REFORMING THE REFORMS IN LATIN AMERICA: MACROECONOMICS, TRADE, FINANCE

By Ricardo Ffrench-Davis

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I. AN INTRODUCTION

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1. THE OUTCOME OF REFORMS

Economic reforms have proceeded at a fast pace across Latin America in the 1990s. By 1997, an optimistic mood prevailed among public and private leaders in Latin American countries (LACs) and in financial and official institutions abroad, with respect to both recent performance and the future of the region.

There had been a generalized recognition by regional authorities of the need of preserving macroeconomic balances. Hyperinflation had disappeared, and many countries were experiencing one-digit inflation rates. Budget balances and fiscal savings had improved considerably. Monetary expansion to finance public deficits had nearly ceased. The quantum of exports was expanding rapidly and diversifying in terms of items exported and markets of destination. Many countries were accumulating significant international reserves (ECLAC, 1995). A long wave of massive privatizations had been made. Frequently it could be heard that already accomplished this first generation of reforms, it was time for the second generation that had been left behind (including areas such as education and the judicial system reforms).[1]

Nevertheless, three significant types of problems were developing. First, some balances were achieved either at the expense of imbalances in other macroeconomic variables (particularly in the external sector) or by neglecting aspects that are crucial for achieving systemic competitiveness or equity (such as investment in human capital); both were conspiring

[1] See assessments of reform processes in ECLAC (1995); IDB (1997); World Bank (1997b); and Burki and Perry (1998).

against a vigorous and sustainable growth. Second, the region's economic conjuncture had been evolving between the late 1980s and the mid-1990s; the former period was dominated by a binding external restriction and the corresponding large gap between the use of productive capacity and potential gross domestic product (GDP); the latter period was characterized by abundant capital inflows and a fading gap. As a consequence, macroeconomic policy should have moved towards actively seeking a timely convergence of the then fast speed of shifts in effective demand and the much slower rises in productive capacity, for when the original underutilization gap became exhausted (see Chapter 6); the diversity of speeds suggested the emergence of new unsustainable dissequilibria. Third, the disregard for a balance in the treatment of society's various goals has resulted in a rising dissatisfaction of broad sectors of the population with the public policies in force, and the resulting uneven distribution of power, income and opportunities.

These three types of problems are directly related to the design and style of implementation of the reforms in progress. Consequently, there is a need to *reform present reforms* in order to improve economic performance and equity. Also evident is the need for a more integrated and comprehensive approach, which encompasses not only economic growth but also social and democratic development (Ocampo, 1998; Stiglitz, 1998a).

One of the crucial objectives of reforms has been to improve the environment for productive activities and to achieve a sustainable higher GDP growth. Notwithstanding, the outcome has been poor. After the 1.2 per cent yearly growth in the 1980s, there was only a meagre improvement to 2.9 per cent in 1990-2000, considerably below the record of 5.5 per cent in the period from 1950 to 1980 (see table 1). This rather poor rate of growth in the 1990s, which in fact implies that convergence with richer countries has not been reinitiated, occurred in spite of a net capital inflow comparatively as large as that received by LACs in the 1970s.

