

An Embedded Market Approach to Chile's Neoliberal Transition

Senior Comprehensive Project
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Abstract

The relationship between markets, economic reform and society is rarely explored in a way that links theory with practice. Formal economic approaches to policy limit the viability of reforms and formal analysis fails to explain macroeconomic outcomes. In this paper I apply a socially embedded economic model to understand the nature of policy design, implementation and reorientation during Chile's neoliberal reform period. I find that only by accounting for networks, cultural influences, institutions and interpersonal relationships can economic reforms be satisfactorily analyzed.

Introduction

The economic decisions of each individual occur within the context of social pressures, previous formative experiences, entrenched structures of interaction and personal relationships. The notion of a 'market' as an institution removed from the realm of the social is an unrealistic conception of how economics functions. Nonetheless, many economists assume that free markets behave in rational and predictable manners because they aggregate the individual calculations of many people. To use this theoretical understanding of markets to design and implement economic policies is sure to have unintended consequences because the social implications of their formation and effect cannot be taken into account in the formal models. I argue that only a social economic approach allows the scope to fully analyze the economic consequences of market reform.

I will review the arguments made by various theories of market-societal relations and show how embedded market theorists provide a more accurate and useful lens through which to analyze the free market capitalist economic system and its implications. I use Chile's neoliberal reform period from 1973 through 1985 to demonstrate the failure of formal economic modeling to explain the complex economic repercussions and the potential of the socially embedded perspective to elucidate concrete and meaningful relationships between social and economic factors.

The debate between this formal approach to economics and a social approach revolves around how individuals make economic choices and how those choices are interpreted and reacted to by others. The formal or neoclassical conception of individuals tends to focus on rational individuals that maximize their personal utility functions. In a world made up of these individuals, a free market is the best organizing institution to allow these individuals to 'meet' in

order to exchange goods and services, with money being the intermediary. A neoclassical individual buying a can of soda would reflect upon the utility of buying a particular brand of soda (the taste) and weigh it against the costs associated with buying it. The rational actor will choose the soda with the greatest marginal utility. The social economic approach denies the existence of isolated and atomistic individuals and instead focuses on the social norms and institutions that shape economic choices. An individual in a social economic understanding will not buy a soda just to maximize their utility but also perhaps to gain prestige with their peers. They did not simply choose a random product, but were influenced by marketing, personal memories of the brand and the politics of the suppliers at the grocery store where the soda was sold. This crucial aspect of economics is not accounted for in an approach that assumes markets to be a-social and composed of atomized rational actors.

To demonstrate the shortcomings of the formalist model of economic analysis, I will explore the design, implementation and the revision of neoliberal economic reforms using a social economic approach to fill in the holes left by its analysis. The design of neoliberal reforms, based on a monetarist approach to economic policy, was highly influenced by personal relationships, the cultural norms surrounding social and political influence, and the structural-bureaucratic aspects of the political system. The implementation of the market-centered reforms did not achieve the medium-term effects desired because they were based on an asocial understanding of their consequences. The nature of the consequences and the subsequent revisions made to the policies can only be fully understood by an analysis of the social implications and political interests that the markets were embedded in. This empirical analysis is the key to grounding the theoretical relationship between markets and society and moving toward a better understanding of the practical implications of economic policy.

Formalist and Embedded Market Approaches

Formalist theorists tend to lean on utilitarian concepts of self-interest and maximization to define the actions of individuals. In a context of scarce resources, individuals are forced to make decisions between alternative uses to achieve the optimal outcome. These assumptions about scarcity and ideal outcome for wants based on material utility are based on unrealistic descriptions of how people actually behave. Economic actors perceive scarcity as a result of socially conditioned information and make their choices based on those perceptions. Materialist assumptions about human wants and needs are inadequate to categorize the multitude of motivations that drive economic choices, like social acceptance and reciprocal gift-giving. For these reasons, individuals cannot only be thought of as materially motivated, atomized, and asocial actors exchanging in a neutral market.

The assumption of an asocial market has its roots in the classical and neoclassical economic tradition. Adam Smith decried the social interactions of merchants because of their tendency to fix prices. It was only with socially and politically isolated economic action that people could truly be ‘free to choose,’ as the title of Milton and Rose Friedman’s book implies. Friedrich Von Hayek takes these assumptions and argues that free markets are the most logical organizing structure for individuals to meet and, through the price mechanism, compile the vast amounts of knowledge contained in each actor’s experiences (Hayek, 1945). Competition between individuals for resources in free markets is seen as the best way to achieve maximum efficiency of production and consumption. The role of the state is limited to enforcement of basic property rights and competition laws and no more. Private markets, being the most efficient allocators of resources, should be allowed to coordinate health, education, and pensions in addition to all other forms of production. These positions are extremes of the neoliberal

perspective, but serve to illustrate the underlying logic that permeates even more moderate agendas. These market theories fail to acknowledge the socially embedded nature of markets and subsequently miss an essential component of their functioning.

