Serie
Reformas Económicas 70

GROWTH AND REFORMS IN LATIN AMERICA AND THE CARIBBEAN IN THE 1990s

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LC/L.1377
May 2000

This document was prepared by Igor Paunovic, staff member of the Economic Development Division of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), for the project "Growth, Employment and Equity: Latin America in the 1990s" (HOL/97/6034), financed by the Government of the Netherlands. The author would like to thank Hubert Escaith, André Hofman, Samuel Morley, Barbara Stallings, Rogerio Studart and Jurgen Weller for their helpful comments. The views expressed in this document, which has been reproduced without formal editing, are those of the author and do not necessarily reflect the views of the Organization.

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ABSTRACT

This paper is an attempt to shed some light on the connection between the growth performance in the 1990s and economic reforms in seventeen Latin American and Caribbean countries. It presents a classification of the countries studied based on comparison of the growth rates in the 1990s and the "base period" (1951-1980). Three groups of countries are identified: leaders, laggards and intermediate cases. An attempt is made to see if there emerges a pattern or any kind of regularity with respect to the causes of the adoption of reforms. Relevant short-term and long-term factors are identified. The way reforms were implemented, and in particular, whether different levels of intensity of macroeconomic stabilization and structural reforms were related to the growth performance in the post-reform period, is also analyzed.

Several characteristics define countries in each of the three groups identified. The "leading" economies had a lower average rate of growth in the base period than in the 1990s and low or negative growth rates coupled with huge macroeconomic imbalances immediately before the reforms took place. That sparked the reform process that was much more comprehensive than in other countries. "Laggards", in contrast, fared much better during the three post-war decades than during the 1990s. Also, their growth rates immediately before the adoption of reforms were not as low as the ones of the "leading" economies, and in most cases they did not experience hyperinflation. As a consequence, the pressure to change was not as strong as in the countries hit harder by the crisis. The intermediate cases have some characteristics of both groups.

An attempt has been made to explain these patterns using political economy concepts. In countries where growth was strong during the base period, powerful interests had a stake in maintaining the status quo and hindered the reform process. In slow-growing economies, in contrast, such vested interests were weaker and less ubiquitous, and thus possibility of change was greater. In addition, pre-reform crises in the former economies did not weaken vested interests enough to enable reformist governments to act successfully. In the latter, crises did have that kind of effect. Moreover, many governments faced credibility problems because of numerous failed attempts at macroeconomic stabilization. Those that adopted far-reaching structural reforms and macroeconomic stabilization signaled their commitment to reforms. Others that lacked a combination of strong stabilization and strong reforms made things worse with partial reforms since the absence of positive results further undermined the support for reforms.

I. INTRODUCTION

In the second part of the 1980s and for the most of the 1990s a change of great proportions has swept the economies of Latin America and the Caribbean. The strategy of development based on import substitution and strong intervention of the state in production of goods, functioning of the market, and redistribution of income was abandoned almost everywhere in the region. Efforts to open up economies, to give more space to private economic agents, and to reduce influence of the state have changed radically the economic landscape of the region. The hopes were high that the new model would result in dynamic economies, leaving behind the legacy of the sluggish growth of the 1980s. In practice, the results were neither as good as enthusiasts were expecting, nor as bad as critics were predicting. As a consequence, a need to assess the recent structural reform effort in the economies of Latin America and the Caribbean has become urgent.

The second part of the 1990s has brought several studies that try to do that. Eclac's "Growth, Employment and Equity" project is one of the most ambitious,[1] but there were also earlier studies by Edwards 1995, Lora and Barrera 1997, Arías and Montiel 1997, IDB 1997. One of the main issues addressed is the question "was it worth it"? Has the enormous effort of changing the region's development model paid off? What are the consequences of the reforms? What are the effects on growth? Is the growth performance satisfactory after a decade of structural reforms? If not, what went wrong? Were the skeptics right from the beginning? And, what is the future of the Latin American and Caribbean economies?

Those studies emphasize the inadequacy of growth during the 1990s, compared with the postwar period. We do not disagree with that judgment, but emphasize that the moderate average growth for the region as a whole during the 1990s is a result of some successful stories and some failures. It is important to investigate both to be able to understand better the nature of institutional changes, and the economic reform process in particular. Essentially, characteristics of both of the economies that seem to have benefited from reforms and the ones that seem to be worse off after the reforms will be explored. We believe that political economy in particular could provide answers to some of the above questions.

Seventeen Latin American and Caribbean countries are studied: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Paraguay, Peru, Uruguay and Venezuela. The choice was constrained by the availability of data, so we could not include Nicaragua and Trinidad and Tobago, for example, both interesting cases but with inadequate data. On the other hand, we wanted to have large countries like Brazil and Mexico, medium-size countries like Colombia and Chile, and small ones like Costa Rica and Honduras. We also included the Dominican Republic and Jamaica as representatives of the Caribbean countries, although they are larger than most of them.

The paper will deal with some less frequently analyzed aspects of structural reforms in Latin America and the Caribbean in the 1990s. First, the countries will be classified according to their growth performance during the decade of the 1990s (1991-2000)[2] compared to a base period (1951-1980). It turns out that for some countries the 1990s represented their best postwar decade, while for others it was the worst one. Second, an attempt will be made to see if there is a connection between the growth performance in the 1990s and the intensity of reforms. Then, we will try to see if there emerges a pattern or any kind of regularity with respect to the causes of the adoption of reforms. Short-term and long-term factors relevant for adoption of reforms will be distinguished. Next, the way reforms were implemented will be analyzed, and in particular, whether different levels of intensity of macroeconomic stabilization and structural reforms were related to the growth performance in the post-reform period. Conclusions will be presented in the final section of the paper.

II. GROWTH IN THE 1990s: A TAXONOMY

Our first step has to do with taxonomy. Is it possible to classify the economies studied using some reasonable criterion and then to discern some common characteristics of the resulting groups? We think it is, and we provide a classification based on the comparison of the growth performance during the 1990s (1991-2000) and the base period (1951-1980).

1. The Basis for Comparison

Some studies have compared the performance of the 1990s with that of the 1980s.[3] We think the results of that comparison are biased, since the decade of the 1990s is compared with an exceptionally bad one ("the lost decade"). The lost decade of the 1980s was a special one in many ways, and it is not good for comparison for at least two reasons. First, the debt crisis almost completely precluded the access to international financing for the economies in the region. In fact, the net transfer of resources was negative during the decade, with its deleterious consequences for growth. Numerous attempts at stabilizing economies failed during the 1980s, resulting in chaotic situations, which do not encourage investment and growth. In that sense, the 1990s is more of a "normal" decade with the resumption of flows of international capital towards the region and with reasonably stable macroeconomic conditions. Second, that decade was a period of transition from one strategy of development to another. Institutions and policies were changing rapidly, sending mixed signals to economic agents, and resulting in instability of the rules of the game.

It is less biased, in our opinion, to compare the 1990s with the three postwar decades.[4] This also makes sense analytically since from the 1950s to the beginning of the 1980s the import-substitution strategy of economic development was predominant in the region, while the new strategy based on free markets has characterized the 1990s. Thus, in a sense it is a comparison of the results of two different strategies of development. It should be added, though, that the process of change from the previous to the new strategy has continued during the 1990s, so the new model has been consolidated only in a few countries. Additionally, by choosing a three-decade period for the base, we hoped to avoid some exceptional events that had a significant influence on the growth of some economies. Examples are oil-price increases in the case of Mexico and Ecuador, huge international infrastructure projects in the case of Paraguay, or the civil war in El Salvador.

2. Performance in the 1990s in General

In order to make a comparison of the growth performance of the seventeen Latin American and the Caribbean (LAC) countries in our sample, we analyzed their growth rates[5] by decade in the last fifty years (Table 1). Their average annual growth rate in that period was 3.9%, but the performance differed widely during that period. The 1950s, 1960s and 1970s had witnessed relatively high growth rates, around 5.0% on average annually. The 1980s, in turn, brought only 1.4% average annual growth. The growth resumed in the 1990s, albeit the 3.4% average did not reach the heights of the 1951-1980 period. As a consequence, one of the most widespread perceptions about the growth record of the 1990s is its inadequacy when compared with the base period.

