CHAPTER

15 Trade and Policy Reform in Latin America

Learning Objectives

After studying this chapter, students will be able to:

15.1 **Describe the strengths, weaknesses, and reasons for import substitution industrialization.**

15.2 **Explain the strategy and performance of economic populism.**

15.3 **Give the main reasons for the Debt Crisis of the 1980s and analyze its relationship to ISI.**

15.4 **Discuss the goals of economic policy reforms that began in the later 1980s.**

15.5 **Explain why some Latin American leaders have become impatient with economic policy reforms.**

INTRODUCTION: DEFINING A "LATIN AMERICAN" ECONOMY

Latin America stretches from Tijuana on the U.S.–Mexico border to Cape Horn at the southern tip of South America. Within this vast geographic area lies such a diversity of languages and cultures that any definition of Latin America must have exceptions and contradictions. For example, *Merriam-Webster's Collegiate Dictionary* defines the region as Spanish America and Brazil, a standard view that leaves out a few small countries in Central and South America (Belize, Suriname, Guyana, and French Guiana) and the island nations of the Caribbean that were outside the region of Spanish and Portuguese settlement. *Webster's* second definition—all of the Americas south of the United States—is more inclusive but purely geographical. Perhaps it is less important to give a precise definition than it is to recognize the variety of physical geographies, cultures, and income levels that coexist within any definition. In fact, the variety is so great that it is worth asking whether these nations can truly constitute a single world region. In other words, what is the "Latin American" experience, and how does it allow us to group together nations as different as Argentina, with its European culture and relative prosperity, and Guatemala, with its indigenous culture and rural poverty?

The diversity within Latin America should make us careful not to overgeneralize. Nevertheless, there are several common themes shared by all, or nearly all, the nations in the region. First, there are common historical threads, beginning with the fact that many of these nations share a heritage of Spanish and Portuguese colonization and a common linguistic base. In some countries, however, the languages of indigenous people are important as well. A second part of their shared histories is that many Latin American countries gained their national independence from Spain and Portugal during the nationalist revolutions of the early and middle nineteenth century. This differentiates their experiences from the colonial experiences of Africa and Asia, and implies that the national identities of Latin Americans are perhaps deeper than in other parts of the developing world.

During the first wave of globalization in the late nineteenth century, many countries were connected to the world economy through exports of agricultural and mineral commodities. Then, in the 1930s, the Great Depression caused many nations to shift their policies away from an outward-looking export orientation toward an inward-looking, targeted industrial strategy. At the same time, state-led industrialization began to encourage more manufacturing along with a new strategy that came to be known as *import substitution industrialization*. More recently, most nations were borrowers in the 1970s, and suffered through a prolonged debt crisis in the 1980s. From that point forward, the region began a wide-ranging set of economic policy reforms, similar in scope to the transformation of Central and Eastern Europe after the collapse of communism. Finally, in the twenty-first century, several countries have grown impatient with the economic reforms of the 1990s and have turned toward more interventionist policies, with more reliance on the state to direct and support the economy.

In this chapter, we examine the origins and extent of the economic crisis that hit Latin America in the 1980s and analyze the responses. Before we examine the crisis of the 1980s and the economic reforms of the late 1980s and 1990s, we must first step back and look at the long-run performance of the economies of Latin America. Then, when the severe problems of the 1980s are viewed in context, it is easier to understand the policy shifts of the 1990s and after.

POPULATION, INCOME, AND ECONOMIC GROWTH

Table 15.1 is a snapshot of the current levels of income and population. The selected countries are 97 percent of the population and 91 percent of the GDP in all of Latin America and the Caribbean. In 2019, more than 624 million people lived in the eighteen countries included in Table 15.1 and they produced gross domestic product (GDP) equivalent to $5,180 billion U.S. dollars. Individual countries ranged in population from under 4 million to more than 200 million, while purchasing power parity incomes varied from $5,600 per person to more than $30,000 per person. Four countries—Brazil, Mexico, Colombia, and Argentina—account for more than two-thirds of the population and GDP of Latin America and the Caribbean.

For long stretches of the twentieth century, Latin America was one of the fastest-growing regions of the world. In particular, from 1900 to 1960, the region's real GDP per capita grew as fast or faster than that of Europe, the United States, or Asia. Individual experiences varied, but most countries saw adequate to excellent growth along with rising living standards. After World War II, most countries in

Latin America experienced good rates of growth, as did most regions in the world, and the two largest countries, Brazil and Mexico, had remarkable increases in their per capita income levels. Circumstances began to change as world economic growth slowed in the 1970s, and Latin American experiences became more varied. Some countries grew faster in the 1970s and some grew slower, but nearly all relied more heavily on government expenditures to stimulate growth. The undoing of this period was the onset of the Latin American debt crisis (1982–1989), which is

TABLE 15.1 Population and GDP for Latin America and the Caribbean, 2019

	Population (Millions)	GDP ($US, Billions)	GDP per Capita ($US, PPP)
Brazil	211.0	1,839.8	15,259
Mexico	127.6	1,258.3	20,411
Colombia	50.3	323.8	15,644
Argentina	44.9	449.7	22,947
Peru	32.5	226.8	13,380
Venezuela, RB	28.5	98.7*	10,797*
Chile	19.0	282.3	25,155
Guatemala	17.4	107.4	11,847
Ecuador	16.6	76.7	8,996
Bolivia	11.5	40.9	9,086
Cuba	11.3	100.0*	..
Dominican Republic	10.7	88.9	19,182
Honduras	9.7	25.1	5,965
Paraguay	7.0	38.1	13,210
Nicaragua	6.5	12.5	5,631
El Salvador	6.5	27.0	9,140
Costa Rica	5.0	61.8	20,434
Panama	4.2	66.8	32,762
Uruguay	3.5	56.0	22,455
Sum of above countries	624.0	5,180.8	16,755
Total Latin America and Caribbean	646.4	5,719.2	16,797

*2018

Source: Data from International Monetary Fund and World Bank, © James Gerber.

described later in the chapter. The Debt Crisis turned the 1980s into a Lost Decade as sovereign debt problems were compounded by negative growth, banking crises, currency crises, and hyperinflation. The Debt Crisis of the 1980s brought an end to nearly fifty years of economic policy, as one country after another tried bold new experiments in their search for a way to restore economic growth.

IMPORT SUBSTITUTION INDUSTRIALIZATION

LO 15.1 Describe the strengths, weaknesses, and reasons for import substitution industrialization.

Economic policy reforms began in the 1980s as a response to that decade's Debt Crisis. They brought the demise of a state-led economic development strategy that had been in place since the 1930s in most countries and they brought the rise of more market-oriented policies. Prior to the economic reforms, countries were private market economies, but they used a heavy dose of state intervention to determine key elements of policy, such as the allocation of credit, investment decisions, and trade patterns. The most important part of this strategy occurred in the trade arena, where countries adopted the economic development strategy known as import substitution industrialization (ISI). After World War II, the theory of ISI was grafted onto a broader state-led development strategy and every country in Latin America, as well as many outside the region, adopted ISI policies. In Latin America, ISI policies were brought to an end in the 1980s and 1990s as countries moved away from state-led development strategies and began to look for ways to harness market forces to promote economic development. This shift from state-to-market was encouraged by a variety of factors, including the long Debt Crisis of the 1980s and a worldwide shift toward greater reliance on market forces.

