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Understanding Market Reform in Latin America: Similar Reforms, Diverse Constituencies, Varied Results

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1.1 Introduction

Latin America has gone through a period of intense market reforms in the last twenty-five years. In contrast to the initial enthusiasm in the late 1980s and early 1990s, a vivid debate currently exists as to whether market reforms have been instrumental in fostering development and whether reforms should be deepened or reversed. Those who favor a deepening consider Chile as the successful flagship signaling the path to follow. Those who favor alternative strategies argue that the Argentine crisis or the transformations in the Venezuelan polity well illustrate the vulnerabilities that the market-friendly programs can create. This debate has an importance that goes far beyond academic circles to the extent that the arguments and conclusions will undoubtedly influence future development strategies to be adopted not only in Latin America but also in other developing regions. This book seeks to contribute to this debate. It presents a set of case studies of market reforms in Latin America (LA) produced within the framework of the Understanding Reform Project (URP), which comprises a larger set of case studies of market reforms in developing countries embracing all regions in the world.[1] The case studies in this book are authored by researchers drawn from the respective Latin American countries who are familiar with the institutional and political peculiarities of their own countries. All of the studies are comparable, given that they all derive from the same closely coordinated research project.

The research work discussed here has a number of distinctive features that are particularly relevant to the current policy debate. To begin with, the country studies comprise the most frequently cited reform cases in Latin America, both successes and failures. These are Argentina (Chapter 2), Brazil (Chapter 3), Chile (Chapter 4), Mexico and Peru (Chapter 5), Paraguay (Chapter 6), Uruguay (Chapter 7), and Venezuela (Chapter 8). The studies explicitly tackle questions that are central to the policy debate, such as: Why reform? What was reformed? Were the results in line with expectations? And, why did similar reforms work differently? The units of analysis in the case studies are not particular reforms (for example, trade or financial reforms) but the market reform processes as a whole, conceived of as instances of institutional change that call for intensive policy implementation. The research methodology assigns a central role to the analysis of the specific initial conditions and the details of the processes by which reforms were reached and implemented. Unlike most existing analyses, which tend to focus on economic outcomes, the authors view market reforms as exercises in institution-building embedded in specific economic, political, institutional, and cultural contexts. With the aim of disentangling the details of the process, the project utilized case-study methodology and adopted a multidisciplinary approach which combines economic, institutional, and political analysis to structure the narratives of the reform experiences.

The main aim of this introductory chapter is to present an overview and to assess the research findings of the country studies contained in the book. It focuses on the issues that are at center stage in the current policy debate on reforms in Latin America[2] and the chapter is structured accordingly. From the analytical point of view, the discussion relies heavily on the empirical and analytical results of the Understanding Reform Project, which are presented in Fanelli and McMahon (2005a, 2006a). Furthermore, this chapter must be read as a complement to the article that Forteza and Tommasi (2006) produced for the URP on Latin America. In the remaining part of this section we briefly discuss the conceptual side of such results. Section 1.2 presents the most salient features of the eight reform experiences analyzed, describes commonalities and differences between these experiences, and identifies stylized facts concerning initial conditions and outcomes of reform in the countries under analysis. Section 1.3 addresses the problematic side of reforms. It focuses on implementation, sustainability, and the legitimacy of the reforms. With the guidance of the conceptual framework, we pinpoint several unsolved questions, which basically have to do with the determinants of institutional persistence and change under structural conditions such as those in Latin America: conditions that include macro volatility, crises and external vulnerability, highly skewed wealth distribution, and a polity in transformation from authoritarianism to democracy. Section 1.4 concludes the chapter and draws policy implications

A brief look at the conceptual approach

We will now summarize the essential features of the conceptual framework (for a more detailed discussion see Fanelli and McMahon, 2005b and 2006b).

Market reform

A market reform is defined as the implementation of changes in the rules of the economic game by a legal authority to widen the role of markets and the private sector and to make the entire economy more open. This definition has implications for the analytical approach to understanding reforms. The most relevant dimensions are scope, depth, and consistency; effectiveness; sustainability; distributional conflict and political economy; uncertainty and learning; and the features of the policy.

Scope, depth, and consistency

Reforms primarily affect the formal rules of the game of the institutional structure. Since the institutional structure consists of rules pertaining to different hierarchies in diverse social domains that show varying degrees of formality, the scope and depth of a specific reform package will largely depend on the hierarchy of the rules to be modified and the domains involved.[3] Furthermore, the functional linkages between hierarchies, domains, and informal institutions will pose consistency constraints on reforms; dysfunctional reforms will likely lead to unsustainable institutional changes.

Effectiveness

To be effective (to permanently change constraints and incentives) the changes in the rules of the game must be designed, executed, and enforced. An effective state and the quality of the pre-existing organizations and institutions are central in this regard. The first generation of papers on reform focused on the analysis of the factors that induce the initiation of reforms (crises, attrition wars and so on) to the detriment of the factors that contribute to making reforms sustainable. Most LA countries have been able to launch reforms, but only a small number of the reforms were sustainable.

Sustainability

The factors that impinge on sustainability are not easy to grasp because sustainability raises the problem of the determinants of institutional permanence and change, which analytically is still in swaddling clothes.[4] Three issues are worth highlighting: first, an institution can be self-enforcing in its domain but dysfunctional with regard to the rest of the domains or rules of upper hierarchies; second, path-dependence is central to understanding institutional evolution, placing idiosyncratic factors at center stage; and third, since exogenous shocks can change the parameters of the institutional game, the features of the shock-generating stochastic process matter to sustainability.

Distributional conflict and political economy

Reforms result from a conscious choice to change the rules of the game and can affect the income, wealth, and political power of varied social groups. For example, different Pareto-efficient outcomes entail different resource distributions and, hence, forward-looking agents will take the probable distributional effects into account. Since market reforms impinge on rules pertaining to different social dimensions and hierarchies, they affect groups of individuals and organizations of varying sizes, who will play different roles as stakeholders to different transactions ruled by the governance structures that will be affected by reforms. The ability for collective action of a given group of individuals or organizations can differ substantially depending on the character of the transactions and governance structures that are at stake. It follows that the ability to solve collective action problems and distributional conflicts is an essential component of reforms and is not independent of the type of reform involved.

Uncertainty and learning

Uncertainty makes it difficult to anticipate what the reform path will be. Hence, the ability to change the rules under uncertainty, to learn, and to rectify are all factors influencing the reform path. Important variables in this respect are the ways in which political decisions are made; the features of the shock-generating stochastic processes; state and organizational effectiveness; and the ability for institutions and organizations to learn (that is, to change beliefs). Macro instability is inimical to cooperation and learning to reform because it increases uncertainty, feeds distributional struggles, and typically induces a short-term bias in decision-making.

The features of the polity

The polity enters the picture because a legal authority must implement the changes in the rules of the game and reforms must be supported by a suitable political coalition and an effective state. The way in which legal authority is legitimized, authority is exerted, and coalitions are built is primarily determined by the characteristics of the polity (that is, whether it is authoritarian or democratic; whether it is liberal or illiberal; whether the state is predatory or developmentalist). Political institutions are key to processing conflict among various stake holders without resorting to violence or civil disobedience. However, we cannot assume that these institutions are completely exogenous to reform; inter-temporal agreements depend on 'state' variables such as the distribution of political power (political institutions), the distribution of resources, and relevant beliefs. In this regard, it is important to determine whether reforms are imposed by special interests, whether the gains are widespread, and whether state capture phenomena are present. These elements impinge on the legitimacy of the reform.

The eight reform experiences analyzed in this book are rather dissimilar; therefore the studies do not necessarily deal with the same aspects of reforms, pinpoint the same set of empirical issues, or embrace all the dimensions covered by the above concepts. We will next summarize each of the country studies and pinpoint the issues that they emphasize.

1.2 Eight Latin American reforms: similar packages, varied results

The design of the reforms in each of the eight countries was essentially inspired by the Washington Consensus (WC) and – to varying degrees – by the ensuing 'generations' of reform blueprints.[5] In light of this fact, the variety of reform results – moving from clear successes (Chile) to outright failures (Argentina, Venezuela, Paraguay) – is at first striking. The evidence provided by the set of case studies included in this book can help account for this fact. The studies reveal that, indeed, the specific reform packages present different scopes and depth, ranging from gradualism to big bang and from orthodoxy to pragmatism. They cover a wide gamut of policy initiatives, implementation problems, and outcomes. The first part of this section summarizes the content of the country studies. The second part presents some stylized facts that we have identified concerning initial conditions, goals, and outcomes.

