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NEW PROSPECTS FOR LATIN AMERICAN DEVELOPMENT

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New Prospects for Latin American Development

Introduction.[1]

> *"[...synergy among political and economic reforms...] give our governments the political incentive and economic capacity to address more effectively the social needs our people face. President Clinton is endeavoring to address those needs in his powerful initiatives on health care, welfare reform and crime, to mention only a few. Leaders throughout the hemisphere are making similar efforts.*
> *Addressing these social needs and providing greater social equity and more responsive, honest and effective government generates more popular support for democratic government, increasing social stability and broadening the base for economic growth. These in turn reassure investors and encourage flows of capital and technology and trade which produce growth.*
> *Some have described this next phase as the "second generation" of reforms. The first generation of reforms aims at taking government out of the things that it didn't do well and probably shouldn't do at all and empowering markets to be the main decision-makers for the economy.*
> *The second generation of reforms aims at giving government the capacity to do well what only governments can do and what markets cannot do or do only imperfectly. The idea here is shared growth to benefit all elements of society and to benefit future as well present generations."*
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> *Remarks to the Council of the Americas by Alexander F. Watson, Assistant Secretary of the State for Inter-American Affairs. May 2, 1994.*

This paper asserts that the nineties have opened new room in Latin America for discussing and implementing development policies and that the multilateral institutions have a role to play in contributing to the analysis and promotion of these policies. The first message is that there has not yet been a serious discussion of the development strategies that Latin American countries should follow to replace the old post-war model. The second is that the new international financial context of the early nineties, assuming it is lasting, clears the way for that discussion and for the implementation of long-term development policies. The third is a manifestation of the hope that multilateral agencies will have the willingness to take advantage of present conditions and commit their intellectual resources to contribute to an open and

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[1] This paper draws on previous work done by the author together with his colleagues at the CEDES Department of Economics: Mario Damill, José María Fanelli and Guillermo Rozenwurcel, and also on J. M. Fanelli, R. Frenkel and L. Taylor (1992). The collaboration of Lucio Simpson is gratefully acknowledged. The author thanks the comments and the editing work of Albert Berry.

uninhibited analysis of alternatives.

The first message may sound bizarre in light of the unprecedented intensive structural reforms of recent years. However, we shall argue that these reforms and policy regime changes implemented were not based on a deep appraisal of their potential as development tools: for both the countries and the multilateral agencies, the reform program was instead driven by a combination of urgency and the lack of well developed alternatives. A role should be left in its genealogy for ideology and political convenience, but we rather want here to stress the lack of solid development foundations than to criticize those other factors.

Evidence supporting the second message can be seen in many Latin American countries. The macroeconomic situation has improved in most cases, although there are some relevant exceptions. Inflation has fallen, and growth and investment have recovered. Foreign capital is flowing again to LA countries and this financing, in conjunction with the debt renegotiations under the Brady terms and the lower international interest rates, has relegated the external debt to a secondary concern. Although the horizon is not completely free of dark clouds, as we shall comment below, the Latin American situation does look better than before at the macroeconomic level.

The same cannot be said of other aspects of the current situation. The "lost decade" accentuated the traditional inequality in income distribution and had devastating effects on the already weakened social-service systems. Recent fiscal adjustments in some countries, although successful in their stabilization objectives, reduced even more the resources devoted to development and social policies. Aggregate growth rates disguise very asymmetric sectoral and regional performances, coupled in some cases with rising unemployment. Political symptoms of the worsening of the life conditions of the poor have been recently observed in some countries.

On the other hand, the governments of the region have generally gained political support from stability and reactivation But there is a parallel increasing public concern about the lack of a well defined development program, able to give continuity to recent macroeconomic trends and to generate improvements in employment and in the life conditions of the poor. Chile seems to be an exception regarding these apprehensions, but the portrait is nevertheless accurate in most cases. The change of focus and perception is not paradoxical, but rather a natural consequence of stability and recovery. Once the heroic stage of economic policy and the sense of urgency related to inflation, fiscal adjustment and debt are left behind, there is more freedom for public, academic, and political concerns about development issues and future prospects.

An analogous motivation has probably induced the recent changes of emphasis regarding Latin American policies expressed by the American administration and the multilateral agencies. The quotation at the beginning of the paper is intended to call attention to these changes, and may also be taken as an evidence supporting our second message. There is a manifest concern with poverty and a new emphasis on social policies, which should undoubtedly be considered positive. However, economic development issues are still not on the agenda and a sustainable improvement of the standards of living could hardly be the result of social policies added to an economic setting unable to foster development tendencies. Nevertheless, the mentioned changes in perception and concern may open the way for the subsequent introduction of developmental issues. This is the main justification for the third message of the paper.

The first two sections of this paper are retrospective, as we consider the intellectual and political origins of the so-called "market friendly approach" (MFA)[2] and suggest why the context of the 1980s was not suitable for discussing and implementing new development policies. We argue that throughout its evolution the MFA carried an original sin. The pros and cons of the former Latin American development pattern were never evaluated in depth because the early eighties debt crisis and its lasting consequences were taken as a thorough proof of its complete inadequacy. The diagnosis was superficial and led to another mistaken judgment: while the economic performances of the 1980s were attributed to long term factors, the effects of international credit-rationing and the consequences of the shocks and external transfers on the macroeconomic dynamics, investment and savings were never fully acknowledged. Starting from these premises, the set of reforms and policy-regime changes that subsequently gave shape to the MFA were mostly conceived as inverted mirror images of the elements of the former model. We also present a stylized explanation of the eighties performance to show that the MFA diagnosis overlooked essential elements, and we suggest that in that context the debate on development policies was in fact not on the agenda. There was the compelling task of stopping at once the negative macroeconomic trends before thinking about a new development strategy.

