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Book Review

[Book Review of] Stabilization and reforms in Latin America : where do we stand? / Hermann Sautter ... (eds.) : Frankfurt am Main, Vervuert, 1996

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Sautter, Hermann, and Rolf Schinke (eds.), Stabilization and Reforms in Latin America: Where Do We Stand? Frankfurt am Main 1996. Verouert. 262 pp.

The book is the third volume of the Ibero-America Institute's Göttinger study series and continues the discussion of recent economic problems in Latin America. The papers published in this volume have been presented at the symposium "Post-Stabilization Problems and Ongoing Reforms in Latin America" organized by the Ibero-America Institute in November 1995.

Apart from the introduction, the volume has two papers which attempt to give an overview over relevant issues. At the beginning of the volume, *Eduardo Lizano* (Wine and Bottles, Old or New? Rethinking Economic Policy in Latin America Once More) gives a list of issues with the goal to "... articulate what the consensus should be ..." rather than to "... work out what the consensus is at present, based on accumulated experiences and lessons learned with economic development and economic policies in many Latin American and non-Latin American countries ..." (p. 18). This is a rather ambitious program. In detail, he presents arguments on the following issues: macroeconomic instability, market size and economic opening, greater supply of exports, the role of markets and prices, the role of the state, profits and wages, the trickle-down theory, profits and domestic savings, human resource development, and economic policy change. It turns out that the program is too ambitious. On the one hand, the author summarizes the relevant issues and provides an overview over papers and books on Latin American economic policies in general and on specific issues, e.g., on agricultural price policies and macroeconomic policies. On the other hand, given the broad spectrum of issues, he cannot avoid to mix up a report on the debate with own thoughts, e.g. with respect to exchange rate policies (pp. 20f.). Own conclusions are also sometimes not based on the arguments presented before, e.g. with respect to the relationship between growth and income distribution (p. 31) and his final comments (pp. 39–42). Furthermore, there are some problems with the consistency of the arguments, e.g. with respect to the pace and sequencing of reforms (pp. 37–38). However, these are minor shortcomings given the fact that he is able to provide arguments on the most important issues and to catch the spirit of the policy change in Latin America towards more reliance on market forces than on government intervention.

At the end of the volume, *John Williamson* (Are Latin American Reforms Sustainable?) adopts a less ambitious approach. He profits from the advantage of having formulated a consensus which is more or less generally accepted – the Washington consensus. He also saves some space when not summarizing this consensus but rather focusing on the general spirit of the policy change and on discussing possible alternatives – import substitution, socialism, Asian interventionism, and greenery. Of course, all of these alternatives are shown to be inferior to the Washington consensus. Finally, he recommends five actions needed for establishing a breakthrough from "hiccup" success stories and "watershed" reforms to a breakthrough into "catch-up growth": stimulating savings, keeping out excessive capital inflows, strengthening public sector institutions, resisting to imitate East Asian success stories when lacking institutional capacity, and addressing Latin America's social debt (p. 254). All of these issues are discussed in the remaining contributions, at least to some extent.

The first two important issues, private savings and capital flows, refer to macroeconomic management. The paper by *Helmut Hesse* and *Antje Heitkamp* (Problems of Monetary Policy in Latin America) focus on the relationship between savings and macroeconomic management on a rather abstract level. The main argument is that an important ingredient for a policy to increase domestic savings is long-run price stability which should be the prior target for monetary policy. The authors compare Argentina

(fixed exchange rate) and Chile (flexible exchange rate) and conclude that a flexible exchange rate is more adequate to provide long-run stability while a fixed exchange rate can, at best, help in the first phase of stabilization. The contribution of *Roque B. Fernández* (Regulation for a Stable Financial System: Prudent Supervision and Liquidity Management in Argentina) on monetary management in Argentina during 1995, when the country sustained the fixed exchange rate notwithstanding substantial capital outflows in the aftermath of the tequila crisis, qualifies the conclusion of Hesse and Heitkamp. The paper shows that even with limited flexibility, the Central Bank is able to maintain financial stability during a period of capital outflows given the institutional setup of a modified currency board supplemented by a full substitutability of the domestic and the anchor currency.

