NBER WORKING PAPER SERIES

FORTY YEARS OF LATIN AMERICA'S ECONOMIC DEVELOPMENT: FROM THE ALLIANCE FOR PROGRESS TO THE WASHINGTON CONSENSUS

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Working Paper 15190
http://www.nber.org/papers/w15190

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
July 2009

I thank Alberto Naudon and Jéssica Roldán for their excellent assistance and comments. The views expressed herein are those of the author(s) and do not necessarily reflect the views of the National Bureau of Economic Research.

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JEL No. F30,F32,N26,O40,O54

ABSTRACT

In this paper I analyze the evolution of economic and social conditions in Latin America from the 1950s through the 1980s, when deep external crises erupted in country after country. The point of departure of our story is the political awakening of the region in the late 1950s and early 1960s and the emergence of guerilla movements in many countries, including in Cuba. I then analyze the Alliance for Progress, a major and ambitious aid program sponsored by the United States whose main objective was to improve social conditions in the region. I show that in spite of the Alliance, social circumstances did not improve significantly; I also show that throughout this period protectionism and government intervention became more ingrained, discouraging productivity improvements. I then deal with inflation, fiscal largesse, and the Mexican debt crisis of 1982, a crisis that led to the so-called "lost decade." The paper ends with a discussion of the launching of the reforms of the Washington Consensus in 1989-1990. I provide a detailed analysis of the most important elements of this consensus, and I touch on some of the implementation challenges.

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I. Introduction

Starting in the late 1930s most Latin American nations followed an economic strategy based on protectionism, government controls, and a broad involvement of the state in economic activities. For some time this approach – which came to be known as Import Substitution Industrialization or ISI -- seemed to work: economic growth picked up in many countries, industrialization proceeded at a brisk pace, and wages in the manufacturing sector increased rapidly. During the early 1950s many observers were optimistic and thought that economic development, reduced poverty, and prosperity were a matter of time. But underneath this veneer of success, deep problems and social tensions were simmering. The newly developed industrial sector, which included huge steel plants, petrochemical complexes, refineries, and auto plants of various sizes, was highly inefficient, and in order to survive required higher and higher import barriers that kept foreign competition out of the country. Consumption goods were significantly more expensive than in the advanced and medium income countries, and simple goods, such as bicycles – the preferred mode of transportation of blue collar workers in third world nations – were out of reach for the poor. In Chile, for example, a bicycle cost four times more than in the United States, a basic radio appliance was more than three times more expensive than in a European nation, and a small heater was 90 percent dearer than in the international markets.[1] One of the collateral effects of protectionism was that the region's currencies became artificially strong. This discouraged exports, hurt competitiveness in the agricultural sector, and generated a widening political gulf between city dwellers and the countryside. As the 1950s unfolded, massive poverty persisted in most nations, and inequality became more pronounced.

In this paper I analyze the evolution of economic and social conditions in Latin America from the 1940s through the 1980s, when deep external crises erupted in country after country. The point of departure of our story is the political awakening of the region in the late 1950s and early 1960s and the emergence of guerilla movements in many countries, including in Cuba. I then analyze the significance and reach of the Alliance for Progress, a major and ambitious aid program sponsored by the United States whose main objective was to improve social conditions in the region and, thus, to reduce the political

[1] See De la Cuadra (1974).

appeal of the left. I show that in spite of the Alliance, social circumstances did not improve significantly; I also show that throughout this period protectionism and government intervention became more ingrained, discouraging productivity improvements. I then deal with inflation, fiscal largesse, and the Mexican debt crisis of 1982, a crisis that rapidly spread through the region and resulted in stagnation and economic suffering for almost a decade, the so-called "lost decade." The paper ends with a discussion of the launching of the reforms of the Washington Consensus in 1989-1990. I provide a detailed analysis of the most important elements of this consensus, and I touch on some of the implementation challenges.

II. The Cuban Revolution and the Alliance for Progress

In the late 1940s the public in an increasing number of Latin American countries became frustrated by the lack of progress in social conditions, and by the brutality of authoritarian and dictatorial regimes. The first signs that not everything was well south of the Rio Grande came in 1952 when Guatemalan President Jacobo Arbenz – only the second person elected democratically in that Central American country – implemented an agrarian reform aimed at redistributing land holdings and reducing poverty among Gutemala's indigenous population. These policies, however, were resisted by landowners and large multinationals, and generated a serious diplomatic rift with the United States. In 1954, with the support of the CIA, the Guatemalan military staged a coup that put an end to Guatemala's incipient democracy and Arbenz's socialist program.

But Guatemala was only the beginning. In the years to come small groups of armed men took to the jungles and mountains of Latin America in efforts to start revolutions that would eventually topple what they consider to be illegitimate and corrupt governments. Senior officials at the U.S. State Department considered these developments as minor nuisances, and were convinced that, in due course, these armed groups would be defeated. But they were wrong, and in January 1st, 1959, Fidel Castro and his men triumphantly entered Havana. At first Castro and his new regime were looked at with sympathy by the Western Democracies. After all, former strongman Fulgencio Batista fell in the category of what president Franklin Delano Roosevelt had called "Our son of a bitch." No one in Washington lamented his departure. Indeed, during their years in the mountains the guerilla forces had gathered strong support among some of the most powerful media outlets and journalists in the United States, including from Herbert L. Matthews, an influential editorial writer at the New York Times and the first United Sates-based reporter to interview Castro in his Sierra Maestra hideaway, in 1957.[2]

Things, however, did not work out as most of Fidel Castro supporters in New York, Washington, Miami and other cities had expected. Instead of building the bases for a modern liberal democracy, Castro moved rapidly to the left and established close ties with the Soviet Union and the other members of the Warsaw Pact. It soon became clear that Castro and his band of rebels were serious about creating a socialist republic 90 miles from the coast of Florida, and that in order to do so they would rely on Moscow's support. But what was even more disturbing to Washington was that Fidel was extremely popular in the rest of Latin America. Guerilla movements tailored after Cuba's *26th of July Movement*, quickly sprung in country after country. Of course, Castro's regime was not fully tailored after the Soviet model, but as Herbert Matthews put it in his 1961 book, it "had borrowed its ideas and methods from Iron Curtain Europe."[3] Without any doubt, by 1960 the Cold War had arrived in earnest in Latin America.

The Kennedy Administration decided to tackle the communist threat through a two-prong strategy: First, military assistance was provided to the region's governments. The aim was to professionalize local armed forces, allowing them to engage successfully Marxist insurgents. Scores of Latin American military officers went through the Pentagon-sponsored *School of the Americas* in Panama. The most famous graduate of this academy is Manuel Noriega, the former Panamanian strongman, who in 1992 was condemned by U.S. courts to 40 years of prison for narcotics trafficking.

The second component of Kennedy's plan was a large economic assistance program named the *Alliance for Progress*. This was formally launched in August 1961, at the Punta del Este (Uruguay) meeting of the Inter-American Economic and Social Council. Paradoxically, it was at this same meeting that Ernesto Che Guevara announced Cuba's aggressive policy of nationalizing, without compensation, United States'

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[2] In 1961 Matthews published a book where he recounts his famous Castro interviews and defends strongly, and with great naiveté, the Cuban Revolution. See Matthews (1961). Another important book supporting the Cuban Revolution was written by Columbia University's sociologist C. Wright Mills (1961).