Summary of the country studies

Argentina

The study comprises the market reforms implemented in the 1990s. The scope and depth of the policy packages were far-reaching, embracing several tiers in the institutional hierarchy and the economic domain. One salient feature of the Argentine strategy of reform was the bundling of measures, such as privatization and market deregulation, with stabilization (convertibility or currency board). The reform process was particularly intensive in the early 1990s. Despite significant early success, it ran into serious difficulties at the end of the decade, ultimately leading to a full-blown economic and political crisis. The Argentine experience vividly illustrates the fact that the effective implementation of legal changes is not sufficient to ensure reform sustainability. The following points are worth highlighting. (a) Although the 1989 hyperinflationary crisis did foster reforms, the Argentine case suggests that crises do not necessarily produce good-quality policies; crisis-induced institutional, distributional, macroeconomic, and political disarray created path-dependence effects that severely constrained society's institution-building ability. (b) After hyperinflation, it was necessary to build institutions to ensure sustainable macroeconomic fundamentals. 'Convertibility' (the currency board implemented in 1991) was an institutional shortcut towards the building of such institutions but it did not work. Budget disequilibria primarily associated with favors to over-represented provinces ultimately dominated the currency board regime. (c) The characteristics of the polity influenced sustainability. President Menem – who led the country from 1989 to 1999 and implemented most of the reforms – resorted to clientelistic political machineries, which, in turn, harmed the quality of institutions and eroded the political legitimacy of the whole process. (d) Under these circumstances, the idiosyncratic distribution of political power and the ability for collective action of some interest groups (powerful provincial governors, some union leaders and conglomerates that participated in the privatization process) hindered the quality of the reformed institutions. (e) Argentina was envisaged as the poster child of the Washington Consensus reforms and the reforms were explicitly supported by multilateral organizations and market participants. After the demise of the reforms, not only the government's legitimacy but also that of the international players weakened. It is no wonder that the ensuing government adopted an anti-reform discourse.

Brazil

The study embraces the entire period of reform from the first stabilization and trade liberalization initiatives of the 1980s. The authors classify the experience as gradualist because market reforms in Brazil are essentially a loosely coordinated process of partial state retrenchment that spans the last twenty years. Since the initiation and deepening of reforms were frequently motorized by the goal of reducing macro instability, initiatives of institutional change were often bundled together with other urgent or popular policies to facilitate their approval. They were not enacted as a coherent, overall change in development strategy, but as an incomplete, flexible, mostly disconnected reform process. The study stresses that what stands out in Brazil's reform process, in comparison with other developing countries, is not so much the depth and nature of the reform, or the main contextual factors encouraging it, but rather the 'why' and 'how' of reform. A democratic polity carried out the reforms; democracy was restored in 1985 after a two-decade authoritarian military government. The fragmented character of the political system, together with the importance of the federal states favored pragmatism and negotiations about reform initiatives. Ideology and partisan politics played a lesser role in fostering market reforms in Brazil than in other countries of the region. Therefore, reforms in Brazil tended to be contested, piecemeal, and pragmatic, in that they largely targeted specific problem-solving. The Brazilian state has been particularly effective at transforming some areas largely thanks to the quality of the bureaucracy it inherited from the previous interventionist regime. For example, the authors call attention to the intensive participation of the BNDES – the Brazilian development bank – in the privatization process. The outcomes are mixed. Reformers succeeded in widening the participation of private players, enhancing productivity in certain sectors, and reducing the inflation rate. They also induced higher trade and financial openness, but were unable to accelerate growth or induce a substantial change in the skewed distribution of income. The achieved growth rates are not comparable to those observed during the import-substitution industrialization period. Indeed, reduced state intervention in the economy was more the result of a pragmatic reaction of the political elite to external pressures and a lack of alternatives than the outcome of a newfound ideological conviction.

Chile

The Chilean market reforms had ample scope and depth; they were a large-scale exercise in institution-building that radically changed Chile's institutional landscape. On the basis of the findings analyzed, it is only natural to classify Chile as a reform success. In the last twenty years it has transformed itself from an 'average' Latin American country into a dynamic economy that now exhibits accelerated growth rates and decreased volatility. This experience has played a prominent role in LA in that, first, it pioneered the implementation of pro-market policies and, second, several countries tried to emulate Chilean reforms. The market-oriented reforms were initiated in the early 1970s and were generated by the demise of the previous regime, which had a socialist orientation and had undergone a severe macroeconomic crisis in the period immediately preceding the *coup d'état* that General Pinochet led in September 1973. The case study describes the entire reform process with emphasis on the political economy and incentives behind the two main political regimes that undertook them: the authoritarian government of General Pinochet between 1973 and 1989 and the democracy that succeeded it. Despite the positive outcomes, the process went through periods of severe disequilibria during the implementation stage. The most important occurred in the early 1980s as a consequence of both domestic policy mistakes – induced by the wrong sequencing of trade and financial reforms and misleading macroeconomic policies – and external shocks, triggered by the debt crisis. Despite this, the authoritarian government was able to implement measures to set the market reforms on track once again. The currency was devalued substantially and the authorities intervened intensively in the banking sector to bail out the system. The acceleration of growth after 1985 played a central role in making reforms sustainable and encouraging the first democratic government – the opposition won the election – to maintain the course of reforms. Other important factors in this regard were the negative 'demonstration effects' provided by the deep macroeconomic disequilibrium that the first government of the newly recovered Argentine democracy experienced in the 1980s and the collapse of the socialist system and the fall of the Berlin Wall. Beyond the important economic outcomes of the reform, what is most significant from the point of view of our analytical interest is that: (a) the transformations in the polity reinforced reforms – the changes in the upper-level institutions of the hierarchy reinforced rather than debilitated the functionality of economic institutions; and (b) Chile managed to overcome a sizable crisis in the 1980s that was largely due to the ill-designed implementation of market reforms; in other countries this type of crisis stalled or reversed reform attempts.

Mexico and Peru

The chapter on Mexico and Peru presents a structural reform process as an attempt to change the institutional setting in which the economy operates, a transaction between agents within a central policy domain so as to alter the pattern of interaction between political and economic rules for the purpose of improving the economy's performance. Peru and Mexico are taken as contrasting examples of the way in which reformers solve complex implementation and sustainability problems. Peruvian and Mexican reformers operated under different formal and informal institutional settings, although they shared similar difficulties and used informal enforcement mechanisms to push the reform process. The chapter argues that the institutional environment provides the setting and means to reject, abort, or enforce the proposed deals in the reform process. The authors emphasize the role of the mental models that agents employ. The reform process in Mexico was gradual and spanned almost twenty years from its beginning in 1982, following the debt crisis and the abandonment of the populist policies associated with oil discoveries and high prices in the 1970s. The chapter distinguishes a number of different groups relevant to policies, embracing technocrats, PRI politicians, and other political forces. Both the PRI and the technocrats lost power after the Tequila Crisis in 1994. The corruption scandals associated with Salina's presidency also ultimately contributed to this result. The weakening of the PRI and the strengthening of new players in Congress and the regions resulted in the stalling of reforms. Growth acceleration did not occur despite Mexico's signing of the NAFTA agreement in 1993 and the reduction of macroeconomic imbalances. Before launching reforms in the 1990s, Peru went through deep macroeconomic disequilibria. The most important indicator was the acceleration of inflation that took the country to the brink of hyperinflation. On the political front, the democratic polity faced the challenge of the Shining Path guerrilla movement. Fujimori's strategy in the 1990s was a kind of shock-therapy, bundling structural reforms with stabilization. The government adopted an increasingly authoritarian stance, which included a self-promoted *coup d'état* and a modification of the constitution to allow Fujimori's re-election. His regime collapsed in late 2000 when corrupt political agreements were revealed. The reform process lost momentum and legitimacy. The ensuing government was not effective at deepening the reforms. The authors conclude that corruption is associated with the lack of strong and operative formal institutional channels to make reforms effective. This raises the importance of 'parallel' or informal institutional channels and results in the hijacking of the reform agenda and corruption. This problem was more severe in Peru than in Mexico. They also argue that the ability to strike intertemporal agreements in Mexico favored gradualism and sustainability. In Mexico, PRI's lengthy tenure provided a longer horizon and coordination capacity. With a long horizon a gradual reform process is more credible as specific transactions can be advanced gradually. In Mexico, successive presidents insisted on including PRI's opposition in the reform negotiations and the central administration provided the means to deliver the presidents' promises. Fujimori, on the contrary, tried to destroy any opposition.

