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9 October 2021

Online at <https://mpra.ub.uni-muenchen.de/110173/>  
MPRA Paper No. 110173, posted 14 Oct 2021 13:29 UTC

# The future of the Central Bank and its autonomy in the Chilean Constitutional Convention

Felipe Castro Azócar\*

**Abstract:** Regarding the discussion on a New Constitution in Chile, the debate on the autonomy of the Central Bank has polarized: Some consider it fundamental for macroeconomic balances, and others question it as an "authoritarian enclave". Should the Constitution settle this issue? It will be seen that it is not so much what it says on paper that matters, but how the autonomy and independence of the Central Bank are articulated in the reality.

**Keywords:** Constitutional autonomy, Central Bank autonomy, price stability, Chilean new constitution, economic policy.

## Introduction

Among the variety of issues raised by constituent candidates, political analysts, and other actors regarding the Constitutional Convention, one that has caused controversy is that of the autonomy and objectives of the Central Bank.

Despite the importance and interest of the discussion in this area, the debate has tended to polarize: Some see in the Bank's constitutional autonomy the "Holy Grail" of solutions to macro problems, and those who see in it nothing more than an "authoritarian enclave". This controversy has been turning into a technical discussion on how to implement the eventual changes, which has simplified the real complexity hidden in this discussion, not considering imperative aspects to be considered, such as the important current context of political transformation and the economic and social effects of the Covid-19 pandemic.

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## Should the Constitution regulate the Central Bank? Notes on its autonomy

During the last decades, there has been a large amount of literature on the variable "independence" of central banks and its relationship with certain economic policy objectives such as inflation<sup>1</sup>. The most orthodox economic doctrine identifies a direct relationship between central bank independence and price stability (Alesina & Summers, 1993), which is why it has been suggested that there is no room for discussion on this point. However, in recent years, increasingly sophisticated econometric instruments and models have challenged the recognition of "independence" as an isolated variable that can be understood (and sustained) on its own (Campillo & Miron, 1997).

The discussion on legal autonomy has had a similar evolution. It has been suggested in the literature that central bank autonomy has no small effect on a country's macroeconomy, especially in the control of inflation (García, 2019). However, legal-constitutional (including legal) autonomy does not necessarily mean effective or *de facto* autonomy, and here is the big caveat of the question. The effective autonomy of a central bank does not arise instantaneously from the simple recognition of its autonomy by a legal system but depends on multiple factors such as the political stability of a country, the financial market (Posen, 1995) and even existing inequality (Dolmas et al., 2000). Hence, it is difficult to establish a clear correlation between independence (or autonomy in the Chilean case) and monetary and inflationary stability. In other words, *de jure* independence<sup>2</sup> alone can hardly be an explanatory variable for good macroeconomic or monetary performance specifically.

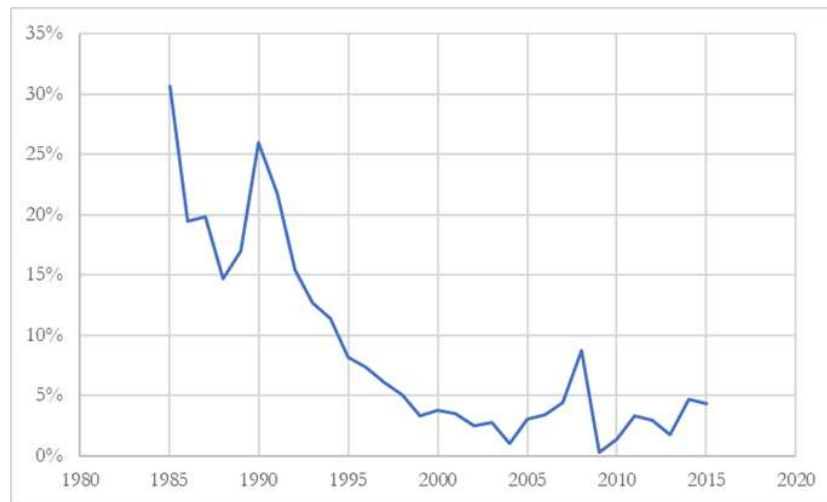
Economic intuition suggests that the more *de jure* independent central banks are, the lower inflation will be in countries, but in an empirical paper, Gutiérrez (2003), shows that there is not much support for this theory "when studying the relationship between *de jure* central bank independence and inflationary outcomes in developing countries". One of the possible reasons for this result could be the importance of variables such as the rule of law and adherence to regulations that do exist in developed countries, among others already mentioned.

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<sup>1</sup> See, for example, Mankiw (2015) and Samuelson & Nordhaus (2009), general textbooks on Economics, as well as ones to be cited in this article.

<sup>2</sup> The exclusive legal recognition, which is put to something *de facto* (or effective) that translates into a real situation.

**Figure I. Percentage of the annual CPI in Chile**



Prepared by the author with data from the World Bank (2021).

Figure 1 shows how inflation in Chile began a strong downward trend in the 1990s and remained stable during the last decade. The most repeated explanations for this phenomenon are since the Central Bank's Organic Law<sup>3</sup> had entered into force a year earlier, and although it is a variable to consider, it would be a mistake to give it explanatory power in isolation, since during that time there was also a strong political, institutional, and international economic relations transformation, which is also (as mentioned) significant. There may be a spurious correlation or even no significant correlation at all.

As Rosende (1997) explains, the legal recognition of the Central Bank's independence is still important, since it allows the objectives of the Central Bank to have a longer-term vision (or State and not government commitments, recalling the classic problem in economics known as the time inconsistency of policy<sup>4</sup>). Successful comparative experiences give strength to this idea, as is the case of Switzerland, the United States, Germany today and before the transfer of the Bundesbank to the European Central Bank, and Italy and Spain after the creation and subjugation of this organization.

