POLITICAL ECONOMY IN A TIME OF CAPITAL OUTFLOWS:

Theory, Historical Analysis, and Prescriptions*

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CAPITAL FLOWS, CAPITAL CONTROLS, AND CURRENCY CRISES: LATIN AMERICA IN THE 1990s. Edited by Felipe Larraín. (Ann Arbor, MI: The University of Michigan Press, 2000. Pp. 330. $62.50 cloth.)
BANKING AND ECONOMIC DEVELOPMENT: BRAZIL, 1989–1930. By Gail D. Triner. (New York: Palgrave, 2000. Pp. 330. $59.95 cloth.)
CAPITAL MARKETS, GROWTH, AND ECONOMIC POLICY IN LATIN AMERICA. By Antonio Jorge, Jorge Salazar-Carillo, and Bernadette West. (Westport, CT: Praeger, 2000. Pp. 226. $69.50 cloth.)
DEVELOPMENTS IN LATIN AMERICAN POLITICAL ECONOMY: STATES, MARKETS AND ACTORS. Edited by Julia Buxton and Nicola Phillips. (New York: St. Martin's Press, 1999. Pp. 241. $24.95 paper.)
CAPITAL FLOWS AND FINANCIAL CRISES. Edited by Miles Kahler. (Ithaca, NY: Cornell University Press, 1998. Pp. 368. $49.95 cloth, $19.95 paper.)
MODERN POLITICAL ECONOMY AND LATIN AMERICA: THEORY AND POLICY. Edited by Jeffrey Frieden, Manuel Pastor Jr., and Michael Tomz. (Westview Press, 2000. Pp. 348. $65.00 cloth, $24.00 paper.)

George Santayanna quipped that those who do not study history are condemned to repeat it. A wealth of literature and empirical evidence suggests a similar caveat for economists who do not study politics. Similar warnings should be heeded by political scientists who are reluctant to delve beyond the textbook channels of politics. Although it is conventional wisdom to say that it is impossible to separate the two fields, in practice, political scientists have traditionally been ill informed about economics, and economists have generally seen politics as being a set of obstacles that demand rent and distort ideal policies. Fortunately,

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this has changed, evident by an ever-growing body of serious literature of political economy. This review examines six volumes which contribute to the development of political economy as a discipline. The review hopes to convince the reader that political economy explanations are a very appropriate means to address contemporary problems in Latin America, that they can help explain the problems associated with liberal reforms and the possibility of future reforms.

All six volumes reviewed here contribute to the literature on political economy, but there are considerable differences in terms of the specific areas that they address and the type of public for each book. Gail Triner's *Banking and Economic Development: Brazil, 1889–1930* is the only single author volume reviewed here. Jeffrey Frieden, Manuel Pastor, Jr., and Michael Tomz's *Modern Political Economy and Latin America;* Julia Buxton and Nicola Phillips' *Developments in Latin American Political Economy: States, Markets and Actors;* and Miles Kahler's *Capital Flows and Financial Crises* are most appropriate for classroom use. The others are destined to be used as complementary readings or for specialists.

Since many of the books are edited volumes covering more than one theme, this review will be organized by theme, allowing complementary chapters to lead the discussion. The first two sections will discuss general questions in political economy and historical patterns in Latin America, respectively. It will draw heavily on comments from the Frieden, Pastor, and Tomz and Triner volumes. The third section focuses on capital flows and the repercussions of the Mexican and Asian crises, reviewing the books edited by Felipe Larraín; Miles Kahler; and Antonio Jorge, Jorge Salazar-Carillo, and Bernadette West. The final section examines the contemporary, incomplete reform agenda. It uses the Buxton and Phillips volume as well as chapters from the others to explain contemporary problems of political economy, giving particular attention to the collapse of the Argentine economy in 2001 and the stagnation in Brazil in 2002.

