The Two Waves of Financial Liberalization in Latin America

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I. Introduction

The economic history of Latin America in the past three decades suggests that the most sensible approach to evaluate the regional processes of financial liberalization, is not to see them as policy initiatives that can be isolated from their context, but rather as a set of experiences that share a set of common features. However, there are still enough noteworthy contrasts in policies and performance between the different LA countries to be able to draw important lessons about the relative merit or lack of it of specific measures.

The long-term trend towards financial liberalization in LA has not been a continuous process but one with a marked break during the eighties as a result of the crises brought about by the failure of the "first wave" of liberalization attemps. These were labeled the "Southern Cone liberalization experiments", and we especially analyze the cases of Argentina and Chile. Though they were short-lived these experiences are for our purposes closed episodes with well-defined beginnings and ends[1].

With respect to the nineties our view is particularly influenced by five national cases: Argentina, Brazil, Colombia, Chile and Mexico. These are the biggest economies in the region. Together they represent more than three quarters of the regional product and were the main recipients of the capital inflows. They also provide

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good examples of a variety of policies and economic performances. However, even though chronologically in the past, evaluating the liberalization processes in the nineties is complicated by the fact that some are not closed cases in a strict sense. Fortunately, it is possible to draw stronger conclusions, particularly regarding the issue of sustainability, by considering the experiences of México and Argentina in the first half of the decade. This period, whose end was marked by the December 1994 Mexican devaluation, was long enough for the endogenous dynamic processes we analyze to fully work their way into a crisis.

This paper also examines the relationship between capital market liberalization and the unfavourable outcomes in terms of employment and the distribution of income observed in most LA countries. By opening their economies to massive capital inflows, the authorities were able to sustain overvalued exchange rates at the same time that they rapidly liberalized their foreign trade regimes. This combination biased relative prices against the industrial sector and led to the restructuring and concentration in the activities producing tradable goods. Thus, employment losses were the result of the loss of competitiveness of local activities. Capital market liberalization consequently increased LA countries external vulnerability not only by exposing them to the volatility of unrestricted capital flows but also because it discouraged export growth and diversification.

The paper is organized as follows: In the next section we review Latin America's experience with capital market liberalization and comment on those features of the process shared by most economies in the region. In section III we analyze the liberalization experiences in the seventies. In section IV we examine the

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experiences of the nineties, focusing first on the problem of sustainability and then on the impact of unregulated capital markets on employment and the distribution of income.

II. Some specific features of capital market liberalization in Latin America.

It is never simple to explain observed economic performance exclusively as the consequence of the implementation of a certain policy. Contexts change and the specific measures we attempt to evaluate are often part of a wider set of initiatives whose effects most often overlap. These considerations are particularly relevant in the case of capital market reforms in Latin America (or LA).

In the first place, with respect to the overlapping of effects, financial liberalization and opening have not been isolated policy initiatives but have always been implemented in LA as components of wide-ranging structural reforms and stabilization programs. Packages of this kind were practiced in the region in the second half of the seventies and their implementation became generalized in the nineties. For this reason, the outcomes of financial reforms have always emerged in combination with the effects of trade opening and public-sector reforms, as well as with the measures and results of macroeconomic stabilization policies. Both in the cases of the seventies and in the more important ones of the nineties, a fixed exchange rate was a first-order ingredient in stabilization packages.

In the second place, regarding the external context of the policies, financial reforms coincided with boom periods in international financial movements. They were always accompanied by massive capital inflows with their own significant effects on the working of the economy.[2] Because of this correlation, the effects of liberalization in LA are not easily distinguishable from those of drastic changes in the size and composition of capital flows.

In the first boom of capital flows into developing economies - the period that followed the 1973 oil shock - the region pioneered drastic financial reforms. (The Argentine and Chilean cases are the most notable experiences.) This phase came to an abrupt end with deep financial and external debt crises. They were followed by the nationalization of private external debts and the establishment of an institutional arrangement in which external financing had to be intermediated by negotiation with the international banks and the IMF, because LA was segmented from international markets. Apart from this link of permanent negotiation, the region remained practically isolated from international capital markets for the rest of the decade. If we were to date that period more precisely, we could say that it lasted between the 1982 Mexican moratorium and the signing of the first Brady Plan to restructure external debt (Mexico 1990). During that time the region operated under a regime characterized by two stylized facts: external financing was rationed and negotiations with creditors and multilateral financial organizations generally imposed macroeconomically significant transfers abroad.

The constraints set by external financial rationing and these transfers dominated policy design and economic performance during the eighties. In the initial years, control over the external and financial crises was absolute policy priority and the institutional setting of financial markets was subordinated to this target. For instance, private external debt was nationalized through massive interventions such as the nationalization of the banking system in Mexico, the generalized refinancing of private debts in Argentina, and a total bailout of the banking system in Chile. In this phase the priority given to external adjustment and the need to regain control over as many policy instruments as possible led to the reversal of previously adopted liberalization and opening policies. As policymakers sought to stabilize their economies, they implemented emergency measures, such as the reintroduction of exchange controls to block capital flight, interest rates regulations to ease the management of the financial crisis.

Although the urgency of the early eighties removed financial liberalization from the immediate policy debate, it reappeared on the agenda of conditionality that accompanied the external debt negotiations. This link became clear in the mid-eighties with the appearance of the adjustment-cum-growth Baker Plan. Since then, coordination between the IMF, the World Bank, and other agencies has increased and the Washington Consensus has become more clearly defined. Even so, capital market liberalization was of secondary relevance in the eighties. The history of the economic performance during that period - especially in Argentina, Brazil, and Mexio, the largest economies in the region - is basically about a sequence of attempts and failures of comprehensive macroeconomic stabilization programs. Inflation and the balance of payments were stabilized for some time before new destabilizing trends required further adjustments and stabilization measures. There were huge real fluctuations around a stagnant trend. Variations in the institutional framework of the financial sector were of secondary importance compared to these cycles.

The eighties' stabilization programs attempted to reconcile the external financial constraint with the achievement of three conflicting goals: debt service, inflation reduction, and recovery of a positive rate of growth. While some countries -

Chile and Colombia, for example - could resolve this conflict in the second half of the period and stabilize the performance of their economies,[3] the biggest were unable to do so until the end of the decade. In Argentina, Brazil and Mexico stabilization was only achieved in the nineties, when transfers abroad reversed abruptly and the region became the recipient of massive capital inflows. Financial liberalization gained new relevance under these conditions. The external constraint ceased to be binding.

The market segmentation of the eighties, the instability that lasted until the end of the decade, and the joint effects of both circumstances on the domestic financial markets determined other specific features of the experiences of the nineties. Similar circumstances characterize the Chilean and Argentine liberalization experiments of the seventies.