The third section is devoted to the early nineties. We argue that the improvement in the regional macroeconomic performance is basically explained by the relaxation of the external constraint. The new conditions, if lasting, open the way for the discussion and implementation of new development policies and also for a new kind of dialogue with the multilateral institutions.

[2] See World Bank (1991).

I. The debt crisis and its economic and intellectual consequences.

I.1. The multiple Latin American ways of starting the eighties.

With the benefit of retrospection it is possible to talk about the common model of development of the Latin American economies in the post-war period. But it is apparent that the countries reacted differently to the international financial conditions of abundant liquidity and low interest rates of the seventies and connected in different ways with the then booming international financial system. The following account shows the varying conditions across the countries of Latin America as they entered the bleak eighties.

Mexico and Venezuela were simultaneously blessed with high oil prices and easy cheap credit. While this was not new for Venezuela, it was for Mexico. Both countries "deepened" the old model accentuating the role of the state in investment and production and attempting to distribute part of the gains in massive social programs. Many of the projects initiated in this last wave of "late developmentalism" led to a significant waste of resources. Both countries overshot demand expansion and fiscal and current account deficits, generated inflationary trends and reduced competitiveness by appreciating the exchange rates. As a consequence, both suffered massive capital flights that represented a big proportion of the accumulated external public debt. In both cases the combination of the "Dutch disease", "late developmentalism" and populist temptations proved to be lethal when confronted with the rise in the international interest rates. In the Mexican case, this was in striking contrast to the previous thirty years of relatively high growth rates, low inflation and financial stability.

Brazil had been growing since the mid-sixties at very high rates combining import substitution and export promotion. It ranked comfortably as an emerging NIC in the early seventies. Confronted with the first oil shock, the country decided to push the industrialization process forward, reducing dependence on imported capital goods, industrial raw materials and energy (as the Japanese did in the past and still do in the present,) taking advantage of abundant international credit and the low interest rate. The strategy worked pretty well for six years, until 1979, when the second oil shock combined with the jump in international interest rates to make the external account unsustainable. Brazil's accumulation of external debt during the seventies was the only Latin American example of a conscious decision to finance higher total and public investment rates with external credit. The strategy's unsustainability was determined by simultaneous, unexpected (and unforeseeable) real and financial external shocks. A case in favor of the strategic decision of the early seventies can be made by mentioning that Brazil is the only big debtor that adjusted its external gap fully and permanently in the early eighties. The articulation of the country with the international financial system was planned and intermediated by the State. Unlike Argentina, Mexico and Venezuela, Brazil did not suffer from significant capital flight amounting to a major portion of the external debt.

The Argentine and Chilean histories are more complex. In the first half of the seventies both countries came to be ruled by democratic governments that intended to implement a revolutionary push towards development. Both

experiences ended in deep economic crises that opened the way to military coups. Grouping together the Peronista and the Unidad Popular administrations is a bit forced, not only because of their ideological differences but also because of their different attitudes towards property rights and the relative role of private and public ownership. But the correspondence is closer regarding the envisaged pattern of development: both planned to overcome a situation of perceived stagnation and uneven income distribution by giving a new impulse to the old State-led ISI strategy of development. The similarities were still greater in the actual practice of economic policy and its consequences. Both regimes set in motion unsustainable populist expenditure and wage policies, lost control of the public finances, generated conditions of more or less repressed high inflation, and ended up with dramatic balance of payments crises. Although both the agendas and the electoral successes of these administrations reflected intellectual and popular dissatisfaction with the previous economic situation, it seems clear that the Argentine (1975) and Chilean (1973) economic crises should be attributed to political factors, inconsistent measures and social turmoil, rather than to the collapse of the previous development model.

The military regimes imposed by the coups attempted another economic revolution, completely in the opposite direction from the former. The crises were seen both in Argentina and Chile as symptoms of a long period of economic mismanagement. Moreover, the former pattern of development was considered inadequate in both cases not only because of its economic failure, but also because social unrest was diagnosed as being rooted in the associated socioeconomic structure[3]. A set of reforms was implemented aimed at substituting a new private-oriented, deregulated and more open economic regime for the old development model. The reforms implemented in Argentina and Chile during this period had much in common with the still unborn "Washington Consensus", although they were combined with a heavy repression of social and political expressions. The new regimes gave the countries rapid access to multilateral support and private credit. It was only then that the Argentine and Chilean economies were actually exposed to the international financial environment, because the countries had remained relatively isolated under the previous administrations. Once financial deregulation was in effect and exchange and capital-flow controls removed both economies became almost completely open on the financial side. Trade liberalization and financial deregulation-opening combined in both countries with the appreciation of the exchange rate (under stabilization programs inspired in the "monetary approach to the balance of payments"), followed by consumption and import booms, financial bubbles and soaring current account deficits financed by the abrupt accumulation of external debt. The increase in international interest rates found both countries with high external deficits and debts. In the Argentine case, as was already mentioned, the capital flight that took place in the last stage of the experience accounted for a significant proportion of the increased debt. It is worth remembering that the policies and the observed results were considered rigorously orthodox and praised by many international financial experts (including the Fund) even in the last stage, when the financing of external accounts was clearly unsustainable. As can be seen, the Southern Cone road to the debt crisis was completely different from the Brazilian and had few points in common with the Mexican experience. The Chilean and Argentine debt crises owed more to the policy experiments than to the

[3] The lack of discipline and high relative weight of urban working classes was attributed to the inner-oriented and State-led development process.

strategy of development followed by the countries until the early seventies.