POLITICAL ECONOMY

Political economy is preoccupied with the choices that actors face based on incentives provided by institutional contexts, given a situation of asymmetrical information. A quick survey of countries, developed or developing, reveals a considerable amount of diversity in terms of tax structures, administrative capacities, monetary regimes, fiscal policies, and export profiles. Emblematic of much of the research in political economy, Torsten Perrson and Guido Tabellini set out to address the question of why is there so much variety. Although both are economists, they emphasize the need to borrow from political science literature, in terms of studying "collective choice and institutions" and economics

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which is "ultimately interested in the outcomes of policy decisions" (2000, 2). Similarly, political scientist Robert Gilpin explains that

> political economy requires an understanding of how markets work and how market forces affect economic outcomes as well as an understanding of how powerful actors, of which the nation-state is by far the most important, attempt to manipulate market forces to advance their private interests. (2001, 40)

After more than a decade of reforms in Latin America, considerable malaise and concern exist among reform advocates that there might be "reform-fatigue." Critics, such as Nobel Prize winner Joseph Stiglitz, insist that the Washington Consensus has failed (2002). Harvard economist Dani Rodrik suggests that the idea of a one-size-fits-all economic policy for developing countries has been thoroughly discredited. John Williamson, who coined the term "Washington Consensus"—although he was told by former Brazilian finance minister Luiz Carlos Bresser Pereira that he could not expect intellectual property rights—has written a number of provocative articles arguing that many of the prescriptions of the Washington Consensus were ignored by the countries that supposedly were slavishly loyal to the international community (i.e., Argentina; see Williamson, n.d.).

Although Stiglitz and Rodrik, and a plethora of others, are correct to criticize the results of the liberal reforms in Latin America, their use of "Washington Consensus" reflects its journalistic meaning (cutting the size of the state and becoming more market-friendly) rather than the academic definition, which spelled out a consensus that still exists among mainstream economists proposed by Williamson more than a decade ago (this controversial article is reprinted in Frieden, Pastor, and Tomz). Using the Washington Consensus as originally proposed, few countries truly followed all ten "commandments." Not only that, but the wholesale criticism of the Washington Consensus obscures the tremendous diversity of policies adopted, discarded and readopted with innovations, in the various countries of the region. It also fails to explain why outcomes differed across the region. If the same policies were adopted in each country, if all were imposed, and all are recessive, it is hard to explain why some countries continued to grow even during some of the most volatile years in the history of global capitalism, while others stagnated, and others have simply imploded.

Political economy literature aims to fill this gap by examining the particular choices of politicians, the incentives they faced, the institutional structure in which they bargained with veto players, and the international environment whose financing of domestic policies can never be assumed to be permanent (Spanakos, forthcoming). Political economy literature aims to explain why utility-maximizing economic theories (classical, structuralist or Marxist) fail to reach the lofty goals initially

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proposed. In a world of second-best strategies, this sort of academic research is necessary.

Frieden, Pastor and Tomz's *Modern Political Economy and Latin America* collects some recent classics in political economy. The book begins by presenting theoretical and analytical perspectives and is followed by a series of cases studies. Frieden, Pastor, and Tomz rightly emphasize up front the importance of the division between structuralist and liberal perspectives on Latin American political economy. The former, focuses on market failures, and the latter on government failures. Each perspective is well represented by sophisticated arguments by H.W. Arndt and Anne Krueger, respectively. Arndt explains the history of structuralist thought, basing it on the work of pioneers such as Raul Prebisch and Osvaldo Sunkel who, while at the United Nations Economic Commission for Latin America (CEPAL), developed theories explaining that classical economic prescriptions did not work in Latin America and other developing countries because of structural rigidities, bottlenecks, and incomplete markets. Arndt writes

> First, prices may give the wrong signals because they are distorted by monopoly or other influences. Secondly, labour and other factors of production may respond to price signals inadequately or even perversely. Thirdly, although ready to respond appropriately to correct price signals, factors of production may be immobile, unable to move quickly if at all. (6)

As a result, the pricing system does not respond to pure market forces of supply and demand, and government resources were necessary to encourage resource mobility, complete markets, and overcome bottlenecks.

Structuralist emphasis on investment and savings is questioned by Anne Krueger, currently first deputy managing director of the International Monetary Fund. She argues that market failure is not nearly as common as alleged, and that government failure is more common. Government intervention is often inefficient and, worse, it creates opportunities for rent-seeking, which further distorts policy and increases costs. The increase in the size of the state in Latin America during the years of state-led growth (from the 1930s to the early 1980s) did not coincide with a comparable improvement in efficiency. In fact, the few efficient state-owned enterprises were looted by the government to subsidize failing entities, and the incentive system discouraged investment in infrastructure and production. Krueger's argument that government should be limited to areas where it has a comparative advantage, such as "maintenance of law and order . . . provision of information . . . and provision of basic services" became increasingly accepted by the end of the 1970s and early 1980s (14).

