Reasons for the success or failure of structural reforms: Argentina and Chile's contrasting experiences revisited*

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Introduction

Starting around the mid' eighties many developing countries from Latin America and elsewhere embarked on ambitious attempts at widespread structural reforms. Most of them tried to follow the market-friendly prescriptions of the so-called *Washington Consensus*. Only a few, however, were really successful, while in the vast majority of cases the attempts fell quite short of initial optimistic expectations.

By comparing two extreme cases in Latin America, the successful Chile and the sorrowful Argentina, the paper tries to identify some of the reasons why two countries that share so many features in common and, roughly at the same time, adopted rather similar approaches to economic reform, could have followed such a divergent growth path.

In order to fulfill this task, the paper is organized as follows. The first section briefly traces the dismal economic performance of Latin America since the early 1930s, pointing to the common weaknesses displayed by both the *Import Substitution* and the *Washington Consensus* development strategies and showing that the Chilean experience of the last twenty years or so is clearly a regional outlier. The second one performs an analytical narrative exercise to highlight the different specific features of Argentina and Chile which are crucial to understand why similar reform packages led to so different outcomes. The last section try to draw some conclusions from the previous discussion, focusing first on the lessons that can be learnt from the failure of *Convertibility* in Argentina and afterwards on the comparative assessment of the two experiences.

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1. Latin America. Different Strategies, Common Weaknesses

There is little doubt that the long run economic performance of LATAM countries in the past seventy years or so, since the world's Great Depression of the 30s, has been rather disappointing, especially in comparative terms.

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] At the beginning of the 60s 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 (Charts 1 and 2), but also on income distribution and poverty indicators (Charts 3 and 4).[2]

After the Great Depression and throughout the rest of the 20th Century, LATAM countries have basically approached economic development following two successive and quite opposed strategies.

The first approach was *Import Substitution Industrialization (ISI)*. While it initially emerged 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 World War Two.

The Debt Crisis of the early eighties 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 (Fanelli, Frenkel and Rozenwurcel, 1992).[3]

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 US, the only remaining super-power after the fall of the Berlin Wall, as well as the international financial institutions (IFIs) based in

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

[2] All charts and tables are included in the Statistical Annex.

[3] Chile represents a special case, because it initiated the reforms in 1975, about a decade before than anyone else. Argentina also underwent a first reformist attempt in the late 70s, but it was rather short.lived.

Washington DC, the market-friendly approach became known as the *Washington Consensus (WC)* (Williamson, 2005).

In spite of the fact that the two approaches were founded on quite opposite premises, neither the ISI nor the WC managed to deliver sustained economic development to LATAM countries.

After WW2, the Asian "tigers" (basically South Korea and Taiwan at that time) also adopted import-substitution industrialization led by an interventionist state, but from the mid 60s 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.[4] 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 export targets were not fulfilled. Third, a high domestic savings rate that helped sustain a significant investment effort without inducing external vulnerabilities.

Moreover, most Asian "tigers" combined fast growth with improving income distribution. In several cases land reform and public investment in human capital, missing or weak in Latin America, played an important role in this regard.[5]

In our view, two common factors are crucial to understand the successive failure of both the ISI and WC approaches, despite their contrasts (Rozenwurcel, 2006). 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 WC 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 70s, both real and (mainly) financial shocks afterwards.

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[4] It is worth recalling that, until more or less recently, political stability in most Asian "tigers" was based on autoritarian regimes which, in several cases, did not hesitate to resort to outright repressive methods to remain in power.

[5] Of course, the countries in the group are not only heterogeneous in political terms but also regarding economic behavior. The case of Indonesia, in particular, where Suharto's regime collapsed in 1998, after almost thirty years of undisputed leadership, in the midst of widespread social and ethnic unrest fueled by a deep economic crisis, underscore the limits of an extermely inflexible and increasingly corrupt authoritarian regime to ensure long run sustainability of economic and social development.

The Chilean experience of the last 20 years is, to some extent, the regional exception that confirms the rule. In this period the country progressively found an adequate balance between market incentives and public policies, managed to achieve a fruitful integration into the world economy, attained fast growth and was able to significantly reduce poverty. 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 select club of countries undergoing sustained socioeconomic development. (Ffrench Davis, 2002)

2. Analytical narrative of development performance in Argentina and Chile since the mid seventies

Regarding their long run economic performance, Argentina and Chile represent two extreme cases in the region. Argentina's gradual decline after the Great Depression deepened since the mid' seventies, sharply contrasting with the Chilean success story beginning in the mid' eighties (Tables 1 and 2 and Chart 5).

Argentina and Chile, as well as the rest of Latin America, share several common structural features. LATAM's competitive advantages are biased in favor of natural resources. Primary commodities, such as minerals in Chile and agriculture in Argentina, explain a large share of the region's exports. These factors permeate the region's political economy via the so-called natural resource *curse*.

Common shocks in terms of trade and *sudden stops* in financial flows (Calvo et al., 2003) caused by abrupt changes in market sentiment have recurrently affected the region. Three events are particularly relevant for the evolution of the market-friendly reform process. As already mentioned, the debt crisis in the early eighties was a key factor in the emergence of the reformist wave. At the beginning of the nineties, the large capital inflows to the region significantly eased the implementation of reforms. The East Asian and Russian shocks in 1997-98, in turn, seem to have worked against the WC reform strategy because, due to the ensuing macroeconomic crisis, a *fatigue* mood has begun to spread among the public opinion and political circles in many countries.

Notwithstanding their common structural features, Latin American countries in general, and Argentina and Chile in particular, display quite significant differences as well, not only in terms of economic structure and performance, but also in terms of their social and political institutions (both formal and informal).

In spite of some common institutional heritage from the colonial era, political and institutional history shows significant variation across countries in Latin America. The quality of institutions and the incidence of corruption varies accordingly, with Argentina positioned in the bad tail of the distribution and Chile in the good one (Table 3, Kaufmann et al, 2003).

Differences in the size of domestic markets, in social and political conditions and in the policy choices made at different points in time are particularly relevant to understand not only the different degree of industrialization reached under the ISI model, but also the different ways followed by the pro-market reform process and, in particular, the intensity of the resistance opposed by affected social groups. (Forteza and Tommasi, 2005)

The following analytical narrative exercise (see Rodrik, 2003) intends to highlight the different specific features of both cases which are crucial to understand why similar (WC-inspired) reform packages led to so different outcomes.

2.1 Argentina in distress: extreme political and economic uncertainty throughout the last quarter of the 20th century [6]

In the past century Argentina´s economic development underwent three quite different phases. During the first phase, which in fact started in the late 19th Century and lasted until the Great Depression, Argentina enjoyed an economic prosperity comparable to that of the most advanced countries in the world. The Argentine economy experienced, with a rather short interruption caused by World War 1, a period of high economic growth led by a dynamic export sector. The development model was based on an almost full integration with the rest of the world that, with the assistance of immigration and foreign capital, allowed the economy to capitalize on its comparative advantages.

In sharp contrast to the previous phase, the period that goes from the Great Depression to the mid 1970's was, broadly speaking, a period of economic isolationism. Industrialization based on import substitution and income distribution based on populist practices were at the core of the development strategy. Despite some achievements after WW 2, during the first peronism, and throughout the sixties, before the first oil shock, the overall outcome, especially from a comparative point of view, was a rather weak long-run economic growth that gradually increased the gap between the country and the developed world.

The ISI strategy crumbled in the midst of a deep political and institutional crisis, and in the almost 30 years that spanned from that moment to the first years of the present decade, Argentina's economic decline dramatically intensified. The country's 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 and income distribution. Two major attempts at market-friendly structural reform were made, one in the late 1970s and the other one throughout the 1990s, but both failed to

[6] This section is mainly based on Rozenwurcel (2004).

bring into being a new and sustainable development strategy capable of replacing the already useless ISI model. Moreover, both experiences ended with major twin crises in the banking system and the external sector.

Political and economic evolution from the mid-1970s to the late 1980s

In 1973 Perón triumphantly returned to power, but after his death a year later the country plunged into high inflation and a frenzy of political violence, fueled by both the left and right wings of the Peronist movement. This paved the way for the military *coup* of 1976. During the following quarter century Argentina became the test ground for two ambitious attempts at a market-based economic reform. In both cases, however, the reformists were unable to put in place a new and sustainable development strategy to replace the exhausted ISI model.

The first attempt took place under the military regime initiated in 1976. The main stated goal of the authoritarian attempt to revamp Argentina, even if it meant annihilating any political opposition, was to impose a "capitalist revolution from above" by eradicating statism and interventionist economic policies, disciplining workers and capitalists, and fully reinserting the country into the world markets.

In practice, the mounting internal conflicts between the three armed forces very soon began to erode the military regime and made it impossible to implement a coherent economic policy package. The outcome was that the public budget remained out of control (Chart 6) , inflation stayed extremely high (Table 4) and the economy failed to stabilize. Under such weak macroeconomic fundamentals, outright trade and financial liberalization resulted in a rapidly growing public and external indebtedness (Charts 7 and 8) and only increased the vulnerability of an already fragile economic environment.

As is well known the military had to leave power in 1983, well before they had anticipated, after a humiliating defeat in the Malvinas-Falklands war and in the midst of a deep economic crisis.

The transition from authoritarianism was led by the Radical politician Raul Alfonsín, who won the 1983 presidential election. During his term, government efforts were mainly focused on the consolidation of democracy. Its economic strategy, however, was based on the flawed assumption that the mere return to democracy would render distressing stabilization measures and troublesome reforms unnecessary. In fact, the political wing of the new government did not conceive of democracy as a tool for generating collective responses to the crisis through negotiation, but as a miraculous panacea that would allow the Argentine society to leap forward while avoiding the costs of painful reforms and reciprocal concessions.

