CHAPTER 9
The Mexican Crisis of 1994 and the Future of the Latin American Reforms

For decades, the state in most Latin American countries grew at a rapid pace. Regulations were piled on top of regulations and, backed by promises of better economic conditions for the majority of the population, the public sector expanded continuously. After an auspicious beginning, this strategy began to falter in the 1970s. Contrary to its architect's expectations, this state-led development approach produced vulnerable and inefficient economies, macroeconomic instability, and an increasingly unequal distribution of income. The debt difficulties of 1982 unmasked the shortcomings of the traditional Latin American policies and generated a major crisis of the state. Suddenly, it became apparent that instead of isolating the region from foreign disturbances, decades of protectionism and heavy regulations had built weak economic structures that were unable to withstand the cyclical shocks of the late twentieth century. When compared to the resilient and rapidly growing economies of East Asia, the Latin American economic systems appeared particularly inadequate.

As the 1980s unfolded, an increasing number of Latin American leaders began to agree that the region was facing a serious crisis and that the transition to the twenty-first century required major economic reforms. Politicians who for decades had advocated an increased involvement of the state in everyday economic life began to argue in favor of competition, international openness, privatization, and a greater role for market forces. In the early 1990s it became apparent to leaders of a number of the region's countries that the market-oriented reforms had to be supplemented with strong and targeted social programs aimed at reducing poverty and providing a social safety net.

This book has provided a history of the market-oriented reforms that swept Latin America during the late 1980s and first half of the 1990s. The progress made in different sectors has been documented and the difficulties found in
the path toward economic modernization have been discussed. The analysis focused on the period of 1982 to 1993 and shows that during this period the vast majority of the Latin American nations went through a true economic revolution. Countries that only a few years ago had been subject to an almost surrealistic array of controls and regulations began to experiment boldly with market-oriented solutions to decades-old problems.

Although in many countries the reform agenda advanced significantly between 1989 and 1993, by 1994 in a few of them the excitement of the initial years was subsiding. In others, interest groups negatively affected by the transformations stepped up their opposition to some of the market-oriented policies. Moreover, in a few countries the implementation of social and poverty alleviation programs lagged behind, generating increased inequality, social tension, and political upheaval. And in some quarters, including the specialized international media, the December 1994 Mexican peso crisis generated some doubts about the long-term viability of the market-oriented reforms.

This chapter discusses how the Mexican crisis of 1994 is likely to affect the future of the Latin American modernization program. The two fundamental questions being addressed are what are the key lessons of the Mexican crisis—both for reformers worldwide and for other Latin countries—and whether the reforms are likely to be consolidated and sustained through time. The more important areas for future policy actions are singled out, and some of the constraints that the region is likely to face are analyzed. The forward-looking nature of the discussion means that the analysis is necessarily limited by the cutoff date for publishing this book. It reflects the prospects of reform sustainability at the time of this writing.

The Mexican Peso Crisis of 1994 and Its Lessons

On December 20, 1994, barely ten days after the conclusion of the Summit of the Americas, Mexico devalued its currency. This event triggered a major crisis that threatened to engulf the region. The authorities initially intended to widen the exchange rate band by (approximately) 15 percent. It soon became clear, however, that this was insufficient; after losing more than US$5 billion in international reserves in two days, the peso was freely floated on December 22. Foreign financiers reacted with panic to the news that Mexico could not maintain the announced parity and began to withdraw funds throughout Latin America. Suddenly, countries that had become the darlings of international investors during 1993–94 were considered high risks, as a number of analysts feared a repetition of the debt crisis of 1982.

The timing of the Mexican events was particularly ironic. During the Miami Summit of December 1994, U.S. president Bill Clinton had singled out Mexico as one of the best models of Latin America's progress in economic and political reform. He was not alone in his praise; almost since the inception of the reform process, Mexico had been considered by the specialized media and the international financial institutions as an exemplary—if not the exemplary—reformer. After the approval of NAFTA, many analysts, and especially Mexican officials, argued that Mexico was about to embark on a final takeoff that would allow it to join, in a relatively short period of time, the ranks of the most advanced nations. This enthusiasm for Mexico's prospects was based on a combination of factors, including the breadth and depth of the reforms undertaken by the Salinas administration, the elimination of fiscal imbalances, the privatization process, and the opening of the economy were often cited as major achievements. However, these analyses failed to notice two important weaknesses in Mexico's development during the early 1990s: contrary to the case of other countries in the region, such as Chile and Colombia, Mexico had only experienced modest growth—GDP had grown at an average of 2.9 percent in 1990-94—and had developed an extraordinarily large current account deficit, which exceeded 7 percent of GDP in both 1993 and 1994 (recall the analysis in chapter 5).

