1. Latin America's quasi-stagnation

Luiz Carlos Bresser–Pereira*

Behind Latin America's 20-year-old quasi-stagnation are not only interest groups of all kinds, but also serious mistakes in macroeconomic policy-making and institutional reform design. The central argument I will develop here is simple. Latin American countries became involved in a 1980s in a debt crisis and, more broadly, in a fiscal crisis of the state. Why did they not overcome the crisis? Why did they not regain the economic stability that had been lost in the crisis? Why were reforms not as effective as one would expect? Economists and social scientists have a general explanation for this: interest groups created obstacles to adequate policy-making. I have no argument with that, but believe, and will argue in this chapter, that there is a second and more important reason: that policy-makers are often incompetent, out of ignorance, fear or arrogance. Often policy-makers did the wrong thing out of conviction, not because of political pressure. Their decisions were the outcome of bad judgement. This was not relevant in the past, when macroeconomic policy and institutional reform strategy did not actually exist. Today they do exist, and often involve strategic, highly important decisions, given the consequences that may arise. Why do we assume that these decisions are always right? Or that right and wrong decisions compensate for each other, so that they may be ignored?

The last 20 years have been ones of near-stagnation for Brazil and, more broadly, for Latin America. If the 1980s have been called 'the lost decade', the 1990s may be seen as 'the wasted decade'. In absolute terms, income per capita barely grew in this period. If one compares it with the previous 30 years, the results are shocking. In the former period one could say that Brazil was catching up with the developed countries and that Latin America as a whole put in an unsatisfactory but still reasonable performance. Since 1980, however, Latin America has stagnated while the developed countries have continued to grow, although at a reduced pace. Per capita income between 1950 and 1979 grew at 3.3 percent per annum in the OECD countries, 2.3 percent in Latin America and 3.9 percent in Brazil. Between 1980 and 1998, the rate of growth in the developed countries went down to just 2.5 percent, but plummeted in Latin America to 0.5 percent and in Brazil to 0.7 percent (Table 1.1).

Table 1.1 Rates of per capita GDP growth compared

Average	OECD	Latin America	Brazil
1950–59	3.1	2.2	3.7
1960–69	4.2	2.5	2.9
1970–79	2.7	2.2	5.1
1950–79	3.3	2.3	3.9
1980–89	2.3	−0.3	1.0
1990–98	3.0	1.4	0.4
1980–98	2.5	0.5	0.7

Note: 'OECD' comprises Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Korea, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom and the United States.

Source: ECLAC, OECD.

The question, then, is why this happened. Why were Latin American countries and particularly Brazil – which I know better – unable to develop their economies in the last 20 years? What went wrong? Are the causes to be found in the markets, or rather in the governments (administrations) and their managing elites? Are the causes essentially domestic, or is there a significant international component involved?

In this paper I will not describe or analyse the macroeconomic instability that prevailed in the Latin American countries. This terrible vicious circle is well known: budget deficits and high public debt leading to fiscal crisis of the state and high inflation; price stabilization causing overvalued currencies, fostering still higher debt; deficits, debt and overvaluation depressing public and private savings, and leading to higher interest rates. All this led to reduced capital accumulation rates and to stagnation or an almost permanent recession. Since I assume that macroeconomic stability is a necessary (although not sufficient) condition for growth, my more general question will be why Latin American countries were unable to achieve it.

In this paper I offer answers to these questions. I will say that a major new historical fact led Latin American countries to near-insolvency, making macroeconomic policy-making and institutional reform design more strategic and more difficult. Politicians and the economists advising them were not able to cope with this added complexity. On several occasions they were incompetent and made serious mistakes, which aggravated the problem they wanted to solve. In section 1, I ask what economic growth depends on. To think just in terms of a production function is not enough.

Capital accumulation and technical progress were sufficient to explain economic growth when long-run macroeconomic stability could be assumed. Now, however, it cannot be. Macroeconomic instability can turn chronic and last for years, particularly when debt is involved. In section 2, I assume that there is today a reasonable consensus on the essential nature of the crisis: that it was a crisis of the developmentalist state.[1] In section 3, I examine the conventional answers to my basic question as given by the right and the left. According to the neoliberal wisdom, the explanation lies in the capacity of local political elites to reform and guarantee property rights. According to the old left, globalization and neoliberal reforms are to be blamed. But we know that the crisis occurred before the reforms. A new historical fact is required. Thus in section 4 I look for a new historical fact that could have prevented macroeconomic stability and caused stagnation. The 1970s foreign debt will be singled out as making macroeconomic policy-making more strategic and more complex in Latin America. In section 5 I review incompetent reform designs, which made their approval in parliament more problematic, and inept macroeconomic policies, particularly the decision to use foreign savings to stimulate growth, and policies to control inertial inflation. In section 6 I underline the wrong decisions leading to exchange rate overvaluation. In the seventh section I discuss the reasons behind these mistakes. In the conclusion I suggest that the incompetence hypothesis cannot be explained in rational or in historical terms. Although these two methods may offer subsidiary explanations for the problem, one should assume that incompetent policy-making is an independent explanatory factor which should be taken on its own.

Governments face serious institutional problems that require well-designed institutional reforms, and must make strategic and day-to-day macroeconomic policy decisions. My hypothesis is that, although interest group analysis may explain why decisions were not timely and correct, failures were more of a personal than of an institutional character. Given the existing pressure groups and ideologies, growth in Latin America would have been possible with the existing institutions if policy decisions had been correct and competent. Institutional reforms to foster growth would have been approved more easily if they had been properly designed. In other words, according to what we could call 'the incompetence hypothesis', the inability to overcome the crisis and resume growth lay mostly in the incompetence of local elites and international advisors to face the new challenges originating from the fundamental changes in international markets, particularly from the debt crisis and the increase in capital flows.

GROWTH AND MACROECONOMIC STABILITY

Growth assumes macroeconomic stability. When an economist is asked what economic growth depends on, the standard answer will be capital accumulation and technical progress. This I would call the 'classical school' answer, and the best simple answer available. If we say that economic development depends essentially on entrepreneurial innovation, we add a Schumpeterian perspective. If we stress the role of externalities, we may be referring to the structuralist economists' balanced growth theory of the 1940s or to the unbalanced growth theory of the 1950s which, in the last 15 years, the new endogenous theory of growth was able to formalize. Refer to the crucial role of human capital, and we have the more significant Chicago contribution to the theory of growth. Say that institutions are essential, and we will be repeating what classical and structuralist political economists said long ago, but with a new rational choice appeal.

I will not go over the enormous and fascinating literature on the subject. Growth theory assumed macroeconomic stability. Why? Maybe because part of this literature was written before Keynes' invention of macroeconomics. Maybe because, when a larger part of the contemporary literature on economic growth was elaborated (in the post-World War II golden years), macroeconomic stability seemed to have been achieved. Now that this illusion is long over, and keeping to the basics, we may summarize by saying that economic growth or an increase in general productivity depends essentially on capital accumulation, technical progress and macroeconomic stability. Capital accumulation, in turn, depends on the one hand on domestic savings, and on the other on favorable profit prospects for businessmen. Technical progress depends on the level of education, supply of entrepreneurial capacity, commitment of business enterprises to research and development (R&D) and rate of capital accumulation (since new investments tend to embody new technology). Macroeconomic stability depends on, or rather may be defined by considering, macroeconomic fundamentals: a balanced budget, a manageable level of indebtedness and having prices right, particularly a 'realistic' exchange rate and an interest rate consistent with international rates.