Origins and Goals of ISI

From the second half of the nineteenth century until the middle of the twentieth century, most of Latin America relied on exports of agricultural commodities (sugar, bananas, coffee, cotton, and grains) and minerals (petroleum, silver, copper, and tin) to earn foreign revenue. These export sectors were often developed or controlled by foreign capital and had few economic linkages to the domestic economy, functioning instead as foreign enclaves within the nation. In cases where the export sector was domestically owned, it usually brought wealth to a relatively small number of people and added greatly to the inequality of power and money pervasive in Latin American society.

World War I and the Great Depression of the 1930s disrupted the flow of Latin American exports and severely reduced export earnings. World War II partially reversed this trend, as many countries turned to Latin America for the minerals and foodstuffs they could no longer make at home due to the war, but at war's end there was another drop in demand for Latin America's commodities. In the late 1940s, a young Argentine economist, **Raul Prebisch**, and a German exile, Hans Singer, developed a theory to explain the loss of foreign exchange earnings. In their view, the fall in demand for Latin American commodities was not solely due to the end of the war but was also a long-run tendency for the prices of primary commodities to fall. Singer and Prebisch argued that coffee, tin, copper, bananas, and other primary commodity exports would inevitably experience price declines relative to the prices paid for manufactured goods.

In trade analysis, the ratio of average export prices to average import prices is called the **terms of trade (TOT)**:

$$\text{TOT} = (\text{Index of export prices})/(\text{Index of import prices})$$

Latin America exported raw materials and imported finished goods, so the Prebisch-Singer prediction was that the terms of trade for the region would decline. For obvious reasons, this view was labeled **export pessimism**.

The reasoning behind export pessimism included both statistical studies and economic theory. Statistical analysis showed raw material prices falling over periods as long as several decades. More recent analysis shows that while prices may fall for extended periods of time, there is no long-run trend up or down. Economic theory holds that as incomes rise, people spend a smaller share of their overall income on foodstuffs and other raw-material-based goods such as textiles and apparel, and they spend more on manufactured items. Consequently, the demand for raw materials declines in relation to the demand for manufactured goods. Note, however, that this effect does not necessarily lead to a decline in the terms of trade for raw material producers, as productivity increases in manufacturing can overwhelm increases in demand and push down the real prices of manufactured goods.

Export pessimism formed the basis of orthodox economic policy from roughly the 1950s through the 1970s. As the head of the United Nations' **Economic Commission on Latin America (ECLA, or CEPAL in Spanish)**, Prebisch guided economic policies throughout Latin America and reinforced a shift that had begun with the destruction of trade in the 1930s. The loss of markets during the Great Depression temporarily forced Latin America away from dependence on raw material exports and toward industrial development through the production of manufactured goods that substitute for imports—hence, the name *import substitution industrialization (ISI)*. Ironically, domestic production of manufactured import substitutes required the importation of large quantities of capital goods (machinery and parts), and in order to earn the revenues needed to buy these imports, most nations continued to depend on raw material exports in the decades after World War II. Primary commodities still make up a significant share of today's exports from Latin America, except in Mexico, and many countries benefitted significantly from high commodity prices and strong Chinese demand between 2003 and 2013. As Chinese growth slowed after approximately 2013, the effects were felt as declining commodity prices and weaker demand.

ISI is a form of industrial policy that focuses on those industries that produce substitutes for imported goods. According to Prebisch and Singer, the inevitable decline in the terms of trade for primary commodities means that the biggest constraint on industrial development is the shortage of foreign exchange. Lower export prices mean that countries find it harder and harder to earn the foreign exchange they need in order to buy the machinery and other capital goods they cannot produce themselves. One of the most important roles of import substitution is to reduce the need for foreign exchange used to buy goods that could be made at home.

ISI theorists argued that a country should begin by producing inexpensive and relatively simple consumer items, such as toys, clothing, food products (e.g., beverages and canned goods), and furniture. Gradually, the focus of industrial targeting should move on to more complex consumer goods (e.g., appliances and autos) and intermediate industrial goods (e.g., pumps, generators, basic metals). In the third stage, complex industrial goods would be produced (e.g., chemicals, electronic equipment, machine tools).

Source: Pearson Education

Criticisms of ISI

The economic tools for implementing ISI are the same as those for industrial policies discussed in Chapter 5. These include a variety of different types of government support, from subsidies of all kinds to trade protection and monopoly power in the domestic market. In retrospect, ISI generated a number of unintended consequences that caused inefficiencies and wasted resources. Among the many criticisms that have been leveled at ISI are the following: (1) governments misallocated resources when they became too involved in production decisions; (2) exchange rates were often overvalued; (3) policy was overly biased in favor of urban areas; (4) income inequality worsened; and (5) ISI fostered widespread rent seeking.

Foremost among the problems of ISI are those related to an overconfident belief in the ability of the state to direct resources efficiently into their best uses. In the 1950s and 1960s, it was often assumed that market failures were far more common in developing nations than in industrial ones, and that one of the main goals of any state should be to correct these through selective and careful state intervention in the economy. In this context, ISI can be interpreted as a set of policies in which government uses its economic and political power to improve on the market.

Many economists think that ISI overestimates the technical ability of government officials to identify market failures and their solutions (see Chapter 5's discussion of industrial policies). It also assumes that government officials are selfless individuals who ignore political considerations and focus only on economic efficiency and what is best for the nation as a whole. This model of political decision-making caused an under-emphasis on problems related to the implementation of economic policies, such as corruption and the lobbying power of economic elites. It also failed to take into account the slow accumulation of special provisions, favors, and economic inefficiencies that built up over time when policies were heavily influenced by politics. This was magnified by the inequality in wealth and income throughout Latin America, where powerful interest groups were able to use ISI policies to their own benefit rather than in the national interest.

A second problem of ISI was the persistence of overvalued exchange rates. Overvaluation was a deliberate policy in some countries, while in others it was a chronic problem stemming from the maintenance of a fixed exchange rate under conditions of higher inflation than those in the countries' trading partners. As a deliberate policy, overvaluation of the exchange rate accomplished several goals. In particular, it made it easier for the targeted industries to obtain the imported capital goods they needed. It also helped to maintain political alliances between the urban working classes and the political parties in power by providing access to relatively less expensive foreign goods. When governments were forced to depreciate in the 1980s and 1990s, they often lost the political support of the urban classes.

