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Why Have All Development Strategies Failed in Latin America?

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Abstract

After the Great Depression and throughout the rest of the twentieth century, Latin American countries basically approached economic development following two successive and quite opposed strategies. The first one was import substitution industrialization. The second was the so-called Washington Consensus approach. While the two views were founded on quite opposite premises, neither the import substitution industrialization nor the Washington Consensus managed to deliver sustained economic development to Latin American countries. Two domestic elements are crucial to understand this outcome. One is the failure of the state. The second is the inability to achieve mature integration into the world economy.

Keywords: Latin America, economic development, import substitution, role of the state
JEL classification: O11, O19, O54, O57

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Introduction

The relevance of economic growth for social welfare cannot be underestimated. Even if the starting point is not rather different, as was the case for most economies before the Industrial Revolution, small differences in growth rates will generate in the long run quite divergent outcomes. Indeed, it is a fact that country differences in per capita incomes have been growing through time. Likewise, the gap between rich countries and the ones that remain poor has deepened.

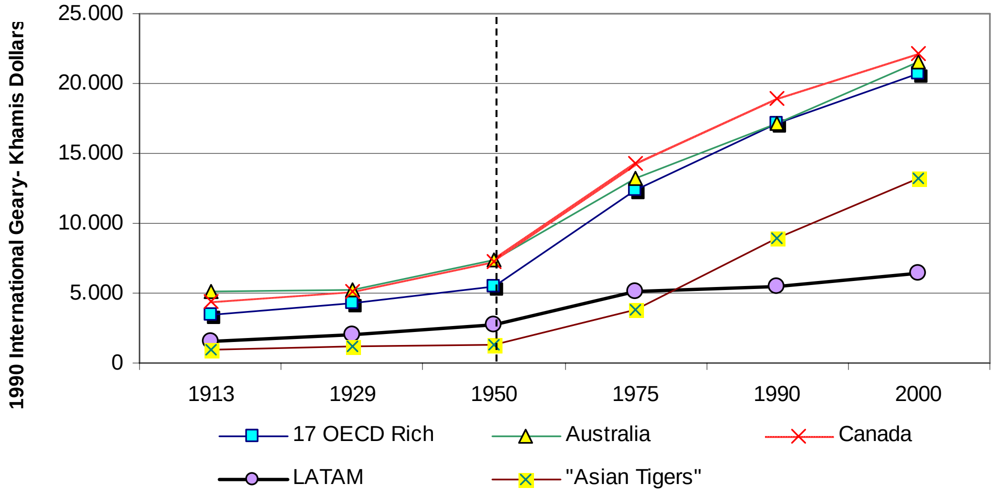
Economic growth depends on capital accumulation, both physical and human, as well as on the evolution of total factor productivity (TFP). Several economic variables, such as present and expected profits, interest rates, investment risks, R&D and entrepreneurship, among others, do affect capital accumulation and TFP. However, social equity, including a fair income distribution, and the working of the institutional framework have been increasingly acknowledged as key determinants of economic growth, not only because they affect the non-idiosyncratic risks of investment, but also because they can promote or discourage entrepreneurship, innovation and technological progress.

The dismal long run performance of Latin American (LATAM) economies since the end of the Second World War (despite differences in initial conditions and other country specificities) brings nevertheless an excellent opportunity to try to understand why economic growth and development can be so elusive. Consequently, the main purpose of the paper is to establish the stylized facts of economic development in Latin America in the post war time and to identify a few common factors underlying the rather poor outcomes achieved, no matter how different the development strategies implemented throughout this period were. To do so, the paper is organized into four sections. The first briefly discusses the long-run economic performance of the region since the Great Depression from a comparative perspective. The second presents the stylized facts of the import substitution industrialization (ISI) period, trying to identify the main reasons of its failure. The third section does the same with the more recent period of market-friendly reforms. Finally, the last section concludes with some general remarks and a few comments on were LATAM countries stand now.

1 Different strategies, common weaknesses

There is little doubt that the long-run economic performance of LATAM countries in the past 70 years or so, especially in comparative terms, has been rather disappointing. While different countries experienced more or less extended periods of improving economic conditions and rapid expansion at different times, sustained growth proved unattainable for the region as a whole. Not only were LATAM countries ineffective in closing the income gap with the developed world (as a matter of fact the gap widened), they were also left far behind by several developing counties belonging to other regions of the world, which showed similar or even worse initial conditions than the ones prevailing in Latin America. In particular, the contrast with the 'Asian Tigers' is remarkably striking.[1] As illustrated in Figure 1, at the beginning of the 1960s the Tigers had on average a much lower per capita income than most LATAM countries. Nowadays, however, they show much better outcomes not only on per capita GDP, but also on income distribution and poverty indicators.

Figure 1: Per capita GDP (1913-2000)



Note: 17 OECD rich: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom and United States. LATAM: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela. Asian Tigers: South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Thailand and Indonesia.

Source: Author's elaboration based on Maddison (2003).

After the Great Depression in the early part of twentieth century and throughout the rest of the century, LATAM countries basically approached economic development following two successive and quite opposed strategies. The first approach was import substitution industrialization. While it initially appeared as a defensive response to the world crisis that put an end to the gold standard regime and reduced multilateral trade to minimum levels, industrialization based on import substitution and an interventionist state became a fully fledged strategy after the Second World War. The debt crisis of the early 1980s made the inherent shortcomings of the LATAM version of the ISI strategy quite evident. As a result, in the second half of the decade an alternative approach gradually emerged. Its advocates stressed that this new approach, unlike the previous one, was market-friendly and consistent with the ongoing process of globalization experienced by the world economy. Because of the support of the USA, the only remaining superpower after the fall of the Berlin Wall, as well as the international financial institutions (IFIs) based in Washington DC, the market-friendly approach became known as the 'Washington Consensus'. In spite of the fact that the two

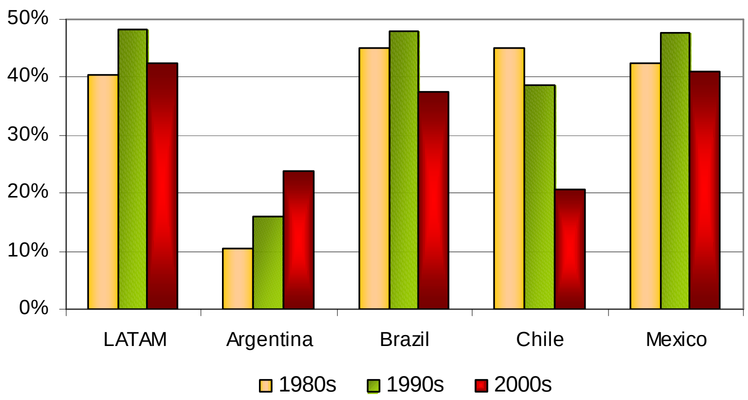
[1] The Asian Tigers include the following countries: South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Thailand and Indonesia.

approaches were founded on quite opposite premises, neither the ISI nor the Washington Consensus managed to deliver sustained economic development to LATAM countries.