There is no rule of thumb to define what is a manageable level of indebtedness. We know, however, that when a country has a high foreign debt, it is supposed to realize extra savings just to pay interest on it. Extra savings means either higher profit rates, if the private sector is the indebted one, or extra taxes, if the state is mainly responsible for the foreign debt. In both cases, it means lower wages and reduced consumption, which can only be achieved if the country has a relatively undervalued currency. Thus, a 'realistic' exchange rate for indebted developing countries is a relatively devalued currency, as I will demonstrate later. If we include the domestic debt in our simple model, and if the state is the one particularly indebted internally, extra taxes may be necessary even if the foreign debt is mostly private. In any case, the cost has to be paid in terms of lower wages received by workers and the new middle class. One can always ask that the extra burden be directed to profits, but the limits to such a policy are set by a simple fact: if the expected profit rate is not high enough and secure enough, capitalists will not invest.

More generally, economic growth depends on adequate institutions that can create incentives to save and to invest in physical and human capital, and on competent reform design and policy-making, which is not automatically assured when institutions are fitted.

THE BASIC DIAGNOSIS

Assuming these general propositions, let me go back to my basic question: why have Latin American countries displayed such poor growth rates in the last 20 years, or, more specifically, why has macroeconomic instability been a constant throughout this period? Answers involve, on one side, a diagnosis of the historical circumstances that led so many countries, first to the crisis, and second, to an inability to overcome it. About the historical circumstances that gave rise to the crisis there is a reasonable consensus that it was essentially a crisis of the state. The developed countries have faced crises of the welfare state since 1973, when the first oil price shock signalled that the state had grown out of control, had become increasingly a victim of rent-seeking activity, and was immersed in growing internal problems, while government intervention distorted market allocation. The requisite fiscal adjustment and market-oriented reforms were then initiated. The Latin American crisis came later, in the 1980s, since economic growth was artificially protracted by the foreign debt adventure. But it came stronger, since the distortions of a developmentalist state were more severe than those of a welfare state.[2]

When at last, at the beginning of the 1980s, the debt crisis broke and the Latin American countries had no alternative but to adjust and reform, the task they faced was formidable. If in 1973 market distortions caused by generalized rent seeking and the imbalance in public finances in Latin America were already more severe than the corresponding distortions in the developed countries, what to say seven years later? Besides permitting the deepening of the existing distortions, the borrowing policy had led to outrageously high foreign debt.[3]

Thus, Latin American macroeconomic instability is associated with the excessive and distorted growth of the developmentalist state, and with the acquisition of a high foreign debt. The import substitution strategy that had been effective in promoting industrialization between the 1930s and 1950s was exhausted by the early 1960s. The economic crisis of the 1960s was a clear indication that the time for change had arrived; that the infant industry argument did not hold any more. But in the same way as fiscal adjustment would be protracted after the 1973 shock, so was the change to an export-oriented strategy in the 1960s. Foreign loans made both delays feasible, but had distressing consequences.

I believe that today there is a reasonable consensus for this basic diagnosis of the crisis. The neoliberal right will have difficulty accepting that, for a period, the developmentalist state was successful, since it is in conflict with historical reasoning. The old left will insist that the reason for macroeconomic instability was not the unavoidable distortions that evolve out of excessive protection of local industry and immoderate growth in state expenditures, but some conspiracy connecting local business and multinationals. But most will accept that the state, which, between the 1930s and 1960s, was active in promoting development and welfare, had since the 1980s turned into a problem, requiring fiscal adjustment and reform. Public savings, which had been positive and were contributing to overall savings, turned negative. The budget deficit that previously financed investment now chiefly financed consumption. State-owned enterprises, which had a major role in establishing an industrial infrastructure for the national economy, were now highly indebted. The state bureaucrats who, for a time, were committed to national projects in which their role was clear, were now lost in their own crisis – a crisis that led many of them to resort to rent seeking if not outright corruption.

THE CONVENTIONAL WISDOM(S)

After 1982, when the debt crisis broke, macroeconomic instability emerged as the central economic problem. Latin American countries had no alternative but to adjust and reform. Pressed by creditor countries and by circumstances, they did just that, but they did not achieve macroeconomic stability. What went wrong? Was it that fiscal adjustment and reforms were not effectively undertaken, or that they were, but nevertheless did not perform? About this there is deep controversy. The right and the left have their own conventional wisdom.

The conservative conventional wisdom is clear. Latin America failed to undertake the reforms that are required in a global world. 'Reform' became a kind of *passe partout*, a miracle word that would solve all problems. Thus if growth did not resume, the explanation must be that reforms did not unfold. Never mind that fiscal adjustment was implemented severely in many countries, that trade liberalization and privatization are now definitive facts in Latin America, that administrative reforms are under way in some countries, that labor markets were made somewhat more flexible. Reforms were 'just on paper' or were 'not enough', or new ones are required.

According to the new conservative view, what is needed is 'economic freedom'. The thinktank Economic Freedom of the World publishes an index ranking countries accordingly.[4] This curious index, in which China is freer than Brazil and Peru ranked higher than Denmark, is, notwithstanding, taken seriously by *The Economist*, since it expresses in correct terminology the right's truth. The magazine's editor, Bill Emmott (1999: 28), for instance, asks in a special survey why the poorer countries haven't caught up in the 20th century. He dismisses answers like lack of skills, lack of capital or lack of entrepreneurship, to conclude with a platitude: that what is lacking is economic freedom and the due protection of property rights, since 'the freer the economy, the higher the growth and the richer the country'. Reforms will lead to this freedom, will reduce the size of the state and deregulate the economy, allowing the market to do its work. If growth did not evolve, it was because reforms were not carried out or were incomplete.

The market-oriented reforms required in Latin America have been undertaken: fiscal adjustment, trade reform, privatization, social security reform and administrative reform. To say that these reforms were not undertaken is simply false. To say that they are incomplete is always true, but it does not explain macro instability. This is a short-run problem, which has to be solved mostly with short-term policies, while institutional reforms have mostly medium-term outcomes. Even economic reforms involving short-term results, such as trade liberalization, do not automatically entail stability and growth. Recently Rodrik (1999), after extensive cross-country regression analysis, concluded that trade reform was not related in a significant way to growth in the 1980s and 1990s; the significant variables were capital accumulation and macroeconomic stability.[5] The only policy directly related to macro stability is fiscal adjustment, but that, although it may partially depend on fiscal reform, is not itself a reform.

But, continues mainstream conventional wisdom, reforms were not carried out, or were insufficient, because they were, and are, opposed by interest groups and populist politicians in Latin America.