The difficulties that Latin American states faced during the 1980s—high levels of debt, closure of international capital markets and major

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fiscal imbalances—encouraged research into the dynamics of political economic bargaining. Price stability is clearly a public good, as such, it benefits the entire society. Yet, stabilization programs were delayed and/ or sabotaged consistently throughout the 1980s and, in some cases, the 1990s. Frieden's "The Method of Analysis: Modern Political Economy" is particularly helpful here in that it offers a methodological framework of inquiry. He explains that "modern political economy as used here has four component parts: defining the actors and their goals, specifying actors' policy preferences, determining how they group themselves, and following their interaction with other social institutions" (37). Frieden, like most of the authors cited in this review, assumes rational choice on the part of actors. Barbara Geddes explains exactly what rational choice is and is not, that it is particularly useful when the analyst can clearly identify groups who have stated preferences and who consciously attempt to realize their goals.

Alberto Alesina reviews a number of theories of political economy, including the Nordhaus model of political business cycles; Alesina, Roubini, and Cohen's research on rational partisan cycle; and Alesina and Drazen's War of Attrition. Fundamental to understanding political economic conflicts, he argues, is the assumption that policymakers want to maintain power and the degree of polarization in society. This is the base for the War of Attrition, which explains that although all actors benefit from price stabilization, groups delay implementing stabilization programs because they are waiting for other groups to give in and accept the bulk of the costs of stabilization. This model is especially helpful in understanding the hyperinflation in the 1980s in Latin America since so many stabilization programs were never implemented or were doomed by the lack of support from critical actors. What the model does not include, however, is that actors may not actively pursue stabilization programs, not because of concern about unilateral costs, but because of the possibility that there will be no benefits, a possibility that political actors must consider given that Latin American history is replete with failed stabilization programs.

HISTORICAL PATTERNS

One of the classic questions in Argentine historiography is whether Argentina became "underdeveloped" following the 1930s (Waisman 1987; Rock 1987). Historians examining other Latin American countries ask similar questions about why development took place as it did, what spurred growth, and how it affected inequality, among other things. John Coatsworth and Nathaniel Leff's contributions to *Modern Political Economy* question how relatively rich colonial Mexico and Brazil, respectively, fell behind the United States. Coatsworth rejects three

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often postulated explanations (Spanish colonial rule, the system of land tenure, and the Roman Catholic Church). Instead, he emphasizes the low level of productivity in Mexico, which was half that of the United States, and the high cost of transportation. Similarly, Leff finds that "in these conditions of low physical productivity and high-cost transportation, abundant land was not associated with a high value of output per worker in agriculture" (111). Stanley Engerman and Kenneth Sokoloff argue that it is a mistake to underestimate factor conditions, which they believe explain much of the difference in the patterns of growth in the United State and Latin America.

The period of the late nineteenth century until the Great Depression has received considerable attention in recent years from historians. Triner's *Banking and Economic Development* details the growth of banking and its effect on development during the First Republic (1889–1930) in Brazil. The book is empirically rich as a testament to the importance of the banking sector during that time period. Triner argues, persuasively, that a modern banking system developed in Brazil during the First Republic, although it did not yield the results (financial depth, the broadening of access, improved credibility of the central monetary authority) that are ordinarily expected by modernization. Instead, she "finds that the Brazilian banking system forming at the beginning of the twentieth century was dynamic and progressive; but it also suggests that banking simultaneously served to concentrate rather than diversify wealth among individuals" (9). The reasons for this, Triner finds, are both domestic and international: the political economy of interests, particularly those of the Union and the most powerful states; and the frequent closure of international capital markets.

The overwhelming dominance of the major states, São Paulo, Minas Gerais, Rio Grande do Sul, and, to some extent, Rio de Janeiro, explains much of the history of banking and development in the late nineteenth and early twentieth century. Triner describes the conflict of interest between the Union and the states and argues that neither could consistently dominate the policy agenda, but clearly the interests of both were present as the country shifted from fixed to looser exchange-rate arrangements. She also describes the groups (exporters, importers, domestic industrialists, etc.) who figured into the debate about exchange-rate policy. The biggest winners seem to be the major states, since per capita income increased on average 2.5 percent in São Paulo, Minas Gerais, and Rio Grande do Sul, whereas it was stagnant or declined everywhere else (21). The states maintained the ability to contract international debt, a privilege available until quite recently, but the federal government was not without sanctioning power, since it could refuse to guarantee the bond offer. Nevertheless, it is quite clear that the growth of the banking industry was concentrated within the already wealthiest states.