Paraguay

The scope of the reforms implemented in Paraguay was narrower than in other countries of the region, although Paraguay had been traditionally open to trade. Privatizations were not important and financial liberalization resulted in two financial crises. In explaining the failures, the authors emphasize path-dependence effects associated with the predatory character of the state under Stroessner's dictatorship. The demise of this predatory state occurred as a consequence of the exhaustion of the traditional sources of rents (the expansion of the agricultural frontier and the construction of large dams in association with Argentina and Brazil). The reform process began in the early 1990s within the context of the transition toward democracy but the new polity failed to replace the institutions of the predatory state with new development-friendly institutions. A central proposition of the case study is that successful policy reform in Paraguay has been impeded by the poor quality of the political institutions the country inherited from the old regime. The lack of an effective bureaucracy and the increasing demands of workers, peasants, and civil society during the transition to democracy were additional obstacles. The existing institutions could neither protect the property rights of actual and potential investors and provide political stability, nor ensure that political elites (particularly the Colorado Party) faced effective, formal constraints on their behavior. Neither could these same institutions promote the participation of a broad cross-section of society in either the formal economy or in the political life of the nation. Given the importance of path-dependence, the authors undertake a brief analysis of Paraguay's political history to highlight a set of elements and events that contributed to the failure of institution-building and policy reforms, such as authoritarian personalities, two bloody wars, and a political culture where interpersonal relations based on kinship, friendship, and partisan allegiances prevailed regularly over impersonal relationships, rules, and obligations. The case study illuminates, in this way, the importance of cultural factors and transactions that are governed by rules of the game in the shadow of the law. These factors render the changes in the legal structure immaterial and the reforms ultimately produced a set of mostly dysfunctional institutions. Since the polity also failed to strengthen the legitimacy of the process, it is not surprising that the reforms proved to be unsustainable.

Uruguay

Like Brazil, Uruguay can also be classified as a gradual reform process. The case study covers the extended period of structural reform that has been taking place in Uruguay since democracy was restored in 1985. The authors adopt a wide approach to market reform. The analysis deals not only with the reforms as they have been summarized in the WC, but also with political reform and the consolidation of democracy. The general goal is to understand reform in a broad economic and political sense. The study does not merely assess the reforms implemented, but also tries to understand why the market-friendly reforms moved faster in some areas than in others, who promoted and who opposed reform, and how the political process shaped the reform. One main point that the study highlights is that civil society played a central role; plebiscites approved or rejected specific initiatives, which decisively affected the content and timing of reforms. They also pinpoint that pluralism was a central feature of the polity. Indeed, Uruguay is a paradigm of how political economy variables affect the implementation and sustainability of reforms. The ultimate outcome of such a process is an amalgam of rules of the game corresponding to different regimes. The authorities advanced substantially concerning trade and financial liberalization, but there has been little progress concerning labor markets and privatization because of the stakeholders' opposition. The reform process has also been affected by the country's external vulnerability. As in the case of Brazil, although a left-wing party won the last elections, there have been no reform reversals. The authors conclude that reformists have not won the battle for public opinion in most policy areas in Uruguay. The disappointing economic performance of the country in recent years and Argentina's collapse contributed to discrediting pro-market reforms. However, at the same time, social and political unrest in Uruguay have been very limited during the crisis, and the political system still appears to be strong. The authors conclude that political pluralism explains the puzzle; the institutions provided channels and legal means (plebiscites) for vocal groups to express disagreement. This strengthened political legitimacy. The cases of Brazil and Uruguay suggest that gradualism and pragmatism can reduce the speed and scope of reforms, but can also strongly benefit sustainability.

Venezuela

The study comprises *El Gran Viraje* (The Great Turnaround), an ambitious agenda of macroeconomic and structural reforms led by President Carlos Andrés Pérez during his second presidency (1989–93) and the *Agenda Venezuela*, which was implemented during the Caldera administration in 1996. From the evidence discussed it follows that Venezuela's limited but revealing experience with market-oriented reform can be classified as a failure. The authors state that although Venezuela's failure to reform may be surprising in light of its massive oil revenues, it is not the case once institutional and political economy variables have been taken into account. They stress that oil revenues allowed policy-makers to maintain an 'illusion of harmony' for an extended period of time by financing an increasingly subsidized and distorted economic system managed through an even more complex patronage-based political system. When the government found itself financially unable to prolong this state of affairs in 1989, the public and the polity reacted harshly. Cultural attitudes generate path-dependence and cannot be changed overnight but the Pérez administration did not take this into account and adopted a big-bang shock therapy based on a textbook version of the WC, which generated popular unrest (the Caracazo) and ultimately undermined political stability. The reforms either reversed or stalled during Caldera's government. The current regime, led by Hugo Chavez, has adopted a strong anti-neoliberal stance. One central implication of the research work is that the general failure of the two reform initiatives that took place between 1989 and 1998 illustrates the overriding importance of political, cultural, and institutional constraints in determining the outcomes of the economic reform.

This is in line with the empirical institutional literature. The experience of resource-rich nations with reform indicates that policy-makers in these countries tend to face stronger opposition in their attempts to reform, suggesting that the political economy of resource wealth has a strong and negative effect on institutional development, promoting rent-seeking behavior and generating untenable expectations based on shared beliefs that are difficult to change.

On initial conditions, goals, and outcomes

One main conclusion of the URP (Fanelli and McMahon, 2006b) is that initial conditions and the overall political context are central determinants of the reform path and that this fact contributes to explaining why similar reform packages frequently result in markedly different outcomes. Table 1.1 presents data concerning a set of initial conditions and contextual dimensions that are highlighted in the eight studies: the level of macro volatility; whether a crisis preceded the launching of reforms; the growth performance under the previous international and policy regime; the extent and quality of the integration in the global economy; social disparities; and the characteristics of the polity and the institutional infrastructure.

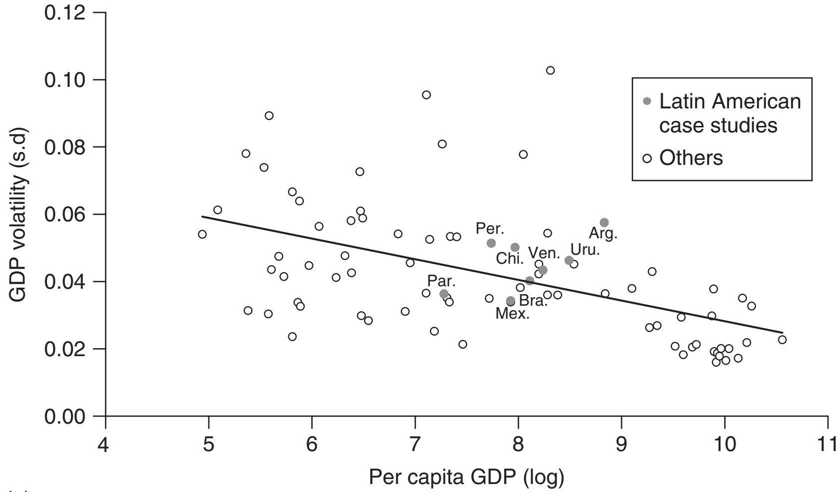
High volatility was a common feature characterizing the pre-reform scenario. To a certain extent, this is not surprising because macro volatility is a standard trait of developing countries. The literature shows that there is an inverse relationship between the volatility of the growth rate and per capita GDP; likewise, consumption tends to be more volatile than income in poorer countries.[6] It is worth noting, however, that the kind of macro instability described in the case studies is often extreme; for example, Argentina underwent hyperinflation and others were on the brink of it in the 1980s (for example, Brazil). Figures 1.1a and 1.1b show that the countries under analysis can be classified as volatile even if we take developing countries as our standard. The countries in our sample tend to be above the volatility/per capita GDP regression line (Figure 1.1a) and almost all of them display higher consumption than output volatility (Figure 1.1b).

As Table 1.1 shows, sizable crises occur in all cases in the period preceding the implementation of reforms and, in some countries, additional crises transpired during the implementation of the reforms. Chile, the leading reformer, launched the program of structural reforms after the economic breakdown that accompanied the fall of the socialist government in 1973 and had to endure a second period of financial and aggregate turbulence in the early 1980s. The vulnerabilities created by an ill-designed sequencing of market liberalization policies impeded the authorities from insulating Chile from the 'debt crisis'. Indeed the long-lasting recessionary and inflationary consequences triggered by this latter crisis affected the entire region, giving rise to the so-called 'lost decade'.