Latin American politicians do indeed engage in populist practices more easily than those in developed countries. This is also part of a developing country by definition. But how can we explain that, with the same politicians, Latin America was able to achieve reasonable macroeconomic stability and high rates of per capita GDP growth in the previous 30 years? One cannot explain new events with old facts. Besides, it is reasonable to say that political behavior in Latin America has improved in the last 20 years. Democracy has become the dominant political form throughout the region. The Latin American democracies cannot be compared with the ones existing in the developed countries, but they are at least democracies. This means they have better institutions and better politicians.

Thus, the conservative or mainstream conventional wisdom about what went wrong in Latin America is not convincing. Unable to reason in historical terms, it tries to explain a new problem – economic stagnation – with old facts: 'lack of economic freedom', 'populist politicians', 'incomplete reforms'. This despite the record of improvement: property rights are now better protected than before, politicians are more modern and democratic, and extensive reforms, although necessarily incomplete, have been accomplished.

The conventional wisdom of the old left goes in the opposite direction but has similar flaws. If globalization is a grace for the right, as it means that markets are becoming dominant all over the world, to the old left it is a curse for the same, but oppositely valued, reason. In the last quarter-century market coordination has advanced while state intervention first came to a halt and then was (moderately) reduced; the left believes this is to blame for stagnation. The curious thing is that it shares with the right the belief that globalization inevitably leads to a reduction in state autonomy. It does not seem to realize that the devious ideological aspect of globalization is precisely that: to say that the state has definitively lost autonomy, and that there is nothing to do about it but to accept and adjust to this new reality.

Together with globalization, continues the old left, came the neoliberal reforms that further reduced state autonomy, leaving developing economies at the mercy of market irrationality. Thus whereas, for the right, it is the lack of reforms that is to be censured, for the old left, it is the excess of reforms and their distorted character that explain Latin America's economic problems. That in some countries reforms were misguided there can be no doubt. Consider, for instance, the case of privatization in Argentina. But one cannot generalize the argument. Actually the old left's wisdom does not make sense for the simple reason that the crisis that led to stagnation has its roots in the 1970s, when neither globalization nor reforms had come of age. Globalization in real (rather than ideological) terms, viewed as the worldwide reorganization of production led by multinational corporations and as the emergence of world financial markets, was a historical fact on its way, but not yet dominant. Reforms came in the 1980s as an answer to the crisis, and thus cannot be its cause.

The right's difficulty of thinking in historical terms is easy to understand. Its present intellectual religion is neoclassical economics and rational choice reasoning, which are notable scientific realizations but are, by definition, ahistorical, of an essentially logical–deductive character. But it is harder to understand why the left is equally unable to think in historical terms, when this is strictly required. After all, we are looking for the causes of a new historical event, namely economic stagnation in Latin America. Historical reasoning is not a monopoly of the left, but it is good to remember that its major thinker, Marx, thought always in historical terms. It was the historical method that permitted him to draw such a profound analysis of capitalism.

Thus both right and left shun history. Not because the historical method is a risky way of reasoning, prone to ideological distortion, but because it involves identifying and coping with change. This is always painful to the right and the left. It requires real thinking, not just the application of stereotypes. It is fashionable to speak of the increasing pace of technological and social change, but when interests and ideologies are involved, it is much easier to stick with an immutable conventional wisdom of a sort.

THE NEW HISTORICAL FACT

Difficult and risky as it may be, there is no alternative but to think in historical terms when we have a historical problem to solve. What was the new historical fact that kept macroeconomic instability unresolved, that turned it into an almost chronic phenomenon? I have already accepted the basic diagnosis for why the problem came about in the early 1980s – it was a crisis of the developmentalist state caused by excessive and distorted growth. But when a crisis emerges and its causes are identified, it is reasonable to expect that it will subsequently be overcome. Why did this not happen?

The failure to take correct strategic policy decisions and adopt well-designed reforms is my main explanation. Reforms are institutional changes; policy decisions are the day-to-day management of the economy. Reforms involve medium-term outcomes; policy decisions may also have medium and long-term consequences, but usually produce results immediately. The economists in charge of policy decisions in Latin American countries, both domestic and foreign (the latter usually IMF or World Bank advisors) failed grossly in stabilizing Latin American economies. Stabilization strategies, specifically price stabilization strategies, took too long to achieve results or cost too much in loss of income. Some cost too much because hyperinflation developed, as in Argentina. In other cases, they cost too much because they involved extremely severe cuts in demand

and particularly in wages, as was the case in Chile. And in other cases, such as Brazil, high costs were related to the time they took to succeed: starting from 1979, when the crisis began, 12 stabilization attempts – some heterodox, most orthodox – failed before the heterodox Real Plan was able to stabilize inflation.

But the same argument that I used earlier to reject the conventional wisdom that populist politicians were to blame for the failure to stabilize applies to my argument as well. The same economists – although certainly less well prepared theoretically – were in Latin America in the previous 30 years, when macroeconomic stability and economic growth prevailed. Thus, before surveying wrong strategic decisions, I still need a new historical fact that changed the picture and caused poor decision-making.

I offer two new historical facts for discussion. One is specific to Latin America: the debt crisis and consequent fiscal crisis of the state. The other – the fact that macroeconomic policy-making is relatively new – will give a more universal character to the analysis.

The Debt Crisis

The debt crisis was effectively a new historical fact, as we may see in Table 1.2: the increase in debt outstanding of Latin America as a whole and Brazil in particular from 1970 to 1980 was immense. This new fact, in this case, is supposed to have two qualities. First, it must have imposed a severe blow on the Latin American economies. I will not offer further evidence for this because it is well known that high indebtedness represented a disaster for Latin America. And second, this new fact, producing such a grave and enduring crisis, should have made economic policy decisions more strategic and more complex. In other words, it is supposed to have produced what on another occasion I have called 'abnormal times', that is, an atypical situation in which distortions of all sorts assume an overwhelming character, requiring exceptionally proficient decisions. If, in these circumstances,

Table 1.2 Outstanding Brazilian and Latin America foreign debt (US$ million)

Year Ending	Latin America	Brazil
1970	27,633	5,020
1980	187,255	57,981
1990	379,669	94,340
1998	558,919	157,553

Source: World Bank, *Global Development Finance*.

policy decisions are not made at the right time and in the right direction, the country may stagnate for many years.

The debt acquired by the Latin American countries in the 1970s and early 1980s, before the 1982 breakdown, fits these two requirements. We had foreign indebtedness before, in the 19th century and in the 1920s, but never to such an extent. What is more important, since the 1930s' crisis, when several developing countries had to restructure their debts, private loans to Latin America were closed, except loans to finance trade. The relatively high rates of growth achieved between 1930 and 1969, and particularly between 1960 and 1969, were thus secured without making use of long-term debt. Quasi-stagnation only appeared after Latin American countries became indebted.

