

THE POLITICAL ECONOMY OF THE NEOLIBERAL TRANSITION

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DEMOCRACY, MARKETS, AND STRUCTURAL REFORM IN LATIN AMERICA: ARGENTINA, BOLIVIA, BRAZIL, CHILE, AND MEXICO.

Edited by William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra. (New Brunswick, N.J.: Transaction, 1994, Pp. 330. \$21.95 paper.)

INFLATION, STABILIZATION, AND DEBT: MACROECONOMIC EXPERIMENTS IN PERU AND BOLIVIA. By Manuel Pastor Jr. (Boulder, Colo.: Westview, 1992. Pp. 176. \$37.50 paper.)

THE POLITICAL ECONOMY OF POLICY REFORM IN DEVELOPING COUNTRIES. By Anne O. Krueger. (Cambridge, Mass.: MIT Press, 1993. Pp. 171. \$22.50 cloth.)

PUBLIC FINANCES, STABILIZATION, AND STRUCTURAL REFORM IN LATIN AMERICA. By Guillermo Perry and Ana María Herrera. (Washington, D.C.: Inter-American Development Bank, 1994. Pp. 133. \$15.00 paper.)

REFORM, RECOVERY, AND GROWTH: LATIN AMERICA AND THE MIDDLE EAST. Edited by Rudiger Dornbusch and Sebastian Edwards. (Chicago, Ill.: University of Chicago Press, 1995. Pp. 426. \$65.00 cloth.)

The transition experience from the end of the debt crisis to the current neoliberal euphoria raises many questions about the consequences of reliance on the market in terms of macroeconomic performance and social welfare. This essay will review five texts and use them to analyze three questions. First, in political terms, where does the demand for neoliberal reform come from, and how do differences in the determinants of this demand affect the success of specific policies? Second, is trade the primary "engine of growth," or will neoliberals have to recognize the importance of other social phenomena, such as education? Third, how should analysts rethink the way that macroeconomic policy is affected by transitions? The success of any given transition is not fully assured, except perhaps in Chile. Particular questions pertaining to social welfare and capital dependence have yet to be resolved.

The Demand for Reform

The literature under review adopts various approaches to understanding the initiation of the process of neoliberal reform. For example, Aaron Tornell's contribution to *Reform, Recovery, and Growth: Latin America and the Middle East*, edited by Rudiger Dornbusch and Sebastian Edwards, employs a simple game-theoretic framework to illustrate the demand for trade liberalization in Mexico as a function of the decrease in fiscal revenues during the 1980s. Tornell views liberalization as a "benefit of crisis" due to a social contest that pits competing rent seekers against each other over a shrinking pie of revenues. Trade liberalization gave a first-mover advantage to the private-sector elite, precisely when that sector was convinced that its main competitor, the parastatal elite, would gain a first-mover advantage through policies such as the nationalization of banks, which blocked private-sector access to fiscal revenue through subsidized credit. That is, the private sector preferred to undergo the adjustment costs associated with trade liberalization and the drastic reduction of the rents generated by customs receipts rather than assume a follower's role that lacked access to subsidized credit.

The issue of the demand for liberalization is also addressed in various contributions to *Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia, Brazil, Chile, and Mexico*, edited by William Smith, Carlos Acuña, and Eduardo Gamarra. For example, Pilar Vergara examines Chilean neoliberal reform, in which General Augusto Pinochet managed to impose a "modernization model" without democratic constraints. This model consisted of a reduced interventionist role for the state and severe restrictions on public spending on social programs. Vergara characterizes Chilean reforms as stressing the liberalization of markets, foreign trade, and exchange rates as well as privatization of traditional social institutions such as health care and social security. Chilean neoliberals argue that the free-market economy is not incompatible with greater social equality, but Vergara finds that the major challenge facing current and future Chilean administrations is to achieve the equity required for long-term growth. Currently, high-income Chileans have a market choice of access to high-quality social services. Yet income distribution has become increasingly regressive, and state subsidies to the poorest groups are now too small to have any lasting positive impact. Hence arises the danger that Chilean growth may become constrained by poverty. One must wonder if other Latin American countries following neoliberal reforms are headed down the same path.