Although overvalued exchange rates had some benefits, they also had costs. Most importantly, they made it difficult to export because they raised the foreign price of domestic goods. This hurt the agricultural and traditional export sectors, directed capital away from agriculture, and contributed to low productivity and income in rural areas. Overvalued exchange rates also hurt industries that did not produce substitutes for imports because they made it less profitable to export. They also made foreign machinery less expensive and caused industrial investment to be too capital intensive and insufficiently labor intensive. Consequently, industry did not create enough new jobs to absorb the growing urban labor force. Furthermore, because most industry is located in urban areas, government investments in infrastructure improvements–such as transportation, communication, and water—were heavily targeted toward cities and their environs. As a result, subsistence farmers and their families did not benefit from, or contribute to, national economic development, and Latin America continued to have the highest levels of inequality of any region in the world.

In addition to a persistent tendency toward overvalued exchange rates, ISI trade and competition policies were heavily protectionist and often favored the creation of domestic monopolies. The lack of foreign and domestic competition meant that manufacturing was often inefficient, uncompetitive, and inwardly focused. With profits from a protected domestic market, many producers had no incentives to invest in modern equipment, further reinforcing the lack of competitiveness of their products. It is ironic that as a consequence of ISI many countries became more vulnerable to economic shocks that originated outside of Latin America. This was precisely the opposite effect from the one that motivated ISI in the first place.

A final problem of ISI is the development of widespread rent-seeking behavior. When governments intervene in the planning and directing of industrial development, they give government officials a wide range of valuable privileges to distribute. These include the many subsidies and licenses that are a part of ISI policies. For example, in order to protect the domestic market and to ensure access to needed imports, governments often required import licenses. At the same time and in order to make imports less costly, they provided foreign exchange to importers at subsidized prices. When government policy creates something of value, such as the license to import or a subsidy to buy foreign exchange, the private sector will spend resources to obtain it. In the absence of strong institutions to ensure the independence of the bureaucracy—and, often, even when strong institutions are present—bribes and corruption become a part of the decision-making. Ultimately, some decisions are made for the wrong reasons, and economic waste is the result.

CASE STUDY

ISI in Mexico

The Mexican constitution of 1917 established the power and the responsibility of the federal government to intervene in the economy in order to act as the leading agent of economic growth and as the referee of social conflict. This role was not institutionalized inside the Mexican government until the Mexican revolution was consolidated in the 1930s under the presidency of Lázaro Cárdenas.

(*continued*)

In order to lead and direct economic growth, government could legitimately claim the need to be powerful—otherwise, powerful social classes could resist the government's directives and initiatives, particularly those with distributional goals or consequences. Therefore, economic policy served not only to meet the needs of the country for economic growth and a fairer distribution but also to increase the political power of government. Mexico nationalized its oil industries in 1938, and throughout the twentieth century a number of sectors were nationalized and turned into state-run monopolies (telephones, airlines, banks, railroads, and mineral development companies). The use of the government budget in this manner guaranteed access to investment funds, while monopoly markets ensured that the favored firms would succeed, at least within the nation.

The government also offered loans and loan guarantees to many firms in targeted industries. Loans and loan guarantees helped firms obtain capital at interest rates that were below market rates. Similarly, the government sold foreign exchange at artificially low prices to targeted firms that needed to buy imports. Mexican exporters were required to convert their foreign exchange earnings into pesos at an overvalued peso rate—too few pesos per dollar—which made exporting relatively less profitable; the government then sold the cheaply acquired foreign exchange to targeted industries. In effect, exporters were subsidizing the development of the targeted industries.

Unlike many ISI nations, Mexico limited foreign investment. Like most ISI nations, however, when investment was permitted (e.g., autos), performance requirements were placed on the foreign firms. A common requirement was that the foreign firm balance its foreign exchange requirements so that each peso of imports was matched by a peso of export earnings. Further interventions occurred in the area of commercial policy where import licenses limited many types of imports. Recall that import licenses are essentially quotas. By the 1970s about 60 percent of all imports were subject to licensing.

From 1950 to 1973, Mexico's real GDP per capita grew at the rate of 3.1 percent per year. By comparison, the United States grew 2.2 percent per year; the fourteen largest Organization for Economic Cooperation and Development (OECD) nations grew 3.5 percent per year; and growth in the six largest Latin American economies was 2.5 percent. At the same time that the economy was undergoing relatively rapid economic growth, industrialization was changing the structure of the economy. Mexico's manufacturing sector expanded from 21.5 percent of GDP to 29.4 percent. Overall, import substitution may have had many problems, but it cannot be called a failure. Judged by the economic growth of its partners, or by its own growth before or after, Mexico attained very healthy rates of growth. In part, ISI was relatively more successful in Mexico than it was other parts of Latin America because it is a large country, where producers can obtain economies of scale. Brazil, for example, had similar or even greater successes.

Growth began to slow in the 1970s, as it did in many parts of the world. One widely shared view is that Mexico's growth began to stall because the country was running out of easy targets for industrial development. Light manufacturing and simple consumer goods industries were relatively easy to start, and the conversion of a part of the nation's economy from subsistence agriculture to simple manufacturing made growth rates look good. The next stages required more sophisticated manufacturing, however, and were relatively harder to start growing. According to this view, Mexico ran out of simple industries to start and inevitably had a harder time producing more sophisticated goods that were further from its comparative advantage.

In spite of rapid economic growth during the 1950s and 1960s, poverty and income inequality continued. Large numbers of Mexicans, many of them indigenous people living in rural areas, did not participate in the growth of the economy. This is evidenced by the fact that in the 1980s a large part of agriculture was still at a subsistence level, using 26 percent of the nation's labor force to produce just 9 percent of the nation's GDP. The urban bias in Mexico's development strategy turned Mexico City into one of the largest metropolises in the world, with more than fifteen million people in the greater metropolitan area by the late 1980s. The sensational growth and crowding of people and industry into the basin that holds Mexico City resulted in serious pollution problems.

The relationship of ISI to the debt crisis of the 1980s is complicated, but most economists think that poor macroeconomic management and external shocks stemming from the collapse of oil prices and rising interest rates played a far larger role than ISI. Certainly, ISI policies expanded the role of the federal government in economic activity and increased government expenditures and borrowing during the 1970s. Nevertheless, overall economic growth remained fairly robust until the mid-1970s. One view is that the easy gains of ISI were gone by the 1970s, and in order to keep growth on track, Mexican presidents used their power over public finances to increase expenditures dramatically. At first the government argued that it could easily afford to borrow in foreign capital markets because the nation became a major oil exporter in 1978 and had high potential oil export earnings. Ultimately, the government's fiscal policies generated enormous public sector deficits, fears of devaluation, and capital flight. By 1982, a year after the price of oil fell, the nation had run out of international reserves and could no longer service its international debt. If the government had not resorted to unsustainable macroeconomic policies, it is less likely that the country would have fallen into the debt crisis in 1982 and subsequently rejected its ISI policies by the late 1980s.

MACROECONOMIC INSTABILITY AND ECONOMIC POPULISM

LO 15.2 Explain the strategy and performance of economic populism.