[3] Matthews (1961), p. 131.

investments in the Caribbean island. Many years later, Richard Goodwin, a lawyer that was then a Special Counsel to President Kennedy, recalled meeting informally with Guevara in Montevideo. Che told Goodwin that the *Alliance for Progress* would fail because it came too late and offered too little. In his own speech at the summit the guerilla Commander predicted that socialist revolutions would spread through Latin America, and that by 1980 Cuba's income per capita would be higher than that of the U.S. at the time of the meeting.[4]

In a major speech announcing the Alliance for Progress, President John F. Kennedy recognized the extent of social conflict in the region. He said:[5]

> "Throughout Latin America – a continent rich in resources and in spiritual and cultural achievements of its people – millions of men and women suffer the daily degradations of hunger and poverty. They lack decent shelter or protection from disease. Their children are deprived of the education and jobs which are the gateway for a better life…"

The Charter of Punta del Este called for ambitious goals for the Alliance for Progress, including:[6] achieving a rate of growth of per capita income of at least 2.5 percent per annum; a more equitable distribution of income; the diversification of regional exports; the implementation of "programs of comprehensive agrarian reforms"; the elimination of adult illiteracy and the expansion of educational coverage; the construction of massive housing for the poor; low inflation and price stability; and putting in place the polices that would reduce the occurrence of major currency crises. In order to achieve these goals the countries in the region were to develop consistent Economic Programs for the medium term and longer run. The charter also established that the United States would provide substantial aid – 2 billion dollars per year --, for at least ten years. Interestingly, there was no call for drastically opening up the Latin

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[4] See Goodwin (2001), Guevara (1997).

[5] President John F. Kennedy's speech on March 16, 1961. See, http://www.fordham.edu/halsall/mod/1961kennedy-afp1.html

[6] The complete text of "The Charter of Punta del Este" may be found at: http://www.yale.edu/lawweb/avalon/intdip/interam/intam16.htm

American economies through the reduction of import tariffs rates and the dismantling of other protectionist measures such as import quotas, licenses and prohibitions.

Implementing the policies of the Alliance for Progress was not easy, however. In the poorer countries there was very limited expertise in economics and it was nearly impossible to design coherent economic programs aimed at meeting the Alliance's goals. Moreover, in most countries the ruling class opposed many of the measures espoused by the Alliance. Land owners were against any form of land reform, and there was great reluctance to implement the type of austere policies required to bring down inflation. In spite of these difficulties, immediately after the Alliance was launched there was a ray of hope, and President John F. Kennedy became a revered figure throughout the region. When he was assassinated in 1963, the poor of Latin America wept as if one of their own had died.

As time passed, enthusiasm turned, first into skepticism, and then into open criticism. Latin American politicians argued that the Alliance was too political – that is, excessively anti-communist --, and that it failed to support important regional goals, including the creation of a Latin American trading bloc. Moreover, according to some politicians the Alliance was fatally flawed, since it did not consider explicitly a role for labor unions, student associations, and other organizations from civil society. In a 1967 article in *Foreign Affairs* Chile's president Eduardo Frei wrote:[7]

> "The Latin American institutions which collaborate with the Alliance do not include trade unions, student federations, peasant leagues, cooperatives… From a political point of view this is one of the weakest aspects of the Alliance…"

There was also disappointment in the United Sates. Instead of strongly rejecting communism, as expected, many of the Latin American countries appeared to be warming up to the socialist camp. A number of U.S. politicians believed that this was money poorly spent; some even said that it was wasted. When Richard Nixon came to power in

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[7] See Holden and Zolov (2000), p. 257.

1969 aid to Latin America declined significantly, and with time the Alliance folded down without much fanfare.

III. Protectionism and Social Conditions

By the late 1960s, half a decade after the launching of the Alliance for Progress, Latin America was a region of contrasts.[8] In some countries, such as Brazil, Mexico, and Venezuela growth had accelerated significantly, and averaged more than 6 percent per year; in others growth was modest at best (Argentina, Chile, Guatemala, Honduras and Uruguay). In some nations instability and high inflation was the norm (Argentina, Chile), while in others inflation was very low, indeed lower than in the United States (El Salvador, Guatemala, Honduras, Nicaragua).

Most countries, however, shared two interrelated characteristics: First, the degree of openness to international trade – both in goods and in financial capital – was very low. And second, in most countries social conditions failed to improve significantly; poverty continued to be widespread, and income distribution remained extremely unequal. In 1970 – three full decades after the initiation of the import substitution development strategy – 40 percent of all Latin America's families still lived below the poverty line; in the rural sector the incidence of poverty was an astonishing 62 percent.[9]

The low degree of openness to international competition was the result of the increasingly protectionist policies implemented since the late 1930s as a way of encouraging industrialization. One of the most influential promoters of this policy was Argentina's Raul Prebisch, who as head of the United Nations Economic Commission for Latin America -- universally known by its Spanish acronym Cepal—led a small group of economists that argued that, unless Latin America industrialized rapidly, it would be left behind. The reason for this, they pointed out, was that in the decades to come international prices for Latin America's exports -- mostly commodities such as oil, copper, wheat, iron ore, and soybeans -- would decline significantly, while prices of imported manufactured goods would increase steadily.

In most countries the industrialization process had gathered force during World War II, when imports of manufacturing goods from the United Sates and Europe dried

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[8] See Edwards (1995)

[9] See Sheahan (1987), Table 2.4. These data come originally from Cepal.

up. During this time the region's nascent industrial sector expanded almost exclusively on the basis of substituting those imports that were not available due to the war effort.[10] During the second half of the 1940s, and as international economic relations began to normalize, Latin America's authorities faced a dilemma: Should industrialization continue to be based on the substitution of imports of consumer goods? Or, should it be tied to an expansion of exports? The former strategy required protecting national industries through even higher import tariffs and other forms of trade restrictions. The latter involved adding value to commodity exports, and maintaining a highly competitive value of the domestic currency. These two approaches differed in terms of the role given to foreign capital – the import substitution model restricted it, while the export-oriented alternative encouraged it --, and had very different implications for the distribution of income. In most countries, the import substitution model implied transferring income from the country side and the provinces, where most export activities were located, to the nascent industrial sector and to the large cities.

During the second half of the 1940s and early 1950s in country after country the authorities opted for the import substitution model. This reflected a shift in political power that had occurred since the Crash of 1929 and the Great Depression. Exporters had lost influence, while the state – and with it, civil servants and bureaucrats – had gained considerable power, as had the new urban industrialist class and labor unions. The technical bases and underpinnings for the protectionist policy drive were provided by the new ideas developed by Raul Prebisch and his Cepal colleagues.[11]

Supporters of the import-substitution strategy – and most notably German born economist Albert O. Hirschman – argued that in order for it to succeed, two conditions were required. First, the protectionist measures had to be strictly temporary, and had to be reduced through time. More generally, import tariffs and other restriction on trade should be, at the same time, sufficiently high as to protect the targeted industry, and low

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[10] Import substitution entailed that resources were devoted to develop activities in which Latin American countries had no *comparative advantage*. Obviously, this is one of the ingredients in the inefficiency of many nascent industries.