Neoliberal theory takes these assumptions about ideal economic functioning and applies it to national policy in order to reduce the power of the state to influence market outcomes. In Chile a particular brand of neoliberalism emerged (monetarism) and the timing and structure of policy implementation has been referred to as ‘economic shock therapy.’ The theory behind monetarism says that by controlling the money supply and allowing markets to set prices, equilibrium will be reached between supply and demand and inflation, the bane of developing economies, can be controlled. Economic shock therapy refers to the process of deep and fast free market reforms that combine deregulation, currency convertibility, capital flow freedom, low tariffs, and other neoliberal policies (Marangos, 2007). Originally coined to describe the Polish economy’s transition in 1990,¹ its basic principles can be seen in the Chilean experience as well. The logic of shock therapy is that only by enacting all of these changes simultaneously can an economy effectively combat inflation and return to growth as soon as possible. The challenge of this approach is how to accomplish the necessary reforms in a context of democracy and public influence during a time of economic hardship for the country. “High inflation and unemployment caused social and political instability, threatening the fragile democratic governments”(Marangos, 2002:269). This is why in Chile the political conditions were conducive to just such an economic program.

Economic shock therapy proponents of neoliberal reforms both epitomize formalist analysis and policy prescription and particularly apply to the Chilean case. Milton Friedman and Arnold Harberger publicly supported accelerated free market reforms in Chile in 1975 to help

apply pressure on General Pinochet and his advisers. These academics use and expand Adam Smith's invisible hand concept to argue that free markets are the most natural social space for people to exist in by virtue of the principles of individual freedom and self-interest.² Markets are not social institutions but rational ones, according to shock therapy, and represent the truest expression of a natural human state. Once market freedom is guaranteed and protected, social harmony will follow because with each individual working in their own self-interest, the community as a whole will benefit.³ This fundamental belief in the neutrality of markets and their a-social nature underlies this perspective's assumptions of free markets.

Karl Polanyi's 1944 work on capitalist development identified the 'fictional commodities' that free markets require in order to function and paved the way for a socially embedded theory of markets. With the publication of 'Economics as an Instituted Process' in 1957, he more directly challenged the formalist models in their accuracy of describing precapitalist economic systems. He pointed out that capitalist economics was not a human universal, but a cultural system of economic structures. An embedded market differs from the formalist conception in that it is not simply individual rational action that determines economic outcomes, but the influences of ideas and social relationships that guides and empowers individuals to make those choices. The role of trust in interpersonal relationships⁴ and of perception and structural arrangements feature prominently in analyses of economic phenomena using a socially embedded market approach.

Socially embedded theories of markets can focus on many aspects of interpersonal and group dynamics to enrich the understanding of economic processes. The role of ideas in shaping perceptions about economic and group interests is crucial for understanding how policies are designed and implemented. Cultural-historical narratives influence political and economic

structures in ways that may be accounted for in formalist models using personal preferences, but cannot be explained by them. These important variables in market and individual actions must be considered in the case of Chile to explain why and how the neoliberal model failed to function according to formal theory. It is with the failures of their assumptions about individuals and markets that a more pragmatic policy evolved and helped return the country to considerable economic success.

Another important approach to analysis using socially and politically embedded market theory is that of institutional studies. The study of institutions as social products that determine the choices of individuals is inconsistent with the atomized and independent, rational economic actors model of neoclassical and shock therapy theorists. Any a-political and a-social analysis is faced with “the innate inadequacies of neoclassical economics associated not only with inconsistent policy prescriptions but also with the effective exclusion of the institutional and political elements of the transition”(Marangos, 2002:272). Eduardo Silva, too, identifies the importance of domestic structures in economic reform: “On the whole, international factors, although strongly conditioning at times, were not decisive by themselves. Domestic structures – political regimes, state institutions, and organizational factors- also intervened”(Silva, 1996:206). The failures of formalist models to account for institutional and structural influence and formation leaves social economic analysis as the most comprehensive framework to use in understanding economic processes.

