

**PRESENTATION OF THE BILL  
ON THE CONSTITUTIONAL  
ORGANIC LAW OF THE  
BANCO CENTRAL DE CHILE**



**BANCO CENTRAL DE CHILE  
1989**



## CONTENTS

	Page
1. THE CONSTITUTIONAL NORM	5
2. AUTONOMY OF BANCO CENTRAL	7
2.1 Autonomy and generation of authorities	8
2.2 Autonomy and coordination with the Executive	9
2.3 Autonomy and responsibility	10
2.4 Autonomy and supervision	10
3. SCOPE OF BANK OPERATIONS AND FUNCTIONS	10
4. RESTRICTED PUBLIC SECTOR FINANCING	13
5. THE PRINCIPLE OF NON-DISCRIMINATION	14



## **PRESENTATION OF THE BILL ON THE CONSTITUTIONAL ORGANIC LAW OF THE BANCO CENTRAL DE CHILE**

Banco Central de Chile has found it advisable to divulge the bill on the Bank's Constitutional Organic Law that H.E. the President of the Republic recently submitted to the H. Government Junta. Provision 97 of the Chilean Constitution sets that a law of constitutional rank shall determine the "composition, organization, functions, and powers" of the Banco Central. The main features of this bill are outlined below.

### **1. THE CONSTITUTIONAL NORM**

The Constitution of 1980, raised Banco Central to constitutional rank thereby introducing a fundamental innovation into Chile's constitutional history.

Indeed, the foundation and development of central banks began in the early 20th century, motivated to a considerable extent by the establishment of the Federal Reserve Bank in the United States, in 1913. Originally, these institutions were constrained by the existence of a monetary regime based on the gold standard. They devoted their efforts almost exclusively to protect banks from the effects of recurring "runs" on deposits often observed at the time.

Their true dimensions, as regards monetary and exchange powers, have become clear only in the past few decades. It is not to be wondered at, therefore, that their formal introduction into the constitutional organization of their respective countries has taken some

time. In Chile, for instance, Banco Central was founded on August 21, 1925, almost simultaneously with the enactment of the Constitution that governed us until 1980. Notwithstanding, its action to guide economic activities did not emerge forcefully until the following decade. Today, it is clear that through central banks governments have acquired a powerful instrument to regulate and control economic activity.

The raising of Banco Central to constitutional rank stems from the decision to seek institutional formulations designed to limit governmental powers for monetary and fiscal policy management. One of the proposals is thus that central banks should restrict monetary operations to preestablished guidelines and that government budgets should not find simple ways to finance excessive deficits.

This worldwide trend is the result of general disenchantment with the governmental macroeconomic management of the last 25 years. Hard upon the Depression of the thirties the view became popular in the Western world that by managing fiscal and monetary policies governments could move their economies into a stable growth pattern freeing them from the sweeping cyclical fluctuations so common in the preceding hundred years. Although the fifties and sixties seemed to confirm this optimistic view, the seventies proved it to be illusory. Indeed, governments showed that fiscal and monetary policies not only could be applied effectively for sound stabilizing purposes, but were also powerful tools for manipulating the economy with electoral aims. In the end, political instrumentalization of central banks and government budgets has become a harmful source of instability in the economy and of rising inflation. In developing countries this situation has often reached serious proportions, detrimental not only to economic efficiency but also to the operation of the democratic system.

The need to regulate governmental monetary powers through the Constitution was stronger in Chile than in the rest of the world owing to this country's peculiar history of inflation. In fact, as any central bank is responsible for watching over the currency's stability, there is no better indicator of central bank performance than the rate of inflation over the years. Between 1929 -first full year for which there is an official price index, only three years after Banco Central de Chile was founded- and 1980 the annual rate of inflation averaged 36%, ranging from -5% in 1930 to 508% in 1973. In 1980, therefore, it became imperative to place Banco Central in a legal framework of constitutional rank designed to guide and place bounds on its future operation.