Table 1
GROWTH OF GDP OF THE SEVENTEEN LAC COUNTRIES, BY DECADES

	1950s	1960s	1970s	1980s	1990s	1951-2000	1951-1980	1951-1990
Argentina	2.9	4.4	2.8	-0.6	**4.6**	2.8	**3.4**	2.4
Bolivia	0.5	5.6	3.9	0.2	**3.8**	2.8	**3.4**	2.6
Brazil	6.8	6.1	8.7	1.7	**2.6**	5.2	**7.2**	5.8
Chile	4.0	4.3	2.7	3.2	**6.0**	4.0	**3.7**	3.5
Colombia	4.7	5.2	5.4	3.7	**2.6**	4.3	**5.1**	4.8
Costa Rica	7.3	6.8	5.5	2.3	**4.4**	5.3	**6.5**	5.5
Dom. Republic	5.8	5.4	7.1	2.5	**5.2**	5.2	**6.1**	5.2
Ecuador	5.0	4.8	9.0	1.8	**1.8**	4.5	**6.2**	5.1
El Salvador	4.7	5.7	2.7	-0.3	**4.4**	3.4	**4.4**	3.2
Guatemala	3.8	5.5	5.7	0.9	**4.2**	4.0	**5.0**	4.0
Honduras	3.1	5.0	5.7	2.4	**3.2**	3.9	**4.6**	4.1
Jamaica	8.1	4.4	-0.7	2.1	**0.0**	2.8	**3.9**	3.5
Mexico	6.1	7.0	6.7	1.9	**3.3**	5.0	**6.6**	5.4
Paraguay	2.8	4.7	8.7	3.1	**2.0**	4.2	**5.4**	4.8
Peru	5.5	5.1	3.9	-0.8	**4.7**	3.7	**4.8**	3.4
Uruguay	2.2	1.6	3.1	0.2	**3.2**	2.1	**2.3**	1.8
Venezuela	7.6	6.0	1.9	-0.5	**2.1**	3.4	**5.2**	3.8
LAC	**4.8**	**5.2**	**4.9**	**1.4**	**3.4**	**3.9**	**4.9**	**4.0**

Source: ECLAC, on the basis of official figures; preliminary figures and estimates for 1999 and 2000. The data for Jamaica for the 1950s and 1960s are from the World Tables, the World Bank (1983).

Some of the above mentioned studies try to explain why it was not possible to grow faster during the 1990s and what should be done to achieve higher growth rates. Our purpose is different. Granted that the growth rate was moderate during the 1990s, we want to know why some countries have been growing above that average, and why others recorded very low growth rates, even lower than during the 1980s (Jamaica, Paraguay). Therefore, we grouped economies in our sample into those that recorded higher growth rates during the 1990s than during the base period (leaders), those that recorded equal or slightly lower growth rates in the 1990s compared with the base period (intermediate cases), and those that recorded much lower growth rates in the 1990s relative to the base period (laggards).

3. Performance in the 1990s: Leaders, Laggards and Intermediate Cases

We call the economies in the first group "leaders" since they fared better in the 1990s than during the 1951-1980 period. In that group belong Argentina, Bolivia, Chile and Uruguay. Chile is the star performer with the 6% growth rate during the present decade. Additionally, for three of the four leaders (Argentina, Chile and Uruguay), it was the best of all five postwar decades. Finally, the economies in that group improved their relative standing in the region. During the base period their growth rates were below the regional average (3.2% vs. 4.9%, respectively), and were considered slow growing economies. On the contrary, during the 1990s those economies outpaced the region's average of 3.4% by one percentage point annually (Table 2).

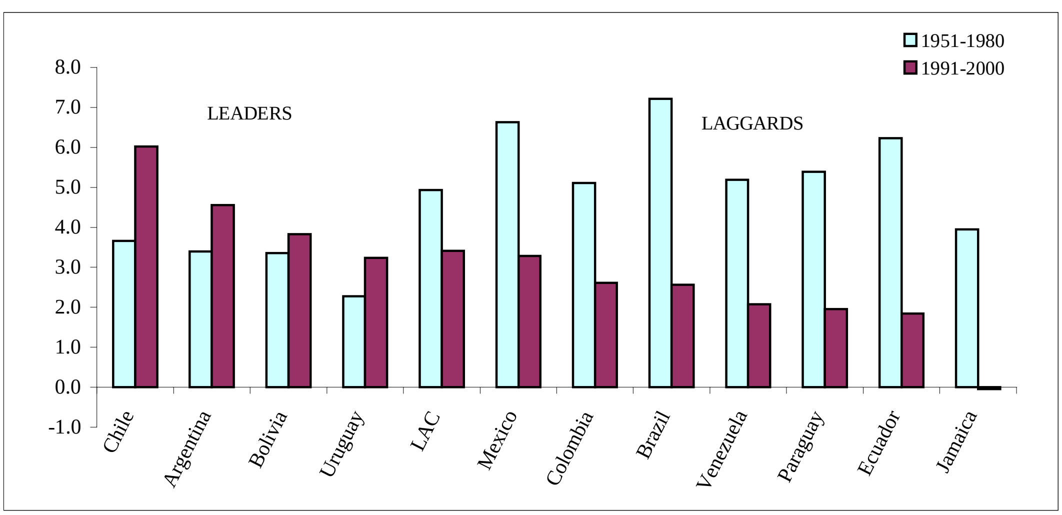
Table 2
THE GROWTH RATES OF "LEADERS" AND "LAGGARDS" COMPARED

	1951-1980	1991-2000
Leaders	3.2	4.4
Laggards	5.7	2.0
LAC	4.9	3.4

Source: ECLAC, Statistical Yearbook for Latin America and the Caribbean, various numbers.

The economies that fared much worse in the 1990s relative to the base period are called "laggards". Their performance in the 1990s lags behind when compared to past performance. More precisely, during the base period their annual growth rate was 5.7%, comparable to the performance of the East Asian miracle economies, only to drop to 2.0% in the present decade. These countries are Brazil, Colombia, Ecuador, Jamaica, Mexico, Paraguay and Venezuela. Moreover, their relative standing in the region deteriorated. In the base period they had been growing faster than the rest of the region, while in the 1990s they lagged behind, below the regional average of 3.4%. The average rate of growth of the seventeen LAC economies during the base period and the 1990s is added in both parts of the figure 1 to facilitate the comparison.

Figure 1
GROWTH OF GDP OF "LEADERS" AND "LAGGARDS" COMPARED: 1951-1980 VS. 1991-2000

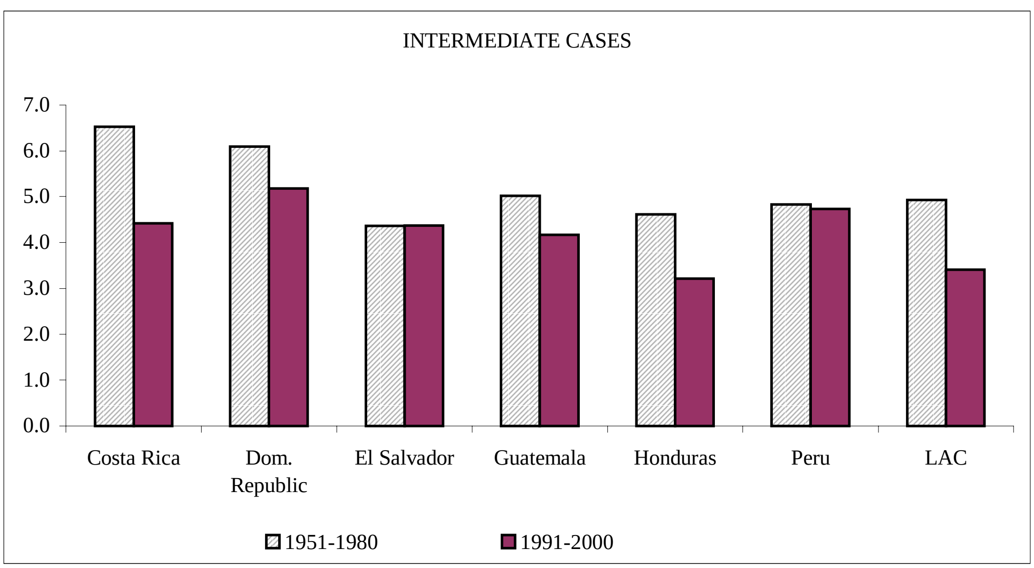


Source: Table 1.

In between are intermediate cases, not easily classifiable. For example, Costa Rica has been growing at the pace of 6.5% during the base period annually, and only 4.4% during the 1990s. On one hand, it is a clear setback, but on the other it is above the average growth rate during the 1990s of the seventeen countries studied. An extreme case within that group is the Dominican Republic. Its growth rate declined from 6.1% in the base period to 5.2% in the 1990s, but the latter figure is the second highest in the region (only Chile performed better during the present decade). Note also that it is also higher than the average of the LAC countries during the base period. For four economies (Costa Rica, the Dominican Republic, Guatemala and Honduras) the growth during the 1990s decelerated, but it was above the average or very close to the average of the region as a whole. Therefore, they did not change their position vis-à-vis the rest of the economies studied.[6] Their performance worsened only when compared with their own past performance, but in general was not bad. Two other economies in that group are El Salvador and Peru. After having recorded a negative growth during the 1980s they both managed during the 1990s to return to their average rate of growth recorded in the base period.