[11] Prebisch joined Cepal in 1949, when his ideas on the need to industrialize were already formed in his mind. See Prebisch (1984). The most influential Cepal publications at the time were "*Economic Survey of Latin America*" (1950) and "*The Economic Development of Latin America and its Principal Problems*" (1950).

enough as to act as a "pressure mechanism" that forced producers to improve productivity and to become efficient.[12] And second, only selected industries should be protected. This recommendation was part of Hirschman's conviction that a healthy and successful growth process was always "unbalanced," and that some industries and sectors were supposed to grow faster than others for prolonged periods of time. Hirschman contrasted his "unbalanced growth" view with what he considered to be blunt and unsophisticated efforts to generate, through the implementation of huge development plans, the indiscriminate creation of large state-owned manufacturing firms, and massive and indiscriminate protection, a "big push" towards industrialization.

According to Hirschman's views – which became very popular in academic circles and among policy makers from around the world – trade restrictions should be used to protect and encourage those sectors with strong "forward and backward linkages." That is, protection should be provided mostly to those industries whose expansion would, at the same time, feed into other promising economic sectors, and demand large amount of inputs and materials from other deserving industries. The goal of all of this was to encourage industrialization in a rapid and effective way. At the time, steel was usually mentioned as an example of an industry with significant forward and backward linkages. On the one hand, steel mills required iron ore and coke coal, and on the other the finished product could be used in the manufacturing of automobiles, white goods and in construction.

Hirschman had come to these views after many years of working in the field as an economic advisor to governments and development agencies – in Europe with the Marshall Plan, and in Colombia from 1952 through 1957. In spite of its appeal, the proper implementation of this protectionist model required a remarkable amount of fine tuning and very precise and detailed knowledge of the economy; indeed, it required the type of knowledge that no government official – not even the best trained, most cable and well informed ones – was likely to have, or ever acquire. Which industries had the greatest linkages? By how much should they be protected? And, for how long? What

[12] Hirschman argued that inefficiency would be avoided if the productive process and the institutional setting "lacked latitude" for errors. He argued that a difficult question was how to ensure this "lack of latitude." With time he came to argue that three mechanisms were usually at work: "voice", "loyalty" and "exit." He associated the latter with economic competition. See his discussion in Hirschman (1984).

was the combination of import tariffs, quotas and licenses that would provide the adequate "pressure mechanism" to force firms to become efficient? And, more important, how to make sure that policy makers were not captured by industrial lobbyists that claimed that their specific sector had extremely high linkages and was utterly deserving of protection? As Columbia University Professor Carlos F. Diaz Alejandro put it, the problem with Hirschman's linkages approach was that its policy implications were extremely complex and were likely to become "dangerous in the sloppy hands of mediocre followers."[13]

And sloppy hands, indeed, they were. Instead of being selective, protection became general and massive. It affected industries with a high degree of linkages, low linkages, and no linkages at all. It took the private manufacturing sector no time to capture policy makers and to convince them that their particular industry was exceptional, had great promise, contributed to the process of technological transfers from the advanced world, and deserved to be protected by tariffs, quotas and even straight prohibitions. In addition, a "reactive lobby" emerged; a lobby whose only goal was to obtain tariff exemptions and permits to import otherwise protected goods at no tariff or at a very low one. Of course, those that managed to become sole importers at low (or zero) import duties made fortunes in very short periods of time. Tariff books throughout Latin America became huge monsters that detailed import tariffs for tens of thousands of goods, described the extent of restrictions and regulations, presented sliding duties' schedules, detailed the coverage of prior licenses and the levels of surcharges, and specified a number of exemptions.

Chile illustrates in a stark way the excesses of protectionist policies during the years of the import substitution industrialization model. In the mid 1960s, and after more than two decades of protection, import tariff and duties continued to be extremely high in the manufacturing sector. This resulted in domestic prices being much higher than what Chilean consumers would have paid if they had freer access to the global market place. It also allowed Chilean producers to be less efficient than if forced to compete with foreign suppliers. In the mid 1960s, for instance, a Chilean consumer paid for a pair of pants 52 percent more than what he would have paid in the international market place; wool coats

[13] Diaz Alejandro, (1984), p. 113.

were 23 percent more expensive, and shoes 20 percent dearer. In 1965, and as already noted, bicycles cost 300 percent more than in the advanced nations. This basically put them out of reach of average blue collar workers. Worse yet, the quality of locally produced goods was much lower than that of goods produced in other regions: shoes wore off more rapidly, white and electronic goods malfunctioned often, and bicycles broke down frequently.[14]

There are more examples: Imported textiles were subject to duties ranging from 80 to 120 percent. Dyed textiles paid a 92 percent tariff, while those made of combed wool paid "only" 80 percent duties. Automobile tires were subject to a 125 percent import tariff, which increased their domestic cost to consumers by at least that much, relative to international prices. Drills paid a 75 percent tariff, heaters 244 percent, electrical motors 162 percent, radios 340 percent, vacuum cleaners 85 percent, and refrigerators 136 percent. I could go on and on, but I think that there is no need for it, as these examples already convey the clear message of how surrealistic things had become in the industrial policy and protectionist spheres.

Incredibly, import tariffs, quotas and licenses were not the whole story. In the mid 1960s the importation of a number of goods was also subject to a 10,000 percent prior deposit at the Central Bank of Chile. These deposits, which earned no interest, were made at the time the import process began, and had to remain at the Central Bank until the goods in question had cleared customs. Needless to say, with a rate of inflation in excess of 30 percent per year, the prior deposit added considerably to the cost of importing foreign goods.

Producers of these and other industrial products were the big winners of Chile's import substitution industrialization policy. However, there were also losers. These were concentrated among exporters – wineries, mining companies, and fresh fruit producers, to name just a few --, that had to pay heavy tariffs on their imported inputs and on capital goods and machinery, but received no government incentives when they sold their products abroad. A few examples illustrate this point: furniture manufacturers had to pay average import tariffs of 20 percent on their inputs, wine producers paid 90 percent,

[14] These data on the extent of protection are from De la Cuadra (1974) and Edwards (1975).

wheat producers 32 percent, and corn farmers paid an average import duty on imported inputs of 28 percent.

Exporters were additionally penalized because, as a result of a high degree of overall protection and the concomitant low degree of openness of the economy, the domestic currency strengthened significantly, and artificially, in value. This meant that for each dollar of goods sold abroad, exporters received fewer units of domestic currency – Escudos at that time – than what they would have obtained under freer trade. It has been estimated that in the late 1960s the degree of currency overvaluation induced by protectionism in Chile was equivalent to a very substantial tax on exports, ranging from 24 to 32 percent of the value of the goods exported.[15]

From today's perspective the irrationality and arbitrariness of Chile's 1960s import tariffs is striking and difficult to understand. Indeed, these levels of protection hardly constituted what Hirschman had called a "pressure mechanism" to force producers to be efficient.