The constitutional law defines Banco Central as "an autonomous body of technical status, with its own assets, whose composition, organization, functions, and powers shall be determined by a constitutional organic law" (Constitution, provision 97). In addition, the Constitution provides that Banco Central may "only operate with financial institutions", though it "may not grant them its guaranty" (Constitution, provision 98, para. 1). Furthermore, "no public expenditure or loan may be financed with direct or indirect credit from Banco Central" (Constitution, provision 98, para. 2), though an exception may be made "in case of external war or threat of war, as the National Security Council shall determine" (Constitution, provision 98, para. 3). Lastly, Banco Central is forbidden to establish "different or discriminating rules or requirements in respect of individuals, institutions, or agencies

conducting operations of the same kind".

Under the Constitution, therefore, Banco Central is an autonomous body. The Organic Law governing its organization and the extent of its functions and powers -which, from their very nature, must be exhaustive- should circumscribe the scope of its operations to financial institutions, forbid it -with one exception- to provide financing for the central government, and prevent discrimination in its operation. The bill on the Constitutional Organic Law under discussion, adhering faithfully to the above tenets, proposes for Banco Central and operational organization that couples national and international experience with foreseen future requirements of the Chilean economy.

## 2. AUTONOMY OF BANCO CENTRAL

The autonomy of Banco Central, as enacted in our Constitution, should be understood in two different, albeit complementary, senses. The first and most obvious refers to its capacity to self-determine the **technical** decisions it must make in exercising its powers. That is what the Constitution means when it grants Banco Central "technical status" (Constitution, provision 97). The matters that central banks normally deal with are indeed fraught with technical tradeoffs particularly unsuited for discussion at other levels of the administration. Banco Central autonomy is appropriate for preserving its technical status.

Though the matters involved in central banking are usually of extreme technical complexity, it is nonetheless true that other government agencies also have to deal with similar matters. Many of these agencies, however, do not enjoy the autonomy provided for Banco Central in the Constitution and the present bill.

The reason is that Banco Central autonomy, in addition to preserving its technical status, is intended to provide the necessary level to safeguard such fundamental economic values as currency stability and normal performance of internal and external payments. As governments are often forced to defer such essential objectives in favor of more immediate considerations, the Constitution provides that government policies be conditioned by the existence of an autonomous central bank.

Undeniably, the management of economic policy requires a high degree of coordination among the various executing bodies. Banco Central autonomy, without detracting from the necessary coordination, is designed to set up a division of powers and the necessary counterweights. The principle of division of powers is widely accepted in policy matters, though it is also arguable in this case that greater coordination would be obtained if the principle were not applied.

Banco Central autonomy to make decisions in a predetermined framework partly offsets governmental powers in macroeconomic affairs. In particular, the definition and application of fiscal policy, though preserved as the exclusive responsibility of the Executive

Branch and the Legislature, is now restricted by autonomous management of instruments so influential on the fiscal budget as monetary and exchange policies. Similarly, the agencies in charge of supervising the financial and capital markets must coordinate with Banco Central, which will issue the relevant rules and regulations in the interests of overall economic stability.

The aspiration to set up an independent central bank in Chile is a longstanding one. The Kemmerer Mission, which proposed the general guidelines along which Banco Central de Chile was founded in 1925, stated in their report that among "bankers, businessmen, government officials, and other competent individuals, it has observed that there is a widespread and deeply rooted fear among the public regarding the success of Banco Central; it is the fear that the Bank may be subject to illegitimate influences from the government and that it may in the end go to ruin owing to the undue interference of politics in the technical decisions it must make, a fear fully justified by the banking history of many American Nations".

To avoid such difficulties the first organic law of the Bank provided that its directing body, the board of directors, would be composed of ten members, only three of whom would be designated by the Executive, the remaining seven to be of various origins. Strict incompatibilities were also stipulated between the post of director and that of member of Congress or other public offices.

Successive amendments weakened the foregoing intent in the following decades, subordinating Banco Central to the government. Under Law N° 8,707, of 1946, four members designated by Congress were added to the Bank's board. DFL N° 106, of 1953, which approved the second organic law of Banco Central, suppressed its autonomy in monetary management, the Bank being **bound** to discount certain public debt instruments. DFL N° 247, of 1960, third organic law, in effect vested all directing powers in the Executive Committee, which was clearly subservient to instructions from the Executive. Lastly, DL N° 1,078, of 1975, fourth organic law, set up the Monetary Council as highest directing body of the Bank, composed exclusively of Ministers and other officials designated by the President.

