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The Liquidity Trap

Latin America's Free-Market Past

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The story is well known in economics lore: A famous academic, one of the world's leading proponents of deregulation and free markets, is invited to Chile, which is in economic trouble. He and his followers propose a series of measures to open the economy, including easing banking restrictions, freeing credit, and eliminating tariffs. Their prescriptions are followed, and, as foreign capital pours in, the Chilean economy booms and becomes a model for the region. Or another version: In Mexico the president turns against the policies that have left the country heavily indebted and starved for domestic investment. He places a group of young foreign-trained economists and engineers in the trade and finance ministries, and they move rapidly to free up key areas of the economy and renegotiate Mexico's external debt. One of the most striking results of their reforms is a dizzying rise in inflows of foreign capital. In both cases foreign politicians, journalists, and bankers praise the reforms for spurring a transformation: from traditional, corporatist economic dogmas and their long history of poverty and economic stagnation to Anglo-Saxon-style competition and free markets.

These may sound like stories of modern Latin America, but both are old. The Chilean example does not refer to the "Chicago boys" of the 1970s and 1980s, nor does the Mexican example describe the Harvard-, Stanford-, and Columbia-trained technocrats whom President Miguel de la Madrid Hurtado pushed forward in the mid-1980s. The foreign expert who so beguiled the Chileans was the French academic Jean Gustave Courcelle-Seneuil, one of Europe's high priests of free-market capitalism, who was invited to Chile from 1855 to 1863 to advise the government. Among other reforms, his followers slashed tariffs in 1864 and even privatized the nitrate mines acquired from Peru in 1882 during the War of the Pacific. The brilliant Mexican technocrats were the *científicos,* a party of idealistic young men who controlled key posts during the administration of President Porfirio Díaz

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in the 1890s. Under the expert guidance of José Y. Limantour, the sophisticated and forceful finance minister, their policies resulted in huge capital inflows, mostly into mining and railroad ventures, and a dramatic increase in Mexico's exports.

In neither case did the success last. The global crisis that swept through the United States and Latin America in late 1873 devastated Chile. As world commodity prices fell, the Chilean economy collapsed, a disaster exacerbated, according to many historians, by Courcelle-Seneuil's free-market policies. Fairly or unfairly, they argue that changes in the Chilean banking laws led to the failure of the country's currency and the abandonment of convertibility in 1878, that the 1864 tariff reduction brought about the destruction of domestic industry, and that privatization concentrated ownership among a small group of Chileans and foreigners.

In Mexico in the 1890s, the wealth of leading businessmen skyrocketed, workers' wages stagnated, and poverty among farmers and farm workers rose. Local banks had written too many loans to those who were politically connected or who speculated on real estate or securities, and when the international market had a periodic downturn, the banking system collapsed. The crisis following the 1907 global contraction was so severe that even members of the elite turned against Díaz. When the president used the crisis as a partial excuse for reneging on a promise to return to democracy, it threw the country into a period of political instability that ended with the start of more than ten years of revolution and, in 1913, a suspension of payments on the external debt.

The parallels with the recent past are striking. Over the last decade Latin American countries have enacted reforms aimed at deregulation and a lowering of trade barriers that is generally referred to as the Washington Consensus. Bankers claim that, in contrast to this "new" model of economic development, which the bulk of economists and financial journalists have supported, the previous interventionist approaches—supposedly the norm in Latin America—were proved to be failures by the debt crisis of 1982 and the subsequent long-term economic contraction. For example, Mexican Finance Minister Guillermo Ortiz recently argued that "turning the clock back is not an option. Going back to a closed economy or statist policies or trying to spend our way out of the recession have been tried before, in this country and elsewhere, and they haven't worked." Even after the December 1994 peso crisis in Mexico, criticism was directed not at the Washington Consensus but at violations of it.

But it is not just the statist models that have not worked. Latin American countries have long histories of periodic enthusiasms for reforming the economy according to sound academic theory and for importing foreign experts. The most famous of these was the American economist Edwin Kemmerer, the "money doctor," who from the 1890s to the 1920s prescribed market reforms for about a dozen Latin American countries. His recommendations were demolished by the Great Depression and remained out of fashion until they were resurrected in the 1980s.

