other speculative games flourished. After 1979, the profitability of the bank was more often based, not on loan activity, but on playing with both the increasingly overvalued currency and interest rate differentials. Borrowing abroad was profitable due to the predictable rise in the value of the Chilean peso, as in Argentina. Chilean banks could make a handsome profit borrowing at one rate from the international market and subsequently lending to the domestic market at a higher

26 Interview, Francisco Silva. The Cruzat-Larrain, Vial, and other grupos established their own research institutes.
interest rate. This arbitrage, or transferring money from U.S.-based accounts to domestic accounts and back again, was more profitable than producing goods.  

Traditional banking practices did not disappear, however. Instead, a juxtaposition of old and new operated together. Alongside international, high-tech practices, the familiar "name-lending" banking persisted. A person's social standing continued to be important. A belief in banking as a largely personal enterprise persisted in Chile as a principal element in lending and borrowing decisions. A banker remarked: "The sensation that if you own a bank you were powerful, was a throwback from the past, when banks were the "gift-bearers of funds". 

At the same time, many bankers in the financial community were ignorant of basic banking operations.

27Beginning in 1978, Chilean monetary authorities preannounced the path of the exchange rate, as in Argentina. During these years, the Libor rate averaged 18 percent, while domestic rates were 25 percent. See Ricardo Ffrench-Davis, "El experimento monetarista en Chile: una sintesis critica", Coleccion Estudios CIEPLAN, Vol 4, December 1982. See also Economic Liberalization. Interest rates stayed above world rates, perhaps due to speculative euphoria after a period of financial repression. See Sebastian Edwards, "Stabilization with Liberalization: An Evaluation of Ten Years of Chile's Experiment with Free Market Policies, 1973-83," Economic Development and Cultural Change 33, no. 2, January 1985, p. 237.

28Interview, Leon Dobry. Banking is based on exchanging a good for a commitment to pay a sum in the future. Thus it re-lies on a certain amount of confidence-building criteria, such as a person's social standing or reputation. The absence of regulations prior to 1981 made such calculations paramount in Chile.
Bankers rarely assessed the quality of debtors through credit analyses of loans. They rarely reviewed the state of their bank's own portfolios. Some even failed to understand how market signals worked: One Central Banker recounted receiving a call in the early years of the reform from a local private banker, who, unable to grasp the concept of free interest rates, asked him at what percentage the "free interest rate" would be set.29

Most commercial banks continued to offer short-term credits, and investment banking departments remained small. For example, Banco de Trabajo never acquired computer facilities, and throughout the experiment, Banco Sudamericano lent only to its established, customary firms. Nor did prospective borrowers willingly comply with new market practices: One banker recounted that a client marched out of his office, his "honor" offended at being asked to produce the company's financial records.30

Traditional practices were not necessarily less profitable. The Banco de Chile, whose market share grew handsomely in this period (under the ownership of Javier Vial), represented a mixture of customs from the traditional school together with newer strategies of banking. While some bankers complained that "arrogant outsider economists

29Interview, Anonymous, former Central Banker. Mauricio Larrain also makes this point in "How the 1981-83 Chilean Banking Crisis Was Handled," p. 4.

30Interview, Ernesto Illanes.
trampled over the older bankers" within the bank, these traditional bankers, who gave loans according to "character and certain feelings about business clients," often carried out the riskiest projects.31

Despite the "generation" gap which emerged between traditional and modern banking practices, no substantive rifts developed between these two types of bankers. Most foreign educated bankers tolerated (and took advantage of the personal contacts of) the "old guard". Moreover, these men were clearly a dying breed and posed little threat to the internationalized, computerized banking. Not many remained in business either; most of the older bankers had been ousted either under the Allende administration or in the aftermath of the military coup.

4. Deterioration of the Economy

1980 marked the height of the banking boom and of Pinochet’s authoritarian political rule. In September, a plebiscite approved a new constitution. The charter extended Pinochet’s power until 1990, demonstrating his firm hold on society and on the ruling military junta. The campaign mounted for the occasion dwelt on both the law and order in Chile and the country’s potential for economic progress. Already in February, the Finance Ministry

31Personal correspondence, Juan Andres Fontaine.
announced that the liberalization process was completed.\textsuperscript{32}

By mid 1981, the financial boom began to lose its strength. In May of that year, one of the oldest, largest, and most internationally exposed conglomerates, the Compañía Refinería de Azúcar de Vina del Mar (CRAV), announced that, due to the fall in the price of sugar on international markets, the company would go bankrupt. Although CRAV did not own a bank, it operated two insurance companies, administered mutual funds, and owned sugar plants and other businesses. It had openly made profits on foreign exchange earnings during the early years of the liberalization experiment. After the CRAV bankruptcy, the business environment changed. A banker recalled the thinking: "If the established CRAV could go under, perhaps 'name lending' to large companies wasn't such a good idea."\textsuperscript{33}

Business groups in Chile had offered little resistance to economic policies which hurt their interests. Initially, as in Argentina, business had perceived that the overall project would favor them as a group. As Chile's industry began to feel the effects of the program, any effective

\textsuperscript{32}The vote was recorded 67 percent in favor, 30 percent against the constitution. See Manuel Antonio Garreton, The Chilean Political Process, pp. 139-140. See also, Que Pasa, February x, 1980, p.2.

\textsuperscript{33}Interview, Oscar Gonzalez. The conglomerate was no innocent international player: Almost 100 years earlier, during the 1898 crisis, CRAV had operated on a pounds sterling capital base. See Kirsch, Industrial Development, p. 118.
political lobbying for industry interests was blunted by the continued support of the industry association, SOFOFA, for the government project. Despite huge losses for many producing firms, the powerful lobby group kept silent. In part, its members could present no alternative policy other than a return to government intervention. Many were skeptical that the application of the policy would endure.\textsuperscript{34}

Moreover, some members of the SOFOFA Board of Directors were themselves prospering from the policies. As owners and directors of grupo organizations, the activities of the SOFOFA leadership were intimately linked to the thriving financial sector. Economic groups, composed of both financial and industrial holdings, simply transferred their assets to financial operations as the characteristics of the economic reform unfolded. Thus the SOFOFA lobby group presented little opposition to policies that hurt industry. As in Argentina, opposing interests were reconciled as the conglomerates wrote off the losses in industry in exchange for gains in importing and in finance.\textsuperscript{35}

At the outset of the reform, the government economic

\textsuperscript{34}Jorge Cauas and Sergio de la Cuadra (1981) suggest that industry postponed opposition actions because they thought them to be temporary, as historical experience had taught.

\textsuperscript{35}While important grupos such as Matte were active on SOFOFA, neither the Cruzat nor the Vial economic groups were members. Many firms simply switched operations and went into the importing business to stay afloat. Interview, Klaus Esser, German Development Institute, Berlin, 14 January 1990.
team had launched an anti-industry campaign in the well-controlled media and were prepared to fight against industry pressures for reinstating interventionary programs. Policymakers remained convinced that, prior to 1973, industry had inappropriately benefitted from state economic controls. Over the years, they regarded the deterioration of most of Chile’s industrial base with indifference.36

The CRAV bankruptcy, however, revealed the fragile condition not only of industry, but of the banking sector. The liberalization of capital flows in 1979 together with Chile’s high interest rates had brought in foreign capital, creating the illusion of a dynamic market and spurring on growth. This external credit had also hidden many of Chile’s nonperforming loans. But speculative capital could just as easily be reversed. As the exchange rate rule began to lose its credibility, the funds (and foreign exchange) headed for more secure investments in dollar-denominated assets. When the foreign loans ceased, many banks were caught with debts that they were unable to pay back.37

36See El Mercurio, various issues, 1976; Latin American Economic Review, Volume 25, 1 July, 1977, p. 98. "Industrialists had been too dominant in the past, at the center of power," recalled a banker in 1990. "It was time that power be handed over to another group of more able businessmen." Interview, Alvaro Bardon.

37Foreign liabilities as a proportion of total liabilities rose from 14.4 in 1978 to 35.8 percent in 1982. Larrain, "How the Debt was Handled," p. 5. Banks became more leveraged; the ratio of borrowing to reserves doubled between 1978 and 1983.
In late 1981, Finance Minister Sergio de Castro assumed public management of four private banks and four finance houses. Over the course of the next year, another three financial institutions were taken over. In all instances, depositors were compensated, and losses were taken by the banks’ shareholders and by the government, which absorbed the difference between the value of assets and liabilities (excluding equity). State monetary officials played down the importance of these Central Bank moves. The interventions were described as normal steps to ensure that market conditions prevailed, and the financial sector continued to operate.3

In 1982, the world economic recession hit Chile. Since 1976, real GDP had grown at an average rate of 7.2 percent per year, but, at the same time, much of Chile’s industry had disappeared due to an increasingly unfavorable (overvalued) exchange rate and continued high interest rates. Between 1978 and 1982, the tablita policy of fixed exchange rate had increased the relative price of Chile’s industrial exports as well as its agricultural products. In 1982, production (GDP) dropped by 14 percent in that year, and unemployment hit 30 percent in Santiago.

[Insert Table 5.3 Macroeconomic Indicators]

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3*El Mercurio, 8 November, 1981, p. 1 describes the takeovers as "inevitable". Two of the intervened banks were the well established Banco Talca and Banco Espanol.
Industry, with the backing of key military officials, did succeed in ousting the powerful Finance Minister Sergio de Castro in April, 1982. He was replaced, however, by his close associate and President of the Central Bank, Sergio de la Cuadra, who maintained much the same policy stance. In June 1982, in response to the deteriorating situation, the new Finance Minister devalued the Chilean currency. Industry (already struggling to capture markets with an overvalued currency) and banks (juggling their non-performing loans) were left to service huge dollar-denominated debts.³⁹

In August of 1982, Rolf Luders, an economist who sat on the Boards of several grupo companies, replaced Finance Minister de la Cuadra. Luders instructed the largest banks to renew the loans that Chilean industries had taken out. The commercial banks dragged their feet on these operations.

On January 13, 1983, Luders instructed the bank regulatory agency, the SBIF, to take control of seven banks and one finance company, and to liquidate three outright. After one day’s work, the Chilean state controlled 70 percent of the domestic bank sector.

[Insert 5.4 Intervened Banks]

³⁹As in Argentina, the loss of export (and import substitution) competitiveness and the rise in international interest rates had forced the shift in exchange rate policy. Chile also faced a drop in international copper prices. See Juan Pablo Arellano, "La dificil salida al problema del endeudamiento", Coleccion Estudios CIEPLAN No. 13, 1984.
C. State Regulation, Banker Cooperation

The extensive interventionary action by the SBIF represented a dramatic reversal of the government's official bank policy position. As in Argentina, the speculative banking and economic downturn had brought the Chilean state monetary institutions back into the business of bank management. Yet, despite the even more contradictory signals that the Chilean intervention transmitted (given its more doctrinaire position and extensive intervention), Chilean bankers remained compliant, engaging in only negligible oppositional behavior towards the government economic team.

