Latin America since the 1990s: Rising from the Sickbed?

Arminio Fraga

The economic performance of Latin America was disastrous in the 1980s. In what is often called the “lost decade,” the region’s economy was disrupted by an international debt crisis and raging inflation. Per capita GDP declined at an average annual rate of 0.6 percent in the 1980s. Toward the end of the 1980s, the frustration with the performance led to a search for sound macro and structural policies. Thus, in the late 1980s and early 1990s, many countries in Latin America were receptive to a package of economic reforms that was dubbed the “Washington Consensus” (Williamson, 1990). The precise reforms varied from country to country, but in general they included some combination of fiscal and monetary tightness, greater openness to foreign trade (if not necessarily to foreign capital), privatization and deregulation. Yet the early 2000s have seen a disappointing economic performance in Latin America; for example, per capita GDP for the region contracted by 2.5 percent in 2002.

The long-time opponents of the Washington Consensus reforms are in full cry. Implicitly and explicitly, they make three broad claims. First, they argue that the economic performance of Latin America has not improved since the 1980s—and that on certain dimensions, like inequality, the economic performance of the region has worsened. Second, they claim that the application of the Washington Consensus reforms is the cause of this poor performance. Third, they hark back to the more rapid growth experienced by Latin America from the 1950s and 1970s, and they argue that economic policy in Latin America should return to government infrastructure investment and industrialization through protection and import substitution that were popular in some countries at that time.

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The first section of this paper compares Latin America’s economic performance in the 1990s with the 1980s and finds definite macroeconomic and social progress during the decade. The following section considers the policy performance of the region during the 1990s and finds that, on a country-by-country basis, the nations of Latin America that were more active in carrying out Washington Consensus reforms also experienced better economic performance. The final section will argue that rather than seeking to reverse the economic reforms that have been carried out, Latin American nations should be thinking about how to extend and complement the existing reforms.

The Macroeconomic and Social Record in Latin America

Is it true that despite enacting a wide range of economic reforms in the late 1980s and early 1990s, the economies of Latin America made little gain in the years that followed? To measure the socioeconomic performance of Latin America over the last two decades, let us examine a number of economic and social indicators.

Table 1 gives a summary of the GDP per capita growth in the region over the last three decades. The seven countries included in the table represent 90 percent of the GDP of the Latin American region. During the 1980s, per capita income declined in five of the seven largest countries, the notable exceptions being Chile and Colombia—which were also the two countries that avoided a debt reduction exercise. Average GDP per capita growth in this sample declined by 0.7 percent per year and thus lagged the United States by 2.9 percent per year, a dramatic case of economic divergence.

In the 1990s, growth patterns in Latin America were mixed, with per capita growth ranging from Chile’s stunning 4.9 percent to Venezuela’s slightly negative performance. This high degree of dispersion makes it hard to speak categorically of “Latin America’s growth performance in the 1990s.” On the whole, however, performance did improve markedly, with average per capita growth increasing to 2.0 percent per year, the same as the United States and a reasonable number in absolute terms. But despite the overall improvement, in most countries a sense of frustration prevailed. This growth record was modest compared to that of Latin America in the 1970s and that of East Asia in the 1980 and 1990s.

While achieving higher growth during the 1990s, Latin America also managed to reduce inflation drastically. As shown in Table 2, rates of inflation varied considerably across these countries, but the average annual inflation rate (weighted by GDP) was 223 percent during the 1980s. Brazil was the last country in the region to lower inflation (with the Plano Real of 1994). In the second half of the 1990s, inflation in the region has averaged just 6.5 percent annually.

Another measure of improved financial stability is a reduction in the number of banking and currency crises, as shown in Table 3. Goldstein, Kaminsky and Reinhart (2000, pp. 19–20) define a banking crisis as one where there was a bank run followed by a closing, merger or government takeover of a bank (or when there
was no such run, all the above or a large-scale government assistance package for
a large financial institution) and a currency crisis as a situation where a large loss
in reserves or a sharp depreciation or both took place. Since crises can be of
different magnitudes, from bad to truly terrible, not too much should be read into
a simple total. But it is nonetheless striking that the number of crises in these seven
large economies declined by about two-thirds between the 1980s and the 1990s.

On the social front, progress took place in many areas. Table 4 presents data
on education and health that speak for themselves: despite the macroeconomic
fiasco of the 1980s, significant progress took place during both decades. Over these
20 years, illiteracy rates were cut in half, life expectancy increased by six years and
infant mortality declined from 50 to 23 deaths per 1,000 births. In Brazil, the most

Table 1
Per Capita Growth: Annual Average per Decade

<table>
<thead>
<tr>
<th></th>
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<td>2.0</td>
<td>–3.0</td>
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<tr>
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<td>–4.4</td>
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Table 2
Inflation Rate

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populous country on the continent, 20 percent of the children of school age were not attending school at the beginning of the 1980s. Now that figure has declined to 3 percent.