I use Chile as an example for two main reasons. The first is that it provides a unique opportunity to see free market reforms enacted quickly and with little counteracting social cushioning. Pinochet’s grip on power by 1975 gave him enormous influence over economic policy, and under him the Chicago school technocrats were given great power to deregulate,

privatize, and liberalize the economy quickly. The second reason is that neoliberal arguments often rest on Chile as an example of the triumph of free market reforms and the productivity that they inspire: "...the case has been profusely publicized as a 'success,' with the support of financial mediums, international institutions, and 'liberal' circles that appear to prioritize 'economic liberty' at whatever price, even above other dimensions of human activity"(Ffrench-Davis, 1983:163-164, translation mine). I intend to show, however, that the 'miracle' of Chilean growth was not sustainable and that a shift to more pragmatic and socially conscious policies was the basis for recovery from the economic crisis in 1982-3. Furthermore, the reasons for the failures of the original reforms and the shift to pragmatism can only be explained using a social economic model.

As General Augusto Pinochet led the military coup that toppled the Allende administration in 1973, a constellation of external economic influences converged with the appearance of the 'Chicago Boys,' economists trained at the liberal University of Chicago. These external influences must be understood in the context of geopolitical and ideological positioning by the United States and liberal economic interests. In the 1950s and 1960s, the US government funded scholarships for Latin American students to study at the University of Chicago and return to their home countries. In Chile, these economists, along with business leaders, proposed sweeping economic liberalization reforms in a paper called *el ladrillo* or 'the brick' that aimed to transform the economic landscape into a free market-dominated system. They lobbied for the lowering of trade barriers, floating of currency, eradication of price supports, reduction of labor regulations, reduced fiscal spending, and privatization of national companies in order to combat inflation and return economic growth. These reforms were clearly designed from a shock therapy paradigm, as the text indicates: "The coherence and unity of the distinct aspects of the political

economy are basic requirements of any program of action and it is important to remember that in many cases the limited or partial application of policies was the element that determined its failure”(El Ladrillo, 1992:23). These policies were implemented to varying degrees over the following decade, but the focus of formalist economic analysis generally begins with implementation, while embedded market theory necessitates an analysis of the manner in which these reforms were designed and implemented.

Policy Design

The economic policies of the Pinochet regime were influenced by a variety of socio-political factors that shaped both their structure and timing. The evolution of bureaucratic divisions, the social networks involved, the personal relationships with Pinochet, external economic influences and the broad popular and professional pressures that were put on the policy process contributed in important ways to the outcome. The Chicago boys technocratic approach to policy design was far from removed from social and political realities, as formal theory would assume. Economic policy cannot be constructed in a vacuum, and the attempt to insulate policymakers from pressures simply obscured the influences and created policies that were unrealistic and unsustainable.

Policy formation under Pinochet can be approached from a variety of angles. Formal modeling uses game theory to describe the sets of incentives available to economic actors and policymakers. The reality is much more complex and subtle, however. It is convenient and admittedly cleaner methodologically to assume impartial incentive structures, but the very structures and norms that guide incentive perceptions are socially constructed and manipulated. For example, after Pinochet led the junta to power, the organizational structure more than the individual incentives of the generals promoted a particular path of economic planning. The Navy

was placed in charge of planning, while the army was mainly in charge of domestic stability and agriculture. This initial bureaucratic configuration influenced the momentum created for particular policies. This initial bureaucratic configuration influenced the momentum created for particular policies. The Chicago Boys' influence was at first constrained by the resistance to market-oriented reforms by the air force, which had control over this policy area (Castiglioni, 2001). The institutional perspectives were different between the three branches, and their particular leanings affected ministerial position choices.

As a result of these different approaches, certain economic interests and policy preferences were favored over others. The networking ability of these groups of business leaders, the relationships that they had with junta leaders and with Pinochet himself, in addition to the position of their economic interests determined the policy design and implementation on the ground. For the first two and a half years of the dictatorship, *el ladrillo* was implemented in a more gradual manner than many of the Chicago Boys would have preferred. This was a result of the particular constellation of power distribution and networking ability of the policymakers (Silva, 1996:68-70). These shock therapy oriented interests were left to try to build a stronger coalition, curry Pinochet's favor, and use the worsening macroeconomic environment to push their agenda against this initial power configuration.