Meanwhile, economic policies had to deal with the consequences of the "debt crisis" and found little room for promoting economic reform. In 1985 the government finally launched the "Austral Plan," a heterodox attempt to fight high inflation. Despite its initial success, the economic authorities never received the full support of the Executive Power to adopt the fiscal measures necessary to consolidate the stabilization effort. As a result, after two years of low inflation and economic recovery the situation worsened again and by 1989, at the end of Alfonsín's term, the economy was mired in hyperinflation and deep recession. It is not surprising, then, that in economic terms the 1980s became known as the *lost decade* (Fanelli, Frenkel and Rozenwurcel, 1992).

Rise and fall of the 1990s' reformist attempt

Luckily enough, notwithstanding the economic crisis, Alfonsín´s efforts to consolidate democracy proved successful and the presidential elections scheduled for that year were held as planned. As a result, the Peronist Carlos Menem became the new President. The period between 1989 and 1999, which covered his two terms in office (Menem was reelected in 1995 after a constitutional reform), constituted the second round of market-based economic reform.

The comprehensive economic reform included, as in the 1970s, the pegging of the exchange rate, this time through the adoption of a Currency Board with a 1-to-1 parity between the peso and the US dollar, as well as deep trade and financial liberalization. Other reforms were also implemented in this case, as additional measures for consolidating the new macroeconomic setting. On the fiscal side were the massive privatization of public utilities and the radical reorganization of the pension system. On the financial side, the autonomy of the Central Bank and the implementation of a new set of prudential regulations for commercial banks, the so-called *Basel plus* standard were observed. At first, both drastic disinflation and fast economic growth seemed to prove this combination right.

The initial successful phase of this second round of market-friendly reforms lasted until mid-1998 and comprised a lengthy expansion in its first four years (1991-94), a subsequent short recession in 1995, and a sharp recovery from 1996 to mid-1998. During this period there was growing optimism about the future of the Argentine economy. In fact, Argentina achieved an outstanding position among emerging market reformers and received widespread applause as a result of its impressive track record in promoting growth and reducing inflation. The country appeared to be one of the most successful cases of market-oriented reforms in a democratic context.

However, some negative signals were already perceptible even during this initial phase: in the economy´s monetary side, rising vulnerability to capital flows and widespread dollarization in the domestic banking system; in the economy's real side, the impressive rise in unemployment despite fast economic growth. Additionally, income distribution indicators were also showing an early worsening. Analysts still debate whether or not the negative trends in labor market and income distribution indicators were a temporary cost of the structural reforms or an early symptom of deeper problems in their design and implementation (Table 5). In any event, it is fair to say that the ambitious program of economic reforms was not accompanied by a set of complementary social reforms aimed at providing a safety net for the segments of society most affected by the ongoing economic changes.

The final phase began in the second half of 1998 and was characterized by an unusually long economic contraction accompanied by a slight declining trend in nominal prices. This phase, a true economic depression, ended in the severe financial and currency crash of 2001.

Throughout the 1990s, and given the policy choice made with the adoption of the Currency Board, capital movements had a direct impact on the fluctuations of economic activity, due to their effect on interest rates, internal liquidity and aggregate expenditure. This was particularly destabilizing at a time of high volatility in international capital flows. During the expansionary years of the early 1990s net capital inflows exceeded the current account deficit, thus allowing for a significant accumulation of foreign reserves while feeding domestic credit creation and a swift economic recovery.

The Tequila episode was followed by significant capital outflows and triggered the sharp recession of 1995. Renewed inflows, nonetheless, allowed the economy to quickly resume its expansionary trend. This time, however, the expansion was considerably more vulnerable than the previous one, because the financial positions of both the private and the public sector were much more fragile than before.

As a result, the Argentine economy could not stand the worsening of the international scenario that followed the crises of Southeast Asia in 1997 and Russia in 1998. The unexpected and prolonged halt in capital inflows to emerging countries, initiated after the Russian default, put an end to the second expansion of the 1990s, and started the deep depression of the last part of the decade. Finally, in the second half of 2001 foreign financial markets were completely shut out for Argentina, determining the unsuccessful conclusion of the second round of market-oriented reform in the last thirty years.

There are two differing explanations about the collapse of the Currency Board regime in Argentina. One stresses the inconsistency between the fixed exchange rate regime and the large deficits generated by the government (Mussa, 2002). According to this view, the accumulation of public debt eventually became unsustainable and led to the loss of access to financial markets and the unfeasibility of maintaining the Currency Board.

The other focuses on the problems caused by the fixed exchange rate regime on the competitiveness of tradable sectors, at a time when a strong dollar (and therefore a strong peso) overlapped with a sharp devaluation in the Brazilian real, Brazil being Argentina's main trading partner (Frenkel, 2002). Following this perspective, the loss of competitiveness induced a decline in investment and triggered a painful depression. A sufficiently long economic contraction would have been the only possible way to induce the deflation required to correct the relative price imbalance under a fixed exchange rate, but this option proved politically unsustainable and eventually led to the end of the convertibility regime.

Both explanations have their merits and do not necessarily contradict each other. However, neither of them is enough to fully explain either the origin or the magnitude of the crisis. Regarding its origin, the crisis was not the direct outcome of an endogenous policy inconsistency, as the fiscalist explanation would suggest, nor the immediate consequence of the loss in competitiveness, as the non-fiscalists would put it. True, the Argentine economy was not competitive enough in world markets and was far from enjoying a consolidated fiscal stance. But these weaknesses alone would not have triggered the crisis unless an unexpected and persistent reversal in capital flows, hitting all emerging economies, started after the Russian crisis of August 1998.

With respect to the magnitude of the crisis, it mainly has to do with two related factors. Firstly, the large correction required in the equilibrium real exchange rate after the external shock caused by the capital flow reversal. Secondly, the expected impact of that correction on the financial positions of indebted agents, mainly the government and the corporate sector. The former factor cannot be attributed to the difficulties created by the Currency Board regime to tradable sectors' competitiveness. The latter is not related to the size of the (flow) fiscal deficit, but to some relevant features of the country's financial institutions affecting the (stock) portfolio decisions of all domestic economic players[7].

To understand why the reversal of capital flows was able to cause such a collapse in Argentina, it is necessary to pay special attention to two structural weaknesses of its economy that the reforms undertaken during the convertibility regime had left unattended.

On the real side, despite aggressive trade liberalization, the non-financial sector of the Argentine economy remained quite closed or, in other words, the share of tradable sector output in total GDP stayed quite small (Chart 9). The initial overvaluation of the domestic

[7] Moreover, the Argentine fiscal stance at that time was quite reasonable, especially when compared to that of other emerging economies.

currency, tolerated as a cost of price stabilization, and the mistaken decision to simultaneously liberalize both foreign trade and finance, lie behind this fact[8].

On the monetary side, financial fragility continued to be a pervasive feature of the Argentine economy. Not only did financial transactions remain basically short-run, increasing rollover risks, but also the portfolio dollarization of domestic agents expanded substantially, inducing large currency-denomination mismatches in financial transactions. The trend was encouraged by policy makers, which regarded it as a way to enhance the credibility of the Currency Board regime[9].

The mix of portfolio dollarization with a relatively small tradable sector made the adjustment to the capital flow reversal much more difficult in Argentina than in most other emerging countries (Calvo et al., 2003). On the one hand, as its economy was quite closed, the required depreciation in the equilibrium real exchange rate was rather large. On the other hand, dollar-denominated indebtedness of "peso-generating" agents (mostly linked to non-tradable activities) made those agents, not only private corporations and households but also the government, highly vulnerable to balance-sheet effects following a sizable real depreciation.

Lending to private firms and households with revenues not linked to the dollar became riskier, because a devaluation of the domestic currency seemed more likely. At the same time, the value of non-tradable collateral tended to fall for the same reason. The result was that access to domestic bank credit became more restricted for the private sector, worsening the contractionary consequences of the external financial shock.

The government, in turn, was unable to ease the private sector financial predicament because it faced similar problems itself. In fact, more than 60% of its debt was denominated in dollars and the share climbed to almost 85% when all hard currencies were considered. Moreover, though the flow fiscal accounts were reasonably under control, the public debt growth had nevertheless been much faster than could have been explained by the accumulation of fiscal deficits (excluding pension reform costs). The reasons were twofold: 1) the issuance of debt-consolidating bonds ("Bocones") acknowledging contingent liabilities with pensioners and government suppliers that obtained favorable judicial sentences in their disputes with the government and, 2) the need to finance the large transition costs arising from the ill-conceived pension system reform launched in mid-1994, with no serious consideration of its implications on the vulnerability of the

[8] Quite remarkably, these were the same mistakes that had been made in the previous Southern Cone reform experiences of the early 1980s.
[9] In fact, it was not even considered necessary to include any provision limiting currency mismatches in the prudential regulatory framework of the banking system.

government's financial position[10]. In sum, the government was facing a rapidly-growing public debt, mainly denominated in foreign currency that could easily become unsustainable under a real devaluation.

Was there a less traumatic course available after the capital flow reversal than the one the Argentine economy followed? If one agrees that a large correction in the real exchange rate was unavoidable as a result of the "sudden stop," the required policy answer would have been to adjust public sector accounts as much as needed in order to face: 1) the consequent increase in the government debt burden and, 2) the implicit contingent liabilities that would inexorably surface as a result of the foreseeable failure of the private sector and the banking system to manage their own larger debt burdens without government assistance. Most estimations suggest that the required adjustment would have implied jumping from the slight primary surplus achieved in 1999, of around 0.5% of GDP, to one of more than 3%, and to keep that surplus on a "permanent" basis.

One can only conjecture whether or not the shift from a fixed to a floating exchange rate regime at that time would have helped the government to execute the required adjustment. On the one hand, it would have made it easier to correct the real exchange rate. Moreover, it might have helped cutting public expenditures, thanks to the effect of inflation on real salaries and pensions (as actually happened after the crisis, as a result of the pass-through effect of the nominal devaluation on prices). On the other hand, however, the severe loss of credibility consequent to abandoning the Currency Board regime, which had become the cornerstone of the whole contractual system, would have certainly made the fiscal and financial adjustment much harder to pursue.