In short, Latin America’s macroeconomic performance was indisputably better in the 1990s than the 1980s, even if considerable room remains for further improvement, and the region’s performance in social indicators showed a continued pattern of improvement as well. But before closing this discussion we must examine two more issues: productivity growth and inequality.

Table 3 presents a measure of total factor productivity growth for the region. The estimates from Pessôa (2003) are based on data from the Penn World Tables, and they represent a residual after controlling for capital and education accumulation and labor force growth. The estimates are lower than the most frequently used productivity numbers, because those numbers typically do not account for investment in human capital. The results of this exercise are quite disturbing. It perhaps isn’t surprising that average total factor productivity growth for the seven largest economies in Latin America was negative 2.28 percent per year in the macroeconomic turmoil of the 1980s. In the 1990s, total factor productivity growth moved into positive territory, although only slightly at 0.33 percent per year. One would expect or hope that over time, the standards of productivity in lower-income countries should converge to the levels of higher-income economies. But if one considers that the global productivity frontier was growing at perhaps 1.5 percent per year during the 1990s, we again see a picture of economic divergence for Latin American productivity.

However, the news on productivity, while poor overall, is at least somewhat mixed. Five of the seven countries do show important improvements in productivity from the 1980s to the 1990s, while Colombia and Venezuela show significant declines. If we exclude these two, the other five improved their productivity on average some 3.47 percent per year. In the 1970s, annual total factor productivity growth for Latin America averaged 0.27 percent. The only country that delivered

Table 3
Number of Crises per Decade

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<th>1990s</th>
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</thead>
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<td>Mexico</td>
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<tr>
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</tr>
<tr>
<td>Venezuela</td>
<td>3</td>
<td>3</td>
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</tbody>
</table>

Note: The index is defined as the number of balance of payments and banking crises that occurred in each decade using the definition of Goldberg, Kaminsky and Reinhart (1998).
positive total factor productivity growth during the three decades was Chile. Brazil posted high productivity growth during the miracle 1970s at a rate of 1.66 percent per year, but failed to continue this pace in the 1980s.

One aspect of performance in Latin America where little progress was made is in the distribution of income. Here the main indicators remained mostly stable at very unflattering levels, although there is some evidence from Ferranti, Ferreira, Perry and Walton (2003) that the income distribution for Latin America as a whole may have become slightly more equal in the 1990s thanks largely to greater equality in populous Brazil. The relative stability of inequality during the 1990s at a time of...
modest but sustained economic growth at least suggests that the gains from growth were being felt across the income distribution.

Policy Evaluation

To what extent did the policy reforms of the late 1980s and early 1990s lead to the improved macroeconomic performance of the 1990s? As a starting point, let’s review the underlying causes of the negative growth, high inflation and balance of payments crises that Latin America faced in the 1980s. We will then discuss the macroeconomic and structural economic reforms that were carried out.

Causes of the “Lost Decade” in Latin America

The economies of Latin America experienced two destructive events in the 1980s. First, a combination of oil price and interest rate shocks rocked the global economy, but had especially difficult ramifications for Latin America. Second, the region experienced the exhaustion of a growth model that had been popular from the 1950s through the 1970s, in which economic policy focused on government-led investment and import substitution. Let’s say a few more words about these events and why their combination was so economically destructive in the 1980s.

Global oil prices spiked upward in December 1973, and then again in 1979–1980. Enormous quantities of dollar assets were transferred to oil-exporting nations, which in turn sought channels to invest their new wealth in a way that would bring a positive rate of return. International banks seeking to “recycle the petrodollars” made substantial loans to Latin America. Because of the government-led economic policies of Latin America (discussed more in a moment), many of these loans were either made directly to government agencies or were guaranteed in some manner by government.

For some years in the 1970s, Latin America paid very low interest rates on these loans, as unexpectedly high rates of inflation held down real interest rates. For example, in 1974, the prime interest rate in the United States was 10.8 percent, and inflation as measured by the Consumer Price Index rose 11 percent; in 1975, the prime interest rate in the United States was 7.9 percent and the inflation rate was 9.1 percent. Thus, in the 1970s, the nations of Latin America that were oil-importers (that is, not Venezuela) suffered from higher oil prices, but experienced large inflows of foreign capital. In a way, the ample availability of foreign financing allowed these nations to postpone adjustment to the oil shock and, more importantly, to continue with the economic strategy of the previous decades. However, this development strategy also involved these economies taking the risk of accumulating large amounts of foreign debt.