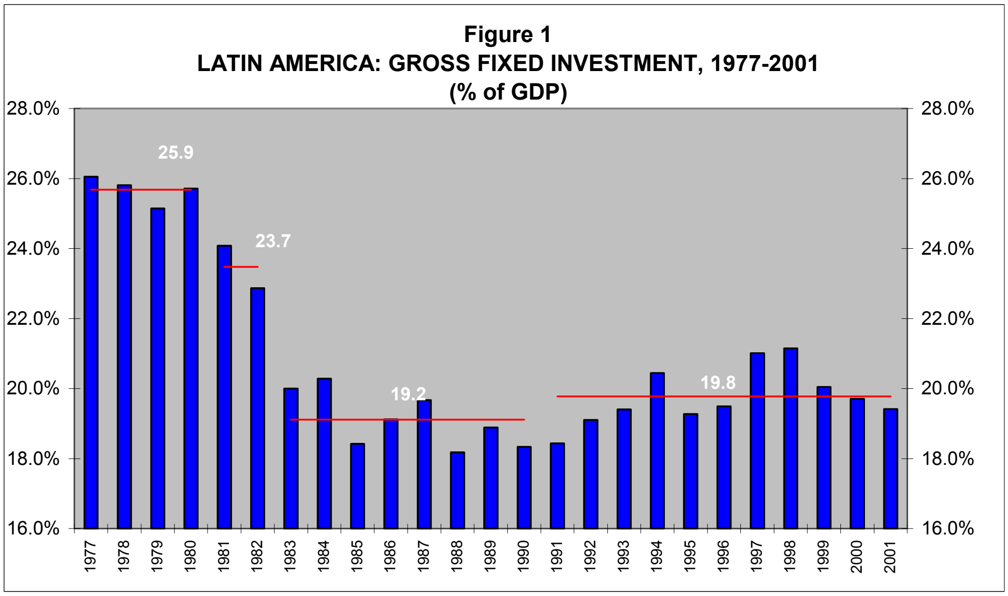
The meagre GDP growth was associated, partly, to a low ratio of productive investment (see figure 1). After a sharp drop of the ratio with the debt crises of the 1980s, the ratio only recovered slightly during the 1990s. In this book we give a highly significant role to this outcome, and we associate it to pitfalls in reforms, particularly in the macroeconomic environment provided and in the weakness of policies directed to *complete* markets of productive factors (labor training, technology and long-term segments of capital markets).

Table 1

LATIN AMERICA: GROSS DOMESTIC PRODUCT, 1971-2001
(annual growth rates, %)

	1971-80	1981-89	1990	1991-94	1995	1996-97	1998-2001	1990-2001
Argentina	2.8	-0.7	-2.0	8.0	-2.9	6.7	-1.0	2.9
Brazil	8.6	2.3	-4.6	2.8	4.2	2.8	1.7	1.9
Chile	2.5	3.0	3.3	7.4	9.0	6.8	2.8	5.6
Colombia	5.4	3.7	3.2	3.9	4.9	2.6	0.2	2.5
Mexico	6.7	1.5	5.1	3.5	-6.1	6.1	3.9	3.4
Peru	3.9	-0.7	-5.5	4.9	8.6	4.6	0.7	2.8
Venezuela	1.8	-1.5	5.5	3.2	5.9	3.4	0.3	2.7
Latin America (19)	**5.6**	**1.3**	**-0.6**	**4.1**	**1.1**	**4.4**	**1.8**	**2.7**

Source: ECLAC, expressed in 1980 US$ for 1971-80, in 1990 US$ for 1980-89, and in 1995 US$ for 1989-2001.



Source: Based on ECLAC figures for 19 countries, scaled to 1995 prices.

Rough estimates show that, during the first half of the 1990s, a period of high overoptimism about the effectiveness of reforms, approximately one-third of GDP growth of LACs was accounted for by increased use of capacity, in a move of effective GDP towards the production frontier or potential GDP; after the Tequila crisis, a similar result emerged with the upsurge of inflows in 1996-97. These moves were, in both episodes, to a significant degree, a response to the fading away of the former binding external restriction. Thus, growth in capacity rose to only some 3% per year, in a decade of high net capital inflows. This rather poor performance is, first of all, a consequence of the low increase in the stock of fixed capital; the investment ratio has averaged in the 1990s some 5 percentage points less than in the pre debt crisis decade. Second, total factor productivity gains have been modest, partly because they are associated to the low level of productive investment (De Long and Summers, 1991). Exports have been dynamic, rising 9 per cent per year in volume, apparently with high investment and productivity gains in the sector; but the capacity increments of LACs have concentrated mainly in the production of exportables, which still represents less than one-fifth of GDP. Furthermore, part of the potential productivity is forgone with capacity underutilization, which recurrently reappears, and is located principally in non-exportables.

The repetition of conjunctures with significant underutilization of productive capacity, results from external shocks and unsustainable domestic macroeconomic policies and outlier macroprices, as illustrated by the cases of Argentina and Mexico in 1995 (see Chapter 10). The effective productivity of the total stock of factors evidently decreased in these two nations in 1995, given that this stock kept growing (although at a slower pace) while effective output decreased. Output recovered in 1996-97, giving way to widespread assertions that the crisis had been superseded fast and efficiently. This sort of wishful thinking or neopopulism tends to lead to a dangerous underestimation of the costs of policy mistakes and to the persistence of ideologism in the design of reforms. Always, the present value of recoveries as well as of drops in output and welfare should be considered in assessing performance of a reform, a policy or an adjustment process. There is a worrisome tendency to underrate the significance of instability and underutilization of capacity (Katz, 1996; Stiglitz, 1998a).