1. Policy Precedents

At the outset of the reform, Ministry of Finance and Central Bank authorities had announced, like their Argentine counterparts, that banks would be treated as any other business: Badly managed banks would be left to go bankrupt. Chile's economic leaders, however, went even further and officially revoked the government guarantee for bank deposits. The banks were left on their own, unlike in Argentina, whose government initially offered complete
government protection.40

The significance of this measure, however, was muted. In the first instance of financial difficulty, the state bailed out a private bank and reimbursed its depositors. In November of 1976, the owners of the Banco Osorno, the second largest bank in Chile, approached the Central Bank authorities to announce their bankruptcy. In accordance with its official executive decrees, the Central Bank should have left the Banco Osorno to the bankruptcy courts. State monetary officials, however, chose to keep the bank afloat and temporarily took over its management. Chilean leaders feared that a bankruptcy would put a damper on Chile’s internationally acclaimed experiment at a moment of enthusiastic foreign interest, and the 1976-1977 Banco Osorno episode was swept under the rug. "A failed bank would have been too expensive in terms of future gains in dollar loans", observed a banker.41

With increasing regularity, the Central Bank assisted

40See El Mercurio, June 14, 1976. Interview, Alvaro Bardon, Central Banker. Prior to 1975, the Chilean state guarantee had actually been an unnecessary provision, given the close state supervision of financing and the negative real interest rates.

41Interview, Leon Dobry. Depositors were reimbursed by the Central Bank. After this episode, some deposit insurance was offered. The majority of the Banco Osorno loans had been extended to the Vial and Cruzat grupos, although the composition of loans received scant attention. The cause of the bank collapse appeared to be mismanagement of funds. The SBIF had reviewed the bank 6 months earlier, and found no improprieties. Interview, Ernesto Illanes, "Interventor" of the bank.
more failing banks. In November 1981 and again in January 1983, failing banks were either given more funds or taken over, and depositors were reimbursed by the state. Despite the official state abdication of responsibility for bankrupt financial intermediaries, the Central Bank assumed the obligations of the failing banks. Yet, despite these bail-outs, 60 percent of bank debt was still not officially backed by state guarantees by late 1982.**

Historically, banks have always turned to governments to act as a "lender of last resort" in cases of financial crisis. No official proclamation could change this fact. Particularly after the Banco Osorno affair, bankers presumed the state would extend a de facto guarantee on deposits.*** The bankers' high-risk behavior rested, in part, on an ignorance about the workings of the financial system after a lifetime of state-led financing. An enormous amount of external financing became available at the moment of the liberalization of the country's capital account, when the

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**Note the contradiction between proclamation (free market) and practice (government intervention). "Everyone knew that the concept of free market was just a way of selling an idea", admitted an economic team member. Interview, Alvaro Bardon.

banking system was already open. The inflow of new funds beginning in 1978 corresponded perfectly with Chile’s developing free market ideology. Bankers simply did not consider the possibility of a downturn.

2. The Superintendencia (SBIF)

Chilean bankers also responded to signs from state monetary authorities. As in Argentina, the lax SBIF regulatory control reflected the dominant position of the Ministry of Finance, which never gave this aspect of financial management much consideration. The low-prestige watchdog agency had few funds to carry out oversight activities such as visits to banks or analyses of bank records. Its director, Boris Blanco, was less than enthusiastic about the banking reforms."

The absence of bank oversight sent political signals about appropriate bank behavior. The 1974 financiera legislation, which had permitted finance houses to operate without regulations, demonstrated this open-door attitude. The fast-paced bank privatizations also suggested that the government was more interested in private ownership than the

"Civil servants were not well trained, nor were they the ambitious, career-types, given the SBIF job prior to 1970. Pinochet’s personal friendship with the SBIF head Blanco might explain his prolonged tenure. The "Chicago Boy" graduates claimed they did not study the subject of financial regulation in coursework. Interview, Sergio de la Cuadra.

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legal regulations governing this ownership. In an ironic twist, the low profile of the SBIF was explicitly intended to demonstrate to investors that the system would not in face destabilizing risks.45

Changes in international banking also rendered existing state regulations obsolete. Since bank activity had been historically controlled by direct state regulations, and real interest rates had remained negative, business failures had been rare, and loans, easily collectible. In the new financial environment, the regulatory agency had neither the resources nor the knowledge to keep track of the rapidly expanding private financial activities. New instruments quickly superseded the jurisdictions of the rules.

Banks, in turn, were supposed to provide information to the supervisory agency. But the regulations were unclear (few bankers understood how to fill out the forms), and the process was unmanageable. Freeing up banking without furnishing banking oversight resulted in high-risk and overly leveraged loan portfolios. Bank practices became highly irregular. Young managerial technocrats (mostly new entrants to the system) exploited every regulatory loophole. As in Argentina, banks rolled over their losses and attracted additional deposits to finance new resource commitments. They manipulated their bookkeeping to create profits for banks, for the affiliated industries, and,

45Interview, Guillermo Ramirez.
subsequently, for their own pocketbooks.

Chilean authorities were, however, more successful than their Argentine counterparts in switching courses, once the need for regulation was recognized. The Central Bank and SBIF did not face active lobbying of competing private sector groups, which had led to infighting in Argentina. In 1979, regulations prohibiting loans to related companies were passed. Only 10 percent of a bank’s loan portfolio could be extended to one client or company, and banks were prohibited from investing in stockholder companies.46

Nevertheless, only in 1982 did the Central Bank began to publish volumes of instructions on compliance, and the SBIF new research team, identifying "related loans" as the culprit responsible for the country’s financial morass, published a monthly newsletter disclosing financial data and analyzing events. Assessing the quality of the portfolios remained a difficult task. The SBIF could do little more than calculate liquidity and levels of indebtedness. There was no centralized data base or standard measure to evaluate bank management. Only by 1983 could the SBIF actually

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document illegal practices."

In response to these new decrees (and in the "spirit of the free market"), grupo owners and managers initially searched for new bank loopholes and expanded the use of others already in practice before 1981. Importantly, Chilean bankers never confronted the authorities on the legality of Central Bank regulatory actions. Instead, they devised elaborate schemes to transfer funds through a triangle of three banks, a technical record-keeping transaction that covered up these "incestuous" loans. Another legal trick was the fabrication of "paper" companies, or fictitious firms, that borrowed funds for grupo use. This deception was marginally within the "anything goes" logic of the era, while leaving the banking structure indebted to its own clients.

Grupo leaders also transferred the savings accounts from their affiliated mutual funds and insurance companies to bank assets in order to finance speculative projects. For example, when the Central Bank decreed that the asset value of "related" portfolios could not exceed the capital base of the bank, Banco de Santiago owners simply transferred their personal deposits to official bank capital.

"See, for example, SBIF, Informacion Financiera, "Algunos Aspectos Relacionados con el riesgo en la intermediacion financiera. El caso Chileno," September, 1982, pp. 5-12. Blanco, the head of the Superintendencia, accused of obstructing implementation of the free market measures, was no longer effectively in charge.
State monetary authorities were slow to counteract such practices."

The distinction between innovative and enterprising operations and outright illegal activities remained fuzzy. As the health of the productive companies deteriorated in 1981, the grupos pumped yet more money into their failing businesses. By December 1982, the top five banks had loaned more than 26 percent of their credit to "related parties". Soon, the logic of the economic group -- that the bank acts to finance the growth of real activities -- was turned on its head."

3. Re-regulation of the Banking Sector

The SBIF take-over of selected banks marked the end of the liberalization experiment. The SBIF intervened in eight financial institutions. The Banco de Santiago and the Banco de Chile, the first and second most important commercial banking institutions in Chile, were included in this take over. The government named outside inspectors for several banks and chose new interventors of the intervened banks, who were mostly former Central Bank, SBIF, or Banco del

"Interviews, Juan Andres Fontaine, Leon Dobry, Guillermo Ramirez, Juan Carlos Mendez; see also Manuel Delano and Hugo Translavina, La Herencia de los Chicago Boys. La Ediciones del Ornitorrinco, Santiago, 1989, p. 113.

"SBIF, Informacion Financiera, February, 1983. See Table 10, Concentration in the Banking Sector.
Estado functionaries. It then solicited foreign banks to purchase the state-run banks. By the end of 1983, the net losses of the intervened banks amounted to 250 percent of their capital and reserves.⁵⁰

While the symptoms of the banking crisis were economic, the real battleground was political. The Chilean monetary authorities did not initially plan to financially shore up the entire banking sector: Five days before the interventions, Luders had announced to the banking community that the state would share the burden of refinancing banks, offering to purchase credits of failing banks at 70 percent of their face value. International lenders to the intervened banks would also be reimbursed the 70 percent.⁵¹

Domestic depositors agreed to these conditions and sold their credits at the discount. Foreign creditors, however, refused Luders' demands. Superintendencia head Mauricio Larrain wrote:

"Foreign creditors exerted severe pressure to get full compensation, in several cases conditioning their foreign trade credit lines and participation in possible external debt rescheduling to full repayment."⁵²


⁵¹According to the new economic team, the costs of absorbing the losses of the accumulated debt was unimaginable. Interviews, Claudio Skarmeta, Guillermo Ramirez, SBIF functionaries. Personal correspondence.

⁵²Mauricio Larrain, "How the Debt Crisis was Handled", p. 14.
After three days, Luders reversed the declaration. The Central Bank would extend guarantees to all foreign liabilities within the overall restructuring of external debt. While contracting private foreign debt had given Chilean bankers a new flexibility to manage their affairs, these foreign commercial banks, unlike international lending agencies, were unwilling to forgive debt portfolios and take losses. 53

As in the Argentine experience, the choice of banks that fell under the state hatchet -- and the extent of state arbitration after the take-overs -- revealed the extent of political power and personalities exercised in financial market outcomes. According to official accounts, banks were officially intervened when they had lost more than 100 percent of their capital and liquidated when they had lost over three times of their capital. But because only sketchy data were available, other criteria were used. A member of the SBIF recalled that determinations were based on the standing of the bank owner (the controlling shareholder) in society, the bank’s history, and its ties to international banking centers. 54

53Foreign banks argued that they had granted loans on the basis of official SBIF reports about the solvency of banks. These banks did grant special terms for restructuring their loans. Correspondence, Rolf Luders; Interview, Carlos Olivos.