In conjunction with the structural aspects of the institutional momentum gained by gradualist interests, the social networks of business interests and military leaders influenced economic policy formation. The 'Monday Club' of anti-Allende interests included prominent business leaders who were frustrated with the nationalization agenda of the UP as well as Chicago-trained economists (many times with those categories overlapping). This social and political group was the central force behind the creating of *el ladrillo*. The translation of

technocratic policy into political doctrine, however, was not simply a move from theory to official Chilean stationary. The cultural legacies of Chile affected the approach that the economists and political leaders used to accomplish reform. Judith Teichman argues that the culture of caudillismo and personismo, forms of political organization focused around a 'big man' and based on personal relationships, strongly influenced the policy design and institutionalization process (Teichman, 2004:24-25). The relationships with Pinochet and the context within which these 'technocrats' viewed themselves changed the ways that the reforms occurred.

Partly as a result of these cultural-historical influences on policy design, but also because no policy can be designed and implemented without human interaction, personal relationships and communication is essential for an analysis of the economic reforms. The development of a relationship between Pinochet and future finance minister Sergio de Castro was a key factor in the growing influence of Chicago school influence and ministry appointments after 1973. As Pinochet consolidated power through the use of strategic dismissals, the shock therapy proponents gained influence through their continued personal connection with the now dictator (Castiglioni, 2001). It is then trust in interpersonal relationships, loyalty to certain political factions and perceptions of power dynamics that contributes to the evolving structures of communication and influence during the policy-making process. Mark Granovetter describes the formal model shortcomings of this important component when he writes: "...loyalty and trust based on personal relations as well as the good behavior based on an internalized social norm are poorly captured by models of economic incentives and rational choice." (Granovetter, 1999:160) Without an analysis of the personal relationships and political maneuverings involved, formalist analysis and policy prescriptions do not account for the realities of economic reform.

The external factors affecting the economy and the strength of various interest group networks changed the structure of power during the dictatorship and altered the access and influence that various individuals had on policy. Access to financial markets allowed conglomerates to restructure their holdings and focus on internationally positioned firms. Financial deregulation coupled with privatization allowed these more favorably positioned groups to expand their influence in important ways, such as the acquisition of *El Mercurio* by the Edwards group (Silva, 1996:101). This expansion into print media and access to public opinion and perception was an important gain in the fight for economic interests through social influence. While the initial opening of the economy in general led to severe interest rate increases that left credit markets virtually inaccessible to the population, internationally focused conglomerates could access credit and fund their subsidiaries at high interest rates (Sheahan, 1997). The fiscal spending cuts were to be deepened during later reforms, but their effect on public employment and the social programs of the Allende administration were severe. Health and education spending were greatly decreased and eventually a voucher system was introduced into the schools to give market forces precedence in determining prices and access to these social goods (Collins and Lear, 1995b). These supposedly economic policies had far-reaching implications for the social environment as education and healthcare were left to aggregate models assumed to consist of asocial rational individuals. This policy design is divorced from the reality of social formation and existence and only an embedded analysis can account for the social effects.

Another force in the policy design process was the preexisting macro-level social organization that influenced the policy options available to the Pinochet regime. While a campaign of violent repression was being directed against any form of anti-junta political organization, Pinochet was not living in another country. He and the other general still had

popular and organized resistance pressures to contend with. An example of this is the influence that the Colegio Médico, the professional association of physicians, had on health policy formation during the regime. The health ministry was made up of many members of the CM and their organized interest as well as their ability to maintain those positions enabled them to exert counter-market reforms that maintained a fairly high level of state involvement, frustrating the Chicago school economists. One of the reasons that the doctor's association was so successful was that the leaders of the CM were institutionally embedded in the health policy arena due to their advisory roles to the Chilean sanitary authorities. After 1975, the CM's power lessened, and eventually the Chicago boys were able to take much more control over health policy by pursuing alternative bureaucratic channels and by changing the law to define the CM as a corporate assembly that effectively removed their power (Castiglioni, 2001). These political and institutional dynamics are essential for understanding the nature of social policies, and are not adequately addressed in formalist models.

The technocratic shock therapy model of economic reform in theory is insulated from political and social influences that will hamper its full implementation. In Chile, despite being claimed as a successful implementation under an authoritarian leader, this process was not removed from social network formation, personal relationships, institutional momentum, cultural and historical influences, and popular and professional interest pressures. Because economic policy cannot be designed and implemented by a single person completely cut off from the socio-political context and must by necessity require interpersonal relationships, a formalist approach to policy design leaves out a critical component of economic reform analysis. The socially embedded approach to markets and policy design allows a broad and comprehensive

approach to understand the varied influences that relationships, perceptions and history have on conditioning political and social policies.