Many economists are convinced that while ISI policies are suboptimal, they had less of a direct effect in creating the economic crisis of the 1980s than misguided macroeconomic policies. The reasons are relatively straightforward. ISI policies involve trade barriers and government support for selected industries. Collectively, these policies may lower a nation's income by a few percentage points, but they rarely lead to a full-blown economic crisis. Faulty macroeconomic policies, on the other hand, often lead to hyperinflation, depression, and balance of payments crises. In addition, while most of Latin America used ISI policies from the 1950s through the 1980s, economic growth remained at fairly high levels for most countries until the early 1980s when growth turned negative in nearly all countries. While it is possible that the 1980s crisis was the culmination of several decades of ISI policies, it is certain that the crisis was directly linked to the faulty macroeconomic policies of the late 1970s and early 1980s.

Populism in Latin America

Many Latin America specialists blame the faulty macroeconomic policies of the region on populist or economic populist political movements that use economic tools to obtain support from labor and domestically oriented business, or to isolate rural elites and foreign interests. The definition of populism is imprecise and lacks consensus, but in general it implies a leader who is an outsider opposed to the status quo. Leaders are often charismatic demagogues who are able to attain power when there are high levels of dissatisfaction with existing conditions. As with all types of leaders, their administrative and economic competency varies from disastrous to highly skilled. Populist can be on the political left or right but in general, Latin American populists share nationalist ideologies with a focus on economic growth and income redistribution. Before the 1970s, populist tendencies did not cause large macroeconomic imbalances and government budgets were more likely to be balanced or near balance, inflation was controlled, and trade deficits did not exist, or were at least manageable. Beginning in the 1970s, however, a new breed of populists began to take power. This group, often called economic populists, was more likely to use expansionary fiscal and monetary policies without regard for the importance of inflation risks, budget deficits, and foreign exchange constraints. They were much more aggressive in using government spending to promote growth, and much less cautious in avoiding the pitfalls of too much spending.

Economic populism is usually triggered by three initial conditions. First, there is a deep dissatisfaction with the status quo, usually as a result of slow growth or recession. Second, policymakers reject the traditional constraints on macro policy. Budget deficits financed through printing money are justified by the existence of high unemployment and idle factories, which offer room for expansion without inflation. Third, policymakers promise to raise wages while freezing prices and to restructure the economy by expanding the domestic production of imported goods, thereby lessening the need for foreign exchange. In the words of one analyst, the policies call for "reactivating, redistributing, and restructuring" the economy.

Early in the populist regime, there is a vindication of the policies. The economic stimulus of government expenditures and newly created money leads to rising growth rates and rising wages. Soon, however, bottlenecks begin to appear.

For example, construction firms run out of particular inputs, such as cement or specialized steel products, and manufacturing firms cannot find the parts they need to repair their machinery. Prices begin to rise, and the budget deficit grows. In the next stage, inflation begins an extreme acceleration, and shortages become pervasive throughout the economy. The budget falls into serious deficit as policies become unsustainable, and wage increases cease keeping up with inflation. In the final stage, countries experience massive capital flight as fears of a devaluation develop. The flight of capital out of the country depresses investment and further depresses real wages.

In the end, real wages are often lower than before the cycle began, and there is an international intervention under the sponsorship of the IMF, which is designed to stop the high inflation and end a balance of payments crisis. Typically, the IMF oversees the implementation of stabilization and structural reform policies that call for serious budget cuts, a slowdown in the growth of the money supply, a reduction in trade barriers, and in general, greater reliance on market mechanisms and less government intervention. While these stages of the populist cycle are an idealization, they capture the essence of the populist experience as it has occurred in many Latin nations.

CASE STUDY

Economic Populism in Peru, 1985–1990

Alan García became president of Peru for the first time in July, 1985. After leaving in disgrace in 1990 he spent several years reforming his image and was re-elected in 2006, serving until 2011. His first presidency is a textbook case of the problems of economic populism, while his second presidency is widely regarded as successful. Before his first election in 1985 and as part of the fallout from the debt crisis, the country suffered through a serious recession in 1983. By 1985, it was on the mend, and García began a program to raise real wages in order to stimulate demand and redistribute income ("reactivate, redistribute, restructure"). In 1986 and 1987, the economy responded to the stimulus of higher consumption with robust growth and without inflation. The lack of inflation was due to the presence of idle factory capacity and unemployed workers. By mid-1987, however, some essential imported inputs became scarce and began to act as bottlenecks on further increases in production. Consequently, inflation rekindled. The exchange rate was a crawling peg that was periodically devalued, but because inflationary price increases were greater than the exchange rate devaluations, there was an inevitable appreciation in the real exchange rate and a significant increase in the current account deficit. Table 15.2 illustrates the course of the major macroeconomic variables and real wages during García's presidency.

(*continued*)

TABLE 15.2 Economic Indicators during the García Administration

	1984	1985	1986	1987	1988	1989	1990
GDP growth	4.8	2.3	9.2	8.5	−8.3	−11.7	−5.1
Real wage (% change)	−8.0	−8.4	26.6	6.1	−23.1	−46.7	−14.4
Deficit/GDP	6.7	3.4	5.7	7.9	8.1	8.5	5.9
Inflation (%)	110	163	78	86	667	3339	7482
Current account balance (millions of US$)	−221	−137	−1077	−1481	−1091	396	−766

Source: Data from Inter-American Development Bank, *Economic and Social Progress in Latin America*, © James Gerber.

Rising budget deficits, trade deficits, and inflation should have been enough to cause a cautious government to reign in expenditures; but instead, García responded by nationalizing the property of the financial services sector (banks and insurance companies) and expanding credit subsidies for favored groups in the agricultural and industrial sectors. In 1988, the government tried to tackle the problem of inflation through devaluations and price freezes, but in order to protect incomes and to bring relative prices into agreement, it simultaneously permitted selected price increases and compensating wage increases.

By 1990, the economy reached the deepest point in its recession. In July, a new government took office and implemented a relatively orthodox stabilization program of fiscal and monetary austerity to end inflation and curb the budget deficit. By then, however, real wages were well below the level they had attained when the previous government took power in 1985.

THE DEBT CRISIS OF THE 1980s

LO 15.3 Give the main reasons for the Debt Crisis of the 1980s and analyze its relationship to ISI.

In August 1982, Mexico announced that it lacked the international reserves it needed to pay the interest and principal due on its foreign debt. Mexico was not the first country to declare its inability to service its debt, but it was the biggest up to that point. Its announcement soon led to the realization that a number of other countries, including most of Latin America, were in similar circumstances. Thus began the Lost Decade.

Proximate Causes of the Debt Crisis

In Mexico's case, the collapse of oil prices in 1981 undermined its ability to earn the revenue it needed to service its debt. The problem was compounded by the fact that a significant portion of its debt was owed in dollars at variable interest rates and that efforts to combat inflation in the United States and elsewhere had resulted in a higher level of world interest rates. Consequently, interest payments on Mexico's debt rose at the same time that the nation's ability to earn dollars shrank.