Instead of declining, as Raul Prebisch, Albert O. Hirschman and others had predicated, the degree of protectionism in Chile – and in most of Latin America, for that matter -- increased through time. For example, by late 1969 import duties on combed wool textiles had increased to 120 percent from 80 percent four years earlier, and tariffs on men's shirts and coats had increased to 120 percent, from no tariff and 23 percent, respectively. Also, export sectors continued to be penalized, both through high costs of inputs and machinery, and an artificially overvaluation of the local currency, the Escudo.

Chile's experience with protectionism during the import substitution industrialization era was hardly unique. In a 1971 study, Bela Balassa estimated that Brazilian and Mexican average import tariffs on manufacturing and consumer goods were as high as in Chile. Moreover, according to his estimates, at that time import tariffs in Latin America were significantly higher that in Malaysia and other East Asian nations. In 1994, English economist Victor Bulmer-Thomas showed that in the 1960s average import tariffs were 131 percent in Argentina, 168 percent in Brazil, 138 percent in Chile, 112 percent in Colombia, and 61 percent in Mexico.[16] In contrast, average import tariffs

[15] See Edwards (1975).

[16] See Balassa (1971) and Bulmer-Thomas (1994).

in the European Economic Community stood at 13 percent. And, according to data compiled by the Fraser Institute, in 1980 Latin American was one of the most protectionist regions in the world; import tariffs across all countries and sectors – including those export sectors with no import tariffs – were, on average, 42 percent. For comparison, at that time average import tariffs were only 15 percent in the so called East Asian Tigers nations.[17]

Starting in the mid 1940s, in most Latin American countries the state grew at a rapid pace. According to the prevailing views, it was not enough to encourage industrialization through massive protectionist policies; in order to build a substantial manufacturing base, it was also necessary to create large state-owned enterprises in what were defined to be "strategic sectors," including sectors with considerable backward and forward linkages. Two interrelated ideas were behind this drive for an active role of the state in the production sphere: first, it was thought that the private sector would be unable to obtain the financial resources required for investing in very large companies in the steel, energy, mining, and oil sectors. This was not a completely unfounded point; what the proponents of the government-led development strategy failed to note, however, was that the private sector inability to obtain the required financing was the direct consequence of poorly developed credit markets, and of legislation that failed to protect the rights of minority owners and share holders. Second, these sectors were considered to be too important to be left to foreign investors. Indeed, since the expropriation of oil fields and the creation of giant state-owned oil company Pemex in 1938, many nationalistic leaders throughout the region argued that Mexico provided the right model to follow.

A number of institutions were created across Latin America as a way of promoting state-owned companies. These included Corfo (Corporación de Fomento de la Producción) in Chile, created in 1939; BNDES (Banco Nacional de Desenvolvimento Economico e Social) in Brazil, founded in 1956; and Argentina's Banco Industrial, from 1944. In Mexico, Nacional Financiera was created in 1934, with the aim of financing large investment projects in infrastructure and basic industries. With time the number of

[17] Krueger (1978) and Sheahan (1987) also provide data that show that other countries in the region had levels of protection similar to those in Chile.

state-owned enterprises grew significantly. Some, such as Petrobras in Brazil, were created from scratch, some were the result of nationalization processes – Pdvsa in Venezuela and Chile's copper giant Codelco are two prominent examples --, and other were acquired by the state as a result of bail-outs of private sector enterprises that had been poorly managed and run into financial trouble. In the late 1970s, heavy industry, telecommunications, water supply, and mining, among other sectors, were dominated by the state throughout most of the region. Also, in some countries the state had a strong presence in the financial sector, and owned or controlled banks, financial concerns and insurance companies. Many of these firms were run with political criteria, developed a bolted payroll, and became highly inefficient. By the early 1980s the vast majority of them were losing money, and contributed significantly to public sector deficits and, thus, to inflationary pressure. In 1990 there were more than 300 state owned enterprises in Argentina, more than 700 in Brazil, and more than a 1,100 in Mexico.[18]

IV. Informality and Unemployment

Starting in the late 1940s unemployment and informality became increasingly pressing problems throughout Latin America. This was the direct consequence of the development model based on protectionism, heavy government regulations, and artificially strong domestic currencies. These policies helped create highly segmented, or dual, labor markets. Some urban workers were able to get jobs in the modern, and highly protected, manufacturing sector. To the extent that these companies were sheltered by high barriers to international competition, they could pay relatively high salaries, as well as retirement and health benefits. However, an informal or unprotected sector co-existed side by side this modern labor market. Informal workers often had the same skills as those employed in modern firms; they just were not fortunate enough as to obtain one of the highly coveted high paid jobs. Informality was concentrated in very small firms, the service sector – repair shops, food stalls --, and menial jobs. These workers received significantly lower salaries than formal workers and got no benefits.

As protectionism grew, so did the extent of informality. In 1950 informal workers represented, on average, 9 percent of the regional labor force. Informality was particularly high in Chile (14 percent), Venezuela (11 percent) and Guatemala (11

[18] See Edwards (1995).

percent). Two decades later, in 1970, the overall degree of informality had climbed to 12 percent of the Latin America's labor force. Peru now led the region with 17 percent, followed by Mexico and Bolivia with 15 percent of informality. In 1989 more than one half of non agriculture jobs were in the informal sector (52 percent). Of those employed in the formal sector, one third worked for the government, and had a dubious level of productivity. This dismal state of affairs captured forcefully the severe limitations of the import substitution protectionist model followed by most Latin American countries without interruption since the late 1930s.[19]

Massive migration from the country side into the cities was another consequence of the import substitution policies. The existence of high paid jobs in the modern sector acted as a strong magnet. The fact that these jobs were few and hard to get, did not dissuade poor rural families that could barely survive in a stagnated agricultural sector that was plagued by economic problems, including unproductive land holdings, and artificially strong domestic currencies that reduced crop prices and exports' competitiveness.

Those rural migrants that failed to find jobs in the modern and protected segment of the economy engrossed the army of the unemployed and of those toiling in the informal sector. They had no benefits, earned very low wages, and were trapped in a perpetual circle of poverty and desperation. Just as the family of Jesús Sánchez – the destitute Mexican family depicted in Oscar Lewis' "The Children of Sánchez"—they lived in slumps; they lived in *villas miserias*, *favellas*, *pueblos jóvenes* and *poblaciones callampas*. They were the victims of violence and crime, their children did not attend school – or, if they were lucky enough, they would barely complete two or three years of formal schooling --, and would die if they got seriously ill.

With time these slums became cities of their own. The dwellings that had started as mere mud huts became sturdier. Slowly, and often with the help of relatives and neighbors, a cement floor was installed. Then it was a solid wall or two, and a few years later it could even be a dining room, or a second story. Governments often tried to improve conditions; they would install electrical connections, and potable water and sewages would be made available. After a number of years – a number of decades is

[19] See Thorp (1998), Tables 6.3 and 6.4.

more likely – some of these poor families had a small capital invested in their houses. However, as Hernando de Soto has pointed out in his book "The Mystery of Capital," there is tragedy and irony in this story. In spite of all the suffering and all the effort, these families lacked titles to their homes; and without a title they were not eligible for small loans, and without financing they could not start a small business. It was just not possible; even if they wanted to do it, even if they had the ability and the entrepreneurial spirit, they just couldn't do it.