Policy Implementation

As the economic reforms were implemented the economy and society of Chile began to react and affect the perceptions about success and failure as well as shift the dynamics of coalitions and power in government. By analyzing the macroeconomic data (See appendix A) in the context of its social and political environment, I will show how neoliberal policies failed to take into account the realities necessary for sustainable growth and stability. The data on inequality, unemployment, inflation, and finance give insight into the changing economic landscape and provide a jumping off point to explain how the larger sociopolitical context made formalist assumptions inaccurate and counterproductive.

Privatization led to parallel increases in unemployment as well as a consolidation of resources under either foreign or domestic elite control. These inequalities set the stage for social power inequalities that are still prevalent today and reflect social structures that preceded them. The position of business interests and their access to bureaucratic channels is mediated by relationships and accepted pathways of communication based on complex social factors. Elimination of price controls in an environment of high unemployment and decreased social control over other aspects of daily life contributed to further destabilization of the social environment in terms of ability to access basic resources. After 1975, once the political environment had stabilized thanks to the repressive measures of the regime and General Pinochet had consolidated power, more drastic measures were taken to combat the still-high inflation rates. Further privatization, fiscal spending cuts, and significant trade barrier reductions were implemented. This left domestic producers exposed to intense international competition,

contributing to further layoffs and increased control by free market forces. The failure of some domestic interests and the flourishing of others must be analyzed in the context of interpersonal relationships as well as economic considerations. This selective process was not natural, as neutral-market theorists propose, but was shaped by interpersonal relationships, cultural norms, and institutional structures. The formal economic model fails to account for these influences in both the formation and expression of economic policies. Only with a socially embedded market model can these subtle structural and norm-governed differences be understood.

Unemployment during Pinochet's rule was a consistent problem and reached extremely high levels following the crisis of 1982. After an initially gradual transition toward less state employment and ownership, in 1975 Pinochet, at the urging of his Chicago school ministers, began his radical neoliberal transformation by quickly reducing tariffs, privatizing companies, deregulating labor laws,⁵ reducing the fiscal budget and reducing currency exchange controls (Edwards and Edwards, 1987). It is after this point that unemployment jumps to 17.2 percent in 1976 and only slowly falls until it jumps again to 22.1 percent in 1982. The neoliberal model claims to be able to, after an initially painful adjustment period, allow the country to eventually get unemployment back down by letting the free market determine the equilibrium price for wages. The data tell a different story, however, and it is only within the context of the political and social environment that a meaningful analysis of the position of labor can occur.

These general initial labor reforms were also accompanied by a reorganization of labor within the economic structure through anti-union legislation, deregulation, and increased ease of hiring and firing.⁶ The anti-union policies were closely tied with the political repression that was occurring, though this overlap was due to the targeting of all potentially threatening organized activity rather than labor per se. Without the ability to organize to collectively bargain

independent of the state, and with the state forfeiting its role as labor-business arbiter, workers were at the mercy of employers with little to no requirement for humane or just treatment. This approach to labor policy is exactly consistent with the formalist perspective of atomization of economic actors within the market. If workers were able to organize and apply pressure to employers to affect wages, then there would be a distortion in the market, causing prices to reflect not demand and supply but an artificial influence (Reynolds, 1999). The recommendations of the Chicago Boys and their industry allies worked to break down the organizational potential of these workers to be more in line with this theoretical perspective.

The analytical problem with this approach to understanding market reform was that business leaders are not functioning without personal and social incentives. They support neoliberal policies because it allows their operations the most flexibility when determining their labor policies. The assumption that without labor unions there will be no distortions in the market is based on a trust that employers will allow the market to clear without using other means to decrease the price of their labor inputs. This assumption is not logically viable in a system of imperfect controls and information, and the data show that the market was unable to adjust as neoliberal models would predict.

The battle for control of inflation is perhaps the success most claimed by shock therapy. However, the control of inflation had less to do with free markets and equilibriums than it did with a temporary and unsustainable peg to the dollar that was instituted in 1979. The more radical neoliberal reforms enacted in 1975 began attempting to control the inflation rate through tighter monetary policy (driving the country into a deep recession in 1975) and fiscal austerity, but the 'miracle' of growth and low inflation was a product of artificially maintained exchange rates. During this period of preannounced rate devaluations during the period from January 1978

through June 1979 and then pegging to the US dollar until 1981 the peso became overvalued relative to other currencies due largely to US currency appreciation. This led to an effective subsidization of imports by the government, a rise in the power of internationally focused business interests with liquid assets, and an illusory success for neoliberal policies and economic theory. When the debt crisis of 1982 hit the Chilean economy, however, credit dried up and halted the purchasing binge. The bubble popped and the faulty logic was exposed. Radical neoliberals can claim the ‘Chilean miracle’ of inflation stabilization only by ignoring the actual logic of inflation control during that period as resulting from currency pegging and wide availability of international capital due in part to bank deregulation.