The collapse of oil prices in 1981 and the rise in world interest rates were not the only external shocks to the economies of Latin America. In 1981–1982, the world's industrial economies entered a deep recession that reduced world demand and prices for many of the raw materials produced in Latin America and elsewhere. In Mexico's case, oil was the critical commodity, but a number of other primary commodity exports experienced a similar decline in their world price.

The price decline for Latin America's exports and the rise in interest rates were significant parts of the mix of events that led up to the debt crisis. These external economic shocks probably would not have caused a generalized debt crisis without some additional factors, however. Historically, debt crises are often triggered by a set of external shocks and are preceded by an acceleration of international lending. In Latin America's case, the lending occurred between 1974 and 1982. Added to these two factors was the complicating problem of mismanagement of national macroeconomic policies in the late 1970s and early 1980s.

During the 1970s, financial institutions in London, New York, and elsewhere were awash in money that they were eager to lend. The rise in oil prices in 1973 and 1974, and again in 1979, led to an enormous expansion of bank deposits by the oil-rich nations of the world. Banks aggressively sought new borrowers beginning in 1974. For Latin America and the Caribbean, long-term, publicly guaranteed debt rose more than sevenfold between 1973 and 1983. The sudden acceleration in commercial bank lending and the rise in the amount of debt made the economies vulnerable to a sudden and unforeseen economic shock.

Table 15.3 shows the size of the debt for some of the most heavily indebted countries after the first year of the crisis. The second column of numbers expresses the debt in net terms (gross debt minus debt owed by foreigners) as a percentage of GDP. The third column shows the net interest payments owed as a percentage of exports of goods and services. This is a useful indicator because nations ultimately have to pay the interest on their international debts out of the revenues they earn from their exports. What we see is that between 10 and 63 percent of the revenue earned by exports went to pay interest and, consequently, was unavailable for purchasing imports or for investing domestically.

Responses to the Debt Crisis

Initially, most analysts in the United States and in international financial institutions such as the IMF perceived the debt crisis to be a temporary, short-run liquidity problem. Under this assumption, the reasonable response is to increase

TABLE 15.3 Debt Indicators at the Onset of the Debt Crisis, 1983

Country	Gross External Debt (Millions of US$)	Net External Debt as a Percentage of GDP	Net Interest Payments as a Percentage of Exports
Argentina	43,634	75.3	62.8
Bolivia	3,328	141.9	38.5
Brazil	92,961	48.3	38.7
Chile	17,315	87.6	32.9
Colombia	10,306	25.1	18.8
Costa Rica	3,646	137.8	45.4
Mexico	86,081	63.8	32.1
Peru	10,712	52.4	20.1
Venezuela	32,158	38.8	9.6

A large percentage of the exports of indebted countries went to pay interest on their debts.

Source: Data from World Debt Tables, 1987; *International Debt Reexamined* 1995, World Bank, © James Gerber.

capital flows to Latin America and other indebted regions so that they would have the financial resources to service their debts and stimulate higher rates of economic growth that enables countries to outgrow their debt.

From the standpoint of U.S. policy, the key to growth was viewed as increased investment, which was possible only if capital flows into the region were restored. The first policy proposal along these lines was that of U.S. Treasury Secretary James Baker in 1985. The Baker Plan tried to organize a renewed lending program by commercial banks. The problem was that most banks that had Latin American loans in their portfolios were trying to reduce their exposure to the region, not increase it. Consequently, few resources were forthcoming under this plan.

Without capital flows from developed country banks, the choices were not attractive. Outright default and disavowal of the debt would cut off most of a nation's trade and investment linkages. The consequences for investment and growth would be risky and potentially disastrous, depending on the reaction of the United States and other governments. On the other hand, if they continued to make interest payments and principal repayment, huge trade surpluses would be required to earn the revenue they needed to pay for imports plus interest on the debt.

Interest payment on the debt owed to foreigners enters the current account as a debit in the category of primary income paid abroad, as discussed in Chapter 9. Consequently, interest payments severely increased the current account deficits of many countries. Recall the fundamental accounting balance of an open economy,

$$S_p + T - G = I + CA,$$

where S_p is private savings, $T - G$ is government (public) savings, I is investment, and CA is the current account balance. Without financial capital inflows to finance their current account deficits, countries must eliminate the deficit through a combination of increased exports and reduced imports. The policies that accomplish this are expenditure switching and expenditure reducing policies. Recall from Chapter 11 that expenditure switching policies such as devaluations of the currency turn the demand for foreign goods into a demand for domestic goods and raise CA directly. Expenditure reducing policies, such as tax increases and cuts in government spending, raise $T - G$ and, indirectly, reduce consumption, investment, and imports. The net effect of expenditure reducing policies is often a recession in which the demand for domestic and imported goods falls due to a fall in domestic income.

To accumulate the resources they needed for their interest payments, governments were forced to follow contractionary policies that caused deep recessions throughout the region. Between 1982 and 1986, the average rate of growth of real per capita GDP was −1.8 percent per year in Latin America and the Caribbean.

By 1987, it was apparent to analysts throughout the world that restoring capital flows was not enough. There was a need for deep reform in the economies of Latin America. First, it was observed that the faulty macroeconomic policies of the region consistently left aggregate national expenditure above national income and that the likelihood of a return to growth was small as long as the gap between the two remained. Second, in their attempt to keep government expenditures higher than warranted, many countries had resorted to printing money, which resulted in high and increasing rates of inflation. Third, the burden of the debt itself was becoming apparent to everyone inside and outside Latin America. After the interest and principal payments were made, insufficient export earnings remained for domestic investment and consumption, and growth was stunted. By 1988–1989, both creditors and multilateral lending agencies such as the IMF were in agreement that debt relief was in everyone's interest.

The growing consensus on the need for debt relief led to the **Brady Plan** in 1989, named after the U.S. secretary of the treasury, Nicholas Brady. Essentially, the Brady Plan gave something to everyone. Creditors were expected to restructure some of the old debt into longer-term debt with a lower interest rate and to make some additional new loans. The multilateral lending agencies, such as the IMF, were expected to provide additional loans on concessional terms (below market interest rates) and borrowers were required to provide evidence of their willingness to begin serious economic reform before any new loans would be forthcoming. The Brady Plan did not end the debt crisis, but it was a significant step toward greater stability in the region. Countries that renegotiated their debt with the Brady Plan package were perceived by the international financial community to have greater credibility and sounder finances. Consequently, after 1989 capital flows began to return to Latin America but this time not in the form of bank loans. Rather, savers and investors in the United States, Europe, and Asia began to increase their direct investment in Latin America, as well as their holdings of various financial assets, such as stocks and bonds issued by private companies doing business there. While large inflows of capital can create problems if they reverse and flow out, they were the additional savings and investment that the region needed to return to its historical levels of growth.