In the early 1980s, the wheel turned. The international banks, in their reason-

1 See Sachs (1989) for a good review of the causes of the Latin American debt crises of the 1980s.
able fear of being exposed to a risk of higher inflation, made most of the loans to Latin America at variable interest rates. In the early 1980s, nominal dollar interest rates climbed high under the pressure of Paul Volcker’s Federal Reserve policy to reduce inflation, and inflation indeed diminished. In 1983, the dollar prime interest rate was 10.8 percent, while inflation was 3.2 percent. Not only were real interest rates sky-high, but also the terms of trade of Latin American oil-importing countries deteriorated, as oil prices remained high and the prices of the exports of most countries in the region declined. As a result, most Latin American countries were confronted with a substantial debt burden, and the region’s oil-importing countries were faced with a much lower ability to pay their debts.

Brazil, the largest economy in Latin America, offers a good example of this pattern. In the aftermath of the oil shock of 1979, Brazil’s initial policy response was to adjust the exchange rate and to tighten domestic demand so as to lower inflation and reduce the growing current account deficit. But soon these restrictive policies were abandoned in favor of encouraging a new inflow of foreign capital, at the cost of further accumulation of foreign debt, now mostly short-term, and inflation pressures. When the liquidity shocks of the early 1980s came, Brazil was vulnerable and ended up having to restructure its foreign debt. The rest of the decade was spent in a series of frustrated efforts to stabilize the economy, which included five failed heterodox anti-inflation plans (price controls, asset freezes and more) and two moratoria on foreign debt payments.

But the drastic growth slowdown was caused by more than the interest rate shocks of the early 1980s. The economies of Latin America experienced relatively rapid growth from the 1950s through the 1970s, and most countries had advocated a growth strategy led by policies of significant government investment and intervention and import substitution. How much credit these specific policies deserve for the growth record of the 1950s to 1970s is controversial. After all, the 1950s and 1960s were decades of rapid growth for the world economy as a whole, which surely buoyed growth in Latin America. It is analytically difficult to calculate what Latin America’s path of accumulation of physical capital, human capital and technology would have been if the government in these years had followed policies in which the government moved toward freer trade and, except for investment in education and public goods infrastructure, left investment decisions to the private sector.

But even if one gives these policies of government investment and import substitution some credit for increasing Latin America’s growth rates in the 1950s and 1960s, it was becoming apparent by the 1970s that this growth strategy was reaching its limits. Part of the reason was that even if import substitution policies had given a boost to certain industries in the 1950s and 1960s, these policies had largely congealed into protectionism that discouraged competition and technology transfer by the 1970s. During this period, in fact, trade openness (defined as the ratio of total trade to GDP) in the main countries declined or at best stayed stable. Even if government-led investment encouraged some additional investment in the 1950s and 1960s, it also encouraged widespread government ownership of industry, with reduced incentives for a culture of innovation and productivity growth.
As noted earlier, productivity growth in Latin America was very modest in the 1970s, which surely suggests that the growth agenda of government-led investment and import substitution was faltering before the “lost decade” of the 1980s. In the 1970s, growth remained possible in part because of an unsustainable increase in borrowed international capital, which in turn took place thanks to the low oil prices and interest rates that prevailed in the period.

When Latin America’s debt crisis arrived in the 1980s, it took some time for a clear diagnosis to be achieved. For awhile, the beneficiaries of the economic strategy of the previous decades were able to block the reforms needed to move into a new growth model. Examples of this phenomenon include the industries that benefited from protection and government subsidies (and their labor unions), government employees and the middle class (by developed country standards). These groups often stood in the way of trade reform, privatization, pension reform and even education reform. But toward the end of the 1980s, if not sooner in some cases, it became clear that something had to be done to re-ignite growth and development in Latin America.

Macroeconomic Reforms

Here the set of economic reforms known as the “Washington Consensus” enters the stage. This list of reforms was originally proposed by John Williamson (1990; 2003) and consisted of ten economic policy recommendations: 1) fiscal discipline; 2) reordering public expenditures toward basic health care, education and infrastructure; 3) tax reform in the direction of a broader base with moderate rates; 4) liberalization of exchange rates; 5) a competitive exchange rate; 6) moving in the direction of trade liberalization; 7) liberalization of foreign direct investment, a recommendation that specifically did not include comprehensive liberalization of the capital account in a way that would also include portfolio capital; 8) privatization; 9) deregulation of barriers to entry and exit; and 10) improved property rights. It is worth emphasizing that Williamson did not offer this list as representing a complete agenda for economic health, only as a list of items on which he believed that a consensus existed at that time among Washington, D.C., policymakers with an interest in Latin America.