In the 1950s and 1960s Latin American economists and politicians longed to obtain long-term loans, believing that in this way they would speed up growth. When, in the 1970s, they were given this power, given the excess liquidity prevailing in the international financial markets, the Latin American countries became indebted and a predictable, but not predicted, disaster ensued. Very few things are more dangerous to any organization, be it a business organization or a national economy, than to suddenly have access to a large amount of money. The probability that this money will be spent poorly is enormous. There are not enough good investment projects to be financed, nor enough competent management to lead the projects. In the 1970s the Latin American foreign debt grew so quickly and became so large, while the international banks took so much time to stop it (for a while), that when this eventually happened, in 1982, most Latin American countries were insolvent. They were left with a huge debt overhang which had to be served out of current national income.

This is old and well-known history. A history of a problem that the Brady Plan, from 1990 on, did not solve but simply got under control, by allowing for restructuring and limited discounting. Here, the important thing is to understand the long-run consequences. On the other hand, since I am assuming that the Latin American countries can only rely on themselves, it is essential to know how the debt affected growth and policy-making in Latin America. That it affected long-term growth negatively is not in dispute. The problem is that, additionally, it made policy-making, already a difficult and hazardous task, even more complex. If this is true for advanced economies, where macroeconomic problems seldom assume a dramatic character, what is there to say of the developing countries, which faced practical insolvency due to the debt? A country enjoys macroeconomic stability when inflation rates are similar to those prevailing in the advanced countries, and interest rates just a little above. Foreign (and domestic) large debts made macroeconomic stabilization in the Latin

American countries much more difficult to achieve, demanding more competent economists and politicians than the ones at the region's disposal.[6]

The 'New' Macroeconomics

Macroeconomic policy is a 50-year-old phenomenon. Before Keynes and the rise of macroeconomics – before central banks became established and relatively independent – one could hardly speak of an overarching macroeconomic policy. Governments adopted forms of economic policy and strove for fiscal and trade account balance, but theory was so poor, and macro data so faulty, that governments were far from having a real macroeconomic policy. Thus, it was understandable that economists, historians and social scientists in general, when trying to understand the economic performance of nations, looked only for interests, not for mistakes. Bad or good decisions would arise systematically out of interest groups or unsystematically out of decisions. Often historians would speak of a 'good' or a 'bad' government, but nevertheless, right and wrong government decisions were supposed to be so evenly distributed that they could mostly be ignored.

This is no longer the case now that macroeconomic policy, and, more recently, institutional reform strategy, has turned into a usual and essential government process. This is a new historical fact. Economic policy has become strategic and may now be held responsible for a substantial part of a government's success or failure. Thus policy decisions (right and wrong), as well as interests, have to be taken into consideration by social scientists, if they want to understand what is going on.

I am not saying that there are no good economists in Latin America, nor that there is a systematic explanation for macro instability. Latin America today probably has better-prepared politicians and economists than it did in the past. Latin American countries are more democratic, and politicians have learned to live with democracy. Since the late 1960s economists have started to study for PhDs abroad, particularly in the more prestigious American universities, giving them more sophisticated economic techniques to work with. But this does not mean that they have a greater – or lesser – ability to make correct and courageous decisions. There is here a trade-off between technical capacity and a deeper knowledge of the economic and political reality in each country. I will not discuss this subject here.[7] Rather, I want to emphasize that the debt crisis and, more generally, the crisis of the Latin American states made economic policy-making more challenging that it was before. More broadly, the emergence of macroeconomic policy and institutional reform strategy made decisions in this area more significant and more subject to error. Good institutions such as those existing in advanced countries will limit the costs involved in perhaps mistaken decisions, but nevertheless, policy decisions now need to be more relevant and strategic than they were in the past.

INCOMPETENT STRATEGIC DECISIONS

What were the mistakes that were made? Has policy-making really been as misguided and unsuitable as I am suggesting? In order to respond to these questions, I will review some basic macroeconomic policy decisions and some decisions on the design of institutional reforms over the last 20 years, asking if they succeeded or not. The criterion for success is different in each case. Success in institutional design is achieved when the reform is approved by congress and, later on, when it is implemented and produces the expected outcomes. I will refer here only to reform approval. Success in macro policy-making is achieved when the economy first stabilizes and then grows. In the case of reforms, we have a political success criterion; in the case of macro policy decisions, we have a technical one.

Many institutional reforms were approved and implemented in Latin America. When a reform does not pass congress, the usual explanation is that voters did not support it or that opposing interest groups were too strong. Both are true, but an entirely different kind of answer must also be considered, an answer that I believe is particularly important. Many reforms are not approved by parliament because the reform design was not competent. Usually proficient design is taken for granted. It should not be. One should not underestimate politicians acting in parliaments. A poorly designed reform is much more difficult to pass than a well-designed one. The reform design has to be simple, its objectives clear, its benefits well defined, its costs sized. All this must be part of the reform design, so that it can be easily understood and gain the support of the public.

There is a growing literature on what is called 'deliberative' democracy, a polity that 'is governed by the public deliberation of its members'. There are advocates of deliberative democracy, such as Cohen (1989: 67), whose definition I just used, or Bohman (1998), who refers to 'the coming age of deliberative democracy'. There are also critics, such as Przeworski (1998), according to whom deliberation easily gets transformed into indoctrination since, in the process, power agents make use of money and privileged information to persuade others. I will not discuss this matter here. Przeworski is correct when he says that the distortions in the deliberation process are usually great. Good laws do not necessarily derive from the public deliberation of citizens. I will only say that public debate, or what Habermas calls 'communicative action', is essential to democracy.

The democratic regime is always deliberative in the sense that citizens' votes in elections and politicians' votes in parliaments are the outcome of individual deliberation preceded by public debate. If a reform is really important, a national debate is necessary for securing support. It is almost impossible to debate at the national level a reform that is poorly designed.

In Brazil the social security reform submitted to congress in 1995 was an example of a poorly designed reform. This reform was extremely necessary, particularly the reform of the civil servants' pension system, since the privileges and consequent costs were huge. According to the Brazilian constitution, civil servants are entitled to a full pension corresponding to the last salary before retirement, which they usually secure at an early age. In contrast, the private workers' pensions system grants few if any privileges. Reform of it was required, but to a lesser extent. Thus, the right thing to do in political terms would have been to present two separate constitutional amendments. Instead, only one amendment was submitted, permitting a few powerful public officials to hide behind the mass of private workers who, although not being deprived of significant entitlements, felt threatened. This threat was felt still more strongly because the reform had additional design flaws. It was complex and obscure. A lot was left to be regulated by ordinary law. Even though Brazilians admit that they have an excessively detailed constitution, they contradictorily require that their rights be defined clearly in the constitution. The consequence was that, notwithstanding the efforts of the federal government in this matter, only a fraction of what was contemplated was approved.

In the case of the second major reform that the Brazilian government committed to in the 1994 elections – tax reform – the design problem has been still more serious. Up to now the finance ministry has not been able to arrive at its own proposal. There is a consensus that the reform is needed but, fearing a reduction in the tax burden, the government has not been able, internally, to arrive at a conclusion.[8]

An interesting research project would be to survey other institutional reforms in Latin America to check to what extent they failed – when they did – because of flawed design. I will now turn to macroeconomic policies, highlighting three areas: foreign debt policy, price stabilization policy and exchange rate policy. I will not bring up decisions on the interest rate, because these are a part of day-to-day monetary policy depending on decisions in the above areas.