Two puzzling features of these economies deserve to be mentioned. First, with the exception of Peru, they are all small, relatively open economies of Central America or the Caribbean. Their growth was never spectacular, but also they were less affected by the debt crisis during the 1980s. In fact, those that did not have political instability and armed conflicts recorded growth that was above the regional average during the lost decade. Second, during the 1990s they experienced a bit of a slowdown compared to the base period, but still managed to grow above the average of the region. This could suggest that the change in model has not made a big difference for them. These puzzles might point towards a higher resilience of these economies, both to external shocks[7] and to changes in model,[8] a feature not fully explored and explained in the literature.

Figure 2
GROWTH OF GDP OF INTERMEDIATE CASES COMPARED: 1951-1980 VS. 1991-2000



Source: Table 1.

4. Changes in Relative Ranking of the Seventeen LAC Economies

We also ranked the economies in our sample according to their performance in the two periods. The results are reported in table 3. It is a real puzzle that the economies that were most successful during the first three postwar decades were so unsuccessful in the 1990s. Brazil, Mexico, Ecuador, Paraguay and Venezuela were star performers and occupied the top of the list of the LAC economies from 1951 to 1980 (Table 3, first column). In the 1990s, however, they fell to the bottom of the list. On the other hand, countries like Chile and Argentina went from the bottom of the same list in the base period to the top of it in the 1990s, while Uruguay and Bolivia went from the bottom in the first period to the middle in the second. It is a crucial fact that must be explained if we are to understand the impact of the reforms on growth performance.[9] The wide disparity of the results then indicates that one should not analyze the effects of the recent reforms by taking all the countries as if they were homogenous. Instead, by examining success stories, intermediate cases and failures separately, one hopes to discern the common characteristics of these groups.

Table 3.
RANKING OF THE SEVENTEEN LATIN AMERICAN AND CARIBBEAN ECONOMIES ON THE BASIS OF THE GROWTH RATES IN THE BASE PERIOD AND THE 1990s

Country	GDP growth (1951-80)	Country	GDP growth (1991-2000)
Brazil	7.2	Chile	6.0
Mexico	6.6	Dom. Republic	5.2
Costa Rica	6.5	Peru	4.7
Ecuador	6.2	Argentina	4.6
Dom. Republic	6.1	Costa Rica	4.4
Paraguay	5.4	El Salvador	4.4
Venezuela	5.2	Guatemala	4.2
Colombia	5.1	Bolivia	3.8
Guatemala	5.0	LAC	3.4
LAC	4.9	Mexico	3.3
Peru	4.8	Uruguay	3.2
Honduras	4.6	Honduras	3.2
El Salvador	4.4	Colombia	2.6
Jamaica	3.9	Brazil	2.6
Chile	3.7	Venezuela	2.1
Argentina	3.4	Paraguay	2.0
Bolivia	3.4	Ecuador	1.8
Uruguay	2.3	Jamaica	0.0

Source: Table 1.

To summarize our first finding, the decade of structural reforms in the LAC countries has brought with it widely disparate economic results. Based on the comparison of the growth performance during the 1990s and the base period, we placed the seventeen countries studied in three groups. In the first one are leaders: Argentina, Bolivia, Chile and Uruguay. Intermediate cases are Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Peru. Laggards are Brazil, Colombia, Ecuador, Jamaica, Mexico, Paraguay and Venezuela.

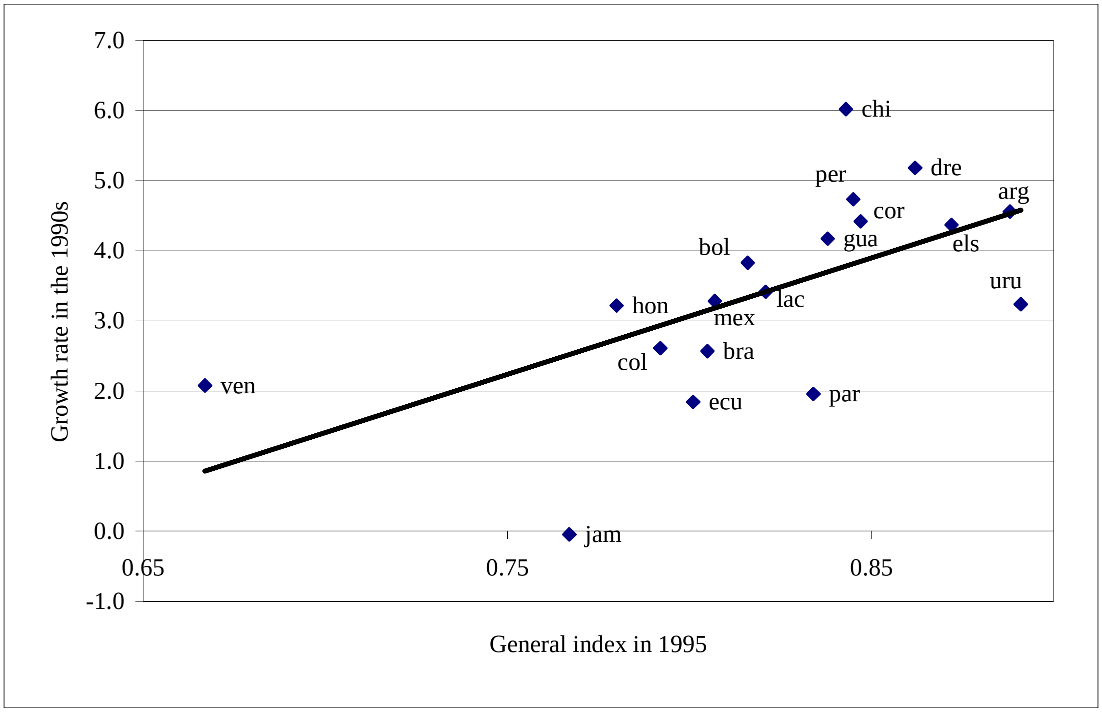
III. GROWTH IN THE 1990s AND REFORMS: HOW ARE THEY CONNECTED?

In this section we will briefly discuss the connection between the growth performance in the 1990s and the structural reforms adopted. Following Rodrik (1996), we distinguish between macroeconomic stabilization, on the one hand, and structural reforms, on the other. Macroeconomic stabilization has an immediate effect on macroeconomic variables and through them on growth, both in the short and long run. In the short run the impact is in most cases contractionary. Fight against inflation and fiscal deficits, two most prominent goals of macroeconomic policy in the region during the 1990s, implied restrictive stance in fiscal and/or monetary policy, with resulting contractionary effects. In the medium and long run, however, the impact is positive since successful stabilization removes several impediments to growth like external financial constraint, instability in relative prices, high interest rates caused by fiscal deficits, and so on.

Structural reforms, by contrast, have primarily microeconomic effects since they change the microeconomic “rules of the game” for economic agents and provide a new set of incentives.[10] Theoretically, therefore, one should expect some indirect influence of reforms on growth. Short-run effects on growth are in general contractionary[11] since economic agents need time to respond to new set of incentives, while in the longer run they tend to be positive.

To measure the intensity of reforms we used an index of reforms presented by Morley, Machado and Pettinato (1999). They prepared five indices for different components of structural reforms (trade reform, liberalization of the domestic financial system, opening the capital account of the balance of payments, tax reform and privatization) and one general index of structural reforms, the latter being a simple average of the five indices. Indices were calculated for the same seventeen countries that we studied, annually from 1970 to 1995. To see the effect of the reforms on growth in the 1990s, we plotted the average rate of growth and the general reform index in 1995.[12] A simple graphic inspection of the interaction of the two variables shows that there is a positive relation between the structural reforms and the growth performance in the 1990s (Figure 3). Those economies that adopted more reforms in general recorded higher growth rates. The correlation coefficient between the two variables is 0.60, and the R2 is 0.36, which means that reforms explain one third of the variation in growth during the 1990s when not controlling for any other variables.

Figure 3
GROWTH IN THE 1990S AND THE INTENSITY OF REFORMS, SEVENTEEN LAC COUNTRIES



Source: Table 1 and Morley, Machado and Pettinato (1999).

Other studies have also found a positive relation between the reforms and the growth in Latin America and the Caribbean during the 1990s. Lora and Barrera (1997) have found that reforms increased the rate of growth in the region by 2.2 percentage points. The estimation of Easterly, Loayza and Montiel (1997) is almost the same (2.1%). Escaith and Morley (2000), on the contrary, find that the direct influence of reforms is quite small after accounting for other factors such as investment, macroeconomic policy and so on that also influence the growth rate. In any case, although the magnitude of the impact is a matter of controversy, it does seem that the recent wave of structural reforms had a positive impact on growth in the region.