Many analysts were caught by surprise by the peso crisis of December 1994. At that time, a number of international investment firms were still recommending Mexican securities to their clients. Their persistent optimism was partially affected by the lack of availability of up-to-date financial information, especially on the evolution of the Bank of Mexico's stock of international reserves. When Secretary of Finance Jaime Serra Puche announced the devaluation on December 20, international financiers, and especially managers of mutual funds in New York, reacted first with disbelief and then with anger. During the next few weeks the financial world witnessed a remarkable spectacle of panics, mutual recriminations (Who lost Mexico? editorialists asked rhetorically), failed rescue packages, congressional hearings, and courageous efforts by policymakers in the rest of the region (especially in Argentina) to isolate their economies from what came to be known as "the tequila effect."

An immediate consequence of the crisis was that it raised, throughout the world, a number of questions regarding the sustainability—and even the merits—of the market-oriented reform process in Latin America and other regions. If Mexico was the best example of a successful reformer, observers asked, what could be expected of other cases? This section addresses some important questions related to the Mexican crisis and its consequences for the Latin American reform process. In particular, it deals with the following issues: (a) why (and how) did the crisis happen? (b) what are its main lessons, especially in terms of the strategy for market-oriented economic reform; and (c) what is the probability that it will spread to other countries in the region? The next section discusses how the Mexican crisis is likely to affect the long-term prospects for the reform movement in Latin America and the rest of the world.
Why Did the Crisis Happen?

The main cause behind the Mexican peso crisis was an unsustainable current account deficit that, starting in 1992, was financed by very large capital inflows (recall the discussion in chapter 5). When, mostly as a result of political developments, capital inflows began to slow down in 1994, Mexico's economic authorities failed to react promptly and with sufficient energy.

In the aftermath of the crisis, many observers asked whether the main actors in this saga—Mexican politicians, U.S. policymakers, and experts from the international financial institutions—had been aware of the weaknesses of Mexico's macroeconomy. By and large, most analysts of the Mexican situation had recognized that the rapid inflow of foreign capital had generated a significant disequilibrium that called for corrective action. For instance, in September 1994, World Bank staff argued in Trends in Developing Economies 1994 (World Bank 1994)—a publication available to libraries, scholars, analysts, and the public in general—that the excessive reliance on capital inflows had made Mexico vulnerable. According to the Bank in this book, Mexico's "current account deficit remains very high.... Underlying the large current account deficit has been a fall in private domestic saving, indicating that foreign capital inflows have in effect financed an increase in domestic consumption" (p. 331). From here it goes on to say that "productivity growth has so far been insufficient to offset the loss of external competitiveness implied by the peso appreciation..." and that "with current account deficits of over $20 billion supported by even higher levels of foreign capital inflows, Mexico is vulnerable to foreign capital volatility."

The Mexican authorities, in particular, acknowledged that the current account gap could not be maintained at the 1993–94 level in the long run, and they had planned to deal with the problem gradually, by slowly reducing the deficit to manageable levels. Broadly speaking, this plan was based on two key assumptions: first, improvements in productivity would increase export competitiveness, helping close the trade gap. Second, the approval of NAFTA would entice additional capital—especially in the form of direct foreign investment—to move into Mexico, providing space and time for the gradual adjustment to work. A number of developments, however, frustrated this plan.

The political shocks of 1994—social unrest in Chiapas, the assassinations of presidential candidate Luis Donaldo Colosio and the PRI's secretary general Ruiz Massieu, the resignation of the attorney general, and the kidnapping of a prominent banker—scared foreign investors, who became particularly leery with respect to currency risk. Each of these negative political events translated into major declines in the stock of international reserves held by the Bank of Mexico. Under orthodox macroeconomic management, this situation would have called for the implementation of a defensive macroeconomic stance, resulting in higher interest rates and, under flexible exchange rate regimes, in a weakening of the domestic currency. This, however, was not an attractive option in an election year. In fact, in an effort to avoid rising peso interest rates, the Mexican authorities followed a two-pronged approach. First, they issued increasing amounts of peso-denominated, but dollar-indexed, short-maturity notes: tesobonos. Second, they followed a policy of targeting peso nominal interest rates, by determining a maximum yield on domestic currency treasury securities (Cetes), above which the Treasury would not sell them. This strategy became known as "drawing the line" (in Spanish, "tirar la rayita") and was in part the result of pressure by a group of U.S. mutual fund managers—the so-called Weston Forum—that threatened to reduce sharply their Mexican exposure if the Treasury raised peso interest rates (see Craig Torres, "Market Forces," Wall Street Journal, June 14, 1994, pp. A1, A6).

Higher interest rates in the United States during 1994 also contributed to the reduction in capital flows into Mexico, further frustrating the authorities' hope of a gradual adjustment. And, although productivity began to improve in 1993–94, it was not enough to generate the expected super boom in exports (on Mexico's low productivity growth and exports performance, see the discussion in chapter 5). As a result of these factors, and in spite of the rapid increase in outstanding tesobonos, capital inflows declined markedly during 1994—from almost US$30 billion in 1993 to only US$10.2 billion in 1994—and the current account deficit was financed largely through a reduction in international reserves, which dropped from approximately US$30 billion in February 1994 (immediately prior to the Colosio assassination) to US$5 billion by December 22.