V. Fiscal Profligacy, Monetary Largesse, Instability and Currency Crises

Protectionism and lack of social progress were only some of the economic problems encountered by Latin America in the 1940 through 1990 period. During these years most countries in the region experienced rapid inflation, balance of payment difficulties, and currency crises. Between 1960 and 1970 inflation in Latin America averaged 20 percent per year, while world-wide inflation was only 4 percent. During that time five Latin American countries had double-digit inflation, and were responsible for the region's high average: Argentina, Brazil, Chile, Colombia and Uruguay.[20]

Macroeconomic conditions turned to the worse in the late 1970s and early 1980s, when most countries experienced accelerating rates of inflation and more frequent currency crises and devaluations. During the 1970's the number of Latin American countries with double-digit inflation increased to fourteen, from five a decade earlier. By 1983-1985 the average rate of inflation had increased to an astounding 300 percent per year. At that time one out of four countries had an annual rate of inflation in excess of 75 percent. This rapid increase in prices had a number of negative effects: credit virtually disappeared, uncertainty increased, investment declined, government controls became stricter, and the population at large – and especially the poor – saw the purchasing power of its wages, pensions and savings erode rapidly.

Two fundamental and interrelated factors were behind this state of affairs: First, government deficits increased significantly in the aftermath of the oil price shocks of 1973 and 1980. In 1970-71 the average public sector deficit in Latin America amounted to a modest 2 percent of gross domestic product, not very different from deficits in the

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[20] Most of the figures in this section had been calculated using data from The International Monetary Fund's International Financial Statistics data set.

Asian Tigers countries. By 1983-85, however, average government imbalances in Latin America had climbed to 6 percent of gross domestic product; in the Asian Tiger nations, in contrast, government deficits remained, on average, below 2 percent of gross domestic product. And second, Latin American central banks printed money liberally in order to finance these fiscal imbalances. After the oil shock of 1980, even traditionally conservative central bankers, such as those in Central America, were forced by politicians to grant very large loans to the government or to ailing state owned enterprises. This excessive creation of liquidity resulted in additional pressure on prices and made already large trade deficits even larger. During the 1970s and 1980s the old principle that "inflation is the result of too much money chasing too few goods" was proven to be correct, again and again.

Between 1950 and the mid 1980s most Latin American countries tried to peg the value of their currencies to that of the U.S. dollar. Since in most countries domestic inflation exceeded international inflation by substantial margins, the value at which the local currency was pegged quickly became inadequate, and the local currency artificially strong.

One of the consequences of high inflation was that wages were adjusted frequently, as were other costs, such as rent, insurance, and prices of intermediate inputs. This "cost push" was extremely detrimental for exporters: because of the pegged exchange rate, the amount of domestic currency that they received per U.S. dollar exported remained constant, while domestic costs of production increased steadily. As a result, exports lost international competitiveness, imports became inexpensive, and large trade imbalances developed. These external deficits were initially financed through foreign borrowing. When external sources of finance began to dry-up, local governments turned to international reserves held at their central banks as a way of covering the imbalances. Eventually, however, country after country ran out of international reserves; when that happened, a bail out by the IMF and a large devaluation were the only options available.

Almost invariably major devaluations and currency crises are followed by periods of economic retrenchment and adjustment. Government expenditures are cut, employment declines, wages collapse, and income contracts abruptly. As a result of currency devaluation, the domestic value of debts contracted abroad and denominated in foreign currency -- U.S. dollars, yen, or other currencies from the advanced counties -- increase dramatically, triggering financial dislocation and massive bankruptcies. This was indeed the case in Latin America during 1983-2003, when the region went through 26 external crises and devaluations. In the aftermath of most of these currency crises -- in eighteen out of the twenty six -- income distribution became more unequal and the proportion of people living below the poverty line increased significantly.

But that is not all. As Richard Cooper documented more than three decades ago, most currency crises in emerging markets usually result in political upheaval and instability. The finance minister under whose watch the crisis exploded loses his job, as does the governor of the central bank.[21] Perhaps the most tragic case in Latin America's recent history is that of Jaime Serra Puche, Mexico's Finance Minister during the Tequila crisis of December 1994. Just before the crisis, Serra Puche was a popular politician that had negotiated the Nafta treaty with the United States and Canada, and who, according to many, was destined to become the next President of Mexico. In fact, many analysts have argued that in 1994 the Mexican Constitution was amended in a way that opened the path for a future run for the Presidency by Serra Puche.[22] The collapse of the peso in December 1994, however, put an abrupt end to his political career: six days after the peso had lost more than 40 percent of its value Serra Puche was forced to resign in disgrace.

Historically, the economic costs of major currency crises have been staggering. Recent research that I conducted using a large cross-country comparative data set for 1975-2005 indicates that after 25 years -- that is, after roughly one generation -- a crisis country will have an income per capita 18 percent lower than that of a crisis-free nation. This means that after seventy five years the income per capita gap between these two

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[21] Cooper (1971).

[22] Until July 1st 1994 Article 82 of the Mexican Constitution, the President had to be a Mexican citizen by birth, son of Mexican father *and* mother. The new Article 82 changed the "and" for "or," and added that the President parents' must have resided in Mexico for at least 20 years. Some analysts believe that this Constitutional reform was passed as a way of allowing Vicente Fox becoming president. Others think that the reform had Serra Puche's name all over it. See http://historicaltextarchive.com/sections.php?op=viewarticle&artid=93

hypothetical countries will be almost fifty percent; that is, the typical crisis country will have a level of income per person equal to one half of the income of the healthy nation.[23]

VI. Oil Shocks and Debt Crisis

In 1973 the international price of oil increased by more than 200 percent -- from approximately 4 dollars per barrel to little over 12 dollars per barrel --, and in 1979 it increased by another 125 percent to approximately 32 dollars per barrel. These major price changes shaped in a fundamental way the path followed by the Latin American countries during the last quarter of the 20th century.

As expected, the large increase in oil prices affected oil exporters and importers in very different ways. The former – and, in particular Mexico and Venezuela – embarked on ambitious development plans aimed at rapid industrialization; Mexico's President José López Portillo, said "we will administer abundance." Most of this effort was led by the public sector, and consisted of gigantic and, as it turned out, inefficient investment projects that were laden with corruption.[24] As a way of leveraging the oil monies, governments in the oil exporting countries borrowed heavily from the rest of the world, and rapidly accumulated very large external debts.

Oil importing countries tried to cushion the sudden worsening in their terms of trade – or prices of exports relative to those of imports – by borrowing liberally from abroad. As their oil-exporting neighbors, they accumulated foreign debt at a pace that turned out to be unsustainable. Many countries that for decades had maintained price stability – mostly the countries of Central America – began to rely on money printing to finance rapidly increasing government expenditures. As a result, inflation increased, exports loss competitiveness, and international reserves held by the central banks declined swiftly.[25] Most countries responded to this situation by implementing exchange and capital controls, and by restricting the purchase of hard currency by local firms and

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[23] This calculation assumes that besides their proclivity to crises both countries are identical. For the formal analysis see Edwards (2007).