Latin American countries made a great mistake in becoming highly indebted in the 1970s – a mistake that I suggested was the historical new fact that made macroeconomic policy-making considerably more difficult than it had been. Yet one could argue that this is an old question. Indeed it is. But what is there to say about so many Latin American countries engaging, in the 1990s, in new debts? The 'growth-cum-debt' strategy, the fantasy that it is possible to stir growth with foreign savings, is back in Latin America.

It is a serious mistake to rely on debt to stimulate growth. This might be reasonable if the countries were not already highly indebted, and if limits were strictly defined. I do not forget basic economic theory, which says that it is valid to borrow when the rate of interest is lower than the expected rate of profit. Yet this kind of microeconomic reasoning is misleading in macro terms. It is impossible to guarantee that borrowing will be directed to new investments. The moment a country opens its financial markets to foreign borrowing, be it short or medium term, it loses control of how the resources will be used.

There is a general condemnation of short-term borrowing given the high volatility of capital flows. Medium-term debt is certainly less harmful than short-term indebtedness. But both are bad. In the 1997–98 emerging markets financial crisis, the countries that were not highly indebted – and that were not tending to acquire more debt given their current account deficits – were not molested. A debt is always a burden for future generations. If the borrowed resources are used well, this burden can be justified. But the chances that this will happen are small when huge amounts of money are suddenly offered to a country. It represents a permanent threat of foreign insolvency. And, while foreign resources are entering the country, the exchange rate will tend do go down, that is, the local currency will be valorized. In the next section I discuss how bad this can be for an indebted country.

In relation to inflation one could argue that it too is an 'old problem', since most Latin American countries have already been able to control their inflation. But at what cost? Take the case of Chile. Pinochet and his foreign advisors were indeed able to control inflation and stabilize their foreign accounts in the 1970s. Chile was the first Latin American country to achieve macroeconomic stability. That is why one cannot speak of economic stagnation in the last 20 years when we refer to Chile. But in the 1970s and early 1980s serious mistakes were made, the costs involved being huge. The country remained stagnant in income-per-head terms from 1973 to the late 1980s. Only after Buchi became finance minister and adopted competent policies did Chile resume growth.

Brazil faced a different problem. Inflation, besides revealing the fiscal crisis of the state and the external imbalance of the economy, assumed an inertial (formally and informally indexed) character. In order to stabilize the economy, fiscal adjustment was essential and trade liberalization would help – has indeed helped – but these two actions were not enough. It was also necessary to neutralize inertia. Most Brazilian economists in government and their local and foreign advisors, particularly from the IMF and the World Bank, knew little or nothing about inertial inflation. It was understandable that they ignored inertia for some time. Most of the ideas related to it were developed principally in Latin America, but also in Israel, between 1980 and 1984. That the first stabilization plans after 1979, when high (more than 100 percent per year) inflation started, did not take into account the new theory one can understand without referring to the incompetence hypothesis. But when we remember that it was only in 1994 that Brazil was able to neutralize inertia and control inflation, and that between 1979 and 1994 12 stabilization plans failed, there is no alternative but to say that incompetence was involved. Only one or two of these plans failed for lack of political support; most – orthodox plans in the large majority – failed for sheer ignorance of economic theory, or for ignorance combined with fear or arrogance.[9]

In Argentina the costs involved in controlling inflation were still higher. Inflation again had an inertial character, although not so clearly as in Brazil. The Austral (1985) plan had a good design but failed for lack of political support for fiscal adjustment – the same reasons that led the Cruzado Plan in Brazil (1986) and the Bresser Plan (1987) to fail. In these cases, mainstream thinking was confirmed. But, differently from Brazil, Argentina did not have time to try many other stabilization plans. Given the fragility of the economy at that time – 1989 – high inflation soon turned into hyperinflation. For two years Argentina lived through episodes of hyperinflation that further disorganized its economy. It was only in 1991, when a currency board was put to work, that price stability was achieved.

The Cavallo Plan was successful. As a matter of fact, it was the only alternative left Argentina, whose economy was caught by two torments: dollarization and hyperinflation. But the plan had an essential flaw: it started from an overvalued peso, which Roberto Frenkel denounced the day after the plan was stated. In accepting a currency overvaluation in order to unequivocally assure price stability, Argentina was reproducing the same mistake Mexico was making at that same moment – a mistake Brazil would also make after the Real Plan. For a few years the Cavallo Plan worked. It even produced two years of high GDP growth, as the economy respired after so many years of disorder, but in 1994 it was clear that the convertibility could not go ahead. Argentina was heading toward exchange rate crisis and default. The Real Plan, overvaluing the Brazilian currency, gave an extra life to Argentinian currency board, as Argentina was able to compensate for its large trade deficits with the rest of the world with a sizeable surplus with Brazil. But in the medium term a currency board makes no sense for a large economy like Argentina's. With the January 1999 devaluation of the Real, which is now in a floating exchange rate regime, Argentina will have no alternative but to devalue and float its own currency, too.

THE EXCHANGE RATE

The late Mário Henrique Simonsen used to say that inflation cripples but the exchange rate kills. There is no worse mistake for a developing and highly indebted country than to have an overvalued currency. Nevertheless, Latin American countries again and again make this mistake. Why is overvaluation such a big blunder? And why is it a recurrent phenomenon?

The exchange rate is the most important price in an economy. For a highly indebted economy it is even more important, since it will increase a debt that is already too high. It is often assumed that an equilibrium exchange rate is one that balances the trade account. It is not. If the country can count on some direct investment, it will be consistent with a reasonable current account deficit – a deficit smaller than the inflow of direct investment so that, besides paying interest, the country may gradually pay off the principal. Thus one might say that a highly indebted country, as are most in Latin America, should have an 'undervalued' currency – an exchange rate that produces a trade account surplus. When in doubt the debtor country should opt always to have its currency undervalued. As a trade-off, creditor countries should have 'overvalued' currencies, that is, a deficit in the trade and current accounts, so that debtor countries can pay off the principal bit by bit.

Financial people in creditor countries do not like to hear that debtor countries should start paying off the principal. What will they do then with their capital surpluses? The same is true of politicians and policy-makers in developing countries. Why should they have to pay a debt that was acquired previously? Why should they reduce the rate of growth – or, more plainly, the level of consumption – to fix a problem that others created? That is why, probably, we don't often hear this kind of argument. Instead of the phrase, 'when in doubt, have an overvalued currency', there is a much more popular maxim among both debtors and creditors: 'a debt is not to be paid, it is to be rolled over'.