The presidential elections affected the policy options, as the authorities ruled out implementing contractionary credit and fiscal policies as a way to reduce the deficit and put an end to the drainage of international reserves. In spite of the decline in international liquidity, the central bank decided to maintain its overall monetary program, sterilizing the reduction in international reserves (see Bank of Mexico 1995). Also, during 1993 and 1994 the fiscal stance became somewhat loose: the overall fiscal balance deteriorated by 2 percent of GDP while the primary balance deteriorated by almost 3 percentage points of GDP. Furthermore, because of the tripartite agreement with business and unions—the pacto—it was decided not to implement an early devaluation as a way to correct the accumulated overvaluation and help the adjustment. After the presidential elections were won by the PRI candidate, Ernesto Zedillo, the authorities still resisted putting in place a contractionary macroeconomic adjustment program. Some analysts have interpreted this as an effort by the Salinas administration—including Salinas himself—to leave office with an unblemished record.

By mid-December speculators sensed that the Bank of Mexico was in a weak position, and Rosalind's whisper was heard with increasing insistence throughout certain circles—"I must tell you friendly in your ear, sell when you can, you are not for all markets." Those who were better informed massively sold pesos and attacked the Bank of Mexico's international reserves. By then it
was too late, as the very low level of international liquidity (approximately US$10 billion) had left Mexico with very little room for maneuvering.

The international financial community reacted to these events in disbelief and generated a chain-reaction financial panic. The lack of a comprehensive adjustment program—including supporting fiscal and credit policies—was seen as a particularly weak aspect of the devaluation package. The announcement by the U.S. Clinton administration of the provision of massive loan guarantees temporarily calmed the markets in mid-January. Soon, however, it became clear that the rescue package would not be approved by the U.S. Congress and that the Mexicans had badly underestimated the magnitude of the crisis, and new panic set in. It was not until April, and after the announcement on March 9 of an extremely strict adjustment program, that the markets began to settle down. At that time it had become clear that Mexico was facing a crisis of almost epic proportions and that its solution would require major and painful measures.

The abandonment of the parity on December 20 generated a major loss in confidence. Memories of 1982 hounded the market, and the public feared a forced debt rescheduling or, even worse, the imposition of capital and/or exchange controls. The demand for Mexican financial assets went into a free fall, and publicly and privately issued securities were redeemed as soon as they matured. This situation was greatly exacerbated by the very short maturity of treasury obligations (trenobonos), more than US$10 billion matured in the first three months of 1995. This sudden drop in the demand for Mexican financial assets provoked a devaluation of the peso that greatly exceeded most analysts’ predictions; the exchange rate almost reached 8 pesos per dollar before the announcement of the March 9 program (compared to 3.3 before the eruption of the crisis). This overshooting of the exchange rate during the early months of 1995—greatly exceeding calculations based on simple purchasing power parity analyses—clearly indicated that in modern economies open to capital mobility the exchange rate plays two fundamental roles: on the one hand it determines (jointly with other variables) the current account balance, and on the other it helps clear the financial market. By missing this dual role of the exchange rate, the original January adjustment program fell short of what was required to calm the markets. In mid-April, however, some calm began to return to the financial markets, and the peso started a steady recovery process.

**The March 9 Recovery Program**

After the failure of early attempts at restoring market confidence, on March 9 the Mexican government unveiled a tight macroeconomic recovery program, backed by a major IMF standby agreement. The program’s main objective was the restoration of stability and the rebuilding of international confidence. The plan also called for an aggressive effort to privatize infrastructure, decentralize governmental functions, reform the legal and judicial system, and improve the effectiveness of social programs. The program had four main elements.

The first was to adjust the prices of public sector goods, increase the value added tax from 10 to 15 percent, and reduce the real level of public expenditure. For 1995, tighter fiscal policy was expected to produce a primary budget surplus of 4.4 percent, twice as large as the one originally envisioned in January 1995.

Second, the authorities adopted a floating exchange rate regime, with monetary policy designed to help stabilize prices. To achieve an inflation target of 42 percent in 1995, the Bank of Mexico committed itself to an expansion of net domestic assets to 23 percent.

Third, to avoid banking problems—and in particular massive bankruptcies—the government embarked upon a program of intensive supervision and regulation, including increases in capital requirements and loan loss reserves and the removal of the ceiling for foreign ownership of Mexican banks. The government established a foreign currency line of credit to enable domestic banks to meet their international commitments and a subordinated convertible debt program to help banks experiencing a temporary fall in their capital requirement and gave FOBAPROA (Fondo Bancario de Protección al Ahorro) the right to convert into capital the subordinated debt of banks and to take them over. Mexico, with the assistance of a major World Bank operation, is engineering a program to strengthen the banking sector.

Fourth, notwithstanding a fiscal contraction, real expenditure for social and rural programs in 1995 was to increase by 2 percent, while other noninterest expenditure is expected to fall by almost 20 percent. An effort was made to fortify the social safety net by expanding the negative income tax, extending public health insurance for the unemployed, initiating a program of public works targeted to the poorest of the unemployed, and expanding the labor retraining program.