IV. REASONS FOR THE ADOPTION OF REFORMS

Next we wanted to explore factors that prompted countries to adopt reforms. Although it is very probable that a host of factors played a part,[13] and their significance varied from country to country, we think that two of them stand out. The first has to do with long-term performance and is partially reflected in the ranking of the economies presented above. The second has to do with short-term factors, the most important being the depth of the crisis during the pre-reform period in individual countries. The depth of the crisis is reflected in both slowdowns in growth and in macroeconomic imbalances.

1. Long-term Performance and the Adoption of Reforms

The idea that past experience could have a determining influence on the current decision-making has been put forward in the political economy literature. Haggard and Webb (1993) mention a "collective memory," which is a product of past "golden ages" or "nightmares" and has a great influence on policymakers. But the idea need not be confined to politicians or policymakers alone. It is plausible to suppose that the public in general tends to form a collective memory that to some extent shapes the worldview and the way the public reacts to important events. It is easier to understand some events if the collective memory is taken into account.[14]

We believe that the change in the ranking of the economies, coupled with the collective-memory hypothesis, could provide a partial explanation for the adoption of reforms. As we have already seen (Table 3), the ranking of the economies studied shows that the best performers in the base period fared much worse in the 1990s, and that the once slow-growing economies performed much better in the present decade. Our hypothesis is that in those economies that occupied the bottom of the list in the base period there was less resistance to change than in those that occupied the top of the same list. Faced with persistent growth differential,[15] the public in the slow-growing economies was less reluctant to accept a change. As the previous strategy of economic development had become perceived as an obstacle to their long-term development, they experimented with other possible strategies.[16] Thus, for the slow-growing economies the economic, social and political costs of adopting reforms were relatively low compared with the potential benefits of them, and the opposition to reforms was not as strong.

On the other side of the spectrum are countries that were star performers in the three postwar decades and occupied the top of the list in terms of growth. In those cases, a change of the model that served them so well was not perceived as a necessity. Even the prolonged crisis of the 1980s did not succeed in discrediting the old model completely. Perceived costs of the reforms were seen there as very high compared to potential benefits. Politically powerful groups with an interest in preserving the *status quo* were able to undermine and/or prevent adoption, implementation and consolidation of reforms. Hence, the reforms in those countries were adopted later than in other cases, and halfheartedly at best. The mediocre performance of these economies during the 1990s helped to perpetuate the internal divisions formed around the issue of the strategy of development. That, in turn, further undermined the process of establishing a political and social consensus on the most important issues of the long-term development strategy.

To see if our hypothesis of an inadequate pre-reform long-term growth is valid we calculated and compared pre-reform and post-reform average growth rates for the seventeen countries studied (Table 4). Note that this procedure is not the same as the one employed to group the economies studied into leaders, laggards and intermediate cases. While there we compared the 1991-2000 period with the base period (1951-1980), here we compare pre- and post-reform performance. The difference is the inclusion of the 1980s, and also the different starting year of reforms in each country.

For the timing of reforms we used Lora and Barrera (1997). Since Lora and Barrera do not provide date for the beginning of reforms in Costa Rica, for that country the timing is from Edwards (1995). Following Lora and Barrera we took 1985 as the starting year for reforms in Chile and 1991 for Argentina and Uruguay. The reason is that early reforms in these countries during the 1970s were subsequently reversed, at least partially. In any case, that affects the order of magnitude, but not the argument itself. Additionally, these early reforms were imposed upon society by military regimes, hence opportunities to freely oppose or support reforms did not exist.

The timing of reforms for all seventeen countries studied is provided in appendix 1. We calculated the growth in the post-reform period starting with the year <u>after</u> the beginning of reforms. The rationale for that is the fact that the impact of reforms on growth during the year they were adopted was in general negligible. The same procedure is repeated with other variables throughout the paper whenever pre- and post-reform performance is compared. In the case of Bolivia, for example, the reforms started in 1985, so pre-reform period goes from 1951 to 1985, while post-reform period is 1986-2000.

The evidence seems to corroborate our hypothesis. As expected, in all leaders (Argentina, Bolivia, Chile and Uruguay) the average pre-reform growth is slower than in the post-reform period. Additionally, the same is true in El Salvador, Guatemala, Jamaica and Peru. The Dominican Republic has pre- and post-reform growth rates equal, while in the rest of the countries pre-reform growth was higher than the post-reform one. In this group are “laggards” and some of the intermediate cases.

Table 4
AVERAGE PRE-REFORM AND POST-REFORM GROWTH RATES, SEVENTEEN LAC COUNTRIES

	Average pre-reform	Average post-reform
Argentina	2.6	3.9
Bolivia	2.6	3.3
Brazil	5.6	2.4
Chile	3.1	6.1
Colombia	4.7	2.7
Costa Rica	5.5	4.4
Dom. Republic	5.2	5.2
Ecuador	5.1	1.3
El Salvador	3.2	4.1
Guatemala	4.0	4.1
Honduras	4.1	3.2
Jamaica	0.1	1.0
Mexico	5.5	3.5
Paraguay	4.9	2.1
Peru	3.4	4.7
Uruguay	1.8	3.3
Venezuela	3.7	2.5

Source: Author's calculations, based on the official data. For timing of reforms see appendix 1, and explanation in the text.

2. Short-term Performance and the Adoption of Reforms

Another concept developed in the political economy literature that could help us better understand the adoption of reforms is the intensity of crises. The basic idea is that crises help in bringing down the opposition to reform. For example, Krueger (1993) wrote: "Turkish reforms in 1980 could be undertaken only after the usual political pressure groups had lost their influence as a consequence of the extreme economic difficulties the country was experiencing." (pp.127-8). We think that in the LAC countries the same might have been the case and that the reason why countries differed in the speed, scope and depth of the adopted reforms has to do with the depth of the crisis prior to the adoption of reforms. There are two indicators that we use here. One is the slowdown in growth in the pre-reform period, and the other is the macroeconomic imbalance reflected in high fiscal deficits and high inflation rates.

2.1 Slowdown in Growth

Since most reforms were adopted in the second part of the 1980s or the beginning of the 1990s, the growth rate in the 1980s is a good indicator of the depth of the crisis. Table 1 shows that Argentina had a negative growth rate, while growth in Bolivia and Uruguay was practically zero during the 1980s. Chile, the fourth country from our group of leaders, is the only exception because it was the first large-scale reformer. It had started its reforms in the 1970s, and in the second part of the 1980s it already recorded positive and increasing growth rates, to end the decade with 3.2% average annual growth rate. Economies that were also strongly affected by the crisis in the 1980s (had negative growth rates) and did relatively well in the 1990s are El Salvador and Peru. On the contrary, the economies that were growing very fast in the base period, decelerated substantially during the 1980s, but did not suffer negative average growth rates.

We also calculated growth rates for five pre-reform years for all countries to see the intensity of the crisis immediately before the adoption of reforms and compared them with the post-reform growth rates (Table 5). In Argentina, Bolivia, Chile, Costa Rica, the Dominican Republic, El Salvador, Guatemala, and Peru, the post-reform growth is substantially higher than the one in the five years prior to reform. Also, in Bolivia and Chile in the five pre-reform years there was no growth at all, while in Argentina it was very slow. In Brazil, Honduras, Mexico and Uruguay, the post-reform growth is somewhat higher than in the five pre-reform years, while in the cases of Colombia, Ecuador, Jamaica, Paraguay and Venezuela, the post-reform growth is slower than in the five years prior to reforms.

Table 5
AVERAGE GROWTH IN THE FIVE YEARS PRIOR TO REFORM AND IN THE POST-REFORM PERIOD

	Average 5 pre-reform years	Average post-reform
Argentina	0.8	3.9
Bolivia	0.0	3.3
Brazil	1.4	2.4
Chile	0.0	6.1
Colombia	3.8	2.7
Costa Rica	2.8	4.4
Dom. Republic	2.8	5.2
Ecuador	4.4	1.3
El Salvador	2.8	4.1
Guatemala	2.8	4.1
Honduras	2.8	3.2
Jamaica	1.8	1.0
Mexico	2.8	3.5
Paraguay	2.7	2.1
Peru	2.8	4.7
Uruguay	2.6	3.3
Venezuela	2.7	2.5

Source: Author's calculations, based on the official data. For timing of reforms see appendix 1, and explanation in the text that accompany Table 4.

2.2 Macroeconomic Imbalance

Perhaps even more important than the slowdown in growth was the magnitude of a macroeconomic imbalance and in some cases a virtual economic chaos in the pre-reform period. In many countries inflation rates evolved into hyperinflations during the 1980s, while fiscal deficits continued to swell. To analyze the importance of macroeconomic conditions, we calculated average inflation rates in the five years prior to reforms and in the post-reform period (Table 6). We did the same for fiscal deficits (Table 7).