Instability is asymmetrical, and inevitably implies, in average, underutilized potential productivity and lower effective output. Actually, recovery increases the flow of output in the present up to the full use of existing capacity, but it cannot recuperate output not generated yesterday. Instability also tends to be asymmetric with regard to income distribution, since high-income sectors, with better access to markets, can take better advantage of the opportunities emerging during economic booms, and then adjust more easily during recessive periods. The available data indicates that distribution has a tendency to deteriorate during recessions and to improve with recoveries, but with less strength on the latter than the former (Morley, 1995;

Hausmann and Gavin, 1996). The more *incomplete* the financial markets and the smaller the capital formation ratio, the larger will be the probability that the regressive effects predominate.

There is a wide variety of paths chosen by LACs in the design of their structural reforms and economic policies. However, there are some distinctive features that reflect common external influences or common domestic approaches which imply significant shortcomings of the first generation of reforms. The prevailing style has involved the repetition of costly mistakes, particularly in the macroeconomic management, the design of financial and trade reforms, and in the weakness of efforts to complete markets.

Many of the reforms were performed under the umbrella of the so-called ‘Washington Consensus’. However, the actual implementation was in several cases more ideological and incomplete than the written “consensus” (see Williamson, 1997, Appendix). Paradoxically, some of the most outstanding errors, for instance related to the exchange rate and interest rates policies, were the result of ignoring most evident advise, such as ‘never revalue when liberalizing imports’. The fact is that the actual evolution of reforms and their effects, reveal serious biases and shortcomings, making necessary a new agenda and a systematic search for more appropriate policies (see, for example, Stewart, 1997; Williamson, 1997; Ocampo, 1998; Stiglitz, 1998b).

On the other side of policy alternatives, countries like Chile have introduced, in the early 1990s, policy changes that have implied less instability of macroprices and aggregate demand, and somewhat more systematic efforts to complement incomplete markets (see Chapter 7). The outcome appears to be, though still far from an optimum, a macroeconomic environment more efficient and encouraging for productivity increases and for irreversible investment (Ffrench-Davis and Reisen, 1998, ch. I; Schmidt-Hebbel, Servén and Solimano, 1996).

In this collection we will examine the strong features of macroeconomic policy-making, trade liberalization, capital flows and financial reforms that contribute to explain why growth performance has been poor on average. We will stress that several varieties of reforms might work in the sense of generating growth and welfare increase after the adjustment process is finished; but the particular features of the transition to new equilibria make a crucial difference, and naive reforms may have an extremely long and costly adjustment period, given the presence of imperfect and incomplete markets. What happens during the process (hysteresis effects on the flows of human and physical capital), together with the time involved, can have significant implications for the well-being of people, being this welfare the ultimate objective of economics. The market record can be improved significantly by reforming the reforms.

2. TOO NAIVE NEOLIBERALISM, TOO LITTLE PRAGMATISM

The present neoliberal fashion tackles various real problems, of great significance, that have been emerging or developed in recent decades, particularly in the 1970s and early 1980s. In the case of LACs, those pitfalls have generated costly dissequilibria, such as the appearance of huge fiscal deficits, high and variable inflation, the worsening accountability of public firms, negative real interest rates, the arbitrariness of effective protection and too many microeconomic decisions centralized by national authorities. However, the right changes can be made in the wrong way. That is what happened, frequently, with some of the neoliberal reforms too loaded with ideologism, depicting a poor understanding of how markets actually do work and their degree of maturity.

Neoliberalism has an extreme faith in the efficiency of the traditional private sector and mistrust for the public sector and non-traditional forms of private organization. There is a tendency to implement reforms abruptly and to the extreme, assuming that markets when liberalized become complete spontaneously; this view regularly disregards crucial inter-relationships among variables, and it is too short-termish.