Similarly, Lourdes Sola's analysis of Brazil in *Democracy, Markets, and Structural Reform in Latin America* finds an absence of active social forces advocating market-based reforms such as trade liberalization and privatization. Rather, Brazil suffers from a "neoliberal paradox": the state,

led first by Fernando Collor and now by Fernando Henrique Cardoso, acts as the principal protagonist and underwriter of neoliberal reforms. Brazilian organized interests such as the entrepreneurial class demonstrated a remarkable ability to adapt to and take advantage of the economic stagnation and high inflation of the 1980s. For example, Brazilian banks are highly adept at making profits on inflationary “float” in the financial system.¹ Therefore, the impetus for trade reform was a political agenda involving the need to increase real salaries through productivity increases and a drop in the price of imports. In the same way, Brazil’s privatization efforts targeted the skewed distribution of income through employee entitlements to purchase shares of privatized firms.

With respect to Argentina, Carlos Acuña shows that the 1980s were characterized by a sequence of aborted attempts to open the economy in order to “thaw” the price freezes associated with heterodox inflation stabilization, to alleviate scarcity of foreign currency, and to eliminate growth bottlenecks associated with an essentially closed economy. By 1989 President Carlos Menem had redefined Peronism by appointing representatives of the powerful Bunge y Born conglomerate to run his first economic team. This decision resulted in an official deepening of his administration’s neoliberal stance. Not surprisingly, the implementation of such policies was carried out ineffectively by more mainstream Peronists within the executive branch. Clearly, something had to give in order to undertake a successful attempt at neoliberal reform and economic opening.

In March 1991, the new finance minister, Domingo Cavallo, announced the Plan Cavallo, a convertibility plan in which the exchange rate was fixed at one U.S. dollar equaling one peso. Any monetary creation had to be backed financially by an equivalent increase in foreign-exchange reserves at the Banco Central. This situation demonstrates what Anne Krueger calls the ability of a crisis to stop politics as usual, creating a window of opportunity for a charismatic leader to employ “technocratic support to take appropriate actions.” According to Acuña, trade opening was supposed to act as a ceiling on domestic price increases, especially wages, and as a mechanism for reducing the cost of inputs through import competition under the convertibility policy. Furthermore, extensive privatization of public-sector enterprises increased the government’s foreign-exchange coffers and solidified the irreversibility of Argentina’s foray into neoliberalism.

In *The Political Economy of Policy Reform in Developing Countries*, Krueger summarizes the Latin American experience as a whole: “One of the most discouraging features of reform programs has been the limited number of success stories” (p. 8). Except for the Chilean transformation and the success of the Mexican *pacto* years prior to the 1994 peso crisis,

1. For a further discussion of this phenomenon, see Armijo (1996).

most policy reforms during economic reconstruction can be characterized as a “stop-go cycle” associated with short-term behavior geared toward securing loans from multilaterals (the World Bank, the International Monetary Fund, and the International Development Bank). The conditionality of such loans often induced a recession through deficit reduction, devaluation, and liberalization of the trade regime. Once any hint of a recovery began, however, economic expansion was constrained by an endemic upward drift in the deficit resulting from political pressures accompanied by a current-account deficit arising from increased private-sector demand for imports. The result is a return to economic conditions ripe for another crisis.

Krueger further asserts that the stop-go cycle in Brazil is a direct consequence of the fragility of Brazilian political coalitions. No reigning governing coalition ever managed to create a sustainable formula to reduce the deficit.² Indeed, the government was often excluded from the most cohesive coalitions, which tended to be private-sector agents opposed to government reform. In contrast with Mexico, for example, Brazilian industrial leaders during the 1980s opposed plans to open the economy. Unions also opposed economic opening for fear that import competition would lead to lower wages. As a result, the Brazilian government could create only a temporary consensus for reform when faced with the most extreme economic conditions.