From the vantage point of the twenty-first century, the most lasting effects of the debt crisis—other than the forgone output due to the recessions of the 1980s–are the deep economic reforms that have taken place in country after country. These reforms are key to explaining the return of capital flows to Latin America. Reforms vary by country, both in kind and degree, but they mark a historical shift away from the protectionist and interventionist policies of ISI and economic populism and toward more open and market-oriented policies.

NEOLIBERAL POLICY REFORM AND THE WASHINGTON CONSENSUS

LO 15.4 Discuss the goals of economic policy reforms that began in the late 1980s.

LO 15.5 Explain why some Latin American leaders have become impatient with economic policy reforms.

By the late 1980s, most countries in Latin America had started a series of economic policy reforms that began to alter the fundamental relationships between business and government and between their national economy and the world. After 1989, the reforms intensified and became more general. In most cases, the reforms consisted of three separate but interrelated features. First, and with varying degrees of success, governments implemented stabilization plans to stop inflation and to control their budget deficits. Second, most countries began privatizing the government-owned parts of their economies, such as manufacturing enterprises, financial and other services, mining operations, tourism, and utility companies. Third, trade policies became more open and less discriminatory against exports.

Throughout Latin America, this package of reforms has come to be known as the **neoliberal model or neoliberalism** because it represents a partial return to classic nineteenth-century European liberalism, which favored free markets and minimal government intervention in the economy. In addition to being labeled as neoliberalism, these reforms also came to be known as the **Washington Consensus** on policy reform. Both the neoliberal agenda and the Washington Consensus were considered policy prescriptions for reform of government finances and management of the economy. Neither was offered as a manual for economic development, although that is how each came to be seen and used. By the early 1990s, growth had returned to most of Latin America, but it remained relatively slow, and disappointment with these policies began to set in after the mid-1990s. Before we look at the reaction that reform disappointment created, it is first useful to discuss the reforms in more detail.

Stabilization Policy to Control Inflation

Many countries sought to avoid the recessionary consequences of the onset of the debt crisis by increasing government spending. The only way to finance government spending, however, was through the printing of more money because tax systems were inadequate and government borrowing abilities were limited by the debt crisis. The reckless printing of money to finance government spending drove a number of nations into periods of hyperinflation, as detailed in Table 15.4.

The solution to the hyperinflation experienced by Argentina, Bolivia, Brazil, and Peru is simple to prescribe: Cut government spending and stop printing money. Together, this set of policies is called **stabilization policy**, as the goal is to stabilize the macroeconomy. The implementation of this prescription was difficult, however. In the short run, if price increases outstrip wage increases, as is often the case in a period of disinflation, then the burden of bringing down the rate of inflation falls mainly on wage earners who experience a fall in their real wages. Consequently, anti-inflation policies create economic hardship and alienate the political support of many wage earners, making governments unpopular with a large share of the population.

A further complication was the lack of agreement over the causes of inflation. Some argued that it was caused by inertia because everyone expected future inflation to be high. This caused producers to raise prices in anticipation of higher future input costs. The problem of inflation developing a momentum of its own, and a lack of empirical information about the depth of this problem, led to two different policy prescriptions for controlling inflation: the orthodox model and the heterodox model.

TABLE 15.4 Inflation Rates, 1982–1992

	Inflation (in Percentage)		
Country	Average 1982–1987	Average 1987–1992	Highest 1982–1992
Argentina	316	447	4924 (1989)
Bolivia	776	16	8170 (1985)
Brazil	158	851	1862 (1989)
Chile	21	19	27 (1990)
Colombia	21	27	32 (1990)
Mexico	73	48	159 (1987)
Peru	103	733	7650 (1990)
Venezuela	10	40	81 (1989)

High rates of inflation were a common problem of the 1980s.

Source: Data from *Crisis and Reform in Latin America*, by Sebastian Edwards, 1995, © James Gerber.

The **orthodox model** minimizes government involvement in the economy. Consequently, its anti-inflation prescription is straightforward—cut government spending, reform the tax system to increase compliance and revenues, and limit the creation of new money. The heterodox model calls for the same actions plus the freezing of wages and prices. In the **heterodox model**, inflationary expectations are so embedded in economic decision-making that price increases will continue even if government spending and new money creation cease. In practice, heterodox plans often ignored the budget deficits that were part of the problem.

Between 1986 and 1992, Brazil implemented five separate heterodox stabilization plans to end inflation, and none of them worked. Similarly, heterodox plans in Argentina and Peru in 1985 succeeded for approximately a year, but then failed as inflation returned with a vengeance. Nevertheless, Brazil and Mexico each ultimately controlled inflation using heterodox methods.

An issue that continued to plague many nations was the problem of inconsistency between inflation stabilization and exchange rate policy. Mexico's experience is a good example of the problem and stems from the fact that the exchange rate is a powerful weapon in the fight against inflation. Mexico fixed its peso to the dollar in the mid-1980s as part of its anti-inflation strategy. Argentina and Brazil did the same under their stabilization plans of 1991 and 1994, respectively. Domestic producers that competed with U.S. goods were forced to avoid price increases so they would remain competitive. Furthermore, prices did not increase on imports of U.S.-made capital goods, which were essential to Mexican industry, thereby helping to hold down Mexican prices for finished manufactured goods. Because Mexico's inflation was still slightly higher than U.S. inflation, the peso became overvalued over a period of time. Ultimately, this contributed to a serious trade imbalance and the collapse of the peso in December 1994, followed by a deep recession in 1995. Since 1994, Mexico has let the peso float against the dollar and has stopped trying to use the exchange rate as an anchor against the current of inflation. Argentina's struggle to control inflation and its use of the exchange rate are discussed in the case study in Chapter 11.

Structural Reform and Open Trade

Stabilization policies to control inflation and curtail large budget deficits are usually one part of a package that also includes **structural reform policies**. One way to keep the two types of policies separate is to recognize that stabilization generally focuses on macroeconomic policies—for example, inflation and government budgets—while structural reform tends to be more microeconomic, dealing with issues of resource allocation. Structural reform policies include the privatization of government-owned enterprises, the deregulation and redesign of the regulatory environment of overregulated industries such as financial services, and the reform of trade policy.

The many initiatives to privatize and reform the regulatory environments of the economies of Latin America are quite remarkable, but this section will focus on the most impressive area of structural reform to date: the economic integration of the region with the world economy. Before the onset of the debt crisis, the economies of Latin America had the most restricted trade systems of all the nations in the noncommunist world. In many countries, the debt crisis reinforced the belief that isolation from the world economy was the only way to protect a nation from shocks that originated in the external environment.