The predominant approach assumes that market signals flow transparently and fluidly among markets and among generations. In doing so, structural imbalances are assumed away, except those generated by state intervention. These assumptions lead to an underestimation of the negative effects on capital formation, the utilization rate of potential GDP, and the distribution among people of productivity and opportunities, that neoliberal adjustment processes tend to generate in the face of external shocks and of anti-inflationary programs. The outcome is associated to the specific features of the set of structural reforms which have been applied.

Paradoxically, the view still in fashion, which is built on microeconomic theory and optimization, jumps to policy recommendations based on the maximization of liberalization. It disregards intermediate positions between the extremes of indiscriminate liberalization and arbitrary interventionism; it also underrates the deep implications of the absence of complementary reforms (a most evident case is that of the absence of effective prudential regulations of financial institutions and public services, parallel to their liberalization or privatization). It is clear that many outstanding specialists in the northern academic world do not share many of the traits of the neoliberal paradigm, and that well developed standard neoclassical analysis can be used to show the dangerous pitfalls of naive market faith (for instance, see Krugman, 1990; Rodrik, 1992; Sachs, 1987; Stiglitz, 1994 and 1998a; Williamson, 1997; Wyplosz, 1999).

The debt crisis of the eighties brought into the forefront the economic agents linked to the financial sphere, in public and private enterprises as well as in ministries and other governmental departments, and in mass media. This situation imposed the predominance of a short-termish bias over concerns for productivity and additions to productive capacity. In speculative markets, as Arrow (1974) points out, a considerable part of the efforts of economic agents focuses on acquiring information leading to capture benefits at the expense of the rest of the economy (capital gains), and tends to lead to a negative sum redistribution, given that real resources are used in the process. At a distributive level, indiscriminate deregulation also concentrates opportunities in favor of sectors with greater access to the financial system and more short-termish; in fact, usually the long term segments of capital markets and small and medium productive firms (SMEs) have tended to loose shares in the financial markets. Macroeconomic policy-making has become to be excessively influenced, probably not purposely, by well-trained specialists in microfinance.

This is not unavoidable, if countries prepare themselves with due anticipation during periods of real and financial boom, they would be capable to reduce their vulnerability during situations of external financing shortage or macroeconomic adjustment. This would allow, with greater freedom and efficiency, to concentrate all energies to progress on the path of reforms impregnated with a pragmatism suitable for development with equity and for the enhancement of democracy.

3. OUR APPROACH

Criticism of neoliberalism tends, frequently, to lack concrete policy proposals. Here we have tried to adopt a systematically policy-oriented approach.[2] Our policy-orientation is pragmatic in the sense of considering the actual working of markets and the response capacity of different economic agents. Various dimensions of structural heterogeneity play a crucial role: among others, heterogeneity in the openness and stability of various external markets; heterogeneity between stages (expansive and contractionary) of the business cycle; variety in the elasticity of response to incentives among regions and among market segments (big and small businesses, rural and urban enterprises, infant and mature firms, consumers and producers, productive and speculative investors); and the effects of the adjustment path on the feasibility of attaining different combinations of objectives (hysteresis), which implies that there is no single equilibrium but rather multiple ones. In short, a series of variables are relevant: the degree of

[2] Our alternative approach can be associated to the so-called neostructuralism, or growth with equity, or productive transformation with equity (ECLAC, 1992).

resource mobility and price flexibility, the eventually destabilizing dynamics of 'automatic' or neutral macroeconomic adjustment policies, depending on the response capacity of diverse sectors and markets, the perceptions or expectations of economic agents, and the sequencing and gradualism of changes (see Chapter 2).

Hence there arises the recommendation of contributing to improve the working of markets, enhancing the role of longer-term horizons and productivist factors. The target is an endogenous development process guided from within (Fajnzylber, 1990; Sunkel, 1993). A crucial space corresponds to regulating capital movements, exchange rates and trade policy, and to the application of a productive development policy, including systematically developing and completing factor markets, which guides the allocation of resources towards investment in physical and human capital, deliberately improving the distribution of productivity and opportunities across society, and promoting the acquisition of comparative advantages. This is the constructive option, in contrast to inward-looking development in the more naive ISI approaches, or outward-looking ones in the approaches based on the integration into world markets via abrupt and indiscriminate import liberalization, and the fading-out of the sense of Nation.