Among the "initial conditions" of the Southern Cone experiments during that period was the particular situation of domestic financial markets. They had recently undergone deep crises and restructuring (Chile 1971-76, Argentina 1974-77), were emerging from a long period of segmentation from international markets, and had adapted to a high inflation environment. The financial markets of the biggest economies in the region found themselves in similar conditions at the end of the eighties. Especially in the three largest countries, the "second wave" of financial liberalization and capital inflows, like the first, generally took the form of a shock in economies that until then had shown low levels of monetization and financial deepening, weakly developed banking systems, a poor menu of financial assets, and scarce credit for the private sector.[4]

The enthusiasm with which liberalization was adopted in the absence of necessary institutional underpinnings left financial systems facing largely unchartered territory. Not surprisingly, they were unable to efficiently allocate the strong injection of funds. The small size and poor diversification of financial markets gave rise to a natural tendency for capital flows to induce major disturbances. Their magnitude was large compared to the existing stocks of money, credit, and domestic financial assets. Such high flow/stock ratios implied strong appreciation pressures in the exchange market and/or high credit and liquidity expansion rates according to the degree of intervention of the monetary authority. They also generated a swift appreciation of financial and real assets, such as land and real estate. Those tendencies were enhanced under the fixed exchange-rate regimes found in the majority of experiences. More generally, the shock implied the emergence of important expansionary financial effects in domestic demand. That is why the initial phase of a real and financial boom and the propensity to generate speculative bubbles - widely observed in developing countries associated with financial liberalization and massive capital inflows - were closely linked to these "initial conditions" in the LA cases.

Lastly, the region's passage from the eighties to the nineties signified the transition from a situation of external financial rationing and transfers abroad to one of abundant financing. This change, in itself, could only have had beneficial effects on macroeconomic performance. The stabilization programs could succeed; there was a generalized drop in inflation; GDP and domestic absorption grew - the latter more than the former. However, the fact that macroeconomic performance improved does not support the view that accepting globalization in the terms of the Washington Consensus was an optimal policy.

In the first place, as already mentioned, the impact of the surge in capital inflows is difficult to distinguish from the effects of liberalization policies. The fact that these policies were undertaken may have played a “signalling” role that encouraged capital inflows, but there is strong evidence that most capital (perhaps with the exception of FDI) flowed to LA in response to decreases in the expected rates of return in the main international markets. In the second place, the performance of LA economies during the eighties is not a relevant basis on which to evaluate the experience in the nineties, since it represented, to a large extent, the unsuccessful attempts by LA countries to overcome the constraints posed by their high debt burden and credit rationing. Thus, though in this paper we are emphasizing the negative aspects of globalization, we are not arguing that the “lost decade” was preferable to the nineties. Rather, one of the lessons of the painful experience of the eighties is that policy makers should strive to preserve fluid access to the international financial markets. The experience in the nineties, in turn, shows that, to minimize the risks it poses, integration in the global economy must be carefully implemented, both in terms of speed and depth.

III. The liberalization experiences in the seventies.

In the mid-seventies Argentina and Chile were undergoing similar political and economic processes. The Peronist and *Unidad Popular* governments had been overthrown by military dictatorships in the midst of deep economic crises. The first phase of the macroeconomic policy of the military administrations did not deviate significantly from the traditional stabilization recipes that both countries had repeatedly put into practice since the fifties. Price controls were lifted, wage increments were repressed, and the exchange rate was devalued. After that, a crawling-peg regime was adopted. Fiscal adjustment was mainly based on the contraction of wage expenditures. Real wages fell dramatically in both countries and employment made a strong drop in Chile. The fiscal adjustment was deep and permanent in the Chilean case and less significant and lasting in the Argentine. An innovation in economic policy was domestic financial reform: the interest rate was freed and most regulations on financial intermediaries were relaxed or removed.

Both economies had been isolated from international financial markets in the first half of the seventies. The eurodollar bank market was already booming in that period, particularly after the 1973 oil shock. (Brazil, for instance, was utilizing this source of external financing intensively.) In the mid-seventies the Argentine and Chilean economies did not have sizable external debts. Their balance of payments had already been equilibrated by the stabilization packages. The orthodoxy of the military administrations gained credibility with the IMF and international banks despite the fact that both economies were experiencing high rates of inflation. High domestic financial yields attracted capital inflows even before the capital account had been opened. Confronted with these pressures the authorities initially gave priority to the control of the domestic money supply and attempted to curb inflows by imposing regulations.

In the second half of the seventies, first Chile and shortly after Argentina implemented new and similar policy packages. Liberalization of the exchange market and deregulation of capital flows were added to the domestic financial reform that had previously been implemented. Trade liberalization programs were launched simultaneously. Tariff reductions were scheduled to converge in a few years to a flat and low tariff.[5] Exchange rate policy was the anti-inflation component of the package.

Exchange rates were fixed by announcing predetermined paths for monthly devaluation rates, converging to a nominal constant exchange rate (the "tablitas"). This macroeconomic stabilization package was inspired by the "monetary approach to the balance of payments".

The following features characterize the external and real performances after the packages were launched. There were massive capital inflows and a first phase of reserve accumulation and high rates of growth in money and credit. There was a strong expansion in domestic demand, led by consumption (and, to a lesser degree, by investment), as well as the emergence of bubbles in financial and real assets. The real exchange rate appreciated continuously because domestic inflation was systematically higher than the rate of devaluation plus the international inflation rate. Current account deficits rose fast and persistently and the external debt soared. When US monetary policy drove up the international interest rate in late 1979, both economies were already showing huge current account deficits and external debt. From then, the increased international rate contributed its own effect to their external fragility. The crisis broke soon afterward. The exchange rate regime collapsed in Argentina in early 1981 and in Chile in 1982. External market financing closed for both economies in 1982 and massive bailouts were implemented to confront the resulting financial crises. Both economies fell into deep recessions.

How can we evaluate economic performance in these cases? The depth and duration of the real consequences is well known. The key question is about the sustainability of growth during and after the crises. The negative external shock played a fundamental role in the genesis of the LA debt crisis. The rise in the international interest rate not only had a direct financial impact, but also other indirect negative effects caused by the ensuing world recession and the fall in the terms of trade. (In the case of Brazil, a highly dependent oil importer at the time, higher import prices added to the effects of the 1979 second oil shock.)

Secondly, the crisis encompassed the entire region. In the highly liquid and low interest rate context of the seventies, many economies had major current account deficits and accumulated important debts. At one end of the spectrum of institutional and policy regimes were the Argentine and Chilean liberalization and opening packages. At the other was the indebtedness policy of Brazil's plan for deepening import-substituting industrialization (or ISI) whereby capital flows were mediated and administrated by the government. Mexico combined elements of both, with increases in public expenditures, as in Brazil, and some market deregulation, as in Argentina. The crisis affected all of the highly indebted economies, and others by contagion, such as Colombia. In the seventies this country had explicitly refused to join the newly developed international financial market by changing its policy regime and had reduced its External Debt/GDP ratio by a half.

Taking into account this diversity, one way of evaluating Argentina's and Chile's liberalization policies is to compare their performances with those of the countries that reached the crisis with other policy settings. Were the real effects less important in the Southern Cone? Did market cushioning mechanisms operate as had been foreseen to limit the extent of the crisis and to reduce its social cost?