54Interview, Claudio Skarmeta. See also, Rolf Luders, "La razon de ser".
According to other accounts, more banks were intervened in order to create the image of a generalized problem, thus averting cases of particular bank infractions. Ultimately, political criteria do have economic relevance in the service of banking; the credibility of a lending source may determine its future profitability. Nevertheless, the state made explicit, political decisions concerning economic allocation issues.\(^55\)

Who was hurt by the interventions? Politically, the object of the government crack-down was the *grupo*.\(^56\)

However, a static economic accounting of concentration of loan portfolios in affiliated companies does not itself explain why some banks were intervened and others were not. The amount of "related loans" of the intervened banks fluctuated between 12 percent and 45.8 percent of total loan portfolios.\(^57\)


\(^{56}\)*Que Pasa?*, 15 March, 1983; Interviews, Alvaro Bardon, Pablo Baraona, Juan Carlos Mendez. Finance Minister Luders became one such offering. He was forced to resign soon after the interventions. Luders was accused of "conflict of interest" due to his commanding position on the Board of Directors of Javier Vial’s economic group. Many opposed Luders’s appointment as Finance Minister, believing that, due to his *grupo* connections, he would not orchestrate an intervention. Intervention of more than the few failing banks also might have reflected an attempt to appease military anger over the economic group phenomenon.

\(^{57}\)These data are published in the SBIF, *Informacion financiera*, monthly issues. See Table 10.
The two largest private banks, Banco de Santiago and Banco de Chile, were too important to liquidate. They were instead "rehabilitated". The Banco de Santiago was taken over by a former General Manager of the Banco del Estado. At that time, 50 percent of the assets of the Banco de Santiago were with the Cruzat grupo. Out of 180 firms listed as creditors, only 20 were "chimney", or producing, companies. The rest were "shell", either investment companies or merely fictitious. After suspending operations for one day, the new Intendente simply started up the bank under state management, with few personnel changes.\textsuperscript{58}

The Cruzat grupo was liquidated; under state management, the bank sold off the those companies which the grupo had indebted to the bank as collateral. Manuel Cruzat, having lost ownership of the Banco de Santiago, negotiated successfully with the government to keep some of his companies. Both of the leading banks were saved, however, and their depositors, reimbursed. "The Banco de Chile was too large, and too venerable an institution to let go, or even be sold to foreigners. As for the Banco de Santiago, it had too many ties to Citibank. The Central Bank simply had to nurse it through."\textsuperscript{59}

Other banks were treated differently. The Banco Unido

\textsuperscript{58}Interviews, Julio Barriga. See also, Mauricio Larrain, "How the Debt was Handled," p. 14.

\textsuperscript{59}Interviews, Javier Barriga (Intendente), Julio Salas, and Anonymous.
de Fomento, with few loans outstanding to affiliated companies, was experiencing temporary liquidity difficulties. The bank was intervened and subsequently liquidated. In this case, the Central Bank is said to have received political pressure from the bank's foreign creditors to "do something". On the other hand, the Banco Edwards and the Banco de Credito E Inversiones were not intervened, largely because they still had a positive capital flow; in part because their portfolio of "related" loans was small. An SBIF official also explained that the family Edwards had a "long tradition of good banking" behavior and the Banco Credito's owner, Jorge Yarur, "was a gentleman".66

[Insert Table 5.5: Concentration in Banking Sector]

At the time of the 1983 massive state interventions, Banco Nacional records showed a bank with a highly leveraged portfolio and high percentages of loans to related companies. The bank was not taken over, nor did its owner, Francisco Javier Errazuriz, receive any penalties. Errazuriz was a public figure, and an old school classmate with several high military commanders. His investments in forestry were important for the state's targeted export plans. In the bank interventions, some banks won, others lost. A former Banco de Santiago manager opined: "We

66Interviews, anonymous SBIF functionary, Pablo Baraona.
thought that our bank had sufficient international contacts to negotiate our own capital increases. But people had to find martyrs, to make statements."

Over the next two years, the Central Bank exercised a freedom from particular banker interests in intervening in -- and effectively subsidizing -- bank operations. Its aim was essentially to keep those banks, that it chose to save, afloat. Under the leadership of SBIF head Hernan Buchi, three strategies were devised: debt-relief programs for borrowers, Central Bank purchases of loans, and recapitalization and sale of banks. Debt "reprogramming" granted lines of credit at low, or subsidized, interest rates to indebted companies to roll over their more "expensive" loans. These debt reschedulings provided in addition generous repayment plans. For one year, indebted firms could operate as though they had no debt.

The state development agency, CORFO, also moved to

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"Interview, Juan Andres Fontaine. It is questionable whether, given the tight international financial conditions in 1983, such an operation would have been feasible. For data on bank portfolios, see SBIF, Informacion financiera, February, 1983, and Table 10. Errazuriz's bank was intervened in 1987, however.

"Already before the massive interventions, the Central Bank had offered banks increased accounting flexibility in recording losses, and in August 1982, it purchased selected non-performing loans. Banks were given an indefinite time to buy back the letters (up to 100 years). There was no real net transfer of resources; banks were given time to repay. They could not distribute profits before repayment. For details, see "Avances en la superacion de la crisis financiera," SBIF, Informacion Financiera. December 1983, Volume 1, pp. 5-14."
inject new resources into the system, establishing new credit lines to priority sectors. Schemes to refinance mortgage and consumer loans kept other sectors from collapsing. The Central Bank program of the "preferential dollar" helped borrowers to pay back international loans. Debtors paid the debts to banks at the official rate and received a Central Bank cash subsidy.63

In February, 1984, the Central Bank, seeking to restore bank solvency, began to buy risky loans from those banks that had not been intervened. A few months later, the two rehabilitated banks, Banco de Santiago and Banco de Chile joined the program. The non-performing loans were taken off the bank books and replaced with low interest bearing bonds. Banks were required to use the income from operations to repay loans before distributing dividends. Chilean banks now became indebted over the medium term to the Chile state.

In early 1985, two years after the bank collapse, the government offered yet another initiative designed to infuse capital in the banking system without a declaration of state intervention. Banks under state management (in particular, the Banco de Santiago and Banco de Chile) offered new stock

63Eliminated in 1987, this program resulted in the largest drain to the Central Bank. In June 1984, the proportion of debt that could be rescheduled under earlier provisions was expanded, and in September, the dollar debts of medium borrowers was converted to Chilean currency. See Ricardo de Tezanos Pinto Domínguez and Arsenio Molina Alcalde, "Evolución Reciente de la Regulación Financiera", in Leon Cohen Delpiano, ed., La Revolución Financiera. 1989, pp. 48-77.
to existing shareholders and to the public. To facilitate these purchases (and guarantee its success), the Central Bank provided generous subsidies to small investors. The credit conditions for this *capitalismo popular* program were liberal: a 5 percent downpayment, zero percent interest rate (in real terms) and tax-free dividends. This recapitalization was completed by 1987.\footnote{Interview, Claudio Skarmeta. Dividends were expected to be low, given that banks had to use most of their profits to repay bad loans.}

In exchange for these generous subsidies, the SBIF demanded compliance from the banks in providing all information on bank activities. These data were essential to evaluate how loans could be repaid, but they also ensured that subsequent regulatory measures were followed. To improve information disclosure, banks were required to undertake more extensive bookkeeping, submitting several types of loans classifications according to risk of default. Stringent rules on bank-firm relationship were issued. Bank surveillance was increased. In 1986, the SBIF was given increased monitoring and enforcement powers. The SBIF was permitted to require a bank to recapitalize, should its capital base deteriorate.

The economic authorities also devised new instruments to promote savings and boost confidence in the credit
markets. Leasing companies, mutual funds, and stock brokerages were introduced. The private-run pension system, set up in May 1981 to replace the existing social security system, required employees to deposit twelve percent of their income with one of these private Pension Fund Administrators (AFP). Originally these agencies were set up as legally independent companies, and prior to 1983, the most important were controlled by the leading grupos. Two or three of the largest pension funds, which among several investment instruments acquired stock of privatized companies, were in turn increasingly controlled by large, multinational holding groups. By 1989, pension funds savings amounted to 60 percent of the domestic savings in Chile.  

D. Explaining Re-regulation in Crisis

The Central Bank maneuvers to revamp the financial sector displayed a poise and a purpose that confirmed the state’s credentials as financial arbiter. More striking than the overt exercise of state power, however, was the

65 A state guarantee on all bank deposits was granted until December 1984.

acquiescence from Chilean grupo leaders. The Central Bank was able to carry out these elaborate schemes in large part due to banker compliancy, which helped to stabilize markets. Although Chilean finance capitalists were well armed with a tradition of keen political deal-making, they nonetheless appeared to yield at every step to government pronouncements.

Bankers could well have challenged the legal propriety of the state liquidation of banks or the selection of officials to manage those banks which had been intervened. In Argentina, bankers actually initiated legal claims against the government (or persons in the administration). Between 1980 and 1982, bankers regarded the policies that Argentine state officials attempted to implement with suspicion; many were outright sabotaged. On the other hand, in the midst of experiencing a major social upheaval in Chile (the May 1983 "National Day of Protest" demonstrated a profound disapproval of the regime), the financial class refused to join the criticism of the Pinochet policies."

In retrospect, bankers had an interest in remaining docile. By all indications, the Central Bank and SBIF were making every effort to revive the country’s financial base, with its elaborated programs that disguised overt state

"For a description of the protests, see Ignacio Balbontín, Movilización social, control social de los conflictos y negociación política, Centro de Estudios del Desarrollo, Santiago, 1987."
subsidies. There was no need for bankers to resist. Yet this functional explanation for banker acquiescence, while descriptively useful, has little explanatory power. Central Bank policies did rejuvenate the banking sector; grupo leaders could not have foreseen this particular outcome, nor could they have been certain that, as individual capitalists, they would survive the massive state interventions.\(^68\)

A comparative study with the experience of Argentina suggests that Chile’s finance capitalists acquiesced to Central Bank directives largely because they faced no internal disputes, which could then become springboards for struggles with the government. They had few allegiances outside their banking practices to which to appeal, either in the press or in the Central Bank or SBIF agency. While Argentine bankers immediately began to complain about "preferential treatment", alternatively towards Interior or Buenos Aires banks, Chilean bankers had no such compelling issues to advance their own causes.

By 1983, Chilean bankers had no institutional venue to lobby for alternative strategies. The private banker lobby group, the Asociacion de Bancos e Instituciones Financieras, which had only recently become active under the leadership of grupo leader Javier Vial, was discredited. Since the two

leading bankers, Manuel Cruzat and Javier Vial had been identified as the culprits of the system, few private banking leaders from the heady days of the financial boom wielded credibility.69

Javier Vial, owner of the Banco de Chile and Banco Hipotecario de Chile, was one of the few people who contested the government actions. Vial is said to have threatened state monetary authorities that, if he and his grupo were taken over, the ensuing loss of confidence in the banking sector would force the government to fall. By this time, however, Vial had no "natural" allies in the banking community or in the military (as the Interior banks in Argentina). He was sent to jail after both his banks were intervened. The rest of the banking community watched and waited as state monetary authorities carried out their housecleaning.

In 1985, over two years after the bank crash, the banking sector was pronounced to be stable, operating under a "liberal" financial regime.70 Responsibility for the crisis was laid squarely on the "incestuous" industry links

69The Instituto Estudios Bancarios "Guillermo Subercaseaux", the low-profile research wing of the bank lobby, took the lead in publishing various studies and conferences, but conducted no public relations or lobbying on behalf of the grupos. Interviews, Maria Elena Ovalle, Julio Salas.