Our approach requires a dynamic and modern private sector, together with active linkages with the global markets and an efficient state. Given a framework of structural heterogeneity, achieving an efficient state –central and local governments, regulatory agencies, and public enterprises-- is not easy. Furthermore, it is necessary to be selective also in the sense of dealing only with that quantity and quality of actions that the state is capable of designing and implementing with social efficiency, and focusing efforts where they will have the greatest impact. These principles help to minimize 'State failures'.

In the LACs of the 1990s, policies have been taking place in a framework where capital formation is comparatively low. We work under the well-established empirical fact of a strong correlation between physical investment and growth, resulting from the interrelation of capital accumulation and the absorption of technical progress (Schmidt-Hebbel, Servén and Solimano, 1996). Hence, careful attention should be devoted to the effects of given reforms or policies on investment ratios and productivity growth (Katz, 1996). We examine in detail effects of trade and financial reforms, of capital flows and macroeconomic management, on capital accumulation and its rate of use and overall productivity.

Factor heterogeneity or market segmentation is one of the most typical features of developing countries. This naturally affects the transparency and flow of information. Factor markets are usually incomplete or underdeveloped. Reforms and policies should strive to actively contribute to complete and integrate them rather than increase segmentation, as it has often tended to occur. Pragmatic gradualism, explicit efforts to achieve more complete markets, macroeconomic–cum-macrosocial balances, should all be geared to strengthen integration of typically segmented markets. Mezzo policies, such as labour training, dissemination of technical knowledge, and space for small and medium firms are at the core of spreading productivity through society. That is the most sustainable road to endogenous dynamic growth with equity.

We have been hearing for many years the slogan of market-friendly reforms and right prices. It is evident the consensus that reforms and right prices are inputs for growth. However, actual poor performance, indicates that friendship has not been effective and prices have diverged from rightness. It is common to observe in neoliberal reforms notably high real interest rates (i.e., Chile had an annual average of nearly 40 per cent for over 8 years from 1975 to 1982, and many LACs are exhibiting outlier rates in the 1990s; ECLAC, 1995, chapter IX). Evidently, these outlier rates make more complicated the evaluation of projects for the allocation of resources, promote speculative rather than productive investment, and contribute to deteriorate the portfolio of financial institutions. The crises of Argentina and Mexico in 1994-95 are also cases of a very wrong price of the domestic currency, unsustainable aggregate demand, and crowding-out of domestic savings.

Reforms should not become a goal, but a means for progress. An identification of the results being sought should be made; then accountability should be demanded. For instance, if a domestic financial reform is implemented in order to increase domestic savings and enhance the volume and quality of investment, reformers should be dissatisfied if financial savings increase while national savings decrease, and if investment must face the dismantling of long-term segments of the capital market and outlier real interest rates. In addition, the liberalization of the capital account, together with large external inflows, has brought many cases of crowding-out of domestic savings; trade liberalization has proceeded *pari passu* with exchange rate appreciation, contradicting all reasonable recommendations; bank privatization has brought in related non-transparent loans and moral hazard, which have produced banking crises and rescues at government expense of up to 50 per cent of annual GDP, according to figures published by the World Bank.

It is impressive that the mistakes carried out in the financial reforms of Argentina and Chile during the 1970s, were repeated in many other countries of the region since the mid 1980s, and in Asian countries during this decade. They share not only the weakness of prudential supervision, but also the booms in short-term segments, the crowding-out of domestic savings, and financial crises highly expensive for the treasury. Comprehensive accountability seems to be rather absent, judging from the frequent applause for many ill-designed reforms whose objectives have not been fully accomplished or which have ended up in critical scenarios.

4. THE MENU AHEAD

In Chapter 2 we present a stylized characterization of the neoliberal and neostructural approaches. We consider the main analytical framework and the policy prescriptions dividing them. Then follows a brief historical overview of growth and investment in Latin America. Subsequently, we focus on the influence of the macroeconomic environment for capital formation, emphasizing the role of macroprices such as the exchange rate, interest rates and import tariffs, and the management of aggregate demand. The significance of a productivistic as opposed to a financieristic environment is stressed; the specific institutions and working of financial markets can make a crucial difference for economic performance.