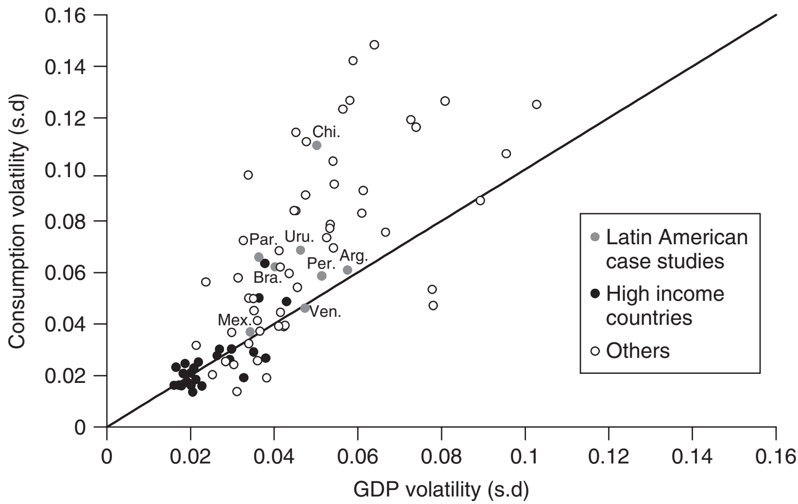
The studies clearly show that the deep disequilibria of the 1980s created a propitious environment for policy innovation. The Chilean reformers

Table 1.1: On the initial conditions

Country	**Macro volatility**	**Crisis**	**Growth under BW–ISI regime**	**Integration with global economy**	**Social disparities**	**Polity characteristics**
Argentina	Very high	Debt crisis and hyperinflation	Disappointing	Deficient	Moderate, worsening fast	Recovered democracy
Brazil	Very high	Debt crisis and very high inflation	High	Deficient	Very high	Recovered democracy
Chile	Very high	Socialist regime demise and debt crises	Disappointing	Deficient	High	Authoritarian/ recovered democracy
Mexico	High	Debt crisis	Good	Deficient	High	PRI semi-democratic regime
Paraguay	Moderate	Exhaustion of rents (Itaipu effect)	Moderate	Moderate	High	Recovered democracy
Peru	High	Debt crisis	Good	Deficient	High	Recovered democracy
Uruguay	High	Debt crisis and failed liberalization	Disappointing	Deficient	Good, reasonably stable	Recovered democracy
Venezuela	High	Struggle over rents	Moderate	Deficient	High	Democratic regime



(a)



(b)

Figure 1.1 (a) GDP volatility and per capita GDP, 1960–2002; (b) Consumption volatility and GDP volatility, 1960–2002
Source: World Development Indicators, World Bank.

introduced significant changes in the reforms that had been implemented in the 1970s while most of the countries under analysis – Argentina, Brazil, Mexico, Peru, and Uruguay – introduced structural reforms as part of the policy efforts to overcome the effects of the debt crisis. The only country that deviates somewhat from this general pattern is Paraguay. The crisis in this case is basically associated with the exhaustion of the sources of rents – the completion of the Itaipu Dam – that had sustained the predatory state. The Venezuelan crisis is also closely associated with struggles over oil rents.

Other relevant commonalities during the pre-reform period are the widespread and systematic inability to exploit the opportunities provided by the international economy, the presence of important social disparities – although the size of these disparities was much lower in Argentina and Uruguay – and the fact that all these countries were undergoing a period of transition from authoritarian polities to democracy when major reforms were launched. The main exception in this regard is Chile, where the reforms were initiated by an authoritarian government, and then deepened substantially by democratic governments.[7]

Growth performance under the previous regime shows much less commonality. The growth data concerning the 1950s, 1960s, and 1970s – when the Bretton Woods (BW) regime and the import-substitution industrialization (ISI) strategy policies ruled – confirm this fact. Table 1.2 indicates that there was a substantial contrast between the remarkably good evolution in Brazil and Mexico, the largest economies in the region, and the exceedingly poor performance in Argentina, Uruguay, and Chile. The differences in the growth rate under the BW–ISI regime were, nonetheless, important for another reason: they created path-dependence. This occurred to the extent that, first, the growth memory influences the public opinion's perceptions of policy options; and second, initial conditions were, *ceteris paribus*, better in those economies that had been growing over a long period. Brazil is a good case in point. The authors highlight that growth success during the BW–ISI favored less orthodox approaches to policy-making and the public bureaucracies associated with the ISI period conserved their effectiveness and were able to contribute to the success of reforms (as is the case of the BNDES participation in the privatization process or the role of the technocracy in Mexico). These path-dependence effects are at the root of the more pragmatic approach to reform in Brazil and gradualism in Mexico. In the case of poorer performers, such as Chile and Argentina, the commitment to 'old' policy views was weaker and, hence, reformers tended to favor approaches more akin to the new WC orthodoxy.

We must take into account, notwithstanding, that independently of evolution during the BW–ISI period, all the countries in our sample went through a period of stagnation or, at least, substantial growth deceleration in the 1980s. The figures corresponding to the 1980s in Table 1.2 are clear in this respect. At the end of the 'lost decade', there was thus a wide consensus that the previous growth strategy was exhausted and that a deep change in the domestic rules of the game would be necessary if the countries were to take advantage of globalization. As the policy and analytic debate on this change unfolded, the proponents of market-oriented reforms tended to prevail. Two experiences played a highly exemplary role in this regard: the 'export-led growth' strategy

Table 1.2: Latin American growth

	Latin America		**Argentina**		**Brazil**		**Chile**		**Venezuela**	
	GDP	GDP per capita	GDP	GDP per capita	GDP	GDP per capita	GDP	GDP per capita	GDP	GDP per capita
1950/59	4.9	2.1	2.4	0.6	6.5	3.3	3.8	1.5	7.7	3.68
1960/69	5.7	2.8	4.4	2.9	6.2	3.2	4.5	2.2	5.4	1.92
1970/79	5.6	3.1	3.0	1.4	8.6	6.0	2.0	0.3	4.9	0.98
1980/89	1.7	−0.4	−0.6	−2.1	2.9	0.8	3.2	1.6	0.0	−2.55
1990/99	2.8	1.0	4.2	2.9	1.8	0.3	5.4	3.9	2.4	0.12
2000/05	2.6	1.1	1.8	0.8	2.3	0.9	4.3	2.1	2.8	0.66

	Mexico		**Uruguay**		**Paraguay**		**Peru**	
	GDP	GDP per capita	GDP	GDP per capita	GDP	GDP per capita	GDP	GDP per capita
1950/59	5.9	2.9	2.1	0.7	2.3	0.0	4.2	1.9
1960/69	7.1	3.8	1.5	0.7	4.0	1.2	5.4	2.4
1970/79	6.5	3.3	2.3	1.6	7.9	4.7	4.6	2.0
1980/89	2.1	0.0	1.0	0.3	4.0	1.0	0.3	−1.9
1990/99	3.6	1.8	3.2	2.5	2.2	−0.5	3.4	1.6
2000/05	2.6	1.1	0.6	−1.3	1.6	−1.1	3.9	1.8

Source: ECLAC.

of the Asian Tigers and the Chilean success at overcoming volatility and restoring growth after having been severely hit by the debt crisis in the first half of the 1980s.