Economists in the international commercial banks and in the IMF and World Bank prefer to speak of the dangers of domestic debt than to speak about the foreign debt. But the fact is that when a country goes bankrupt, it is always because, after an irresponsible lending–borrowing venture, the international creditors suddenly suspend credit. And since a country, in contrast to a firm, cannot go completely bankrupt and close, since the population and the territory are always there, the country is always 'open for business'. The subsequent 'business' of a country that has incurred foreign insolvency will not just be an increase in risk premiums, but years and years of economic stagnation.

Before that happens, the inflow of foreign money will keep the local currency overvalued, inflation will go down and wages will go up. Governments, using the easy credit, will increase state expenditures – or cut them less than they should. The classical populist cycle will be reproduced. Its harm will depend on the degree of over-evaluation of the currency and the relative size of the domestic budget deficit.[10] Soon the loans that were thought to be financing investment projects showing a rate of return superior to the rate of interest being paid (despite the large risk premiums paid) are financing consumption. Debt is accumulating and a crisis is just a question of time.

In the 1970s currencies were overvalued in anticipation of higher rates of growth coming from debt-financed investments. The outcomes are well known. In the 1990s a new reason for overvaluation popped up: to guarantee the just-achieved price stabilization. Thus in Mexico, Argentina and finally Brazil, currency overvaluation was the immediate outcome of price stabilization – an outcome which many took, rather, as a tool. Control of inflation would come out of an 'exchange rate anchor'. In Argentina in 1991, the exchange rate was in fact the anchor. But in Mexico in 1987, the price and wage freeze that partially neutralized inertia, and the social agreement achieved with workers were crucial. In Brazil, the URV (*Unidade Real de Valor*, or real value unity), which fully neutralized inertia, was the significant variable in achieving price stabilization.

Once stabilization has been achieved, and after a period of time – a few months, a year maybe – it would be reasonable to expect the exchange rate to reach an equilibrium. But this did not happen. Why? Because, almost without noticing it, Latin American countries were soon back in the 1970s. Debt is once again a tool for growth. The international financial community's discourse to a country that has just stabilized prices is clear: 'Behave well, control the budget and make the reforms, and we will finance your growth'. For the developing countries' elites this is a wonderful discourse. The fact, to repeat Barbosa Lima's phrase, that 'capital is made at home' – that countries cannot rely on foreign savings to develop their economies, that usually countries finance more than 95 percent of their capital accumulation out of their own savings – was soon forgotten.[11] We are back to the twin evils of increasing debt and exchange rate overvaluation.

When a country has an overvalued economy and the financial community is aware of the fact, besides costs related to increased consumption and increased indebtedness, there is another terrible cost: potential growth loss. Financial markets immediately add an 'exchange rate risk' to the interest rate to be paid by the country – an exchange rate risk that adds to the existing 'country risk'. The interest rate skyrockets. On the supply side of loanable funds, loans will only continue to be rolled over if the interest rates include these premiums. On the demand side, the local authorities are constrained to maintain the high interest rate for another reason: they must keep aggregate demand – and thus, imports – under control, in order to avoid increasing current account deficits and further international loss of credibility. High interest rates mean lower investment rates, and potential growth loss.

What do economists in government and their advisors say about all that? To answer this question look, for instance, at what happened to Brazil between the second semester of 1994 and the Russian crisis in September 1998. Almost all economists said that productivity increase would solve the problem; or that fiscal adjustment would do the job. Economic theory is a realm open to debate, but assertions like that simply show economic ignorance. The proponents of the productivity increase argument forgot that other countries also increase their productivity, and that one has no control over that. The fiscal adjustment proponents forgot that fiscal adjustment might lead only to devaluation if it is so drastic that it provokes deflation. With deflation the prices of non-tradable goods, particularly wages, are reduced in relation to those of tradable goods, thus accomplishing real devaluation. This is not a rational form of devaluing. Besides the unavoidable reduction in wages, it produces widespread unemployment.[12] It was only after the Russian crisis, around three years after the real should have been devalued, that most economists realized that devaluation was required.[13] A few months later, in January 1999, the decision was taken, but the huge costs in terms of potential growth loss and increased indebtedness had already been incurred, and could not be recovered.

REASONS

These policy mistakes, that is, unsuitable policies or reform designs, were adopted due to poor judgement or incompetence. Similar policies may have been adopted for rational motives, in response to self-interest or the demands of pressure groups. I am not dismissing the relevance of interests. I am saying that there is not just one reason (interests) but two reasons (interests and incompetence) behind a wrong policy decision, a decision that produces detrimental outcomes. In both cases we have mistaken policies, but if the cause is interest group pressure or populism, one cannot say they were the fruit of mistakes. In the second case, however, the mistake, the bad judgement, is the relevant variable. In many cases the two causes may come together. But my contention is that, in relation to the damaging policies just surveyed, the main reason why they were adopted was incompetence. In some cases the policies were severe, imposing sacrifices on the population and elites. Thus, they were not the result either of populism or pressure group action. They were the consequence of ignorance, fear, arrogance or a mixture of all these. As Whitehead (1997: 11) observes, over the past 20 years governments in Latin America have confronted extremely complex economic dilemmas, while 'one of the features of both apolitical *técnicos* and the more politically empowered technocrats or technobureaucrats is that they tend to apply with great authority and self confidence, ideas they have derived at second-hand and without drawing on strong local tradition of theoretical elaboration and debate'.

They involved ignorance of the complexities of economic theory or unqualified application of abstract economic theory to Latin American economic problems. In saying that, I am not returning to the old argument that economic theory does not apply to developing countries. It does, as it applies to the developed countries. But it applies provided, in one case as in the other, that the theory is not applied automatically, is not transformed into a series of clichés, but is proficiently defined and implemented. Alec Cairncross, a distinguished economist who spent a large part of his life in and out of government, emphasizes the gap between theory and practice – a gap that, I would add, makes mistakes unavoidable. In his words: 'Specialists in economic theory do not reach the same conclusions on controversial issue . . . [A] wide gap necessarily exists between the ideas embodied in economic theory and the matters to which policy has to give attention' (Cairncross 1996: 256).

Besides ignorance, fear and arrogance, there is a second argument to explain these policy mistakes or incompetence: 'confidence building'. This is an area between self-interest and incompetence. Latin American elites are subordinate elites. They do not limit themselves to seeing the United States and, more broadly, the developed countries, as richer and more powerful nations, whose political institutions and scientific and technological development should be imitated. No, they see the elites in the developed countries both as the source of truth and as natural leaders to be followed. This subordinate internationalism ideology, already called 'colonial inferiority complex' and *entreguismo*, is as detrimental to a country as old-time nationalism. With the industrialization of Latin America and the emergence of new local elites after the 1930s, some predicted that this ideological subservience would recede. Indeed, for some time it was possible to see signals of a new mood in Latin American governments and elites. But when the countries became highly indebted, and their economies came to depend more on financial market credit, subordinate internationalism was back in place.

Now, however, it had a 'good' economic theory argument behind it. As international financial markets and mainstream economic theory assert, economic policy must be endowed with 'credibility'. There is an extensive literature on this subject. In strict macroeconomic terms an administration has credibility when it decides that it will follow a given policy, and then follows it. But in the political realm, credibility is identified with credit and confidence. Thus, a policy will have 'credibility' if international economic authorities, in Washington, and international financial markets believe that it is consistent and adequate. In this case, the country viewed as being committed to stability is able to build confidence and obtain access to credit.