Would it have been possible for the government to carry out such a drastic adjustment? There can be many opinions regarding that question. However, considering that the economy was entering a period of depression at a time when large segments of society were beginning to heavily feel the fatigue of almost a decade of reform, and considering, as well, the massive wealth redistribution that fiscal and financial adjustment would have involved, it is extremely unlikely that any government could have performed such a task successfully.

Leaving aside the counterfactual world, we know that reality took a very different course. A heterogeneous political coalition had won the national elections and taken office by the end of 1999. The new Administration, headed by President De la Rúa, was committed to preserving the convertibility regime. Maintaining a fixed nominal exchange rate made the correction of the real rate extremely slow and painful, but the government discarded the shift to a floating regime, fearful of the balance sheet effects and the credibility implications

[10] According to public figures, Argentina's public debt amounted to us$ 144 billion by the end of 2001, or 54% of GDP. Of that total, some us$ 32 billion (12% of GDP) can be attributed to the materialization of contingent liabilities, while another us$ 21 billion (8% of GDP) to the transition costs of the pension reform.

of such a policy change. On the other hand, successive measures taken to increase the primary surplus were fiercely resisted by the affected sectors, thus systematically blocking the fiscal adjustment.

In the meantime, the economy was steadily deteriorating, worsening the financial distress of the government and the private sector. As a result, the position of several domestic banks began to weaken, also affecting investors' perception regarding the strength of the entire system. In mid-2001 a bank run started, distributive conflicts grew out of control, and the government proved politically unable to regain the initiative. Finally, by the end of December that year, rampant social turmoil forced President De la Rúa to resign, well before the end of his mandate. The default on the public debt and the abandonment of the Currency Board regime followed soon afterwards.

The Collapse of Convertibility

The crisis reached its peak in 2002. The GDP fell almost 11%, the largest reduction since World War I, led by a dramatic 36% plunge in aggregate investment and with its productive equipment component dropping almost 48%. The cumulative decline in GDP over the 1999-2002 period was 20%. As a result, the GDP per capita in 2002 was about 11% lower than that of 1993, one decade earlier. The sharp deterioration of activity levels had a significant impact on employment: the unemployment rate reached a maximum of 21.5% in April 2002. At the same time, the dramatic devaluation of the domestic currency caused a strong 41% increase in price levels, although, fortunately, not triggering an inflationary spiral. Given that nominal wages showed on average only a minor improvement, real wages fell drastically. This fact and the reduction in employment severely worsened poverty and indigence levels.

During the first half of that year, economic performance was strongly influenced by the immediate effects of the abandonment of the Currency Board regime: the huge devaluation of the peso, the banking crisis, the default on the public debt, the loss of confidence in the contractual system, and a generalized political and economic uncertainty. Despite the progressive implementation of exchange rate controls and the interruption in the payments of public and almost all private services on the debt, the Central Bank systematically lost foreign currency reserves throughout the first six months of the year, thus revealing the intensity of capital outflows during that period, as well as the impact generated by the net positive payments of capital and interest to multilateral institutions[11]. The recurrent postponement of a new agreement with the IMF, finally reached in January 2003, even led

[11] Net payments to IFIs totalled $4.1 billion dollars, or about 4 percentage points of GDP in 2002.

to the deferment of a payment to the World Bank in November, the first time in its history that Argentina did not fulfill an obligation to a multilateral institution.

The way in which the government initially handled the earliest consequences of the crisis only aggravated problems. On top of the already existing restrictions on withdrawals from bank accounts, and, in order to face the financial collapse triggered by the simultaneous run on deposits and foreign currency exchange observed at the end of 2001, the government decided to impose an asymmetric "pesoification" of bank assets and liabilities, as well as the reprogramming of term deposits. These measures had dramatic redistributive wealth effects which exacerbated the public's loss of confidence in banks and in the enforcement of contracts at all levels.

Throughout the first half of the year financial institutions continued losing deposits as a consequence of the trickle down *("goteo")* of funds allowed by the existing regulations and the sentences of judges in favor of investors *("amparos judiciales")*. To avoid a generalized closing down of institutions, the Central Bank had no choice but to assist the banking system with massive rediscounts.

To further complicate the economic environment, the fiscal stance experienced a sharp deterioration despite the fact that nominal primary expenditures were kept stable throughout the year and, therefore, showed a sharp reduction as a proportion of GDP. Then, the primary balance of the national government in the first quarter of 2002 was a deficit of 1.7% of GDP, and both the federal and many provincial governments were forced to issue bonds that began to circulate as "quasi-monies" to face their current expenditures. A decade after the hyperinflation episodes of the late eighties and early nineties, the country was once again in the brink of another hyperinflationary outburst.

The recovery: a new opportunity for development?

When most analysts foretold the entering into a new hyperinflationary period, some indicators surprisingly began to show a slow recovery as of the second quarter of 2002. The primary fiscal balance switched into a surplus position, thanks to the positive effect of price increases on tax collection, mainly the VAT and the tax on banking transactions, and to the establishment of a new tax on exports (the so-called *retenciones)*. At the same time, bank deposits halted their decline and began to rise, while the outflow of capital dropped significantly. These elements, together with the sizable trade surplus, allowed for the recovery of the Central Bank's reserves and the gradual stabilization of the foreign exchange market. As a result of this gradual improvement on the monetary and fiscal aggregates, the brisk fall in economic activity began to reverse as of the second half of 2002.

The economic recovery noticeably accelerated since 2003, with all macroeconomic variables exhibiting a quite positive performance. This improvement in economic activity took place simultaneously with a sharp drop in inflation and interest rates, as well as the gradual normalization of the financial system and the steady recovery of Central Bank's international reserves.

What were the underlying forces which drove this unexpectedly fast and strong recovery? Firstly, an extremely propitious international context. With the global economy in expansion and a dollar losing ground against the other world's major currencies, the price in dollars of Argentina's main export commodities (especially, soy edible oil) hit extraordinary levels, thus generating a substantial improvement in the country's terms of trade. Furthermore, international interest rates have been exceptionally low until recently and their subsequent increment has been remarkably gradual. While their direct impact on the local economy will remain relatively weak as the country progressively recovers its creditworthiness, one should not sidestep the effect of low interest rates on world economic growth (and that of Brazil, in particular) and the resulting indirect impact on the demand for Argentine exports.

Secondly, a substantial improvement in the real exchange rate (thanks to a moderate pass-through of devaluation on domestic prices) and a drastic recomposition of relative prices which allowed for the fast emergence of a widespread process of import substitution, even in an initial domestic scenario of great economic and institutional uncertainty. The huge level of idle resources (both labor and physical capital) after four consecutive years of declining economic activity, made this process possible.

Thirdly, despite the strong pressures of different lobbies and the IMF, which called for immediate structural and institutional reforms, economic policy reacted with a proper dose of gradualism. It seems highly likely that an attempt at restructuring the defaulted public debt, renegotiating the contracts of the privatised public utilities or pushing for the consolidation of the banking system in the period immediately after the crisis would have had traumatic consequences in the short run, generating increased uncertainty and blocking Argentina's economic recovery. Likewise, monetary policy was handled in the same pragmatic way. Once the initially high inflation expectations subsided, it adopted greater flexibility allowing for the monetization of the economy and the continuity of the recovery.

The pragmatic and gradual approach of economic policy, together with the successful implementation of a *sui generis* unemployment insurance funded with multilateral financing (*Plan Jefes y Jefas de Hogar*), made it possible for the social conflict to remain under control.

Lastly, the relative normalization in the political setting following the April 2003 presidential elections, which put an end to a period of more than 18 months of extreme uncertainty and institutional deterioration, created a more confident environment on the domestic scene, as shown by the high initial support for the new government, and particularly the President, that emerged in public opinion polls.

It cannot be taken for granted, of course, that the current trend wil be sustainable in the long run. Gradualism and pragmatism are not enough to ensure growth sustainability and economic development. The task requires not only consolidating what has already been achieved, but also addressing some major pending issues that the Kirchner's administration has so far postponed:. Among them, to mention the most pressing ones at the macro level: 1) to reach a set of relative prices consistent with both social and economic sustainability and low inflation, 2) to ensure the fiscal balance on a permanent basis, 3) to conclude the process of contract renegotiation, including tariff restructuring,. with public utilities' privatised firms, 4) to warrant the proper funding for the required aggregate investment effort.

Nevertheless, despite the fact that some big questions have yet to be settled and several difficult policy decisions have yet to be made, it would be unreasonable to minimize what has already been achieved. Firstly, because a rather fast expansion is already in its fourth consecutive year. But even more important, because some of its underlying fundamentals suggest that the country might at last be facing a real opportunity to find a feasible path for sustainable growth.

Indeed, it is worth pointing out that the current post-crisis recovery is different from other comparable events– particularly the recoveries following hyperinflation in 1989/90 and the Tequila effect in 1995 – in that it is less vulnerable to potential external shocks, or even to political or institutional domestic setbacks. This is so because the present economic environment, including a floating exchange rate regime, a competitive real exchange rate, a Central Bank that can operate as lender of last resort for the banking system, and a surplus position in both the fiscal accounts and the external current account, makes the economy more resilient to deal with possible negative exogenous shocks.

Moreover, perhaps for the first time since the first quarter of the 20th century, the Argentine economy simultaneously shows three factors that are necessary conditions for any successful development strategy in a globalized world: fiscal discipline, a reasonable low level of trade protection and a competitive exchange rate.

2.2 From economic and political chaos to an economically vibrant democracy: a Chilean Miracle?

Adopting a long run perspective, three different historical periods (Chumacero et al., 2005) can be distinguished in the evolution of the Chilean economy from the late 19th Century to the present. As was also the case with Argentina, the changes from one period to the next were basically induced by the impact of large exogenous shocks on economic performance and policies.

The 1878-83 Pacific War against Bolivia and Peru resulted in a significant and positive wealth shock for the country and the State with hefty medium and long-run consequences. After winning the war, Chile annexed territories, until then belonging to Bolivia and Peru, that were very rich in saltpeter and copper, among other minerals. As a consequence, Chile became, for all practical purposes, a World saltpeter monopolist.