In sum, except for the remarkably positive fact that democracy was returning to the region, the pre-reform picture was highly discouraging. It is no wonder, then, that the goal of implementing decisive changes in the initial conditions appears at center stage in the reform programs analyzed in the studies. Indeed, the studies indicate that pro-market coalitions prevailed in the political arena because public opinion – or, at least, the leaders who won the elections – perceived that market-oriented reforms were the best instrument to overcome both the sizable macro disequilibria that were being observed in the 1980s and some of the key traditional obstacles to development in LA. More specifically, the debates that preceded the intensification of reform efforts and the evidence in the case studies indicate that structural reforms were intended to:

1. *Reduce aggregate volatility and the frequency of crises*. A number of the WC measures aimed to achieve macro stability.
2. *Improve the degree and quality of the integration with the global economy*. It was central in the diagnosis of the failure of the ISI experience that Latin American countries' trade and capital accounts were too closed and financial markets too repressed.
3. *Accelerate growth*. This would be the consequence of abandoning market-repression in favor of market-friendly policies and institutions (privatization, deregulation, and secure property rights). Specifically, heterodox measures to accelerate growth were banned either explicitly or by default.[8]
4. *Ameliorate social problems*. The redirection of public expenditure towards primary health care, primary education, and infrastructure was the WC's main instrument; the ensuing generations of reforms recognized that specific policies were necessary, especially concerning poverty alleviation and the goal of empowering the poor.
5. *Contribute to strengthening democratic institutions*. This was not in the WC. However, the political discourse more or less suggested that liberal democracy and markets were complementary and the accent of the second-generation blueprint on institutions would naturally include the role of upper-level institutions.
6. *Promote a new market-friendly culture*. Informal institutions were not in the WC, but entered the picture hand-in-hand with the increasing emphasis on the need to reform the formal rules of the economic game. By opening new opportunities, a deregulated environment would change informal cultural patterns, strengthening entrepreneurship and investment and empowering the poor (for example, via land titling).

Given the centrality of these goals on the reform agenda, it is only natural that, for better or worse, public opinion and the political elite's perception of the reforms' degree of success is heavily influenced by the judgment on the degree to which reforms were effective at achieving these goals, although, of course, growth and macro stability have played the most prominent roles in the outcomes versus goals debate.

Although the late 1980s were by no means promising, growth has recovered in the last fifteen years – when major reforms were implemented. This recovery, however, shows four main weaknesses. First, the performance under the newly defined domestic institutional setting is far from impressive when assessed on the basis of the performance of the Latin American economies in the 1950s, 1960s, or 1970s, when the ISI policies and state interventionism were the rule rather than the exception (see Table 1.2). Second, although there are cases of great success (for example, Chile), in several cases the growth processes were unstable and substantial crises occurred (for example, Argentina, Venezuela, Mexico, Uruguay). Third, although these crises were in part associated with failures in international capital markets, the international financial architecture proved to be inefficient at either preventing the occurrence of crisis or at managing its consequences (see Prasad et al., 2004). It is no wonder, consequently, that both domestic and international institutions are being blamed for not helping to recover growth and some authors suggest that there is reform fatigue. Fourth, there was no substantial progress concerning distributional issues and social inclusion. The income distribution indicators show that distribution has not changed much in the last two decades (although it worsened substantially in Argentina), while poverty indicators improved and unemployment worsened (ECLAC, 2006). Social inclusion and poverty have been a problem in LA in the past, and they are still a problem.

To be sure, from the analytical point of view, comparing goals and outcomes is not the best way to determine how instrumental market-friendly reforms were in restoring growth and stability. For one thing, we need to control for the influence of other exogenous variables that impinged on reform results. It is one thing to describe what happened after the initiation of reforms and quite another to attribute the outcomes to specific policy initiatives. One important conclusion of the URP (Fanelli and McMahon, 2006b) is that it is very difficult to identify the policy–outcome linkages. However, although this is somewhat obvious at the academic level, it is not necessarily so at the polity and public-opinion levels. The coalitions supporting Washington Consensus-like policies presented reforms as a way to restore a sustainable growth process and not much effort was devoted to discussing the subtleties of the policy–outcomes linkages. Therefore, even recognizing the difficulties in assessing the policy–outcome linkages, an examination of the degree to which structural constraints have changed in the 'post-treatment' period is relevant from the political economy point of view because citizens have to vote and investors and politicians have to make policy decisions in a world devoid of counterfactuals.[9]

1.3 The problematic side of reforms: implementation, sustainability, and legitimacy

The preceding review reveals four important facts: one, all countries have been able to initiate substantial market-oriented reforms; two, the implementation difficulties were more complex than had been expected; three, the sustainability of the newly-instituted market rules is far from guaranteed in several cases; and four, weak substantive results have produced a certain 'reform fatigue' in the region (Lora et al., 2004) and, as a consequence, the legitimacy of the process is under scrutiny.

Why was it 'easier' than expected to initiate pro-market reforms? The evidence in the studies assigns a critical role to crises and favors the hypothesis that crises beget reforms. The periods of deep macro and financial disequilibria – particularly those associated with the debt crisis – were instrumental in tearing down the political economy equilibrium corresponding to the ISI regime. The transformations in the international scenario also contributed to accelerating institutional changes; in particular, the exchange rate instability and financial deregulation in developed countries and the positive demonstration effect of 'export-oriented' policies in Asia. The ISI policy regime and the postwar shared beliefs about development strategies that had been functional to the BW order became increasingly anachronistic under globalization, which made outward orientation more appealing and weak macro policies more painful. Hence, both the changes in the environment and the endogenous forces associated with the exhaustion of the ISI regime called for institutional changes. While the endogenous evolution of the 'quasi-parameters' defining the ISI political economy ultimately produced a crisis, the characteristics of the changes in the international parameters help to explain why the orientation targeted deregulation and opening.

These developments account for three salient characteristics of reform implementation. First, given that reforms were fostered by macro instability, the bundling of stabilization and structural reforms was the rule rather than the exception in the case of LA. Policy bundling additionally reflected a mounting consensus concerning the fact that achieving macro stability was a requisite to restore sustainable growth. Nevertheless, the studies suggest that policy bundling techniques were not particularly well known. For one thing, in some instances (notably Argentina) policy bundling became an important obstacle to deepening structural reforms because public opinion perceived the failure of stabilization as the failure of the reform package as a whole. This is only natural to the extent that the reformers' rhetoric generally emphasized the importance of bundling structural change and stabilization policies. This rhetoric was not based on a sound knowledge of ways to build institutions under volatile conditions, that is, about ways to sustain structural reforms if the stabilization of the economy were to take longer and demand a greater effort. Indeed, the contrast between the successful Chilean experience and the Argentine and Uruguayan performances in the 1980s suggests that the Chilean positive evolution partly had to do with the ability to keep reforms going even in the face of a crisis, which to a degree resulted from policy mistakes concerning sequencing. Argentina and Uruguay incurred similar sequencing mistakes but were unable to maintain the reform momentum during the lost decade. Second, trade and capital account opening, together with a dramatic relaxation of controls on foreign direct investment, was the first reform implemented and has shown significant progress; the indices of reform progress in trade and liberalization show the best performance (Lora et al., 2004; Forteza and Tommasi, 2006). To be sure, the studies document that the opening occurred at different speeds and reversals have occurred. But the current overall degree of financial and trade openness cannot be compared with the ISI period. The most revealing example in this regard is the significantly higher degree of opening that Mexico and Brazil currently show, two economies that grew substantially during the ISI years. In addition, when reversals did occur, they were mostly temporary and triggered by deep balance of payments crises. Chile in the 1980s is a good case in point. But even Argentina and Uruguay, which underwent sizable crises, were able to sustain an open economy. Third, the progress of external liberalization contrasts with the difficulties on the domestic side of structural reforms. The country studies document numerous cases of delay, stalling, and reversal. Delay is the rule rather than the exception concerning the second-generation proposals for upper-level institutional changes (the judiciary, regulatory bodies), but first-generation reforms such as privatization, tax reforms, the deregulation of financial intermediation, and increasing labor market flexibility also show little progress or sustainability problems.

These facts indicate that political economy factors have been a primary determinant of the observed implementation path to the extent that the content and timing of reforms depended on the way in which the authorities solved the tension between the opposing forces of globalization and pro-market orientation, on the one hand, and political and stakeholders' pressures on the other. Furthermore, the studies document that the characteristics of the policy choices were heavily dependent on the specific features of the constituencies involved and the economic situation. Those reforms that implied substantial political conflict or had strong distributional implications, but were not strictly required to maintain trade and financial opening in the short run or to stabilize the economy, tended to be delayed or stalled, as was the case of labor market reform. In other cases, the authorities could not avoid the implementation of measures with hard distributional consequences. This was typically the case of stabilization programs, which were difficult to postpone because global markets are intolerant of macro disequilibrium. This process eventually led to the emergence of dysfunctionalities between the rules of the game that were effectively implemented in different domains.

One indicator that the implementation difficulties have frequently been severe is that the case studies report that all the countries underwent post-reform crises, although the ability to control the consequences differed significantly. The reforms in Argentina, Venezuela, and Paraguay were the interlude between two macroeconomic crises. In the cases of Chile, Peru, Mexico, Uruguay, and Brazil, on the other hand, the post-reform turbulences did not lead to a collapse. Chile was the only case in which the polity deepened institutional transformations following a post-reform crisis. Indeed, the size of the crisis and the polity's ability to manage the consequences were primary factors in determining the overall sustainability of reforms.