[24] López Portillo was born in 1920 and died in 2004. Many of his obituaries remembered both his promise to "administer abundance" and the corruption that plagued his administration. See, for example, the obituary published by Spain's El Mundo, in: http://www.elmundo.es/elmundo/2004/02/18/obituarios/1077065549.html

[25] The currencies of El Salvador, Guatemala, Honduras, and Nicaragua were for decades pegged to the U.S. dollar. Costa Rica was an exception in Central America, and suffered from periodic currency crises.

individuals. Businessmen and families traveling abroad were allowed to purchase nominal amounts of foreign exchange that did not cover the costs of hotels or subsistence. As trade deficits became larger, a number of countries adopted multiple exchange rate regimes, where different transactions, including the exportation of different varieties of the same good, were subject to different exchange rates. These systems were highly inefficient and encouraged corruption and black markets, and eventually forced the countries that adopted them -- including the Central American nations -- to devalue their currencies and abandon their decades-long fixed exchange rate regimes.

On the evening of August 12th, 1982, Mexico's Finance Minister Jesús Silva Herzog, a respected economist known for his charm and thunderous baritone voice, flew to Washington D.C. The purpose of the trip was to inform his American counterparts that, in spite of the high price of oil, Mexico -- on of the world's major oil exporters -- would be unable to make interest payments on its debt that were due the following Monday.[26] His first meeting during the morning of Friday the 13th, was with Jacques de Larosiere, a Frenchman that at the time headed the IMF. Fund officials had recently returned from Mexico City and were already preparing a sizable loan that, they hoped, would help stabilize Mexico's finances. The meeting with de Larosiere was short and to the point; the two officials agreed that the sooner the IMF funds were made available the better. They also concluded that Mexico would need additional financing, and that some of it had to become available immediately. Silva Herzog's next stop was at the Federal Reserve, where Chairman Paul Volcker rapidly grasped the impact that a Mexican default would have on world financial markets. He said that the Fed would work with other national and international institutions in an effort to find a solution to Mexico's problems. During the next few weeks Volcker would play a key role helping arrange a bridge loan from the Bank of International Settlements -- an international institution headquartered in Basel whose goal is to coordinate central banks from around the world -- and organize the G-7 response to this unexpected turn of events. In spite of the efforts made by Volcker, and by Secretary of the Treasury Donald Regan and other officials from the advanced countries, it was not possible to avoid the Mexican default.

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[26] The account of the first days of the crisis presented here draws on Kraft (1984) and Boughton (2001), as well as on my discussions with Mexican and other officials involved in the negotiations.

The causes behind the 1982 Mexican crisis read like a catalog of Latin America's economic excesses and policy mistakes of the import-substitution era. Surrealistic government regulations and controls, coupled with generalized protectionism, had greatly distorted the price system. This, in turn, resulted in a significant misallocation of productive capital. Instead of financing capital projects in areas where the country had competitive advantages, huge investments were made in inefficient and gigantic initiatives with low or no economic return. Monies were also wasted in corruption and in mammoth infrastructure projects that did not contribute to improving efficiency, making exports more competitive, or accelerating economic growth. Massive government expenditures put pressure on prices and inflation, and resulted in the rapid accumulation of foreign debt. The collapse of the Mexican peso in 1982 -- in one year it lost almost 75 percent of its value -- was a traumatic event that marked the beginning of Latin America's darkest hour, the "lost decade."

During the next seven years income per capita in most Latin American countries barely grew, social conditions worsened quickly, and some countries suffered serious bouts of hyperinflation. In 1989 the rate of inflation in Argentina exceeded 3,000 percent; in Bolivia it was almost 12,000 percent in 1985, and in Brazil it climbed to almost 3,000 percent in 1990. Worse yet, during most of the "lost decade" many countries in the region were governed by military dictators that violated human rights, prohibited dissent, and persecuted political opponents.

VII. The "Lost Decade," Heterodoxy and the Brady Plan

In the mid 1980s, and as the regional debt crisis deepened, a number of plans were put in place in efforts to find a "silver bullet" that would expeditiously return the region to growth, low inflation and stability. Plans based on heterodox ideas, such as generalized price controls and half-baked monetary reforms, were implemented in Argentina (*Austral Plan*), Brazil (*Cruzado Plan*), and Peru (*Plan Inti*).

Many of these heterodox plans were presented as a way of simultaneously solving the debt crisis and reducing income disparities. Many of these programs relied on a populist rhetoric and pursued unsustainable macroeconomic policies to obtain short term benefits – including income distribution effects --, without regard for long term consequences. This was particularly the case in Peru, where during Alan García's presidency the fiscal deficit ballooned, and money was printed at an increasingly rapid pace by the Central Bank. At the same time, and in an effort to quell inflation, prices were tightly controlled at artificial levels. Remarkably, the architects of this program argued that in Peru things were different than in the rest of the world, and that instead of fueling inflation, larger fiscal deficits would result in lower prices![27] But of course Peru was not a special case and was not different from the rest of Latin America or the rest of the world, for that matter. At the end these populist policies ended up in failure: inflation skyrocketed, unemployment went through the roof, and growth was negative. Worse yet, Peru spiraled into political chaos, with the Maoist *Shining Path* guerilla movement taking control of vast parts of the countryside.

By the end of 1980s inflation was out of control in countries as diverse as Argentina, Bolivia, Brazil, Peru, and Uruguay. As it has always been the case, the poor were the ones that suffered the most. They couldn't protect themselves from the ravaging effects of continuously increasing prices, nor could they move their savings to Miami, Panama City or Zurich.

As the years passed, and the region sank further into economic dysfunction, it became increasingly apparent that a solution to the crisis would require coordinated action by the Latin American governments, advanced countries, creditors, and the international multilateral institutions. A breakthrough was achieved in 1989 when the "Brady Plan" – named after the United States' Secretary of the Treasury Nicholas Brady -- was announced. This initiative was based on three simple principles: First, defaulted bank debt was to be exchanged for new long-term bonds with a lower face value. The terms of these exchanges were such that the Latin American debtors were de facto granted significant debt relief. Second, in order to be eligible to participate in the Brady debt exchanges the country in question had to show a commitment to implement some basic economic reforms. And third, the creditor banks and nations would be willing to provide fresh funds to participating countries, in order to help them jump-start their economies, resume growth and propel enough activity as to return to a normal state of affairs.

[27] See Dornbush and Edwards (1991) for a discussion of Peru's experience under President Alan Garcia's first government.

Agreeing on the details of the Brady Plan was not easy, and took repeated rounds of consultation and bargaining. Negotiations with Mexico – one of the larger debtors – became particularly complicated during the first half of 1989. Newly elected president Carlos Salinas de Gortari insisted in obtaining major debt reductions, as well as sizable fresh financial resources from international banks and from the multilateral institutions. Discussions dragged for months and involved official from the Federal Reserve Board, as well as from the G-7 governments. In late July 1989 an agreement was finally reached, and Mexico received debt relief of approximately 55 percent of the face value of its debts. Venezuela and Uruguay followed in 1990 and 1991, and Argentina and Brazil in 1992.

