LATIN AMERICA AND THE WASHINGTON CONSENSUS

Overcoming Reform Fatigue

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THE COUNTRIES of Latin America began a process of reform about two decades ago, with a view to restoring growth and overcoming the debt crisis that had enveloped the region. Macroeconomic policies focused on the immediate priority of stabilization. To restore its medium-term growth prospects, Latin America also needed to make deeper changes in its development strategy, including proceeding with financial liberalization, opening up to foreign investment and trade, privatizating state-owned enterprises, and deregulating markets. The aim was to promote more open, competitive economies by expanding the role of markets and reassessing the role of the state. These structural reforms became another element of a strategy that—with financing support from the international financial institutions—would help overindebted economies regain access to international capital markets.

But the initial enthusiasm for the so-called first-generation reforms was not matched by results, which did not meet expectations. The region's external debt renegotiations were concluded, and capital flows resumed at the same time as growth became more vigorous. However, growth rates were lower than those recorded in the post–World War II years (Chart 1), and, during the second half of the 1990s, the region once again experienced financial crises that largely reversed earlier gains.

The meager results of the past 20 years have led to doubts about the path followed. Certainly, the harshest complaints have come from those segments of the population that were most burdened by the costs associated with the economic restructuring programs. However, dissatisfaction has intensified and become more widespread in a context of low growth and efforts to reduce the enormous economic inequalities in the region proving unsuccessful. Dissatisfaction with economic performance has led to disenchantment with economic reform and even with democracy. The Latinobarómetro survey (Lora and Panizza, 2002) found that about two-thirds of those surveyed in 17 countries of the region in 2001 were dissatisfied with the results of democracy and felt that their country had not benefited from privatization.

This may well undermine the will to continue with the effort to make our economies more efficient and equitable. A reassessment of why reform has so far yielded such poor results is therefore in order so that steps can be taken toward building the necessary consensus on the outstanding tasks of formulating and implementing policies for restoring growth.

Failed or insufficient reform?

Progress with the first-generation reforms has been uneven, both from country to country and in terms of the various items on the agenda (Lora, 2001). The lifting of barriers to trade (Chart 2) and foreign investment facilitated the integration of the Latin American economies into the world economy. The reform effort also led to financial sector liberalization. However, less progress has been achieved in the areas of privatization and deregulation, especially the latter. Similarly, actions taken to create a legal framework appropriate for a market economy have been insufficient both in the labor market and in the policies implemented to encourage competition in goods markets. We also observe that reforms have been under way longer in some countries; for example, Chile started much earlier than the rest of the region.

One fundamental area in which improvement has been more lasting is that of fiscal and monetary discipline. While progress has been uneven, countries such as Chile and Mexico are beginning to see the expected results; these economies have succeeded in delinking from recent episodes of turbulence and volatility. However, much remains to be done in this area. One of the basic reasons for countries to maintain a sound public finance position is that it increases their margin for maneuver to respond to cyclical fluctuations. The improvement achieved in the fiscal position in our countries—with the exception of Chile—is still inadequate for the achievement of this objective, as is pointed out by Artana, López Murphy, and Navajas (2003). Similarly, despite efforts to avoid excessive indebtedness, virtually all Latin American governments have been unable to generate the resources necessary for formulating and implementing long-term public policies aimed at accumulating physical and human capital. These policies are fundamental for raising the potential for economic growth and thus improving income distribution.

Some analysts emphasize the slow pace of the reform effort and conclude that so little progress has been made that positive results cannot be expected. The empirical evidence at our disposal points to a more complex assessment. First, we must not underestimate the results achieved, insufficient though they may be, compared with the situation of two decades ago. Indeed, various empirical studies suggest that the improved economic performance of the 1990s was attributable largely to the reforms. Second, a review by Lora and Panizza (2002) of the empirical evidence reveals that even if only the first-generation reforms were completed, growth could increase, on average, by one and a half percentage points above average growth rates recorded in the 1990s. This result would have a huge impact but would still prove inadequate for addressing the challenges facing the region.

This is a somewhat discouraging finding. However, we must ask what the point of reference is for assessing the effect of economic reforms to date. The common point of reference has been the list of policies set forth in the so-called Washington Consensus. The Consensus was not a recipe or a set of best practices, much less a coherent strategy. It was merely, as stated by the author of the phrase (Williamson, 2000), a list that, in its time, reflected the lowest common denominator of policies recommended for Latin America.