70See El Mercurio, February 17, 1985, on the occasion of Hernan Buchi's ascension to the post of Finance Minister.
to banks, although, all indications suggest that the culprit lay in poor supervision of financial institutions and the banks' high indebtedness rather than the grupo structure itself. Nevertheless, the campaign against the grupo was successful. As a result of this drive, Chile's conglomerates were no longer organized around banks; industries were sold off, and the structures substantially reconstituted. "The grupo leaders were made out as the bad guys - the greedy yuppies - responsible for the mess". Once these individuals were ousted, the "free market" experiment could resume.\(^1\)

This chapter has shown that the Chilean financial policy was, like its Argentine counterpart, forced to re-regulate after a period of liberalization. The elaborate Chilean Central Bank regulatory mechanisms permitted the state to prop up certain banks: The capitalismo popular stock offering was, in effect, dispensing government funds to the particular sectors of the banking community, as were the Central Bank purchases of non-performing loans. The pension system similarly acted to force savings.

\(^1\)Interview, Julio Salas, Enrique Sequel. Numerous observers pronounced the grupos as the root of Chile's problems. Fernando Dhase's 1979 study Mapa de la Extrema Riqueza, condemning Chile's economic groups had a profound impact. Even government officials, who opposed his perspective, accepted the analysis and conclusions. Interviews, Sergio de la Cuadra, Juan Andres Fontaine. See also Oscar Munoz, El colapso de un experimento economico y sus efectos politicos, Coleccion Estudios CIEPLAN No. 16, Santiago, June, 1985.
This kind of re-regulation, however, was possible in large part because Chile's bankers were not divided among themselves over policy and political allegiances. The relatively homogenous grupos economicos had few alternatives and little reason to question government leaders' policy choices.

In both countries, bank liberalizations initially led to a greater reliance on the market mechanism. The banking policy reforms helped to reset these boundaries. State monetary authorities relinquished control over economic benefits, offering the private sector more opportunities for financial gain. In turn, through access to domestic and international sources of credit, the Argentine and Chilean banking sectors gained economic muscle and political influence. The balance between "public" and "private" was rearranged, if only conditionally.\(^2\)

During the reform process, Chilean state authorities were able to establish -- and maintain -- confidence and credibility in the markets, a trust which was tested during the moment of the bank failures. Such an understanding was possible due to consensus within the domestic banking

\(^2\)Note, however, that power relations between state and civil society need not satisfy some fixed equation; a loss of control by the state is not necessarily a gain for the banker. In fact, the Argentine banker soon lost its political and economic clout. See Alfred Stepan, "State Power and the Strength of Civil Society in the Southern Cone of Latin America", in Peter B. Evans, Dietrich Rueschemeyer, Theda Skocpol, eds., Bringing the State Back In, Cambridge University Press, Cambridge. 1985, pp. 317-343.
sector. The Argentine state, on the other hand, was unable to negotiate these new "spaces" for state oversight and societal responsibility due to increasing splits and infighting within financial circles.
CHAPTER VI.

THE COMPARATIVE POLITICS OF FINANCIAL LIBERALIZATION:
POLICY OUTCOMES AND NEW DIRECTIONS

This dissertation reexamines a moment in the 1970's when Chile and Argentina both took initiatives to liberalize financial markets, under similar regime types and with similar histories of state-led lending and borrowing arrangements. It suggests that the similarities in these institutions and practices of bank regulation explain why, initially, the two countries witnessed strikingly similar policy developments under free market experiments: As financial market regulations were lifted, an explosion of speculative lending and borrowing ensued, and it was not long before the domestic banking systems in both countries collapsed. The variations in subsequent financial re-regulation in the early 1980's then reveal why, after a few years, banking arrangements in Chile and Argentina looked quite distinct from either the era of state-controlled credit schemes or the free-market model.

This dissertation points to a recurrent cycle in financial policy in order to identify the point of policy divergence. After periods of deregulation, most countries are forced to follow a phase of re-regulation. This pattern
emerges in most cases, from the 1980's savings and loan deregulation in the United States to the post Cold War Eastern European financial liberalizations. Focusing on re-regulation, or the period of retrenchment, helps to identify the moment that financial policies begin to follow different paths.

What explains these variations? The foregoing chapters have argued that the patterns of bank re-regulation were shaped largely by the capacity of key financial actors in state and society to form coalitions with their peers. In Argentina, historical cleavages among bankers helped to establish which bankers would be adversaries in the new competitive environment. These splits then served to undermine economic policy, particularly at a moment of adversity and crisis. The private sector conflicts obstructed the public tasks of implementing regulatory policy and monitoring bank activities. In Chile, with no previous experience of regional splits, the organization of the financial community remained cohesive, contributed in part by its smaller numbers. Chilean bankers permitted state leaders to gradually rebuild financial markets.

Both structure and choice matter in shaping these outcomes. Once the reforms were under way, elite strategic choices influenced outcomes. A new set of market actors with new interests, and using new market instruments, emerged in response to the changed economic environment.
Moreover, the liberalization policy itself substantially altered the effects of financial structures and economic relationships on policy outcome.

The liberalization reforms also reopened deep-seated historical debates in these two Southern Cone countries. State credit policies, borrowing and lending practices, and relationships between bankers and the state, established during the previous one hundred-plus years of banking, created the institutional framework for the subsequent radical financial policy shift. In the 1970’s, these long-standing arrangements and attitudes would not be recast simply as a result of a few liberal policy directives.

A. The Comparative Account: State Policy and Banker Organization

Indeed, similarities and differences in financial organization and state policies of these two Southern Cone countries had an important historical dimension. In both Argentina and Chile, financial intermediation emerged as the export industry grew in the early 19th century. Foreign export companies contracted local merchant banks to handle the financing of the grain and beef industries in Argentina, and of copper and nitrate mining in Chile. Gradually, the state apparatus in each country acquired a pivotal role in organizing investment activities and distributing export revenues. Already in 1850, the Chilean government offered
preferential financial treatment to encourage mining and landowning interests, and Argentine government agencies solicited and managed foreign investment and infrastructure development.

Early in Argentina's history, conflicts over political power and economic autonomy emerged between the Capital of Buenos Aires and the Provinces. Many of these struggles centered on issues of credit and rights of regional monetary creation. Although, by 1900, most of the battles over sovereignty had been settled in favor of the central government in Buenos Aires, splits between regional and Capital bankers over credit and money creation persisted. The rifts between capital and interior became firmly entrenched. In Chile, most bankers were based in the capital region (the cities of Santiago and neighboring Valparaiso) and experienced little of these regional cleavages.

By 1900, the countries were run under highly centralized political systems, with the federal capitals of Buenos Aires and Santiago directing national policy. The monetary policies of the Central Banks responded to the financing needs of the governments, while the state banks, the Banco de la Nacion de Argentina and the Banco del Estado de Chile, became powerful distributors of public credit.¹

¹In Argentina, the bank supervisory agency (Superintendencia) was part of the Central Bank, while in Chile, it was created as a separate institution.
International sources of credit, however, were important for the economic development of both countries. Chile and Argentina elites remained generally friendly to foreign investors, since they offered capital, national resource development, and public services. The domestic banking profession became associated with the socially correct, internationally-oriented, landed elite. In turn, decisions on loan transactions were not necessarily based on credit worthiness, but on social ties and land ownership.² British, German, Dutch, Spanish, and, later, United States investors competed particularly vigorously for Argentina’s credit markets.³

Suspicion of foreigners, however, was a heritage of all colonial regimes. Latin American borrowers saw foreign financial agencies earning easy profits by selling debentures in overseas markets and subsequently lending the proceeds to them at substantially higher rates. International credit crunches also created havoc in Latin American economies. In 1874, in 1880, and again in 1889, foreign credit was withdrawn as international liquidity temporarily dried up. Hostility toward foreign economic activity grew,

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²This aspect of banking is not unique to Argentina or Latin America; see Anthony Sampson, The Moneylenders: Bankers and a World in Turmoil, Viking Press, NY, 1982 for an entertaining account of the sociology of bank lending.

³In 1927 Argentina was the seventh largest economy in the world; until 1934, the country was the largest single recipient of British overseas investment.
then, not only in response to the huge foreign profits from railroad and public utility investments and the (mostly British-owned) speculative and money-lending agencies, but also because of the sudden withdrawal of this credit.¹

Public, national financing offered an alternative source of funds for domestic borrowers. It acted as a safeguard against the vagaries of foreign credit. By collecting and managing these foreign capital, governments could reduce the cyclical effects of the market. Already by 1900, the Argentine government was soliciting and guaranteeing foreign loans; in fact, foreign agencies also preferred to invest in government bonds rather than lend directly to private customers.

Chilean and Argentine governments increasingly controlled, regulated, or restricted foreign operations after World War I. As the state selectively allocated these funds, it established political coalitions with newly-emerging local industrial groups. These political deals helped to produce a belief that government, rather than capital itself, was responsible for financing economic

¹In Argentina, in particular, early and loud voices objected to losses of national sovereignty as foreign governments repeatedly implemented force to help their own investors. Chile’s President Jose Manuel Balmaceda (1886–1891) was one of the first Latin American leaders to raise the specter of nationalization, suggesting that the government take over Chile’s nitrate deposits.
development.  

From 1930 on, the participation of the state in allocating credit grew secularly in both Chile and Argentina. In Chile, the industrial development agency, CORFO, directed the flow of credit to industry. Using revenues from Chile's copper and nitrate mining activities, CORFO provided coherence and congruity to state credit policies in the midst of shifting political coalitions and economic priorities. Argentina's General Juan Peron, elected President in 1946, created a powerful industrial bank and centralized the country's bank deposits. Despite Peron's overthrow in 1955, the Argentine state continued with similar credit policies. In both countries, funds were distributed by state agencies through increasingly elaborate credit allocation schemes.  

Private bankers in these countries became essentially collection agents for the Central Banks. While private sector groups in both Chile and Argentina exercised substan-

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*While by no means the single prevailing economic ideology, the "statist" vision was an important foundation for state credit allocation, banker practices, and business strategy. While the distrust for anything foreign became an effective political tool, the acquisition of anything foreign became a practical device for getting ahead. See Peter H. Smith, *Politics and Beef in Argentina*, Columbia University Press, New York, 1969, p. 26-31, for discussion of the "internal dynamic to anti-imperialism" in that country.

*After Peron's ouster in 1955, the bank system was revamped, but the level of state control (through the powerful state bank lending and borrowing and the Central Bank operations) remained high.*
tial influence -- at times, a veto power -- over the recipients of state-subsidized credit schemes, ultimately state agencies decided which regions or industries would receive credit. Capital markets practically did not exist, and the only other source of credit was supplied by the informal market. Government-sponsored and informal bank loans were short term (one to three months), and variable interest rates (rates which moved with the changes in price levels) were unknown.