VIII. A Lonely Star: The Launching of the Chilean Reforms

During the second half of the 1970s, and while most of Latin America moved further and further in the direction of protectionism and government control, a remarkable experiment was taking place in Chile. Under the aegis of a military government that in 1973 had overthrown socialist president Salvador Allende, free market reforms were being implemented at a rapid pace. The aim of these policies was to transform Chile into an open, stable, highly productivity economy that could compete internationally and grow through export expansion. At the time the sole idea of attempting a free market model in Latin America seemed farfetched and exotic.

In the formulation and implementation of Chile’s reforms, the ideas of a group of technocrats known as the “Chicago boys” were fundamentally important. This was a group of economist -- most of which had been trained at the University of Chicago -- that worked incessantly and with religious zeal in the design and implementation of the reforms. With the passage of time this group acquired a legendary status. They have not escaped controversy, however. They have been credited with Chile’s successes and they have been blamed for all sort of atrocities, including aiding and abetting the violation of human rights. However, they were neither supermen nor evil-doers. Moreover, during the early years of the reforms they made some serious mistakes – including having allowed a major and artificial strengthening of the currency between 1979 and 1982 --, and their role was mostly constrained to defining technical aspects of the different policies.

With time, and after some initial mishaps and problems, the Chilean reforms – which are discussed in great detail in Edwards and Edwards (1991) – began to bear fruit: exports grew rapidly, per capita income took off, inflation declined to single digits, wages increased substantially, and the incidence of poverty plummeted.

The return to democracy in 1990 gave the Chilean model the legitimacy that it had lacked during the military regime of strongman Augusto Pinochet. All of the sudden a succession of left-of-center governments led by men and women that had fiercely opposed Pinochet's dictatorship – many of them had been imprisoned or exiled by the military –embraced a free markets' economic model based on free competition, a strong and dynamic private sector, and openness to the rest of the world. During the next two decades Chile became the brightest star in the Latin American firmament. Its policies were praised by experts from around the world, and its experience was used as a benchmark to evaluate modernizing reforms in faraway places, including in former communist countries and African nations. As will be seen in the rest of this book this enthusiasm for Chile's achievements is justified and well founded.

IX. Latin America's Divergence during the Protectionist Era

Some authors have claimed that the period extending from the end of the Great Depression through 1980 – just before the eruption of the Mexican debt crisis of 1982 -- was Latin America's golden age. The evidence discussed in this paper does not support this contention. It is true that growth per capita was high -- higher, in fact, than during any comparable period since Independence --, but it was not as high as that experienced by those countries that today we call "advanced," or by the Asian Tigers, or other relevant comparison groups. In fact, from a comparative perspective, and with the exception of Brazil and perhaps Mexico, during the period 1938-1980 Latin America's growth was mediocre. This was not a period of catching up; on the contrary, for the vast majority of countries in the region it was a period of divergence, a period when their income gap relative to the wealthy countries and other emerging regions such as Asia increased, rather than declined.

According to data compiled by Leandro Prados de la Escosura, between 1938 and 1980 only one country in Latin America – Brazil – posted a higher rate of growth of per capita income than the OECD's 14 richest countries (3.4 percent in Brazil vs 2.9 percent in the OECD). Mexico grew as fast as the OECD, and Ecuador and Venezuela at a slightly lower rate (2.7 and 2.6 percent).[28] The rest of the region experienced average growth rates of income per capita ranging from 2.2 percent (Argentina and Costa Rica) and 1.2 percent (Honduras).

Some authors have argued that the good times were concentrated during the first thirty years of the import substitution model. According to this view, mistakes in the form of excessive protection and regulations, and an overstretched government were made after 1975. For example, Rosemary Thorp has said: “Latin American economic performance during the three decades that followed the Second World War was outstanding.” This, however, is stretching things considerably. It is true that between 1950 and 1973, a period sometimes referred to as the “first phase” of import substitution, per capita growth was positive – indeed at an average of 2.6 percent per annum, it was higher than any time before or since --, but in spite of this, the income gap between Latin America and the advance countries did not decline. In his 2007 book “*Contours of the World Economy, 1-2030*” Angus Maddison presents data that show that during that period income per capita grew in Western Europe at an average of 4 percent per year, significantly faster than in Latin America. In the so-called Western Offshoots – the United States, Canada, Australia and New Zealand – income per capita grew at an average rate of 2.5 percent per year, virtually the same rate as in Latin America, and in Asia income per capita expanded at 3.5 percent per year. Between 1950 and 1973 Latin America only grew significantly faster than Africa. And once the complete run of the import substitution model is considered – from the end of the Great Depression to the beginning of the reforms of the Washington Consensus’ reforms in 1990 – its record is extremely poor, indeed.

The lost decade of the 1990s was the culmination of Latin America’s affair with protectionism and a government-led economic strategy. These ten years were devastating for the people of the region, and in particular for the poor and the disadvantaged. For the region as a whole, income per capita *declined* at an average rate of almost 1 percent per year. Income per capita in Argentina *contracted* at an annual rate of 2.3 percent. The

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[28] Notice that Mexico, Ecuador and Venezuela are oil exporting countries. See Prados de la Escosura (2007).

reduction of income per person was 2.2 percent per year in Bolivia; it was 1.6 percent in El Salvador and 1.8 in Guatemala. In Mexico income per capita *contracted* at an average annual rate of 0.5 percent; the annual *decline* was 2.6 percent in Peru and 2.4 percent in Venezuela. During the 1980s income per person expanded in only five countries: Brazil, Chile, Colombia, Paraguay and Uruguay. But even in these nations, performance was mediocre; their income per capita grew at an average rate of 0.8 percent per year. Average wages also declined dramatically during this period. For example, in Mexico, average wages in 1988 were 27 percent below their 1980 level; in Costa Rica they were 11 percent below than in 1980; in Peru, wages were 20 percent lower than in 1980; and in Venezuela average wages declined by 8 percent between 1980 and 1988.[29] Definitely, labeling the 1980s the "lost decade" is neither hyperbola nor exaggeration.

X. Market Reforms and the Washington Consensus

By the late 1980s the economic conditions in Latin America were so desperate, and the decades-old protectionist policies had become so discredited, that the public -- and politicians, for that matter -- were ready to try a completely different economic model. Even exotic ideas -- at least from Latin America's historical perspective -- such as a market oriented economic system based on competition and openness to the rest of the word were contemplated.

As the 1980s turned into the 1900s an increasing number of Latin American countries embarked on market-oriented reforms. These programs, which have received the name of the "Washington Consensus," were based on efforts to reduce fiscal imbalances and inflation, open the economy to international trade, deregulate investment and the business sector, develop domestic capital markets, and privatize state owned enterprises. In addition, there was an effort to reallocate public expenditures towards the poorest segments of society.[30]

In contrast with the *Alliance for Progress*, the Washington Consensus was not an officially sanctioned economic program. It was rather a collection of loosely articulated ideas aimed at modernizing, deregulating, opening up, and reforming the Latin American

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[29] The income per capita data are from Cepal's data bank: http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp?idAplicacion=6&idTema=151&idioma=e. The data on (inflation adjusted) wages are from Edwards (1995).