It is easy to see that in many countries fiscal deficits and/or the inflation were uncontrollable in the immediate pre-reform period. Especially severe were the cases of Argentina, Bolivia, Brazil and Peru, where the inflation in the five pre-reform years skyrocketed. With the exception of Brazil, all of them managed to lower inflation and improve the fiscal situation in the post-reform period. Less severe, but still serious were cases of Mexico (both fiscal situation and inflation), Honduras and Jamaica (the fiscal situation), and Uruguay (inflation). In the case of Chile, macroeconomic imbalances were much more severe in the period prior to the military takeover in 1973. Had we taken 1974 as a year of the start of reforms, both the fiscal deficit and the inflation rate would have been much higher than in our tables 6 and 7.

Table 6
AVERAGE INFLATION RATES IN THE PRE- AND POST-REFORM PERIODS, SEVENTEEN LAC COUNTRIES

	Average 5 pre-reform years	Average post-reform*
Argentina	1382.8	4.5
Bolivia	2199.4	15.9
Brazil	1331.8	9.5
Chile	21.5	13.7
Colombia	27.6	20.8
Costa Rica	17.1	16.8
Dom. Republic	39.5	7.4
Ecuador	59.7	29.8
El Salvador	21.9	11.8
Guatemala	16.7	16.2
Honduras	12.1	18.8
Jamaica	18.0	26.5
Mexico	87.9	20.9
Paraguay	24.9	16.9
Peru	2464.9	35.7
Uruguay	85.2	34.2
Venezuela	35.7	49.3

*The period covered is from the first post-reform year for each country to the end of 1998.
Source: Author's calculations, based on the official data. For timing of reforms see appendix 1, and explanation in the text that accompany Table 4.

In these countries the sense of urgency was increasing and macroeconomic stabilization was seen as a priority. Hyperinflation ruined not only private-sector agents with fixed incomes, but also public revenues, aggravating fiscal problems, which had already deteriorated thanks to the debt crisis. Capital flight and the inability to borrow on the international capital markets had an adverse impact on investment, both private and public, which was then reflected in sluggish or stagnant growth rates. To break out of that circle, many macroeconomic stabilization packages were adopted. However, the number of failed macroeconomic stabilization attempts during the 1980s in the region is impressive.[17] The apparent inability to stabilize the economy further discredited the old model of development and encouraged policymakers to try something different. The success of the East Asian countries with the export-oriented model of development, as well as the dynamic growth of Chile in the second part of the 1980s, contrasted sharply with the apparent inability of many countries in the region to put their house in order.

Table 7
FISCAL SURPLUS AS PERCENTAGE OF GDP IN THE PRE- AND POST-REFORM PERIODS

	Average 5 pre-reform years	Average post-reform*
Argentina	-1.1	-0.6
Bolivia	-13.5	-1.7
Brazil	-2.3	-6.2
Chile	0.3	1.5
Colombia	0.5	-1.4
Costa Rica	-1.9	-2.7
Dom. Republic	-0.3	0.6
Ecuador	1.3	-1.5
El Salvador	-0.8	-1.1
Guatemala	-1.6	-0.9
Honduras	-5.2	-4.2
Jamaica	-4.6	2.0
Mexico	-10.3	-0.3
Paraguay	0.5	0.3
Peru	-5.3	-0.8
Uruguay	-0.9	-1.2
Venezuela	-1.3	-1.1

*The period covered is from the first post-reform year for each country to the end of 1998.
Source: Author's calculations, based on the IMF data. For timing of reforms see appendix 1, and explanation in the text that accompany Table 4.

3. Vested Interests, Intensity of Crises and Reforms

As we have already seen, the long-term growth of some countries was less than satisfactory compared to the one of their neighbors in the region. Likewise, some countries were hit harder by the crisis during the 1980s, both in terms of growth and macroeconomic imbalances. Therefore, an inability of the previous model of economic development to deliver a satisfactory performance in both the short and long run appears to be one of the crucial preconditions for the adoption of reforms in the countries studied.

In the literature on the political economy of reforms, the influence of "vested interests" (e.g. Krueger, 1993) and the intensity of crises (e.g. Drazen and Grilli, 1993) are two recurrent themes. It is not difficult to see that the vested interests of those who believe they would lose if reforms were adopted make them defenders of the status quo. If reforms are adopted, they are likely to try to undermine or even completely reverse them. The crucial question, then, is the strength of the anti-reform coalitions and their ability to affect reforms. In those countries where the growth rates in the past had been relatively high, it seems logical to expect more resistance to reforms. Politically powerful groups with vested interests could appeal to "the collective memory" of the good times, and try to prevent changes from taking place. The opposite is true in the countries with less dynamic growth performance in the base period. Those that seek to preserve the status quo are not as strong. Thus, it is easier to forge reform coalitions and to carry out reforms. In a sense, "the collective memory" of those countries helps, or at least does not prevent, the adoption of reforms.

Additionally, the crises could have been responsible for the weakening of the anti-reform coalitions. In the countries where the pre-reform growth was very low, or even negative, and the macroeconomic imbalances translated into hyperinflation, the reform process went further, and reforms were deeper. Argentina, Bolivia, and Peru are the cases in point. In turn, in countries that did not experience a very strong crisis, the pressure to change was not as strong, and the influence of anti-reform groups was stronger (Ecuador and Venezuela).

4. Viability of the Old Model

A question that comes to mind after seeing the results of the laggards in the 1990s refers to the necessity of adopting reforms and changing the economic model of development. It might be argued that those economies that were growing rapidly in the 1970s should not have changed the model because after the reforms they have been growing at a much slower pace. Since the previous model worked so well for them, was it really necessary to abandon it? We think that the answer to that question is positive for several reasons.

First, already in the 1970s the rate of growth had began to slow down in some countries. According to Ramos (1997), strong decreasing returns appeared already in the 1970s, as reflected in stagnating total factor productivity. The decade itself recorded a formidable 4.9% growth rate for the countries in our sample. However, it was in large part due to the oil price increases that translated into very high growth rates in Ecuador and Mexico, international infrastructure projects in Paraguay,[18] and the abundance of cheap financing in the international market for virtually all of the countries in the region. The growth based on excessive borrowing became unsustainable by the end of the decade, rendering the economies of the region extremely vulnerable to external shocks.

Second, the import-substitution strategy had reached its internal limits and pretty much exhausted its potential for growth. As long as import coefficients were not low, the import-substitution strategy was able to provide dynamic growth. Yet, as they gradually diminished, a substitution of imports became less and less dynamic source of growth. If we look at the import coefficients of the three large LAC economies, we find that they reached during the 1980s their lowest values in the postwar period. They were only 4.5 for Argentina in 1985, 4.7 for Brazil in the same year, and 8.3 for Mexico in 1983. This means that the possibilities of substitution of imports had become negligible. In other words, some other source of growth was needed. For smaller countries in the region the import coefficients never dropped as low,[19] but their capacity to be self-sufficient is evidently much smaller. Therefore, the level of import coefficients for a small country where the import-substitution strategy reaches its limits is probably somewhere between 15 and 25. During the 1980s they dropped to that level in most of the countries studied.

Finally, the external circumstances have changed substantially. The process of globalization has transformed the international economic relations in the 1980s and 1990s, rendering the import-substitution model obsolete. Already in the 1980s capital flight was a serious problem. Today, with the growing difficulties of enforcement, policies designed to limit international capital flows would have to be increasingly distortionary in a world of highly developed capital markets.

V. THE MIX OF STRUCTURAL REFORMS AND MACROECONOMIC STABILIZATION

We also wanted to explore the way reforms were implemented. Macroeconomic stabilization and structural reforms might be implemented separately or in a single “package”. Is the way they are implemented relevant for growth in the post-reform period? Is some kind of balance between the two needed in order to reach higher growth rates? In order to answer that question we looked at both the intensity of structural reforms and stabilization effort of the seventeen LAC countries. The characterization obtained was then compared with the growth record in the 1990s.

1. Measurement of Stabilization Effort and the Intensity of Reforms

To measure the stabilization effort during the reform and post-reform years, we used fiscal results and inflation rates as indicators.[20] A combination of the two gives us an idea of how successful the stabilization effort was.[21] Those countries that managed both to substantially lower the inflation rate and to reach and maintain fiscal accounts in equilibrium are said to have had a strong stabilization record. Those countries that lowered somewhat the inflation rate and the fiscal deficit are characterized as having a moderate stabilization effort. In the third group are those countries that experienced some improvement in one indicator and deterioration in the other one, or where both indicators deteriorated.

Our reading of the data for the seventeen LAC countries (Table 6 and 7) gives us five countries which could be characterized as having had a strong, seven a moderate, and five a weak stabilization effort. In the first group are Argentina, Bolivia, Chile, the Dominican Republic and Peru. In the second group, which is probably the most controversial one,[22] is Colombia, El Salvador, Guatemala, Jamaica, Mexico, Paraguay and Uruguay. In the third group is Brazil, Costa Rica, Ecuador, Honduras and Venezuela.