Studies emerging in the 1950's from the new field of development economics supported this policy evolution. Out of the devastating economic shortages of the Depression and the war years emerged the argument that the market economy was not self-propelling. A United Nations-sponsored research institute, the Economic Commission on Latin America, argued that the patterns of trade between developing countries and northern industrialized Europe had created structural limitations to economic growth for Latin America. To avoid a dependency on imports, developing countries should use policy tools such as taxation, tariffs and subsidies to encourage the development of domestic industry. In finance, the state was encouraged to promote savings and borrowing. Direct state subsidies -- in the form of credit -- could stimulate desirable investments, lifting developing
countries into self-sustained growth.7

Argentina's financial system was significantly larger than Chile's. In 1975, Argentina listed 116 commercial banks (17 foreign), 80 financial companies, and 424 credit companies. On the eve of its financial reform, the Chilean system had 20 commercial banks, and 21 savings and loan institutions. (During the Allende administration four of the five foreign banks had left.) The smaller size of Chile's banking community contributed to its cohesiveness in the face of the dramatic liberalizing reforms in the sector.

The traditional method of financing in Chile, which evolved from the grupo economico structure, also effectively narrowed the base of financial actors in that country. The overlapping "circles" of inter-company ownership and management meant that several extended families owned the majority of the banking system. These inter-company banks provided important services to their producing partners, in particular, supplying cheap financing, both from the bank itself and through government preferential credit programs. The bank's direct returns of investments were, then, often less important than the access these banks offered to subsidized loans and services.

In this research, the concept of the structure of

7This "structuralist" school was dominant within the development economics group. See Raul Prebisch, The Economic Development of Latin America and Its Principle Problems, United Nations, New York, 1950.
financing is distinguished from the organization, or nature of alliances, among bankers. For, in Argentina, similar large economic networks, or grupos económicos, had made inroads by the 1960’s. The financing arrangements that grupos offered made sense in the economic environments of both Chile and Argentina.

While the structure of financing was similar in Chile and Argentina, the organization (or relationships) among financial actors was not. Although Argentine regional bankers did diversify and grow during the country’s period of economic expansion, they remained essentially isolated from the traditional Buenos Aires-based bankers and their conglomerates. The bank lobby organizations which emerged in Argentina reflected this split; ADEBA and ABRA had Capital constituencies, while ABIRA represented the Interior banker interests.

By the 1960’s, neither the Chilean nor Argentine economies had "taken off" under state-led programs. Economists pointed to the highly regulated state-led policies of credit allocation as the primary culprits. Levels of financial activity were particularly low. In Argentina, recorded bank deposits as a percentage of GDP had dropped from 21 percent in 1955 to seven percent in 1976. Moreover, the state was a net demander of these savings, and among the top ten banks, official banks made up 80 percent participation. In 1968, the Chilean state demanded 75
percent of total credit. Monetization levels (currency in circulation as a percentage of a country's economic activity) in Chile remained below 10 percent of GNP. Argentina's levels reached a low of 11 percent in 1977.  

The 1960's also found both the Chilean and Argentine political systems struggling to cope with rising discontent over economic stagnation and popular demands for change. In Chile, increased political mobilization and unstable alliances kept governments deadlocked over policy reforms. In Argentina, Peronist populism confronted entrenched economic and political interests, obstructing political coalitions and producing repeated military interventions. In both countries, the major organized social groups, classes and parties became locked in conflict, often among themselves. No one sector was able to establish stable, enduring alliances or an institutionalized system of governance.

Economic liberalization presented an alternative to groups which saw their countries mired in this stagnation and buried under state controls. The emergence -- and dissemination -- of a new idea over how to promote economic development expressed the discontent of economic elites with the system. The neo-monetarist vision diagnosed the problem

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"G. F. Macroeconomia S.A., "Informe: Sistema Financiero Argentino", December 1985; see also, Latin American Economic Review, V. #23, 17 June, 1977. For comparison, US monetization levels in the 1960's were over 50 percent."
of low economic productivity as a result of excess state regulation and advocated pulling the state out of all sectors of the economy. Espoused by IMF officials and Latin American economists alike, the well-developed theory made it more difficult to envision and present appropriate alternatives, such as an improvement of the existing system. The recent experiences of state-led programs were understood as political and economic failures. What better argument for a new policy than the collapse of its perceived antithesis?

In a further coincidence of history, Argentina and Chile were offered increased access to international financial loans at this conjuncture. For the previous 40 years, foreign capital had entered the countries only sporadically, and largely through multinational corporations. In the early 1970’s, this money was suddenly available due to excess liquidity in the world credit markets. As Anthony Sampson has written:

In the early years...the raising of international loans was a sedate and gentlemanly business...But as it became more lucrative and competitive, the loan officers of the banks began--around 1970--to solicit business...Some of the banks were no longer acting simply as intermediaries between a surplus and shortage of funds: they were now actively selling loans."

Argentina and Chile became the recipients of these sales

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pitches from U.S. and European banks.¹⁰

In the 1970’s, the two countries each increased the size and scope of state lending and borrowing programs. In Chile, Salvador Allende was elected president of Chile under a coalition of leftist parties, and the country’s banking sector was nationalized. By 1973, 95 percent of banking and finance was run by the state. Such policies shattered the remaining working agreements between the state, political parties and business groups. Although the backdrop of Argentine politics was different, Juan Peron’s third electoral victory in November 1973 led to the nationalization of Argentine banks and the virtual takeover of credit allocation to industries and consumers. When Peron died in July 1974, and his second wife assumed the presidency, a new economic crisis developed, guerrilla warfare increased, and the fragile Peronist political coalition disintegrated.

In September 1973, the Chilean armed forces stormed the Presidential palace and formed a provisional military junta. In March 1976, two and a half years later, Argentine army tanks entered Buenos Aires and assumed political control of the state. In both countries, the militaries were willing executors of a forceful policy - and regime - change.¹¹

¹⁰Argentina received a greater percentage of international loans than Chile, but its overall position in the international economy did not differ significantly.

¹¹Political scientists saw similarities in these military regimes and labeled them as "bureaucratic-authoritarian". Later works questioned whether Chile
These military organizations received broad-based support to carry out sweeping reforms after the political instability and economic chaos. Most political parties, labor unions, and business associations had encouraged or, at least, stepped aside to let the armed forces intervene. As the new government economic teams in Chile and Argentina set out to engineer financial reforms, there was little dissent over a policy to release the banking system from state control. The moment of policy implementation marks the consolidation of an alliance between military and major capitalist groups.12

The financial liberalization measures were implemented in Chile in April 1975, and in Argentina in June 1977. After 1978, both countries also followed a similar exchange rate policy, which in theory, kept the Central Bank from meddling in foreign exchange dealings. The policy preannounced the path of the exchange rate to get prices in line with international levels, devaluing the currency


12 While some industrial sectors in Chile and Argentina did not embrace the new free-market state, many did not actively oppose financial liberalization, in part, because acting as good entrepreneurs, they transferred their operations from production to the business of importing and financial speculation, profiting from the new climate.
monthly at a diminishing rate. Accompanied by other free-market economic policies which dismantled regulations in trade, prices, and foreign investment, the bank reform was a blueprint law for letting the market determine the allocation of money. Banks moved to a fractional reserve system. They raised money and allocated credit to firms privately and offered customers new instruments such as longer term loans and indexed rates. New commercial banks were authorized; many emerged through mergers or conversions from the informal financial houses.\textsuperscript{13}

This spectacular change in both the level and nature of bank activity tested the institutional integrity of the Central Banks and Superintendencias. These policymaking and monitoring agencies were not prepared for their new "free-market" duties. They were given inadequate funds to carry out data collection, and many functionaries did not have proper training to carry out the new supervisory activities. Policymakers initially underestimated the need for regulation and supervision of the private banking sector. Within a few years, it was clear that Bank regulators were not penalizing (or even stopping) improper bank practices.

\textsuperscript{13}The number of commercial banks in Argentina rose from 119 in 1977, to 219 in 1979, while in Chile, the overall numbers were smaller, but the rise no less significant; from 21 commercial banks in 1974, to 38 banks in 1980. In Chile, the number of financieras jumped from 0 to 21 between 1974 and 1978, while in Argentina, numbers rose from 80 to 138 between 1976 and 1978. Financieras soon became converted to, or merged with, commercial banks, which reduced these figures in both countries.
After years of low risk and protected credit arrangements, both countries' financial sectors exploded with activity, growing rapidly. The currency overvaluation and high interest rates created a sharp rise in imports and massive capital inflows. Financial investors made easy money by playing with the predictable exchange markets. Nevertheless, the lack of convergence between expected and real values of the exchange rate created expectations of a devaluation. Both governments were forced to devalue their currency; Argentina, in the spring of 1981, after the bank collapse, and Chile, in mid-1982, in the midst of the bank sector breakdown.

There were, of course, variations between these two free-market programs. Foreign banks were welcomed in Chile; in 1982, almost one half of the commercial banks were foreign-owned. In Argentina, foreign bank branches were restricted in a range of activities, and their numbers did not rise so precipitously. On the other hand, capital flows

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"In Chile, credit as a percentage of GNP rose from below 10 percent to 18.4 in 1978, and x in 1981. Argentina, at the same starting point in 1976, reached 23 percent by 1980. Assets of the financial system (as a percentage of GNP) grew in Chile from 19.7 percent in 1970 to 69.2 percent in 1980; Argentina's figures are just as spectacular: 17.8 percent in 1970 to 48.9 percent in 1980. Superintendencia de Bancos e Instituciones, (SBIF), Informacion finacieras, Santiago, various issues; and R. Arriazu, A. M. Leone. R. H. Lopez Murphy. "Politicas Macroeconomicas y Endeudamiento Privado: Aspectos Empiricos", in Carlos Massad, Roberto Zahler, Deuda Interna y Estabilidad Financiera, Volume II: Estudios de casos, Grupo Editor Latinoamericano, Buenos Aires, 1988."
were freed in Argentina from the outset, while international capital controls were lifted in Chile only four years after the program was initiated, in mid-1979. Argentina’s elaborate system to reimburse banks for keeping high reserves and its policy of government guarantees were not officially available in Chile (although in practice, as banks were closed, Chilean public officials did reimburse depositors).

This dissertation has argued, however, that these kinds of policy differences appeared to "wash out" in the face of the systemic collapse of the banking systems in both countries. In order to explain the re-regulation of the financial system, neither differences in government guarantees nor the varied treatment of foreign bankers and capital flows explain much of the Argentine and Chilean banker responses.

8. Keys to Policy Divergence

The cohesion and make-up of the banking communities, however, did shape the nature of banker responses in Argentina and Chile and the subsequent financial reform policy outcomes. Splits within bankers in Argentina inhibited government policy re-regulation.
1. **Associations within the domestic banking community**

The cleavage between Argentine capital and interior bankers was generated from early nation-building struggles. These rivalries were cemented, stifled, and then reinforced by Argentine state credit policy. The political significance of this rift remained unappreciated until the country's financial opening in 1977.