CAPITAL TIDES

The pattern in Latin America's economic history does not seem to change much. Whenever Latin countries have embarked

on programs of deregulation and free markets, and commodity prices were high and global liquidity was abundant, the response of the local economy was usually positive and sometimes miraculous. There's the rub: if commodity prices were high and global liquidity was abundant. When these conditions were reversed, the same countries that eagerly embraced sound economic theory found themselves devastated by economic contractions and defaulted on the foreign loans that had financed the expansion. All Latin American booms have had in common the conditions of excess global liquidity resulting in capital inflows, and high or stable commodity prices. Whether the regime was pro-market or interventionist seems to have mattered less.

While economists identify reforms as the chief determinant of economic success, history suggests a wider set of forces. In the 1860s a Latin American lending boom occurred when English and French capital poured into a wide variety of risky foreign investments, including shady railroad stock and the bonds of an effectively bankrupt khedive of Egypt. Another occurred in the 1880s, when the passion for investment included Ponzi schemes and Florida swamps. In the 1920s, the liquidity generated by German reparations payments and the Federal Reserve's 1927 easing of U.S. monetary conditions to help the British return to the gold standard helped spur both a Wall Street stock market rally and the huge capital inflows of the Latin American "dance of the millions." Forty years later the lending wave to less-developed countries took place because commercial banks were eager to recycle the vast petrodollar flow. It collapsed at the end of the decade, just as previous booms had collapsed during global monetary contractions, this time with the sharp contraction engineered during the Carter administration.

Why do these booms occur? Probably because in times of great liquidity, investors' tolerance for risk grows enormously and high-risk projects with high expected returns are flooded with capital. When these projects are in poorer countries, the capital influx can easily set off a self-fulfilling local boom. Latin America is growing, but over the past five years it has had a large capital inflow—it took in $201 billion of private capital in 1995 alone and $182 billion the year before.

This history suggests that when large amounts of capital flow into Latin America, the result is an investment boom that causes a spurt of economic growth—growth, however, that has never been sustainable. It may suggest further that bankers are naive to assume that a combination of a new market orientation among the political elite, reducing market barriers and failures, and increased credibility will pull these countries out of the cycle of poverty and underdevelopment. Only wider political participation can broaden the benefits of growth and, when the next liquidity crisis comes, prevent popular backlash and default on the debt. Nor should some divergence from the Washington Consensus be regarded as backsliding.

NO SAVING GRACE

The bankers who tout the current round of reforms as a real break with the past usually argue that they will result in higher domestic savings rates in Latin America. Once the savings at home are sufficient to replace foreign investment,

the argument goes, the region's economies will be uncoupled from international capital and able to achieve the growth rates of the Asian tigers. But there is a problem here too. The growth in the savings rate is not uniform among these nations, nor is it sustainable. Furthermore, increased savings may be an effect, not a cause, of improved economic performance, and they could dry up in a significant economic downturn.

Most important, since free capital flows are part of the Washington Consensus package, it is not clear that higher domestic savings rates will always result in greater domestic investment. High savings, generally produced by savvy upper and upper-middle classes, can fuel capital flight. Preliminary work by Michael Adler, a finance professor at Columbia University, suggests that domestic investment in Argentina has a closer correlation to foreign capital inflows than to the national savings rate. Argentine savings tend to accumulate in offshore accounts and behave like foreign hot money. If Adler is right, then domestic savings, rather than cushioning domestic investment from the volatility of international capital flows, may actually exacerbate volatility. Attempts to force savings into strictly regulated pension funds will not necessarily solve the problem, since in times of trouble local governments often treat pools of domestic savings as piggy banks available for purposes other than prudent investments.

CULVER PICTURES/HARPER'S WEEKLY

Latin America, take your medicine.

Confidence in the Washington Consensus might be merited if the growth spurts in Latin America had occurred only when local governments were experimenting with free-market philosophies, and not during what Sebastian Edwards, one of the theorists of the new consensus, describes as periods of "heavy state interventionism, inward orientation, and disregard for macroeconomic balance." These cases are usually defined to include the import substitution of the 1960s and 1970s, Brazil in the 1930s and 1960s, the early American Popular Revolutionary Alliance in Peru in the late 1950s, and Argentina under Juan Peron (1946-55 and 1973-74). Even these regimes have experienced intervals of rapid growth before breaking down. Brazil, two years after the 1964 military coup that brought with it a

nationalist and corporatist ideology, began a period of extraordinary growth celebrated as the "Brazilian miracle." Mexico during much of the reign of José López Portillo in the 1970s posted impressive economic numbers when it tried the now-discredited import substitution model. But, like the free-market regimes, these alternatives invariably produced disappointing results.