Though international experience on the subject is diverse, it may be observed that industrialized countries with the highest macroeconomic performance -Federal Germany, the United States, Japan, and Switzerland- all have a high degree of autonomy in their central banks. Even in these cases, however, the powers with which central banks are endowed are frequently offset by mechanisms for information and consultation with the Executive, veto powers in certain cases, and like measures.

The present bill, echoing the constitutional provision regarding Banco Central autonomy, provides for generation of authorities, coordination with the Executive, accountability to other branches, and supervision.

## 2.1 **Autonomy and generation of authorities**

The highest directing body of the Bank will be its Council, composed of five members,

including the President and Vice President of the Bank. All council members will be appointed by the President of the Republic, subject to approval by the Senate. Council members will serve for a term of ten years and may be reappointed. The President of the Bank will be designated by the President of the Republic from among the council members and will serve for five years (or the remainder of his term as council) and may be reappointed. The President of the Bank may be removed by the President of the Republic, subject to the consent of the Senate, upon grounded request by at least three members, for noncompliance with policies or standards issued by the Council. The office of President and council member are full-time, subject to strict incompatibilities, and may be the object of accusation before the Court of Appeals of Santiago, in the event of breach of any of the relevant provisions.

The high command of the Bank is therefore in the hands of a collegiate body: the Council. Its members are renewed in turns over time, which ensures continuity of Council policies. Under normal conditions, the Council is not completely renewed in the course of a single presidential term of office, which lasts eight years; this ensures a broader range of points of view within the Council. The structure of power within the Bank is also carefully balanced. The Council determine the policies to be implemented and designate the Vice President (among themselves) and the General Manager. The President, Vice President, and General Manager compose the Executive Committee, responsible for executing the policies issued by the Council. The President is the chief executive officer and representative of the Bank. Council members may supervise the execution of their policies not only by their indirect participation on the Executive Committee, but also by requiring the President to report occasionally or from time to time, and demanding publication of their resolutions, in addition to removal of the President as described above.

The importance that the bill attaches to the role of council members does away with option of having councillors represent sectoral interest or bodies. Such a formula would be appropriate for broadbased assemblies restricted to defining general guidelines, and would be clearly inappropriate for a Council such as the one proposed in the bill.

## **2.2 Autonomy and coordination with the Executive**

To ensure proper coordination between the Bank and the Executive, represented by the Ministry of Finance, the bill contains the following provisions:

- (a) The Bank is bound to keep the Executive informed, through the Ministry of Finance, about policies and general instructions issued in the course of operations, and to advise it in related matters or others deemed relevant for such purposes.
- (b) The Minister of Finance, or his representative, may attend Council meetings with the right to speak.
- (c) The Minister of Finance, whenever he sees fit, may suspend application of a Council resolution for up to 15 days, unless at least four Council members insist to the contrary.

- (d) In the event of imposing specific exceptional exchange restrictions, the Minister of Finance has the right to veto, which may be overridden only by the favorable vote of all Council members.

Items (c) and (b) above are most important. Item (c) has a precedent in German legislation and presents the advantage of forcing Banco Central to discuss with the Executive **before** adopting certain highly significant resolutions, if it wishes to avoid the difficulties associated with suspension. The final decision in this event rests with Banco Central. Conversely, item (d) provides for veto power by the Executive in the event of exchange restrictions, defined as exceptional in the bill, although the favorable vote of the full Council may override the veto. This provision is concerned with the very profound effect that certain exchange restrictions may have on domestic activities.

### **2.3 Autonomy and responsibility**

Under the bill the Bank is obliged to report to the Minister of Finance and the Senate. The Bank Council shall submit to them a report on policies and programs to be applied in the following year, showing the effects thereof on the main items in the Bank's financial statements foreseen for the period. At the end of the fiscal year the Bank shall publish a report including financial statements, describing execution of the planned policies and programs.

Through the Senate, public opinion is informed on the plans and management of the Bank. If the Senate and public opinion properly take up the control function contemplated in this provision, the practice may provide a fruitful occasion for public debate on monetary, financial, and foreign exchange policies, as logical supplement to normal budgetary debate.