In the 1970s, Chile broke with this tradition and began to reform its trade policies. Mexico and Bolivia followed in 1985 and 1986, and by 1987–1988, it was apparent throughout Latin America that trade had to be more open if economic growth was to be restored. In the late 1980s and early 1990s, nearly all the countries of Latin America began reducing both the level of tariffs and nontariff barriers (NTBs) and the variability of tariff rates across industries and goods. Table 15.5 shows the changes in tariffs that occurred between the mid-1980s, when the reforms began, and the early 1990s and beyond. As large as the tariff reductions were, the effect of the elimination of NTBs such as quotas and import licensing requirements was even more dramatic, as many countries eliminated all or nearly all these barriers. By the early 1990s, most of the tariff and nontariff changes had been implemented, and countries began to turn to alternative forms of market opening.

The three main goals of trade reform were to reduce the anti-export bias of trade policies that favored production for domestic markets over production for foreign markets, to raise the growth rate of productivity, and to make consumers better off by lowering the real cost of traded goods. In response to the changes in trade policy, the growth rate of exports picked up in most countries, while nontraditional exports increased dramatically. Furthermore, productivity rose in a majority of countries for which there is data. The productivity increase is at least partly the result of trade opening due to the impact of technology transfers, the improved investment climate, and the pressures on local firms to remain competitive.

TABLE 15.5 Average Tariff Rates, in Percents, Selected Countries

	1985	1992	2010
Argentina	28	14	11
Brazil	80	23	13
Chile	36	11	5
Colombia	83	12	11
Mexico	34	14	7
Peru	64	18	5
Venezuela	30	17	13

Latin American countries have dramatically reduced their trade barriers, including tariff rates. Most of the opening occurred between 1985 and 1995.

Sources: Data from *Crisis and Reform in Latin America*, by Sebastian Edwards, 1995; World Bank, *World Development Indicators*, © James Gerber.

CASE STUDY

Regional Trade Blocs in Latin America

Latin America has many regional trade agreements and some of the oldest. The first wave of agreements were signed in the 1960s as Prebisch and others began to recognize that ISI strategies eliminated the possibility for economies of scale and productivity increases that come with it. As long as production was limited to the home market, firms in many sectors would not be large enough to invest in research and development and to compete internationally. The solution was to encourage regional trade agreements such as the Central American Common Market (1961), the Caribbean Free Trade Association (1966, now called the Caribbean Community and Common Market) and the Andean Pact (1969, now called the Andean Community of Nations). The goals of these agreements are shown in Table 15.6. While the agreements conferred

TABLE 15.6 Selected Regional Trade Blocs

Trade Bloc	Year	Members	Goals
Andean Community of Nations	1969	Bolivia, Colombia, Ecuador, Peru	Customs union
Caribbean Community (CARICOM)	1973	Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, Saint Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago	Customs union
Central American Common Market	1961	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua	Customs union
Dominican Republic-Central America Free Trade Agreement (DR-CAFTA)	2005	Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, United States	Free-trade area
Common Market of the South (MERCOSUR)	1991	Argentina, Bolivia, Brazil, Paraguay, Uruguay, Venezuela	Customs union
United States-Mexico-Canada Agreement (USMCA)	1994	Canada, Mexico, United States	Free-trade area
Pacific Alliance	2011	Chile, Colombia, Peru, Mexico	Free-trade area

commercial advantages on firms located in member countries, they did not significantly alter trade patterns, nor did they increase the flow of trade within the regions. Countries resisted pressures to lower their tariffs, and momentum toward freer trade within trade blocs quickly dissipated. By the 1980s, the agreements were on paper only and were having scant effects on member countries.

With the onset of trade reforms in the mid-to-late 1980s, regional trade agreements once again became popular. Mexico took the lead in starting bilateral talks with the United States in 1991 which were soon joined by Canada. In addition to economies of scale, trade agreements seemed to hold the promise of attracting foreign investment as well as increasing market access and possibly diversifying trade partners. From the 1990s forward, a large number of agreements have been implemented as countries revitalized old agreements, signed new plurilateral agreements, and also created bilateral FTAs with countries inside and outside Latin America. For example, Mexico is a member of 22 regional trade agreements, including with Japan and the EU, and Chile is party to 29 agreements, including with the EU, China, Japan, and the United States. A complete list is available through the OAS's Foreign Trade Information System, http://www.sice.oas.org/agreements_e.asp.

The Next Generation of Reforms

The Washington Consensus overlaps with stabilization policies and structural reforms, and they are commonly mixed together under the label of neoliberalism. Neoliberalism and the Washington Consensus are negative terms throughout most of Latin America, primarily because the reforms of the last two decades have created uncertainty and change, but they have not begun to fulfill expectations of growth and prosperity. That is, the narrowly defined Washington Consensus may have helped some countries to end hyperinflation or runaway budget deficits, but it has not solved some of the region's most pressing and fundamental long-term problems. Inadequate growth rates, dramatic inequality, and vulnerability to macroeconomic crises and volatility continue to plague most of the countries of the region. After the reforms of the 1980s and 1990s, economic growth rates increased, but were still too low to offer much encouragement, and rates of poverty and levels of inequality hardly changed. Analysts in the mid-1990s began to talk about "reforming the reforms" and a "second generation of reforms," while popular frustration over the lack of material improvement in many countries led to widespread disillusionment with the reforms. Several countries (Brazil, Venezuela, Bolivia, Ecuador, Nicaragua) elected leaders who promised an end to the reforms or to at least moderate them, and while the new policies have varied, there is generally a much stronger element of nationalism and a reduction in market-friendly policies. Some leaders, like Hugo Chavez in Venezuela (1999–2013), called for the creation of a socialist bloc in Latin America and a complete repudiation of the last two decades of reforms.

More moderate reformers have begun to develop a second generation of reforms that take into account the region's institutions, and that address the problems of social and economic inequality. The reformers' goals are to develop more inclusionary economic systems by creating opportunities for excluded groups, to make countries less prone to macroeconomic crises, and to create greater flexibility by addressing some of the legal and institutional rigidities. For example, many small firms and individual-owned businesses or homes are located on property for which owners do not have a formal title. This situation makes it impossible for them to use their assets as collateral for loans, or to participate in the formal financial system. In effect, it limits growth by disallowing the full economic participation of a large share of small-scale entrepreneurs. To address this problem, bureaucratic processes must be redesigned and simplified, while legal and judicial structures must be reorganized to meet the needs of small businesses and individuals rather than large companies and powerful political interests. Similarly, bankruptcy laws that encourage risk taking, competition policies that break up monopolies, and financial sector supervision that limits unnecessary or unwanted risk are all areas that need work.

Mechanisms for addressing Latin America's highly unequal distribution of income are also on the agenda. In many countries, a long history of exclusion has blocked economic opportunity for particular groups, including indigenous people, African Americans, and isolated subsistence farmers. Although conditions vary greatly, most countries share an income distribution that is among the least equal of any region of the world. The mechanisms for addressing inequality are a greater emphasis on primary education and health care for children, as well as a set of social policies called **conditional cash transfers (CCT)**. CCT began in Brazil and Mexico and have been adopted in most of Latin America. These programs vary somewhat in their size and administration, but in each case, households are given a small monthly cash grant that is contingent on their children's school attendance and often also requires regular health check-ups and vaccinations. The thinking behind the programs is that families are more likely to send their children to school if there is a financial incentive, and the incentive has the added bonus of replacing any lost wages that might result from attending school rather than working. Early research into program effectiveness shows that there has been an increase in primary school attendance and a slight decrease in economic inequality.