With regard to the real effects, Chile experienced the deepest recession in the region and Argentina's contraction can be counted among the largest. In the first half of the eighties GDP in both countries contracted more than Mexico's and Brazil's and also more than the regional average. In Chile the adjustment led to a drastic cut in labour demand and unemployment rates reached 30 per cent. In Argentina the adjustment took place principally through a drastic fall in real wages and a sustained three-digit inflation ensued. The extension, depth and social costs of the Southern Cone's financial crises also surpassed the relative importance they attained in the other countries facing a negative external shock.[6] Market stabilizing mechanisms - i.e. price and interest rate flexibility and real resource allocation and portfolio flexibility - either did not work as had been foreseen or gave rise to perverse effects such as the deepening of the crisis due to a rise in domestic interest rates. Be it for the greater relative importance of capital flight (Argentina), for worse previous external debt indicators (Chile), for higher financial fragility (both countries), or for fewer available policy instruments (both countries), the Chilean and Argentine policy regimes showed low ability to defend themselves against the volatility of international financial markets. An inter-country comparison does not favor financial liberalization.

An alternative way to evaluate the policy packages is to analyze the macroeconomic dynamics they generated while attempting to weigh the significance of the jump in the international interest rate. Was growth on a sustainable path prior to the external shock or did local macroeconomic dynamics already show signs of instability? One important fact is that both countries' domestic financial crises preceded their external crises and devaluations by over one year. In Argentina, the collapse of the exchange rate regime occurred one-and-a-half years before the Mexican crisis.

In fact, both countries show strong evidence of an endogenous cycle with a turning point and contraction phase which emerged independently of the evolution of the international interest rate. It was jointly driven by domestic financial developments and the evolution of the balance of payments. Cross effects were positive in the first phase and negative in the second. The cycle affected the real economy mainly through financial linkages: the evolution of credit, asset holders' portfolio decisions, and the financial situation of firms, though a key factor aggravating the dynamics and magnitude of the disequilibria was also the strong tendency for the increase in the relative price of non-tradable goods, to levels that implied a severe deviation of the real exchange rate from its long-term equilibrium level. The cycle´s phases can be clearly discerned in the trajectories of the current account, the level of international reserves, and the domestic interest rate. The stylized facts are as follows:[7].

The opening of both the trade and capital accounts was accompanied by the predetermination of the nominal exchange rate. From that moment on there was persistent exchange rate appreciation. The inflation rate tended to fall but was systematically higher than the sum of the programmed rate of devaluation plus the international rate of inflation.

The launching of the package was followed by an injection of funds from abroad. The monetary base, bank deposits, and credit grew swiftly, as did the number of financial intermediaries. There was rapid appreciation of domestic financial and real asset prices. Domestic demand, production, and imports tended to expand. The increment in imports caused by trade opening, exchange rate appreciation, and expansion in domestic demand steadily widened the trade deficit. Likewise, the current account deficit showed an increase, which was only gradual because the external debt was initially small. Initially, capital flows were higher than the current account deficit and reserves accumulated. Its increment led to the domestic money expansion mentioned above.

The evolution of the external accounts and reserves marked one aspect of the cycle. There was a continuous but gradual increase in the current account deficit, while capital inflows could shift abruptly. At a certain moment the deficit surpassed the level of inflows. Reserves reached a maximum and then contracted, inducing monetary contraction overall. However, the cycle was not exclusively determined by this mechanical element: the size of capital flows was not an exogenous datum. Portfolio decisions regarding assets denominated in domestic currency and dollars were not independent of the evolution of the balance of payments and finance. Both played a crucial role in the process.[8]

The domestic interest rate was a clear indicator about financial aspects of the cycle. It fell in the first phase and then turned upward after a certain point. Because the exchange-rate rule initially enjoyed high credibility, arbitrage between domestic and external financial assets and credit led at the beginning to reductions in the domestic interest rate and the expected cost of external credit. The latter became negative in both countries. The real domestic bank lending rate became negative in Argentina and fell dramatically in Chile (to one-fourth its previous value). Lower interest rates helped spur real and financial expansion. However, financial fragility in the sense of Hyman Minsky (1986) increased significantly, due to both the rise in leverage and the increasing currency mismatch between assets and liabilities, two factors that would become crucial once interest rates started to rise.

In the second phase, rising domestic interest rates and episodes of illiquidity and insolvency appeared, first as isolated cases and then as a systemic crisis. What explained the increase in nominal and real interest rates? The nominal domestic interest rate can be expressed as the sum of the international interest rate, the programmed exchange-rate devaluation rate, and a residual accounting for exchange and financial risks. The was the main variable explaining the increase in the interest rate. On the one hand, financial risk rose in conjunction with financial fragility. But, more importantly, the increase in the risk premium was with the evolution of the external sector. The persistent increment in the current account deficit - and at some point the fall in reserves - reduced the credibility of the exchange rate rule. Higher interest rates were needed to equilibrate portfolios and attract foreign capital. In turn, Illiquidity and insolvency spread a la Minsky, threatening a systemic crisis. Episodes of bankruptcies in banks and firms further contributed to reducing the credibility of the exchange rule. This dynamics proved to be explosive in both Argentina and Chile. At the end of the process no interest rate was high enough to sustain the demand for domestic assets. There were runs on Central Bank reserves, leading finally to the collapse of the exchange rate regime. The resulting devaluations further deepened the financial crisis.

This analysis highlights the relatively minor (direct) role of the international interest rate in domestic financial developments. Its increase in the late seventies overlapped with the endogenous cycle and surely contributed to a more rapid deterioration of the current account, but this seems to have been its principal impact on the domestic cycle. As pointed out earlier, the exchange rate and financial risk premia were the main contributors to the upward trend in domestic interest rates in the second phase.

We should also mention that neither the fiscal deficit nor the existence of public guarantees on bank deposits played significant roles, but merely exacerbated the dynamics driven by the mechanisms we are emphasizing. Argentina had both and before Chile´s program unravelled, the conventional wisdom[9] attributed its troubles to these "sins". In the end, however, Chile suffered the same fate as Argentina, despite the fact that it was recording a fiscal surplus and that it had eliminated deposit guarantees with the explicit purpose of making the working of the financial system more efficient and less risky. In this regard, though it certainly contributed to the crises, the importance of moral hazard in the "Southern Cone" experiences has been greatly exaggerated in some literature. Though the weaknesses of the financial system played a very important role as destabilizing factors, they should be mostly attributed to the deregulation of banking in a context of very lax supervision and enforcement by the Central Bank.

Those are the generic features of liberalization and opening processes in Latin America. If having a robust, difersified and well-supervised banking system had been considered a prerequisite for implementing financial opening packages, then none of them would have been put into effect, either in the seventies or the nineties.[10]

IV. The experiences of the nineties

In this section we do not enjoy 100 per cent hindsight. LA experiences in the nineties are not far-off closed cases, but rather current or recent history. However, enough time has passed for some features to be discerned. With respect to sustainability in particular, the Mexican and Argentine 1994-95 crises mark a watershed and delimit a period - the early nineties - which can be analyzed as a *fait accompli*. In the first part of this section, we examine macroeconomic performance early in the decade, contrasting Mexico's and Argentina's stylized facts with those of other economies in the region whose dynamics proved to be more stable.

IV.1. Sustainability problems[11]

IV.1.1. The region's macroeconomic performance in the early nineties

Stabilization efforts in the eighties confronted the extremely difficult task of reconciling external debt service obligations with the preservation of basic macroeconomic balances, both external and fiscal. This was made more difficult by the fact that the deterioration in the external accounts was closely related to that in the fiscal accounts, via the rise in interest payments on the foreign debt.