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Additionally, Triner emphasizes how the closure of global capital markets encouraged the treasury to force its debt on local banks at the expense of the growth of the banking sector. In what will sound familiar to casual observers, Triner explains how Brazilians tried to reduce their international vulnerability in 1914, that international financial missions were sent in the 1920s to set up orthodox policies, and, in the absence of global capital markets, the federal government chose to reduce its debt profile through inflation. Triner explains that the choice of monetary expansion and inflation is the result of a lamentable lack of independence of the central monetary authority, a situation which still prevails (although under discussion).

Most Latin American markets were cut off from developed markets during the World War I, and structuralists argue that this was essential for the development of domestic industry. Rory Miller's contribution to Frieden, Pastor, and Tomz (2000) argues that this characterization exaggerates the amount of development during the period. Carlos Diaz-Alejandro argues, however, that external shocks in the center following the Great Depression did encourage changes in the periphery. The nature of the changes in the development strategy depended on the vulnerability of each country, but it became clear, after the 1930s, that the predominant strategy for development in Latin America was one of state-led growth with a heavy emphasis on the development of domestic markets. The choice of import-substitution industrialization (ISI) seemed to respond to perceived political and economic needs, but, as Fernando Henrique Cardoso and Ann Helwege argue, clear flaws in the policy choice of ISI became obvious over time. The most common criticism of ISI is based on a reading of the East Asian experience which argues that fiscal accounts were not monetized in East Asia, as was the case in Latin America and, more importantly, the East Asia model shifted towards export-led growth much earlier than Latin America (Mahon and Sachs in Frieden, Pastor, and Tomz 2000).

The call for reform in Latin America was resounding during the 1980s. Liberalization promised to address the problems of high levels of inflation, reduce debt burdens, and allow a return to growth (Williamson in Frieden, Pastor, and Tomz 2000). Although neoliberals are associated with a dogmatic attack on the state, hoping to make it as small as possible, most of the mainstream criticism of the state-centric model in Latin America emphasized not state size, but state capacity (Levy, Pradham in Frieden, Pastor, and Tomz 2000). Undeniably, the shift in conventional wisdom was that state intervention should be reduced to allow for the market to become more competitive. This explains much of the shift towards free trade (Dornbush in Frieden, Pastor, and Tomz 2000). An important criticism, however, is raised by Dani Rodrik (in Frieden, Pastor, and Tomz 2000) who argues that the Latin American liberaliza-

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tion packages went much further than their Asian counterparts and many reforms, such as financial reform and trade reform, were included in larger stabilization packages even though their role in stabilization was questionable. In their contributions, Carol Wise, Manuel Pastor, and Luigi Manzetti emphasize the politics and economics in developing a North American Free Trade Area and a customs union in the Southern Cone (Mercosul). The fact that a free trade agreement between Mexico and the United States, and an agreement between Brazil and Argentina, and its smaller neighbors, were pursued actively demonstrates the changing sign of the times.

Frieden, Pastor, and Tomz consider other reforms, among these the idea of central bank autonomy. Sylvia Maxfield argues that independent central banks are necessary for countries to regain credibility among international investors, but Delia Boylan argues that, in the case of Chile, the independence of the central bank was established only prior to the end of the Pinochet dictatorship, demonstrating the fear that the Left would revert to previous populist, expansionary policies. Regardless of intentions, independent central banks seem to lead to lower inflation, add credibility to markets, and encourage financing in the form of capital flows. Of course, capital flows are not always beneficial, even when capital is entering the country.

CAPITAL FLOWS

Since the end of the Bretton Woods system of fixed exchange rates, capital has become very mobile with the improved fluidity of international financial transactions allowed by new technologies and complex financial contracts which reduce risk through hedging. Over a trillion dollars are traded daily just in currency markets. Capital which left Latin America in the 1980s, yielding a capital account deficit in many countries, returned in a very powerful, if volatile, way in the 1990s. During the 1990s, countries both benefited and suffered from bountiful capital inflows, and suffered when capital flows were reversed. Since the attacks of September 11, 2001, the default of Argentina three months later, and the crisis in credibility in U.S. corporate finance, global capital markets have been dry and stingy, especially in relation to Latin American countries (with possible exceptions of Mexico and Chile). The three books reviewed in this section address the problems and opportunities offered by capital flows particularly in light of the Mexican and Asian crises.