After the Second World War, the Asian Tigers also adopted ISI led by an interventionist state, but from the mid 1960s or so they managed to gradually shift towards an outward-oriented development strategy based on fast export growth and a rather adequate balance between market forces and state intervention. This was made possible by a combination of factors. First, political stability which enabled the adoption of sound macroeconomic policies, including fiscal discipline, and kept inflation rates at low levels. Second, a state strong enough to put into place not only effective incentives, including a competitive exchange rate and export promoting policies, but also heavy penalties on private firms when targets were not fulfilled. Third, a high domestic savings rate that helped sustain a significant investment effort without inducing external vulnerabilities. Needless to say, all such factors have been so far completely absent in Latin America. Moreover, the Asian Tigers combined fast growth with improving income distribution. Land reform and public investment in human capital, missing or weak in Latin America, played an important role in this regard.

The Chilean experience of the last 20 years is, to some extent, the regional exception that confirms the rule. In this period the country attained fast growth and was able to significantly reduce poverty (Figure 2). However, the high level of social inequality still needs to be sharply reduced and its productive structure has yet to overcome several weaknesses for Chile to join the club of countries undergoing sustained socioeconomic evelopment (Figure 3).

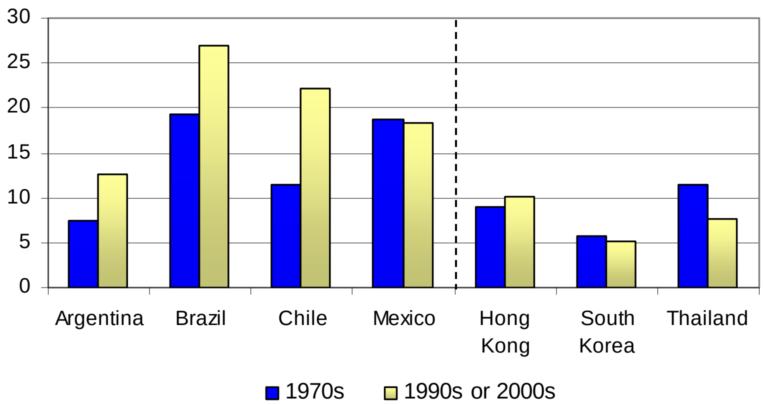
Figure 2: Population below the poverty line



Source: Author’s elaboration based on ECLAC database on social indicators.

In our view, two common factors are crucial to understand the successive failure of both the ISI and Washington Consensus approaches, despite their contrasts. On the one hand the failure of the state to fulfill its role. Indeed, governments were unable to deliver the required public policies and institutions, no matter how different they were under each of the two strategies. On the other hand, excessive protectionism under ISI and unrestrained liberalization during the Washington Consensus period prevented Latin America from achieving a fruitful integration into the world economy. They also made the region extremely vulnerable to external disturbances which were common to both periods, albeit for different reasons—terms of trade shocks until the late 1970s, both real and (mainly) financial shocks afterwards.

Figure 3: Evolution of inequality (QV/QI)



Note: QV and QI are the income averages of the fifth and first quintiles respectively.

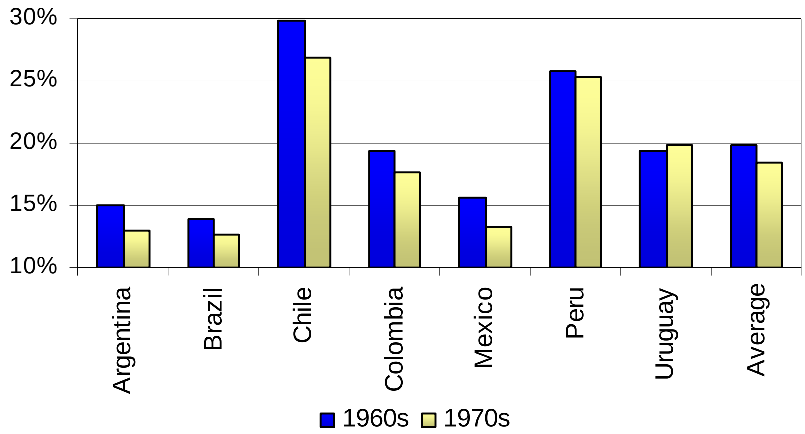
Source: Author's elaboration based on WIID database (www.wider.unu.edu/wiid/wiid.htm, version 2.0a, June 2005).

2 The ISI period

With the outbreak of the worldwide economic depression that followed the collapse in share prices on the USA stock market in October 1929, the world economic context changed radically. The sharp decline in USA economic activity spread to European countries and, as a result of the large drop in effective demand in the advanced economies, international trade fell dramatically, decreasing approximately 30 per cent during 1929-32. Meanwhile, many countries sought to ease their balance of payments difficulties by devaluing their respective currencies, thus undermining the gold standard. This, in turn, accentuated the decline in trade flows and triggered similar protectionist reactions in other countries. The approach of Latin American countries regarding their integration into the world economy was modified by this new scenario. The 'comparative advantages' paradigm, based on the exchange of raw materials for manufactured products, was no longer useful for peripheral countries. In the same way, the decline in the terms of trade imposed several problems in the external accounts of the balance of payments. The natural response of LATAM countries was to elevate import tariffs and to impose exchange controls in order to restore the equilibrium in the external accounts.