As a consequence, LA countries overburdened with debts and facing credit rationing were extremely vulnerable to any unfavourable developments on its external or fiscal fronts, even to shocks that, in other circumstances, would not have been so destabilizing. On the other hand, occasional positive shocks were not enough to drag the countries out of the mud. This asymmetric response of LA economies, showed that their fate was mostly determined by their debt overhang and lack of access to foreign financing.

This situation reversed in the nineties. Almost every country closed its fiscal and external gaps. This important difference made possible the lower inflation rates and higher rates of growth observed across the region. Changing international financial conditions and their impact on the evolution of the external sector are the main causes of the improvement.

With the relaxation of the external constraint, macroeconomic performance improved because most of the destabilizing negative-feedback mechanisms could be deactivated. Firstly, the availability of external resources allowed domestic absorption and activity to expand. Capital inflows were of such a magnitude that many countries experienced an excess supply of foreign currency despite rapid growth of imports. There was generalized reserve accumulation and exchange-rate appreciation.

Higher economic activity and exchange rate appreciation favored stability. The latter contributed significantly to the reduction in inflation and improvement in the fiscal accounts by diminishing the real value of interest payments on the external debt. At the same time, tax receipts improved with the rise of activity and sales. Lower inflation rates also helped raise tax collection, directly by increasing the real value of taxes and indirectly by easing the implementation of tax and administrative reforms. Additionally, fiscal equilibrium was facilitated in some countries through the implementation of massive privatization schemes, mostly financed with foreign capital.

IV.1.2. The Mexican crisis and its repercussions

Until mid-1994 Brazil was the main and important exception to these regional trends. The Real Plan stabilization program, launched in July 1994, then put the economy in line with the rest of the large LA countries, with respect to inflation, the balance of payments, and appreciation of the exchange rate.

Paradoxically, only a few months after the Brazilian economy was synchronized with its neighbors, Mexico and Argentina were hit by external and financial crises and confronted another round of adjustments. Official and multilateral support to both countries in 1995 prevented a default on external payments and the reemergence of a scenario like that in 1982. In contrast to that experience, financial markets rapidly reopened for Latin America.

Mexico had been at the forefront of the region's stabilization and structural reform processes. It led international investors' expectations about Latin America as a whole. Its evolution in the early nineties was assessed as a stable development process with increasing international trade and financial integration, particularly with the United States. Mexico was seen as the vanguard for similar changes elsewhere in LA. The Mexican crisis abruptly changed perceptions by showing that the good performance of the nineties was not immune to a resurgence of instability. In this sense, the crisis marked a watershed for the region as a whole. It ended a period whose beginning can be situated in 1990, when Mexico signed the first Brady agreement.

Both the Mexican and the Argentine crises, triggered by the tequila effect, suggest we explore the region's sustainability problems in the early nineties by comparing these two cases - with proven difficulties - with other countries which demonstrated more robust performances.

IV.1.3. Capital flows, the exchange-rate appreciation and the external fragility

In 1991-93 net inflows of financial resources into the region amounted to about US$166 billion, while current account deficits added up to $98 billion. In every country net capital inflows were higher than the current account gaps, giving rise to the accumulation of reserves. Of total inflows, $75 billion went to Mexico, $29 billion to Argentina, $20 billion to Brazil and $8 billion to Chile. These four countries received 80 per cent of the total regional inflow in 1991-93, and Mexico alone absorbed about 45 per cent. Outside these countries, capital inflows were also significant in Peru and Venezuela.

Exchange-rate appreciation was universal, but its magnitude differed across countries. Mexico and Argentina experienced the greatest appreciation in comparison with the real exchange rate prevailing in the second half of the eighties. In 1994 Chile and Colombia were at the other end of the spectrum. The degree of relative appreciation was determined by the level of the exchange rate at the beginning of the nineties and its subsequent dynamics. In Mexico, where the stabilization program dated from late 1987, a significant appreciation had taken place in 1988. The process persisted at a slower pace until 1990 and accelerated from 1991. In Argentina, the exchange rate experienced an important appreciation in 1990 and was nominally fixed at that already appreciated real level in 1991. Further appreciation continued into the early nineties. In contrast, Chile and Colombia entered the nineties with relatively depreciated exchange rates. Chile's subsequent rate of appreciation was lower than in the rest of the countries. In Colombia, the process accelerated in 1994. Brazil maintained a depreciated exchange rate until 1993. The exchange rate appreciated strongly after the Plan Real was launched, particularly in its first year, and it kept rising, though at a slower pace, reaching a maximum in early 1996. Despite a minor devaluation, at the end of 1998 the real exchange rate was still as high as it was at the beginning of 1996. In the end, and despite an IMF support package, Brazil was forced to abandon its exchange rate regime and adopted a system of dirty floating as from the January 1999 devaluation.

The different evolution of exchange rates was associated with the macroeconomic policies each country followed. Mexico and Argentina implemented stabilization policies in which a fixed nominal exchange rate was a crucial ingredient, fully deregulated their capital accounts, and adopted a passive attitude vis-à-vis capital inflows. On the other hand, Colombia, Chile and Brazil (until 1994) included real exchange rate targets in their exchange, fiscal and monetary policies.[12] Chile and Colombia adopted crawling-band exchange rate regimes, regulated capital inflows by imposing differential taxes according to the types of flows - which required the maintenance of some control over the foreign exchange market - and implemented sterilization policies. These strategies did not always completely fulfill their objectives, but they did lead to better overall performances.[13]

The region's trade deficit showed an increasing trend, reaching \$15 billion in 1993. However, this total is biased by Brazil. During 1991-94 Brazil accumulated a \$50 billion trade surplus despite the jump in imports induced by the Plan Real in 1994. By contrast, Mexico's trade deficit was \$63 billion in 1991-93. The Argentine deficit was \$8 billion. In both cases the deficit resulted from a rapid growth of imports. This trend persisted in 1994 when the deficit of the two countries totaled \$29 billion. Imports also grew fast in Colombia, where the trade balance passed from a \$2.3 billion surplus in 1991 to a \$2.1 billion deficit in 1994. In Chile the trade account was in surplus in the early nineties, except for 1993.

The region's annual growth rate in imports went from 10.3 per cent in the second half of the eighties to 16.1 per cent in the nineties, while the rate of growth of exports declined (except in Brazil). In Mexico, growth of imports had already tripled that of exports in the second half of the eighties and this ratio persisted into the nineties. In Argentina, exports increased by 5.5 per cent per year in 1991-94, while imports grew by 55.6 per cent per year in the same period.

Overall, the Current Account Deficit/Exports ratio (CAD/X) for Latin America was 27.5 per cent in 1993 and slightly lower in 1994. This regional average is biased by the more favorable results of Brazil's external sector, where the current account was practically in equilibrium. With this in mind, the regional average for the indicator of external fragility can be used as a standard for the comparison of the national cases.