Between the early 1880s and the mid' 1920s saltpeter output averaged about a quarter of GDP. On the one hand this allowed the State to extract monopoly rents by way of a tax on exports, which averaged around one third of the FOB price and accounted for about half of the ordinary fiscal revenues from 1880 to 1920. On the other hand, the significant increase in exports generated a severe case of *Dutch Disease* and, as a result, pressures to protect non-mineral tradables. Moreover, with the sharp increase in government revenues rent-seeking practices flourished.

As a result of the Great Depression, saltpeter and copper production, which constituted most of Chile's exports, collapsed. In 1932 they only reach 12% and 15%, respectively, of their 1929 record levels. As in the rest of Latin America, the economy became increasingly closed to foreign trade and capital flows, and a new regime, based on import substitution and pervasive government intervention, surfaced.

The Chilean economic performance throughout the ISI period was rather disappointing: rates of growth were well below those of the advanced countries and even of most LATAM economies; exports stagnated; chronic inflation progressively turned into high inflation. As a result of growing social unrest, starting in the late 1950s, a succession of economic and political experiments took place: first a *conservative regime*, then a *reformist regime*, and finally the so-called *Chilean way to socialism*. During Allende's socialist administration social conflict reached unprecedented levels and triggered a huge socio-political and economic crisis which led to a military *coup d'etat*.

The two phases of market-friendly reforms under Pinochet's dictatorship

The initial concern of the Pinochet administration was to restore a minimum of macroeconomic stability. The failure of Allende's government had indeed led to extreme economic uncertainty and a deep recession. In 1973 per capita GDP fell 7.2 per cent, net Central Bank reserves became negative and, in September that year, inflation peaked at an annual rate of about 1000 per cent.

The relatively moderate economic policies adopted immediately after the *coup*, however, produced mixed results and did not fulfill the military's expectations, particularly regarding inflation. At the same time, the international crisis triggered by the oil shock worsened domestic economic prospects. In such a scenario the radical neoliberal reform agenda proposed by a technocratic group of right-wing economists, the so-called *Chicago boys*, started to gain increasing support among the military authorities and the business community. Finally, in April 1975 the appointment of Sergio de Castro, the leader of the group, as Minister of Finance marked the beginning of the *neoliberal counter-revolution*. (Silva, 1991).

During this initial phase, which lasted until 1981, price controls (including the exchange rate) were removed , the share of progressive taxes was sharply diminished , the public sector became smaller, drastic changes in labor market regulations were implemented [12] and outright trade and financial liberalization was speedily introduced [13]. The widespread restitution of expropriated land and enterprises to their former private owners and the first privatisations of some public companies, which was a key element of this phase, helped the government to win massive support in the business sector. In the same vein worked the new business opportunities opened by the financial reform and the replacement of the pay-as-you-go retirement system by a privately managed fully-funded system based on individual accounts, a move which was later on followed by several other countries in the region.

Throughout the 1970s, however, the neoliberal strategy was jeopardized by two threats: uncontrollable high inflation and the first oil shock, which together with the strong fall in copper prices, led in 1975 to serious disturbances in the balance of payments and a sharp fall in GDP, accumulating 21% from the beginning of 1975 to the end of 1976.

Inertial inflation due to indexation proved extremely resilient to monetarist policies. While demand contraction led to sharp declines in activity, the yearly rate of inflation remained around 300%. It was only after the government decided to complement the monetary restraint with other less orthodox stabilisation devices that inflation began to subside. Besides periodic nominal revaluations of the exchange rate which were profusely publicised, from 1976 to 1978 the government systematically manipulated the CPI as an implicit (rather peculiar) deindexation mechanism.

After such a severe recession, the bounce back of activity was rather strong, allowing the economy to start growing at a fast pace for several years. The robust recovery helped create

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[12] Authority to set wages and dismiss workers was restored to individual firms while collective bargaining was limited to the firm level.

[13] Custom duties, which averaged 94%, were drastically reduced to a 10% uniform rate in June 1979 while non-tariff barriers were eliminated. In the domestic financial system entry requirements were relaxed, directed credit allocation was removed, interest rate controls were lifted and, towards the end of the decade, most constraints on international capital flows were eliminated.

a feeling of economic success and greatly contributed to the government's victory in the 1980 plebiscite which approved a new Constitution and institutionalized the authoritarian regime.

In 1979 the government considered that conditions were ready to adopt the monetary approach to the balance of payments: foreign trade was completely open and the fiscal budget was in surplus. The main purpose was to achieve convergence of domestic inflation to the international rate by fixing the nominal exchange rate. A fast growing external indebtedness made the monetary approach viable by funding the sustained increase in the current account deficit.

The strategy was successful in stopping inflation (Table 4): by the end of 1981 convergence had been accomplished. The neoliberal technocrats, however, had discarded the chances of a balance of payments crisis because the public sector was in surplus and foreign loans were taken by the private sector. Therefore, they underestimated the seriousness of growing external imbalances. Indeed, from 1979 to the debt crisis the real exchange rate lost about one third of its purchasing power (Chart 10), the external debt doubled (Charts 7 and 8), in 1981-82 the export boom faded away and in 1981 the current account deficit reached a peak of 14.5% of GDP, which stretches to 21% when measured using the 1976-78 average exchange rate. As a result, the Chilean economy entered a severe recession, the worst in the whole of Latin America, and the GDP plummeted for the second time in almost a decade: 14% in 1982-83.

As a result of the crisis the confidence of the population in the government and its policies began to weaken and, in April 1982, Pinochet was forced to reshuffle his cabinet and fire Sergio de Castro, appointing another *Chicago boy*, Sergio de la Cuadra, who decided to continue the policies of his predecessor.

As the crisis continued, an active political opposition started to unfold and finally, in April 1984 the *Chicago boys* were replaced by a more pragmatic economic team. After the adoption of a series of unorthodox measures, the reintroduction of certain protectionist measures, the adoption of stricter regulation in the financial system, the nationalisation of private debt and the granting of massive financial assistance to the private sector, plus a series of successive devaluations, the economy began to show signs of improvement. The improvement, however, was strongly biased in favor of the wealthy, while at the same time the government remained tough with labor unions and other popular organisations. As a result, despite economic recovery, income distribution suffered an additional deterioration.

In any case, in February 1985, when as a result of economic recovery the momentum of the political opposition had subsided and the government had regained some of its political power, Pinochet appointed Hernán Büchi, an economist with close connections with the *Chicago Boys*, as the new Minister of Finance. From then on the regime reverted to its previous neoliberal economic stance. Custom duties were reduced to a flat 15%, firms that had fallen under public sector management during the crisis were given back to the private sector and most of the remaining large traditional public enterprises were also privatised. Most significantly, the economic team adopted an active policy role intended to increase private savings and exports. Regarding the former, a tax cut including some special incentives on savings (made possible by lower public expenditure) was implemented. Regarding the latter, the key decision was the adoption of a high real-exchange-rate policy.

The post-crisis recovery was characterized by sustained growth in aggregate demand and production. The acceleration of economic activity was fueled by expansive monetary and fiscal polices and quite favorable terms of trade (due to an increase in copper prices which extended until the second half of 1989). In fact, towards the end of the decade the economy showed clear signs of overheating: in 1989 the growth in GDP reached a peak of 10% and in 1990 the annual inflation was 23%, twice the rate in 1988.

After the defeat of Pinochet in the October 1988 referendum it was clear that transition to democracy had started and, in all likelihood, the new President would come from the ranks of the political opposition.

By that time, however, it was also evident that the reforms set in motion by the military regime had produced a deep and long lasting impact on the Chilean economy. The business sector transformation, including the emergence of new, more innovative and competitive large conglomerates, had been truly impressive. Moreover, the country had fully integrated into the world economy while exports had become the growth engine.[14]

However, Pinochet's legacy also comprised a dramatic worsening on social inequalities and a rather heterogeneous productive structure. Also, from a short term viewpoint, politically motivated expansionist economic policies had created important macroeconomic imbalances (Ffrench Davis, 2002).

Continuity and change: the second wave of reforms under democracy

From 1990 to the present Chile has been governed by a coalition of center and leftwing political parties, the *Concertación de Partidos por la Democracia*. Despite existing concerns that economic and social demands from labor unions and other social groups could overwhelm the government, breaking fiscal and monetary discipline and dismantling key economic reforms, democratic transition proved politically and economically robust.

The main priorities of Patricio Aylwin, the first President elected by the *Concertación*, were to secure the continuity of economic expansion along with a stable macroeconomic

[14] Between 1974 and 1980 the share of non-traditional exports (including industrial ones) jumped from 10% to 24% of the total. In the eighties that share went on climbing until, in 1989 it reached 30% of total exports.

environment and to build the necessary support to pass through Congress a tax increase to roll back part of the tax cuts introduced in the late 1980s. The latter was an essential piece to put the social programs of the new government in place. The only other planned reform had to do with the labor code, which was bound to appear as a key issue in any social dialogue initiative (a priority of the new government).

It is worth mentioning that right-wing parties retained a significant veto power to limit the scope of the government's initiatives because of the presence of non-elected senators (*senadores designados*) in Congress, due to a special stipulation included in the 1980 Constitution. As a result, the tax increase and the labor reform, as well as other laws negotiated in Congress with the opposition, fell always short from the government's initial intentions.

Despite the fact that, besides the above-mentioned initiatives, the government did not have an explicit reform agenda, it took advantage of specific circumstances to introduce reforms in several areas. In most cases these were pilot programs which were deepened further in later administrations.

- *International Trade*: there was a unilateral reduction of import duties (one of the very few restrictions to trade remaining at the time) from a uniform tariff of 15% to 11%. An agenda to negotiate a FTA with the US was placed, taking advantage of an invitation from President Bush (senior) to create a Free Trade Area of the Americas.