The new protectionist policies provided domestic industrial sectors with an opportunity for expansion. Nevertheless, this was not the result of a deliberate strategy aimed at fostering the countries' industrial development. Rather, it was basically the outcome of a defensive reaction adopted by governments in light of the new global economic scenario. Moreover, the outbreak of the Second World War in the late 1930s, with the natural protection it provided, implied an extra push to incipient industrialization. Nonetheless, after the end of the war import substitution industrialization was adopted as a deliberate policy option by many governments, not only in LATAM countries but also in East and South East Asia. During the early stages of the ISI strategy in Latin America, import substitution made fast progress in the so-called light industries, manufacturing consumer goods. In fact, their share in total imports declined sharply. However, the 'easy' phase of the ISI, far from substituting domestic production for aggregate imports, tended to replace imports of consumer goods with those of inputs and capital goods necessary to sustain the process of industrialization.[2] On the other hand, availability of the foreign exchange required to pay for these vital imports remained highly dependant on primary exports and, therefore, subject to the extreme volatility of the international prices of commodities. The outcome of this strategy was rather closed economies in which firms focused almost exclusively on protected domestic markets. In Figure 4 we can see the trade ratios of LATAM countries for the 1960s and 1970s, when the ISI strategy was consolidated: they were not only low but, in most cases, showed a declining trend. Even Chile, the country with the highest ratio in the sample (around 30 per cent of GDP), was quite closed in international terms.

Figure 4: Trade openness (exports + imports/GDP)



Source: Author's elaboration based on ECLAC database.

In many countries the adoption of the ISI strategy was the result of the hegemonic position of the military which, in repeated occasions, even ruled the countries for prolonged periods. In fact, the ideology prevailing in the region's armed forces considered industrialization as a necessary step towards 'economic independence' and national autonomy. An active role of the state was also thought crucial to further stimulate this process, particularly regarding the production of war material. As industrialization went on, however, it became more and more reliant on imports of

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2 Hirschman (1973).

intermediate inputs and capital goods. In a context of stagnant exports the natural consequence was recurrent balance of payments crises that imposed a stop-and-go pattern to the economic performance of LATAM countries. Import dependence and the stop-and-go nature of the business cycle became more evident in the larger economies of the region, where industrialization reached the so-called heavy industries. In these sectors, moreover, the optimal minimum scales of industrial plants are usually bigger and the costs of inefficiencies arising from operating below such levels are more severe. Although industrialization in the Asian Tigers was also initially based on import substitution, in the late 1960s and early 1970s its path started to diverge from the one followed by LATAM countries. Basically, the fact that the Tigers were not able to generate enough foreign currency through their exports of primary goods, as was the case of most LATAM economies, forced them to adopt export-oriented industrialization strategies (Oman and Wignaraja 1991).

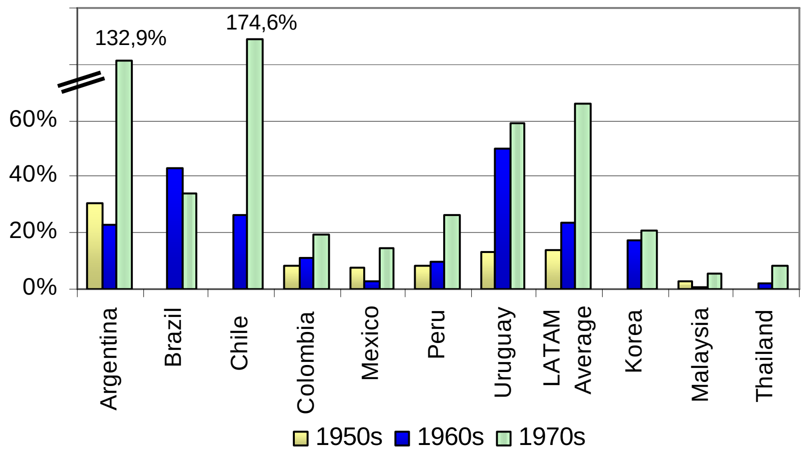
Nevertheless, this change did not imply a weakening in the role played by the state in the allocation of resources. Basically, domestic markets remained protected and financing continued to be heavily subsidised. The main difference with LATAM countries was the capacity of the government to discipline domestic industries by means of export targets, government supervision and credible time limits to protectionist policies, in order to make their production more efficient and competitive in foreign markets.[3] In addition to this, the macroeconomic context was substantially different in both regions. Although state economic interventionism was a common feature of both experiences, in the case of the Asian Tigers this was combined with sound macroeconomic policies that resulted in robust public finances, low levels of inflation, and less volatility. The combination of an adequate mix of policy incentives ('sticks and carrots') and a stable macro environment was key in order to provide the private firms the right business climate required for allocating their resources in productive activities and planning longer term investments projects.

That was not the case in LATAM countries. Despite extreme protectionism and significant subsidies (both in terms of export drawbacks and financing with negative real interest rates), the industrial sector never became a mature and internationally competitive sector. A closed economic environment, the politically biased management of state-owned enterprises (SOEs) and the pervasiveness of unfair regulations favouring the interests of small but powerful groups, led to a context where rent-seeking behaviour tended to prevail over entrepreneurship (Krueger 1990). Moreover, political populism was the main resort by which governments in the region attempted to manage social conflicts and income distribution. Rent seeking and political populism caused the public

[3] As a picturesque example of the disciplinary power of the state in East Asia, we can mention the case of Park's dictatorship in Korea. Shortly after taking power, he imprisoned the principal businessmen of his country, accusing them of having illegally enriched themselves during the previous regime. Even though they were set free shortly afterwards, this only occurred after these businessmen committed themselves to carrying out specific investments requested by Park. See Rodrik (1995); also Amsden (1996).

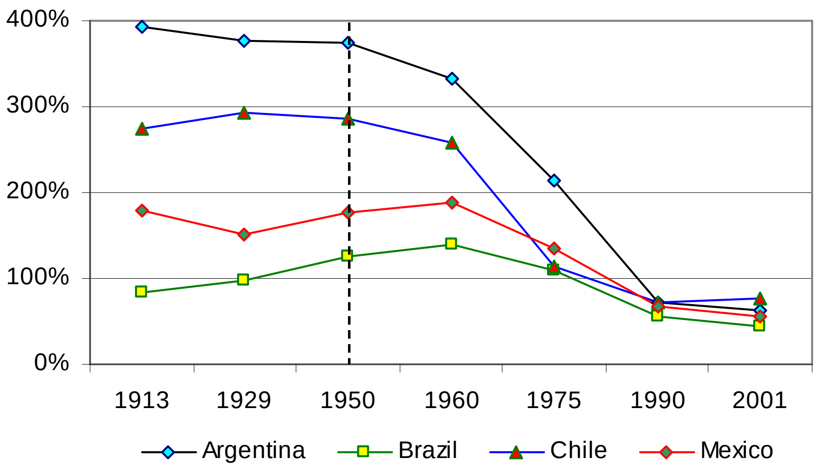
sector to display chronic fiscal deficits which were basically financed by printing money. As a result, since the mid 1960s LATAM countries performed much worse than the Asian Tigers both in terms of inflation (Figure 5) and long-run economic growth (Figure 6).