Financial market deregulation was an important precursor that led to both the impressive growth between 1977 and 1982 as well as the spectacular recession of 1982-83. As part of the neoliberal agenda of shrinking government control over markets and the enabling of private control over resources, banks were progressively allowed to increase their ratio of foreign liabilities as well as the rate of foreign liability accumulation. This occurred between 1979 and 1980, though capital controls were being removed even earlier than this (Edwards and Edwards, 1987). The theory behind this loosening of controls on capital and balance sheets was that there was no threat to the country from increases in private debt, because the government was not guaranteeing it. This belief in the separateness of political/social stability and private ownership and debt in free markets is precisely the kind of mistaken approach that a formal economic analysis brings to economic policy design and implementation.

The reality, of course, is that if liquidity disappears due to internal or, in this case, external forces it affects social and political groups disproportionately and thus affects the stability and power balance in the country. When interest rates began to climb precipitously the

government came under intense pressure to reassert itself and to absorb the losses of the private banking institutions that it had let go during deregulation. Edwards and Edwards describe the role of state involvement when they write: “As it turned out, and not surprisingly perhaps, this lack of regulation played a critical role in the financial crisis of 1981-82, and in the overall collapse of the Chilean experiment.”(Edwards and Edwards, 1987 p.62) The pressure mounted until in late 1981 Pinochet was forced to rescue two major banks and in 1982 810 banks failed, pushing the financial system into crisis. This marks the beginning of a policy reformulation that responded more effectively to social and political realities.

The failure of the neoliberal model to account for the political and social realities in Chile during the implementation period is borne out by the macroeconomic data when understood in context. This context is essential to an analysis that aims to discern the true causes of economic policy effects rather than the formal model’s supply and demand equilibrium models. With the collapse of the radical program after 1982, Pinochet moved his policy approach to a more pragmatic focus on providing social stability and domestic protection as a result of changes in economic and political pressures.

Shift to Pragmatism

As the economic environment shifted from one extreme to another during the economic crisis, the interests in the strongest position to influence the political process changed. Different social and political networks sprang up in response to power vacuums and increased importance in an export and domestic market rather than import and finance economy. Capitalist coalitions formed around domestic industries that were now crucial to develop the export sector and return to growth. The threat of an alliance with the newly mobilized communist (Movimiento Democrático Popular) and the Christian Democrat-led coalition (Alianza Democrática) parties

was enough to alter the political reality that Pinochet faced. These newly empowered groups had been trying to coordinate policies for some time, but with the crisis came focus and willingness to cooperate. Additionally, civil opposition to Pinochet's policies erupted with the announcement of an "Emergency Program" in 1983.

"Beginning in May 1983, the Chilean labor movement, middle class professional associations, opposition political parties, and shantytown dwellers staged a series of monthly national days of protest. Flourishing opposition groups demanded Pinochet's resignation and an immediate and full transition to democracy. In short, the military government's project for political and social transformation was in jeopardy, and Pinochet's rule was under challenge."(Silva, 1996:183)

This pressure manifested itself both directly, through public unrest, and indirectly, through attempts to include capitalists in the opposition coalition. This forced Pinochet to listen to the pragmatic coalition of business leaders who were advocating a plan they released in 1983 entitled *Recuperación económica: Análisis y proposiciones*. These policy recommendations included debt rescheduling, lowering interest rates, running a small fiscal deficit, tolerating 30 percent inflation, and beginning public works and housing programs (Silva, 1996:176). With the increased pressure for policy change coming from the masses and with a capitalist coalition offering a coherent policy alternative that provided more flexibility in relation to the domestic social environment, Pinochet revised his adherence to a strictly neoliberal plan.

The failures of neoliberal policies to create a sustainable set of economic policies combined with the social and political pressures created and organized by networks of firms and organizations led to a pragmatic neoliberalism that focused on some of the same liberalization goals, but approached them with a social awareness that shock therapy or pure neoliberal doctrine does not allow. The content of the pragmatic policy platform demonstrates sensitivity to

social concerns through public works programs and an expanded role for the state in regulating markets that cannot be understood as neutral institutions as the Chicago boys would argue.