It should be noted that Kahler's *Capital Flows* and Larraín's *Capital Flows, Capital Controls, and Currency Crises* were written just as the wreckage from the Asian crisis was being discovered (1997–98). Antonio Jorge et al.'s *Capital Markets, Growth, and Economic Policy in Latin America* was

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published immediately following the 1995 Mexican banking crisis. The books have three very different audiences. The Larraín book (2000) contains essays directed at economists and economic policy-makers and emphasizes the role of capital controls as well as what causes capital inflows. Kahler's volume (1998) takes a broader perspective blending historical essays with chapters on the political economy of capital flows, reforms in developing countries, and the international financial system. Jorge et al. (2000) was the result of a conference immediately following the Mexican crisis in 1995. Unfortunately, none of the chapters has been updated since, and some of the chapters are transcripts of speeches. The result is an engaging time capsule of responses from bankers and analysts, but it is lean on academic muscle.

Reinhart and Reinhart, in their contribution to the Kahler volume, define capital inflows as "an increase in the demand for a country's assets" (94). The definition is remarkably simple yet valuable in that it emphasizes demand. What the literature surveyed attempts to address is why this demand existed, and how to temper it so that countries suffer neither from too much currency appreciation nor too much volatility in capital accounts. A classic article by Guillermo Calvo, Leonardo Leiderman, and Carmen Reinhart, referred to ubiquitously throughout the Kahler volume, also appears in Frieden, Pastor, and Tomz (2000). In the article Calvo, Leiderman, and Reinhart argue provocatively that the major factor behind capital inflows to Latin America is external. Push factors, such as low interest rates and slow growth, in developed countries encouraged investors to seek more profitable returns elsewhere. Although the authors mention pull factors, such as reforms in developing countries and high real interest rates, they believe that capital flows are a result of push factors.

One of the two leitmotifs of the Larraín volume is to investigate this claim. In their contribution, Corbo and Hernández recognize the importance of push factors, but they emphasize pull factors because push factors cannot explain the variation in capital inflows in developing countries. After the Asian crisis, they argue, "private capital flows—especially foreign direct investment—continued toward countries that had good fundamentals and adjusted their policies quickly in response to the shock" (Larraín 86). Recognizing the importance of both push and pull factors, the case studies in the book, Sturzenegger on Argentina, Garcia and Valpassos on Brazil, Cárdenas and Steiner on Colombia, and Larraín and Labán on Chile, tend to look at indicators that are "intermestic," such as spreads, which implicitly include both push and pull factors. In their contribution, Larraín, Labán, and Chumacero argue that domestic structural reforms (pull) attract and explain much of long-term capital inflows, while short-term flows are better explained by conditions in developed markets (push).

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The contributors to the Kahler volume also argue in favor of a sophisticated and complex vision of capital flows. Rachel McCulloch and Peter Petri argue that investment in emerging markets seeks both high yields and diversification, but the latter is more important. They also argue, quite credibly given the increased correlation between movements in equity markets in developed and developing countries since 2000, that increased globalization and integration of global financial markets would reduce the diversification appeal of emerging market investments. Eichengreen and Fishlow attack this issue of capital flows from an historic perspective by identifying three cycles of investment in emerging markets since World War I (1924–29, 1976–81, 1990s) and they argue that each cycle was different due to the type of inflow (bonds, bank loans, and equity financing, respectively) and the risks posed to global capital markets. The nature of the crises and the response of the countries in each cycle were quite different. The global crisis in 1930 led to state-led growth strategies, while the regional crisis of the 1980s led to fiscal adjustments. The country-specific problems of the 1990s led to monetary adjustments.

Sylvia Maxfield's contribution separates inflows based on the goals of investors (yield, diversification) and their perspective (short- or long-term). Differentiating among these investors explains whether investors are more likely to respond to push or pull forces. She argues that mutual funds tend to have short-term horizons and to be driven by yield, while hedge funds are equally short-term in perspective but are more concerned with risk diversification. Commercial bank loans tend to be long-term and driven by yield, whereas pension funds and insurance companies are long-term and concerned with diversification. Although Maxfield finds that push factors are more compelling than pull, there are clearly incentives for developing countries to attract pension-fund and insurance companies and to be reluctant to accept money from mutual funds and commercial banks. She writes "[b]orrowers can try to shield themselves from yield-oriented investors by avoiding portfolio investors entirely, or choosing to structure their borrowing to fit the needs of pension funds and insurance companies" (Kahler 90).