Figure 5: Average annual inflation rates



Source: Author's elaboration based on IMF statistics.

Figure 6: Relative per capita GDP (LATAM/Asian Tigers)



Source: Author's elaboration based on Maddison (2003).

The contrasting economic performance of Latin America and East Asia suggests that the ISI failure in most of Latin America has less to do with its alleged inherent weaknesses than with its inadequate implementation (Rodrik 2003). True enough, Latin America as a whole did grow faster between 1930 and 1975 than in any previous or subsequent period of its history. Furthermore, industrial exports began to expand in the mid 1960s in some of the largest LATAM economies.[4] Mexico and Brazil, in particular, did quite

[4] In any case, already in the mid 1980s, the share of manufactured exports in the total remained much lower in Latin America (25.1 per cent in 1985) than in East Asia (51.7 per cent in the same year). See Narula (2002).

well throughout the period.[5] Moreover, in most countries economic growth was accompanied by significant progress on income distribution. These improvements, however, were almost exclusively based on direct subsidies, tax deductions and subsidized credit at negative real interest rates, mainly financed with the surpluses of the pay-as-you-go pension systems and the inflation tax. In sum, the ISI model implemented in LATAM countries proved unsustainable in the long run. Their limitations became more severe throughout the 1970s, as fiscal imbalances increased, inflation rates accelerated and economic activity tended to deteriorate *pari passu* with the worsening of external conditions arising from the oil shocks at the beginning and end of the decade.

External difficulties notwithstanding, two domestic elements are crucial to understand the breakdown of the ISI strategy in Latin America. One was the failure of the state to work as an engine of growth. The large inefficiencies of SOEs and the government's inability to appropriately combine the subsidies granted to private firms with suitable controls and penalties in case of their improper use, not only induced chronic fiscal deficits and short-run macro instability, but undermined overall productivity and long-run growth as well. Populist redistributive policies, moreover, heightened fiscal imbalances while, at the same time, impinged on the returns of the most productive economic sectors.

The second factor was the extremely inward orientation of industrialization induced by extended and protracted protectionism, which prevented LATAM economies from taking advantage of foreign markets as a disciplining device to gradually enhance the competitiveness of domestic firms. The indefinite postponement of the economy's opening to foreign competition kept domestic markets mostly in the hands of oligopolistic firms with fewer incentives to enhance productivity than to preserve their market shares by resorting to rent-seeking practices. Moreover, protectionist policies crystallized a structure of relative prices with a strong anti-export bias, particularly harming tradable sectors. As the failure of the ISI strategy became more evident, there was a change in the conventional wisdom about what the developing countries should do in order to reach sustainable development. Nevertheless, the easy availability of financing in international markets, mainly as a consequence of the surpluses in OPEC countries, made it possible to postpone the inevitable economic adjustments.

At last, in the late 1970s, several LATAM countries launched programmes of economic reforms tending to reduce inflation, overcome external constraints and resume growth by increasing the openness of the economy and reducing the involvement of the State in the economy. The programmes implemented in Argentina, Chile and Uruguay were the more ambitious: they combined drastic trade and financial liberalization with severe cuts in public expenditures and a preannounced schedule of nominal exchange rate

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[5] Indeed, Brazil was among the fastest growing economies in the world.

devaluation to curb price volatility. Inertial inflation arising from formal and informal practices of price indexation, however, resulted in the overvaluation of domestic currencies, large trade imbalances, an upsurge in foreign debt (both public and private) and, particularly in the case of Argentina, huge fiscal imbalances. The so-called Southern Cone liberalization attempts ended abruptly in the early 1980s, in the midst of simultaneous exchange rate and banking crises.

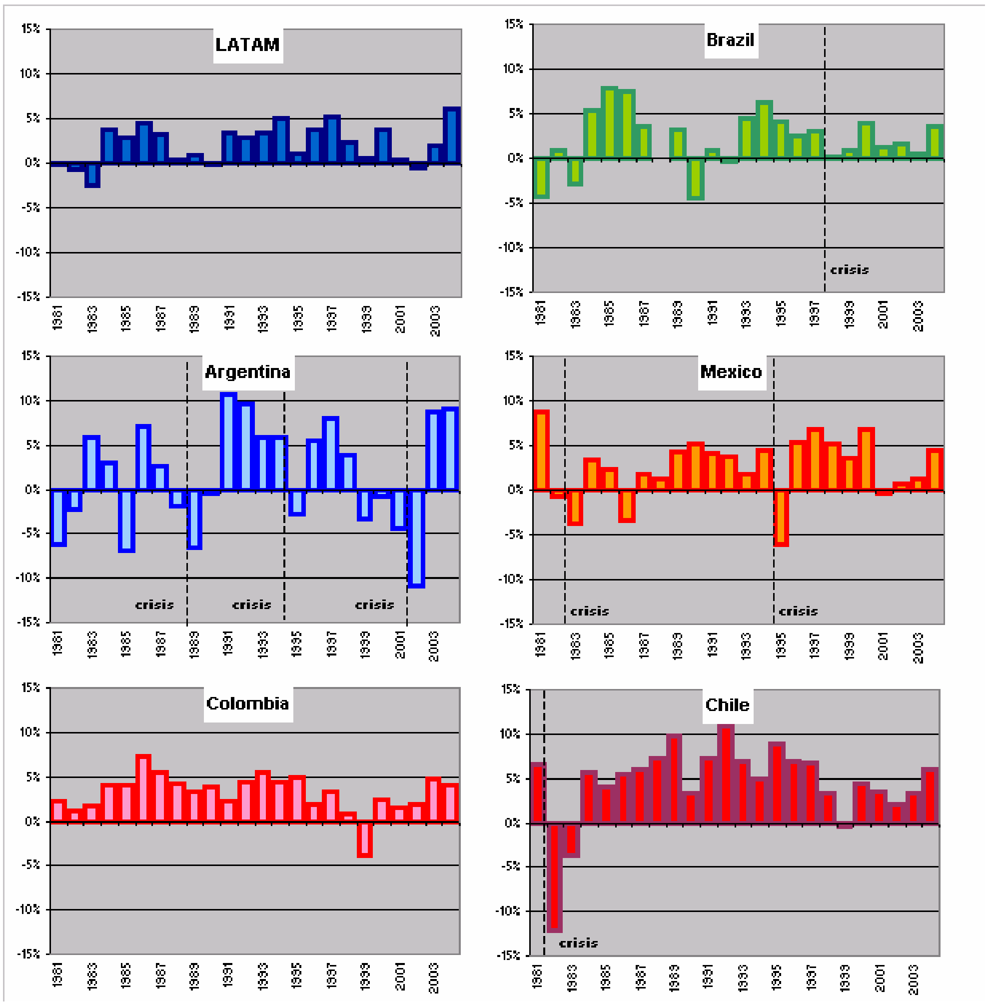
The rise in international interest rates as a consequence of the tightening in the monetary policy adopted by Paul Volcker, Chairman of the Federal Reserve, in the early 1980s, forced Mexico, where a somewhat similar process of liberalization cum real exchange rate appreciation had also been in place, to default on its external debt. Mexico's decision accentuated the already ongoing crisis in Argentina and triggered those in Uruguay and Chile. But it also deteriorated the external stance of the rest of LATAM countries, substantially increasing their foreign debt burden. The new international context of credit rationing and the subsequent attempts at closing the external and fiscal gaps particularly hit public and private investment, severely undermining the growth prospects of Latin America as a whole. The 1980s became known as the 'lost decade' for the region as a whole. Throughout that period per capita GDP decreased in all countries, with the only exception of Chile and Colombia.