For a reform to be sustainable, two conditions should be met: first, the emerging institutional structure should be robust to (exogenous) changes in the relevant environment; second, the self-enforcing outcomes that the new rules generate should not cause (endogenous) modifications in the parameters that result in the demise of the institution. In light of these conditions, the post-reform institutional outcomes analyzed in the studies can be classified into three categories: sustainable (Chile), weakly sustainable (Uruguay, Peru, Mexico, Brazil), and unsustainable (Argentina, Paraguay, Venezuela).

Both endogenous and exogenous factors were important threats to sustainability. Concerning the latter, two primary sources hindered sustainability. The first was the international economy. The studies document that external vulnerability was important. The Tequila, Asian, and Russian crises severely affected the reform path. In the case of Uruguay and Paraguay, the Brazilian devaluation in 1999 and the Argentine default in 2001 were also key determinants. The second was the democratization of the polity. The changes in the international scenario with the end of the Cold War were functional to democratization because the 'communist threat' ceased to 'legitimize' dictatorships. The process of democratization was the cause of domestic shocks that were exogenous to economic institutions, whose different consequences on reforms depended on the characteristics of the constituencies involved.

As to the endogenous factors that impinged on sustainability, the evidence in the studies suggests that *institutionalization* played a central role. The characteristics of institutionalization were endogenously determined by the interactions between the quality of the blueprint, state effectiveness, and political economy factors. Since these elements differ from country to country, the ultimate outcomes of the process – the instituted rules – show a wide variance and diverse degrees of functionality. In some cases the outcomes were basically in line with expectations, but in others they differed substantially. We have seen that the changes were significant in those areas where the pressure exerted by globalization forces was strong (trade, foreign investment, and financial flows). Conflictive areas, in contrast, show less progress. Therefore, the current institutional frameworks are amalgams of formal and informal institutions corresponding to the old (ISI) and new (market-oriented) regimes – including mutant institutions resulting from reversals – combined in different proportions. The Argentine experience with convertibility is a good illustration of the way in which a dysfunctional institutional structure can undermine sustainability. The Argentine authorities implemented a currency board regime, which is a very effective but extremely rigid strategy to curb high inflation. By prohibiting monetary emission originating in domestic sources, it was assumed that the fiscal deficit would be checked and that the labor market would become more flexible because the currency board was incompatible with a loose fiscal policy and rigid nominal prices. Of course, the downside was that the dysfunctionality between the rigid rules of the currency board and the existing institutions in the fiscal and labor markets led to a macroeconomic breakdown. The important point is, however, that the fiscal and labor formal and informal rules of the game dominated the currency board rules and the macroeconomic crisis spilled over into other domains, making the entire reform attempt unsustainable.

The implementation and sustainability problems documented in the studies show that reformers did not fail to initiate the reforms, but to institutionalize them. Indeed, one key weakness of the market-reform approach was that it conceived of institutionalization as a 'comparative static' rather than a dynamic exercise. The Chilean polity and state bureaucracy have been very effective at institutionalizing the reforms, to the extent that a functional structure of market-friendly institutions emerged from the process. In Mexico and Peru, the new rules of the game have been effectively introduced in many areas, but the functionality of the structure as a whole is not as good as that of Chile. In addition, the transformations in the polity in these two countries also hindered the quality of reforms. In Brazil and Uruguay, the new institutional amalgam includes rules pertaining to both the market-oriented and the older paradigm. Furthermore, in these two countries the path-dependence constraints highlighted by cognitive institutionalists (Denzau and North, 1994) are highly relevant. In Uruguay, deeply-rooted shared beliefs about the role of the state in the economy led to the rejection of reforms in plebiscites that stakeholders had pushed. In Brazil, trade liberalization and privatization did not displace the shared beliefs about the importance of industrial policies inherited from the ISI period. BNDES is a good example of the hybrids that resulted; while BNDES played a significant role in the privatization process, it still allocates a huge amount of credit using non-market criteria. In Paraguay, cognitive path-dependence was also relevant, although the problem lay in the upper-level informal institutional framework. The polity was unable to sustain the new institutions because many of the predatory practices of the previous political regime persisted. On the other hand, even in the cases of overall failure, it is possible to identify areas in which the new rules of the game were effectively introduced. In sum, the evidence indicates that achieving a minimum of functionality is not an easy task and the threat of getting caught in a political-economy trap is always latent.

Public discussion basically overlooked the institutionalization process. To be sure, macroeconomic stability was considered a critical element in guaranteeing reform sustainability and it was stressed that it was central to ensuring budgetary equilibrium, to checking for moral hazard in banking, and to enhancing price flexibility. It was also diagnosed that the roots of these problems were institutional disarrays and, accordingly, a good part of the first and second generation of reforms consisted of blueprints for fiscal accounts (from taxes to privatization), prudential regulation, and labor market flexibility. But surprisingly, no systematic analysis was made of the factors determining institutional change and the sustainability of the rules recommended. In the pre-reform period, the political economy analysis stressed ways to create the conditions (that is, to build a pro-reform coalition) to initiate reforms. The case studies suggest that more attention should be paid to the post-reform political economy.

In view of the problems with institutionalization, it is surprising that the issue is still largely overlooked. Current debates mainly revolve around the substantive (specifically, the growth rate and equity) rather than the institutional output of reforms. Indeed, an evaluation focusing on growth and distributional results is not entirely correct in terms of the market reform's analytical underpinnings. In effect, the WC proposals – especially the second-generation reforms – are based on a procedural rather than a substantive approach to development.[10] In the WC view, implementing the right institutional framework will allow the economy to achieve its highest growth potential; it does not say that such a potential will necessarily be high or equitable. Hence, reforms should in the first place be assessed by their effectiveness at institutionalizing the correct rules of the game.

Is the current emphasis on outcomes rather than rules misleading? This conclusion is difficult to sustain. To begin with, the reformers' political discourse emphasized that the new policies would stabilize the economy, accelerate growth, and alleviate poverty. It was of course easier to transmit a message based on expected substantive results to the relevant constituency. It was clearer to public opinion what growth and lower inflation meant than what 'successful' institutional change was. There is, however, an additional difficulty: the proponents of the WC did not explicitly state at the analytical level how the degree of success of institutional changes should be assessed. For example, it is unclear whether the occurrence of an exogenous shock, say, the Russian crisis, can justify discouraging results. Ex ante, reformers had stressed that the changes in the rules of the game would make the economy more resilient to shocks. But they did not specify ex ante what kind or size of shock we should expect to be 'filtered' by the more resilient rules and policies implemented and what kind or size of shock we should not. This was a central issue concerning the assessment of the performance of several Latin American economies after the 1998 Russian crisis, which gave rise to a period of high instability and stagnation. And finally, reforms coincided with democratization, a period in which various segments of the population gained the right to voice their demands. One central requisite for democracy to gain legitimacy was precisely to show that it would effectively strike a balance between contradictory demands without jeopardizing stability and growth. In this critical historical juncture, the choice of the rules of the economic game was to a large extent perceived as the choice of a regime that could match the needs for legitimacy of the new democracies. This is another reason why substantive growth and distributional outcomes mattered to reforms. In many of the instances analyzed in the studies, the reforms' outcomes far from fulfilled the new democracy's need to strengthen legitimacy. When the outcomes did fulfill such requirements, as in the case of Chile, institutionalization was successful.

In sum, why did the results of Latin American reforms vary so widely across countries if they were based on similar blueprints? The studies suggest the hypothesis that this was due to the fact that the blueprint had to become institutionalized and that institutionalization is embedded not only in the realm of the economy, but also in society and the polity. Hence, the blueprint mattered, but the idiosyncratic features of the constituency mattered too. Indeed, sustaining reforms may have been harder than initiating them because too much emphasis had been placed on the efficiency-enhancing properties of market institutions and too little on the process by which a blueprint becomes a functioning institution that is legitimately enforced by the polity. It can be argued, then, that no one-size-fits-all blueprint exists that can work independently of the context.