This leads to the second leitmotif of the Larraín book: what should countries do to discourage capital inflows, to protect themselves from the volatility that was all too common during the 1990s? Garcia and Valpassos' chapter on Brazil and Cárdenas and Steiner's chapter on Colombia demonstrate that a variety of methods—sterilization, liberalization of outflows, controls on inflows, among others—were tried with limited success. The latter states that "[a]fter all is said and done, probably the only macroeconomic policy that Colombia did not try during the last five years is fiscal restraint" (Larraín 217). A similar statement could certainly be said of Brazil where a real and permanent

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fiscal adjustment has still not occurred. In the meantime, capital controls appear to have limited effect, particularly when they are not part of a credible fiscal and macroeconomic strategy.

Such credibility may very well be why Chile's capital controls are considered by some to be so successful. The readings on Chilean capital controls in the Larraín volume (which devotes considerable time to Chile) are lukewarm, not what one would expect given the high ratings the non-Chileans tend to give the Chilean program. Low levels of taxation had a small effect on reducing the volume of capital inflows and led to a substitution effect where non-taxed inflows grew, thus it did stimulate some longer-term investment (Valdés-Prieto and Solo in Larraín). Nevertheless, Chile was forced to continually expand its exchange rate band and to shift the weight of the currency basket used as a base. Velasco and Cabezas, in a comparison of Chile and Mexico in the Kahler volume, find that Mexico's enthusiasm and desperation for foreign capital put it in a much weaker and more volatile position than Chile, which maintained more stringent requirements on capital. In the 1980s, Chile had higher levels of growth, lower levels of inflation, enjoyed fiscal surpluses, and the majority of the investment it received was foreign direct investment (i.e., long-term). The reverse was true of Mexico. But this was not necessarily the result of capital controls.

The Chilean stance towards international capital, of which capital controls was one instrument, was crucial but as Velasco and Cabezas warn "do not expect capital controls to do more than they can" (Kahler 155). This is important for the many critics of the Washington Consensus who want to reduce volatility to financial markets and believe that capital controls *à la* Chile is the way to do it. It is a mistake to separate Chilean "success" in the area of capital controls from the strong fiscal context in which it took place, an environment of considerable credibility. One should not forget, as often occurs, that almost all Latin American countries have imposed capital controls of various forms and few have been successful (as the other case studies in the Larraín volume demonstrate).

The case studies in the Jorge et al. volume are interesting not because of the success or failure of a particular type of policy, but because they show the immediate reaction of analysts and academics following the Mexican crisis. They also show that most of their reactions to what seemed a rapid recovery turned out to be so wrong. A few authors were prescient, but most believed that the countries had "learned their lessons" and could continue on the path to growth. José Antonio Ocampo's chapter argues that Colombia was not especially affected by the Mexican crisis, and, in fact, it may have benefited from the crisis. CEPAL's executive director may indeed have been correct at the time but Colombia's recent economic performance suggests a sluggishness that one would not expect given Ocampo's optimistic portrait. Humberto

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Petrei's chapter on Argentina appears the most far off in its predictions. He suggests that the Argentine government did the right thing when confronted with the Mexican crisis—and the possibility of either strengthening or loosening the currency band arrangement—when the government chose to deepen the country's link to the dollar. He mentions in passing that some academics think the currency board should be scrapped but he says he strongly disagrees with this. Of course, growth resumed rapidly after the Mexican crisis, but only briefly. The economy began to slow during 1998, and since has moved from recession to depression to implosion.

Julio Quesada's chapter on Mexico is among the most interesting because of the sociological element involved in his personal narrative as the head of Citibank's Mexican operation in 1994. The narrative describes the state of the market at the time and the euphoria surrounding Mexico's seemingly inevitable surge towards first-world status. Even after the Chiapas revolution and the assassination of PRI presidential candidate Luís Donaldo Colosio, many did not see the handwriting on the wall. In retrospect, the crisis was easy to predict (given the worsening of Mexican current accounts and the overwhelming dependence on portfolio capital), but at the time the idea that emerging markets were truly "emerging" encouraged even investors to turn a blind eye to the problems in Mexican economic fundamentals and the political uncertainty which seemed to explode in 1994.