The fact that during May the exchange rate stabilized, and that the stock market has regained part of the lost ground, suggested that the adjustment program put in place was working.

**Lessons of the Crisis**

The 1994 peso crisis in Mexico teaches a number of important lessons. Some are broad and are related to the design of reform packages in economics throughout the world. Others are more specific to Latin America and refer to the future of the region’s reform movement. In this section some of the general lessons—most of which have to do with economic transitional issues—are briefly discussed. In the next section, some lessons specific to Latin America are addressed, including those related to the sustainability of reforms.

The following five lessons, related mostly to the implementation phase of the reforms, emerge quite clearly from the Mexican crisis.
La crisis mexicana de 1994.

La crisis mexicana de 1994 fue un evento político y económico significativo en la historia de México. La crisis fue el resultado de una serie de factores, incluyendo una disminución de la demanda mundial, el endeudamiento externo, la caída del precio del petróleo y la devaluación del peso mexicano. La crisis afectó a muchos otros países de América Latina y fue un hito en la historia de la integración económica en la región. La crisis mexicana también marcó el inicio de una nueva era de incertidumbre en el mercado financiero global.
eliminating—or substantially reducing—corruption and reducing the extent of overall violence and crime are likely to increase political support for the reform process.

The consolidation of the reforms does not imply that every single policy measure will be maintained unaltered through time. It does mean, however, that the public debate begins to take place within well-specified boundaries that respect the fundamental pillars of the new economic approach: stability, openness, and a strong state that has a limited role as a producer and provides social services efficiently and fairly. In a democratic regime, specific policies are bound to be challenged and to change through time. However, although policies evolve in different directions, the broadly defined economic regime is stable.

By early 1994, only in Chile had the reform process entered the consolidation phase, with broad political support for the main pillars of the new economic regime—openness, market orientation, macroeconomic stability, and poverty alleviation—and where the probability of a policy reversal appeared to be very low. Chile has a third-generation "reformist" government, and the current political debate suggests that the candidates for office will continue to run on platforms that promote reform. Also, institutional reforms geared toward ensuring the durability of the new economic system, including a clearer budgetary process and an independent central bank, have been implemented. Until the Chiapas uprising of January 1994, many analysts also thought that the Mexican reforms were consolidated. The Zapatistas' revolt and the assassination of the PRI candidate Luis Donaldo Colosio introduced, however, questions among some observers. These two events greatly affected Mexico and led to the crisis analyzed above. At the time of this writing, the reform process in the rest of Latin America is at different stages of implementation and enjoys different degrees of political popularity. The re-election of Alberto Fujimori in Peru and Carlos Menem in Argentina—both of which ran on platforms based on deepening the reforms—in 1995 suggest that these two nations may also be entering the consolidation phase.

From a policy perspective, the consolidation of the new economic system in Latin America will require action in three broad areas: first, maintaining prudent macroeconomic management; second, deepening the structural and institutional reforms in order to continue improving productivity and, ultimately, accelerate the rate of growth; and third, implementing decisive social programs aimed at reducing the extent of inequality and alleviating poverty. Underneath these actions is the need to rebuild the state. The new state that emerges in the years to come will have to be strong but very different from the state of the 1970s and early 1980s. As Latin America moves toward the twenty-first century, the state should stay away from those spheres where the private sector operates efficiently and act decisively in those where the private sector hesitates or fails. The state should provide social services for the poor, support quality education, contribute to the provision of basic infrastructure, provide a stable and credible regulatory system that encourages investment and protects consumers, ensure a macroeconomic environment conducive to export expansion, and develop rules and regulations that protect the environment.

The recent experience of the pioneer reforming country, Chile, suggests that in an economic system based on openness and competition and in a state active on the social front, productivity growth is one of the pillars of economic progress. In this context, the absorption and adaptation of technological progress become key elements of the development strategy. They ensure that the degree of international competitiveness is maintained, generating rapid real wage increases. The creation of a good-quality educational system (a task that is still incomplete in Chile), which provides the basis for successfully adopting new techniques, thus is fundamentally important.

A key lesson from the Chilean experience, and one that politicians and policymakers sometimes find difficult to accept, is that it takes substantial time for the reforms to generate full benefits in the form of sustained rapid growth, low and stable inflation, export booms, and permanent increases in wages. It takes time for resources to be reallocated, it takes time for new projects to come to fruition, and it takes time to open new international markets. Now that the urgency of the debt crisis seems far in the past, patience is taking over in some countries. However, as the experience of Brazil has shown, attempts to skip phases in the reform process—and in particular to bypass macroeconomic stabilization—are costly and ultimately unsuccessful. Multilateral and bilateral institutions should continue to support the reform process by providing funds and technical assistance that will help smooth the transition toward a modern economic system. In particular, the new emphasis on social projects is entirely appropriate and promises to be highly productive. At the same time, multilateral institutions should constantly monitor the evolution of the reforms and use their leverage fully to ensure that impatience, shortsightedness, and short-term political pressures do not derail this effort.