Chapter 3 reviews the trade reforms implemented in LACs in recent years. A sharp increase has been recorded in the neutrality of trade policy, drastically reducing the dispersion of effective protection; the reformers have foreseen that this will result in more competitive firms, higher productivity and rising export-oriented production of tradables. We contend that, in order for trade reforms to be successful, it is necessary that the present value added by the creation of new activities (mostly exportables) exceeds the present value subtracted by the destruction of existing ones (mostly importables). This tends to require an increase in exports greater than the decrease in import substitution; consequently, with an expansion of the share of tradables in GDP. It is expected that export activity will have positive spillover effects on the rest of the economy, which will depend upon the degree of diversification and the quality of value-added in goods and services exported; and international competitiveness must be attained through a continuing increase in productivity rather than by low wages and rising subsidies or tax exemptions.

Indeed, generally speaking, countries' performances as regards capital formation and overall productivity have not been satisfactory. First, the analysis of the trade policy reforms shows that most LACs adopted an abrupt import liberalization together with a weaker export promotion (or non-existent, beyond the direct impact of the tariffs reduction on imported components of exportables); this implies a sharp contrast with successful East Asian experiences. Second, significant inconsistencies have prevailed, particularly the coexistence of import liberalization with exchange rate appreciation; usually real interest rates have also been extremely high, discouraging investment and the restructuring of output. Third, a scant comprehensiveness has characterized policy sets, with weak or negligible efforts to improve factor markets, such as labour training, technology, infrastructure and long-term segments of capital markets. The shortcomings or incompleteness of these markets during the transition, have been a significant deterrent for private investment. Overall, negative pulls appear to be stronger than positive pulls on investment during the transition to post-reform equilibria.

We present a number of policy prescriptions that could complement or improve existing ones. Given the rules of the new World Trade Organization, some readers might be surprised by a discussion on active trade policy. However, there are three points that provide space for thought and action. First, trade policies played a crucial role in the acquisition of comparative advantage in East Asia in previous decades. If the policies cannot be replicated, maybe such positive outcome cannot be replicated either by the new emerging economies, but might there be a substitute road? Second, LACs still have tariffs other than zero. Even the prevailing levels, averaging around 10 to 12 per cent and ranging normally between zero and 20 per cent, actually provide a significant space for differentiated effective protection. Third, national policies directed to complete or complement imperfect markets can have differentiated effects among sectors and among diverse factors of production.

The debt crisis left a long-lasting mark on LACs. It is a neat case of misbehaviour in the period of abundant external financing, during which the crisis was created. The external disequilibrium and the mounting debt could have been avoided or softened sharply, as shown in Chapter 4. The effects of the adjustment during the crisis are a clear example of the inflexibilities and market incompleteness prevailing in LACs; this was so in the countries then without reforms, like Brazil or Peru, or already with deep and extended reforms, like Chile. Actually, as is well known, Chile was the country that experienced the worst recession in all Latin America in 1982, while the impact on Colombia was the softer in the 1980s.

In rough terms, during the eighties, for each dollar of negative shock in net transfers of funds to Latin America, there was an equivalent drop in GDP, and aggregate demand had to be reduced by two dollars; thus, an excess expenditure of one dollar was corrected with a drop of two dollars in expenditure. Clearly, high under-utilization of productive capacity testifies that effective switching-policies were lacking. There was a subsequent additional cost, a nexus with the future, associated with the sharp drop in capital formation that followed.

Management of the crisis by IFIs, with an active participation of creditor banks and the US government, avoided a collapse of international finance, but left the debtor nations burdened with the bulk of the costs of a shared error of three parties: IFIs, creditor banks and LACs. It was a case of enforced asymmetric sharing of costs, as discussed in Chapter 4.

Latin America enjoyed a booming expansion of capital flows during 1991-94 and subsequently in 1996-97. These inflows overcame a binding external constraint that was responsible for the severe economic recession and low domestic investment of the 1980s. Nevertheless, these inflows have also had an undesirable effect on exchange rates, balance on current account, control over the money supply, and the resulting vulnerability to negative external shocks. There is no unbeatable reason why LACs cannot improve the balance between positive and negative effects of economic events. The policies adopted in the boom stage are determinant in softening bubbles and unsustainable imbalances, with the selectivity of policies during the downward adjustment being important, but second to their quality in the former (ECLAC, 1998).