Colombia's entry to the eighties was different again. The salient stylized fact of the seventies is that the country did not significantly alter its relationship with the changing international financial system. It continued growing following essentially the same strategy of development, (a mixture of ISI and export incentives), preserving the external trade regime and the financial and exchange regulations intended to segment the domestic market from abroad. As a consequence, while gross external debt rose moderately throughout the decade, net debt remained practically constant and the debt/GDP ratio fell by about a half in the period. Colombia, for better or for worse, did not attempt to give a big push towards development nor to implement deep structural reforms. Among the countries examined, it represents the only clear example of continuity. If any case can be made for linking the Latin American debt crisis and the disastrous performance of the eighties to the perpetuation of the old development strategy and policy regime, Colombia should be the prominent example. But this is precisely the country that is an exception to the average Latin American performance. Although in the early eighties Colombia had to bear a (relatively) moderate impact from the international financial crisis, caused mainly by the generalization of credit rationing, it did not experience a full-scale debt crisis and continued growing during the rest of the decade, achieving the best performance in the region over the eighties as a whole.

Let us now draw some conclusions. The first is that the different ways in which the Latin American countries adapted to the former period of easy and cheap international financing ended up in negative results. Moreover, when the experiences are classified according to the degree to which economic policy adapted (in a broad sense) to the international setting (with Colombia at one extreme and Argentina and Chile at the other), the more adapted countries were the most severely affected by international volatility when it arose. A similar classification can be established according to a more specific criterion: the extent to which the mechanisms embodied in the different policy regimes to offset negative external shocks were market-based or not. This standard generates a classification of countries similar to the one above. The more market-based policy regimes suffered greater destabilization when the economies suffered external shocks. The market-type stabilizing mechanisms (i.e. the flexibility of prices and of the domestic rate of interest and the flexibility of portfolio and real resources allocation) did not work as they were supposed to, or gave rise to "perverse" mechanisms (e.g. the financial dynamics generated by the increase in domestic interest rates.) In stressing this conclusion we are not advocating isolation nor regulations under any and all circumstances, but, simply noting that the pendulum has swung too far in the opposite direction. The observation is especially relevant because some countries in the region have adapted to the nineties' international financial environment by replicating in many respects the most negative experiences of the seventies. We return to this point below.

The second conclusion is that the debt crisis and its lasting consequences can hardly be attributed exclusively nor primarily to the collapse of the post-war development model or, more precisely, to certain inherent features of that model. The lack of flexibility of the real sector, the rudimentary character of the financial sector and the fragility and rigidities of the fiscal sector were all typical features of Latin economies and played significant roles both in the genesis of the crisis and in the dynamics of the adjustment process. But, as argued above, the main prerequisites of the crisis emerged in a

relatively short period as effects of the conjunction of the particular conditions in international financial markets and ad-hoc domestic policies. Taking the crisis and its lasting consequences as a demonstration of the endogenous collapse of the post-war development path is a non-sequitur.

This conclusion does not imply praise for the old Latin American development model as a whole nor advocation of a return to it. Many of the criticisms presented by neoclassical development economists were well founded[4]; some had already been pointed out by Latin American analysts[5]. Besides, the present domestic and international contexts differ significantly from the conditions prevailing in the fifties and sixties, making any return to recreate the old pattern impractical. But this is not the point. The point is that the debt crisis and the stagnation which followed were seen by too many observers as an overall test of the merits of the earlier model. At the extreme, the whole post-war development model and policy regime, together with each of their components, were blamed for the situation. The critique focused on such different items as development banks, exchange regimes, financial regulations, trade and industrial policies, public enterprises and so on. The next logical step -- the design of an alternative framework and a set of institutional and policy reforms -- was largely based on the assembling of inverted mirror images of the elements of the old framework. This procedure paid little attention to the development potential of the resulting combination nor to its internal consistency.

Neither of the two steps of the above logical sequence has rigorous foundations. On the first, a serious evaluation of the pros and cons of the former Latin American development path is still awaited. On the second, it is worth emphasizing that even if the negative assessment of Latin American post-war development were correct, this would not imply that doing the opposite would induce development. Knowing what not to do is not the same as knowing what to do. A consistent development strategy capable of substituting the old one should be designed and evaluated considering its own merits, founded on analysis, experience and a deep understanding of the countries' characteristics and potentials.

I.2. Missing issues and biased focus in the MFA.

We looked at the experiences of the seventies to understand the range of circumstances in which different LA countries entered the eighties. The moral of the story is that (almost) all roads led to the same place. Here we look at the eighties from the opposite viewpoint. Instead of stressing the country specificities underlying external debts and deficits, we focus on the common stylized facts regarding the macroeconomic dynamics and the consequent emergence of new constraints to growth.

During the eighties Latin America experienced the worst economic crisis of the post-war period, triggered by the abrupt deterioration of the foreign variables faced by the region. The magnitude of the negative external shocks was widened at the domestic level by the extreme weakness of the macroeconomic setting. In the period preceding the shock,

[4] See J. M. Fanelli, R. Frenkel, G. Rozenwurcel (1990)

[5] For instance, in the work done by ECLA since the mid-sixties.

as we noted above, the public sector was typically running huge deficits, the financial sector showed a marked fragility and there was a tendency toward unsustainable current account deficits. The anatomy of the crisis and its effects on growth can be succinctly described in terms of the fiscal and external gaps and in terms of the transmission mechanisms that tended to amplify the disequilibria represented by these gaps.[6]

Obviously, the first impact of the negative external shock was to open the external gap. The drop in the terms of trade together with the increase in interest rates induced a huge imbalance in the current account, with the exception of Colombia. The highly indebted countries, with the only important exception of Chile, were unable to finance the increased disequilibria because of the lack of access to voluntary sources of credit and the scarcity of funds provided by multilateral organizations. Consequently, the possibility of smoothing the adjustment by increasing indebtedness in the short run was precluded and the main objective of macropolicy became that of generating a trade surplus equal in magnitude to the deficit in the financial services account.