In discussing Latin America’s actual economic reforms, it has become conventional to consider them in two broad categories: macroeconomic and structural. The macro portion of the consensus basically recommended fiscal prudence and monetary restraint (which does not appear on Williamson’s list). The structural side recommended a focus on opening to trade and investment, tax reforms, privatization, deregulation, a certain degree of financial deregulation and improved property rights. Broadly speaking, the reforms sought to control the plague of inflation, to reduce the incidence of balance of payments crises and to move growth policy away from the closed-economy government-led strategies of the three decades that preceded the 1980s.

To what extent were economic reforms actually implemented and successful in Latin America? On the macro front, it would be extremely useful to compare data
on the fiscal stance of government between the 1980s and 1990s, but good data here are simply nonexistent, especially for the 1980s, when fiscal behavior throughout the region is widely thought to have been extremely weak. Sizeable portions of spending controlled by the central government often occurred through government-owned companies or banks that did not appear in the national budget, and regional or provincial governments often incurred large liabilities that were poorly recorded, if at all, but were nonetheless eventually passed on the central government.

Perhaps the two clearest macroeconomic indicators are the dramatic reduction in the rate of inflation and the decline in the number of banking and balance of payments crises that took place in the 1990s, as documented earlier. These patterns clearly suggest that sound fiscal, monetary and exchange-rate policies became more prevalent in the 1990s.

But although Latin America’s macroeconomy improved if judged by the dismal economic record of the 1980s, it was far from fully healthy. As Table 3 shows, even in the 1990s, Brazil and Venezuela have had three banking or balance of payments crises each, and Mexico had two. Argentina escaped the 1990s without such a crisis, but then experienced a severe crisis in 2001–2002.

This inability of Latin American countries to create a stable macro environment can be illustrated by the investment ratings in Table 6, which looks at the ratings of the main countries in Latin America and Asia from 1993 to 2003 (a decade chosen for the availability of ratings). Each entry in the table represents the number of years each country had an investment-grade rating (that is, a credit rating of BBB or higher) by Standard & Poor’s. In Latin America, only Chile maintained an investment grade rating during this entire decade. Colombia also ran its macroeconomy competently in the early 1990s, but had to deal with huge political risk. Mexico had two years of an investment grade rating. The other countries did not have an investment grade rating in any year.

The experience of east Asian countries, shown for comparison in the table, suggests that it is difficult for an economy to stay on the development track, at least after reaching middle-income status, without maintaining an investment-grade rating. Growth cannot be sustained if a country is frequently running into macro crises. The crises in themselves typically represent a large, often dramatic detour from a path of growth. Moreover, crisis-prone countries have less access to capital and credit, and that at a higher cost.

Argentina and Brazil deserve a brief digression here, as the countries most recently affected by severe economic disruption. Brazil managed to end hyperinflation in 1994, but for the next four years, it had to cope with a fixed, and eventually overvalued, exchange rate and excessively loose fiscal policy. Moreover, Brazil’s exchange rate and perceived risk suffered from contagion after the economic crises in east Asia in 1997–1998. Thus, Brazil ended the 1990s with a balance of payments crisis in 1998–1999. Brazil recovered well following the forced depreciation of its currency, the real, by promoting significant fiscal adjustment and reform and by adopting an inflation-targeting framework for the conduct of
monetary policy. But after a period of six quarters of growth at annual rates of 4 percent or higher, Brazil again had to face turbulent times: first in 2001, following the global bear market in stocks, contagion from the crisis in Argentina and a domestic power blackout, and then following the (fortunately unfounded) fears that a victory of Lula da Silva of the Workers Party in the presidential elections of late 2002 would lead to populist policies and economic and financial collapse. From a macroeconomic standpoint, the aftermath of Lula’s election has proven to be quite encouraging, but Brazil still has to deepen further the credibility of the economic turnaround now underway.

In 1991, Argentina adopted a fixed exchange-rate policy that tied its peso to the U.S. dollar using a currency board approach. The country also implemented a wave of structural reforms. Argentina did manage to post good economic growth rates during the 1990s, second only to Chile. But during the end of the 1990s, Argentina’s growth rate slowed down significantly as a consequence of a weakening fiscal stance and domestic inflation that, in combination with fixed exchange rate, led to an appreciation in real terms of the peso. The currency board arrangement collapsed in 2001. From 1999–2002, Argentina’s GDP declined by approximately 20 percent! Recovery has now begun as the economy has rebounded back from the depths of this incredible collapse, but much remains to be done if Argentina is to go beyond the bounce.