The idea that the way in which the political process recognizes and addresses class and distributional conflicts affects the stabilization process is also a central theme of *Inflation, Stabilization, and Debt: Macroeconomic Experiments in Peru and Bolivia*, by Manuel Pastor Jr. He offers as a microcosm the contrast between Bolivian orthodox policies and Peruvian heterodox policies during the 1980s.³ What is novel is that Pastor treats both heterodoxy (price-freezing and income policies) and orthodoxy (strict monetary contraction and devaluation) as sociopolitical approaches to stabilization, a choice that can be justified empirically. For example, by testing for structural and inertial components of inflation through an analysis of sticky prices and causality tests between money and prices, Pastor makes a convincing case that heterodoxy was the correct antidote for Peru. Given the breathing room supplied by wage and price controls, a policy of conciliation toward capitalist behavior to remove import-induced constraints on growth targeted the structural bottlenecks at the root of Peruvian hyperstagflation. Pastor finds no such structural evidence in hyperinflated Bolivia, however. Instead, he concludes that money-price causality ran in the usual monetarist direction, hence the tax and devaluations policies implemented by the Bolivians were socially and

2. See also Roxborough (1992) and Arce (1997).

3. For those interested in model-oriented analyses, the simple orthodox and heterodox macroeconomic models presented in Pastor's second and third chapters are accessible for students who have had a course in intermediate macroeconomics.

economically consistent. Moreover, the Bolivian devaluation courted the social sector whose action was required to ensure stabilization: foreign capital.

Although both countries appear to have followed the correct economic prescriptions for their socially concerted approaches, neither policy succeeded. Bolivia is still plagued by slow growth even though its patently orthodox policies stabilized inflation dramatically. Peruvian heterodoxy was never implemented in its ideal form. Pastor reinforces Krueger's assessment of the political breakdown that led to these failures. Even temporary stabilization brings about "a rise in social and political support for the government. The proper action at this point involves using the political 'honeymoon' to push through medium-term corrections such as the expansion of import capacity through export promotion and import substitution" (p. 60). Both Peru and Bolivia failed to take advantage of their windows of opportunity.

A lesson to be learned from all this discussion is that neoliberalism and trade reform are likely to be more effective and successful when they are closely related to the goals of macroeconomic stabilization, as was the case in Argentina and Chile. In countries where neoliberal reform continues to reflect social and political struggles, as in Brazil, less capacity exists for taking advantage of trade as an "engine of growth." Indeed, despite a devaluation crisis, the Mexican case shows that liberalization can serve as a useful preemptive strike against macroeconomic mismanagement. Yet the current income-distribution problems in Chile and high unemployment in Argentina illustrate that the success of neoliberal reform will eventually be limited unless its social consequences are anticipated and addressed in a timely fashion.

Empirical Justification

Does the empirical evidence support the claim that trade is an engine of growth? This question was addressed exhaustively in Edwards (1993), part of which is presented again in *Reform, Recovery, and Growth* in a clear, nontechnical fashion (chap. 1). Edwards's essay is an excellent synthesis and test of the economic arguments for free trade that underlie neoliberal reform. His discussion is open-minded and avoids the type of free-trade dogma that generally separates economists from other social scientists. For example, Edwards is quick to point out that the export-oriented industrialization widely credited for the East Asian "miracle" should not be confused with trade liberalization because imports have yet to be liberalized in those countries. Moreover, any preoccupation with tariffs as an indicator of protection is highly misleading because quantity restrictions (quotas) abound, and real exchange rate depreciation is just as important as trade controls.

This study is an important and long-overdue complement to economic theory because in neoclassical models, trade raises the level of aggregate output but not necessarily its rate of growth. Growth is measured in terms of total factor productivity, which is the difference between growth in gross domestic product (GDP) and the growth in capital stock and the labor force. Edwards posits two primary sources of growth: that occurring from domestic technological innovation and human capital accumulation (education), and countries' ability to catch up by absorbing and imitating innovations occurring abroad. Edwards argues that this convergence should produce a convergence of growth rates across nations.