Already in the early 1900's, most financial agents looked to government banking programs to secure financing in the face of increasing uncertainties in foreign credit markets. As the government became centralized in Buenos Aires, bankers in the capital region were favored. They received government-subsidized credits and expanded their business outward into the pampas. By 1940, Buenos Aires was the undisputed center of financing, and the competitive disputes between rural and urban banking groups appeared to have disappeared. Moreover, restrictions on bank lending based on sectors and geographical location carved out specific "turfs" for bankers, inhibiting open conflict. Regional bankers carried out profitable business in the growing industrial town of Cordoba, or the newly developed wine region of Mendoza, or the sugar industry in the Tucuman region. With each change in government leadership, from Peronist to military-elite back to reformed-Peronist, different sectors and regions received different levels of
support. The "big" monied classes -- the beef production, the wheat exports, the food and textile conglomerates -- continued to be based in the Buenos Aires province.

Capital and Interior bankers came into direct competition for the first time only during the 1977 liberalization drive. The new banking laws permitted free entry into the Buenos Aires market to all Argentine banks. The previously unaccredited financiera directors could now easily register as banks. Regional bankers could now compete in the Buenos Aires market; in 1977, bankers from the Provinces set up their own banking services in the Buenos Aires capital.

The animosities emerged generally between established banking groups and these newer entrants. They were, essentially, struggles over turf. The Buenos Aires bankers recreated an historical conflict out of fears that the Interior bankers would take over their business. As Chapter Four argues, data on bank lending in this period is unreliable, helping little to assess the financial basis for this fear. While bankers might have paid close attention to monthly statistics on bank "ratings" (deposit levels), the preponderance of illegal activities and the absence of any long term lending meant that bank assets rose and fell according to one-time speculative deals, rather than according to particular financial strategies. Clearly, all banks had opportunities for profit making, although in most cases, bankers could not be certain of who was winning, and
who was losing.

The hostility was, however, based on perceived loss of markets, and by a change in the rules of the game toward greater competition, which traditional bankers were not prepared to accept. The high-profile practices of the new bankers threatened the Buenos Aires bankers: This elite group believed that, by drafting the original bank legislation, it had won the exclusive rights to the benefits of the economic project. From this policy experience as well as from their historical dominance over the market, these bankers claimed a special alliance with the reform policy-makers. Recriminations were voiced in the press against the "upstart" banker practices, although the traditional Buenos Aires bankers -- everyone -- was playing according to the same frenzied rules.

The Argentine Central Bank became mired in internecine conflicts fed by the disputes within the banking sector. The two rival groups of Argentine private bankers strove to take advantage of the sudden changes within the Central Bank. Traditional bankers had long ties with Central Bank functionaries. Other Central Bankers, younger of foreign-educated, were open to the demands of the Interior banks.

Argentine military leaders were also drawn in the conflicts. Factions within the Argentine armed forces forged competing alliances with the two rival bank groups. As a group, the Navy tended to ally with Capital banks,
while the Army supported Interior and cooperative banks. Already early in the policy, these rival coalitions clashed when the Navy commander "persuaded" state economic leaders to help out "military-favored" banks when they made a particularly bad loan decision. Only at the moment of the bank re-regulation attempts (and because banks split up into competing camps) did the interference and meddling of the armed forces became a critical political factor.

In turn, differences among bankers became politically significant only after the liberalization policies began to fail. In March 1980, when several leading (Provincial) banks were forced to declare bankruptcy, and the Argentine Central Bank intervened, imposing additional regulatory restrictions, all the bank factions turned and attacked the Central Bank. The state (or parts of the state -- the Central Bank and Finance Ministry) now became the center of contention for the feuding banking groups, even though the regulations were necessary and even predictable in light of the collapse of the banking system. The military, rumored to have meddled in bank affairs over the course of the policy, was also unable to distance itself from the crisis.

The events surrounding the bank collapses are key moments in understanding the problématique of re-regulation. In Chile, the state intervened just as overtly as in Argentina -- in one day in January 1983, 70 percent of the banking sector fell under state control. Its economy
suffered even more: While Argentina's GNP dropped 11 percent between 1980-1982; in Chile, between 1981 and 1983, GNP dropped 15 percent. The same initial confusion and lack of confidence over the new regulatory situation prevailed among Chilean bankers. Moreover, as in Argentina, initial state decisions on which banks to liquidate were based on personal and political considerations.

These same conditions -- a collapsing economy and government partiality -- created little controversy in Chile, unlike in Argentina. Over the course of the policy, the Chilean banking community had faced few internal disputes. Historically, banking had been centered in the Santiago-Valparaiso nexus and run by a small group of elites. Moreover, many of the risk-adverse, traditional bank managers, who might have agitated against the new bankers, had already been ousted from bank leadership in Chile's bank nationalizations under Allende. Finally, when Chilean's development corporation, CORFO, privatized the banks in 1975, few persons (or firms) had the capital to outright acquire these financial institutions. Groups who favored the "free-market" experiment were offered the option to purchase these banks on credit. These players took a commanding position in the new marketplace.

Reform of Chilean monetary institutions was consequently more effective. With fewer splits within the banking community, there were fewer issues and "special
favors" for the Central Bank to attend to. Potential struggles within the Chilean Central Bank over the new economic pie were resolved quickly. At the outset of the policy shift, the new Chilean economic team fired most of the Central Bank upper level functionaries. New officials implemented policies relatively unfettered. These dismissals were also widespread in the Finance and Economic Ministries. In Argentina, meanwhile, the "old guard" had remained; if not in management positions, then in the woodwork of the Central Bank.

A conflict between old and new Chilean banker never recast itself into competing political coalitions, as in Argentina. When banks began to fail, there were few culprits -- no distinct group of bankers -- on which to assign blame. The financial crisis appeared to break out "within the family". There was a sense among Chilean bankers that they were "all in this together".  

This comparative account suggests that similar policy shifts redistributed economic power within financial sectors differently, and thus, over time, shaped political coalitions differently. State monetary authorities in both

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15 If any split emerged in the Chilean banking community, it was between managers and bank owners. Managers did not approve of the risky portfolios of their own bosses; while managers could never win out in a conflict with the owners, they did, however, unwillingly provide facts about their bank operations to the authorities. In this way, bankers helped the Superintendencia in its efforts to monitor financial practices.
Argentina and Chile openly intervened in the operations of the banks. The actions were greeted very differently by the banking groups in the two countries due to the internal relationship among bankers. The Chilean government successfully restructured the financial sector through a slow process of re-regulation; offering more generous terms to their bankers than in Argentina: buying up bad loans, and extending new, low-interest loans, but also putting some bankers in jail and reorganizing selected banks -- using new policy instruments to shore up the coalitions of support, which had briefly been questioned. Argentina's Central Bank, distrusted and attacked from all sides, resolved the acrimonious confrontation by effectively nationalizing the banking sector. The two countries then started down substantially different policy paths.

2. Cleavages and Policy Outcome

Confrontations between the Buenos Aires and the regional banking communities in Argentina hindered financial policymaking and contributed to its ultimate reversal. An argument that identifies private sector factionalism and cohesion to explain a policy outcome also challenges the conventional views of how capital relations are constituted -- that is, how creditors and borrowers eventually deal with each other.
Dominant explanations of the operation of financial systems have actors responding largely to the nature of the economic problems and economic drives. Individuals are viewed as rational actors who compete for power or resources. Indeed, the competing marxist perspective also view interests as logically deduced from market positions.

In our cases, it was not the structures of banking and lending practices alone that created the policy difference, but rather, the way in which actors perceived their role within these institutions. While interests and organizations of groups do explain banking arrangements, left unexplored are questions of how these interests are identified and formed in different countries and under different conditions.

How, then, can splits within a banking community influence state policymaking? There are many good reasons for thinking that cleavages in a sector may lead to the breakdown of state-led policies. It is not a point well explored in the literature; in fact, in some respects, it is counter intuitive. If a sector is fraught with internal strife and dissension, the sector might well be less able to undermine or reverse state policy. Yet, under capitalist systems, public policies often do work best when the state can count on an industry association or leading private sector actors to help administer the particular policy. Such cooperation is harder to elicit when factions within
the sector are fighting amongst themselves.

The process of deregulation is not sectorally or politically "neutral", as the free market ideology asserts. In the liberalization drives of the 1970's, Argentine and Chilean leaders gave private sector actors a large and unsupervised role in financial arrangements -- to shift the boundaries between state responsibility and societal activity. Their likely rationale was that, with the private sector responsible for economic growth, political fights over performance and distribution could be transferred away from the state to another, non-political, arena.

A public policy whose foundation lay in deregulation, then required the cooperation of the relevant private sectors. The Chilean and Argentine state and leading capital groups needed to forge new alliances (both with and among each other) over the new rules of the game. If the sector is split by cleavages, however, the state and its policies quickly become another pole of contention for the rival sectors, blocking these working agreements. Competing groups, who had turned to different parts of the state for advantage or protection, more readily blamed the state for adverse outcomes.

Thus disagreements among bankers -- splits over policy, or competition over social status -- help to understand the puzzle of breakdown in state policy. State officials are often not knowledgeable enough to work out the details of
policy implementation; they need private sector actors to help administer the policy. When groups are internally divided, this cooperation is harder for the state to command.\textsuperscript{16}

For the case of finance, such policy deadlocks can become even more pronounced. The practice of money management produces inherent conflicts between individual and collective capitalist rationality. The individual financial intermediary, or bank, is apprised of a whole range of depositor and creditor positions. As a custodian of other people's money, it tends to undertake risky lending to bring in high yields. Banks also operate on the presumption that any adverse outcomes and losses will have to be covered by state monetary authorities. Such activity, understandably, tends to destabilize the financial system. As a collective, however, banks seek close state regulation of their business to generate confidence in the stability of markets and to ensure the smooth running of the system. Thus, splits within a banking sector will undermine this objective of stability which collective actors seek.

Lastly, the sector, or groups, must be important contributors or recipients of the policy in order for their intra-sectoral coherence or cleavage to matter. Bankers were clearly key to the success of the financial

\textsuperscript{16}This may be the case even in instances of state-led policies.
liberalization in Argentina and Chile. They had the potential resources to withhold investment (a "capital strike") and to sabotage state policy.

Does the regime type matter? Are military-authoritarian governments more prone to the effects of cleavages and coalitions in the private sector than elected governments? The impact of private sector cleavages is tested at a moment in which an authoritarian state is called on to regulate the banking sector. From a comparative view, however, it appears as though competitive regimes are subject to this same mechanism, if not more so, as the cases of the United States oil policy and French socialist policy suggest. Whether under authoritarian or competitive regimes, the level of analysis that best captures how financial policy deregulation evolves is not a strong state, but cohesive state-private sector pacts. These coalitions are more easily secured, the argument goes, when the private sector remains undivided, or cohesive.