The consequences of the effort to generate a trade surplus at any cost were strongly distortive from the point of view of stability, especially because the exchange rate policy was oriented to increasing the real exchange rate via nominal devaluation. This led to an impressive acceleration of inflation and many countries (Peru, Bolivia, Brazil, Argentina) were put on the brink of or directly experienced hyperinflation.

The fact that in most Latin American countries the bulk of the foreign debt was held by the public sector meant that the external shock had a direct impact on the fiscal accounts. The increase in the international interest rate exogenously augmented public expenditures in a context in which the government was already facing severe problems in financing the existing public deficit. This implied that there was a simultaneous widening of the fiscal gap together with the opening of the external gap. This had two important consequences at the macroeconomic level. In the first place, given the shallowness of the domestic financial system and the difficulties in the access to external financing, most governments resorted to inflationary finance. This rendered monetary policy passive and greatly helped to validate the inflationary pressures stemming from nominal devaluation. In the second place, the attempts to reduce the deficit fell basically on public investment, whose reduction entails the least political conflict in the short run. The behaviour of public expenditures is one of the most important causes of the observed contraction in the investment rate. In addition to its direct effects on global investment, the fall in public investment induced a reduction in private investment because of the existence of a "crowding-in" effect that relates the two. On the other hand, the increase in the real exchange rate and the public sector imbalance, together with the acceleration of inflation and the existing indexation mechanisms, acted as transmission belts that spread the crisis into the weak existing financial sector. Many countries (e.g. Argentina, Chile, Brazil, Mexico, Uruguay) experienced a financial breakdown that made the financing of investment projects extremely

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[6] An analysis of the L.A. macroeconomic dynamics of the eighties in this terms can be seen in J. M. Fanelli, R. Frenkel, G. Rozenwurcel (1990). More detailed country analysis can be seen in M. Damill, J.M. Fanelli and R. Frenkel (1992), (1992a), (1992b), (1992c), (1992d); J.M. Fanelli and R. Frenkel (1994); M. Damill and J.M. Fanelli (1994) and in the bibliography quoted in these papers.

difficult.

In this scenario of extreme macroeconomic uncertainty, there was a huge reduction in the private saving and investment rates and, related to the latter, a stagnation in the process of learning and innovation with the consequent deterioration in the international competitiveness of the economy. Foreign direct investment followed a trend similar to aggregate investment. Moreover, the process of growth was additionally hampered by the fact that this environment favored capital flight, used by economic agents as a defensive tool against inflation and financial instability.

By the end of the eighties it was clear that important structural changes were necessary if the growth process was to regain momentum in the region. In this context of extreme instability, however, it was very difficult to articulate stabilization efforts with policies oriented toward growth and structural change. Furthermore, the context of the debt crisis was not propitious for re-thinking the development strategy since economic policy was almost completely determined by the need to achieve a minimum level of stability. Growth and development issues lost ground both in theoretical thinking and on the economic policy agenda.

The crises of the early eighties were not temporary episodes but generated lasting consequences. They triggered macroeconomic dynamics that in many cases led to the amplification of the original disequilibria and caused a persistent worsening of economic performances. In these contexts, growth was constrained by many new obstacles.

With the aim of organizing our thinking about the constraints to growth posed by the eighties macroeconomic context, in a previous paper (J. M. Fanelli, R. Frenkel and G. Rozenwurcel (1990) we classified these obstacles in three categories. The first constraint is related to the global availability of resources. Sustained growth requires a sufficient amount of savings, which was impeded by the reversal of external transfers and the reduction in per capita productivity and income. We call this the Smithian constraint. The second constraint to investment stems from the deep breakdown of the domestic financial system, capital flight and credit rationing at the international level. It is necessary to ensure that the non-consumed part of income will be invested, because it is not warranted that savings will be automatically invested. Because this is the problem highlighted by the Keynesian tradition, we called this the Keynesian constraint. Third, there is the limitation to growth that results from the inefficiency in the allocation of a given amount of resources. If a low efficiency had been a feature of the old pattern of development, it surely worsened in the highly unstable and uncertain context of the eighties. We call this the neoclassical constraint.

We think that this classification helps to clarify the erroneous MFA diagnosis of economic performance during the eighties. It also sheds light on an important source of discrepancies and controversy between the MFA, on one side and, let us say, a Latin American perspective, on the other. Synthetically, while economic policy experience and the more careful analyses of most countries' experiences highlighted the relevance of all constraints, the MFA focused almost exclusively on the third. In putting the emphasis on the low efficiency of resource allocation, the MFA almost completely disregarded the first and second constraints to growth in its explanation of the actual performance of most countries as well as in the consequent policy advice.

Although this focus seems to be consistent with the MFA diagnosis of the debt crisis, overlooking its lasting

domestic and international repercussions was not a logical implication of the diagnosis. The rationing of international credit, the need to effect heavy external transfers and the consequently unstable macroeconomic dynamics imposed new constraints to growth that should have deserved adequate consideration, independently of any diagnosis of the debt crisis' origins.

The mentioned difference was deeper than any specific disagreement about the promoted reforms, because it was a difference in focus and perceived priorities. This basic difference impeded the establishment of a common framework and a comfortable environment for discussing development policies in the eighties.