In his contribution, Gustav Ranis warns that overvalued exchange rates are not sustainable and that "once credibility is damaged, the result could well be the resumed flight of the previously returned capital which is still relatively footloose, resulting in the possibility of another round in the old stop-go tradition" (Jorge et al. 185). The Asian crisis, and problems in Brazil in 1998 and Argentina in 2001 confirm this. What began with the pro-market exuberance (often irrational) exhibited in the Jorge et al. book is now replaced by the spectacle of unemployed graduate students, union leaders, nongovernmental organizations, and various others protesting outside of the meetings of the International Monetary Fund (IMF) and the World Bank, the Summit of the Americas, and the World Trade Organization. In recent years anti-reform politicians (at least in rhetoric) and "opposition" leaders have gained considerable space, frustration with liberal reforms has grown, and the appetite for further reforms has shrunk—precisely when a new stage of reforms are truly necessary.

REFORMS

Part of the problem with launching a new round of reforms is that the expectations of the first round were never met. This is particularly the

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case of the most ideological liberal doctrines, such as Francis Fukuyama's *The End of History*. Although Fukuyama is probably correct that liberal democracy will continue to be the dominant political economic arrangement, it should not be assumed that this arrangement will not be without its critics or that there will be an "end" of politics. Buxton and Phillips argue that the conflict over second-stage reforms affirms the importance of history and politics and challenges any sort of teleological market triumphalism. Second-stage reforms are especially conflictual because they lack the consensus that supported the first-stage (trade liberalization, privatization, etc.) and they are long-term, institution-building reforms (improving accountability, educational performance, distribution of wealth; see Kruger 2000; Spanakos n.d.).

The volume focuses on the current political and economic conjuncture in Latin America, looking at how political actors and interest groups react to a situation of low inflation but also low growth. The issue of low growth, a common criticism of the liberal model, is taken up by Phillips and Buxton in their introduction and Duncan Green's chapter, which states that liberal reforms have had a very important effect in eliminating high levels of inflation, "but growth is fitful, investment and savings remain low, and such limited gains have only been achieved at a profound social cost" (19).When compared to Latin American performance during the ISI years, this characterization seems quite just. However, when comparing the performance of the 1990s to the 1980s, the comparison is weaker. Additionally, and this is why the entire "package" of reforms is important to consider, savings and investment ratings were lower than expected and growth inconsistent partially because of the maintenance of overvalued exchange rates and a policy of high interest rates. Now that most major countries have moved towards more flexible currency arrangements, interests rates should come down (relative to what they were) and investment ratios should increase.

Many of the chapters in the Buxton and Phillips volume are critical of the current situation, but their criticisms are mainly positive and not ideological. This strengthens the criticism offered, particularly by George Philip and Daniel Hellinger. Philip's chapter argues that "the progress made by most countries in the region in respect of democratization and economic recovery has not so far been matched by the development of effective state institutions" (33). Although critics tend to attack the Latin American state as too big, he muses that, if anything, it is probably too small. Size of the state aside, he is no doubt correct that Latin American states are still not as administratively effective as would be desired. This issue is fundamental since the provision of public services, regulation of market competition, maintenance of law and order, and social integration require an efficient, transparent, and credible state, which can only occur when state administrative capacity improves considerably.

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Hellinger's chapter focuses on political behavior and the rise of new political actors. Surprisingly, despite the many criticisms of "neoliberalism," opposition politicians find themselves without a platform, accepting the basic tenets of the Washington Consensus or proposing some watered-down CEPAL version of neostructuralism. But clearly the opposition does not see much gain in great ideological debates. In addition to changes among politicians and political parties (particularly on the Left), Hellinger emphasizes the importance of think tanks and the media. The role of these two groups is clearly important and it has increased significantly during the past decade. The most disturbing part of Hellinger's analysis, however, is the confirmation of the limitation of electoral democracy, which is vaguely reminiscent of the complaints of the Left in the 1960s. He says the "[e]lections in Latin America have tended to more often act as a brake than an accelerator on social change . . ." (69). This has indeed limited the quality of democracy, as he says, but given Latin America's historic economic and political volatility, it also has some advantages.

The move to the center, described by Hellinger, and the acceptance of a reform agenda have heightened the credibility of Latin American countries. During the 1990s, this has encouraged a considerable, though volatile, flow of capital and high levels of investment. However, in 2001 and 2002, international capital markets dried up considerably. In contrast to the Mexican and Asian crises, Latin American economies that are currently under pressure are not rebounding quickly. The literature reviewed above is insightful.