It is interesting to underline the situation in 1993 because it constitutes the most immediate antecedent to the changes that took place in 1994 and which we describe below. In 1993 the ranking of countries by different external fragility indicators showed a clear pattern. Regarding the CAD/X ratio, Chile and Colombia had lower levels than the regional average while Mexico and Argentina doubled it. Moreover, the ranking remains unaltered if account is taken of the proportion of the current account deficit financed by FDI[14], with Argentina and Mexico appearing at the bottom of the list. The External Debt/Exports ratio exhibited a similar pattern, although Brazil's high relative external indebtedness pushed its level close to that of Mexico and Argentina. In 1994 Colombia's CAD/X ratio rose slightly - but remained lower than the regional average - and the ratio fell in Chile. Meanwhile, the ratios worsened in Mexico and Argentina, increasing by 20 per cent with respect to 1993.

IV.1.4 The turning point in 1994

At the end of 1993 Mexico and Argentina were the economies with the most unfavorable indicators of external fragility in the region . Difficulties in sustaining the macroeconomic performance of the early nineties were foreseen, to the extent that the dynamics resembled the initial phases of the Southern Cone experiences analyzed in the previous section. Thus, a turning point with a subsequent contraction was to be expected. In fact, some evidence of a turning point was visible in 1994, well before Mexico´s December devaluation. One indicator of such a change was a shift in the trend of international reserves in both Mexico and Argentina.

However, the precise timing of the contractionary phase can be anticipated or delayed by events that are external to the endogenous cycle. It was precisely one of these events, the strong rise in interest rates engineered by the Federal Reserve from February 1994, which created the background for the attack against Mexico late in the same year. Following the Fed's decision there was an upward shift in the yield curve in the US, but there was a more than proportional impact on LA bond prices. Consequently, along with the increment in interest rates, there was an increase in the region's country-risk premia. They rose significantly more for Mexico and Argentina than for other countries, in line with their higher levels of external fragility. The relative performance of financial assets is symptomatic: important drops were observed in the cases of Argentina and Mexico early in 1994; a slightly smaller decline occurred for Brazil; and prices stabilized for Chilean assets.

The rise in the risk premia of LA assets in reaction to the increase in US interest rates represented the first wave of herd behaviour against emerging markets, a behaviour which would later reappear[15] in the Asian and Russian crises and would also manifest itself in the “strange” positive correlations between the Nasdaq Index and emerging-market asset prices[16].

How can this rise in the country-risk premia in response to the change in the Fed´s policy be explained? A plausible hypothesis is that international investors perceived an increase in external fragility as a result of the impact of the higher interest rate that the debtors had to confront. But, by reducing their exposure to higher risk - i.e. demanding higher compensation for the risk – financial-market players accentuated the original unfavorable impact of the higher international interest rate. This movement, in turn, increased the probability that the economy might be pushed towards a “bad equilibrium”. This set the stage for the sudden shift in market sentiment that would later coordinate the negative expectations that precipitated the Mexican devaluation. In turn, Argentina´s perceived weaknesses immediately led to contagion. In this sense, the Mexican and Argentine crises did not erupt suddenly in a quiet landscape, but were the last episodes in a period of increasing financial tension ignited by the changes in monetary policy in the US.

Together with the increase in country-risk premia came a decline in capital flows to Argentina and Mexico which significantly modified the trend in the regional aggregate. In 1994 total inflows amounted to $47 billion, compared to an annual average of $55 billion in 1991-93 and a maximum of $70 billion in 1993. The reduction was fully explained by the two countries, and particularly by Mexico, whose capital inflows dropped from $30 billion in 1993 to $10 billion in 1994. In contrast, Brazil's and Colombia's capital inflows augmented in 1994 and the rest of the region's were similar to their levels in the preceding year.

The fall in capital inflows in Mexico and Argentina was concomitant with an increase in the current account deficit in both cases. In 1993 the deficits had amounted to $23.5 billion in Mexico and $7.5 billion in Argentina. They grew to $30.6 billion and $11.1 billion in 1994, respectively. As the joint outcome of lower capital inflows and higher current account deficits both countries recorded reductions in their reserves in 1994 for the first time in the nineties. In Argentina, because of its currency board regime, falling reserves induced contractionary monetary effects even before the tequila effect triggered the crisis.

IV.1.5. The tequila effect

The initial turbulence generated by the Mexican devaluation affected Latin America and other more distant markets for some time. But after a relatively brief period, the economies of Chile and Colombia did not register further perturbations. In the case of Brazil, the abrupt balance-of-payments effects of the Real Plan had already placed the economy in a fragile external position and in the first half of 1995 the country had capital outflows. Nevertheless, Brazil counted with abundant reserves and the turbulence only brought about a deceleration in growth[17].

In contrast, the tequila hit Argentina with full force. The contagion effect in this episode appears to be a continuation of the common trends mentioned above and was associated with the similarities of the Mexican and Argentine macroeconomic situations. In Argentina, the Mexican crisis triggered a financial crisis and a strong outflow of private capital in the first half of 1995 - partially compensated for, as in Mexico, by the increase in the public external debt. Both economies experienced deep recessions. In 1995 GDP contracted by 6.6 per cent in Mexico and by 2.8 per cent in Argentina. Both countries' 1995 unemployment rates doubled those of 1993.

IV.1.6. Synthesis and conclusions

Latin American macroeconomic experience in the nineties was similar in some key aspects to that of the seventies. The combined effects of liberalization and opening of financial markets, massive capital inflows, trade opening, and exchange-rate appreciation generated growing external and financial fragility. Economies became prone to perverse financial cycles and vulnerable to changes in international conditions. The similarity with the experience of the seventies is closest in the cases of Mexico and Argentina. They showed strong parallelism between the real, financial and external developments of the 1991-94 period and the initial expansionary phase of the Southern Cone experiments. This parallelism was especifically related to the role exchange-rate policy and capital inflows were intended to play in the two countries´ macroeconomic programs and with respect to the goal of achieving full integration with international financial markets. Capital inflows were encouraged through various means (including complete deregulation) but policy was predominantly passive with respect to their domestic monetary and financial effects.

There were, however, some differences compared to the seventies, particularly the fact that fiscal policy was less expansionary and benefitted from the proceeds generated by the privatization of public enterprises. Moreover, in the case of Argentina the financial system´s regulatory framework was much better than in the seventies and required banks to maintain levels of reserves well above the international average. The better health of its banks contributed to save Argentina from a final debacle _a la Mexico_ but it did not spare it from having to ask for a multilateral rescue package to stop a capital outflow that was depleting deposits and international reserves. In the end, smaller fiscal deficits as compared to the eighties seem only to have influenced the timing of the crisis, but not its eventual outbreak.

In effect, in the Southern Cone experiences the turning point was reached in a shorter time via domestic financial developments. For this reason, the real dimension of the cycle was mainly a reflection of the financial cycle. The expansionary phase of the financial cycle lasted longer in the Mexican and Argentine experiences in the nineties, giving rise to deeper and longer-lasting real effects of the combination of trade opening and exchange-rate appreciation.[18] We will discuss this point in the following section.

The analysis we presented above highlights the 1994 increment in the international interest rate as the external factor which triggered the change of trends in capital inflows and reserves observed that year in Mexico and Argentina. Obviously, this increment is not comparable in magnitude and duration to the 1979 increase. Besides, its incidence on external fragility took a different form because of the distinct external financing mechanisms that predominated in the seventies and the nineties. Floating-rate bank credit predominated in the seventies, so that the increase in the international interest rate affected external fragility mainly by raising the current account deficit. Bond debt predominated in the nineties but also, because of the implementation of the Brady debt-restructurings, there was a drop in the percentage of debt paying market interest rates both in Mexico and in Argentina. In this context, the increase in the international interest rate affected external fragility mainly by reducing capital inflows and augmenting the country-risk premium, and not so much by increasing the average interest rate paid. Thus, whereas in the seventies the current account was more sensitive to variations in the international interest rate in the nineties it was less sensitive (until late in the decade) but capital flows were more volatile.