The process of policy shift toward the pragmatic interests occurred in the context of personal connections to Pinochet and interpersonal relationships between organized labor and business interests. Through Pinochet's consolidation of power he increased the importance of the status of individual and social group relationship with him. "The economic team's continued presence as a pivotal decision-making unit, however, was contingent on Pinochet's support"(Castiglioni, 2001:51). This support began to wane for the Chicago boys as pressure rose to address the economic crisis in a socially and politically viable manner. He did not, however, give in immediately to influence from the new coalition of pragmatists. He selectively appointed certain leaders and not others, working all the while to play different factions within the opposition against the others. His initial attempt to place a domestic market sympathizer in a subordinate but visible role failed to calm the opposition and in August of 1983 he finally appointed Sergio O. Jarpa as minister of interior, bending to the wishes of the newly created opposition group *Alianza Democrática*.

Pinochet was not through with his political maneuverings with this appointment, however, and limited Jarpa's power while still making concessionary appointments in other areas. These seemingly uncoordinated ministerial placements were really shrewd political calculations for Pinochet's personal grip on power. The interplay of political pressures and Pinochet's complex reactions gave rise to a set of economic policies that cannot be explained by simple individual rational action choice, but can only be analyzed in the context of the networks formed by different social groups, the bureaucratic structures involved, and Pinochet's own personal drive to maintain power through manipulation of the process of economic change.

The economic policies implemented after the crisis of 1982 took into account the social realities in Chile through public employment programs, nationalization of banks, protection of domestic producers through increases in tariffs, and fiscal deficit spending. The state once again became involved, to a limited extent, in the realm of production and credit. After the failure of the neoliberal model to maintain a stable and healthy system, support for pragmatic neoliberal policies was widespread and after Pinochet brought capitalists back into the fold through ministry position concessions, reforms were broadly consistent with this approach. The years after 1983 were very successful in terms of macroeconomic indicators. Growth picked up once more and unemployment steadily dropped after pragmatic policies were implemented. Inflation remained a problem, likely due to fiscal deficits and the assumption of private debt as government liabilities, but general sociopolitical stability was maintained.

The narrative provided by proponents of strict neoliberal reformers and shock therapy theorists fails to do justice to the sources of real growth and stability in the Chilean economy in the late 1970s and early 1980s. The collapse of the model is clear evidence of the unsustainability of the type of technocratic and ideological policymaking that is removed from the social consequences and acknowledgement of its own social and political influences. The legacies of the neoliberal reforms that were kept even after the pragmatic coalition gained influence include, among others, persistent income inequality⁷ and an institutionalized educational inequality as a result of decentralization and a private voucher system implemented in 1979-80 (Torche, 2005a; Collins and Lear, 1995). The success of the Chilean economy since 1982 cannot be credited to radical neoliberal theory but to pragmatic economic reforms that liberalize while recognizing the social and political impact of policy design and implementation.

Concluding Remarks

The consequences of the formalist explanations of the relationship between markets and society in Chile are a mischaracterization of the causal chain connecting free-market power restructuring and the social environment. The macroeconomic variables are not abstractions that can be analyzed in an asocial context, but a set of indicators that have been influenced by a complex system of norms, structures, agents, and perceptions. The process of policy design and implementation, which is patently social, sets the stage for the implications of the reforms and their effects can only be understood through reference to that history and social context within which it occurred. An understanding of the societal-market relationship based on formalist market assumptions leads to mistaken conclusions about the implications of growth, recession, and even freedom. Economic interaction consists of networks and structures embedded in social existence, and when aggregated individual freedom in a technical sense is equated with social outcomes and used to justify a shift to free market power over society, the false assumption is expressed in a market failure and misunderstanding of the process.

Embedded market explanations for the Chilean experience account for the social experience as a result of market-power restructuring by identifying the market logic as a product of the process of formation and its dynamic interaction with the people and groups that it affects. The role of ideas and norms cannot be measured by rational-choice modeling of economic decision-making. An ideational analysis of national and global trends of policy discourse influence is necessary to study the market-social relationship in an international context.⁸ An elite-led discourse analysis of market-societal relationships based on disembedded markets adds to the analysis of Chile through its focus on agency and its relationship to institutions. The dominant neoliberal discourse embodied in the strategy of the placement of Chicago school

economists in the Chilean government provides an insightful analytical frame to help explain the ability to manipulate the understanding of public interest in terms of economic interest.