The neoliberal view, then already prevailing, attributed the failure of the liberalization attempts of the late 1970s to the incomplete nature of their reforms. Therefore, under the increasing influence of this view on the region's elites and policymakers, a second and broader wave of market-friendly structural reforms began to take shape in the late 1980s. The leverage achieved by the IFIs in LATAM countries as a result of their lending support and, consequently, their growing influence over their economic policies, also contributed to the dawning of this second wave. According to their advocates, the (relative) success of the Chilean experience, allegedly based on fully orthodox economic policies, was the example to be followed by the rest of Latin America. In the early 1990s, when the region regained access to international financial markets, the second round of market-friendly reforms, fuelled by large capital inflows, became unstoppable.

3 The Washington Consensus period

In the 30 years or so that spanned from the crumbling of the ISI strategy to the present, Latin American's economic decline dramatically intensified. Economic performance was among the worst in the world, exhibiting amazingly high macroeconomic volatility, recurrent and deep disruptions and a dismal record in terms of long-run growth (Figure 7) and income distribution. As was already mentioned, a first attempt at replacing the already useless ISI model by a market-based development strategy took place in the late 1970s and early 1980s. Twin fiscal imbalances in the public accounts and the balance of payments, an unsustainable growth in domestic and foreign indebtedness (both public and private) and the increasing fragility of domestic banking systems throughout the region were the main outcomes of this early attempt. The 1982 Mexican default and the ensuing debt crisis put an end to this process when voluntary financing to the region virtually disappeared. Most LATAM countries spent the 'lost decade' squeezing domestic absorption to transfer real resources abroad, while a feasible solution to the debt crisis was recurrently postponed.

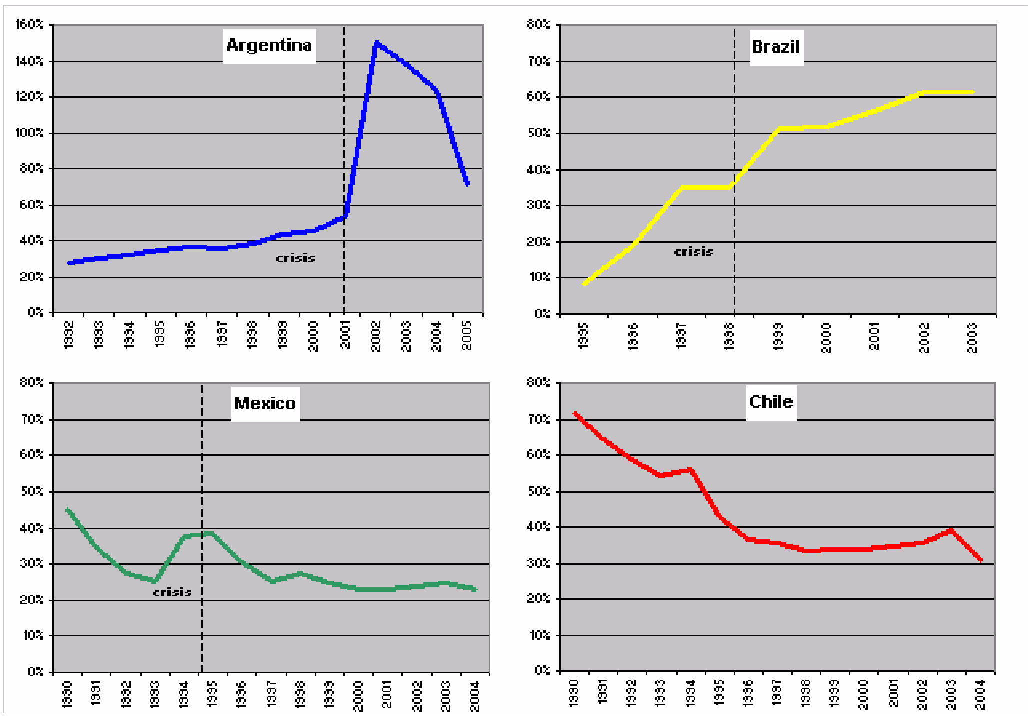
Figure 7: GDP growth



Source: Author's elaboration based on ECLAC and IMF statistics.

The mainstream view among scholars and policymakers blamed the halfhearted and incomplete nature of the reforms undertaken during the liberalization process of the late 1970s for its failure. The proper answer to the breakdown of the first attempt was therefore a second and broader wave of market-friendly structural reforms. This second round began to take shape in the late 1980s under the umbrella of the debt relief provided by the Brady Plan and gained momentum when the region recovered access to international financial markets in the early 1990s. Because of the support of the USA government, as well as the Washington DC IFIs, the blueprint of the reform process became known as the Washington Consensus.[6] The list of recommendations contained in the Washington Consensus blueprint was this time far more ambitious than the one that had guided the 1970s reforms. Outright trade and financial liberalization were once again at the core of the strategy. This time, however, widespread market deregulation and the privatization of SOEs made also part of the strategy. Moreover, to prevent financial liberalization from generating undesired volatility, the domestic banking system was to be strengthened by the adoption of stricter prudential regulations and, when possible, the lifting of barriers to foreign bank participation. To be sure, the scope and progress of the reform process varied from country to country depending on their initial economic conditions and other traits of their institutional and social environment, but the Washington Consensus ideas strongly influenced economic policies and performance throughout the region.