1.4 Conclusions and policy implications

Chile is the only case that can undoubtedly be classified as a reform success. The other cases show that reforms have only partially achieved the desired goals (Mexico, Peru, Uruguay, and Brazil) or resulted in outright failure (Argentina, Paraguay, and Venezuela). For reforms to deliver their expected outcomes, several observers currently argue that it would be necessary to deepen and complete the process based on a second-generation (or even third-generation) blueprint aimed at improving the rules of the game in various areas. The basic hypothesis is that the disappointing outcomes are associated with poor institutional frameworks. Other researchers who have been following the process closely, however, are not optimistic about the possibility of deepening reforms in the future because of 'reform fatigue' affecting both public opinion at large and all the major players in the game of economic reform (Lora et al., 2004). Reform fatigue is defined as the lack of public support, the loss of confidence in the benefits of pro-market reforms, and/or a less proactive stance towards reforms. After assessing several hypotheses that can account for reform fatigue, Lora et al. conclude that the increased rejection of reforms is associated with growth slowdowns in many countries in the region and that an eventual recovery would not facilitate the re-initiation of the process because of two obstacles: first, the fragmentation of the political system, partly resulting from the reform process; second, public opinion's negative perception of the market-oriented reform strategy.

These views well reflect the current disenchantment with the outcomes of 'market-oriented' reforms in LA but are of little help concerning policy guidance. The second-generation reform agenda is institution-building intensive. Although LA institutions undoubtedly present important flaws, the remedy is somewhat paradoxical in light of the evidence. If the existing polities were unable to create a suitable environment for the (simpler) first generation of reforms, why would they be able to institutionalize new and sophisticated rules of the economic game? This view tends to overlook the 'technical' complexities of institutionalization that we pinpointed – crises, an amalgam of institutions of different vintages creating dysfunctionality – and the political economy constraints on reforms, such as state capture, clientelism, or the existence of patrimonialistic polities. In fact, the second-generation agenda more or less implicitly assumes the existence of a benevolent 'institutionalizer' and therefore leaves the political economy question unsettled. The reform fatigue diagnosis does take into account political economy variables in explaining why reforms have stalled. However, it falls short of fully characterizing the fatigue situation from the analytical point of view. Lora et al. (2004) state that the region was caught up in a low-growth equilibrium trap but the analysis is not particularly informative about how this situation evolved. It is necessary to develop hypotheses as to what exogenous/endogenous forces could break this equilibrium, and what policy initiatives could help the authorities to overcome the trap and restore a growth process that public opinion considers legitimate.

We believe that the reform fatigue equilibrium will not persist and that the present reform hiatus reflects the search of Latin American leaders and public opinion for new strategies that can sustain a new coalition in the polity domain. The way in which the fatigue equilibrium will evolve towards the next stage, however, is not irrelevant to the goals and policies to be adopted. One way in which the status quo can change is via a period of crisis. As we have seen, crises are double-edged swords. They open windows of opportunity not only for better policies but also for political opportunism. In addition, crises have path-dependence effects that can hinder institutionalization. So, if the low-growth equilibrium is displaced by a sizable crisis, it will become more difficult to anticipate the content of the new strategies. For example, there could be a significant reversal in the reforms, as in the case of Venezuela. An alternative to overcoming the fatigue equilibrium is to reform the reforms without generating a crisis. In any case, the first necessary step to definitively supersede the status quo is to find a strategy to accelerate growth and to persuade the relevant constituencies that the structural obstacles to sustainable growth will be effectively addressed. The successful Chilean evolution indicates, however, that no precise and detailed blueprint exists for the transition towards sustainable growth. The path is largely context-specific, uncertain, and very demanding in terms of collective action at different levels.

On the basis of the evidence provided by the case studies, we can draw some lessons that may be useful to policy design. More specifically, it follows from the evidence discussed that the way out of the status quo requires policy-makers:

(a) To accelerate growth, taking into account the distinction between initiating and sustaining growth.
(b) To design context-informed policies.
(c) To establish economic institutions that are both growth-friendly and functional with respect to other components of the pre-existing institutional structure.
(d) To ensure the political legitimacy of the process.

Point (a) highlights the need to accelerate growth in the sense of Rodrik (2005). The reforms have largely failed in doing so. Although the growth rate of the last fifteen years has exceeded the growth rate during the lost decade of the 1980s, the reforms were as a rule unable to accelerate growth. On average, the post-reform observed growth rate has been lower than the pre-lost decade period. A closely associated and disappointing fact is that traditional obstacles to sustained growth in Latin America, such as a markedly skewed income distribution, sluggish productivity growth, or external vulnerability were unaffected. The studies indicate that Chile is the only country in which substantially higher growth resulted from reforms. In the other seven countries the periods of growth were short and followed by substantial decelerations and, in some cases, by sizable crises. To be sure, it would be wrong to ignore the influence of variables other than domestic reforms on growth. Volatile financial markets, in particular, characterized the international scenario, and the developed countries' protectionist stance showed a bias against products in which the region enjoys comparative advantages, such as agricultural products. We should not overlook, nonetheless, that reforms were expected to create a flexible economy that would not only take advantage of globalization's opportunities but would also become more resilient to external shocks. Chilean reformers – and to a certain extent the reformers in the countries classified as weakly sustainable – performed better, even though they have also had to deal with the globalization hazards.

According to Rodrik (2005) growth accelerations are feasible with minimal institutional change, while the deeper and more extensive institutional reforms required for long-term convergence take time to implement and mature. It seems that Latin American countries still need to find a way to strike a balance between 'heterodox' means to accelerate growth and ways to ensure the institutionalization of the rules of the game to procure sustained long-run growth. The analysis of the economic policies to initiate growth is not the goal of this book, which focuses on institutional change. But we do want to emphasize two points: first, the acceleration of growth is central to ensuring the political legitimacy of any process of institutional change; second, the measures specifically oriented to ignite and accelerate growth should take into account the sizable experience accumulated during both the ISI and the market-reform periods in LA. One important fact to consider is that the details of the Latin American institutional and political economy context matter for any type of policy. The evidence in this book suggests that the Chilean specific advantage – and that of other successful reformers (see Fanelli and McMahon, 2006b) – has had primarily to do with the ability to manage the process of institutionalization and with strengthening the political legitimacy of the process.

Point (b) on designing context-informed policies calls attention precisely to the role of contextual factors. Fanelli and McMahon (2006b) summarize and discuss the elements of the context that have typically influenced the reform path in the 31 countries covered by the URP. Here, we would like to pinpoint the role of four phenomena that repeatedly appear in the LA studies and are important in explaining why expected outcomes have frequently departed from the blueprint's path: crises, structural changes, macro volatility, and distributional tensions. More specifically:

- *All reform experiences were preceded by sizable crises and crises also occurred as part of the reform processes.* The crises examined in the case studies illustrate how they often open Pandora's Box. They often destroy existing institutions, induce important wealth redistribution, increase macro volatility and, as a consequence, exacerbate income struggles and make way for political opportunism. The occurrence of a crisis in the post-implementation period should be conceived of as one of the largest downside risks of reform attempts. The policy implication is straightforward: it is important to assess the probability that a certain reform path leads to a crisis. Reformers should ideally perform exercises along the lines of the value-at-risk exercises that bank risk-managers perform routinely. To be sure, we do not know what the precise characteristics of the stochastic process generating crises are, but we need to develop methods to evaluate the downside risks of reforms.
- *Structural changes were sizable and created substantial disequilibria during the reform stage.* Permanent shocks were associated with three primary sources: globalization, the transformation of the post-World War II institutions inherited from the ISI period, and the democratization of the polity. These sources of shocks will likely persist. Globalization will continue to be a source of exogenous shocks to which domestic institutional structures will have to adapt. Likewise, democracy is far from settled in the region and the upper-level institutions of the polity will be a source of both negative and positive shocks affecting the rules of the economic game.
- *By international standards, Latin American countries are highly volatile.* Although some variables, such as inflation, have shown a downward trend

and macro policies are now more orthodox, this structural feature has not disappeared; consumption, investment, and income continue to show high variance. With the exception of Chile, the reforms did not substantially reduce volatility. Hence, macro volatility will remain at center stage. The methods to initiate and to sustain growth – which call for institutional deepening – must be robust to aggregate volatility. Beyond the effects on economic incentives and financial intermediation (which are not the focus of our analysis) we must take into account that volatility hinders the institution-building ability. It hinders the willingness to cooperate in that it shortens the horizon for decision-making and exacerbates income struggles.