The very fact that such a consensus was reached represented remarkable progress. Nonetheless, there were many other aspects of public policy formulation still to be resolved—among which the sequence of reforms deserves special attention—and, in recent years, the debate about some of them has been revived. In particular, the crises of the late twentieth century reopened the debate on the extent to which some of the reforms, or the order in which they were adopted, increased the vulnerability of the Latin American economies.

A series of financial crises and periods of financial market volatility have been reflected in a setback in welfare and poverty alleviation, as well as in the region's growth prospects. Specialists point to the gap between financial liberalization and the required strengthening of prudential supervision as well as to the slow adjustment of exchange arrangements to the increase in capital mobility as basic causes of the region's vulnerability.

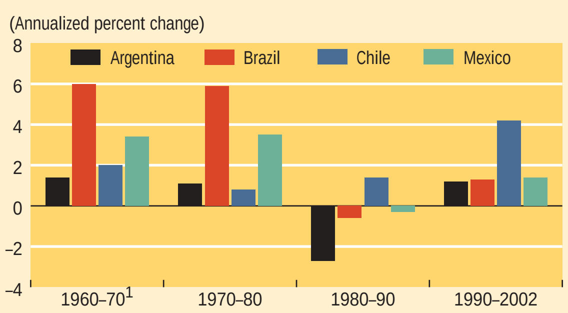
Progress in privatization is still inadequate, not only because of the slow pace of the sale of state-owned assets but also because of deficiencies in the design of the process. The purpose of privatization was to transfer activities out of the purview of the state to the market, thereby enabling the state to focus on the activities for which it is best suited. However, the sale of assets previously owned by the state did not always lead to the development of efficient markets and enterprises. In many cases, the regulatory framework had not been strengthened. Privatization did not always conform to best practices and, at times, resulted in the conversion of public monopolies into private ones. Even worse, harmful incentive structures were frequently created for both the regulators and the regulated.

It is also unfortunate and common to find cases where the state granted implicit or even explicit guarantees to private investors who ventured into sectors previously controlled by the state. To a large extent, this reflects problems in other areas, in particular the lack of deep capital markets capable of financing long-term projects. The result has been public guarantees of returns for private investment, through either regulatory permissiveness or financial guarantees. One area where progress has been insufficient is the design and strengthening of regulatory systems that create the right incentives for both the regulators and the regulated.

In an optimal design, priority would have been given to the way in which the markets would function and to the regulatory and supervisory systems that should have accompanied privatization, as well as to the incentives that were being created for the new enterprises. However, there was also an element of political strategy: those who were proposing that the reforms take place as quickly as possible were seeking to ensure that changes could not be reversed. From that standpoint, any sense of optimal sequencing and of the elements necessary for ensuring the efficient functioning of the privatized enterprises is completely lost. In the event, reform fatigue is attributable, to a large extent, to the resulting problems.

Can the region's poor performance be explained by the insufficiency of reform efforts or by their excesses? The debate on public policies in Latin America has been centered excessively on this question. While posing the problem in

Chart 1
Only modest revival
Per capita GDP growth has been disappointing despite reforms over the past two decades.



Sources: IMF, *International Financial Statistics* and World Economic Outlook database.
[1]For Brazil, 1963–70.

these terms has revived public debate and fed the rhetoric, it seems to have exhausted its usefulness for formulating a strategy to stimulate growth. The real complexity of the problem has been oversimplified, and the false idea has been nurtured that there is a set of policies that, if adopted, would resolve the problems once and for all. A false perception is thus given credence among the electorate in the quest for an illusionary quick fix for existing problems.

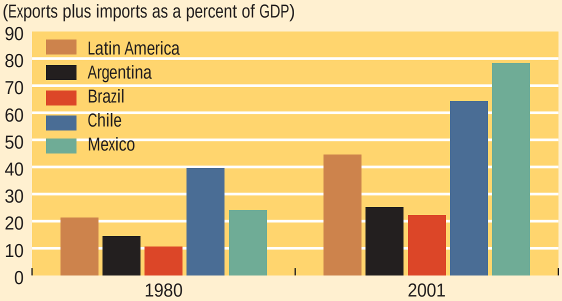
The truth is that, even if a framework of ideal public policies were put in place, overcoming the region's backwardness is a long and difficult task. As William Easterly illustrates in *The Elusive Quest for Growth*, economists have had changing ideas about the key factor in development. Although a set of best practices can be identified at each point in time, and we should certainly seek to introduce them, structural change is always an unfinished task; the effort required is one of constant adaptation to changes created by the reform process itself, by the external environment, by the emergence of technologies that alter the organization of specific markets and industries, or even by the rise and fall of entire industries and sectors. What we need is the flexibility to embrace continuous change and adaptation. This assumes the constant improvement of standards of education to facilitate the process of adjustment to new conditions.