However, this does not mean that everything can be discussed, especially given the interesting arguments that question the independence of central banks based on democratic

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<sup>3</sup> Chilean Law No. 18,840.

<sup>4</sup> This problem is related to the fact that decisions that seem to be more efficient at a given moment may not be so in the future. Those in charge of economic policy may announce in advance the policy they will carry out, influencing the expectations of economic agents and their decision-making, and they may not keep their word.

control (which is a potential source of positive externalities). But for such a discussion it is important, once again, to differentiate between *de jure* and *de facto* independence or autonomy. Taking this distinction into account, it would not seem necessary to deprive the institution under consideration in this article of its legal autonomy; it would even suffice to rethink the debate and evaluate the need for the role of the central bank to be regulated at the constitutional level or simply at the legal level. Indeed, the current legislation (both constitutional and that found in Law No. 18,840) does not preclude the fact that there may be some sort of political control or influence over the Central Bank. Madariaga (2020) is right when he points out “that traditionally there has been a preference for advisors who lean towards a certain economic orthodoxy”; but it is no less true that nothing prevents a circumstantial majority from deciding to appoint heterodox economists.

Going further, the powers of the Minister of Finance, recognized by the organic law, such as attending the meetings of the Central Bank Council with the right to speak, proposing the adoption of certain resolutions, and suspending the application of a resolution or resolution adopted at a meeting, should not be ignored<sup>5</sup>. All these powers leave room for a government of the day to be able to interfere in the central bank (although they may seem insufficient, this is not a bad thing).

There have also been questions about the Central Bank's inflation-control objective. It has been argued that it responds to economic orthodoxy and that it is too conservative. Along these lines, it has been suggested that the Central Bank should consider objectives of protection and promotion of employment. Contrary to all this, in the first place, it is false that the Central Bank has only an inflation target (its duty is not only to watch over the stability of the currency, but also to watch over financial stability), and it is also false that it is conservative (just look at the inflation target of the European Central Bank, which is 2% per year<sup>6</sup>, as opposed to the Chilean Central Bank, which has a target of 3%<sup>7</sup>).

Secondly, as de Gregorio (2006) argues, having an inflation target does not mean that the costs of unemployment are not considered, since it is not always intended to be achieved

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<sup>5</sup> Law No. 18,840. Article 19.

<sup>6</sup> See: <https://www.ecb.europa.eu/ecb/tasks/monopol/html/index.en.html>.

<sup>7</sup> See: <https://www.bcentral.cl/web/banco-central/el-banco/gobierno-corporativo/funciones-del-banco>.

as it is not indifferent to the economic cycle (a matter that depends on the economic policymakers). The author adds that "the advantage of specifying the objective of macroeconomic stability in terms of an inflation target avoids the disadvantages of defining two objectives that could be incoherent", especially since it is difficult to know the product of full employment, which could lead to a trend of acceleration or deceleration of inflation depending on the estimation of that product. All in all, what is striking for the public conversation and the work of the Convention would be to state positions on how this economic policy objective is pursued, whether by obeying fixed rules or discretionarily, or by adopting an active or passive role depending on the circumstances, specifically in times of economic crisis due to extraordinary events or to the economic cycle itself.

The above requires attention in consideration of two issues: i) The presence in Chile of a radically more disaggregated political landscape than in the 90' and early 2000', and ii) The greater demands of public spending to face the crisis produced by Covid-19. The former for reasons already mentioned, such as problems of political stability and governance that constitute an explanatory variable of *de facto* autonomy, while the latter since public debt and deficits can encourage an aggressively expansive monetary policy, generating inflation. This is the result of the apparent lightness with which some countries take fiscal policy and the lack of awareness of its effects on the time horizon<sup>8</sup>, added to the public debt purchase programs that the main central banks have implemented because of the financial crisis.

Thus, it is necessary to abandon the dogma of *de jure* independence of central banks as the solution to all macroeconomic problems (as this generates a vice that impoverishes the deliberative exercise). Efforts should be made to ensure that this independence is *de facto*, opening the possibility of studying other complementary mechanisms to guarantee it. In this sense, as mentioned above, it would be appropriate to discuss whether it is necessary to incorporate the Central Bank in the Constitution or whether it would be sufficient to give it a merely legal status since both ways could ensure effective independence. Examples of this case are the Federal Reserve of the United States, the Reserve Bank of New Zealand, the

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<sup>8</sup> Such is the case of Argentina and European Union countries such as Spain, Portugal, Greece, France, and Italy, which have public debt close to or above 100% of GDP (International Monetary Fund, 2019).

Bank of Canada, and the Bank of England, which, although they do not have constitutional autonomy, would be difficult to discuss their effective autonomy.

It also seems advisable to consider positions concerning the design of the economic policy setting for which the agency is responsible. These designs could be based on fixed rules or discretionarily, and it would be desirable to find a meeting point (or moderation) because formal institutions coexist with situations that may become extraordinary, although they must enjoy stability in any case. From this point of view, it could be considered, among other things, that the Central Bank should make its inflation target more flexible, or that it should follow rules like those of the Bank of England, where the definition of the inflation target is determined by the government of the day, but it is the Bank which autonomously defines its monetary policy to achieve this goal<sup>9</sup>. However, they must be the essential elements that the Convention should contemplate to address this issue.

## **Conclusions**

Economic policy is managed in an uncertain world, and discretion indeed gives flexibility to better respond to unforeseen events. But given the political business cycle and the economic challenges brought about by the Covid-19 crisis, limited discretion would be the perfect balance between a wide margin of action and a strong framework to avoid the capture of the Central Bank by political power, which can have undesirable economic effects.

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<sup>9</sup> See: <https://www.bankofengland.co.uk/monetary-policy/inflation>.

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