In addition, the Bank is bound to publish any resolution that at least one council member deems of general interest.

### **2.4 Autonomy and supervision**

At present the Bank is supervised by the Superintendency of Banks and Financial Institutions. Given that this institution specializes in supervising commercial and other banks, and that, furthermore, it is in the purview of the Executive, the bill excludes the Bank from such supervision, except as regards the report on requirements and conditions to be met by financial statements. It provides instead for publication of the Bank's financial statements together with the opinion of outside auditors.

## **3. SCOPE OF BANK OPERATIONS AND FUNCTIONS**

Banco Central de Chile was founded in order to regulate the money supply and

preserve the stability of the domestic currency defined in terms of its price in gold, under the prevailing gold standard. Decree Law N° 846 gave the Bank the monopoly of the money supply; however, consistent with the objective described above, issuance was restricted to sale and purchase of gold and foreign currency, and rediscount of internal credit instruments was strictly limited.

This notion lost weight in the following decades, when the Depression led to suppressing the gold standard. Banco Central then took up a more active monetary role. The second organic law was enacted in 1953, stating that the Bank's objective was to "promote orderly and progressive development of the national economy, by means of a monetary and foreign exchange policy that, while endeavoring to avoid inflation or depression, will allow the country's productive resources to be optimally allocated". The emphasis thus shifted from monetary stability to full employment of productive resources, though "endeavoring to avoid inflation or depression".

The third organic law of Banco Central, enacted in 1960, extended the Bank's powers to the field of finance, allowing it to set reserve requirements and regulate distribution of credit. In addition, pursuant to DFL N° 250 of the same year, Banco Central merged with the Commission on Foreign Exchange responsible since its creation in 1931 for regulating foreign trade and exchange rate operations. The Bank's Executive Committee was thus empowered to issue general rules applicable to foreign trade and exchange rate operations.

The fourth organic law, of 1975, defined Banco Central as an institution under public law and forbade it to engage in credit operations with economic agents other than financial institutions and the Treasury. The definition contained in the Constitution is consistent in this respect with the organic law of 1975.

The present bill states that the object of the Bank is to "oversee the stability of the currency and normal development of internal and external payments".

"To this effect, the Bank will be responsible for regulating the money supply and credit, performing credit and foreign exchange operations, and issuing rules on monetary, credit, financial, and foreign exchange matters".

"In exercising these responsibilities, the Bank shall respect freedom of trade".

The main responsibilities of Banco Central may be grouped as follows: (a) regulating the money supply; (b) performing operations in support of specific financial institutions, whenever financial system stability so requires; (c) issuing financial regulations; and (d) issuing foreign exchange regulations.

**(a) Regulating the money supply**

The bill provides for Banco Central monopoly of issuance of banknotes and coinage, and fixes the internal credit operations that the Bank may generally perform for

purposes of monetary regulation. It includes granting credit lines, acquiring documents, accepting deposits, operating on the open market, and setting reserve requirement.

**(b) Support to financial institution to oversee financial system stability**

Banco Central is authorized to provide liquidity support to institutions in cash difficulties deemed temporary, where possible failure would jeopardize financial system stability. This provision embodies the theory and practice of central banking since the foundation of the Federal Reserve Bank in the United States of America, in 1913, until the present time. Renewal of such loans requires a Council resolution adopted by the majority of all Council members, following a report by the Superintendency of Banks and Financial Institutions. The bill also empowers Banco Central, in the event of insolvency of a financial institutions, to act as "lender as last resort" (Provisions 120, 129, and Title XIV of the Bank Law).

**(c) Financial system regulations**

In making it responsible for monetary and financial stability, the bill grants Banco Central powers to issue rules applicable to banks and financial associations as regards deposits commissions, interest, collaterals and bonds, and required relations between assets and liabilities. It is likewise empowered to issue rules concerning credit cards. These powers are all contained in the organic law currently in effect, though some are somewhat amended by the present bill. In particular, the Bank's power to determine the indexing mechanisms for financial operations is restricted to transactions carried on by banks, financial associations, and savings and loan cooperatives.