Sebastian Edwards, Roberto Steiner, and *Fernando Losada* (Capital Inflows, the Real Exchange Rate and the Mexican Crisis of 1994) give an excellent outline of the relevant transmission mechanisms when discussing the pros and cons of fixed and flexible exchange rate systems. One may ask whether or not it makes sense to provide another paper on the tequila crisis? The answer is no – generally, everything has been said – and yes because in this case it is said again in a very convincing way. This is because the authors concentrate on the main issues, i.e. the dependence of inflation inertia on the exchange rate regime, the long-run sustainability of current account deficits, and the reasonable size of short-run appreciations of the real exchange rate. In each case, only a few equations are needed to identify the most important parameters in a small (partial equilibrium) model. Estimations and simulations then yield plausible results which are very telling for explaining the Mexican experience. First, it is demonstrated that the fixing of the exchange rate actually decreased inflation inertia significantly without being able to eliminate it. This, however, was only the case in the early phase of exchange rate-based stabilization. In the following years, inertia returned to the initial level. Second, the steady-state equilibrium for the current account deficit, assuming no change in the reserve position, is characterized by the extent to which foreigners are willing to hold domestic assets and by the growth rate. A current account deficit of 7 percent of GDP would then require a real growth of 7 percent and foreigners willing to hold domestic assets up to the level given by the GDP. Therefore, Mexico's current account deficits – more than 7 percent of GDP in 1993 and 1994 – clearly exceeded the sustainable level. Third, the short-run dynamics of the real exchange rate are determined by supply and demand elasticities. Assuming parameters which are consistent with the actual current account deficit in Mexico, the authors calculate a real appreciation of less than 10 percent. Again, the figures for Mexico have been out of range. The paper also contains a set of conclusions for other countries and conclude that "... some of these lessons are, in fact, nothing more than the reformulation of old truisms that had been forgotten with the emerging markets euphoria ..." (p. 106). One of these lessons is that a successful stabilization program needs to keep the current account deficit under control which, in turn, requires high public savings and the stabilization of private savings.

The remaining papers address the strengthening of public sector institutions, the design of own trade strategies, and Latin America's social debt. *Leonardo Auernheimer* (Good Governance after Stabilization: Avoiding a Negative-Sum Game) outlines a model of a rent-seeking society which is not driven by the median voter but by the competition between two productive sectors for subsidies. The model is able to mirror the development of actual economic policies in Latin America because it explains the increase of government intervention up to a point where subsidies to be distributed have decreased significantly and the consequent decline of demand for government intervention. This suggests that Latin America needs not only a smaller state but a state strengthened in its capabilities to establish reliable property rights, to correct market

failures, to provide public goods, and, most importantly, to resist pressures to restart the "intervention game" after a reform period.

Patricio Meller (Regional Free Trade Agreements as an Alternative to Unilateral Liberalization: The Case of Chile) discusses the problem of defining a foreign trade strategy given the fact that export growth is still unsatisfactory in many cases and given a general trend to create trade blocs and to discriminate against non-member countries. In this situation, the relevant question is whether to establish own trade blocs and refrain from further unilateral liberalizations in order to maintain some bargaining power. Meller uses the example of Chile to demonstrate the appeal of unilateral liberalizations for a small country. However, he acknowledges that gaining market access is of utmost priority in maintaining a strong growth in exports. He rightly argues that going for regional trade blocs makes sense as long as this leads to a greater market access, i.e. that regional integration in the form of free trade arrangements supports a strategy of outward orientation.

Hermann Sautter and *Rolf Schinke* (The Social Dimension of the Latin American Reform Process) discuss policies to reduce poverty. Contrary to the macroeconomic management, the rent-seeking, and the trade issue, this is an issue which regained attention only recently. As Sautter and Schinke remark, an improvement of income distribution is of utmost importance in the Latin American context because of the highly unequal distribution of incomes on the continent. During the reform process in the 1980s, income distribution even deteriorated which led to problems with the sustainability of reforms. The paper has two main contributions. First, it differentiates between the problems of temporary poverty and the problems of chronic poverty. Second, it outlines the two complementary solutions to the problem, i.e. economic growth and the improvement of insurance schemes. In summary, they conclude that "... Latin American health services, sickness insurances, and pension systems neither help the already poor to overcome their poverty nor can these programs efficiently prevent the non-poor from becoming impoverished. The systems are administratively inefficient and they produce high financial deficits ... (The) need ... (for) ... reforms has been debated for a long time. What is new in this debate, is the stress on deregulation and privatization which corresponds to the ideological dimension of the ongoing reform process ..." (p. 224). The paper contains also an overview over reform efforts and shows that Latin American countries adopt different reform strategies. While Costa Rica is cited as an example for an improvement of the public system, Chile represents an example for a partial or even full substitution of the public by a privately funded system. Clearly, social security is one of the most interesting topics for future discussion.

All in all, the volume is a valuable contribution to the discussion of economic reforms in Latin America. It is most appropriate for readers who try to gain an overview over the issues currently discussed. They will find the main arguments and they will benefit from the literature cited in the papers. The main shortcoming of the volume is that it deals with one of the main issues in future discussions, i.,e. social security, while only implicitly treating others, e.g. domestic savings and labor market policies. Future volumes may discuss these issues in more detail.

Rainer Schweickert