A comparative study of the effect of private sector splits on policy outcome also highlights the limits of the weak state-strong state dichotomy. The case of Uruguay, which also underwent similar banking reforms under military rule in the 1970's, suggests that even an historically

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17See Peter Hall, "Pressure Groups and Pluralist Politics", in Peter Hall, et al., (eds.) Developments in French Politics, Macmillan, 1990 for the French case; and Debora Spar and Raymond Vernon.
strong state may become riddled with internal disputes and splits. Disagreements within the financial sector over the direction of exchange rate policy contributed to the deterioration of re-regulation attempts in that country.16

C. Policy Conclusions

Both Argentina and Chile are particularly interesting cases for a study of the politics of financial reform. In 1992, these countries represent two of the leading deregulation and privatization experiments. Yet, fifteen years earlier, both countries opened up financial arrangements to free market practices, with less than intuitive results. What are the lessons from those experiments, both for predicting Argentina’s fickle policy course, and for better understanding the politics of banking reform in middle-income countries?

1. The Importance of Regulation

The first message is the importance of financial re-regulation under situations of market opening. The bank

liberalizations in Argentina and Chile set off a series of economic reactions. As Hyman Minsky's financial crisis theory accurately recounts, the high interest rates and overvalued peso brought foreign capital inflows into the country, starting overall credit expansion. The system, however, became "fragile", as assets became increasingly risky. Asset-holders took out more credit to keep themselves afloat. In Chile, in particular, grupos economicos borrowed increasingly from their own banks -- from within the system. At some point, banks could no longer pay on maturing loans, and the Central Bank took over the private banks, reversing the free-market experiment.¹⁹

The financial liberalization also encouraged high-risk bank practices and operations that were patently illegal. In both Chile and Argentina, banks found ways to carry out three-way (or triangle) transactions and fabricated paper industries to lend money to their own companies. Many bankers speculated on foreign exchange markets with funds that were not theirs to risk. State regulators were not prepared to handle such behavior. They were unable to monitor the percentage of loans outstanding to companies or clients; nobody even checked the existence of these loans, or of the companies, for that matter.

The international practices of the Bank of Commerce and Credit International (BCCI) that were uncovered in 1991 are not unfamiliar to the Argentine or Chilean banker. A similar "vicious circle" developed, as bad loans were taken out to cover previous shaky loans. The same absence of regulation is apparent, but on an international level.\textsuperscript{20}

On a domestic level, the U.S Savings and Loan system exhibited much of the same behavior in response to U.S. deregulation in the 1980's. These practices largely resulted from the lack of regulation and supervision of banks by some independent and unbribable authority. Through a series of disastrous bankruptcies, the U.S. government was forced to re-regulate the savings and loan market.\textsuperscript{21}

The policy conclusion that a neutral authority can better ensure effective regulation is an argument in favor of politically democratic forms of rule. Despite the unsuitable role that the U.S. Congress played in the recent U.S. savings and loan debacle, elected officials are, as a rule, more accountable in supervising bank activities.\textsuperscript{22}


\textsuperscript{21}See American Political Science Association Newsletter, Spring 1991 for series of articles on the savings and loan crisis.

\textsuperscript{22}Democratic regulation should not be confused with Central bank policymaking, for which evidence suggests that insulating Central Banks from democratic politics helps to keep down deficit spending.
2. Future Directions for the State in Finance: Redrawing Boundaries between State and Society

While this dissertation recognizes the advantages of getting the state out of making monopoly decisions over who gets credit (given the present direction of present international financial integration), it also refutes the misleading notion that states really do abdicate responsibility for financial markets. This argument is intended both in the sense that states should not surrender this role as a policy recommendation, and that they likely cannot give it up. The state must participate in the regulation and supervision of banking; moreover, in times of crisis, the banks turn to the state to mediate their operations -- both with foreign creditors and with the countries' macroeconomic indicators. In the end, states cannot sit back and let banks operate freely.

Indeed, the policy of financial liberalization, as most economists define it, failed in Chile as well as in Argentina, in the sense of releasing domestic financial institutions and practices to a free market. Clearly, those countries which opened up financial markets have ended up with different arrangements of lending and borrowing. In 1982, Argentina's Central Bank essentially closed up the financial system, fixing interest rates ceilings and establishing a 100 percent reserve requirement for bank deposits a year and a half after the bank collapse. Chile's
monetary authorities also kept a firm control over monetary and credit aggregates; yet it was handled through an arms-length regulation. The spectacular bank collapses brought the states in both Chile and Argentina back into the business of selective financing. The governments were forced to resort to preferential lending by the magnitude of the crisis.

Routine, prudential oversight of financial institutions is a far cry from selective credit allocation controls of the past. Yet, the extraordinary measures implemented between 1982-1986 were also more than distanced, hands-off bank regulation.

What are, then, the best strategies in a world of increasingly international financial integration? Since the policy divergence between Argentina and Chile, the observed economic performance of Chile has also been striking. This contrasting performance makes the case study of policy interest. Since 1985, Chile’s capital markets have expanded, its foreign debt has dropped, and its productive GNP is growing steadily.

Why has financial reform succeeded in Chile? The range of countries which are imposing new, market-oriented reforms suggests that states are experimenting, often reactively, with a variety of measures designed to improve their competitive advantage in an open world. In Chile, state monetary authorities and bankers hit upon a formula not
unfamiliar to great powers: mercantilism. As the state opened its financial markets to international capital, it did not truly yield responsibility for its financial markets, but, in fact, re-regulated banks and securities markets in response to increasing opportunities in international capital markets. Such openings brought economic benefits to its regions.

This feature of the grand liberalization movement has been overlooked. With this kind of leverage, the "free market" no longer operates; instead, the state carefully monitors its banks and the monetary environment to remain competitive and attractive to international capital. These policies are commonly labeled "de-regulation". This term, however, masks a complex process of regulatory change at several levels. The very operation of market economies depends on the existence of regulations concerning property rights, contract, currencies.

Changing rules generally leads to a process of drafting new regulations. Since these new rules are untried or untested, they create new interests and new distortions. As Chile and Argentina lifted regulations and transformed banking practices, such struggles emerged. These new interests (and conflicts) were then new topics for public policy.
3. Postscript: Ode to a new capitalist player

In 1989, Chile’s military ruler Augusto Pinochet held a second referendum to affirm his authoritarian rule. This time, his mandate to govern was soundly rejected, and a transition to democracy was set in motion. In September, 1989, a coalition government under the leadership of veteran Christian Democrat Patricio Alywin was elected. This new administration, under Finance Minister Alejandro Foxley, took pains not to dislodge (or even modify) the financial reforms that had been implemented over the last six years. Legislation to create a more autonomous Central Bank from the executive was completed briefly before the end of military rule. The terms of office of its president were set to alternate with those of the executive branch. The 1983 banking crisis appeared a distant bad dream.

Both Chile’s and Argentina’s devastating financial crisis, however, contained deeper roots (than simply grupo excesses) and bore longer term consequences (than the elimination of the grupo structure). The economic teams’ lax monitoring of banking practices revealed that the mix of free market ideology, together with little institutional

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23Some observers, arguing that a free market is not compatible with authoritarian political regimes, have suggested that this transition was inevitable. Chile does not supply evidence either way for this argument, since the free market never ruled. Nor does this dissertation argue that Chile’s transition to democracy was brought about by the political consequences of any of the economic reforms.
experience in regulation, can be fatal. The subsequent state interventions reaffirmed both countries' use of traditional instruments of statecraft.

The differences in these public interventions also underscore the importance of private sector organization in public policy. In particular, internal banker splits undermined the ability of Argentine policymakers to pursue a distance, cooperative regulation, forcing that country to return to more direct forms of regulation.

For Chile, the episode also cemented new dynamics in the relationship with private sector bankers: an arms-length -- but, by no means impartial -- support for market-oriented activities. The state has stayed away from direct sectoral financing: State participation in finance dropped from its 1975 figure of 46.0 percent of loans and 54.8 percent of deposits, to 16.8 percent and 20.9 percent in 1988. Chile’s Central Bank no longer directly allocates credit nor determines its cost. The notion of a centralized financial clearing house, which prevailed for much of the country’s history, has been abandoned.24

At the same time, the concept of "free" banking has also been shelved. The empires of key grupo leaders, which rose under the short-lived period of liberalization without regulation, have been dismantled. In its place, a new kind

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of capitalist player has emerged in Chile. The pre-1973 state-led credit allocation system has not reappeared; the era of bankers as the "benevolent dispensers of the state largesse" has passed.\textsuperscript{25} The new bankers that emerged have adopted a market-oriented "world view". International business surveys highlight the emergence of a new generation of Chilean free-marketeers.\textsuperscript{26}

Nevertheless, this philosophy comprises a limited role for the private entrepreneur. Chile bankers are not quite the innovative financial capitalists that were originally envisioned, Instead the dissertation identifies the triumph of a rather more docile, team player. Chile's free-wheeling financial markets have been tempered, and Central Bank, through its rescheduling mechanisms, manages important portions of the total banking system loan portfolio.\textsuperscript{27}

As an American banker in Chile remarked, "There isn't the real capitalism here, as Schumpeter might have described..."

\textsuperscript{25}In a 1978 study of the Alessandri, Frei, and Allende administrations, Barbara Stallings observed that "the private domestic bourgeoisie simply cannot be relied on to provide the main source of investment. They have neither the traditions nor the resources (although they have many more resources than those they devote to investment)... The state has no choice but to take the lead in the accumulation process." Stallings, \textit{Class Conflict}, p. 233. Over the course of the free market experiment, such "traditions" have been gradually recast.

\textsuperscript{26}See, for example, Inter-American Development Bank (IDB), \textit{Economic and Social Progress Report in Latin America, 1988 Report}. IDB, Washington, 1988, p. 360.