The argument implicit in *Reform, Recovery, and Growth* is that trade produces dynamic advantages of three kinds that affect productivity and growth in the long run: higher capacity utilization and more efficient investment projects; more liberalized economies that experience faster growth in exports, which stimulates GDP growth; and export expansion that relaxes foreign-exchange constraints on growth. Moreover, the revolution occurring in "endogenous growth theory" predicts a relationship of long-run equilibrium between output and economic growth.

Edwards then tests for an empirical relation between trade and growth that captures the most appealing features of the endogenous growth literature. He estimates growth in total factor productivity as a function of six factors: trade distortions as measured by import and export taxes; initial gross national product over the time series, meant to summarize the country's "catch-up potential" (those with a lower GDP have more catching up to do and will grow faster); human capital as measured by increased rates of attainment of secondary education; an estimate of the role of government participation in the economy to ascertain whether government expenditure crowds out private growth investment; a measure of political instability assumed to be negatively correlated with growth; and the degree to which government uses inflation to finance its expenditures. The inflation variable is tailor-made to ascertain the effects of the most volatile macroeconomic variable in Latin America over the period studied (1971 to 1982).⁴

The results support the view that after controlling for other "endogenous factors," countries with open trade regimes tend to grow faster over the long run than do countries with distorted trade sectors. Edwards is quick to point out, however, that this analysis provides no information on the transition to economic opening. Instead, post-reform policy analysis for the case of Mexico, Chile, and Colombia is based on a discrete set of data points on import and capital inflows, exports, trade distortions, and labor and factor productivity over the 1980s and early 1990s. This approach leads to some puzzling results, such as a decrease in Mexican total

4. Actually, the data set consists of fifty-four countries.

factor productivity from 1978 to 1982 and from 1987 to 1991, when one would expect that the trade reforms over this period would have increased total factor productivity.⁵

In my view, the trade results are not the most important contribution of *Reform, Recovery, and Growth*. Even the most casual observer of economics would have predicted the positive correlation between growth and trade regime. Several other interesting variables that appear to influence growth strongly, notably education and political stability, deserve further policy investigation than they are given here. It is to be hoped that an updated analysis will be made of these variables and their application to Latin American countries.

Macropolicy

At the end of the 1980s, the World Bank refocused its lending targets away from the type of macroeconomic stabilization adjustment generally associated with the International Monetary Fund and went back to its traditional concern for structural adjustments that will ensure long-term growth. Yet while doing so, the World Bank never lost sight of the performance of a country's fiscal deficit as a quantitative target for meeting the conditionality terms of loans. The question of what specific deficit measure to use has always been a bone of contention in Latin America. For example, it is well documented that in the early 1980s, the "conventional deficit" used by the IMF failed to account for sources of budget endogeneity. That is, the deficit affects the macroeconomy, but the converse is also true. Nominal debt payments fluctuate with the rate of inflation, and thus in periods of high inflation, these payments automatically rise and the government's borrowing requirement automatically increases without any discretionary policy action. Brazilian policymakers argued this very point early on in the debt crisis, but it took several IMF-sponsored stabilization fiascos for the multilaterals to recognize this source of endogeneity and create what is now known as the operational deficit—the primary benchmark for all conditional lending.

It is therefore refreshing to read about the Inter-American Development Bank's anticipation of new sources of budget endogeneity during the transitions to economic opening now occurring in Latin America. Guillermo Perry and Ana María Herrera's *Public Finances, Stabilization, and Structural Reform in Latin America* usefully summarizes the assessment of taxes and fiscal policy during periods of high inflation, devaluation, privatization, and trade liberalization in Argentina, Chile, Colombia, and Mexico. The lessons to be learned are numerous. Most are discussed intu-

5. Edwards explains this outcome as an aggregate distortion of strong sectoral responses in the areas immediately affected by trade reform.

itively.⁶ Trade liberalization is a budgetary issue in terms of its effects on customs receipts in the revenue side of deficit calculations. Indeed, Perry and Herrera show that the long-term effect of trade liberalization is a steady downward trend in customs receipts that must be recognized in any assessment of fiscal stance.