Figure 8: Public debt (as % of GDP)

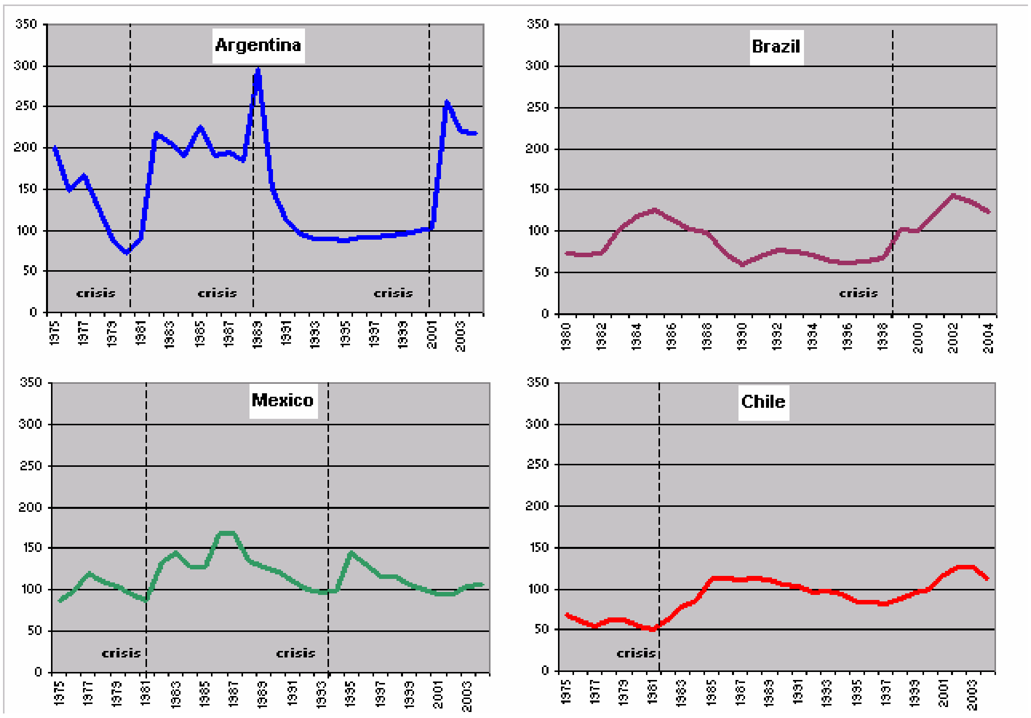


Source: Author's elaboration based on public information of each country.

A stable macroeconomic environment was vital to carry out the proposed reforms. Therefore, fiscal discipline and sound money were two basic tenets of the Washington Consensus agenda. In this regard, the change in the institutional framework of monetary policy was seen as a major move in order to keep at bay political pressures, enlarge Central Bank autonomy and deprive politicians and bureaucrats from the conventional mechanism of printing money. The underlying idea was simple: if the government was denied access to central bank credit, it would then be forced to balance the budget by

6 Williamson (1990).

Figure 9: Real effective exchange rate (average 2000=100)



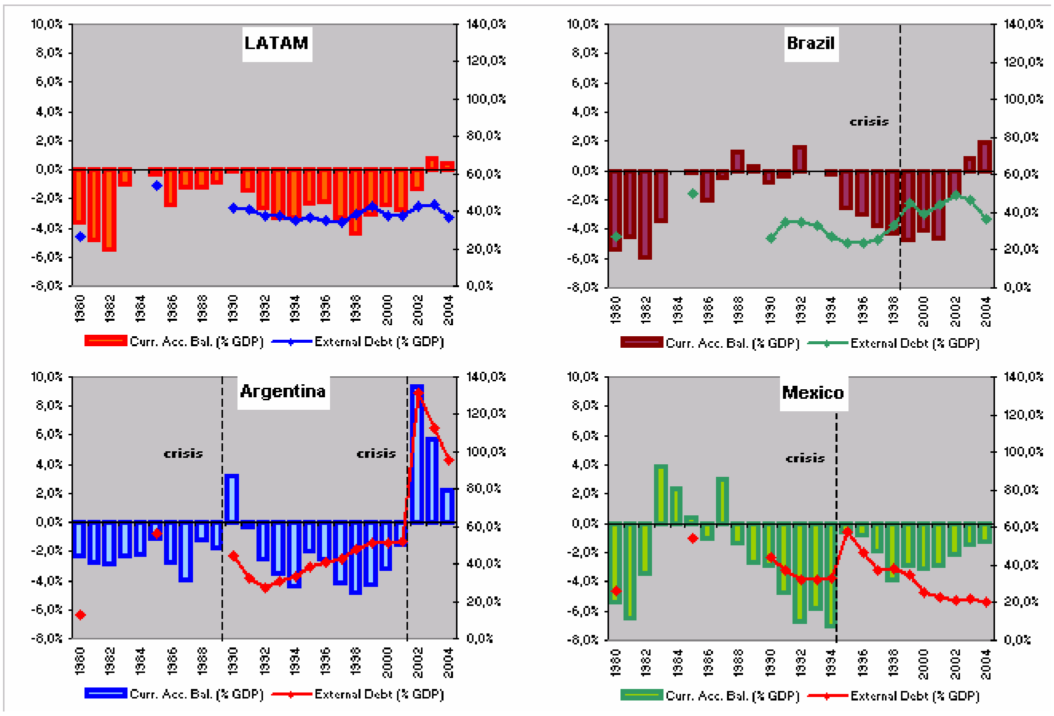
Source: Author's elaboration based on IMF statistics.

streamlining public expenditures and/or reforming the tax system and improving tax collection. The transitory funding required during the completion of fiscal reforms was to be provided by the privatization of loss-making public enterprises. In the same vein, the partial or full privatization of the pension system was aimed at consolidating the intertemporal solvency of the public sector.

In most cases, however, the idea did not work well. In practice, political populism was not that easy to eradicate. Politicians and public bureaucrats managed to substitute foreign indebtedness for central bank funding. Easy access to international financial markets allowed many governments in the region to circumvent fiscal discipline. For several counties the cost was the growth of unsustainable public indebtedness (Figure 8). As already mentioned, trade liberalization was one of the crucial pillars of the 1990s reform. Its main goals were to increase efficiency in resource allocation, eliminating the anti-export bias present in import tariffs, and to help fight inflation by imposing market discipline on domestic firms that had behaved as price-makers in rather imperfectly competitive environments for decades.