[30] See, Williamson (1990).

economies. There has been considerable controversy on whether the name Washington Consensus correctly reflects the origin of these ideas. I have argued elsewhere that the Washington institutions – the U.S. Treasury, the World Bank and the International Monetary Fund – had little to do with the specific aspects of these reforms.[31] It is true that to participate in the Brady debt forgiveness program the Latin American countries had to show *some* commitment to modernizing their economies. However, there was no detailed list of reforms that had to be implemented. Clearly, the actual policies were not imposed or forced upon the Latin American governments. These reform programs were largely home-grown, and were Latin America's own response to more than a decade of crisis; they were developed by a group of foreign-trained economists that have been labeled as "technopols."[32] In fact, the Washington institutions were skeptical – and in some cases openly opposed – to some of the most daring reform proposals. To be sure, as time passed, and more and more countries adopted these policies, Washington began to support the effort. At the end of the road, however, the question is not the genesis of the reform ideas, but why did so many counties – virtually all of the Latin American nations, with the exception of Cuba – embarked on this reform effort.

In a highly influential article published in 1989, John Williamson summarized the main goals of the modernizing reforms that at the time were being implemented -- or, in some countries, just contemplated --, in a number of Latin American nations. He also named this emerging approach towards economic policy the Washington Consensus. Williamson's list of ten policies may be summarized as follows:[33]

- Achieve fiscal balance, as a way of reducing inflationary pressures, and stabilize prices.
- Target public expenditures towards the poorer groups in the population. Priority should be given to government expenditures aimed at

[31] See Chapter 3 in Edwards (1995)..

[32] See, Dominguez (1997).

[33] See, Williamson (1990). Williamson has a knack for labeling economic policies with easy to remember and effective terms. In the 1960s he referred to the exchange rate system based on small and periodical government-controlled adjustments of the value of the currency as a "crawling peg" exchange rate regime. That is precisely how these exchange rate regimes have been known among economists ever since.

improving social conditions and reducing poverty; generalized subsidies, which benefit mostly the middle class, were to be avoided.

- Implement deep tax reforms, in order to reduce evasion, increase government income and eliminate perverse incentives to production and investment.
- Free interest rates and modernize the financial sector. Interest rates had to be market determined, and not set by government officials in an arbitrary fashion. A well functioning capital market would help allocate scarce capital to the most productive uses. Also, market determined interest rates would discourage capital flight.
- Avoid artificially strong currencies that discouraged exports. By staying away from currency overvaluation the probability of major, and very costly, crises would be greatly reduced.
- Reduce the extent of protectionism, and to rationalize trade policy. That is, the irrational structure of protectionism that had evolved over half a century – and that was documented above -- had to be dismantled and replaced by lower import tariffs.
- Encourage foreign direct investment. The region's lack of resources would benefit from investment by foreign companies. In addition, these firms were likely to provide new technology and management techniques that would help increase productivity.
- Privatize inefficient state owned enterprises. In particular, many of the companies that had found their way into state hands during the last 20 years had to be sold to private investors – both domestic and foreign.
- Deregulate business transactions including investment decisions. Red tape had to be cut, barriers to entry in key industries eliminated, and competition encouraged.
- Improve legal protection of property rights, as a way of securing higher investment by both foreigners and nationals.

It is important to emphasize, once again, that these ten policy areas were not defined by the Washington bureaucracies at the IMF, World Bank or United Sates Treasury department. Williamson could have listed twelve policy areas – the "Washington Dozen," say – or fifteen or even twenty; but for ease of exposition he chose to synthesize what he believed was the core of the ongoing modernization reform movement in the ten propositions listed above. Interestingly, these ten policies – and the name "Washington Consensus" for that matter – acquired a life of their own, and were soon considered to be some sort of official pronouncement on what the reform countries should do and what they should not do. In many ways this is unfortunate, since a number of analysts have evaluated the reform effort through the lenses provided by this list, and, thus, have missed many of the subtleties and complexities of the actual individual country stories.[34]

During the first half of the 1990s country after country began to implement a variety of modernization policies. Different nations proceeded at different speeds, and emphasized different aspects of the reforms, but the vast majority made progress in four areas: fiscal deficits were reduced, tax reforms were implemented, import tariffs were lowered, and state owned companies were privatized. In most countries the initial results were impressive: inflation declined drastically and growth increased significantly: while in 1989-90 average inflation was 940 percent , in 1993-94 it was 129 percent; gross domestic product per capita growth was 2.2 percent in 1993-94, and -0.5 percent in 1989-1990. Also, in most countries, and after a decade of steep declines, wages recovered rapidly.[35] It is not an exaggeration to say that by 1994 there was heightened hope regarding the Latin American economies. All of the sudden it appeared as if, after decades of frustration, the Latin American economies were ready to take off.

But behind these impressive early results hid important weaknesses: Many countries – including the three largest ones, Argentina, Brazil and Mexico – had pegged the values of their currencies to the United States' dollar at artificially high levels; moreover, during the first half of the 1990s they allowed this currency overvaluation to

[34] Discussions on the Consensus may be found in Birdsal and De la Torre (2003), and in Kuczynski and Williamson (2001).

[35] The average rates of inflation are influenced by the hyperinflation countries. During the same period the median rate of inflation declined by one half, from 26 percent to 13 percent.

increase. This reduced exports' competitiveness in the global market place, and encouraged speculation. But currency overvaluation was not the only problem: in most countries, the privatization of public utilities – including energy, water, sanitation, and telecommunications – was implemented without first putting in place proper regulation and competition policies. As a result, state owned monopolies were replaced by privately-owned monopolies. Moreover, in a number of countries privatization was surrounded by corruption and giveaways, where insiders – including government functionaries in charge of the public enterprises and of the sales' process – ended up buying large blocs of shares at conveniently low prices.[36] At the same time, most countries failed to – or were unwilling to – move forward in the creation of strong and modern institutions that would encourage the rule of law, protect property rights and reduce the extent of corruption. Although these three areas – competitive exchange rates, competition policies, and protecting property rights through institutional reforms --, were part of the original Washington Consensus Decalogue, most countries paid only lip service to them. As a result and as the years passed, most countries were unable to move to the higher phases of the growth transitions, and became increasingly vulnerable to changes in global economic conditions. During the second half of the 1990s and early 2000s many of them succumbed to deep and costly currency crises that increased unemployment, wiped out savings, reduced wages, and generated disappointment and anger. In many countries these crises also paved the way to a new crop of populist governments that rejected globalization and were skeptical of the merits of market orientation.

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[36] For a report on improprieties during Chile's privatization process see, for example, the report prepared by the lower house of parliament in 2004 (Cámara de Diputados de Chile, 2004). For a reaction to the report see the comment by the right-of-center think tank Libertad y Desarrollo in www.lyd.com/noticias/privatizaciones/privatiz.pdf.

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