- *Distributional struggles were a source of tension during the reform process.* This is no wonder given that the pre-existing highly unequal income distribution has shown no weakening as a consequence of reforms and the changes in the rules of the game per se have generated winners and losers.

The channels through which these elements have influenced the reform path vary across countries and from one stage of the reform to another. Indeed, one important contribution of the country studies has been the detail and analyses they have provided with respect to the way in which policymakers and the polity managed unexpected developments. Beyond diversity, however, the evidence indicates that these four elements will continue to play a major role in Latin America, even if it is also likely that their relative significance will change as reforms evolve. For example, we expect that the more successful the initiation of growth and institutionalization, the less important the risks of crises and macro volatility will be; but structural changes will still be important, as will distributional tensions. Hence, if reforms are exercises in building sustainable institutions, it is critical to take into account the constraints that these four elements pose to institutionalization strategies.

Point (c) on growth-friendly and functional institutions underscores how important the degree of functional compatibility is between the rules of the economic game and the different segments of the overall institutional framework. The overall framework that resulted in most of the countries is an amalgam of old (ISI) and new (market-oriented) – formal and informal – rules of the game. This amalgam is highly idiosyncratic. In each country it resulted from the implementation of (mostly first-generation) reforms, specific initial conditions, 'exogenous' forces – the pressure of globalization, idiosyncratic external shocks, democratization – and the outcomes of distributional conflicts that occurred in the process. It is not surprising, then, that in several cases the emerging structure was dysfunctional and did not produce the expected policy and economic outcomes. The studies provide a wealth of illustrations about the dysfunctional outcomes produced by: (i) financial liberalization within a context of weak supervision and volatile capital flows (Chile, Uruguay, Argentina); (ii) exchange rate regimes that are inconsistent with price rigidities and the political economy of the fiscal accounts (the Argentine currency board); (iii) price liberalization that triggered distributional effects that could not be handled by the institutions that were meant to manage distributional conflicts (the Caracazo); and (iv) privatizations that fed market power because they preceded the establishment of suitable regulatory bodies (repeatedly documented in various LA countries).

A set of rules designed to induce Pareto optimality may be dysfunctional with respect to other domains (that is, cultural legacies, legal traditions, macro instability) or the resulting equilibrium can be considered unjust and therefore illegitimate. This indicates that there can exist relevant trade-offs between economic efficiency, political legitimacy, and overall functionality that the polity must assess. Likewise, it is likely that growth acceleration and the amendment of undesired outcomes produced by a dysfunctional institutional structure will call for discretional policy decisions (such as the establishment of a highly competitive exchange rate or capital controls in Chile). It follows that policy-makers must be empowered with some degree of discretion to change the outcomes so as to ensure that a given function is performed and the overall functioning of institutions is ultimately growth-friendly. This means that one central role of the polity during the institutionalization process will be, precisely, to define the boundaries within which policy-makers can exert constrained discretion. Of course, to pose constraints on discretion and isolate the authorities from rent-seekers and patrimonialistic and clientelistic politicians is a daunting challenge.

This is a challenge that few polities have faced successfully. But it is inevitable. The experiences covered in this book show that the first generation of reforms attempted to widen the room for rules (rather than discretion) and was also highly vulnerable to opportunistic politics and rent-seeking. Indeed, the experience of unsustainable and weakly sustainable countries suggests that an improper assessment was made of the downside risks entailed by some reforms that were being implemented within a context in which structural changes could introduce dysfunctional elements. It seems that managing reforms calls for a risk management approach in line with the principles successfully adopted in other policy areas. For example, in managing monetary policy, 'The risk-management approach has gained greater traction as a consequence of the step-up in globalization and the technological changes of the 1990s, which found us adjusting to events without the comfort of relevant history to guide us' (Greenspan, 2005: 3).

Point (d) stresses the political legitimacy of the process. The authors of the Chilean study emphasize that one of the reasons for Chile's success lay in the polity's ability for consensus-building, especially after democracy was recovered. They also state that the process was facilitated by the substantial acceleration of growth. This second point suggests that achieving positive results at an early stage is central, independently of whether the 'best' rules of the game have already been implemented. The Chinese experience with reforms is a good case in point (Fanelli and McMahon, 2006b), but there are good illustrations in the Latin American cases too. The authors of the Brazilian and Argentine studies stress that in these highly volatile countries, the achievement of rapid results concerning inflation was instrumental for the first reforms that Cardozo and Menem implemented to gain momentum and legitimacy. In addition to growth and macro stability, rapid advances concerning poverty alleviation and social inclusion may also have contributed to legitimizing a subsequent process of institutional deepening.

The rapid initiation of a growth process is important for another reason. In a highly volatile and thus uncertain context, the materialization of 'good' states of nature has informative content for the public opinion in general. Positive results are tangible signals that the benefits are worth the effort; in addition, given that there can be multiple equilibria with very different distributional implications, results that improve the situation of a broad cross-section of society signal that the power elite is not redefining the rules of the game in its favor, as was the case with state capture and the patrimonialistic and predatory states.

We have emphasized the importance of some phenomena, such as structural shocks, volatility, and distributional consequences. However, even in more stable countries, prudent policy-makers keep these factors in check. Reflecting on monetary policies, Greenspan (2005: 3) makes this point clearly:

> Given our inevitably incomplete knowledge about key structural aspects of an ever-changing economy and the sometimes asymmetric costs or benefits of particular outcomes, the paradigm on which we have settled has come to involve, at its core, crucial elements of risk management. In this approach, a central bank needs to consider not only the most likely future path for the economy but also the distribution of possible outcomes about that path. The decision makers then need to reach a judgment about the probabilities, costs, and benefits of various possible outcomes under alternative choices for policy.

In sum, the challenges posed by the current 'reform fatigue' bring the issue of procedural versus substantive approaches to development to the fore. To a certain extent, the Chilean success can be interpreted as the product of a remarkable ability to strike the balance between the substantive and procedural approaches and between the sometimes contrary short-run requirements of growth acceleration and pro-growth institutionalization. If a new pro-development coalition that can overcome the 'reform fatigue' trap takes shape in the region, we believe that it will likely combine the substantive and procedural approaches to development, and policy-makers will likely adopt constrained discretion to manage the risk originating in reforms and globalization hazards. Yet, it is unlikely that any reform attempt be successful if, as Sen (2004) has emphasized, the main legitimizing question cannot be answered: Why reform? In the case of Latin America, one can safely say that most agree on the answer: to overcome underdevelopment.

Notes

1. The project was developed and first organized by the Global Development Network (GDN) with funding from the World Bank, the Government of Italy, and the Government of Austria. It was coordinated by the Center for the Study of State and Society (CEDES), Buenos Aires, and GDN. This book is highly complementary to the other volumes containing the results of the project that Palgrave has been publishing; see Fanelli and McMahon (2005a, 2006a).
2. Two recent papers that well illustrate the analytical issues at stake and public opinion as reflected in Latinobarómetro are Lora et al. (2004) and Panizza and Yañez (2006); see also Forteza and Tommasi (2006).
3. On hierarchies, domains, and institutions, see Aoki (2001), Dixit (2004), and Tommasi (2002).
4. To answer the question of why and how institutions change, two questions are central according to Greif and Laitin (2004): How does an institution persist in a changing environment? How do processes that it unleashes lead to its own demise? On institutional change, also see Aoki (2001) and Denzau and North (1994).
5. On the Washington Consensus, see Williamson (1990) and the discussion in Fanelli and Popov (2005).
6. On the stylized facts concerning the volatility of developing countries, see Aizenman and Pinto (2004).
7. It should also be mentioned that military governments, in the mid-1970s, also launched the first market liberalization attempts in Argentina and Uruguay.
8. There is, however, a somewhat intriguing reference to the need for a 'competitive' exchange rate in the WC.
9. On the role of counterfactuals in political and institutional analysis, see Przeworski (2004).
10. This distinction is based on Fanelli and Popov (2005). According to these authors, the approaches to development can be classified into two categories, substantive approaches (SA) and procedural approaches (PA). A reformer sustaining SA will tend to specify the substantive goals to be achieved by reform (that is, a given reduction in poverty, certain types of technological upgrade, a minimum growth rate) and, hence, the results of the reform could, in principle, be assessed on such a basis. A reformer adopting PA, in contrast, will focus on building and improving the rules of the game. The SA emphasizes the final destination of the journey toward development; the PA focuses on the construction and improvement of the tracks that are supposed to lead the economy toward the best economic outcome.

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Note: Bold entries refer to tables.