The three fundamental policy elements for the future—prudent macroeconomic management, further structural and institutional reforms, and poverty alleviation—often reinforce themselves. For instance, efforts to maintain macroeconomic balance, and thus avoid inflation and real exchange overvaluation, protect the purchasing power of the poor. Also, social security reforms increase the degree of efficiency of the labor market, which increases productivity, while at the same time improving public sector finances and the overall macroeconomic balance.

**Prudent Macroeconomic Management**

As Mexico showed so dramatically, in spite of significant progress during the last few years, in most countries the macroeconomic situation continues to be vulnerable. In many cases—Bolivia, the Dominican Republic, and El Salvador,
for example—the public sector deficit has recently shown an upward trend. More important, with the return of democracy there are some indications that public finances may be subject to political cycle pressures. To safeguard the continuity of the reforms, the nostalgia for populist episodes should be avoided and prudent macroeconomic management maintained. Fiscal discipline will have to be intensified in order to generate higher public sector savings. Monetary policy should be cautious and real exchange rate overvaluation avoided—points made very clear by the Mexican crisis. More specifically, in the years to come, the following macroeconomic issues will be particularly important:

- In the short run it will be crucial to monitor capital movements and avoid overborrowing, unnecessary real exchange rate appreciation, a loss of competitiveness, and a decline in export dynamism.
- There will be a need to devise policies that encourage domestic savings, especially private savings.
- The authorities will have to make sure that investment in infrastructure recovers to levels compatible with rapid growth.
- A serious effort will have to be made to develop institutions that add transparency to macroeconomic policy and isolate macroeconomic management from short-run political pressures.

The theme that unifies these four policy areas is the need to maintain fiscal discipline. This message cannot be emphasized enough: as the region’s history has repeatedly shown, fiscal imbalances often spawn serious crises that encourage speculation, retard growth, and increase poverty and frustration. Moreover, macroeconomic instability is often associated with political crises.

During 1992 and 1993 virtually every country in the region received large volumes of foreign portfolio capital. These inflows, which in some cases—Argentina, Chile, and Mexico, for example—constituted significant percentages of GDP, were the result of a number of factors, including the reduction in interest rates in the United States and a perception in international financial markets that the Latin American reforms have been largely successful. The increased availability of foreign resources affected countries’ ability to manage monetary policy, pressured real exchange rates toward appreciation, and allowed these countries to run large current account deficits and accumulate sizable international reserves.

As the Mexican crisis evidenced, in most countries the volume of capital inflows observed in 1993–94 is not sustainable in the long run (current account deficits of 5–7 percent of GDP are, under most circumstances, not compatible with long-run solvency, when GDP is growing at 3–5 percent, regardless of the level of interest rates). The experience of the early months of 1995 also suggests that in countries where public finances remain under control, adjustment to lower capital inflows is likely to be gradual and smooth. If macroeconomic management is less than prudent, it is possible that a sudden halt in capital inflows will occur, generating potentially serious macroeconomic dislocations.

In many countries, the reform of social security systems will be an important and, in some cases, urgent component of economic programs for the next few years. If adequately implemented, these reforms are likely to generate a series of four related positive effects. First, they will tend to reduce the fiscal burden on the central government, helping to achieve fiscal balance. Second, they will introduce choice in the health provision system, helping to improve its efficiency and fairness. Third, they will reduce labor market distortions, encouraging employment and productivity growth. And fourth, as is the case in Chile, they will encourage the development of local financial markets, providing a very important boost to private savings. Naturally, for the social security reforms to be fully effective and credible, it is necessary to implement an adequate regulatory system that closely monitors operations, avoiding corruption and reckless behavior.

The low level of domestic savings represents one of the most serious weaknesses in the region’s macroeconomic position. In spite of significant progress in deregulating the financial sector, savings—and in particular private savings—continue to be low, which limits the pace of capital accumulation, slows down new investments in infrastructure, and curbs productivity growth. In 1993, the median ratio of gross domestic savings to GDP was 20 percent, more than 10 points below that of the East Asian economies (World Bank, World Development Report 1993). To achieve rapid growth in the years to come, Latin American countries have to raise domestic savings and investment to levels closer to those of the successful economies of East Asia.

Increases in public savings constitute the most rapid and reliable way of increasing domestic savings. Moreover, recent evidence from East Asia suggests that when higher public savings are accompanied with reforms that create safe and reliable financial institutions, especially banking sectors, increases in private savings are likely to follow (World Bank 1993a). The need to implement efficient and effective regulatory and supervisory systems cannot be emphasized sufficiently; the recent history of the region is replete with major financial and banking crises that have had enormous costs.

In most countries, higher government savings should be achieved through a combination of higher revenues and reduced expenditures. On the revenue side, tax administration and tax compliance need to be improved. In particular, the prosecution of tax evaders should be stepped up and penalties for tax evasion increased (in many cases this will require a broad revision of tax legislation and a modernization of the judicial system). On the expenditure side, subsidies should be eliminated and government waste tackled. The reduction in military allocations also provides important possible sources of income, but its potential should not be overstated. Recent figures from the United
Nations Development Programme show that, with the exception of Honduras and Nicaragua, military expenditures in Latin America are below the average in the developing countries. In that regard, however, a reduction in waste and (implicit and explicit) subsidies still provide the most promising source of increased savings. In many countries, accelerating the privatization process would also affect public savings. This would happen mostly through the reduction of subsidies and transfers made by central and regional governments to money-losing state-owned enterprises.