With only a few exceptions (Chile, Colombia), however, Latin American trade liberalization was not only fast and deep, but it was simultaneous to financial liberalization and exchange rate based stabilization policies. In the context of pegged or quasi-pegged exchange rate regimes, massive foreign capital inflows strongly biased relative prices and profitability against tradable sectors and in favor of non-tradable goods and services.[7] Price increases in public utilities that came along with privatizations also worked in the same way. As a result of the peculiar combination of simultaneous trade and financial liberalization with overvalued real exchange rates, most Latin American countries experienced a significant deterioration in their trade balances and large deficits in their current accounts (Figures 9 and 10). The progressive rise in interest payments and dividend remittances tended to accentuate those deficits. Foreign direct investments, attracted by privatizations and some other business opportunities, covered part of the current imbalances, but the main bulk of the deficit had to be financed by public and private external indebtedness (Figure 10).

Figure 10: Current account balance and external debt (as % of GDP)



Source: Author's elaboration based on ECLAC and IMF statistics.

To be fair, the market-friendly strategy was initially successful in bringing down inflation. In several countries it also attracted significant flows of foreign direct investment (although privatizations were by far the main driver) and encouraged a more dynamic and diversified export performance. Basic infrastructure and the provision of public services did improve as well (Ocampo 2004). Nevertheless, without any kind of compensating policies to assist economic sectors in distress, the structural transformation that took place in LATAM economies had critical consequences on employment, income distribution and social welfare. Moreover, given the increasing external vulnerability and financial fragility of the region, when growing distress in

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[7] The policy mix involved accepting a high risk, to the extent that trade liberalization demands a higher real equilibrium exchange rate, while unrestricted capital flows and the fixing of an overvalued nominal exchange rate in countries which are structurally net capital importers, tend to keep the real exchange rate below its equilibrium level.

international financial markets triggered sudden stops in capital inflows, they caused severe financial and currency crises in most Latin American countries, interrupting economic expansion abruptly and forcing several governments to unilaterally renegotiate or even default their foreign financial obligations (Calvo 1998). Mexico (1994-95), Argentina (1995), Brazil (1998-99) and again Argentina (2001-02) probably experienced the largest crises, but only a few countries remained unaffected by this trend. As mentioned by Frenkel (2003), some common factors can be found in all the crises:

- pegged or quasi-pegged exchange rates regimes;
- overvalued real exchange rates;
- unrestrained capital movements;
- large capital inflows during economic expansions, both as a proportion of monetary aggregates and relative to the size of domestic financial markets; and
- weak supervision and inadequate regulations in the banking system.

In the appalling context of the Latin American economic performance of the last decades, Chile stands out as a remarkable exception. After the failure of its first liberalization attempt in the late 1970s, its economic achievements over the last twenty years, both in terms of growth and poverty reduction, were presented by the supporters of the Washington Consensus approach as evidence of the success of the market-friendly development strategy when properly implemented. In fact, however, the attempt to portray the Chilean experience as a success of the Washington Consensus approach is, to say the least, an oversimplification. To be sure, in line with Washington Consensus recommendations, Chile dramatically improved its fiscal and monetary stance. Also, it widely opened its economy to trade and extensively deregulated its real and financial domestic markets. Moreover, its privatization programme was one of the most ambitious in the developing world.

However, and despite its rhetoric, the Chilean economic policy complemented its orthodox approach with several measures that were not included in the Consensus blueprint. In particular, the country never privatized CODELCO, the public copper enterprise, a major source of foreign exchange and public revenues. It also combined its unilateral reduction of import tariffs with an active policy of export incentives and a successful strategy of bilateral trade negotiations aimed at diversifying its foreign markets. The other distinctive element of the Chilean economic policy since the late seventies and until very recently was its clear commitment with the maintenance of a competitive real exchange rate. This goal was accomplished by adopting a crawling peg regime complemented, when necessary, with capital controls to discourage short-term inflows. It was only a few years ago that Chile decided to lift capital controls and switch to a flexible exchange rate regime. To conclude this brief comment on the Chilean case, it is worth stressing that, in sharp contrast with most of the LATAM countries, a strong institutional framework and an efficient public administration provided a strong backing to the effectiveness of economic policy.

Summing up, as happened during the ISI period, the two common elements that seriously undermined the overall outcome of the Washington Consensus experience were: (1) the failure of the state to play its required role, that in this case was to properly supervise and complement the role of markets; and (2) the inability to substitute a mature integration into the globalize world economy, properly balancing risks and opportunities, for the previous excessively inward orientation of the ISI period. The omnipresent public sector of the ISI period was replaced by a state that did not fulfill its most basic duties. The extreme protectionist policies of the past were replaced by completely unrestricted trade and financial liberalization.

The unproven notion that privatizations would automatically induce a dramatic improvement in systemic efficiency and productivity contributed to minimizing the attention paid to the way in which privatizations were carried out. In several cases this approach prevented the development of truly competitive markets in the privatized activities while, at the same time, made it easier for both public officials and private agents to engage in corrupt practices. Other basic regulations were also missing, including effective anti-trust regulation, consumer protection and adequate prudential supervision on banking and private pension funds. Moreover, the need to establish a social safety net to alleviate the inevitable social and economic hardships of the structural transformations was overtly neglected.

The reduced presence of the state in the regulation of economic activities, however, was not enough to curb the expansionary fiscal behavior of the past. The idea that the complex political economy issues that shape public sector performance could be easily managed by limiting the government's access to central bank credit was at best naive. Beneath the surface, this approach failed to modify the deep determinants of public sector profligacy, which remained basically unchanged. As a matter of fact, the deeply ingrained populist practices of Latin American politicians and public bureaucrats were not eliminated by the reforms. Instead, when those politicians and bureaucrats found out that their old source of financing was no longer available, their immediate reaction was to look for a new one. The easy access to foreign financing prevailing in the international capital markets until the late 1990s solved their problem: the issuance of public debt substituted for the inflation tax.

Indeed, despite the allegedly neoliberal inspiration of the reforms, in this area the policy course followed in most LATAM countries throughout the 1990s could be best characterized as neopopulist. Quite paradoxically, by disregarding the role of the state in a market economy and reducing public sector reform to the privatization of public firms, the Washington Consensus rhetoric helped preserve the status quo in the workings of the public sector.