Given that the Washington Consensus approach outlined by Williamson (1990, 2003) clearly calls for fiscal restraint and competitive exchange rates, it would be peculiar to blame those recommendations for the recent difficulties of Brazil or Argentina, which arose from a lack of fiscal restraint and persistently overvalued exchange rates. But setting aside the question of how to allocate blame, the question that follows is why does Latin America display a propensity for macroeconomic instability? Was the problem a lack of understanding of what needed to be done? Or poor implementation of the recommended policies? Or some political problem characteristic of Latin America that makes it difficult to enact such policies? I will return to this issue in the conclusion.

Table 6
Ratings S&P Index

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<tr>
<td>Thailand</td>
<td>10</td>
<td>Venezuela</td>
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</table>

Note: Index is defined as the number of years each country was considered investment grade by S&P from mid-1993 to mid-2003.
Structural Economic Reforms

On the microeconomic front, in addition to the progress in education and health mentioned above, significant structural reforms took place during the 1990s, as reviewed for instance by Edwards (1995). Eduardo Lora (2001) of the Inter-American Development Bank has collected information on the reforms that occurred, and I draw on his account here.

Substantial structural economic reform has occurred. In the area of foreign trade, tariffs for the 12 largest economies in Latin America dropped from an average rate of 49 percent in 1985 to less than 20 percent by 1994. Over a similar period, nontariff barriers affected 38 percent of imports in the mid-1980s, but only 6.3 percent of imports by the mid-1990s. In domestic financial markets, most countries have eliminated interest rate controls and substantially reduced the extent to which banks are required to make certain loans, although some mandated lending still exists in Colombia, Mexico and Venezuela, among others.

Many countries have reduced the high marginal tax rates that used to exist for personal income, along with lower taxes on corporate profits and the reduction in tariffs mentioned earlier. As a replacement, many Latin American countries have enacted value-added taxes, although the value-added tax is often applied with many exemptions and different rates.

Privatization has been substantial. In Brazil and Peru, cumulative privatizations between 1988 and 1999 exceeded 10 percent of GDP in 1999. In Argentina, Mexico, Venezuela and Colombia, cumulative privatizations over these years were 5 percent of GDP or more. Over half of all the privatizations by value in the developing countries of the world happened in Latin America. The privatizations in energy, telecommunications and finance have often brought with them an increase in foreign direct investment.

The specifics of how far these and other reforms reach on a country-by-country basis can certainly be explored in greater depth. There has been less deregulation of rules that may discourage hiring by restricting labor flexibility or by government imposition of large nonsalary costs for employee benefits. But overall, the depth and speed of these market-oriented structural reforms is impressive.

Lora (2001) calculates an overall index of structural reforms, which is admittedly pieced together based on the available evidence. For example, the trade component includes tariffs, but not nontariff barriers, since the evidence on nontariff barriers is shaky. The index, which appears in Table 7, is a simple average of reform indices in the areas of trade, financial system, labor, taxation and privatization. The numbers should be considered on a scale from 0 to 1,000, where zero consists of no reforms and 1,000 would be complete reform. The index shows a substantial degree of reform in the second half of the 1980s, with more reform in the 1990s.

The formal empirical evidence has not yet demonstrated a clear link from structural reforms to growth. In subsequent work, Lora and Panizza (2002) tried to identify which of the structural reforms had a greater impact on growth and productivity. Their panel and time series regressions fail to find a statistically

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significant impact of structural reforms on growth and productivity, with the exception of trade reform, where a significant link is found. One might surmise that the impact of macroeconomic crises remains large enough in the region that correlations between structural reforms and economic growth are difficult to discern. Still, the evidence on growth rates and, especially, the evidence on productivity gains in the 1990s relative to the 1980s presented in Table 1 do seem to suggest that the overall reform efforts initiated in the 1980s, including those on the education and health fronts, have had a positive impact.

**Summing Up**

The 1980s were indeed a lost decade for Latin America in terms of macro performance. Most countries in Latin America spent it trying to digest the aftermath of the debt and inflation crises of the early and middle years of the decade. Performance in the 1990s was significantly better than in the 1980s, with higher growth and lower inflation. Per capita growth averaged almost 2 percent in the 1990s, a reasonable but somewhat modest number when we consider that the United States grew at almost the exact same rate and east Asia grew a lot faster.