Lastly, let us consider the comparison between Mexico and Argentina and the countries showing more robust paths. It is clear that the different performances could not be exclusively explained by the elements examined in this paper. With this caveat in mind, the above analysis suggests two types of factors differentiating the countries' performances.

First, differences in macroeconomic policy stand out, particularly regarding the exchange rate. Greater fragility is associated with more exchange-rate appreciation whose degree, in turn, is related to the nature of the exchange rate regimes and monetary policies adopted by the different countries. The other important difference lies in the conception that ruled the interaction between the domestic financial system and the international capital markets. Both aspects appear to be associated, so that policies relating to the capital account are congruent with a country's macroeconomic orientation. Mexico and Argentina implemented an unrestricted opening of the capital account. In contrast, the countries that attempted to preserve some monetary and financial autonomy (like Chile and Colombia) implemented regulatory norms aimed at cushioning the capital flows and influencing their composition[19]. These policies seem to have reduced the volatility generated by short-term flows, even if they were not able to filter all “speculative” capital movements.

IV.2. Employment and income distribution

There have been widespread negative effects on employment and the income distribution in LA in the nineties. The stylized facts linking macroeconomic and distributional developments are the following:

- Recovery of growth. GDP growth rates improved significantly.
- Reduction in inflation. In the high inflation countries (Argentina, Brazil, Mexico, Peru) the new conditions made successful stabilization plans possible. In the moderate inflation countries (Colombia, Chile, Uruguay) a gradual reduction in inflation took place.
- Trade opening. All countries either implemented or completed trade policy reforms aimed at reducing tariffs and eliminating non-tariff restrictions on imports.
- Public-sector deficit reduction. The public sector deficit dropped due to lower inflation and higher activity, in part from administrative and tax reforms and in part from adjustment of public expenditures.
- Important privatization programs were implemented, in terms of both the magnitude of the resources and the volume of employment involved.
- There was a significant appreciation of real exchange rates in comparison with levels prevailing in the second half of the eighties.
- High trade deficits arose because of the strong increment in imports, implying a marked increase in the share of domestic demand covered by imports.

These stylized facts cannot be exclusively attributed to either the changes in the international financial conditions and capital inflows, or the policies implemented by the countries in this new context. They were the result of a combination of these factors and had significant effects - some positive, others negative - on the labor market, employment, income distribution and poverty.

Positive effects can undoubtedly be attributed to higher levels of activity and the reduction in inflation. Higher activity implied greater demand for labor. The reduction in inflation had positive effects on the purchasing power of wages and reduced the "inflation tax" which falls mainly on the lowest-income sectors. Those positive effects were particularly important in the exchange-rate anchored "shock" stabilizations, where the launching of the program was followed by a strong recovery in demand and activity, a rise in labor demand, and an improvement in the purchasing power of low-income sectors. Similar but weaker benefits were observed elsewhere.

Other effects have negative impacts. Privatizations of state enterprises were usually preceded or followed by rationalization processes with a plunge in the employment level. Analogous effects followed expenditure adjustments at various levels of the public sector, because they generally imply contractions in employment and wages. These effects on employment and wages were "once-and-for-all." Their relative importance differed across countries. Although they did not have a significant global impact in some cases, they were important in specific regions or segments of the labor market.

Lastly, there were the joint repercussions of trade opening and exchange-rate appreciation. This combination had persistent negative effects on employment in the traded goods sector, particularly in manufacturing.

The decrease in tariffs and elimination of non-tariff restrictions were aimed at increasing the efficiency and productivity of the tradable sector, by greater competition in the domestic market exerted by imported goods and by easing domestic firms' access to cheaper and more advanced (or better quality) capital goods and intermediate inputs. Trade opening thereby implies the displacement of firms and employment in the less efficient areas of the tradable sector. In the simplest version of the theory on which the policy is based, the simultaneous creation of new employment in activities gaining competitiveness through increases in productivity should compensate for those negative effects[20]. More complex versions admit a somewhat extended period of falling employment and negative redistributional effects, which can and should be alleviated by public policies. Beyond those assertions, the fact is that trade opening took place in Latin America in the nineties together with the appreciation of the exchange rates.[21] This combination worsened the loss in competitiveness of existing activities and inhibited incentives for new export or import substituting ventures, thereby accentuating negative effects on employment.

All of the above-mentioned effects, both positive and negative, were observed in all countries in the region. From their relative intensity resulted the signs and magnitudes of aggregate effects. The evolution of employment and income distribution over time also depends on the different velocities of the processes involved. One highly relevant case, because of the importance of the countries involved - notably Argentina, Brazil and Mexico - rested on the dynamics generated by exchange-rate anchored stabilizations, in contexts that simultaneously involved trade opening, privatization, and fiscal adjustment. Typically, a cycle in employment and low-income-sector earnings emerged, There was an initial upward trend in which the positive effects of reactivation and the reduction in inflation predominated. A downward phase followed in which the initial effects tended to attenuate and the negative effects predominate, particularly the persistent results of the combination of trade opening and exchange-rate appreciation.

We can illustrate those circumstances with Argentine data on employment. The employment rate (employment/population) tended to grow between 1991 and 1993, and then to fall systematically until its 1996 level reached a figure that was well below the 1990 observation. It should be stressed that in 1993, when the employment rate began to drop, Argentina was still undergoing an output expansion. The contraction in employment particularly affected males, heads of household, and full-time job holders. Two-thirds of the contraction corresponded to the manufacturing sector. Although privatization and fiscal adjustment in the provinces had adverse effects on employment, the most important negative impact came from the restructuring and concentration in activities producing tradable goods.[22] Similar outcomes were also observed in Brazil and Mexico.[23]

IV.2.1. The combined effects of trade opening and exchange-rate appreciation

This issue deserves a more detailed analysis. The behavior of labor demand in manufacturing can be disaggregated into three components. In the first place, a positive component originates in the increase in aggregate demand. The higher the increase in demand, the larger is the effect on manufacturing production and employment. In the second place, given the increase in aggregate demand, there is a negative effect on production and employment derived from the degree of penetration of imports serving this demand. The higher the share of aggregate demand covered by imports, the lower is the domestic production and employment. In the third place, the need to gain competitiveness, on the one hand, and the change in relative prices favoring imported inputs and machinery, on the other, can lead firms to reduce employment per unit of production. This increase in the productivity of the labor force results from changes in product composition (for instance, lower product diversity and greater imported input components), efficiency gains through restructuring, and substitution of machines for the labor force.

As was already mentioned, the observed outcome of those processes has generally been a contractionary trend in manufacturing employment. That is, the increase in the aggregate demand for manufacturing goods - even in its expansionary phase - was not sufficient to compensate for the negative components: the direct displacement of domestic production by imports and the process of labor reduction per unit of production in the surviving firms. It should be mentioned that small- and medium-sized enterprises (SMEs) found it the most difficult to remain open. The closing of SMEs was an important cause of the contraction in employment.