THE WESTERN MODEL

The point is not that that economic policy does not matter or that there is no hope for economic success in Latin America. Rather it is that the current reforms are not at all new and that historically they have not led to sustainable economic growth. Long-term growth may have more to do with political maturation and democracy. Ironically, the democratizing goals of President Ernesto Zedillo Ponce de Léon may do more for Mexico's economic prospects than will the determination of his predecessor, Carlos Salinas de Gortari, to open the economy. This is a much-argued point, since in the short term the correlation between democracy and rapid growth may not be very strong. But the fact remains that the only countries that have achieved sustained economic growth are those in which political power and participation are widely distributed.

In Latin America, opening the economy and keeping money sound has too often increased the value of assets at the expense of real wages, coupled with promises of future relief once the economy takes off. But without robust mechanisms for sharing power and economic benefits, all previous bouts of liberal economic reform have run up against popular opposition that led to the reversal of reforms. During the bursts of rapid growth attributable to large capital inflows, as the dominant groups grab a disproportionate share of the benefits, the rest of the country cannot absorb the inevitable external shocks—a capital shortage or collapse of commodities prices. The middle and lower-middle classes that suddenly emerge during boom periods lose everything in the bust. Given these groups' subsequent antipathy to the economic regime and the unwillingness of the local elites to share power, it is not surprising that the prevailing economic system is almost never able to outlive a major external shock.

If free markets have not worked in the past, how should Latin American policymakers proceed? The nineteenth-century United States is often held up as an economic model for Latin America, but its backers depict a mythical country of laissez-faire capitalism, orthodox monetary policies, and free trade, whose citizens naturally gravitated toward sectors where productivity growth was fastest. This picture leaves out the government's important role in promoting manufacturing, digging canals, subsidizing nearly all the railroads, and, above all, protecting domestic manufacturers from competition with the much more productive English. Of all major countries in the second half of the nineteenth century, the United States was the least open to international trade. In fact, one of the most important causes of the Civil War was the trade policy conflict between the free-trading South, which was content to export commodities and import manufactured goods, and the protectionist North, which was determined to promote domestic manufacturing.

Perhaps Latin American policymakers should study the efforts of the brilliant eighteenth-century Secretary of the Treasury Alexander Hamilton to convert the United States, a nation of squabbling farmers and corrupt politicians, into a major economic force. Under the Hamiltonian system, sustainable growth was the result of a pragmatic and unorthodox combination of a reasonably focused infant-industry policy, protection of high-productivity growth areas of the economy, fairly intense domestic competition, and free capital flows. Like Latin America more recently, the United States in the nineteenth century suffered severe economic fluctuations tied to changes in global liquidity, but these took place in a nation where political power was widely shared and where populist movements were regularly able to capture power democratically and seize a portion of the economic benefits.

Since the benefits of the recent growth in Latin America have not been widely distributed, international bankers should not insist on a rigorous, even zealous, free-market orthodoxy that imposes a burden on the poor. Bankers continue to argue that such reforms will bring long-term growth and are too willing to tolerate income inequality in the near term. Without real popular political participation, economic growth has rarely helped the poor. Global liquidity will inevitably contract again—perhaps in this decade—and if the past is any indicator, Latin American economies will suffer disproportionately. Without popular support, currently fashionable reforms will not survive.

Latin America's historical record is bleak, and it is difficult to be optimistic about the region's prospects, but given the strong will there and in the United States to see economic success south of the border, it would be tragic if the current period proved just one more failed attempt at catch-up. World markets are going through another cycle of abundant liquidity, and funds will continue to flow into the emerging markets for many more years, leading to bursts of growth in many parts of Latin America. It would be foolish, however, to confuse this growth with the success of the Washington Consensus. Bankers generally agree on the correct course for Latin America, but local authorities should not put too much faith in their advice.