Perry and Herrera begin by discussing the controversy over deficit measurement that arose in the mid-to-late 1980s, when deficits reflected three endogenous components. The first was the Olivera-Tanzi effect—the loss in real tax revenue due to the fact that most taxes are not immediately withheld in Latin America, and the lag in payment therefore causes tax revenues to decrease and deficits to increase. The second factor was the failure of public-sector prices to adjust with inflation. The third was real devaluation in order to stimulate export earnings as a source of debt servicing. This overview sets the stage for the authors' main message: "stabilization programs must take these cyclical characteristics into account in order to prevent cyclical trends in public finances. Neither the governments nor multilateral organizations have paid enough attention to this problem . . ." (p. 34). This interpretation parallels the contribution by Jaime Ros to *Democracy, Markets, and Structural Reform in Latin America*. Ros's first diagram (p. 300) and his accompanying explanation is the best pedagogical exposition of the symbiotic interaction between inflation, deficits, devaluation, and monetary growth that I have encountered thus far.

Ros as well as Perry and Herrera identify how devaluation can create significantly different budgetary effects depending on its direct effect on the macroeconomy. Consider first that a devaluation increases the price of imports. This outcome can lead to a fiscal crisis through a short-term liquidity-induced recession in countries where the import content of domestic production or the average worker's consumption basket is high (as in Argentina and Chile). Alternatively, devaluation can make primary exports more competitive in the world market. In this case, export earnings increase public savings and improve the national fiscal stance to the extent that public saving does not adversely affect the private capital formation necessary for growth. In either scenario, the portfolio effects caused by international capital arbitrageurs may either exacerbate or counteract the impact of a devaluation. Hence policymakers must be careful to account for permanent rather than temporary changes in capital flows.

Pastor's *Inflation, Stabilization, and Debt* reinforces the lessons of the transition about devaluations. Specifically, growth in Latin American countries is often constrained by imports rather than by capacity. That is, regardless of trade orientation, domestic manufacturers are often dependent on imports for key intermediate components in production. This

6. A notable exception is the quasi fiscal deficit, which is neither formally defined nor explained, although it appears often as a major point of concern in Perry and Herrera's analysis.

finding implies that the increased import costs that devaluations produce may dominate the degree to which devaluations spur exports. Such an outcome is known as a contractionary devaluation. Empirical evidence of this effect is cited both by Pastor and by Morley (1992). Hence Pastor warns that as the exchange rate becomes the primary policy variable in the neoliberal era, Latin American countries must be careful that those who determine the exchange rate do not come to dominate decision making. The danger is that neoliberalism may produce a new sort of dependency associated with investment and financial-capital bottlenecks or volatility.

Conclusion

In terms of future research, several “substantive lags” have been identified here that are associated with the neoliberal transition. These lags must be understood to ensure long-term success. First, what is the political economy of “getting prices right”? The unemployment experiences associated with neoliberal reform in Argentina and the *apertura* in Colombia as well as relative price disparities in Peru that have persisted long after the “Fujishock” show that it takes much longer than most economists would admit for markets to arrive at clearing prices. A related point is that future benefits of trade orientation require investment in education and technology for gains to be more than short-lived. Labor-market “flexibility” only generates a short-term comparative advantage. The Chilean government appears to have recognized this point in restoring union rights. Third, wage-based comparative advantage is extremely regressive. Contrary to the conventional perception of Asian success stories, problems with income distribution quickly constrain growth in Latin America through political channels. In summary, the “takeoff” is upon us, and it is to be hoped that economic transformation will be accompanied by the social improvements necessary for sustained development as well as growth.

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