II. Politics and ideas in the eighties.

II.1. The political origins and the evolution of the MFA.

At least since 1982, the year of the Mexican moratorium, the Fund and the Bank have been intensively involved in stabilization and adjustment. Since the mid-eighties structural and policy reforms have been explicitly incorporated into the sets of conditions for adjustment lending. After more than two years of muddling through without any clear direction, the idea of taking advantage of the critical situation to promote modernization reforms that would restore growth, stated officially through the Baker initiative, was considered an important step forward and welcomed.

The initiative was intended to give a new "virtuous" character to the badly needed funds of the international agencies. On the one hand, the agencies, and therefore the American administration, were inevitably and significantly involved in the management of the debt crisis and in the rescue operations. In one way or another the agencies' available funds had to flow to the debtor countries as an essential element of the financial arrangement that followed the crisis. Besides, the governments of the region did not have many alternatives and were, as a consequence, in a particularly vulnerable position. The countries were starving for international currency, which increased their willingness to accept and promote the reforms favored by multilateral institutions and raised the leverage that lending conditionality had on domestic policy.

There was little time to think about the components of the modernization reform-package. The ingredients included in the recipe came from a variety of sources, although they shared a common flavor obviously akin to the more-free-market-less-state general orientation that was at the peak of its prestige in the American administration at that time. Trade liberalization had long been a preferred policy of the Bank. Financial liberalization and opening had been previously promoted by American advisors in other parts of the world and were also in fashion in the developed countries. It is worth mentioning again that both trade and financial reforms had been simultaneously implemented a few years before in Argentina, Chile and Uruguay, in the so-called Southern Cone liberalization experiences, with disastrous results. Even neoclassical economists were at that time formulating cautious assessments of those experiences and deriving policy recommendations full of warnings about gradualism and sequencing[7], but little attention was paid to those caveats. Privatization was added a bit later, a component imported probably from the British Thatcherite cuisine, not yet sufficiently tasted and evaluated by their own chefs.

The components coming from the Fund tradition were incorporated directly in their raw form. Stabilization and external adjustment had to be pursued according to the old rules together with the structural reforms. Fiscal austerity, reduction in public expenditures and devaluation were all to help reduce domestic absorption and the current-account deficit. Mixed with the modernization flavors that promised to satisfy the appetite for growth of the LA countries, the

[7] See J. Fanelli and R. Frenkel (1993)

recipe also included the bitter taste of external adjustment at any cost. In a context of high external debt, high rates of interest and international credit rationing, that component of the package implied giving priority to the generation of significant trade surpluses to facilitate heavy financial transfers.

The set of modernization and adjustment measures was a complex policy mix that came to life with lending conditionality while the economists of the Fund and the Bank attempted to rationalize it. The job seems to have been easier for the economists of the Fund than for their colleagues in the Bank, probably because it did not come along with any major change in the Fund's practice, whereas the Bank's staff was confronted with a very difficult task[8]. The comparative intellectual difficulties and the priorities determined by the practice of lending conditionality reflected in the substance of the earlier rationalizations, in which macroeconomic considerations and adjustment issues carried most of the weight, while structural reforms aimed at fostering growth emerged rather as complementary[9].

Ideas evolved while experience accumulated. "Successful" cases played an important role in this process, providing empirical support and strengthening the rhetoric of policy proposals. For example, the Bolivian 1985 program was a model of a successful drastic reform and orthodox stabilization for some time. The Chilean growth recovery from the mid-eighties made the country the model of a successful trade reform. However, the selection of cases and policies was biased by predetermined ideas. On the one hand, the evaluations of the "successful" cases never went deep enough to provide a complete picture. In the Chilean case, for example, where the reforms were implemented in the seventies, little attention was paid to the dramatic crisis of the early eighties and no role was attributed to the fact that Chile, despite having the highest debt/GDP ratio in Latin America, was able to avoid realizing significant external transfers because it received much more support from the multilateral agencies. In the Bolivian case, no mention could be found of the fact that the external gap widened after 1985 and was financed by multilateral institutions because the country became eligible with the 1985 program. On the other hand, the selection excluded some obvious cases. For example, Colombia showed the best real Latin American performance in the eighties, but was rarely mentioned as a relevant experience because it did not provide a case for illustrating the promoted policy reforms.

An attempt at systematization was produced by John Williamson in 1989[10]. The paper was properly entitled "What Washington means by Policy Reform" because the author aimed at putting together not only the explicit orientations of the Bank and the Fund but also the less formalized judgments of these agencies and those of the American administration. The paper did not seek a full rationalization of the promoted measures but it rather pursued the more modest target of providing a comprehensive presentation of the whole set. The very fact that this paper was written and the diffusion it had show that it came to fill a gap and that at the end of the eighties the policy package was still vague.

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[8] See, for example, M. Guitian (1987) and M. Kahn, P. Montiel and H. Nadeem (1986).

[9] See, for example. the proceeds of the seminar organized jointly by the Bank and the Fund in Washington D.C. in February 1987, published in V. Corbo, M. Goldstein and M Kahn (1987).

[10] J. Williamson (1990).

The modernization and adjustment set of policies was systematically presented and rationalized by the Bank in the World Development Report 1991 under the name of "the market friendly approach to development"[11]. While Williamson's paper could be read as friendly advice about what the agencies and the American administration saw as positive (what the author called "the Washington Consensus"), founded more on common sense and sensible practice than on theory, the WDR 1991 up-graded the set of policies and its rationalization to the status of a General Theory of Development. Beyond this ambitious aim and in spite of its inconsistencies (some of which may be attributed to the fact that it was written by many people) the WDR 1991 is the most complete presentation of the set of ideas that gained political momentum in the mid-eighties and evolved during the rest of the decade. The book should not be read as an academic product. As an official document of a multilateral institution, its contents had to reflect compromises and its edges be smoothed. For the same reasons, because it is a public statement, it does not include some delicate topics involving lending practices, for instance the cross conditionality of the Bank and the Fund and the requirement of a simultaneous agreement with the private creditors to be eligible for structural reform lending. More generally, most of the issues regarding the international financial context in which the policy reforms were to be implemented are disregarded in the document. Taking these facts into account, it is a bit surprising to see how audacious it is on some issues.