How does exchange-rate appreciation affect each of these components? With regard to growth of aggregate demand, a stronger exchange rate operates as a constraining factor, directly by inhibiting exports and indirectly by limiting the growth in domestic demand. External and current account balances register deficits and a high import elasticity is observed. External fragility tends to deepen when the economy accelerates its expansion. In 1995, Mexico and Argentina were examples of sudden cuts in growth imposed by their crises, as again was Brazil in 1997/1998, which implemented contractionary monetary policies after facing intense speculation emanating from the Asian crises. But most interesting are the contrasting experiences of Argentina and Brazil after the August 1998 Russian crisis which, despite the lack of substantial trade and direct financial linkages, provoked a contagion that dried up financing for both countries. Since that episode, Argentina has suffered from a protracted recession, made even worse by the rigidity of its exchange-rate regime. Brazil has fared better and there has been growth resumption, to a large extent because it was forced to float its overvalued currency. Despite receiving a significant financial assistance package from multilateral and bilateral creditors just before the collapse of its exchange rate, Brazil was not able to withstand massive capital outflows and the interest rates needed to attenuate them, and let the Real float in January 1999[24]. Unlike Brazil, Argentina, which has sticked to its one-to-one parity with the dollar, has become a textbook example of how external fragility associated with an appreciated exchange rate operates as a severe constraint on the potential rate of growth.

The role of the exchange-rate appreciation is also clear via the second channel mentioned above. It amplifies the effects of the trade opening by further reducing the competitiveness of local activities. Consequently, given the aggregate demand level, it tends to increase the direct displacement effects of domestic production and employment by imports. It inhibits manufacturing activities for exports and the domestic market which, even in an open trade setting, would be competitive with a more depreciated exchange rate.

Lastly, the negative effect of exchange-rate appreciation is also significant for the process of labor reduction per unit of output that takes place within firms. A strong exchange rate enhances incentives to reduce the labor force because it additionally lowers the relative price of imported inputs and machines with respect to labor cost.

IV.2.2. The macroeconomic configuration and trends in employment and income distribution: diagnosis and the proposed remedies

The macroeconomic configuration underlying the combination of trade opening and exchange rate appreciation can be synthesized in three characteristics: fragility of growth, high unemployment, and a trend toward increasing inequality. External fragility makes it difficult to sustain high rates of growth. Behind external fragility and unemployment lies the low international competitiveness of domestic activities. Overall competitiveness did not improve in the nineties despite important gains observed in labor force productivity because relative price changes neutralized their effects.[25] The third characteristic was mainly a consequence of the first two. High unemployment and the pressure it exerted on wages generated a persistent trend toward higher inequality.

The accumulated experience of the nineties appears to be driving economists from differing schools of thought to agree on the diagnosis sketched above. The most negative features regarding competitiveness, employment and income distribution, as well as the most severe sustainability problems are associated with policy regimes that lose sight of the real targets of macroeconomic policy and open the capital accounts without any restrictions.

Despite a greater consensus about the diagnosis, in Latin America there is a marked cleavage regarding the orientation of policies which might reverse these negative features. Instead of pragmatically revising the macroeconomic scheme and the conditions of financial opening, the dominant view attributes the problems to a supposed incompleteness of liberalizing reforms. It uses this *a priori* line of reasoning[26] to explain why the economy does not behave as the theories behind the already implemented reforms predicted it would. In a permanent escape into the future, this orientation recommends further reform in the face of any difficulty arising in economic performance. So, a "second generation" of reforms follows the first, and the process continues *sine die*.

With regard to competitiveness and employment problems, in particular, this orientation seems to believe that the remedies are embodied in the very development of present trends. The pressure unemployment exerts on wages should lead to a reduction of labor costs and, through this mechanism, to the simultaneous "solution" of the fragility, competitiveness, and employment problems. This orientation sees the institutional rigidity of the labor market as the most important obstacle and advocates "flexibilization" as the main policy instrument to resolve employment problems.

Faced with this issue, an academic comment might be that there seems to be no successful cases involving this kind of model in the development experience. Losses of competitiveness associated with financial opening and massive capital inflows have not been offset by reductions of real wages. Even if processes of this kind were viable, they would surely be long and painful stories. We believe, nevertheless, that the main criticism of the mainstream orientation is not derived from an analytical point of view but from a normative one, since the "solution" implies promoting a social structure that is even more unequal and unfair than the one we currently find in Latin America.

This opinion should not be interpreted as a defense of existing labor legislation - which in many countries is obviously obsolete and inefficient - but rather as a criticism of the prevailing idea that the "cause" of employment performance is located in the rigidity of labor market institutions and that, consequently, flexibilization is the most important policy orientation in this regard, if not the only one.

Perhaps the cleavage over policy recommendations can be better understood if we express it in more technical terms. As such, it becomes clear that its deep roots date back to the origin of macroeconomics as a discipline. It is worth remembering that the discipline was born with Keynes's analysis of the causes and remedies of the Great Depression's unemployment. Also, that the unemployment diagnosis was at the center of the debate Keynes sustained with his contemporaries.

The orientation we are criticizing asserts that there is only one equilibrium price configuration in every economy, which includes full employment (or better, unemployment at its natural rate) in the labor market. When high rates of unemployment or employment generation problems are observed, these problems must be attributed to imperfections in the labor market. The diagnosis, most often implicit, is that institutional obstacles inhibit the working of competition in this market, preventing the price of labor from falling to the point at which the unemployment rate equals the natural rate. However, this view disregards the importance of the precise trajectory followed by the economy in the past and its influence over the present, the so-called hysteresis phenomenon. This implies that the current macroeconomic configuration may be heavily determined by the past. Thus, under initial conditions characterized by a high level of indebtedness, macroeconomic equilibrium requires lower wages than in, otherwise similar, countries with low debt levels.

In this regard, consider the economic situation in Latin America at two points in time: the second half of the eighties and first half of the nineties. In the first, the international interest rate was high; economies were financially rationed and made significant transfers abroad; absorption was lower than output; production was stagnant and productivity decreased. In the second period, the international interest rate was lower; economies had access to international financial markets and received transfers from abroad; absorption was greater than output; production was growing and productivity went up. However, employment in the second period was lower than in the first, even though there seems to be no doubt that there was a positive shock between the latter and the former. Why then should real wages have to fall to preserve equilibrium conditions in the labor market, as is suggested by the diagnosis mentioned above?

The paradox we reach from the idea of a unique equilibrium configuration highlights the inadequacy of this perspective. The alternative means considering the possibility of multiple equilibrium configurations depending, among other circumstances, on the factors imposed by the external context and economic policies as actually implemented. Some configurations are more favorable to employment and growth. Others imply that the economy is being driven to low-growth and low-employment traps. The observed changes between the eighties and the nineties do not appear to be paradoxical from this perspective. The conjunction of massive capital inflows and the implementation of the liberalization and open policies drove some LA economies to low-growth and low-employment macroeconomic configurations.