These embedded analyses, by identifying the formalist logic as incompatible with actual economic functioning and policy design, provide the most powerful lens to understand Chile's experience with neoliberal reforms under Pinochet's regime. The macroeconomic indicators demonstrate both the failure of neoliberal policies to clear the market as well as the failure of formal economic analysis to accurately describe the outcomes. The failure of a deregulated financial sector, increase in unemployment, and rise in income inequality are indicators of the bankruptcy of an asocial, atomized conception of economic actors. Inflation may be indirectly controlled by monetary policy, but by denying the social intermediary, an important level of analysis is lost in the assumptions. The opening of the Chilean economy, deregulation of business, reduction of social provisions and state spending, and shift of government capital to private hands during wholesale privatization are all significant steps toward the complete submission of a complex and sometimes irrational society to rational models. The dangerous implications of this tendency are only understood with an embedded understanding of free market functioning.

The decision between rational modeling and social market design is filled with tradeoffs of efficiency, productivity, innovation, and social justice, but without a clear understanding of the theoretical implications of a shift in this relationship, economic policy consequences cannot be understood. The assumptions necessary for a formalist market are not consistent with the demonstrable reality of social existence on a number of counts. Psychologically, the purely material-motivation assumption made by formalist theorists does not account for emotional investment, social perception, or human errors of logical computation based on evolutionary or

socially conditioned responses.⁹ Socially, the treatment of labor, land, and money as commodities and the separation of the economic and social spheres produce a relationship of domination that is not anticipated by theories paradoxically based on claims of freedom and choice. The functioning of formalist economic policies is contrary to economic and social reality, though their utility is undeniable as it relates to creating generalized incentive structures and modeling some individual economic choices in particular social contexts.

This careful balancing act between the social environment and market freedom is not a question with a definite answer, but the relationship between free markets and society determines the consequences of any shift of power between them. The case of Chile clearly demonstrates this relationship through its unique history of sweeping market reforms and resulting measurable societal changes. Only by understanding the impact of networks and culture on policy design and implementation, the social relationships surrounding labor and capital, and socially conditioned economic perceptions can the macro economy be analyzed. The embedded market structure provides the best explanation of the causal process revealed through a chronological analysis of market reform and its consequences. Through a continued study of free market-societal relationships with a socially embedded model, more case-specific policy prescriptions can be accurately constructed to facilitate the most socially and economically productive balance of power.

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Appendix A

Table 1: Macroeconomic Data 1970-89

Year	GDP growth	Inflation	Unempl.	Gini
1970	2.1	34.9	6.9	
1971	9	22.1	5.8	46
1972	-1.2	163.4	3.7	44
1973	-5.6	508.1	4.3	44
1974	1	375.9	9.4	44
1975	-12.9	340.7	15.4	47
1976	3.5	174.3	17.2	53
1977	9.9	63.5	13.3	51
1978	8.2	30.3	13.8	51
1979	8.3	38.9	13.7	47
1980	7.8	31.2	11.8	50
1981	5.5	9.5	11.1	49
1982	-14.1	20.7	22.1	53.91
1983	-0.7	23.1	22.2	54.2
1984	6.3	23	19.3	55.5
1985	2.4	26.4	16.3	53.2
1986	5.7	17.4	13.5	53.9
1987	5.7	21.5	12.2	53.1
1988	7.4	12.7	10.9	54.5
1989	10	21.4	9.1	51.88

Sources: GDP, inflation, unemployment – (Bosworth et al., 1994); Gini – UN data;

Notes

¹ For contrasting analyses, see Sachs, ch. 6 (2005) and Klein, ch. 9 (2007).

² For a critique of this interpretation of Smith, see Lubasz (1995).

³ This argument has been picked up by others to argue for a link between free markets and free political systems- See Friedman and Friedman (1962) and Groombridge (2000).

⁴ For a discussion of trust in social networks, see Granovetter (2005).

⁵ For a description of labor deregulation and union policies, see Collins and Lear (1995a), ch 7.

⁶ For more information about the labor structures in Chile, see Amvedo-Dorantes (2005), Leiva (2006), and Collins and Lear (1995b).

⁷ For more information about Chilean inequality, see Collins and Lear (1995b), Amvedo-Dorantes (2005), Torche (2005b), and Gindling and Robbins (2001).

⁸ For elaboration and analysis of this type, see Whyte (2007), Marois (2005), and especially Blyth et al. (2007).

⁹ For a fascinating discussion of the psychological aspects of market decisions, see Shermer (2007).