Investors and governments should have learned their lessons after the Mexican and Asian crises: large current account deficits and overvaluation lead to economic stagnation and, if there is an exodus of capital, can force a disastrous devaluation. These warning signs were present in Argentina since around 1999. Various IMF programs kept its economy on life support, but its demise was inevitable once investor confidence was shaken (as Ranis suggests). Brazil's current account deficit is actually improving (though still considerable) and is running a considerable primary fiscal surplus (including revenues and expenditures, but not interest payments). A lack of clarity among presidential candidates, particularly the victorious front-runner Luis Inácio Lula da Silva, combined with a worrisome composition of debt (80 percent is linked to the dollar, the interest rate, or inflation) gave investors reason for concern. As capital fled and the *real* weakened, opposition presidential candidates refused to express commitment to existing contracts or a sound macroeconomic policy, and gave only passing support for an IMF agreement (Spanakos 2002). As a result, what could have been a short-term speculative attack, has lasted for over eight months and is likely to persist until the president-elect

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demonstrates a clear willingness to deepen fiscal, social security and tax reforms.

Doomsayers predict another "lost decade" while optimists talk about "correcting" previous exuberance and returning to business as normal. Neither is likely to be the case, but, as the literature surveyed here suggests, domestic and international policymakers can affect the direction in which these economies go. On the international side, there must be some sort of international financial work-out system as Sachs suggests in Kahler. A recent paper by Anne Krueger shows that this is something that the IMF is considering although a bankruptcy court is clearly controversial, and the IMF is rightly concerned about moral hazard if it is perceived to encourage default (Krueger 2002). Eichengreen and Fishlow argue persuasively that bilateral solutions, attempted in the case of Korea, are problematic. A best case scenario would probably include the design of some sort of association which could represent sovereign bond holders, thus, resolving collective action problems and facilitating renegotiation of debts and reducing the risk involved.

But Latin American countries can expect only limited assistance from international investors, who are not charitable institutions, and from OECD governments, who have grown weary of repeated bailouts. Emphasis must be given to domestic reforms. East Asia has been more resistant to the vicissitudes of capital flows because foreign direct investment played a larger role than portfolios, and fiscal and monetary policies were more consistent. Latin American countries have improved their fiscal and monetary stances, but they continue to face pressures. During a time of capital outflows, a policy of capital controls will only hasten the flight. Once inflows return, some form of limited controls on short-term capital might help. But this is a minor part of a more significant puzzle.

Latin American countries must improve their tax collection and try to improve their ability to finance public spending through domestic taxation, without the kind of temporary, regressive, and cascading taxes that were introduced to fill gaps in countries like Brazil. Sachs offers additional prescriptions: avoid fixed exchange rates or currency boards in the long-term unless the economies are small and very open; avoid dollarization of bank accounts and short-term debt. The former suggests that Panama, and other Central American countries, may indeed be safe by adopting the dollar, but it is probably not a good long-term strategy for Ecuador. The large countries, Brazil, Mexico, Venezuela, Argentina, Chile, and Colombia, are better off maintaining flexible currency policies, which allow them to adjust automatically to exogenous fiscal shocks.

But this adjustment ability is limited when too much debt is dollar-denominated (i.e., linked to the value of the dollar) even if it is paid out

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in the local currency, as in the case of Brazil. Obviously, there are also risks in individuals maintaining bank accounts in dollars, as Argentines learned the hard way when these accounts were included in the involuntary seizure of bank accounts (*corralito*). But also dangerous is issuing large volumes of short-term public debt in dollars or local currency notes linked to the dollar. External debt will always need to be issued in some, potentially several, hard currencies, but public debt should be maintained in local currency. Although investors will be wary of this, it is critical that governments maintain some flexibility. As Gary Cox and Mathew McCubbins argue in a recent article on political economy, governments must always choose between "decisiveness" (flexibility) and "resoluteness" (credibility) (2001). The crisis of the 1980s encouraged countries in Latin America (with Chile and Colombia being exceptions) to overemphasize the former at the expense of the latter. More recent events highlight the importance of flexibility, although the creation of institutions—via second-stage reforms—should mitigate the loss in credibility.

In his contribution to the Jorge et al. volume, John Williamson argues that many writers have incorrectly assumed that policy reform is not sustainable. In all likelihood, most major reforms, in terms of stabilization, will be maintained regardless of what type of opposition government emerges out of the current economic difficulties in Brazil, Argentina, Ecuador, and Venezuela, if early elections are held. Further reform is needed, but, following, Frieden, examining the actors, goals, policy preferences, and the interaction with social institutions, it is clear that the environment for further reform is not very good. But, as Haggard and Webb argue, crisis can spur reform. The region in the world with the most perverse distribution in income would certainly benefit if this were the case (Freiden, Pastor, and Tomz 2000).

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