Chapter 5, written before the Tequila crisis, reviews the analytical foundations of the role of capital flows in development and the issue of capital account opening, discussing the contribution it can make to capital formation and macroeconomic stability, and the conditions in which it can have the opposite effects, with intertemporal destabilizing adjustments. Subsequently, it focuses on the sources of the 1990s boom in capital flows and some of the policy implications that emerge from the supply side, and appraises the impact of these flows on LAC markets and the domestic policy implications. The risks associated to the rising and high deficits on current account, the sharp exchange rate appreciations and rising volatile external liabilities recorded in 1990-94 are stressed. The policy mixes of Chile and Colombia (particularly a reserve requirement deterring short-run inflows) directed to soften the volume of capital inflows and to affect is composition are presented as illustrative cases (Ffrench-Davis, Agosin and Uthoff, 1995; Ocampo and Tovar, 1998).

The intertemporal character of financial transactions and incompleteness of markets contribute to making finance one of the most imperfectly functioning and prone to cycles in the market economy (Stiglitz, 1994). Hence, improved information, financial sector regulation and comprehensive prudential macromanagement of financial flows constitute a public good for which there is a shared role for governments on the supply side (creditor nations) and on the demand side (debtor nations).

Chapter 6 analyses the interrelation between the macroeconomic framework and growth. After reviewing the recent macroeconomic evolution, highlighting its progresses and shortcomings, it focuses on the policy implications of the existence of gaps between productive capacity (productive frontier) and its rate of utilization (effective demand). The way in which a persistent gap tends to negatively affect the speed of expansion of the production frontier and effective productivity is illustrated by examples from the 1980s and 1990s, including the Tequila Effect. It then reviews economic policies that affect the proximity between the production frontier and effective demand, with particular reference to the cases of anti-inflationary policies and external shocks. Chapter 6 concludes with some remarks on enhancing the sustainability of macroeconomic policy and right macroeconomic prices.

The need for effective measures to ensure that capital inflows enlarge productive investment and are consistent with a sustainable macroeconomic environment is emphasized: the composition, the level and deviations from the trend of the volume of flows are crucial (Agosin, 1998; Uthoff and Titelman, 1998). The explanation rests on the diverse capacity to react of different markets and agents. In periods of surges (as opposed to a stable trend), liquidity constraints for consumers tend to be released faster than for investors, given the weaknesses of long term segments of capital markets. As well, consumers can react faster than productive investors since the latter need to identify, design and develop new projects, what is a time consuming process; given the irreversibility of investment, favorable expectations assumed at a particular time by long-term investors must be sustainable for a longer horizon.

Chile has led the way in neoliberal reforms, carried out under the prolonged umbrella of the dictatorship of Pinochet. The case has become paradigmatic, which grants great relevance to understanding the process, its ingredients and outcome. A brief overview of the over sixteen years of the Pinochet regime is presented in Chapter 7. The starting point, in 1973, was extremely distorted and in need of reform. However, several much-needed reforms were applied at an inconvenient conjuncture, or applied too abruptly, or went too far beyond the optimum, or were extremely naive, with consequent sunk costs (Foxley, 1983; Ramos, 1986). Overall growth in the 1973-89 period was only around 3 per cent per year, with worsened income distribution and a greater likelihood of macroeconomic instability. But the fact is that many reforms are already implemented, some several years ago.

Reforms to reforms in the President Aylwin's government (1990-94) are discussed. Principally, we examine the changes in macroeconomic policies, which achieve an outcome notably different from that of the previous government. In fact, the previous large average gap between effective and potential output was replaced by an effective demand persistently close to the production frontier, as a consequence of an active macroeconomic management. Regulation of capital flows, carried out against the fashion of the early 1990s (Ffrench-Davis, Agosin and Uthoff, 1995; Agosin and Ffrench-Davis, 2001), together with the application of an active exchange rate policy and the maintenance of a strict prudential supervision of the financial system, played a determining role in achieving stability and saving Chile from following Mexico and Argentina in the crisis of 1995.