The general reform index provided by Morley, Machado and Pettinato (1999) was used to assess the intensity of structural reforms. The indices for 1995 were used[23] as a basis for grouping of the LAC economies into those that have had strong, moderate and weak structural reform efforts. In order to determine cut-off values we calculated the standard deviation of the values of indices. The outlying index of Venezuela was excluded since it would affect the standard deviation too much. The economies whose index falls within one standard deviation around the average value of the index for the seventeen countries studied were labeled the economies with moderate intensity (the value of index from 0.803 to 0.839).[24] Those above 0.839 are said to have had a strong structural reform effort, while those below the value of 0.803, a weak one (Table 8).

As could be seen, Argentina, Chile, Costa Rica, the Dominican Republic, El Salvador, Peru and Uruguay are economies whose intensity of structural reforms[25] is strong, measured by the general reform index in 1995. In the moderate group are Bolivia, Brazil, Guatemala, Mexico and Paraguay. They are around the Latin American average. The group of countries whose structural reform effort could be considered as weak (compared with the Latin American average) is composed of Colombia, Ecuador, Honduras, Jamaica and Venezuela. It is important to note that we consider these values of indices relatively low only when compared with the rest of the economies studied. In fact, on the scale going from 0 to 1, all of these economies, with the exception of Venezuela, fall between 0.75 and 0.80.

Table 8
REFORM EFFORT MEASURED BY THE LEVEL OF REFORM INDEX IN 1995

COUNTRY	REFORM INDEX IN 1995
Strong reform effort	
Uruguay	0.891
Argentina	0.888
El Salvador	0.872
Dominican Republic	0.862
Costa Rica	0.847
Peru	0.845
Chile	0.843
Upper cutoff value*	0.839
Moderate reform effort	
Guatemala	0.838
Paraguay	0.834
LAC (arithmetic average)	0.821
Bolivia	0.816
Mexico	0.807
Brazil	0.805
Lower cutoff value*	0.803
Weak reform effort	
Ecuador	0.801
Colombia	0.792
Honduras	0.780
Jamaica	0.767
Venezuela	0.667

*Cutoff values are 1/2 standard deviation above and below the average value of the index for seventeen countries studied, respectively.
Source: Author's calculations, based on Morley, Machado and Pettinato (1999).

2. Stabilization Effort and the Intensity of Structural Reforms: Results

With the characterization of both macroeconomic stabilization effort and intensity of structural reforms,[26] we can see how they relate to the post-reform growth results. Table 9 presents in a concise manner the characterization of the seventeen economies studied based on the stabilization effort and the intensity of structural reforms. In italics are the "*leaders*", underlined are the "intermediate cases", and in bold are the "**laggards**".

Two of the "leaders" have had both strong stabilization effort and strong record on structural reforms. Furthermore, Bolivia had a strong stabilization effort and moderate reforms, and Uruguay the other way around. But none of the leaders had a moderate-moderate combination, or any other characterization. In the strong-strong group are also the Dominican Republic and Peru, two of the countries that recorded some of the highest growth rates in the 1990s of all the countries studied. On the opposite side are the "laggards". They are in the weak-weak group (Ecuador and Venezuela), moderate-moderate (Mexico and Paraguay), a weak stabilization effort and moderate structural reforms (Brazil), and a moderate stabilization effort and weak structural reforms (Colombia and Jamaica). Intermediate cases could be found all along the main diagonal and in the moderate stabilization effort/strong structural reforms cell. This shows, in our opinion, that intermediate cases share some characteristics of both leaders and laggards.

Table 9
STABILIZATION EFFORT AND THE INTENSITY OF STRUCTURAL REFORMS, SEVENTEEN LAC COUNTRIES

		STABILIZATION EFFORT		
		strong	**moderate**	**weak**
STRUCTURAL REFORMS	**strong**	*ARGENTINA, CHILE,* PERU, DOMINICAN REPUBLIC	EL SALVADOR, *URUGUAY,* **COSTA RICA**	
	moderate	BOLIVIA	GUATEMALA, **MEXICO, PARAGUAY**	**BRAZIL**
	weak		**COLOMBIA, JAMAICA**	**ECUADOR,** HONDURAS, **VENEZUELA**

Source: Author's elaboration.

Two countries deserve a special comment. According to our characterization, Costa Rica is the economy with strong structural reforms. However, preliminary results of Eclac's "Growth, Employment and Equity" project show that the structural reform effort of Costa Rica is not as strong as suggested by the index and should be considered as moderate. That would effectively put it in the cell with Guatemala, Mexico and Paraguay. Also, Bolivia's moderate reform effort is an average of a very high index for four components of reforms (trade reform, domestic and international financial liberalization, and tax reform) and a very low one for privatization. Yet, in 1995 and 1996 a massive privatization program was implemented, amounting to US$ 1700 million (around 25% of GDP). Unfortunately, that was not captured by the index. Hence, Bolivia would be in the upper left cell (that is, a strong-strong combination) if the index went beyond 1995.

Additionally, structural conditions have probably been more important in some countries than in others. In Brazil and Mexico, for example, a big developed and protected industrial sectors were bound to have adjustment problems once the protection was eliminated. No wander then that resistance to reform was stronger and that post-reform growth was lower.

Thus, according to our characterization, the seventeen LAC countries studied are placed on the main diagonal or reasonably close to it. Therefore, it appears that there exist a relatively strong relation between the stabilization effort, the intensity of structural reforms and the post-reform growth performance.

3. A Possible Explanation: Credibility…

Why would a combination of a strong macroeconomic stabilization and intense structural reforms result in a higher growth rate in the post-reform period? We believe that one of the reasons is credibility. If one looks at numerous attempts at stabilization that failed in the region, the number is bewildering. Krueger (1993) wrote that between 1986 and 1991 Brazil have had eleven finance ministers and six major reform programs, all of them unsuccessful. For almost a whole decade of the 1980s, and in some cases well into the 1990s, policymakers in many LAC countries were unable to stabilize their economies, bring down inflation and control fiscal accounts. Introduction of new currencies, heterodox stabilization plans with *pactos sociales*, indexation of salaries and wages, and so on, proved to be unsuccessful substitutes for a credible and irreversible[27] macroeconomic stabilization.

In another context, but also trying to explain the political economy of policy reform, Sachs (1994) wrote: "Governments that have reached hyperinflation cannot, *self-evidently*, be expected to develop complex industrial policies or structural policies. After all, they aren't even carrying out their most fundamental task" (p.510, italics in original). *Mutatis mutandis*, the same applies to governments trying to stabilize their economies. After they have been adopting one stabilization program after another, there is no reason to believe that this time they "mean business".

Rodrik (1989) develops that idea formally in a model where private sector decisionmakers are not able to tell how serious the government is about the reform process. The credibility problem of the government is especially acute in countries where governments or finance ministers rotate rapidly. The resolution of the credibility problem is a kind of <u>overshooting</u>. The government has to signal that it is truly dedicated to reforms, and one way of doing it is to overshoot, i.e. to undertake a larger policy reform than would have been necessary had it not been for the credibility problem. Hence, the magnitude of reforms and the pace at which they are carried out could serve as signals that the process is irreversible.

The more severe is the credibility problem, the stronger is the signal needed. Indeed, after governments have mismanaged their economies for so long (many times governments of the same political party), and attempted many stabilization programs that failed, there is no reason to expect them to do the job properly next time they promise to do it. Since the recent history of the LAC countries is full of failed stabilization attempts, an overhaul of the whole system, including a macroeconomic stabilization and a broad range of structural reforms, may be needed to succeed. In that manner, economic agents get a credible signal that the government is committed to reforms and that the rules of the game have changed radically and will remain stable in the foreseeable future.

Argentina is a good example of both a pre-reform instability and post-reform-cum-stabilization stability. A successful stabilization was achieved only after the convertibility law had tied the hands of the policymakers. It sent an unmistakable message to economic agents that the stabilization was irreversible and that the rules of the game had changed for good. Thus, after a number of years of macroeconomic mismanagement and failed attempts at stabilization, policymakers provided economic agents with an overwhelming proof that they are serious. If that kind of a message is accompanied by intense structural reforms, economic agents could be assured that the rules of the game, both at macroeconomic and microeconomic level, have been changed irreversibly.

4. … and Comprehensiveness…

Another way a government could signal its commitment to reforms is to undertake very comprehensive reforms in a very short period. When a critical mass of reforms is reached, the uncertainty about the future course of reforms is greatly reduced. Rodrik (1991) shows that even moderate amounts of uncertainty regarding the durability of reforms can act as a large tax on investment. Because investment in physical capital is partly irreversible, rational investors wait until much of the uncertainty regarding the future course of reforms is eliminated. This creates a vicious circle since without new investment, and hence no growth, the likelihood of policy reversal is much higher. Again, sweeping reforms, and/or a combination of strong macroeconomic stabilization and intense structural reforms, may reduce the uncertainty about the future course of the reform process and induce economic agents to invest.