Nonetheless, and in spite of the fact that it was published at the beginning of the nineties, the Report belongs to the eighties. Its essence is an enthusiastic eulogy of a set of policies to allow countries to overcome economic stagnation and the persistent degradation of their standards of living, i.e. the situation that most countries were experiencing in the eighties. The "lost decade" is the implicit scenario of the document and it refers to what the countries should do in that context, although it carefully downplays the salient characteristics of the period: the debt crisis, its domestic consequences and the conditions that prevailed during the decade in the international financial markets.

II.2. Latin American policy urgencies and pragmatism.

In the ears of a Latin American country in the context of the eighties the message of the "Washington Consensus" or "market friendly approach" may have sounded as follows: "International factors may be important, but there is little you can do about them. Concentrate on taking the right domestic measures, because this is the only thing you can do and because it will make you eligible for multilateral support and attractive to international investors." Although the omission of international factors in the analysis and policy recommendations could have been considered cynical, the lack of power of Latin American countries to modify the international context that followed the debt crisis seemed to be a realistic assessment. So, any country adopting a pragmatic approach to the policy proposals might have asked itself three different questions:

First, are the "market friendly" reforms and policies the best way to achieve a development path, under normal

[11] See World Bank (1991). We developed a critical analysis of the WDR 1991 in J. M. Fanelli, R. Frenkel and L. Taylor (1993).

conditions?

Second, will these measures, or any others for that matter, be effective if the economy continues to be obliged to effect heavy external transfers while facing international credit rationing? Although it was clear that the implementation of the promoted package was associated with multilateral financial support, it was also apparent that this support was insufficient to remove the external constraint and the pressures for additional external and fiscal adjustment. In some cases (e.g. privatization) there was a positive correlation between reforms and the financing of external and fiscal gaps. But there were also trade-offs, import-liberalization vs. the lack of external resources, financial liberalization and rising interest rates vs. the weight of domestic debt on fiscal expenditures, and devaluation vs. reduction of inflation.

Third, do the issues tackled by the MFA recommendations constitute the complete set of obstacles to stabilization and the recovery of growth, or are there other overlooked constraints (in addition to the external factors) that have to be addressed?

The previous argument tries to stress that from a pragmatic policy perspective the questions regarding the MFA proposals had to go well beyond the first, i.e. had to focus on other questions besides their general suitability as development tools under normal conditions. In conditions where most countries had experienced a decrease in per capita output and investment rates and the permanent threat of explosive financial and inflationary trends, the most urgent questions involved the policies needed to stop those trends. Let us emphasize that it was not merely a question of the distinction between stabilization and structural reforms, because in the extremely deteriorated context of the eighties these were inextricably linked, and any program capable of curbing the above-mentioned trends had to include substantial structural reforms. But these structural reforms had to be judged according to their contribution to the main policy task. Some measures, such as fiscal reform and privatization, fitted well in both the MFA and the effective policy requirements. Other promoted policies, such as domestic financial reform, were more or less neutral with respect to prevailing urgencies. Another set of measures, such as tariff reductions and financial opening, because of the mentioned trade-offs, had to wait for favorable international financial conditions.

The pragmatic approach helps to explain why MFA proposals were rarely discussed in Latin America from a developmental point of view. Besides, in many countries both policy concerns and the analysts' attention were focused on other issues. Potential participants in a debate on a development strategy were busy looking for ways out of the new constraints to growth established by the eighties context. Regarding the MFA agenda, calling attention to the missing issues was for many Latin American economists more important than discussing its development capabilities. In fact, there was not at the time, nor is there in the present, a more or less developed set of policies suitable for replacing the old development strategy without repeating its mistakes. This lack of alternatives is precisely the reason for this paper.

III. The new conditions in the nineties.

III.1. The global regional economic situation.[12]

The economic situation of the region has greatly changed in the present decade. Most Latin American countries have shown a positive growth rate and a fall in inflation. This has given rise to a new set of problems in the research agenda. Before discussing the new issues, it is important to look at the most important facts that determined the change in the Latin American economic environment.

What is it that changed in Latin America between the 1988-89 period, when the average growth rate fluctuated around zero and many countries were suffering from inflation rates approaching hyperinflation, and the 1991-93 period, characterized in most countries by positive growth and falling inflation. In answering this question, the role of the already implemented structural-reform programs is usually emphasized. However, the most remarkable difference between the two periods is the evolution of the external sector. First, there was a significant fall in the international interest rate. Second, there was a sudden and marked reversion in the direction of capital flows.

The decrease in the interest rate had a very important positive income effect on the region's national income and also induced a loosening in the external gap via the reduction in the financial services account deficit. While in the 1988-89 period the net payments of interest and profits abroad amounted to 36 billion dollars per year, in 1991-93 these payments totaled US$ 29.7 billion per year. This positive effect, nonetheless, was partially offset by the decrease in the terms of trade. So, despite the fact that the situation would have been worse if the interest rate had not been declining, it seems that the income effect of the diminishing interest rates was not strong enough to explain the improvement in the Latin American situation. But the fall in the international interest rate also generated an important substitution effect, explaining at least in part the observed reversal in the direction of capital flows. The reduction in the foreign interest rate made investment in financial assets issued within the region more profitable, helping to stop capital flight. The lower interest rate also raised the net return on investments in productive assets, which may be very important in explaining not only the volume of FDI flowing into several countries in the region, but also the success of privatization in countries like Argentina, where there was an active participation of multinational firms in the process.