During the last decade or so, investment in infrastructure has been neglected in almost every country. Roads have not been maintained, power capacity has barely expanded, and ports have not been modernized. There is ample empirical evidence suggesting that infrastructure investment has positive externalities and a very high social rate of return (Aschauer 1989 and Uchimura and Gao 1993). Policies toward infrastructure investment will have to focus on two fundamental aspects. First, public investment should increase. However, to ensure high social rates of return, individual projects should be subject to rigorous economic evaluation. Second, a credible regulatory framework that ensures property rights and thus encourages private sector investment in infrastructure should be implemented. This is particularly important to ensure that newly privatized utilities will continue to expand their capacity (multilateral financial institutions will have an important role in helping these countries devise ways to increase long-term funding for privatized utilities and infrastructure projects).

Institutions play a fundamental role in determining the course of economic policy. At the macroeconomic level, the consolidation of the reforms that foster competition will be helped greatly by the creation of institutions that ensure the transparency of policymaking, avoid short-term political cycles, and allow the authorities to commit themselves credibly to a future course of action. Clearly defined and mandatory budgetary processes constitute a basic but extremely important institutional priority that has been often absent in Latin America. The national legislature should be required to approve a consolidated budget for the public sector as a whole before the initiation of the fiscal year, and the executive should be legally (and factually) constrained by it. (Surprisingly, a large number of Latin American countries lack a well-defined and mandatory budgetary process; the absence of this is closely related to the historical fiscal laxity in many countries of the region.) The implementation of independent central banks constitutes a second institutional reform that could add credibility to macroeconomic policy. This measure—recently implemented in Argentina, Chile, Colombia, Mexico, and Venezuela, among other countries—would (partially) isolate the monetary and, in some cases, exchange rate policy from partisan short-term political battles. As the Mexican crisis clearly indicates, however, the formal independence of the central bank is not a sufficient condition for avoiding monetary crises. In addition, appropriate policies should be promptly implemented. In an extensive comparative empirical study, Cukierman (1992) found that the degree of independence of the central bank is directly related to the long-term degree of macroeconomic stability. Naturally, for this reform to be truly effective it should have political legitimacy. This means that the notion, and practical implications, of a truly independent central bank have to have broad support among the population at large. The experience of Chile after 1989 suggests that even if the electorate initially has mixed views regarding this type of institution, it can, with the passage of time, come to support it strongly. However, the experience of Venezuela in April 1994, when the majority of the members of the Central Bank board resigned under pressure, indicates that when there are extreme differences of opinion between the executive branch and the central bank, the formal independence of the latter may not be that relevant in determining the course of monetary policy.

Deepening Structural and Institutional Reforms

In spite of significant progress, the modernization process is in its early stages in some countries. In some cases, such as the Dominican Republic, Ecuador, and Guatemala, the transformation process has just begun. In others, such as Colombia, Costa Rica, and Uruguay, the structural reform process is more advanced, but important institutional changes, including the creation of modern regulations and rules, are still lagging. In still other countries, the reform process has only affected the central (or federal) government and has not yet reached the provincial and municipal levels. In many countries, unrealistic regulations, red tape, and rampant corruption at the local government level greatly reduce the effectiveness of the reform effort. The historical evidence from Chile and Mexico strongly suggests that incomplete and partial reforms tend to stand in the way of a major economic takeoff. Broadly based reforms exhibit synergy and positive spillovers; partial reforms tend to generate credibility problems and encourage the postponement of investment and restructuring projects (Edwards 1993c).

During the next phase, the reform process will have to focus, in most countries, on two areas. First, measures geared toward increasing efficiency and productivity should be continued to ensure rigorous and sustainable growth. Second, the reform process should increasingly aim at creating institutions that strengthen the new Latin American state. This two-pronged approach toward deepening the reforms will not only accelerate the rate of growth but also strengthen the sustainability of the reforms. More specifically, the most important areas where the reforms have to be deepened include the labor market, education, privatization and deregulation, the civil service, and the consolidation of openness.

In virtually every country, the labor market is still a forgotten area in the reform process. As argued in chapter 8, labor market legislation is rigid in Latin America, and the use of labor is subject to substantial taxes that discour-
In a number of countries—including Bolivia, the Dominican Republic, and Ecuador—the state continues to play an important role in the productive process. Streamlining the size of the state through new rounds of privatization is likely to increase overall efficiency, allowing the public sector to strengthen its fundamental role of implementing social programs, providing education, and supporting investment in infrastructure.