There was great variance in the growth and social records across countries in the region. Countries that got the macro right, like Chile and Mexico (after 1995), grew faster than the regional average. Structural reforms were implemented with varying degrees of commitment and success across the region. Thus far, and one must keep in mind that a decade of reforms is a short period of time by the standards of understanding trends in long-term growth, it has proven difficult to find ironclad evidence linking specific reforms to specific increases in growth. But total factor productivity growth moved into positive territory in the 1990s after averaging minus 2.28 percent per year in the 1980s. Finally, structural reforms alone did not guarantee success, as the case of Argentina illustrates.

Chile, the star performer in Latin America, both has the best macroeconomic policy performance and the best and earliest record in implementing structural

### Table 7

**Structural Reforms Index**

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*Note:* Read the Index as a range 0–1,000, where 0 consists in no reforms as opposed to 1,000.  
reforms. One can reasonably argue that sound policies were applied and worked in Chile, and to some extent in Mexico, after 1995. In most other countries in the region, poor performance even after the reforms of the 1990s can be blamed on macroeconomic crises, often driven by loose fiscal policy and an overvalued exchange rate in an environment of large and volatile capital flows. On the whole, economic progress was achieved in Latin America in the 1990s. Still, one wonders why only Chile and Mexico have done well. The question is really one of political economy, to which I now turn.

**Populism and Economic Reform**

Populism has a long and disastrous history in Latin America (discussed in the essays collected in Dornbusch and Edwards, 1991). There are a number of definitions of populism for different times and places, but here is one useful definition aimed at the context of Latin American experience (Kaufman and Stallings, 1991, p. 16):

[Populism] involves a set of economic policies designed to achieve specific political goals. Those political goals are: (1) mobilizing support within organized labor and lower-middle-class groups; (2) obtaining complementary backing from domestically oriented business; and (3) politically isolating the rural oligarchy, foreign enterprises, and large-scale domestic industrial elites. The economic policies to attain these goals include, but are not limited to: (1) budget deficits to stimulate domestic demand; (2) nominal wage increases plus price controls to effect income redistribution; and (3) exchange rate control or appreciation to cut inflation and to raise wages and profits in non-traded-goods sectors.

This definition of populism bears an intentionally close resemblance to Latin America’s policies of import substitution and government-led industrialization that held sway from the 1950s to the 1970s. Import substitution helped gain support from organized labor while isolating foreign enterprises. Government-led investment was typically carried out through a combination of large fiscal and/or quasi-fiscal deficits and economic and financial controls.

Perhaps the main paradox of populist government in Latin America in the twentieth century is that even after decades of populist governments claiming to represent the interests of the poor and middle-class, the historically high levels of inequality in Latin America did not decline much, if at all. Indeed, even basic health and education services for the poor, which one might think would be a staple of “populism,” were often neglected by populist governments. The populist economic formula was to assure highly visible benefits to key constituents just before elections, and then to pay for those benefits with macroeconomic crises and a lack of flexibility and productivity at other times. Yet many of those in the target
audience for populism apparently believed, despite the continuing high levels of inequality, that their relative or absolute status would be even worse under the parties opposing the populist government (when alternative parties were available).

Since the late 1980s and early 1990s, many Latin American countries have tried to implement economic policies that are the opposite of those prevailing under populist governments: macro stability, structural reforms, institution building, a focus on health and education and so on. What has led some countries to persevere and succeed with sound policies, while others seem to experience repeated reversals? In other words, what made the more successful countries tick? The answers to these questions are not simple. I will first summarize some of the key political dynamics in the countries that have been the main focus of discussion here and then attempt to draw some general lessons.

The Political Dynamics of Reform by Country

Mexico is an example of a country where populist governments were often seen during the twentieth century. In fact, many times during the last several decades Mexico experienced economic crises at regular six-year electoral intervals, as the government overspent before the election to ensure popular support and then suffered inflation and in some cases debt defaults after the election. Mexico began some structural economic reforms in the 1980s, but it seems as if the nation’s debt crisis of 1994–1995 finally led to deeper change. Mexico abandoned a managed exchange-rate regime that had played a recurrent key role in the financial crises of the past. Mexico took the giant step joining the United States and Canada in the North American Free Trade Agreement (NAFTA). Finally, in 2000, the PRI party lost the presidential elections for the first time in 70 years, but the transition took place smoothly. Not too long after, Mexico’s debt became investment grade, and now prospects for sustained growth appear to have improved.

Brazil has been implementing a number of reforms that may allow it to follow a path similar to Mexico. Since the “lost decade” of the 1980s, Brazil has tamed inflation, managed a banking crisis in 1996–1997, improved health and education and instituted structural economic reforms. Perhaps most interesting, as already mentioned earlier, Brazil faced a financial crisis in 2002 driven primarily by the expectations that a victory by the opposition in the presidential elections would throw Brazil back to macro instability and populism. However, the new government of President Lula da Silva began its time in office by following sound macroeconomic policies. Thus, Brazil may have a fair shot at turning the page on two decades of slow growth.