Macrosocial balances were also given priority, as a fundamental ingredient of growth with equity. Consequently, a new reform to the previous reforms increased the tax burden so as to finance higher investment in people. The better balance among relevant policies made it possible to achieve the largest rate of growth of productive capacity and the higher capital formation ratio ever recorded in Chile, and to achieve a sustained process of both increased real wages and rising productive employment, as documented in chapter 7. Nevertheless, a significant poverty reduction (from 45 per cent of the population in 1987 to 23 per cent in 1996) has not been followed by a better income distribution.

A significant upsurge has taken place in reciprocal trade within Latin America in the 1990s. In fact, intra-regional exports tripled in the seven years up to 1997, covering then 23 per cent of total exports of goods. If attention is focused on growth and shares of non-traditional products, both are notably higher in intra-regional trade.

In Chapter 8 we outline an analytical framework, placing the discussion in a globalizing world, but with limitations both to access to markets and to producing non-traditional exports. These goods and services face distortions and incomplete markets, which preferential regional trade agreements (PRAs), in an environment of open regionalism, can contribute to removing progressively and efficiently. It is stressed that PRAs are significant for these products rather than for traditional exports, for which extra-regional markets will remain the main source of destination. Then we examine the evolution of reciprocal exports in the 1990s, showing that they are actually more intensive in technology and value-added. In this sense, regional trade contributes to a more dynamic productive transformation of the domestic economies, and can complement policies directed to enhance systemic productivity.

The merit of Chapter 9 is that it was published in June 1992, two and a half years before the Tequila crisis, advising of the disequilibria that was starting to be built with massive financial capital inflows, appreciating exchange rates and rising deficits on current account in several LACs. These concerns gave rise to the research project on the “new financial surges towards Latin America” which we coordinated for ECLAC (see Ffrench-Davis and Griffith-Jones, 1995), whose conclusions, completed by mid 1994, constitute Chapter 5 above.

Over the last few years, international financial flows have increased dramatically. These financial flows, mostly of a short-term nature, exhibit sharp swings; usually they generate high stocks of volatile external liabilities and overly appreciated (outlier) exchange rates during periods of excessive optimism. This distortion has affected developed economies (for example, Europe in 1992) as well as emerging economies. The Mexican crisis of December 1994 (the so-called Tequila Effect) and its strong contagion towards Argentina, is a clear example of the potentially harmful effects of absorbing too much external financing, over several years, with a composition propense to volatility.

In Chapter 10, we argue that the impact of the Tequila Effect did not spread more widely to other countries in 1995, mainly due to several positive external shocks experienced by the region, associated with terms of trade improvement, highly dynamic growth of world trade, devaluation of the US dollar and, in addition, IFIs/US timely massive intervention (Lustig, 1997). Nevertheless, the global impact was significant in that Latin America saw negative growth rates up to March 1996, while domestic investment fell substantially. The negative effect was clearly stronger in those countries, such as Argentina and Mexico, considered more successful by financial markets, that had applied more permissive policies toward the heavy volatile capital inflows, and had experimented greater exchange rate appreciation between 1991 and 1994. On the contrary, Chile, other country classified as successful, as previously mentioned, applied effective policies deterring volatile inflows and actively intervened to moderate exchange rate appreciation; thus, it was able to remain immune to the Tequila Effect.

The limited contagious effect encouraged a fast recovery of capital inflows in 1996-97 (with a larger long-term component, partly fostered by privatizations), followed by a vigorous recovery of economic activity. Thus, 1997 and 1994 were the two best years of economic performance in Latin America since 1980, both followed by downward adjustment. The consequent optimism should have been qualified by the dangerous reinitiation of exchange rate revaluations during recovery in 1996-97, and the modest generation of investment and productive capacity. Has the lesson not been learnt? A new and generalized process of adjustment is under way in Latin America, associated to the contagious effect of the Asian crises. Once again, GDP growth will downswing, productive investment will be affected and the social indicators will deteriorate. The new crisis, originated now in Asia, provides a renewed opportunity to revise the design of macroeconomic policy, specially that implemented in periods of future booms and risk of hyperoptimism in financial markets, and to advance towards a progressively more pragmatic and integrated approach.

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