The reversal of capital flows has been impressive. As a consequence of the fall in interest payments abroad and the increase in capital inflows, the net transfer abroad by the region became negative in 1991-93 for the first time in nine years. While Latin America transferred an annual average of 21.9 billion dollars abroad in the years 1986-90, in 1991-93 it received 22.3 billion dollars per year. The relaxation of the extreme credit rationing that the region faced during the eighties allowed many countries to finance a higher current account deficit. Consequently, there was a strong reduction in the trade surplus; indeed, for the first time since 1983, Latin America generated a trade deficit in 1992 and 1993.

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[12] This part draws on a report prepared for the UNCTAD 1993 Trade and Development Report and published in Spanish in M. Damill et al. (1993)

With the relaxation of the external gap, many of the mechanisms that contributed to the seriousness of the crisis during the eighties were deactivated. First, the availability of external credit allowed an expansion of domestic absorption. In effect, the reversal of capital inflows was so abrupt and significant that many countries faced an excess supply of foreign exchange, even though the trade and current account deficits have been increasing fast. Consequently, the region as a whole accumulated international reserves during the period and most countries revalued their currencies.

Beyond its consequences on the balance of payments, the expansion of economic activity and the real appreciations had beneficial effects on macroeconomic stability. Fiscal revenues were buoyed by the recovery. The lower real exchange rate also contributed to fiscal balance by lowering the real value of interest payments on the outstanding public debt. Add the positive income and substitution effects of the fall in the international interest rate, it is not surprising to see that there was an extraordinary improvement in the fiscal equilibrium throughout Latin America in the last three years. Many countries in the region are now running fiscal **surpluses**. The lagging exchange rate also played an important role in the observed process of disinflation. In most of the countries this is one of the key factors explaining the significant fall in the inflation rate even in a context of expansion of domestic absorption.

Despite the improvement of performance in terms of inflation and recovery of activity level, the macroeconomic process in Latin America remains subject to important weaknesses. Two points deserve to be stressed. First, it is unlikely that the present situation of increased capital inflows and low interest rates that has induced a negative transfer abroad will persist in the future. Consequently, in order to sustain the present path of imports and domestic absorption, it will probably be necessary to increase exports at a higher rate in the future. But many countries are experiencing severe problems in raising their level of exports due to the lagging exchange rate. If the real exchange rate were corrected to eliminate the anti-export bias and reduce the trade deficit, there would be a worsening of macroeconomic stability both in inflation and fiscal balance. Thus, many countries are facing a trade-off between stability and competitiveness.

In the second place, it seems that the crisis of the eighties has left a strong negative legacy on the ability of most countries to restore a **high** growth rate path. The rates of investment and domestic savings, severely affected by the crisis, are still well below pre-crisis levels. In addition, the obsession with reducing the role of the public sector has cut public investment to extremely low levels.

III.2. A country focused analysis.

Although the description presented above seems to reflect the global regional situation reasonably well, there are significant differences across countries, even at the aggregate macroeconomic level. To get a more balanced view it is useful to classify the larger countries according to their growth prospects, with emphasis both on their main macroeconomic problems and on their relative fragility vis-á-vis the international financial context.

A first group (Colombia and Chile) comprises those which have shown good growth rates for an extended period since the mid-eighties and do not suffer serious disequilibria which might threaten short-run stability. Their dependency

on external finance to sustain growth is low. For different reasons and by different means, both economies have achieved acceptable balance in the fiscal and external accounts and not suffered extreme macroeconomic instability (by Latin American standards). In both cases, the closing of the fiscal and external took place prior to the new external financial conditions that the region has faced since 1991. Thus, growth recovery and macroeconomic stability were achieved independently of the new financial environment.

Argentina and Mexico are the prominent examples of a second group. These countries have been growing in recent years, but the growth process is more fragile. Stabilization programs based on the nominal exchange rate as an anchor of the price system are underway.. There is a persistent trend toward exchange-rate appreciation, although at declining rates, together with an increasing distortion of relative prices against tradeables. The real appreciation and the simultaneous opening of the economy are restraining exports and fueling imports, leading to a deterioration in both the trade and the current accounts. In this scenario, the magnitude of the external savings requirements is similar to that of the pre-crisis period in the early eighties. The sustainability of growth depends increasingly on external finance. The recent expansion has mainly been led by consumption. Although there was an increase in investment, the rate is still significantly below the pre-crisis level. In these countries, in brief, the projection into the future of present trends implies widening disequilibria. Consequently it is expected that there will be important changes in some macroeconomic parameters in order to make the growth process viable.