As argued in chapter 7, it is important to recognize that the reform of the state, and especially privatization, should go hand in hand with the implementation of modern regulatory and supervisory frameworks. Particular emphasis should be given to the creation of truly professional and independent regulatory agencies, whose role is to ensure that the newly privatized public utilities do not abuse their power and that the authorities will not expropriate their assets. The implementation of regulatory institutions requires creating financing schemes that allow them to operate autonomously, without interference from political forces.

In some countries, such as Argentina and Brazil, government proceeds obtained from privatization have been used to finance current government expenditures. This is a dangerous practice that, under some circumstances, undermines fiscal responsibility and discipline. A preferred approach is to use privatization proceeds to reduce government liabilities, especially in social security. Indeed, a potentially serious danger in many privatization processes, such as in some of the Eastern European countries, is that the state diverts itself of productive assets while it retains substantial liabilities. By using the proceeds from privatization to retire government debt, the magnitude of this problem can be reduced substantially.

In most countries, the administrative organization of the state responds to an era where dirigisme and planning were dominant. There are numerous ministries that are supposed to deal with economic issues in a command fashion, and few modern and autonomous supervisory agencies. There is a clear need to continue restructuring the public sector in order to increase efficiency and accountability. A recent study on the East Asian miracle (World Bank 1993) suggests that a very professional, efficient, and well-paid bureaucracy played an important role in the economic success of that region. In Latin America, there is an urgent need to modernize the judiciary system. The credible protection of property rights through a well-functioning and transparent court system is a key element for encouraging investment and ensuring the sustainability of the new economic regime. Additionally, in modern economies it is essential to have a lean and transparent conflict-resolution system that protects the rights of individuals and groups at the same time that it defuses costly confrontations. A deep reform of the judiciary is a fundamental requirement for truly consolidating the reforms. Justice is slow and ineffective in most of the region; corruption is common, and cases tend to drag for long periods of time.
Social Programs and Poverty Alleviation

As discussed in chapter 8, the Latin American countries historically neglected the social sectors. This resulted in staggering poverty indexes and in the most unequal income distribution in the world in the early 1980s. Today the poorest 20 percent of Latin Americans receive approximately 4 percent of GDP. As the Mexican crisis painfully shows, a fundamental task in the years to come is to address poverty and inequality with vigor and urgency. This would not only improve the living conditions of the population but also provide stability to the new economic system and to the region’s new democracies. Failure to act aggressively in this area will exacerbate distributive conflicts and is likely to prompt discontent and, in some cases, even create the bases for a return to populism, dirigisme, and eventually chaos. As history has shown again and again, populist policies are often attractive in the short run, but their ultimate outcome is frustration and stagnation. Only to the extent that the region’s development strategy becomes inclusive, allowing all segments of the population to benefit from growth, will the new system endure.

The new approach toward poverty and the social sectors should be based on three elements. First, policies that are conducive to growth and that create employment and generate higher wages should be fostered. Economic growth is the most important and durable path leading out of poverty. Consolidating the structural reforms along the lines discussed above should be the instrument through which higher growth is sustained. Second, government programs that raise the living standards of the poor should be vigorously implemented in the short run. This would allow government to tackle immediately the most serious consequences of poverty, including malnutrition, access to health services, and the provision of potable water. Directly involving the community in the design and implementation of many of these social programs is likely to increase their probability of success. Recent information from Chile suggests strongly that policies that emphasize higher growth and targeted programs can be highly successful. In little more than three years, the combination of strong growth and targeted social programs helped to reduce the number of people below the poverty line by 1.3 million, more than one-quarter of those in poverty in 1989. And third, policies that reduce inequality and provide efficient public services to the middle class should be undertaken. These policies should focus on areas that both have a positive effect on economic growth and are likely to generate a broader political support for the reform process. Improving the quality of the educational system and creating new institutions that strengthen the state—and, especially, reduce violence and crime—appear to be particularly appealing to the middle class.

Countries today must ask what additional steps they can take to increase the complementarity between the reforms required to recover growth and those required to improve long-run equity. Is it possible to reallocate public expenditure radically and quickly to eradicate the worst aspects of poverty in the short run without impairing public finances and the control of public deficits?

Reform programs based on market orientation are likely to increase the labor intensity of the growth process. Trade liberalization and reforms that reduce taxes on the use of labor and subsidies for the use of capital should be accelerated. Because schooling is one of the major determinants of income distribution in Latin America, investments in human capital and skills should be increased. To reduce inequality, an effort should be made to improve cost-recovery, making sure that the wealthy pay for their services. And, since in most countries the poor are concentrated among the indigenous population, programs especially targeted toward this segment of society should be undertaken.

Countries could be much more aggressive in reallocating public resources toward targeted social services, without impairing the fiscal adjustment or the pursuit of other efficiency objectives. With public expenditures usually accounting for 25 percent of GDP, a 10 percent reallocation of the budget can have a significant impact on the welfare of the poorest groups. Countries should aim at generating an increase equivalent to 2 to 3 percent of GDP by broadening the tax base, improving tax collection, and reducing evasion. Additional revenues can be obtained by eliminating subsidies, especially those that accrue mostly to the wealthier segments of society. In undertaking this kind of policy, however, an effort should be made to compensate the poor directly for the reduction of subsidies.