Chile is the main economic success story of Latin America, with by far the highest rates of per capita GDP growth in both the 1980s and the 1990s. Chile suffered an economic crisis in 1972–1973 under the populist economic policies of the Allende government, which helped to drive the military takeover in 1973. However, the military dictatorship then experienced its own economic crisis in 1982–1983, which paved the way for what we now know turned out to be a permanent shift to sound macro and micro policies starting about 1985. Following
Chile’s transition back to democracy in 1989, these sound macroeconomic policies were maintained and in many instances deepened. Within a few years, investment as a proportion of GDP jumped up by 6 percentage points and per capita GDP growth increased by almost 3 points, as usefully reviewed by Schmidt-Hebbel (1999). In the case of Chile, it seems likely that memories of the economic fiasco under Allende in the early 1970s were still fresh in the minds of the highly competent group that took over after the military.

Argentina was an eager economic reformer, willing even to enact a policy as strong as fixing its exchange rate to the U.S. dollar with a currency board. It was rewarded in the 1990s with by far the largest gain in per capita growth and in productivity compared with the 1980s—more than twice the change of any other country. But Argentina was unable to solve its persistent problem of government deficits. Eventually, these budget deficits, together with contagion from Brazil’s 1998–1999 crisis, led to a loss of confidence in Argentina’s currency peg. As Argentina’s exchange rate mechanism fell apart in 2001–2002, the country suffered an extremely severe recession with GDP declining more than 20 percent from peak to trough over 1999 and 2002.

Of the six countries discussed here, the two that had the lowest growth rates of per capita GDP in the 1990s were Venezuela and Colombia. Venezuela is a country where the spirit of populism remains strong and that has also suffered considerable political instability in the last few years. Venezuela also had relatively high inflation into the late 1990s; it had as many financial crises in the 1990s as it did in the 1980s; and it ranks relatively low on the structural reform index. Colombia is the one large economy in Latin America where the growth rate was lower in the 1990s than in the 1980s, despite the country’s relative macroeconomic stability (as certified by its investment-grade debt ratings for many years) and an average performance on structural reform. Presumably, the answer for Colombia’s problems lies in its severe degree of political instability, which has verged on civil war in certain regions.

**Popular Opposition to Populism?**

The supply of populism is always abundant, all over the globe. But why has the demand for populism been so high over the years in Latin America? A full answer to this question is beyond the scope of this paper, but it does appear that the turnaround stories in the region were driven primarily by a decline in the demand for populism (and not by a decline in the supply).

Overcoming populism is not a politically easy task. The rhetoric of populism continues to have a strong appeal across much of Latin America. There is widespread nostalgia for the economic growth rates of the 1950s and 1960s and for the belief, widespread at the time, that Latin American countries could assure their own prosperity with somewhat dirigiste policies of government-led investment and import substitution. The fact that the success of these policies taken as a whole was questionable even in the short term, and that in the long term these policies were largely responsible for their own demise, seems to be overshadowed by the failure of other policies to guarantee glowing results.
Populist economic policies often deny that any tradeoffs are needed, at least for the vast majority of the population, while good economic policies often create a mix of losers and winners, whether real or perceived. Once threatened, special interest groups then gang up and obstruct the path of development-friendly reforms. The most important instance of such phenomena comes in the upfront sacrifice needed to eliminate budget deficits and to lower inflation. Latin America has seen a long history of weak fiscal and monetary practices and institutions, one weakness feeding the other down a vicious circle of macroeconomic instability.

The interaction between loose fiscal and monetary policy, inflation and exchange rates has been especially destructive. The cycle begins when populist fiscal policies increase government debt and, when accommodated by loose monetary policy, lead to inflation. One approach to fighting inflation that has been a constant feature of the Latin American scene over the years has been the use of the exchange rate as an anchor. While there is no known episode of hyperinflation that did not end with the help of an exchange rate anchor, it is also true that in most instances in Latin America the pegging of the exchange rate took place without the necessary fiscal discipline. The combination of a pegged or fixed nominal exchange rate with continuing domestic inflation invariably led to an appreciation of the real exchange rate, which in turn led to unsustainable current account deficits and subsequently, to a balance of payments crisis. Many if not most of the macroeconomic crises in Latin America in the last decade follow this general pattern: Mexico in 1994–1995, Brazil in 1998–1999, Argentina in 2001–2002.