**(d) Foreign exchange regulations**

The bill defines exchange rate operations broadly. It includes import and export payments, and transactions in foreign currency or instruments denominated in foreign currency, even though not involving transfer of funds abroad or not made in foreign currency. It also provides for freedom to engage in foreign exchange operations, though Banco Central is thereby empowered to introduce limitations and restrictions as warranted by the need to oversee currency stability or ensure balance of payments financing. Such limitations and restrictions include prohibition to operate outside what is known as the "formal exchange market", regulation of such operations, and exceptionally power to suspend, restrict, or subject certain operations to prior approval. This last power may be exercised only for justified reasons, temporarily, and requires exceptional procedures, including the Executive's veto power described above.

Banco Central powers in foreign exchange matters arise from its close connection with monetary affairs in an open economy such as this one. The interrelation between monetary

and exchange rate policies is increasingly understood throughout the world. In Chile, this notion is embedded in Banco Central legislation since 1960.

On this subject, however, the present bill introduces substantial amendments into the 1960 law. First of all, it authorizes foreign exchange operations in general and grants Banco Central powers to prohibit, restrict, or regulate specific transactions in particular. This reverses the present position, where whatever is not explicitly permitted is forbidden. Secondly, a hierarchy of applicable provisions is established, where restrictive provisions are temporary, and the range of applicable penalties is explicitly set forth. Renewal of such penalties is subject to veto by the Minister of Finance. Finally, as regards foreign trade, Banco Central powers are restricted to regulating and supervising export returns and import coverage of goods and services. It is then excluded from its terms of reference any other functions connected with foreign trade policy that might otherwise be entrusted thereto. The bill involves revoking SD N° 471, of 1977, known as the "Foreign Exchange Law".

#### **4. RESTRICTED PUBLIC SECTOR FINANCING**

The Constitution, apart from granting autonomy to Banco Central, contains an additional provision to forbid it to grant the administration "direct or indirect" credits, except in the event "of war or danger thereof".

The constitutional provision seeks complete separation between administration of the State and management of monetary policy. The prohibition to finance the public sector supplements and reinforces Banco Central autonomy. The public sector is thus restricted to finance its activities from its revenues and by obtaining internal or external credit.

The first organic law of Banco Central had a similar purpose in providing that loans granted by the Bank to institutions in the public sector could not exceed 20% of its capital and reserves. It also set that each loan required the agreement of at least 6 out of the 10 directors of the Bank. The law added that subject to approval by 8 directors the limit on public sector loans might be raised from 20% to 30% for three months.

As was the case of other provisions of the same organic law, these limitations were first amended and later suppressed, under successive reforms undergone by Chilean central banking legislation. As pointed out above, Banco Central was not only authorized to overstep the stipulated margins but was also bound, by way of discounting documents issued by Caja Autónoma de Amortización de la Deuda Pública, to finance government's deficits.

This form of fiscal financing, by causing inflation, provokes serious distortions in the price system and operation of economic activity. It also in fact becomes a tax that affects money holders and non-indexed receivables by detracting from their purchasing power. The constitutional ban on fiscal financing by issuing money therefore provides effective protection of the Legislature's exclusive power rule on the amount and distribution of taxes.

## 5. THE PRINCIPLE OF NON-DISCRIMINATION

Lastly, the constitutional law subjects Banco Central to the principle of non-discrimination. This means that its resolutions may not establish rules or requirements involving differential treatment or discrimination among "individuals, institutions, or bodies conducting operations of the same nature". The foregoing notion is an application of the principle of "equality before the law", the keystone of any free society.

Discriminating treatment may involve either granting Banco Central resources to specific individuals or institutions without justification, or issuing regulations arbitrarily benefiting some to the detriment of others. As for the former, pursuant to the present bill, as explained above, the Bank is obligated to report annually to the Minister of Finance and the Senate on its programs and policies for the present fiscal year and to issue a Report accounting for execution thereof in the preceding fiscal year. This information also includes accounting data on forecast and actual financial statements. The transparency of information derived from these provisions is designed to limit Banco Central ability to distribute its resources on insufficient grounds.

Regarding the Bank's regulating powers, its obligation to publish its general resolutions and the complain procedures contained in the law basically retain the provisions of the prevailing legislation.