The second element that contributed to shaping the final outcome of Washington Consensus reforms has to do with the relationship established between stabilization policies on the one hand, and trade and financial liberalization on the other. Stabilization policies mainly chose the exchange rate as nominal anchor. Simultaneously, with the full support of multilateral institutions and the establishment of industrialized countries, the USA in the first place, Latin America embarked on a process of outright trade and financial liberalization. As mentioned before, the speed and depth of trade liberalization deepened the overvaluation of the domestic currency associated with the use of the exchange rate as nominal anchor. The combination of overvaluation and liberalization dramatically altered relative prices and triggered a sharp transformation on the real side of the economy. At the same time, the sudden change in relative prices generated a competitiveness gap that helped to raise the current account imbalance. External adjustment was postponed because a growing foreign indebtedness provided the funds required to finance the persistent current account deficits. As a result, Latin American economies became not only less competitive but also more vulnerable to the volatility of world financial markets (Rozenwurcel 2003).

The risks posed by the mix of a stabilization policy based on a pegged exchange rate and a simultaneous trade and financial liberalization were hardly unknown in the region. The Southern Cone's dismal experience with trade and financial liberalization in the 1970s had been extensively discussed in the sequencing literature of the 1980s. The need to carefully consider the timing of stabilization and liberalization in the goods and financial markets was one of the main lessons arising from that discussion (Fanelli et al. 1992). Therefore, one can only conclude that policy mistakes were not the only reason behind the inconsistent implementation of stabilization and liberalization. The interests of powerful economic players that benefited from the new scenario despite its social costs certainly played a significant role in the process. There is nothing surprising in this fact. What is less understandable is the support given to this process by the multilateral institutions and other participants in the Washington Consensus.

4 Where does Latin America stand now?

After the Great Depression and throughout the rest of the twentieth century, LATAM countries have basically approached economic development following two successive and quite opposed strategies. The first one was import substitution industrialization. The second was the so-called Washington Consensus approach. While the two views were founded on quite opposite premises, neither the ISI nor the Washington Consensus managed to deliver sustained economic development to LATAM countries. External difficulties notwithstanding, two domestic elements are crucial to understand the breakdown of the ISI strategy in Latin America. One was the failure of the state to work as an engine of growth. This was so because of the large inefficiencies of SOEs, the government's inability to appropriately combine sticks and carrots in its relationships with private firms, and the use of populist policies as the main redistributive device. All this not only induced chronic fiscal deficits and short run macro instability, but undermined overall productivity and long run growth as well. The second factor was the extremely inward orientation of industrialization induced by extended and protracted protectionism, which prevented LATAM economies from taking advantage of foreign markets as a disciplining mechanism to gradually enhance the competitiveness of domestic firms.

The strong social coalition supporting the status quo, including industrial firms, benefiting from captive domestic markets and public subsidies, industrial workers, favoured by low prices of food staples and utilities, and public bureaucrats, taking advantage of the power given by the discretionary channelling of public funds, prevented the progressive transformation of ISI into an export-led industrialization strategy as was the case in East Asia. A first attempt at replacing the ISI model by a market-based development strategy took place in the late 1970s and early 1980s. The 1982 Mexican default and the ensuing debt crisis abruptly put an end to this process when voluntary financing to the region virtually disappeared. The neoliberal view, then already prevailing, attributed the failure of the liberalization attempts of the late 1970s to the incomplete nature of their reforms. According to this view, the proper answer to the breakdown of the first attempt was therefore a second and broader wave of market-friendly structural reforms. This second round began to take shape in the late 1980s and gained momentum in the 1990s.

The structural transformation that took place in LATAM economies under the Washington Consensus did not deliver its promises either. Not only was their long-run growth performance even worse than under ISI, but huge wealth and income inequalities accompanied their poor growth record. Moreover, the increasing external vulnerability and financial fragility of the region resulted in severe financial and currency crises in several Latin American countries. As happened with the ISI strategy, the two common elements that seriously undermined the overall outcome of the Washington Consensus experience were, first, the failure of the state to play its required role, that in this case was to properly supervise and complement the role of markets and, second, the inability to substitute a mature integration into the globalized world economy, properly balancing risks and opportunities, for the previous excessively inward orientation of the ISI period. Nevertheless, practically all countries in Latin America have experienced a significant recovery in the last couple of years. In 2004, in a context of remarkable macro stability, the region as a whole grew almost 6 per cent, the highest rate in the last 25 years (see Figure 7), and it is expected that growth will be around 4 per cent in 2005 and 2006. If this performance materializes, the regional per capita GDP would increase 10 per cent between 2004 and 2006.

While it is true that growth resumption has been favoured by positive external conditions, it is also true that LATAM countries seem to have learned a few lessons. In fact, thanks to more flexible exchange rate regimes, growth in the region has been fuelled by significant increases in exports. Instead of generating current account deficits, therefore, this time economic expansion has been accompanied by current account surpluses. Moreover, governments are taking advantage of this favourable situation to improve their fiscal stance and reduce public indebtedness ratios. Foreign debt ratios are also declining and country risk premia are close to their historical lows.

Will this new scenario become sustainable? In order for this to take place LATAM countries have yet to consolidate the newly acquired macro stability, increase their investment ratios and dramatically reduce poverty and improve social equity. While current international conditions are positive, several uncertainties are present and it would be foolish to bet on the indefinite permanence of current trends. Therefore, the region has still to find its own way to take advantage of the opportunities created by economic globalization (adding value to its exports and diversifying their composition and destination, or attracting FDI towards dynamic sectors among other initiatives), while at the same time protecting itself from its negative effects. In this regard, designing effective countercyclical macroeconomic policies, as well as capital-flow regulations (particularly considering the role of these flows on LATAM's business countries) is crucial. Moreover, LATAM countries need to find their own mix of market incentives and state intervention consistent with economic development under their specific circumstances. The fact that the emergence of dynamic economic activities is not necessarily an endogenous outcome of liberalized markets alone needs to be acknowledged. Rather to replace the private initiative, public policies should aim at fostering linkages between the most dynamic firms and sectors and the rest of the economy.

Finally, social objectives should be mainstreamed into economic policy. The benefits of economic growth will not trickle down spontaneously to the less favored groups in society. Besides fostering democracy, institutional development and the quality of their political systems, LATAM counties will have to build proper safety nets and put into place efficient redistributive policies in order to achieve this goal.

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