Over the last twenty years, a few countries, including Mexico and Chile, have become among the most open and outward-oriented countries anywhere. In a relatively short period, Latin America has undergone a historical shift from a relatively closed, inward-looking region in which national governments led economic development strategies, to a relatively open, market-oriented region. This shift has required fundamental changes in economic policy and in the thinking of politicians and citizens. In many respects, the region had no choice because the previous strategy of ISI was unable to ease the debt crisis of the 1980s. So far, the results of these reforms are disappointing, but they highlight the need for reformers to consider more than economics alone as they struggle to find the sources of economic development in a more integrated world environment.

CASE STUDY

The Chilean Model

Chile suffered through a brutal dictatorship in the 1970s and 1980s. General Augusto Pinochet came to power in 1973 after a military coup that overthrew the democratically elected Salvador Allende. Pinochet tortured and jailed an unknown number of Chilean citizens and tortured and killed an estimated 2000–3000 more. He was an extreme nationalist who knew little about economics and preferred advisors who had no affiliation with previous governments. After the failure of his first economic advisor, he selected an ambitious group of Chilean academics who were outside the country's political establishment and who had received training at the University of Chicago. The University of Chicago was known for its free-market ideology, and Pinochet's economic advisors came to be known as the Chicago Boys.

The Chicago Boys quickly ended Chile's import substitution policies. They rapidly privatized banks, copper companies, and other firms that had been nationalized. They cut tariffs steeply, ended most import licensing requirements, and opened the Chilean economy to the world. Agricultural subsidies were cut and government supports were dismantled. The economy, which had been in crisis, began to grow two years after Pinochet gained power and after a disastrous recession in 1975. But the growth was illusory, and when a worldwide recession started in the early 1980s, Chile's economy collapsed. Banks were renationalized, and many of the trade reforms were turned back.

After two more years of crisis, the economy began to recover in 1984. This time, the Chicago Boys practiced a more pragmatic style of policymaking and growth remained strong through the remainder of the 1980s. By 1990, Pinochet was gone and democracy had been restored. A coalition of center and left parties, called Concertación, came to power and remained in office until 2010. During Concertación's twenty years in office, the presidency alternated between centrist Christian Democrats and leftist Socialists, but economic policy remained relatively constant. Ricardo Lagos, the Socialist Concertación president from 2000 to 2006, explained,

> *I do believe . . . that to have sound economic policies is not something of the right-wing or the left-wing parties. It's simply sound economic policies– now (that) took some time to learn.*[1]

Under the Chicago Boys and the brutal dictator Pinochet, and under Socialist and center-right (Christian Democrat) members of Concertación, Chile implemented a broad spectrum of market reforms. These governments introduced school vouchers that subsidize students, not schools. They established a system of individual retirement accounts that workers manage like a

(*continued*)

[1]Quote by Ricardo Lagos

mutual fund account. They built infrastructure such as roads, but if the government's budget was stretched too thin, they made them toll roads and got the private sector to construct them. They implemented a uniform tariff that is the same on all goods so it does not divert investment away from one sector and toward another, and they slowly reduced the tariff over time.

The governments that came after the Pinochet dictatorship kept many of the same market-oriented policies, even when the Socialists controlled the presidency. They added a series of new initiatives, however, to provide greater social justice. Health care was expanded, along with retirement funds for people who were too poor to have built up an individual account, and infrastructure spending was increased to connect the country and to increase mobility of goods, services, and people. Poverty rates fell, incomes rose, and Chile became a model for many other countries. Lagos explained the government's perspective in the following way:

> *It's one thing to say, "Look, we have a market economy." It's a different story to say, "I don't want to have a market society." I think it is really the big issue today in the world. It's true we are living in a global world where the market is allocating resources, but where to allocate resources in the area of public goods and services is something that remains in the domain of the citizen.*[2]

Summary

- Latin America was one of the fastest-growing regions of the world throughout most of the twentieth century. Growth came crashing to a halt in the 1980s, however, and only began to return in the late 1980s and early 1990s.
- Until the recent reforms, Latin American economic growth has focused on inward development rather than outward orientation. Productivity in subsistence agriculture has lagged behind overall growth, leading to much higher rates of poverty in rural areas than in urban ones.
- The primary development strategy of Latin America was adopted in the 1930s, 1940s, and 1950s. It came to be called *import substitution industrialization* (ISI) and focused on the inwardly oriented development of industries that could produce goods that would substitute for imports. This model of development was favored because it was thought that Latin America would suffer ever-declining terms of trade for its primary commodity exports, and that ISI would reduce the need for foreign exchange and imports, thereby making the region less vulnerable to economic shocks from outside.
- Economic growth under ISI was adequate, but ultimately it led to an inefficient manufacturing sector, excessive rent seeking, a persistent tendency

[2]Quote by Ricardo Lagos

toward overvalued exchange rates, and too great a concentration of resources on the urban sector.

- ISI policies were often made worse by the tendencies of many countries to elect or support economic populists. Populists favored economic growth and redistribution while, in the extreme, they ignored economic constraints such as government budgets and foreign exchange shortages.
- Populist policies generated macroeconomic instability, which often led to hyperinflation and falling real wages.
- The debt crisis that began in 1982 affected every country of the region, even those without high levels of debt or debt problems. As a result of the crisis, it became extremely difficult to borrow internationally.
- The main causes of the debt crisis were the increases in lending during the 1970s and the external shocks of interest rate hikes and primary commodity price decreases, especially oil. The faulty macroeconomic policies of many Latin American governments during the late 1970s and early 1980s made them more vulnerable to the shocks.
- The debt crisis resulted in negative growth throughout the region for most of the period from 1982 through 1987. By 1987–1988, the need for significant reforms in economic policy was apparent to almost all governments.
- From the mid-1980s through the present, the governments of Latin America have engaged in serious reforms of economic policy. The reforms have first tried to create macroeconomic stability through controlling inflation and reducing budget deficits. Stabilization policies have been followed by structural reforms that have opened trade, privatized, and reduced and redesigned the regulatory environment.
- Growth has returned to most of Latin America, but dissatisfaction with the economic reforms is widespread. Job creation is less than desired, inequality persists, and economic growth is below the rate necessary to significantly reduce poverty.

Vocabulary

Brady Plan

conditional cash transfers (CCT)

Economic Commission on Latin America (ECLA, or CEPAL in Spanish)

economic populism

export pessimism

heterodox model

neoliberal model or neoliberalism

orthodox model

Raul Prebisch

stabilization policy

structural reform policies

terms of trade (TOT)

Washington Consensus