Latin American Market Reforms Put to the Test

By the beginning of the 21st century, Latin America was supposed to have living standards comparable with those of developed nations. At least, that was the implicit promise behind the ambitious economic reforms undertaken by most countries in the region during the last two decades of the 20th century. Unfortunately, not all expectations have been fulfilled.

Instead, a wave of dissatisfaction and questioning of the wisdom of market-oriented policies is spreading throughout Latin America and the world. It began with a vocal antiglobalization minority, but the ranks of the discontent seem to be growing, most recently fueled by Argentina's 2001–02 meltdown.

Why is Argentina, a country that was often praised for its reforms and cited as an example for other emerging economies, suffering one of the most severe economic depressions of its history? If the best student is in deep trouble after having done what the teacher advised, what awaits the rest?

Many analysts fear that this wave of antimarket criticism will swing the pendulum back to the populist and authoritarian policies that market reforms were meant to replace. The fear is justified in that the reforms have not yet improved living standards to the degree promised. During the 1990s, per capita income in Latin America was far below that of both Asian and industrial economies (*Chart 1*).

Nonetheless, much of the criticism seems premature for two reasons. First, market reforms have improved the living standards in a number of Latin American countries, such as Chile, Nicaragua, Honduras and Costa Rica. Second, many criticisms typically overlook historical circumstances. The drive to market reforms originated not in purely ideological considerations but in the harsh economic realities that most Latin American countries faced in the 1980s.

Chart 2

GDP Per Capita Growth in Latin America, 1950–2000

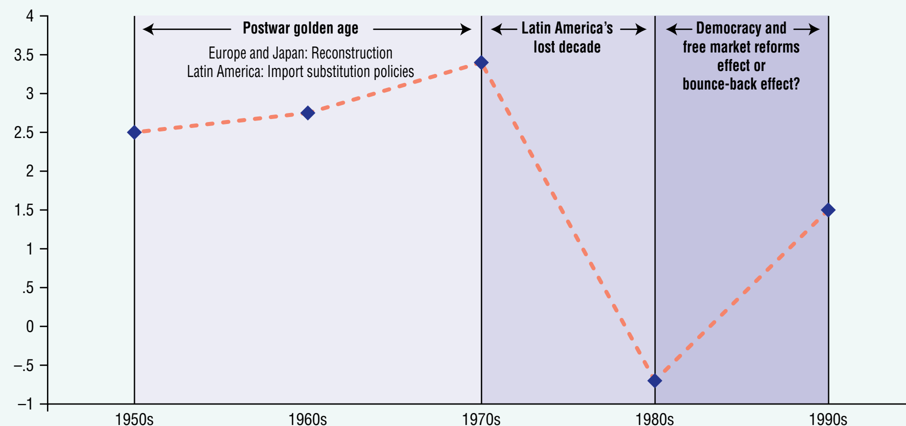
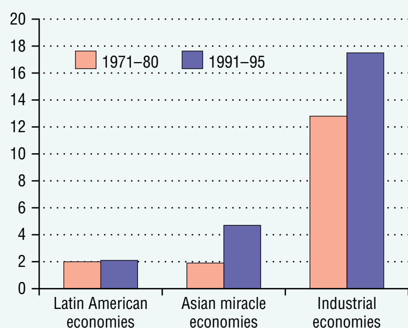


Chart 1

Comparison of Per Capita Income, 1971–80 and 1991–95



* Simple average.

SOURCE: Inter-American Development Bank calculations based on World Bank statistics.

The Road to Market Reform

From the Great Depression until the 1980s, the apparent success of centrally planned economies prompted many developing countries to embrace the idea that governments, rather than markets, were best equipped to deliver endless prosperity and opportunities to their citizens. In the spirit of centrally planned economies, most Latin American countries adopted a growth strategy in the form of import substitution policies—those aimed at protecting and developing national industries through government intervention. The results were high import tariffs, government subsidies, nationalization of major industries and other forms of protectionism. Domestic prices were controlled. Currencies carried a high devaluation-risk premium, which made equipment imports needed for industrialization very expensive.

This import substitution strategy appeared to work at the beginning; GDP per capita steadily increased at an average annual rate of 3 percent between 1950 and 1980 (*Chart 2*). Less apparent, however, was the debt buildup taking place at the same time. A foreign debt crisis erupted, beginning with Mexico in 1982 and spreading throughout Latin America with such devastation that the 1980s became known as "the lost decade." GDP per capita declined at an average annual rate of 0.7 percent during the decade. Hyperinflation was endemic. By 1986, three out of four Latin Ameri-

can countries had inflation rates above 30 percent.