The fact that investment in physical capital is partly irreversible could also explain the behavior of the "leaders" in the post-reform period. In countries where both macroeconomic stabilization and structural reforms were strong, the positive response of economic agents to new rules of the game translates into new investment. As results in the form of higher rate of growth become evident, a pro-reform coalition is strengthened, and new interests in favor of the continuation of reforms are formed. That suggests an existence of a virtuous circle where new reforms produce new beneficiaries, which then demand a continuation and consolidation of reforms. Some side effects are also important. As investment grows, the growth rate of the economy is higher, government revenues are higher, which further stabilizes the economy, making a policy reversal less likely. That, in turn, suggests that the relationship of the growth performance on the one hand, and macroeconomic stabilization and structural reforms on the other might be non-linear. In other words, there might exist a threshold that should be crossed if macroeconomic stabilization and structural reforms are to be successful and irreversible. The higher the credibility problem, the higher the threshold.

To see if the above applies to the economies studied, we asked if there was a positive response of the economic agents to the new rules of the game. ECLAC data were used for a comparison of coefficients of gross fixed capital formation in the three pre-reform years with those in the 1995-1997 period.[28] The change between the two periods is presented in the third column (Table 10).

In Argentina, Bolivia, Chile, the Dominican Republic, El Salvador and Peru, economies where reforms were profound and the stabilization effort was considerable, the response was the strongest. The response was more moderate in Uruguay. Honduras and Colombia have also a relatively large increase in the coefficients of gross capital formation and in that sense are atypical. In the rest of the economies the changes are very small, and in Venezuela there was a decrease in the coefficient.[29] Although this evidence is not based on a systematic study,[30] we think that it does lend support to our hypothesis.[31]

Table 10
COEFFICIENTS OF GROSS FIXED CAPITAL FORMATION IN TWO PERIODS, SIXTEEN LAC COUNTRIES

	Three years prior to reform*	1995-1997	The change
Argentina	15.7	23.1	7.4
Bolivia	9.5	15.9	6.3
Brazil	18.9	20.1	1.3
Chile	14.9	29.9	15.0
Colombia	16.7	22.4	5.7
Costa Rica	19.0	21.3	2.3
Dom. Republic	26.0	32.7	6.7
Ecuador	19.1	19.3	0.2
El Salvador	13.2	18.8	5.6
Guatemala	13.3	16.4	3.1
Honduras	19.9	25.5	5.6
Mexico	16.0	17.1	1.1
Paraguay	20.2	21.5	1.3
Peru	20.7	28.5	7.8
Uruguay	11.7	14.8	3.1
Venezuela	18.3	16.4	-1.9

* For timing of reforms see appendix 1, and explanation in the text that accompany table 4.
Source: Author’s calculations, based on the data from ECLAC, Statistical Yearbook for Latin America and the Caribbean, various numbers.

To see how great is the need for stability of the rules and the fear of policy reversals, one has to look at political developments during the decade. In three countries (Argentina, Brazil, and Peru) reform-minded governments changed constitutions to guarantee the continuation of reforms. Reelection of the incumbent presidents was possible because they were seen as guarantors of the irreversibility of the reform process.

5. … and Synergy…

Another important concept that could be used to explain the fact that economies with strong reforms and strong macroeconomic stabilization records have been growing faster than the rest, is synergy. We believe that apart from the strong signaling function, the combination of strong macroeconomic stabilization and strong reforms has merits of its own. Specifically, a strong macroeconomic stabilization will, after some short-run recessive effects, provide a framework that is much less distortionary for economic agents than the previous one. It is well established that inflation, for example, is costly and that its elimination is beneficial for the long-run growth. The same is true of structural reforms. Multiple exchange rates, multiple interest rates, protection of domestic products with licenses, quotas, tariffs in the excess of what would have been necessary for infant industries, and a welter of regulations and bureaucratic obstacles to normal business in general have detrimental effects on economic growth. Mainstream economic theory suggests that economic welfare would be maximized when distortions are minimized. Accordingly, a removal of distortions of both macroeconomic and microeconomic nature would have beneficial effects on economic activity and the rate of growth. Therefore, there might exist a mutual reinforcement of those benefits as the reform process goes on. In other words, there might be a synergistic relationship between the effects of structural reforms and macroeconomic stabilization.

6. … and Transparency

Lastly and closely connected with previous points, we believe that the increased transparency played a significant role in the post-reform period. Hyperinflation, multiple exchange rates, multiple interest rates, and a spate of regulations usually characterized a pre-reform period in many countries, making it very difficult to operate normally. That lack of transparency increased the costs of transactions (for example, costs of management of money in inflationary situations and costs of protection from sharp exchange rate movements and foreign currency shortages), and induced a bias toward short-term investment decisions. That, in turn, prevented much investment from taking place, further decreasing the growth rate of the economy. The opposite is true in the post-reform period. Transparency increases significantly, permitting long-term investment decisions to take place, which positively affects the growth rate. Therefore, the effect of macroeconomic stabilization and structural reforms is a change in the investment climate from a negative to acceptable one.

VI. CONCLUSIONS

We have tried to shed some light on the connection between the growth performance in the 1990s and structural reforms and macroeconomic stabilization, and have reached some interesting conclusions. First, there is a wide disparity in the growth performance in the 1990s of the seventeen countries studied. There are “leaders” and “laggards” and to understand the effect of structural reforms on growth, it is necessary to explain the growth performance of both groups. Second, the leading economies had a lower average rate of growth in the base period than in the 1990s, low or negative growth rates immediately before the reforms took place, and huge macroeconomic imbalances. That sparked the reform process and made it much more comprehensive than in other countries. “Laggards”, in contrast, fared much better during the three post-war decades than during the 1990s. Also, their growth rates immediately before the adoption of reforms were not as low as the ones of the “leading” economies, and in most cases they did not experience hyperinflation. As a consequence, the pressure to change was not as strong as in the countries hit harder by the crisis. Third, the economies with stronger growth record during the 1990s have had a much better macroeconomic stabilization record and have adopted deeper and more comprehensive structural reforms.

We tried to explain these patterns using political economy concepts. In countries where growth was strong during the base period, powerful interests had a stake in maintaining the status quo and hindered the reform process. In slow-growing economies, in contrast, such vested interests were weaker and less ubiquitous, and thus possibility of change was greater. In addition, crises in the former economies did not weaken vested interests enough to enable reformist governments to act successfully. In the latter, crises did have that kind of effect.

Moreover, many governments faced credibility problems because of numerous failed attempts at macroeconomic stabilization. Those that adopted far-reaching structural reforms and macroeconomic stabilization did well in the sense that they overcame the credibility problem. They managed to signal that the reform process is irreversible and that the rules of the game have changed for good, both at macroeconomic and microeconomic level. Others that lacked a combination of strong stabilization and strong reforms made things worse with partial reforms since the absence of positive results further undermined the support for reforms. The investment climate did not improve as expected, which further weakened the chances of future reformers.

There were also some reinforcing elements that point towards the possibility of synergy between macroeconomic stabilization and structural reforms. Finally, in terms of transparency, the post-reform environment is much friendlier to long-term investments than the pre-reform crisis situation.

We believe that this analysis takes us a step closer to an explanation of the relationship between structural reforms and growth performance. Although reforms have had specific and unique characteristics in different countries, there are also some fundamental common threads. Specifically, Argentina, Chile and Peru are the examples of strong macroeconomic stabilization and intense reforms, and the payoff was formidable. On the other side of the spectrum are Ecuador and Venezuela, countries that have changed the course several times during the last fifteen years, increasing the uncertainty for economic agents and reducing the credibility of the policymakers. There are also intermediate cases that seem to be more resilient, and for which the change in model has not made a big difference (the Dominican Republic, El Salvador, and Costa Rica). And for still other economies (Mexico, Paraguay) the reforms did not work as expected, and the payoff has yet to materialize.

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APPENDIX

Appendix 1
Timing of structural reforms of the seventeen LAC countries

Argentina (II)	1991
Bolivia	1985
Brazil	1994
Chile (II)	1985
Colombia	1991
Costa Rica	1988
Dom. Republic	1990
Ecuador	1992
El Salvador	1988
Guatemala	1988
Honduras	1990
Jamaica	1987
Mexico	1988
Paraguay	1989
Peru	1990
Uruguay (II)	1991
Venezuela	1989

Source: Lora and Barrera (1997). Since they do not provide a date for the beginning of reforms in Costa Rica, for that country the timing is from Edwards (1995). For Argentina, Chile and Uruguay, the start of a second wave of reforms is used since the results of the first wave of the 1970s was partially reversed during the debt crisis of the 1980s.