The art of economic policy making does not consist in merely discovering the equilibrium point and promoting all the deregulation needed for market forces to conduct the economy spontaneously there. The art consists in managing economic policy in an international context that is more influential and volatile than ever before to induce relative prices and incentives that favor growth, employment and a rise in real wages to accompany improvements in productivity. These configurations do not depend on only one instrument, but on the persistent implementation of every policy instrument focusing on these real targets.

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[1] There is surely no cause for objection in the case of Argentina, although the could be in the case of Chile. The most commonly told story about the path of reforms there sees the process as a somewhat continuous sequence in which the first steps were completed in the seventies. In this narrative the external and financial crisis of the eighties and its real consequences have secondary significance and do not represent a discontinuity.
Chile was certainly the country in Latin America that most preserved the reforms implemented in the seventies during and after the crisis. Therefore, the point is debatable. However, there is no room in this paper for a detailed analysis of Chile´s history. For our purposes, the Chilean crisis in the eighties closes a period whose performance can be evaluated by itself. With this, we do nothing more than recover the perspective from which the Southern Cone experiments were observed in the years following the debt crisis. The story mentioned above was constructed later on in the late eighties, when Chile was deemed the prime LA example of the Washington Consensus´s success. See John Williamson (1990), Fanelli et al (1992), World Bank (1991) and Fanelli, Frenkel and Taylor (1992).

[2] Cases in which liberalization has not been followed by massive capital inflows are rare but do exist. Bolivia, in the second half of the eighties, did not receive private inflows despite having deregulated and fully opened its financial markets in 1985. There are cases in both the seventies and the nineties of significant capital inflows without major liberalization measures. Brazil is the most important example in both periods.

[3] Chile and Colombia, for different reasons, were cases of minimal transfers abroad. In Colombia, because its external debt was relatively small. Chile, showed the highest regional debt/GDP ratio but its transfers were minimal because it received a relatively greater proportion of multilateral support. See Mario Damill, Jose Maria Fanelli and Roberto Frenkel (1994).

[4] The relatively deeper development of Chile's financial system in the late eighties makes it a relevant exception to this observation. Chile did not undergo inflation rates of the order registered in the biggest economies and its macroeconomic performance was stable in the second half of the eighties. Colombia's macroeconomic performance was also stable, but its financial system was small and poorly diversified.

[5] The tariff reduction schedules were considered rapid at the time. They would be perceived as gradualist under the current conventional criteria.

[6] In Argentina the fiscal direct cost of the post-crisis bailout is estimated at $5 billion (at that time the private external debt was $14 billion.) In Chile the issue of public domestic debt to finance the bailout amounted to one third of GDP. See Mario Damill, Jose Maria Fanelli and Roberto Frenkel (1994).

[7] We presented a formal model in Roberto Frenkel (1983). It is sketched in John Williamson (1983) and restated by Lance Taylor (1991).

[8] Neoclassical models based on different "adjustment speeds" of the trade and capital accounts following a simultaneous trade and financial opening were constructed to interpret the cycle. These models replicated the initial expansionary phase but neither the contractionary one nor the crisis. See Sebastián Edwards (1984). The symmetry of neoclassical models suggestded a second phase in which downward price flexibility could correct exchange-rate appreciation and the current acount deficit, leading the economy to a new equilibrium. There was no such deflation in the cases we are considering here. In addition to the complete implausibility of a deflation of the size and velocity that would be necessary to re-equilibrate the current account, these models ignored financial relations. In the financial system, there is no symmetry between the expansionary and contractionary phases. In any case, the supposed deflation would aggravate the liquidity and insolvency problems that characterize the contractionary phase.

[9] See Ronald Mc Kinnon (1982).

[10] Liberalizing and opening capital markets only after the economy is stabilized, open to trade, and financially robust is precisely the recommendation of the "sequencing" literature, developed in the eighties after the evaluation of the Southern Cone experiments, among other cases. These orthodox prescriptions were lost along the roads to the Washington Consensus as actually applied. See Sebastián Edwards (1984) and Ronald Mc Kinnon (1991).

[11] The following discussion draws on Roberto Frenkel (1995).
[12] Some capital flow regulations were implemented in Brazil after the launching of the Real Plan according to the changing circumstances of capital flows. However, the set of exchange, monetary and capital account policies resembles those of Argentina and Mexico more than those of Chile and Colombia.
[13] Mexico and Argentina, on the one hand, and Chile and Colombia, on the other, entered the nineties with different economic realities and varying degrees of freedom to define their policies. Chile and Colombia had stabilized their economies in the mid-eighties and were growing at relatively high rates in the second half of the decade. It is understandable that their macroeconomic policies were oriented in the direction of preserving stability in the face of capital inflows. In contrast, Mexico had only recently implemented its stabilization program while Argentina began in 1991. Both programs used a fixed exchange rate as the main "anchor" for inflation. Their sustainability depended fundamentally on continuing capital inflows.
[14] Even though financing a current account deficit with FDI is clearly preferable to other more volatile sources, the long-term contribution of FDI flows to the balance of payments should not be overestimated. First, the growing presence of multinational firms is usually associated with a permanent increase in the level of imports. Second, the rate of reinvestment of profits can fall drastically after a first period of rapid expansion, particularly during a recession which depresses “animal spirits”, leading to an increase in profit remittances, even in the context of a recession. In essence, insofar as FDI requires a risk premium with respect to the rate of return on external debt, its servicing should likely be more expensive, even if it is more desirable because of its lower volatility.
[15] In some countries with even less basis in terms of “fundamentals”.
[16] In some cases the correlations are indeed paradoxical. Thus, the rise in oil prices, which should have improved expectations about the Mexican economy, was associated with a decrease in that country´s asset prices. ¿What convoluted argument can justify such behaviour?
[17] Though, as mentioned before, Brazil was finally forced to give up its exchange-rate regime in January 1999, after a period of very strong pressures against the Real following the Russian crisis in August.
[18] Emerging out of a very deep recession in 1990, Argentina's GDP grew swiftly in the early nineties. Instead, Mexico's slow growth suggests that depressing real effects were important from the beginning of the nineties. We have already mentioned that trade opening and exchange-rate appreciation had been operating in this case for some years beforehand. See Jose Maria Fanelli and Roberto Frenkel (1998) on Argentina and Rudiger Dornbusch and Alejandro Werner (1994) on Mexico.
[19] Brazil is an intermediate case. It turned restrictions on and off applying selective taxes to limit short-term capital inflows.
[20] See Bela Balassa et. al (1986).
[21] These circumstances contradicted conventional recommendations about the macroeconomic policy that should accompany trade opening. See Anne Krueger (1984).
[22] Cf. Roberto Frenkel and Martín Gonzalez Rozada (1997)
[23] Cf. Mario Damill, Jose Fanelli and Roberto Frenkel (1996) and Edward Amadeo (1996)
[24] Prior to the Brazilian crisis, the Central Bank of Brazil was setting an adjustable band for the dollar value of the Real, and maintaining a continuing crawling peg within it.
[25] Calculations with a common methodology for various countries can be seen in Víctor Tokman and Daniel Martínez (1997). It is worth mentioning, however, that the quoted calculations are not *vis-a-vis* the rest-of-the-world productivity, which is implicitly assumed constant, so in fact competitiveness may have decreased.
[26] By hypothesis, the lack of success must be attributed to insufficient reform.