The unparalleled crisis of the lost decade motivated a policy debate, not much different in intensity and motivation from the current one. Heavy-handed government intervention was rejected for market reforms in hopes that the region would return to its fast-track growth rate of the 1950–80 "golden age." Emphasis on the market economy pushed import substitution policies by the wayside. Trade opened up. Institutional and political reforms replaced dictatorships with democracies. Latin America began the 1980s with 10 democracies (out of 26 countries); by 1990, all but four countries were democratic, and by 2000, only Cuba was not.

The big government era came to an end. Privatizations—turning over government institutions and activities to the private sector—became prevalent. Domestic financial systems were deregulated, and controls on capital flows and foreign currency transactions were eliminated. Latin America experienced a dramatic turnaround in the 1990s. GDP per capita growth rebounded to positive territory (*Chart 2*), and inflation declined. By the end of 1996, only one country had an annual inflation rate over 30 percent.

Even so, market reform critics argue that the progress was unrelated to the reforms. GDP per capita in the 1990s grew at rates that, although higher than in the 1980s, were still about half the growth rates of the import substitution era. They conclude that the relatively good performance of the 1990s is only a natural bounce-back that would have happened anyway. They also emphasize that unemployment has been climbing throughout Latin America roughly since the mid-1990s, even in countries where the reforms seem to have worked best, such as Chile.

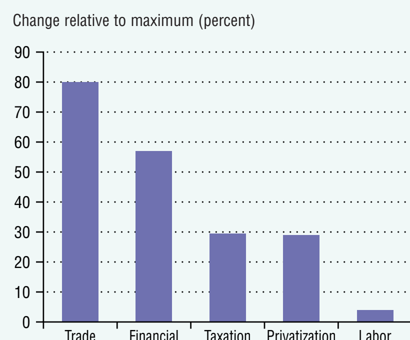
Bumps in the Road

These observations suggest that the question is not why market-friendly reforms have not been successful, but rather why they haven't been *as successful* as their advocates promised. Existing economic theory provides some guidance. The theorem of the second best asserts that the absence of government intervention in a particular market or set of markets does not guarantee a favorable outcome for the society as a whole when imperfections or regulations in other markets are not removed at the same time. In other words, introducing free market reforms in some areas, but not others, is not necessarily better than a little bit of government intervention in *all* markets.

Chart 3

Progress of Structural Reforms, 1985–95

Change relative to maximum (percent)



NOTE: Progress is measured as the change in the index between 1985 and 1995, divided by 1 minus the value of the index in 1985. Indexes are simple averages of the indexes per country.

SOURCE: Lora, Eduardo (1997), "A Decade of Structural Reforms in Latin America: What Has Been Reformed and How to Measure It," OCE Working Paper no. 348, Inter-American Development Bank, Washington, D.C.

Although Latin America has made great progress in some areas, such as financial and trade liberalization, not much has been accomplished in terms of labor market legislation (*Chart 3*). The second-best theorem suggests that opening up trade while keeping labor markets heavily regulated may be bad policy because it may not guarantee enough jobs to employ the workers displaced by trade liberalization.

Domestic policies of the Latin American countries are not the only ones at fault. Developed countries also have failed to liberalize trade in agricultural products, textiles, steel and other commodities. Therefore, in another application of the second-best theorem, trade liberalization for one group of countries is not necessarily the best policy when the trading partners do not reciprocate. Thus, both the failure to remove labor market regulations and the protectionist policies of developed countries may be responsible for the underachievement of market-friendly reforms.

Another theorem, the second-welfare theorem, may also apply. Roughly stated, this theorem asserts that a free market economy can make everyone better off than an economy without free markets, provided the losers in the transition from one regime to the other are appropriately compensated. In implementing market reforms in Latin America, policymakers may have overlooked this important caveat. Stubbornly high poverty rates may very well be the lingering social consequence of that omission.

In any case, the market-friendly reforms introduced in Latin America since the 1980s have succeeded in rescuing the region from the stagnation to which it seemed condemned during the lost decade. But these reforms have fallen short of achieving the prosperity they promised. However, it is premature to attribute the failure to any intrinsic shortcomings of the reforms. The evidence seems to point instead to serious asymmetries and lack of depth in implementation.

On the issue of market reforms, as in almost anything else, the devil seems to be in the details. No question, those details may be imperative for the fate of market reforms. Policymakers and scholars will have to be more aware of the potential bumps in the road of market-friendly reforms and engineer ways of driving over them as smoothly as possible, without wrecking the economy in the process.

Provided this challenge is confronted with technical competence and patience, available economic theory supplies plenty of reasons to be optimistic about the ultimate ability of market reforms to deliver, in due time, on their prosperity-for-all promises.

—Carlos E. J. M. Zarazaga
Sherry Kiser

Zarazaga is a senior economist and executive director and Kiser an associate economist and coordinator in the Research Department's Center for Latin American Economics at the Federal Reserve Bank of Dallas.