In a democratic society, reform requires consensus building—it requires acceptance of the fact that change creates winners and losers and thus reinforces the incentives for innovation and efficiency. In a democratic political system, there is also a need to respond to the concern for equity by developing mechanisms to compensate losers and finding ways of distributing the benefits of change. These issues also arise in the international context, where coordination is necessary to arrive at agreements that facilitate the integration of the emerging economies into global markets on competitive and mutually beneficial terms.

Chart 2

More open

Latin America has become more integrated with the world economy over the past two decades.



Source: Economic Commission for Latin America and the Caribbean, 2002, *Statistical Yearbook for Latin America and the Caribbean* (Santiago, Chile).

The role of institutions

Experience with the first round of reforms has helped create what seems to be a growing consensus on the need to redefine priorities in the reform process. Whereas the initial effort was concentrated almost exclusively on reducing the state's role and broadening the role of markets, today the emphasis is on the positive aspects of state intervention—that is, actions that are fundamental for ensuring the proper functioning of the market, in particular institution building. Moreover, the past 20 years have taught us that structural change does not consist merely in adopting sound policies; it also involves sustaining the process of change by developing institutions that are well adapted to local conditions and that help countries confront new challenges. Last, we cannot ignore those reforms that have had adverse effects. They often reveal flaws in the prioritization of policies, but, above all, they highlight the inadequacy of efforts to strengthen the institutional framework, which should support liberalization policies.

The debate on the second-generation reforms has emphasized the need to supplement reforms with elements not previously envisaged. We now have more detailed and specific knowledge of the institutional framework and the necessary prerequisites for preventing blunders in privatization and for reducing the risk of crisis in a context of greater capital mobility and liberalized financial markets.

Proponents of second-generation reforms point to institution building as necessary for bringing forth the potential benefits of earlier reforms. Emphasis is placed on the budgetary process rather than on meeting a specific target for the fiscal balance and on the strengthening of autonomous central banks rather than on rapidly lowering inflation. On these two issues, the outlook is particularly encouraging in light of progress made in building a broad consensus on economic stability as a prerequisite for growth. Nonetheless, institution building goes well beyond these two examples.

The emphasis on institution building rather than on the implementation of "correct" policies points to the ability to take account of local conditions in policy formulation as a key to success; in this sense, it could be said that the devil is in the details. Indeed, we note that there is no single, common solution to similar problems in the advanced economies: banking plays a preponderant role in the financial systems of continental Europe and Japan, while securities markets play a more important role in the United Kingdom and the United States. The differences between these systems may be explained by historical accident or by local circumstances, but both systems have the merit of being efficient institutional solutions to attain financial deepening.

The road ahead

International agencies and governments alike are facing new challenges in the development of the agenda for institution building. As pointed out by Naím (1999), this new set of reforms creates challenges that are different from those of the first-generation reforms. Indeed, implementation of most of the first-generation reforms required merely the will of the authorities: a decree suffices to dismantle exchange control measures, and deficit control depends on discipline in public spending. Moreover, many governments faced a political environment that enabled them to quickly introduce changes whose impact on the economic system was far-reaching. The measures required for second-generation reforms are more complex: it takes years to establish a system of effective prudential supervision, and the strengthening of government agencies requires the development of a career civil service and a multitude of actions as described by Kuczynski (2003). On an administrative level, the second-generation reforms are proving more difficult to manage because they require the involvement of numerous actors, and each of the multiple tasks has different requirements.

In addition, the political environment is such that governments experience more difficulties in introducing new measures, while the use of conditionality to drive reforms is no longer an option. Institution building must, by definition, come from each country's own efforts, as a response to the search for solutions in the field, so that agreements can be reached and rules of conduct established to smooth interactions.

From a historical standpoint, the process of change in Latin America began only two decades ago, and there is still a long way to go. The development of institutions designed to meet the needs of each country requires considerable effort. Success depends on the creation of broad a consensus on the path to be followed. ■

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