The indebted developing countries need 'credibility' and credit, so they faithfully and uncritically follow Washington's and New York's recommendations, whether specific or vague, reasonable or mistaken. They are followed as if ultimate macroeconomic truth was crystallized in Washington (the official view) and New York (the financial market view). I may be engaging in some caricaturist simplification, but this is not far from reality. The confidence-building game is the new form of international subordination in Latin America and, more generally, in the developing countries. It is a source of serious economic policy mistakes.

One could say that there is no alternative for the developing country, that the World Bank and IMF have no choice but to define lock-in strategies that, when followed, will show creditors that a particular country will honor its obligations. I am not discussing the developed countries' and their agencies' alternatives. I am not criticizing the World Bank's or the IMF's 'incompetence'. On average, they are quite competent agencies, but as bureaucratic agencies, they are not well prepared to face abnormal times. However, this is not my subject. I am speaking about the alternatives facing developing countries' governments. They may either adopt a critical, although sympathetic, approach to foreign advice, or just engage in confidence building. They may follow the policies they believe correct, negotiating and compromising when this is necessary, or they may just assume that what the creditor expects them to do is correct. When they choose the last alternative, as Latin American countries have done again and again, they will be prone to serious problems.

Philippe Faucher observed that countries will engage or not in the confidence-building game depending on their relative strength or weakness in a negotiation. Somehow economic agents can impose their views and decide on the warranties that they wish to extract in transactions with other agents. Any owner of a property will do a credit check and/or ask for a warranty before signing a rental contract. This is a real constraint, a code of conduct imposed upon economic agents.[14] I agree with Faucher. The relative strength of the negotiators is a decisive factor. Sometimes, in their negotiations with the IMF and the World Bank, governments are supposed to compromise. But how much? How far? I have nothing against serious and critical confidence-building efforts, nor even against compromises. What I am singling out as a major source of incompetent macroeconomic policies is the uncritical adoption of developed countries' recommendations.

When a country does what it believes should be done, and not what it is expected to do, it may, for a time, lose confidence. But if the assessment of its policy-makers is correct, good outcomes will soon spring up. Financiers, politicians and bureaucrats in New York and Washington are pragmatic: they only care about results. In the 1930s, while Argentina paid off all its foreign debt, Brazil did not pay, engaged in extensive negotiations, and more than once did not honor its commitments. Nevertheless, given its superior economic performance, it was not treated differently from Argentina by creditors.[15]

Salinas' Mexico was the first Latin American country to consistently follow this strategy. In August 1989, it irresponsibly signed the term sheet of a debt agreement with commercial banks, just six months after the Brady Plan was announced. The debt reduction was insignificant but, as it was then argued, it 'built confidence' and reduced interest rates paid by Mexico. From then on up to the December 1994 crash, the Salinas administration was fully engaged in confidence building, often at the expense of the national interest and/or of the macroeconomic fundamentals. The rushed debt agreement was clearly against the Mexican national interest. The fixed exchange rate policy was opposed to macro fundamentals. While financial markets did not realize the increasing overvaluation, their confidence in the Mexican economy increased with the 'strength' of the peso. Since then, in other Latin American countries, this confidence-building practice has been repeated again and again.

In saying that, I am not saying that it is bad to build confidence in international markets. Nor am I saying that their vision is always wrong, much less that the national interests of developing and developed countries are always in conflict. I believe just the opposite. Foreign analysts' appraisal of the macroeconomic problems in Latin America is usually proper. On the other hand, developed and developing countries increasingly have mutual interests. But sometimes national interests are in conflict, and often economists and financial people in Washington and New York are plainly wrong on strategic issues, as we have just seen.

Latin American elites – particularly politicians and economists – are supposed to think with their own heads, since they have responsibility for what happens in their countries. In each Latin America country local thinking capacity is already available. There is no reason to trust foreign analysts, who know little about each economy and are not really committed to the countries they review or advise.[16] To build confidence is convenient if not necessary. But Latin American governments should do that in their own terms, instead of just asking the rich countries what they should do. This is not just an absurd form of national subordination, it is also a mistaken generalization about what economists in the developed countries think. Their views are in fact much more varied and complex than financial markets and confidence builders assume.[17]

A METHODOLOGICAL CONCLUSION

One could argue that this is not a 'well-behaved' explanation: to emphasize incompetence and relate it to ignorance, fear and arrogance. Instead, taking it for granted that mistaken decisions were made, would it not be adequate to fall back on conventional rational choice analysis? Rather than saying that people are incompetent, would it not be more reasonable to ask about the incentives and punishments leading to the wrong decisions? More broadly, according to the traditional way of thinking of all social science, would it not be more acceptable to say that pressure from interest groups and social classes, or popular demand, led to ill-advised decisions? No doubt I could have adopted this alternative. It is a safe one. But I would not be adding anything to the understanding of what happened in Latin America.

First, it should be remembered that there are good and bad governments and so there are right and wrong decisions. Good governments are those whose politicians and officials take decisions that are mostly right, as good states are those that rely on institutions to help government leaders make more secure investment decisions in the private and in the public sector. The history of a country is usually the story of how good governments have pushed the country ahead and how bad governments have held it back. When we study history we are able to say that one country, in a given period, achieved peace and prosperity because it was well governed, while another failed for lack of good government.

We know very well that often inflation was not controlled because this or that interest group would suffer from macroeconomic stability, or the hard policies required to achieve it. But when there is high inflation and almost everybody is suffering, this type of reasoning loses a large part of its explicative power. Strong political support emerges for harsh policies to fight inflation. If, in these circumstances, policy-makers are not able to control inflation, interests cease to explain what is taking place, and we have no alternative but to look for incompetence.

I have said in this paper that the strategy of using foreign savings to achieve growth was of mutual interest to both creditors and debtors, that in the short term an overvalued currency is wonderful for everybody. So, one may say that there are rational reasons behind mistaken policy decisions. But should I then conclude that the policy-makers who made the wrong decisions were not incompetent but dishonest, protecting their own interests or those of their constituencies rather than the public interest? In some cases I would accept that this is true. But if we go over it more carefully, this view, in spite of its academic prestige, is more shocking than my incompetence hypothesis. And probably endowed with less explanatory power.

My hypothesis is particularly useful in understanding the quasi-stagnation Latin America underwent in the last 20 years if the wrong policy decisions and the mistaken reform designs do not involve a vote in congress, as most do not, or, if they do involve a parliamentary decision, if the required majority is not too big.[18] Most of the wrong macroeconomic policy decisions and all of the faulty reform designs I have referred to in this paper did not depend on a vote in parliament. In many cases, previous popular support was not necessary and interest groups were divided or just not involved. If the decisions were wrong or inept, the only explanation is incompetence.