\textsuperscript{27}See Mauricio Larrain, "How the 1981-83 Chilean Banking Crisis Was Handled", 1989, pp. 22-23.
no creative destruction. No creativity. Everyone simply follows the directives of the Finance Minister. They are real good capitalist team players." ²⁸

TABLES

ARGENTINA:

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Number of Private Institutions

Table 4.2  Selected Macroeconomic Indicators

Table 4.3  Structure of Financial System,
Deposits & Loans (in Percentages)

Table 4.4  Liquidation of Financial Organizations

CHILE:

Table 5.1  Number of Establishments(a)

Table 5.2  Structure of Financial System

Table 5.3  Selected Macroeconomic Indicators

Table 5.4  Financial Institutions intervened
and/or liquidated

Table 5.5  Concentration in the Banking sector
% of bank credit loaned to
"related" ownership or management
Table 4.1: *ARGENTINA: Number of Establishments*

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<td>725</td>
<td>721</td>
<td>468</td>
<td>402</td>
<td>288</td>
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Sources: Banco Central de la republic Argentina, Boletin Estadistico, various issues.
Table 4.1: ARGENTINA, Number of Private Institutions

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<td>423</td>
<td>377</td>
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<td>Consumer Credit Corporation</td>
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<td>14</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<td><strong>Total</strong></td>
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<td>721</td>
<td>497</td>
<td>468</td>
<td>449</td>
<td>295</td>
<td>233</td>
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Source: Banco Central de la Republica Argentina, Boletin Estadistico. Various issues.
* from May 31: Pre-reform figure.
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<th>Year</th>
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<th>Inflation rate</th>
<th>real exchange rate</th>
<th>index of real wages</th>
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<td>1972</td>
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<td>24.2</td>
<td>109.4</td>
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<td>1974</td>
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<td>444.1</td>
<td>142.8</td>
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<tr>
<td>1976</td>
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<td>6.4</td>
<td>175.5</td>
<td>95.8</td>
<td>69.3</td>
</tr>
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<td>-2.9</td>
<td>159.5</td>
<td>68.8</td>
<td>79.8</td>
</tr>
<tr>
<td>1979</td>
<td>6.2</td>
<td>100.8</td>
<td>53.6</td>
<td>88.7</td>
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<td>1980</td>
<td>0.8</td>
<td>104.5</td>
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<td>1981</td>
<td>-6.2</td>
<td>164.8</td>
<td>121.8</td>
<td>71.7</td>
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<tr>
<td>1982</td>
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<tr>
<td>1973–1982</td>
<td>0.3</td>
<td></td>
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</tbody>
</table>

Real exchange rate = deflator domestic prices/consumer price index
The Index for real exchange rate is 1973=100

Sources: Banco Central de la Republica Argentina; Indec; FIEL.
### Table 4.3: ARGENTINA: Structure of Financial System, Deposits & Loans (in Percentages)

| YEAR | 6-77 | 12-79 | 3-80 | 5-80 | 12-81 | 12-1
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<tr>
<td></td>
<td>Dep./Loans</td>
<td>Dep./Loans</td>
<td>Dep./Loans</td>
<td>Dep./Loans</td>
<td>Dep./Loans</td>
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<td>83</td>
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<td></td>
<td></td>
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<tr>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>41.2/37.1</td>
<td>53.6/--</td>
<td>55.9/51.2</td>
<td>39.2/36.2</td>
<td>21.1/--</td>
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<td>Capital</td>
<td>25.5/--</td>
<td>32.1/--</td>
<td>32.1/--</td>
<td>25.3/--</td>
<td>11.2/</td>
<td></td>
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<tr>
<td>Interior</td>
<td>15.7/--</td>
<td>21.5/--</td>
<td>23.8/--</td>
<td>14.9/--</td>
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<tr>
<td>Foreign</td>
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<td>9.8/--</td>
<td>11.6/--</td>
<td>12.8/14.0</td>
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<tr>
<td>Official</td>
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<td>36.5/38.4</td>
<td>34.7/--</td>
<td>44.6/--</td>
<td>46.6/48.3</td>
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TOTAL = 100%

Sources: June 1977: Banco de la Republica Argentina; March 1980: Ambito Financiero, 8 May 1980, p. 1, 9 December, 1980; Asociacion de Bancos Argentinos (ADEBA), Memoria. (After 1985, "intervened" financial institutions are not included)
Table 4.4: **ARGENTINA: Liquidations of Financial Organizations**

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<th>Year</th>
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<th>Non-bank Financial</th>
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<tr>
<td>1980</td>
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<td>18</td>
<td>28</td>
</tr>
<tr>
<td>1981</td>
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<td>7</td>
<td>14</td>
</tr>
<tr>
<td>1982</td>
<td>3</td>
<td>26</td>
<td>29</td>
</tr>
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</table>

**Total**: 26 81 107

Source: Banco Central de la Republica Argentina, 1984.
Table 5.1: CHILE: Number of Establishments(a)

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<tr>
<th></th>
<th>70</th>
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<th>80</th>
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</tr>
</tbody>
</table>

a) Excludes CORFO, a public institution that grants credit.
b) 15 of these banks had been purchased by CORFO.
c) Financieras (whose liabilities are primary short-term time deposits) under the supervision of the Supervisory agency.
d) After 1987, one of these financieras was foreign-owned.

Table 5.2: CHILE: Structure of Financial System

<table>
<thead>
<tr>
<th></th>
<th>% TOTAL LIABILITIES</th>
<th>% TOTAL ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>74  78  81  88*</td>
<td>74  78  81  88*</td>
</tr>
<tr>
<td><strong>1. BANKS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State Bank</td>
<td>34.6 20.0 15.0 12.9</td>
<td>36.5 23.0 17.8 19.0</td>
</tr>
<tr>
<td>Private Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>National</td>
<td>45.3 68.9 71.9 72.3</td>
<td>51.3 66.3 68.0 61.8</td>
</tr>
<tr>
<td>Foreign</td>
<td>0.4 0.7 4.3 10.5</td>
<td>0.4 0.8 4.7 15.2</td>
</tr>
<tr>
<td><strong>2. NON-BANKING INSTITUTIONS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Housing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Financiers</td>
<td>0 4.0 3.3 1.5</td>
<td>0 4.4 3.1 1.2</td>
</tr>
<tr>
<td>Savings &amp; Loan</td>
<td>19.3 6.3 5.5 3.0</td>
<td>11.7 5.6 6.3 2.8</td>
</tr>
</tbody>
</table>

Source: SBIF, Informacion financiera, Santiago, Chile, various issues; Boletin Mensual, Banco Central de Chile, various issues.

**/ Includes liabilities that the Central Bank controls, and letters of credit (venta de cartera) owed to the Central Bank.
<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth rate</th>
<th>Inflation rate</th>
<th>terms of trade</th>
<th>index of real wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949-1960</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1965-1980</td>
<td>1.9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1970</td>
<td>--</td>
<td>36.1</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1971</td>
<td>8.9</td>
<td>26.5</td>
<td>78.1</td>
<td>129.5</td>
</tr>
<tr>
<td>1972</td>
<td>-1.2</td>
<td>254.5</td>
<td>71.9</td>
<td>100.6</td>
</tr>
<tr>
<td>1973</td>
<td>-5.6</td>
<td>606.1</td>
<td>83.3</td>
<td>81.3</td>
</tr>
<tr>
<td>1974</td>
<td>1.0</td>
<td>369.2</td>
<td>88.0</td>
<td>68.1</td>
</tr>
<tr>
<td>1975</td>
<td>-12.9</td>
<td>343.3</td>
<td>53.1</td>
<td>65.9</td>
</tr>
<tr>
<td>1976</td>
<td>3.5</td>
<td>198.0</td>
<td>57.1</td>
<td>67.8</td>
</tr>
<tr>
<td>1977</td>
<td>9.9</td>
<td>84.2</td>
<td>51.3</td>
<td>74.8</td>
</tr>
<tr>
<td>1978</td>
<td>8.2</td>
<td>37.2</td>
<td>50.5</td>
<td>79.6</td>
</tr>
<tr>
<td>1979</td>
<td>8.3</td>
<td>38.9</td>
<td>59.5</td>
<td>86.1</td>
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<tr>
<td>1980</td>
<td>7.8</td>
<td>31.2</td>
<td>59.8</td>
<td>93.5</td>
</tr>
<tr>
<td>1981</td>
<td>5.7</td>
<td>9.5</td>
<td>50.0</td>
<td>101.9</td>
</tr>
<tr>
<td>1982</td>
<td>-14.4</td>
<td>20.7</td>
<td>46.7</td>
<td>102.0</td>
</tr>
<tr>
<td>1973-1982</td>
<td>1.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>-0.8</td>
<td>23.1</td>
<td>54.9</td>
<td>91.0</td>
</tr>
<tr>
<td>1984</td>
<td>6.3</td>
<td>23.0</td>
<td>47.2</td>
<td>91.2</td>
</tr>
<tr>
<td>1985</td>
<td>2.5</td>
<td>17.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>5.2</td>
<td>21.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>5.0</td>
<td>12.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>7.4</td>
<td>21.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>9.4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Real wages indexed 1969/70 = 100

Sources: Banco Central de Chile, Boletin Mensual, WIDER publication
### Table 5.4: CHILE: Financial Institutions intervened and/or liquidated

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>4 /a</td>
<td>2 /a</td>
<td>7 /b</td>
</tr>
<tr>
<td>Finance Companies</td>
<td>4 /a</td>
<td>1 /a</td>
<td>1 /a</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8</strong></td>
<td><strong>3</strong></td>
<td><strong>8</strong></td>
</tr>
<tr>
<td>Loans of Institutions (%)</td>
<td>13.0%</td>
<td>1.5%</td>
<td>45.0%</td>
</tr>
</tbody>
</table>

/\a first intervened, subsequently liquidated
/\b Two banks liquidated, one intervened and subsequently merged; four intervened, subsequently privatized.
Table 5.5: CHILE: Concentration in the Banking sector
(Percentage of bank credit loaned out to "related" ownership or management)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>de Chile (Vial Group)</td>
<td>16.1</td>
<td>18.6</td>
<td>17.9</td>
</tr>
<tr>
<td>Hipotecario y de Fomento de Chile (Vial Group)</td>
<td>17.1</td>
<td>n.a</td>
<td>n.a.</td>
</tr>
<tr>
<td>Santiago (Cruzat-Larrain)</td>
<td>44.1</td>
<td>42.3</td>
<td>49.3</td>
</tr>
<tr>
<td>Hipotecario de Fomento Nacional (Cruzat-Larrain)</td>
<td>28.2</td>
<td>27.4</td>
<td>21.4</td>
</tr>
<tr>
<td>Colocadora Nacione' de Valores (Cruzat-Larrain)</td>
<td>23.4</td>
<td>23.8</td>
<td>27.2</td>
</tr>
<tr>
<td>De A. Edwards (Edwards Group)</td>
<td>15.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credito e Invers (Yarur Group)</td>
<td>8.6</td>
<td>11.9</td>
<td>9.3</td>
</tr>
<tr>
<td>Nacional (Errazuriz)</td>
<td>29.1</td>
<td>25.7</td>
<td>24.0</td>
</tr>
<tr>
<td>Industrial y de Comercio Exterior (Matte Group)</td>
<td>4.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>O'Higgins</td>
<td>8.0</td>
<td>9.1</td>
<td>8.7</td>
</tr>
<tr>
<td>Internacional</td>
<td>20.1</td>
<td>22.8</td>
<td>3.4</td>
</tr>
<tr>
<td>Sud Americano</td>
<td>13.0</td>
<td>14.8</td>
<td>16.3</td>
</tr>
</tbody>
</table>

Financiera
- Ciga                                    | 26.1      | 24.1     | a.       |
- Corfinsa                                 | 19.3      | 20.8     | 18.0     |
- Fusa                                     | 21.0      | 22.5     | 12.0     |
- Interes Social                           | 14.9      | 15.4     | b.       |

Definition of "related" persons or firms:
Linked directly or through a third party to the ownership or management of the institution. Loans between banks are excluded.

a. Interes Social transformed into bank.

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