If one looks at the experiences of a number of countries in Latin America and asks how the political pressure for populist economic policy was at some point interrupted, it seems that in most cases the situation got bad enough for people to realize that change was necessary and therefore had to be politically supported. These changing beliefs led to a collapse in the demand for populism and to a strong mandate for change. In Chile, the experience under Allende in the early 1970s seemed to generate this sort of consensus. In Mexico, the financial crisis following the election in 1994 seemed to be the final straw. There doesn’t seem to be any general rule that causes people to believe that enough is enough. At least to this observer of policy cycles all over the developing world, there seems to be a fair amount of randomness involved in many of the episodes, whether they end in failure or success. In different situations, the key causes for the rejection or continued acceptance of populism may include external factors, such as whether the world economy seems welcoming and expanding, or internal factors such as the competence or charisma (or lack thereof) of the particular group running the country at a given moment.

In Chile in 1989, in Mexico in 2000 and so far in Brazil in 2003–2004, the new economic regime became more credible when political change took place and was followed by the continuation of sound economic policies. This point is quite important. Once a country proves that sound policies are no longer the preferred choice of a few enlightened technocrats or autocrats, or of a single political party that may soon be out of power, business and investor confidence increases, hori-
zones are lengthened for both private and social investments, and the economy can move to a path of higher and sustained growth.

In all these cases, an important starting point of the economic change was the prominent role of sound macroeconomic policies in jumpstarting the process. Economies that suffer hyperinflation or frequent financial crises will find that other economic reforms have little traction. But when a reasonable degree of macroeconomic reform is in place, then structural and microeconomic reforms add to the credibility of the overall development program and also have a positive impact on growth via productivity gains. A reasonable degree of macroeconomic stability improves the odds that the package of economic change will be sustained, even if there is a turnover of political parties.

The economic record of the 1990s in Latin America shows improvement over the 1980s. The region displayed significant gains in per capita economic growth and in productivity. But so far, only Chile has reached the stage of per capita growth consistently strong enough to put that nation on a path toward convergence with high-income economies. Mexico and perhaps also Brazil appear to be on their way to demonstrating that the vicious circle of low growth caused by macro instability and micro inefficiency can be broken. However, a few years ago, Argentina would have been cited as a rising star among Latin American economies, only to take a dramatic step backward into macroeconomic crisis in the last few years. Meanwhile, Venezuela and Colombia are sunk deep in severe political discord that goes much beyond the choice between populism and the kinds of economic reforms discussed in this paper.

Given the somewhat modest growth performance of the 1990s, it is not surprising that one still finds on the discussion menu in most countries proposals to return to the closed-economy government-led development model of the 1950–1970 period, perhaps supplemented by better social policies. While the improvement of social policies is an essential part of any successful strategy, there are good reasons to be skeptical of this nostalgic return to 1950s economic policies. First, this approach in itself is not a substitute to sound macro and financial policies, as it is usually implied by most of those who support it in the real world. In fact, there is good reason to think that the 1950s approach tends to be associated with populism, nationalism and weak macro policies because of all the inconsistent demands it places on the state that cannot be met, at least in the short run. Second, these proposals ignore that the old model ran its course. As discussed above, it spun off the macro road and ran into greatly diminishing if not outright negative returns at the efficiency level. Lastly, in a world where the global growth frontier seems to have moved from physical capital accumulation to human capital development and technology improvement and where trade and financial integration places a premium on flexibility, sound macro and microeconomic policies are necessary so as to be able to deal with real shocks and with the financial booms and busts of this era.

The best course is to persevere with a sound agenda of reforms and to avoid the temptation of looking for shortcuts in the past. The path forward must surely
include a sound macroeconomic framework, a focus on education and health, on microeconomic efficiency and flexibility, on building institutions, on creating a culture of trust and respect for the rule of law and so on. Each country will probably find a different way to reach these goals. This diversity of policies is the natural outcome of a constrained optimization exercise where the constraints are the country’s history, culture and traditions, as well as the particular sequence of shocks, positive and negative, faced during different periods. Even when successful, the process takes time and requires a long view of things, something not always available because governments tend to be impatient. One can only hope that some learning will take place over time in Latin America and that the success stories of some countries inspire others to move in the right direction.

I wish to thank Andrei Shleifer, Timothy Taylor and Michael Waldman for suggestions, editing and encouragement far beyond their formal role; Persio Arida, Amaury Bier, Pedro Bodin, Pedro C. Ferreira, Ilan Goldfajn, Peter Kenen, Samuel Pessôa, Pedro M. Salles and Sergio Werlang for comments on an earlier draft; and Igor Barenboim, Caio Megale and Tamara Wajnberg for superb research assistance.

References