- *Regulation of capital flows*: changes were in different directions: on one hand, the Central Bank lifted restrictions to capital movements and the door opened gradually to allow private companies to issue bonds and stocks in international markets. On the other hand, and under pressure from long and short-term capital inflows, reserve requirements to foreign loans (linked to the time length of the loan) were introduced.

- *Capital market reform*: when the government took power it was clear that a reform to domestic financial and capital markets was needed to adapt them to the emerging reality of huge long-term savings accumulated in the then new pension system.

- *Privatisation*: the political coalition supporting the government had been very critical of privatisations made during the military regime. While there was a tacit understanding not to reopen previous privatisations, nobody was expecting the new government to actually privatise other state companies. The decision to sell a majority fraction of the last major hydroelectric power generator in the hands of the state was, therefore, a major shift in the *Concertación*. The privatisation was conducted in such a way as to strengthen competition in the electric sector, something neglected during the privatization of the 80s.

- *The beginning of Public Works' concessions*: A program to grant concessions of public infrastructure to the private sector got started. The concessions took off in full in the second half of the 90s, and totally revamped Chilean infrastructure in less than a decade.

The second government of the *Concertación* led by Eduardo Frei started in 1994 and began with what, later on, would be classified as *second generation reforms*. On the one hand, President Frei gave a strong priority to the incorporation of the private sector into traditional public sector activities, as a way to push ahead with the modernisation of infrastructure. Key issues in this area were the privatization of ports, concessions of public works and privatisation of water and sewage utilities, which became emblematic of his modernisation platform. A second component of the government agenda was set in motion by the Minister of Finance, who pushed to place education (primary and secondary) as a key priority for the government. Finally, a group of lawyers and academicians had been pushing for a major renewal of the legal system.

In addition to these themes, the government also promoted other areas of reform: the initial steps of civil service and public finances' management reform were introduced as pilot programs. The Frei administration also pushed for a major reduction in import tariffs, together with the signing of as many bilateral free trade agreements as possible. Even though it was not successful at the beginning, the government managed to materialize his proposal during the Asian Crisis, when a majority of Congress was ready to agree to a gradual reduction in average tariffs from 11% to 6%, to be completed in five years and fully compensated by hikes in indirect taxes.

Fiscal discipline remained basically unchanged throughout the successive democratic administrations. With the fiscal accounts in surplus, public debt experienced a systematic reduction over this period. The recession caused by the Asian crisis led to a small deficit in 1999, but by 2000 fiscal accounts were back in blue when President Ricardo Lagos' new administration adopted a so-called *structural* fiscal rule (Chart 6), a rule that has greatly reduced the chances of procyclical fiscal policies.[15]

The building of an independent Central Bank was a difficult process, involving a very complex negotiation during the transition between military and democratic rule in order to name the first board of the Bank. After the initial hurdles and a learning process during the 1990s, accommodations have been made and the Bank is now led by his fourth chairman and has gained significant credibility about its commitment and ability to keep inflation

[15] The *structural fiscal balance* as defined in Chile has two major corrections from traditional measures: the standard correction in fiscal revenues to take into account departures from potential GDP (and normal tax collection) and the special adjustment to copper revenues, based on long-term projections of copper prices. In order to improve transparency in the computation of the two corrections, these parameters are set after public consultation with committees of outside experts.

under control. Along this process there have been major changes in policies which took place smoothly, without any significant conflicts.

The governments of the *Concertación* compare quite favorable with the previous authoritarian regime in terms of GDP growth, savings and investment, inflation, fiscal performance, real wages and poverty alleviation. There are still pending challenges, however, regarding equity on income distribution and the development towards a less vulnerable and more innovative economic system (García Hurtado, 2006)

3. Concluding Remarks

3.1 Learning by suffering: what went wrong in Argentina during the 1990s?

The reform attempt of the 1990s was certainly inspired by the recommendations of the Washington Consensus. Besides, until the international financial crisis of 1997-98, before its weaknesses became evident, the Argentine reform process was touted, domestically and internationally, as evidence of the soundness of the market-friendly approach to economic development. After the collapse of the Currency Board, then, it is understandable that the failure of the reform experiment to set off a new and sustainable development model was interpreted as proof of the shortcomings of that approach. This interpretation is only partially right.

To be sure, the problem with the Washington Consensus does not lie so much in its list of recommendations. Indeed, there is little doubt that any developing country should try to endorse fiscal discipline and sound money, favor a more important role by markets in resource allocation, limit the role of the State in production while inducing a greater private sector participation in the economy, and encourage a deeper integration with world markets, as suggested by the Washington Consensus. The real problem with the Washington Consensus is that its agenda was sold as an effective blueprint for development, valid for all times and places irrespective of the specificities of different country contexts, when it was actually useless as a concrete guideline for policy purposes[16].

The 1990s' experience in Argentina clearly shows how the huge distance between abstract principles and the actual implementation of the reforms seriously undermined the overall outcome of the whole process. A few key lessons from such a dismal experience are discussed below.

[16] In fact, the relatively few recent successful development processes, from Chile on one extreme to China on the other, while moving towards more market-friendly policies, tried to follow their own development strategies.

- **Under structural reform the cost of inconsistent policies can be extremely high**

A first indication of the distance between principles and implementation appeared in the relationship actually established between the stabilization policy on the one hand, and trade and financial liberalization on the other. Both macroeconomic stability and a deeper integration to world markets were, of course, part of the WC check-list. The stabilization policy of the Menem administration chose the exchange rate as nominal anchor, and to make its commitment credible adopted the Currency Board, the most rigid alternative among fixed exchange rate regimes. Simultaneously, with the full support of multilateral institutions and the establishment of the US and other advanced countries, Argentina embarked on a process of outright trade and financial liberalization.

The stated purpose of the liberalization process was twofold: to promote integration with the rest of the world and to discipline domestic markets, thereby reinforcing the stabilization effort. However, 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 (Chart 10).[17] The combination of overvaluation and liberalization dramatically altered relative prices and triggered a sharp transformation on the real side of the economy. The segmentation of domestic credit markets made the adjustment to the new context for otherwise viable firms in the tradable sector very difficult. At the same time, the sudden change in relative prices generated a competitiveness gap that helped raise the current account imbalance. However, external adjustment could be indefinitely postponed because a growing foreign indebtedness provided the funds required to finance the persistent current account deficits (Chart 7). As a result, the Argentine economy became not only less competitive but also more vulnerable to the volatility of world financial markets.

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 Argentina. Moreover, 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.

One can only conclude, therefore, 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 certainly played a significant role in underestimating the risks of failure of the Currency Board scheme and the subsequent exit

[17] The domestic currency was already significantly overvalued when the Currency Board regime was established. Moreover, inertial inflation during the first months of the new regime and the expansionary trend in government spending further intensified the problem.

costs. This fact is hardly surprising. What is less understandable is the support given to this process by the multilateral institutions and other participants in the Washington Consensus.

- **Populist practices are hard to eradicate and can survive even under the disguise of neoliberal rhetoric**

A second element that contributed to shaping the final outcome of the reform process has to do with the behavior of the public sector. Of course, to ensure a robust fiscal stance and a sound monetary policy were two central tenets of the WC agenda. The Currency Board device and the independence of the Central Bank were the instruments that would help to attain these goals, inducing the government to behave responsibly and get rid of the fiscal deficit. The privatization proceeds would provide the transitory funding required during the adjustment period. However, beneath the surface, this approach failed to modify the deep determinants of public sector behavior, which remained basically unchanged.

The idea that the complex political economy issues that shape public sector conduct could be easily managed by blocking the government's access to Central Bank credit was at best naïve. As a matter of fact, the deeply ingrained populist practices of Argentine politicians and public bureaucrats were not eliminated by the reforms. Instead, when they found out that their old source of financing was no longer available, their reaction was to look for a new one. In other words, despite the fact that politicians and public bureaucrats were deprived of the conventional mechanism of printing money as a result of the Currency Board regime, they were able to preserve many of the traditional expansionary fiscal policies of the past by issuing public debt. The easy access to foreign financing prevailing in the international capital markets until the late 1990s favored this new alternative.

To summarize, no matter what the allegedly neoliberal inspiration of the reforms, in this area the policy course followed in Argentina throughout the 1990s could be better 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.

Moreover, the unproven notion that privatisations 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.

- **Weak institutions may not impede spells of high growth but they do hamper sustainable development**

Finally, beneath populist pructices and policy inconsistencies, there is a third important element to be considered. This factor has to do with certain features of the traditional political economy environment prevailing in Argentina, which has somewhat intensified over the last quarter century. These features reflect the preference of the central socio-economic actors and of the citizenry as well, for non-institutionalized forms of conflict negotiation. This was especially apparent in the economic arena after 1983. The greater stability of democratic rules neither translated into the development of parliamentary mechanisms for effectively debating economic policies, nor led to the creation of alternative corporatist and bureaucratic instruments. In the 1990s this trait enabled Menem's administration to extremely concentrate its power in the Executive Branch.

More specifically, we argue that the *top-down* style of the reform process fed a "vicious circle" of underinstitutionalization based upon a perverse confluence of public and private actors. The former tried to keep discretionary powers, but in order to succeed they had to offer significant pay-offs to some private firms –such as the ones running the newly-privatized public utilities—and provincial governments. In this implicit agreement there was also a sort of complicity of private actors, who failed to promote the appropriate mechanisms and institutions encouraging the participation of the different social groups. Consequently, the winners tended to favor the strengthening of particularistic one-to-one linkages with the public sector, often overlapping with outright corruption. The losers, in turn, increasingly relapsed into apathy and withdrawal, also contributing to the anti-institutional bias of political practices.

The combination of a top-down style of decision-making with a non-institutionalized way of conflict resolution helped speed up the achievement of macro stability, eased the implementation of certain controversial reforms and triggered a relatively short period of rapid growth. It did so, however, at the cost of discouraging social involvement in the reforms. As a result, the process did not consolidate and the brief spell of high growth was once again interrupted by a severe crisis.