The defining characteristic of a third group (including Brazil and Venezuela) is the continued existence of the restrictions which typified the eighties. Brazil is experiencing very high inflation rates and GDP has been stagnant in the last years. After many attempts to close the fiscal gap (some of which succeeded in the very short run) there is the generalized belief that sustained fiscal equilibrium is impossible without a complete reform of the fiscal system. Many of the difficulties stem from the lack of credibility in stabilization shocks of any kind, following the failure of the many previous attempts. This is specially so regarding the entrepreneurial sector. Venezuela, on the other hand, has shown relatively high growth rates in the early nineties, but the cost was the reopening in 1992 of both the fiscal and the external gaps. The levels of external and fiscal disequilibria are comparable to those of the pre-1989 adjustment period. Although 1989 reforms were intended to transform the way in which the Venezuelan economy worked, trying to make it less dependent on oil and giving more room to the private sector, the outcome resembled the past more than had been expected. In 1990 and 1991 a favorable shock in oil prices and capital inflows stimulated economic activity and provided resources to sustain the closure of both the fiscal and the external gaps. Subsequently private consumption continued to increase, but then oil prices fell and capital inflows were not enough to compensate for the current account deficit, which had to be financed by public sector indebtedness and contraction of reserves. This process greatly resembled the dynamics of the eighties. The combination of a lagging exchange rate and falling oil proceeds produced a huge fiscal imbalance. The expectation that the leading role previously assumed of the state be taken after the reform by the private sector was not fulfilled. Private investment fell by 50% after the 1989 shock and has not recovered since then.

It should be stressed that both Brazil and Venezuela confronted serious political crises in the nineties. Political

uncertainty eroded the credibility of economic policies and made it harder to reach political consensus for the fiscal reforms and stabilization policies that seem to be urgently needed in both countries. However, the similarities between Brazil and Venezuela that we have underlined should not conceal the fact that both Brazil's level of industrial development and its external situation will put it in a relatively better position if the political and fiscal problems can be overcome.

III.3. A better context for discussing and implementing development policies.

Although a detailed analysis of the recent Latin American macroeconomic performances shows significative differences regarding external fragility and the continuation of the typical eighties dynamics in some cases, it can be assumed that the region is now in a better position from which to embark on a lasting growth process. The most important positive changes regarding growth potential can be synthesized as follows.

First, most countries have regained access to international financing so the external sector is no longer acting as a binding constraint to growth. Obviously, this does not mean that the problem of ensuring intertemporal external consistency can be dismissed. On the contrary, as we commented above, this should be a serious cause for concern, particularly in the cases of Argentina and Mexico. But the relief of credit rationing implies that intertemporal financial consistency replaces the point in time liquidity constraint characteristic of the eighties. Second, the improved international financial conditions have eased the adjustment of the fiscal sector, although significant problems remain in this area. In some cases the adjustment led public expenditures, particularly public investment, to very low levels that would be inconsistent with a lasting recovery of growth. However, the short run closing of the fiscal gap could be a first step on the road to deeper and more development-oriented fiscal reforms. Third, alleviation of the pressures coming from the external and fiscal gaps has generally allowed the improvement of macroeconomic and financial performance, thus helping to strengthen private sector "animal spirits."

In short, the constraints to growth posed by the external debt crisis and its lasting consequences have been significantly alleviated. Besides, most of the destabilizing mechanisms that in the eighties aggravated the pressures coming from the external and fiscal gaps have been deactivated. The region has thus regained enough degrees of freedom to face the challenge of designing economic policies suitable to both stabilization and development.

Although the macro-constraints characteristic of the eighties seem to have been overcome, history does matter and consequently the early nineties conditions are significantly different from the past. On the one hand, many of the vestiges of the crisis still remain. There are a set of key problems and specific policy measures that deserve attention. First, the rates of investment and domestic savings are still too low; the recovery has not yet been strong enough to restore the pre-crisis levels. Second, financial systems and capital markets are still weak and small. The degree of monetization is remarkably low while the term maturity of financial instruments is very short. Third, as was already mentioned, the closing of the fiscal gap does not seem sustainable in many countries, either because it is based on the "repression" of

public investment in economic and social infrastructure (Mexico) and/or because it depends heavily on the proceeds of privatization (Argentina). Some countries did not even attain budget equilibrium in the short run (Brazil). Fourth, the interruption of the growth process, in itself, has had long-lasting and permanent negative consequences on the development process, especially regarding the generation of employment and increases in productivity. These problems are in fact the main motivation for the task of designing a new development strategy, capable of restoring employment creation, investment, and innovation. On the other hand, the economic structures have also changed significantly. In some respects the changes have been the spontaneous result of a chronically weak performance, as, for instance, the restructuring of industrial sectors and the dollarization of savers portfolios. In other respects the changes have originated in the structural reforms already implemented as, for instance, privatizations, tariff reductions and liberalization of external trade and financial opening. Most of these structural changes seem to be irreversible, for different reasons, and form part of the setting that a new development strategy should take into account.

The classification employed in the previous section to analyze the constraints to growth in the eighties can be recalled here to review the main challenges that new development policies will face in Latin America. First, to sustain growth it is necessary to generate sufficient savings. Second, it is necessary to ensure that the non-consumed flow of income be invested in the country. Third, it is necessary to guarantee an efficient allocation of real resources. Problems related to each of these issues remain in the nineties, but the improved conditions enable policy makers not only to focus on the basic necessary conditions but to actively confront problems related to development as an evolutionary process, where innovation and participation are crucial. With this broader focus in mind it is necessary to add to the former classification a fourth issue, highlighted by the Shumpeterian tradition: the need for establishing an economic setting conducive to fostering local capabilities and technological innovation.

Let us conclude the paper by suggesting that the nineties could also provide a better environment for the dialogue between Latin America and the multilateral institutions. Some sources of misunderstanding and controversy have been left behind. The largely implicit debate around the main factors to blame for the "lost decade" and the consequent differences regarding policy priorities may be considered closed with an even result. On the one side, the new conditions relegate the question of the "missing issues" of the MFA to a secondary importance. On the other side, some of the central structural reforms of the MFA have been already implemented and their effects, for better or for worse, make part of the new setting. Thus, leaving behind most of the controversial issues, a dialogue towards the design of a new Latin American development strategy can now be established on a new basis.

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