But, the questioning could go on, why, in several crucial stands, were policy-makers incompetent and misled? Because the new problems, the high debt overhang in particular, were too difficult for them to tackle. Because, being ideologically subordinate, they gave up their own judgement and resorted to confidence building. Because good institutions were not present to facilitate their job – institutions that in Latin America have never been fitted. Because making the right decisions requires courage not only to assume the consequences – this is a rational choice problem – but also to think for oneself, and the humility to learn from one's errors. In government, among officials, fear and arrogance are pervasive emotions. These are tentative responses, since to explain why people are incompetent or competent is almost as difficult as to ask why they are usually selfish but sometimes generous.

Critiques coming from an alternative methodological perspective could question whether it would not be more reasonable to explain the crisis using historical or structural arguments – the crisis of the state, the debt crisis, globalization. I have done that. The method is powerful in explaining why the crisis erupted, but limited in informing us as to why governments were not able, for so many years, to overcome it.

But, one can still ask, am I not ignoring the learning process? No, I am not. Economists in Latin America or advising Latin American countries finally learned to control inertial inflation. They also know today better than they knew before the costs of an overvalued currency sustained only through high interest rates. Maybe sometime they will learn the dangers involved in the growth-cum-debt strategy. The problem with macroeconomic policy, however, is that new problems are emerging, requiring new solutions. The problems may be less dramatic than those confronted by Latin American countries in the last 20 years. That is the case in the advanced countries, where macroeconomic stability has prevailed for many years. But this does not mean that the policy makers of developed countries are exempt from mistakes. Their mistakes are probably less serious, less evident, but they are there.

In synthesis, the failure to stabilize and resume economic growth following the debt crisis in Latin America has been attributed to incompetent macro policy-making, and to a confidence-building strategy that subordinated policy to international official institutions and the financial community. The crisis came out as a crisis of the state – the Latin American developmentalist state. Reforms and short-term macroeconomic policies were not able to restore stability and growth, less because they were not implemented or were excessive than because they were flawed. Their failure was due not so much to interest group pressure – although this was relevant – but because they were marked by serious policy mistakes, incompetence and bad judgement. Incompetence and mistakes in Latin America were magnified or made more frequent due to two new historical facts. One is specific to Latin America: the foreign debt acquired in the 1970s and the consequent relative international insolvency, which made policy-making more difficult to design and implement. The other has a broader reach: the fact that macroeconomic policy is a historically recent, 50-year-old phenomenon. Before that policy decisions could be viewed as relatively irrelevant, with mistakes compensating for right decisions, and none having much impact on the economy. Not any more: with the growth of the state in this century and the emergence of macroeconomic policy and, more recently, institutional reform strategy, decisions cannot be ignored. Good and bad governments matter.

NOTES

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1. I have defined Latin America's and Brazil's crisis as a crisis of the state – as a fiscal crisis, a crisis of the mode of state intervention and a crisis of the bureaucratic form in which it was managed – in many works. Here I will refer only to Bresser Pereira (1993).

2. In others papers I have defined the 20th century as the 'social–bureaucratic state', which assumed three basic forms: the 'welfare state' among the developed countries, particularly the European ones; the 'developmentalist state' in the developing countries, particularly the Latin American ones; and the 'communist state' or the 'Soviet-type state'.
3. Ten years later, in 1990, the Brady Plan did not solve the debt crisis; it simply permitted the restructuring of debt. In doing so, it gave room for a new wave of international lending and led to the concept of 'emerging markets'.
4. See Gwartney and Lawnson (1999) and www.freetheworld.com. The organization uses 53 institutions around the world to arrive at its Economic Freedom Network Index. In Brazil, where a practically unknown institution is in place, the 1997 freedom index, which can vary from 0 to 10, was 5.5, out of 119 countries surveyed.
5. According to Rodrik (1999: 1): 'The claims made by the boosters of international economic integration are frequently inflated or downright false . . . The evidence from the experience of the last two decades is quite clear: the countries that have grown most rapidly since the mid-1970s are those that invested a high share of GDP and maintained macroeconomic stability'.
6. Domestic public debt in Brazil, for instance, which was around 2 percent of GDP from the 1940s to the 1960s, rose to around 6 percent of GDP in the 1970s, 15 percent in the 1980s and 30 percent in the 1990s. Often in the later periods the domestic debt increased with foreign debt: given the inflow of foreign currency, the local government would buy it, in principle in order to sterilize it and so control the money supply, but in fact as an easy form of financing the budget deficit.
7. It should, however, be said that in the case of Brazil, where local PhD programs in economics and political science are well established, I favor short-term (one-year) stages in foreign universities over complete PhD programs.
8. On this subject, see Melo (1998) and Bresser Pereira (1999).
9. I described these 12 cases in Bresser Pereira (1996).
10. On the populist cycle see the classical papers of Canitrot (1975) and Sachs (1989). I edited a book on the subject in Brazil.
11. According, for instance, to Martin Feldstein (1995), the author of a study on how investments were financed in the OECD countries, the correlation between gross savings and gross investments in the period 1970–72 is almost perfect: if a country saves little, it will invest little. In this study Japan appears at the top of the list: it saves 34 percent and invests domestically 32 percent of GDP; the United States, at the bottom, saves 18 percent and invests 19 percent of GDP. The other countries are dutifully distributed between the two extremes, maintaining the close correlation between savings and investment.
12. In this period my official responsibilities made it impossible for me to expose my views in public. But even so I was able to present these arguments in a short paper that made no explicit reference to Brazil (Bresser Pereira 1997).
13. The ideal moment to devalue the Real was October 1995. At that moment the economy was already fully de-indexed, and, responding to the Mexican crisis, a tight monetary and a severe fiscal policy had brought down demand.
14. Remarks made by Faucher in an e-mail commenting on a draft version of this paper.
15. See Abreu (2000).
16. Writing on Russia, Fareed Zakaria (1999), for instance, asserts that although Russia bears most of the blame for its crisis, 'advice given by thousands of advisers with billions of dollars and accompanying aid, has proved incomplete, ineffective or counterproductive, depending on whose analysis you accept'. Although the Russian case is extreme, in Latin America the role of advisors was not essentially different.
17. Paul Krugman, for instance, belongs to the American elite, but cannot be mixed up with the ideas confidence builders in Latin America take for granted. Writing about the 1997–98 emerging countries' financial crisis, Krugman (1998) gave to his article the title 'confidence game'. It is precisely the same thing that I have been calling 'confidence building' for some years. He first criticizes the economic policies offered by multilateral organizations and financial institutions – policies that contradict good and simple eco-

nomic theory. And then he concludes: 'During the past four years, seven countries – Mexico, Argentina, Thailand, South Korea, Indonesia, Malaysia, and Hong Kong – have experienced severe economic recessions, worse than anything the United States has seen since the '30s, essentially because playing the confidence game forced them into macroeconomic policies that exacerbated slumps instead of relieving them. It now looks extremely likely that Brazil will be forced down the same route and that much of the rest of Latin America will follow. This is a truly dismal, even tragic, record'.

18. An excessively large required majority is, for instance, that required in Brazil to reform the constitution: three-fifths.

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