3.2. Learning by comparison: contrasting the analytical narratives of Argentina and Chile

Economic performance in Argentina and Chile started to diverge dramatically after the debt crisis of the early 80s. From then on, as illustrated by Chart 5, Chile's per capita GDP has almost systematically outperformed that of Argentina.

While in the two countries quite similar attempts at trade and financial liberalization, initiated in the late 70's, ended in complete failure a few years later, the rather different social ability to process that failed experience or, in other words, to learn from previous mistakes, is probably one of the key factors explaining the increasingly divergent paths that both countries followed afterwards.

One inevitably has to turn to non-economic factors, related to the specific political and institutional history of both countries, to understand their different learning capacities. In fact, a few years after the 1973 military takeover Chile began to gradually (re)build a political and economic institutional framework effective enough to ensure social governability and keep distributive conflicts under control. The process was, of course, far from idyllic but proved to be robust enough to withstand the turbulences of democratic transition and flexible enough to slowly undo the most outrageous features of Pinochet's authoritarian regime.

On the contrary, the military Junta that took power in 1976 in Argentina, despite its brutally repressive nature, never managed to set up an effective governance structure to deal with the county's unsettled social conflicts. As a result, the transition to democracy was unexpectedly brought forward by the country's defeat in the Malvinas-Falklands war and took place in the midst of a deep economic and social crisis. Relentlessly struggling to cope with an unstable and fragile economy and a divisive society, Argentina´s democratic regime has remained rather weak. Having emerged from the collapse of *Convertibility*, the country is now experiencing another bout of fast growth. It is still too early to know, however, whether this time the process will last longer than previous episodes.

Several lessons can ceratinly be drawn from the comparison of these two contrasting experiences. To conclude the paper we briefly present a few of them which we consider particularly relevant for understanding the reasons of success or failure of structural reforms.

- **Economic and socio-political history as well as initial conditions do matter**

✓ Timing of events (such as the end of the cold war, the Malvinas-Falklands war or the different moments of democratic transitions in both countries) can have the utmost importance on outcomes.

- ✓ Differences in political culture (centralized or federal organisation of the country, political party systems, cohesion of the military, compliance with norms, stability of public bureaucracy, level of corruption and the like) have critically influenced policy choices.
- ✓ Most policies, including those of the Washington Consensus type, are corruptible if the underlying political economy permits or encourages it. Consider for example Argentina's (or, for the sake of the argument, Russia's) experiment with mass privatization. Washington Consensus policies themselves cannot legislate powerful rent-seekers out of existence. Rank ordering different policy regimes requires a more fully specified model of political economy than the reduced-form view that automatically associates governmental restraint with less rent-seeking.
- ✓ Besides policy choices, differences in resource endowments and specialisation patterns have had a significant impact on access to foreign markets. For instance, subsidies to agriculture in the European Union, the US and other advanced economies have been especially harmful for Argentina but much less so for Chile.

- **Authoritarianism is neither a sufficient nor a necessary condition for reform**

It is undeniable that authoritarianism and outright repression made it easier for the Pinochet administration to fight and defeat political and social opposition to market-friendly reforms at the early stages of the process and, particularly, in the aftermath of the debt crisis of the early eighties. Nevertheless, the Argentine case clearly shows that authoritarianism is certainly not a sufficient condition for reform. Even more important, perhaps, is that several emerging countries in different regions of the world are currently proving that authoritarianism is neither a necessary condition to jump-start development.[18]

- **Social learning is key and depends on country-specific conditions**

Successful reforms are those that package sound economic principles around local capabilities, constraints and opportunities. Since these local circumstances vary, so do the reforms that work. An immediate implication is that growth strategies require considerable local knowledge. A certain amount of policy experimentation may be required in order to discover what will work. It is worth noting that many instances of successful reform were preceded by failed experiments. This was the case in Chile and Argentina with the first attempt at trade and financial liberalization in the early eighties. The failure, however, led to quite different reactions in both countries.

[18] India, South Africa, Ireland and most of the former socialist countries in Eastern Europe, just to mention a few cases, clearly exemplify this point.

A strong governance structure and the achievement of fiscal discipline in Chile prior to the crisis were key for the country to learn from the experience and make the necessary adjustments. The several unresolved distributive conflicts (social, sectoral, regional) that permeated even the internal structure of the military government, prevented Argentina from doing so.

- **Continuity pays**

Policy mistakes and setbacks were not, of course, absent from the Chilean process at several points in time. In sharp contrast with the Argentine case, however, the successive administrations were capable of ensuring the continuity of the initially chosen development strategy. Continuity, albeit with changes in emphases and priorities, was quite remarkable during the transition from dictatorship to democracy.

- **Successful reform processes always encompass, albeit in different combinations, orthodox and unorthodox policy prescriptions**

Even Chile, the poster-child of market-friendly neoliberal reform, adapted the WC prescriptions to its own conditions and devised its own policy mix of orthodox and not-so orthodox policies. Just to mention a few among the latter:

- ✓ A peculiar variety of incomes policy (including the banning of trade union activity and the manipulation of the consumer price index) was implemented to fight inflation
- ✓ Codelco remained as a SOE and has played a key role in ensuring the fiscal balance as a major revenue source
- ✓ International networking of Chilean technocrats granted privileged access to IFIs financing, mainly WB, and eased the foreign financial constraint after the debt crisis in the early eighties
- ✓ Trade liberalization was coupled with a competitive real exchange rate policy , proactive export promotion (through ProChile) and a huge number of bilateral FTAs in the process of internationalisation of the Chilean economy
- ✓ Capital controls were adopted to discourage volatile short term capital flows in the nineties

- **Development is not the result of a once-and-for-all reform package. It rather entails a continuous process of *reforming the reforms***

While Chile's economic performance has been remarkably successful, the country has still a long way to go in closing the gap with the developed world. Nowadays, probably the country's main challenge is to adapt its strategy to meet the new demands that the development process itself generates. Just to mention a few, three of the most pressing policy issues Chile is presently facing are:

- ✓ Promoting R&D and innovation to upgrade the productive structure, induce forward and backward linkages from natural-resource based towards higher value-added activities and diversify exports
- ✓ Reducing inequality in opportunities and improving income distribution
- ✓ Enhancing political participation

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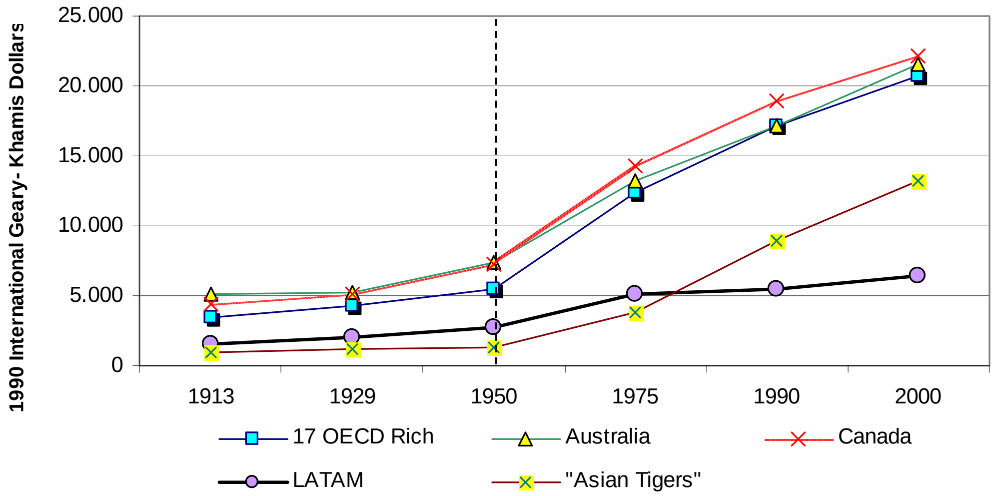
Statistical Annex

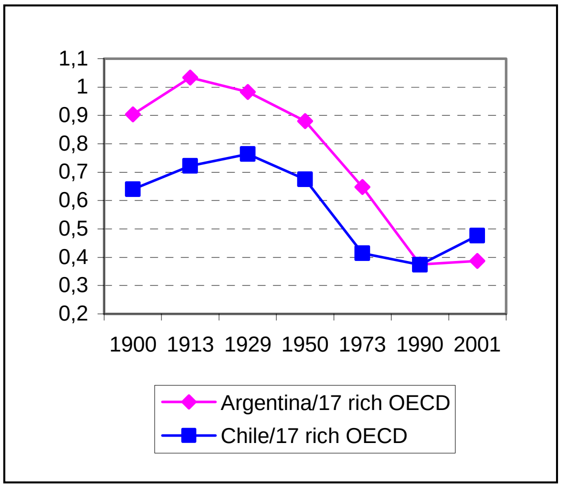
Chart 1. Per Capita GDP (1913-2000)

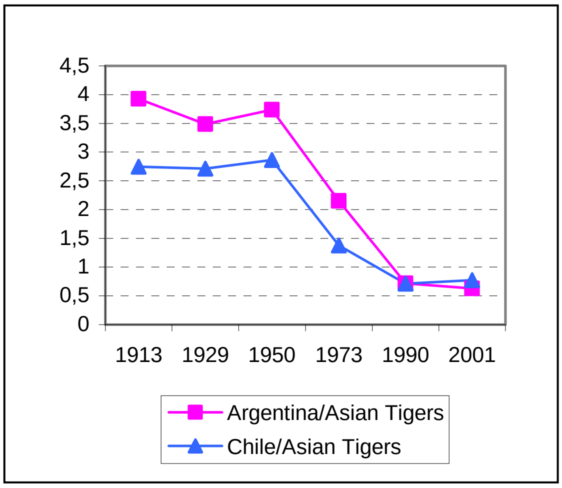


17 OECD Rich: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom and United States.
LATAM: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela.
"Asian Tigers": South Korea, Taiwan,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

Source: Own elaboration based on A. Maddison (2003), "The World Economy. Historical Statistics".

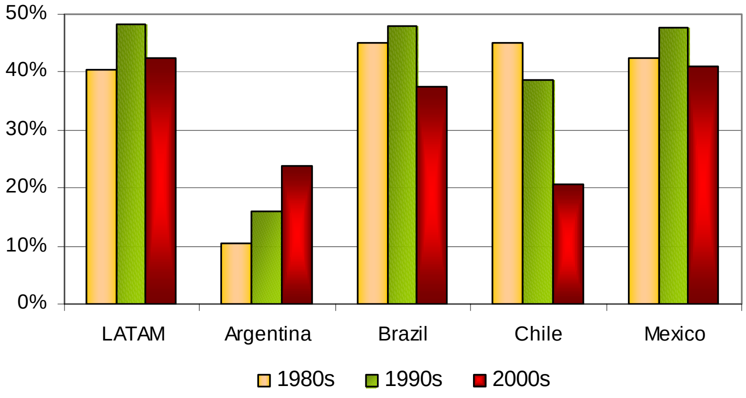
Chart 2. Argentina and Chile, Relative per Capita GDP against OECD countries and the Asian Tigers (1900-2001)





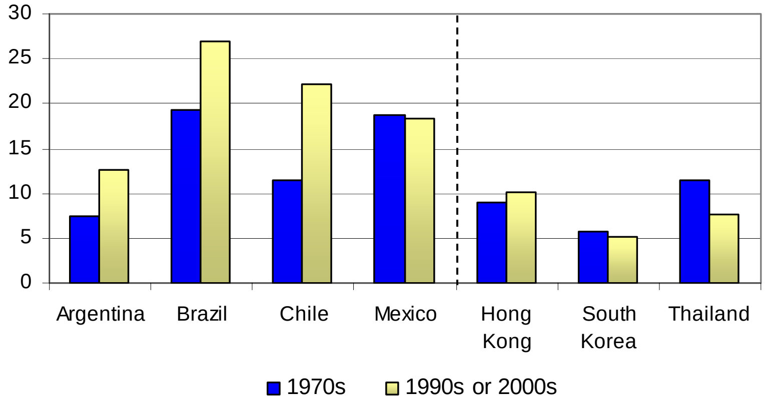
Source: Maddison (2001)

Chart 3. Population below the Poverty Line



Source: Own elaboration based on ECLAC.

Chart 4. Evolution of Inequality (QV/ QI)



Source: Own elaboration based on UNU/WIDER Database.

Table 1. Argentina and Chile, Per Capita GDP evolution

	1900-1913		1914-1929		1930-1975		1976-2005	
	Argentina	**Chile**	**Argentina**	**Chile**	**Argentina**	**Chile**	**Argentina**	**Chile**
per Capita GDP annual groth rates	2,50%	2,40%	1,88%	2,23%	1,54%	0,71%	0,52%	3,36%
Frequency of per Capita GDP annual Falls	31%	15%	38%	44%	35%	39%	47%	10%

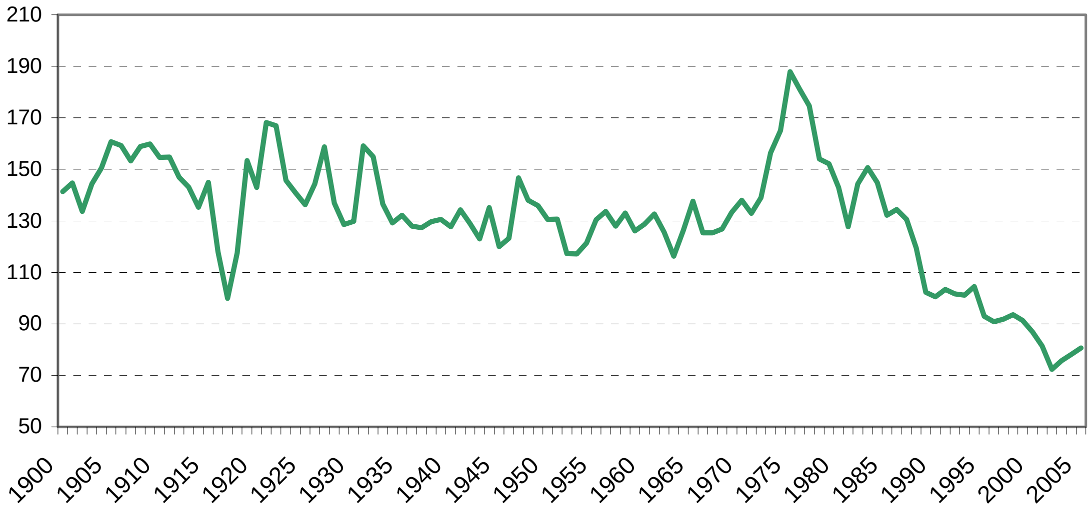
Source: Own figures based on Maddison, A. (2001), “The World Economy: a Millenial Perspective”, OECD and ECLAC .

Table 2. Argentina and Chile, Growth Volatility (Variation coefficients, 1975-2000)

	Investment Growth	Consumption Growth	GDP Growth
Argentina	7.1	2.4	1.8
Chile	2.6	2.3	1.1

Source: Fanelli (2002)

Chart 5. Relative per Capita GDP, Argentina/Chile (1900-2005)



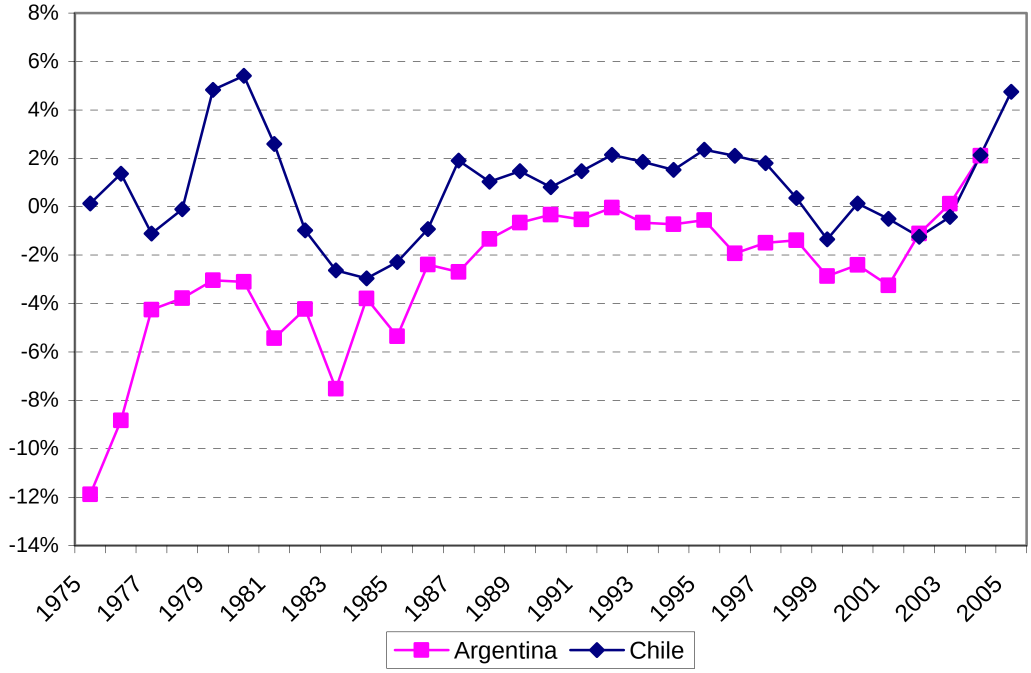
Source: Maddison (2001) and own elaboration based on IMF Statistics.

Table 3. Latin America, Key Features of Public Policies since the 1980s

Country	Stability	Adaptability	Enforcement and implementation	Coordination and coherence	Public-regardness	Efficiency	Policy index
Argentina	Low	Medium	Low	Low	Medium	Low	Low
Brazil	High	High	High	High	Medium	Medium	High
Chile	High	High	High	High	High	High	Very High
Mexico	High	Medium	High	Medium	Medium	High	High
Paraguay	Medium	Low	Low	Low	Low	Low	Low
Uruguay	High	High	High	Medium	Medium	Medium	High

Source: Stein and Tommasi (2005).

Chart 6. Argentina and Chile, Public Surplus (Deficit)/GDP (%)



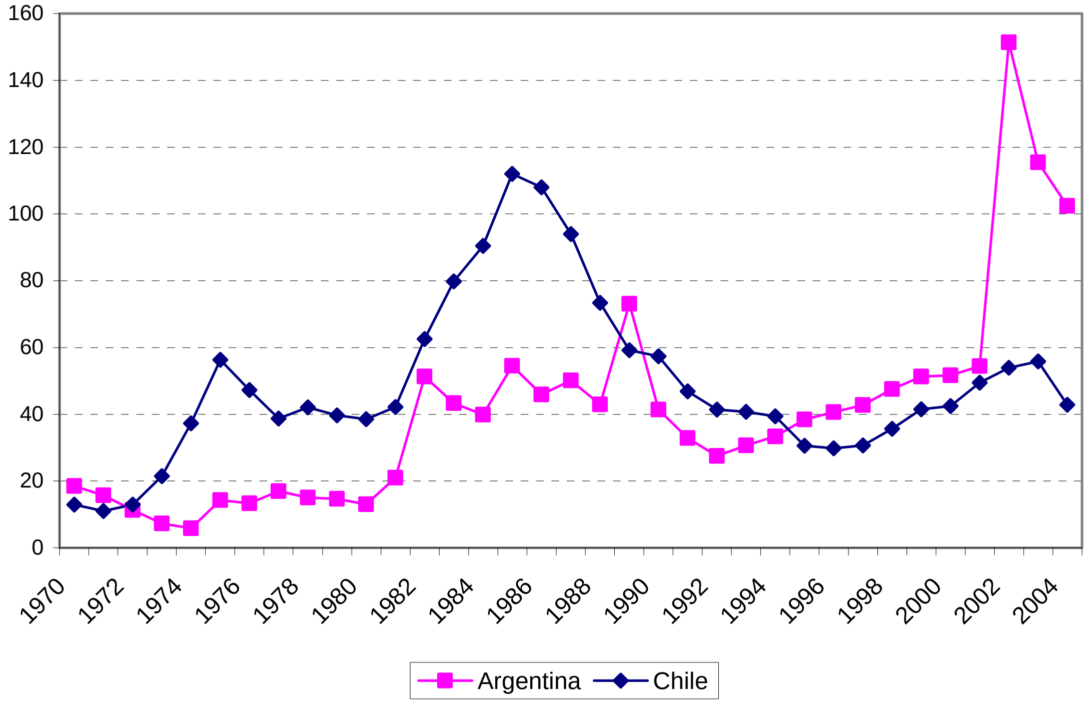
Source: IMF Statistics and Central Bank of Chile

Table 4. Argentina and Chile, Average Annual Inflation Rates

	Argentina	Chile
1970-74	38,3%	198,7%
1975-79	227,6%	150,4%
1980-84	268,1%	22,4%
1985-89	863,3%	20,3%
1990-94	505,1%	17,5%
1995-99	0,8%	6,0%
2000-04	8,3%	2,8%

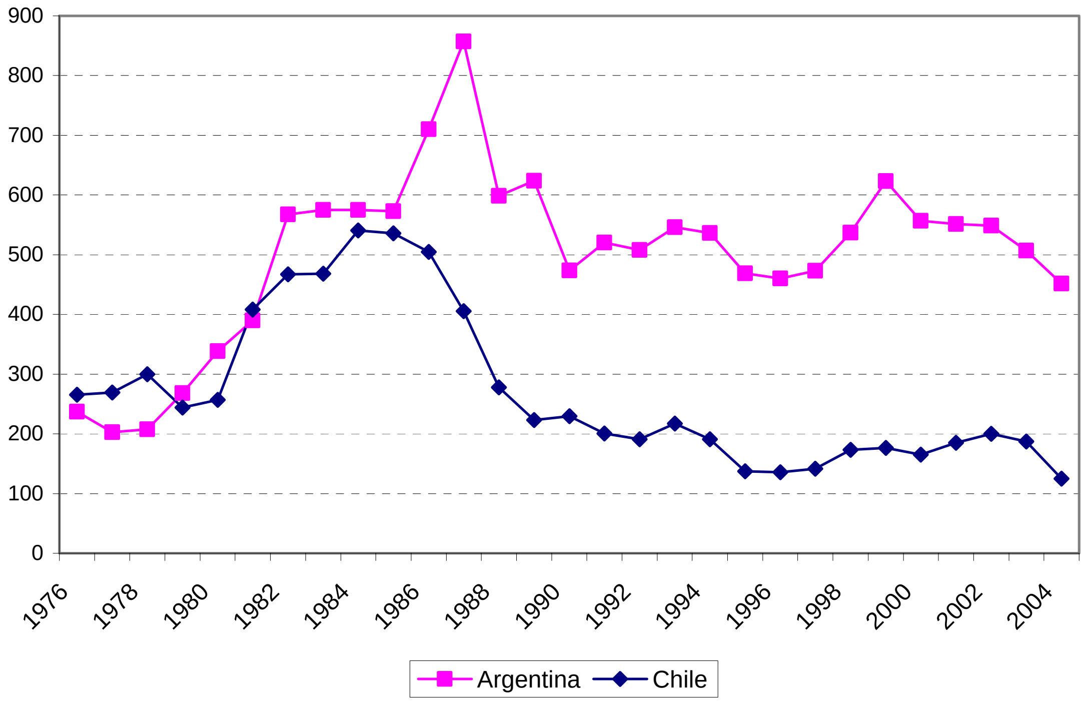
Source : IMF Statistics

Chart 7. Argentina and Chile, Gross External Debt/GDP (%)



Source: Lane Milesi (2004) and ECLAC.

Chart 8. Argentina and Chile, Gross External Debt/Total Exports (%)



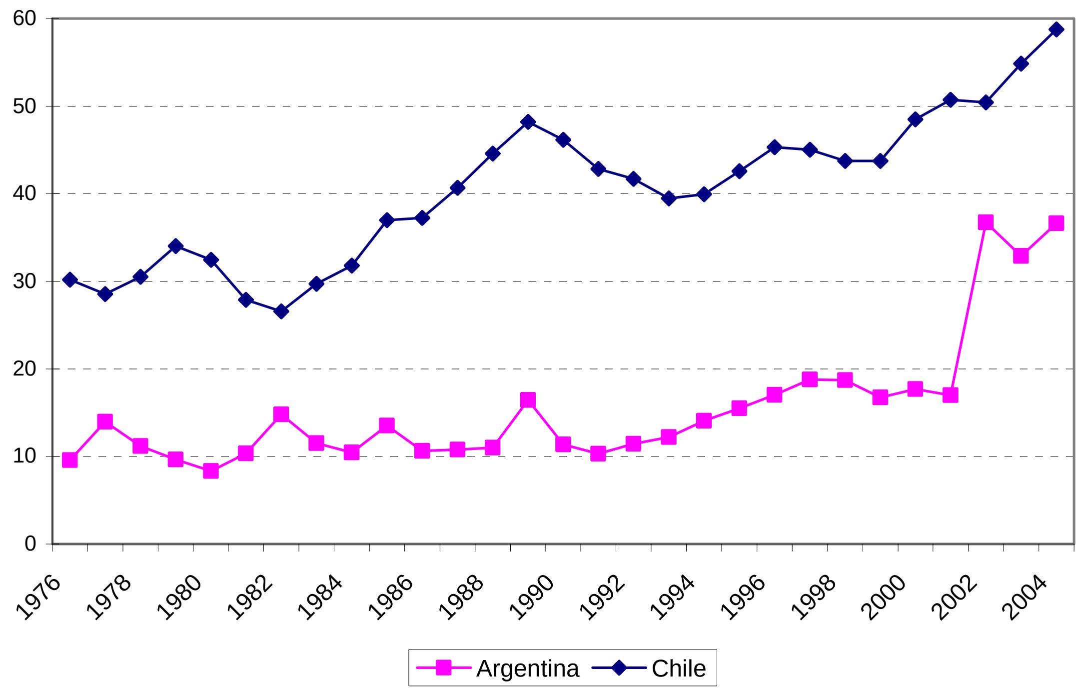
Source: Lane Milesi (2004) and ECLAC.

Table 5. Argentina and Chile, Unemployment, Poverty and Inequality

	Unemployment (%)		Head Count Ratio		Gini (%)	
	Argentina	Chile	Argentina	Chile	Argentina	Chile
1986	**4.4**	8.8			44.5	
1987	5.3	7.9		**45.1**		56.4
1989	7.3	5.3				57.9
1990	9.2	5.7		38.6		56.5
1992	7.0	**4.4**	19.7	33.0	45.4	55.8
1993	9.0	4.5	**18.3**		**44.4**	
1994	12.0	5.9	20.1	27.6	45.3	**54.8**
1995	16.0	4.7	26.6		48.1	
1996	16.6	5.4	29.4	23.2	48.6	57.5
1997	13.4	5.3	27.7		48.3	
1998	12.1	7.2	28.2		50.2	
1999	13.5	**8.9**	30.5		49.1	
2000	14.7	8.3	32.6	20.2	50.4	**57.6**
2001	**18.1**	7.9	38.4		52.2	
2002	17.5	7.8	**57.5**		**53.3**	
2003	16.8	7.4	54.7	**18.7**	52.8	
2004	13.6	8.8	42.3		50.8	
2005	11.6	8.0	38.4		50.2	

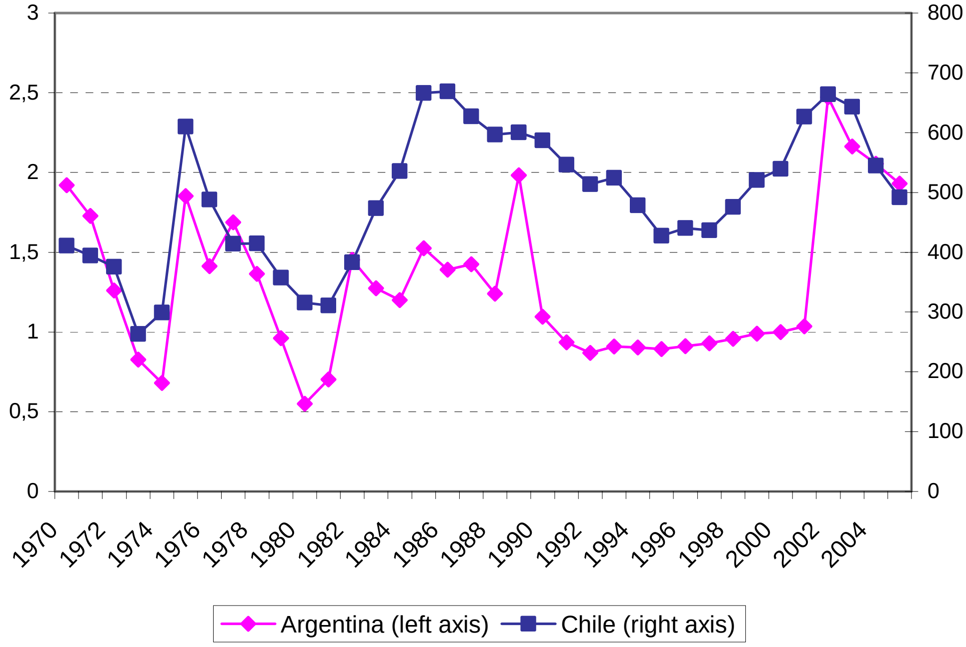
Source: ECLAC, IMF Statistics, INDEC and World Bank

Chart 9. Argentina and Chile, Foreign Trade/GDP (%)



Source: Lane Milesi 2004 and ECLAC.

Chart 10. Argentina and Chile, Real Exchange Rate



Source: IMF Statistics. Bilateral real exchange rate local currency/US Dollars, using GDP deflators.