Appendix 2
Indicators of structural reforms[1] in Latin America and the Caribbean, 1996-1998, selected countries

	Commercial			Financial			Capital account			Privatization			Tax reform		
	96	97	98	96	97	98	96	97	98	96	97	98	96	97	98
Argentina	+	+	-	O	O	O	O	O	O	++	++	+	- +[2]	-	- +
Bolivia	O	O	O	O	O	-	O	O	O	+++	++	O	O	O	O
Brazil	-	+	-	+	O	O	O	O	-	++	+++	+++	+	- +	- +
Chile	O	O	+	O	O	O	+	+	+	++	+	+	O	O	O
Colombia	O	O	O	+	O	+	-	O	+	+++	+++	+	-	+	+
Costa Rica	+	+	+	++	+	+	O	O	O				-	O	+
Jamaica				O	O	+	O	O	O				-	O	O
Mexico	-	-	O	O	O	-	O	O	+	O	+	+	O	+	O
Peru	O	+	O	O	O	+	O	O	+	+++	+	+	O	+	O

Legend: **(-)** a step back in the reform process
(O**)** no reform activity
(+) some activity
(++) moderate activity
(+++) strong activity
(   ) no data available

Sources: ECLAC, Economic Survey of Latin America and the Caribbean, various years; IMF Country Reports (various); Exchange Arrangements and Exchange Restrictions: annual report 1997 and 1999, the IMF; World Development Indicators, 1997 and 1998, the World Bank; Corporate Taxes 1997, Price Waterhouse.

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[1] Indicators are based on the work of Morley, Machado and Pettinato (1999).

[2] When there are plus and minus signs in the same box, there were two types of changes with effects in opposite directions. For example, an increase in the maximum marginal tax rates on corporate incomes and a decrease in the maximum marginal tax rate on personal incomes.

Notes

[1] This paper is part of that project, but the analysis is developed independently, and with a different set of data. Additionally, the scope is different because seventeen Latin American and Caribbean countries are studied here, as opposed to only nine countries covered by the project. However, conclusions reached in this paper and in the synthesis book of the project (Stallings and Pérez, 2000) are very similar.
[2] Throughout the paper "1990s" refers to the period from 1991 to 2000.
[3] For example, Lora and Barrera 1997, IDB 1997.
[4] The 1951-1980 will be called the base period throughout the paper.
[5] Simple averages are used since weighted ones do not make much sense if units of analysis are individual countries.
[6] Therefore, our additional criterion for classification is a relative change in position of countries in the sample studied. This is also related to our hypothesis later in the paper that inadequacy of long-term growth was one of the reasons for adoption of reforms.
[7] Resilience to financial shocks, however, might stem from the underdevelopment of their financial systems, while they are probably as vulnerable to commercial shocks as other countries in the region.
[8] Other factors, like financial aid from the USA to support friendly regimes, might have also been relevant.
[9] An immediate explanation that comes to mind is a convergence. Economies with high growth during the base period slow down in the 1990s, while the opposite is true for the low-growing economies in the base period. The only problem is that the convergence hypothesis compares the level of income per capita, and the growth rate is then derived from it. According to that hypothesis, economies with low level of per capita income should have a higher growth rate, while the opposite is true for those that have high per capita incomes. In the countries we studied, both among leaders and laggards there are economies with relatively high and relatively low per capita income. While for Venezuela, a country with one of the highest per capita income in the region, some slowing down in the 1990s seems reasonable, for Ecuador it does not. Likewise, an increase in the growth rate in the 1990s is to be expected for a poor country like Bolivia, but not for Argentina and Uruguay, two of the most developed countries in the region. Therefore, we think that some other explanation of that puzzle should be looked for.
[10] It might be argued that there are microeconomic effects of macroeconomic stabilizations as well. While that is true (inflation reduction, for example, alters the way economic agents discount future events), the effect of macroeconomic stabilizations is primarily macroeconomic in its nature, with some microeconomic implications, while the effects of structural reforms are primarily microeconomic with some short and long run macroeconomic implications.
[11] For example, Escaith and Morley (2000).
[12] The reason we used the index in 1995 is that for many countries in our sample the beginning of the decade was still a time of rapid changes. Peru for example had the value of 0.537 in 1990 (a weak reformer) and 0.845 in 1995 (a strong reformer). The same is true of Argentina and some other countries. We also prepared a quasi-extension of that index (appendix 2) to see if there were big changes in the index from 1996 to 1998. The only big change that has occurred is a strong privatization activity in Brazil and Bolivia. For that reason we think that the index in 1995 is pretty representative of the reform effort during the decade.
[13] A prominent place among them belongs to the influence of external economic and political factors on internal policymaking. For a review, see Stallings (1992).
[14] Haggard and Webb (1993) give the example of the West German near obsession with inflation in the postwar period, stemming from the perception that fiscal deficits and hyperinflation not only brought economic hardships, but also contributed to the rise of Nazism. Examples from the region could be provided, too. Argentine experience with hyperinflation during the 1980s helps explain the importance attached to the Convertibility Law that successfully stabilized prices and has become a cornerstone of the macroeconomic policy during the 1990s.
[15] For example, the growth of Argentina in the base period was 3.4% on average, while that of the neighboring Brazil was more than double (7.2%).
[16] Those experiments started as early as the mid-seventies in the Southern Cone countries (Ramos 1986).
[17] In the section 5 we will discuss some of the reasons why so many of them failed.
[18] The decade of the 1970s is the only one with an exceptionally high growth rate for Paraguay.
[19] During the 1980s the import coefficient of medium-sized and small countries ranged from 8.5 in Peru to 32.6 in the Dominican Republic.
[20] A third possible indicator of the macroeconomic stability is a current account deficit/surplus of the balance of payments. We do not consider it to be a good indicator of the effort to stabilize economies in the LAC countries

during the 1990s for three reasons. First, the increase in the influx of foreign capital due to higher interest rates in the region (which were in turn a result of a successful stabilization) was difficult to avoid. Even Chile and Colombia with certain restrictions on the inflow of short-term capital have had real appreciations of their currencies in the 1990s. Second, the effect of the structural reforms on the current account of the balance of payments, especially of the opening of the capital account and the liberalization of foreign trade, is clearly adverse in the short run. And finally, after almost a decade of suppressed consumption of imported goods (both in a private and public sector) due to the debt crisis of the 1980s, there was a need to compensate for it. We believe that the three elements just described made the balance of payments to a great extent exogenously determined, and made the management of the current and capital accounts of the balance of payments an extremely difficult task, if not outright impossible one.

[21] There is a possibility that a strong stabilization effort did not translate into a successful stabilization in a short term. However, societies that do reach a consensus on the necessity of a macroeconomic stability and consequently do put a lot of effort into achieving and maintaining macroeconomic equilibrium usually succeed in doing that.

[22] In some countries inflation receded somewhat, but fiscal situation deteriorated. Colombia, for example, had a relatively good macroeconomic situation when the reforms were introduced, but it has been deteriorating persistently ever since. The difficulty stems from the fact that what was considered as a good indicator at the beginning of the decade of the 1990s (an inflation rate of 20%, for example), turned out to be unacceptable at the end of the decade.

[23] See the explanation in the footnote 12.

[24] One standard deviation was used since in a normal distribution some 68% of the “population” in the middle of the distribution would fall within it. The rest (32%) could than be considered as extremes.

[25] Since Morley, Machado and Pettinato (1999) measure “the degree of liberalization or freedom from government intervention or distortion” (p.9), a strong structural reform effort should be understood as the effort to achieve more liberalized and less distorted markets.

[26] Admittedly, there is a nontrivial degree of arbitrariness in classifying countries as having had a strong, moderate or weak stabilization effort and intensity of structural reforms, but for our purposes a more elaborate characterization is not needed.

[27] By irreversible we do not mean eternal. Macroeconomic conditions constantly change, both for internal and external reasons and policymakers respond by changing policies. But macroeconomic stabilization is irreversible, in our opinion, if it provides relatively stable macroeconomic conditions in the next three to five years, which is also a time horizon most investors consider sufficient for starting new projects. When we use the term “irreversible” in the rest of the paper, it will be in the sense just described.

[28] We compared averages for three-year periods to lessen the influence of short-term factors.

[29] We did not have data for Jamaica, so there are only sixteen countries in the table 10.

[30] For a systematic study of investment in the 1990s in the region see Moguillansky and Bielschowsky (2000).

[31] There is no doubt that the level of investment in the region is still low, especially if higher rates of growth are to be obtained, and in many cases has not yet returned to the levels of the base period. That, however, does not contradict with the fact that the investment response was the greatest in the countries where both stabilization and reforms were the most intense.