Historically, many Latin American countries have attempted to use labor legislation—including minimum wages, regulations on dismissals, and restrictions on temporary hiring—to improve income distribution and reduce poverty. These policies, however, failed badly. Instead of helping the poorest groups of society, they introduced serious distortions that discouraged employment creation and produced a small group of highly paid jobs in the protected sector. In addressing the needs of the poor, it will be important to avoid the mistakes of the past. Social policy concerns should be addressed using direct and well-focused instruments rather than distortions in the labor market. These instruments should be dynamic and flexible, stimulating the creation of jobs and allowing the economy to respond rapidly and productively to changes in international competitive conditions. This, indeed, is one of the fundamental lessons from the East Asian miracle.

Conclusions

The Latin American reforms have been broad and impressive. Few analysts would have predicted in 1984 that, merely a decade later, most of the region would be embarked on a sweeping transformation process that has significantly reduced the economic role of government and opened these economies
to the rest of the world. In spite of their depth and scope, the transformation and modernization processes in Latin America are largely unfinished. Moreover, as the Mexican peso crisis of December 1994 clearly showed, macroeconomic equilibrium often continues to be fragile. In many countries, the results in terms of growth and social progress have not yet met expectations, and in almost every country there is a need to build new institutions that will help maintain the new economic order. Consolidating the reforms, making them a permanent feature of the Latin American economic and social landscape, is an enormous challenge facing the new democratic leaders.

Latin America is a tremendously diverse region. In the decades to come, we are likely to see the evolution of somewhat different modes of development across countries. There will be different emphases and priorities, including different economic roles for the state. History strongly suggests, however, that to generate sustained growth and prosperity while maintaining their idiosyncrasies, national strategies should respect the fundamental pillars of what in this book I have called the new Latin American consensus: macroeconomic stability, outward orientation, and a state that stays away from production and efficiently provides public services and social programs aimed at effectively reducing poverty and inequality.

The economic history of Latin America has been compared to Gabriel García Márquez’s classic novel One Hundred Years of Solitude (García Márquez 1970). Events seem to repeat themselves endlessly, following irregular and magical cycles of sorrow and frustration. The recent reforms that engulfed the region are beginning to break this melancholic circularity. After decades of timid performance and spiraling inequalities, and in spite of the Mexican crisis, there are rays of hope.

Appendix 9-1: The Simple Economics of Current Account Sustainability

The Mexican peso crisis of 1994 has raised questions about what is a “sustainable” level for the current account deficit in a particular country. Although there are no mechanical rules on this subject, there are some helpful guidelines that analysts can follow to detect departures from sustainability. This appendix develops a very simple approach for analyzing long-run current account behavior, and it briefly discusses which macroeconomic indicators are helpful to provide early warnings of an external crisis.

In general, there will be an “equilibrium” level of a country’s liabilities that foreigners will be willing to hold in their portfolios. Naturally, this “equilibrium portfolio share” will not be constant and will depend on a number of conditions, including interest rate differentials, the perceived degrees of country and exchange risk, and the degree of openness of the economy. Moreover, when countries embark on (what is perceived to be) a successful reform pro-

gram, the “equilibrium” level of the country’s liabilities that will be willingly held by international investors is likely to increase as they will be eager to take part in the country’s “takeoff.”

Assume that in equilibrium international investors are willing to hold in their portfolios a ratio $k^*$ of the home country’s liabilities relative to its GDP.$^{10}$ Denoting liabilities by $L$ and GDP by $y$,\textsuperscript{11}

$$k^* = L/y.$$  

$k^* = k^*(...)$, in turn, depends on a number of variables, including interest rate differentials and perceived country risk. Equation 9-1 implies that the net accumulation of this country’s liabilities will be, in equilibrium, equal to:

$$\Delta L = g L,$$

where $g$ is the “long-run” rate of growth of real GDP. Of course, if instead of the country’s GDP, an alternative benchmark is used—say, exports—$g$ should be interpreted as the rate of growth of that variable.

$\Delta L$ in equation 9-2 is this country’s capital account surplus, and is equal to the current account deficit, plus the net accumulation of international reserves. The current account, in turn, is equal to the trade account deficit $T$ plus the service account. The latter can be approximated by the product of the rate of return on liabilities $r$ (for short, this will be referred to as the real rate of interest on the country’s liabilities) times the stock of liabilities. Denoting the current account deficit by $C$, it is possible to write:

$$\Delta L = \Delta R + C,$$

$$C = T + rL,$$

$$T = (M - X),$$

where $M$ is total imports and $X$ is exports. Assuming, as a first approximation, that the accumulation of reserves is equal to zero, equations 9-2 and 9-3 imply:

$$\Delta L = g k^*.$$  

This says that the “sustainable” current account to GDP ratio—that is, the current account deficit that can be maintained in the long run without violating the portfolio equilibrium condition (equation 9-1)—is equal to the desired liabilities to GDP ratio $k^*$ times the long-run real GDP growth. Moreover, from equations 9-2’ and 9-4, it follows that: