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INCOMPETENCE AND CONFIDENCE BUILDING BEHIND LATIN AMERICA'S 20 YEARS OLD QUASI-STAGNATION

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Behind Latin America's 20 years 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 Americans countries got involved in the 1980s in the debt crisis and more broadly, in a fiscal crisis of the state. Why did they not overcome the crisis? Why did they not achieve economic stability, which had been lost with the crisis? Why reforms were not so effective as one could expect? Economists and social scientist have a general explanation for that: interest groups, which create obstacles to adequate policymaking. I have no contention about that, but I believe, and I will argue in this paper, that there is a second and increasingly important reason. Because policymakers are often incompetent, out of their ignorance, fear or arrogance. Often policymakers did wrong out of conviction, not of political pressure. So, they were unfit, their decisions 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 exist, and often involve strategic, highly important decisions, given the consequences they may arise. Why to assume that these decisions are always right? Or that rights and wrongs compensate themselves, so that they may ignore?

The last 20 years have been 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

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period. If one compares this period with the 30 previous years, the results are shocking. In the former period one could say that Brazil was catching up the developed countries and Latin America as a whole presented an unsatisfactory but still reasonable performance. Since 1980, however, we have dismal outcomes for Latin America, which nearly stagnated, while the developed countries continued to grow, although in a reduced pace. Per capita income grew yearly between 1950 and 1979 at 3.3 percent in the OECD countries, at 2.3 percent in Latin America, and at 3.9 percent in Brazil. Between 1980 and 1998, the rate of growth in the developed counties went down just to 2.5 percent, while it plummeted in Latin America to 0.5 and in Brazil alone, to 0.7 percent a year (Table 1).

Table 1: Rates of GDP per Head 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

Source: ECLAC, OECD.
Note: "OECD" includes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Korea, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom, and United States.

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

In this paper I will not describe or analyze the macroeconomic instability that prevailed in the Latin American countries. Its terrible vicious circle is well-known: budget deficits and high public debts leading to fiscal crisis of the state and high inflation; price stabilization causing overvalued currencies, which, on its hand, foster still higher debts; deficits, debts and overvaluation pressing for lower public and private savings, and for higher interest rates. All this leading to reduced capital accumulation rates, and to stagnation, or to 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 will try to offer an answer to these questions. I will say that a major historical new fact led Latin American countries to near insolvency, making macroeconomic policy-making and institutional reform design more strategic and more difficult. A difficulty that politicians and economists advising them were not able to cope with. In several occasions they were incompetent, and made serious mistakes, which aggravated the problem they wanted to solve. In section one, I will ask myself an old question: on what does economic growth depend? To think just in terms of production function is not enough. Capital accumulation and technical progress were enough to explain economic growth when macroeconomic stability could be assumed in the long run. It cannot be anymore. Macroeconomic instability may turn chronic and last for long years, particularly when a debt question is involved. In section two, I will assume that there is today a reasonable consensus on the essential nature of the crisis: a crisis of the developmentalist state.[1] In section three, I will examine the conventional answers to my basic question, coming from the right and the left. According to the neoliberal wisdom, the explanation lies in the capacity of the local political elites to reform and guarantee property rights. On the other hand, according to the old left wisdom, globalization and the neo-liberal reforms are to be blamed. But we know that the crisis came before the reforms. A new historical fact is required. Thus, in section four I will look for a new historical fact that prevented macroeconomic stability and caused stagnation. The 1970s foreign debt will be singled out. It made macroeconomic policymaking more strategic and more complex in Latin American. In section five I will review incompetent reform designs, that make their approval in parliaments more problematic, and inept macroeconomic policies, particularly decisions relative to use foreign savings to grow, and policies trying to control inertial inflation. In the next section I underline the wrong decisions leading to exchange rate overvaluation. In the seventh section I discuss the reasons behind the mistakes. In the conclusion I suggest that the incompetence hypothesis cannot be explained either in rational, or in historical terms. Or, rather, that although these two methods may offer subsidies for the problem, one should assume that incompetent policymaking is an independent explanatory factor, which should be taken on its own.

There are serious institutional problems to face, that require well-designed institutional reforms, and there are strategic and day-to-day macroeconomic policy decisions to make. My hypothesis is that, although interest groups analysis may explain why the correspondent decisions were not timely and correctly made, 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 were correct, competent. And institutional

[1] - I 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 it is managed – in many works. Here I will only refer to the one in the common book with Maravall and Przeworski (Bresser Pereira, 1993).

reforms, which would foster growth, would have been more easily approved if their design had been proper. Or, in other words, according to what we could call "the incompetence hypothesis", the inability to overcome the crisis and resume growth lied mostly in the incompetence of the local elites and of the international advisers to face the new challenges originated from the fundamental changes in the international markets, particularly from the debt crisis and the increase of capital flows.

Growth and Macroeconomic Stability

Growth assumes macroeconomic stability. When an economist is asked on what depends economic growth, the standard answer will be: it depends on 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 will add an Schumpeterian perspective. If you stress the role of externalities you may be referring to the 1940s structuralist economists' balanced growth theory or to the 1950s unbalanced growth theory, that, in the last fifteen years, the new endogenous theory of growth was able to formalize. Refer to the crucial role of human capital, and you will have the more significant Chicago contribution to the theory of growth. Say that institutions are essential, you will be repeating what classical and structuralist political economists said long ago, but with a new rational choice appeal.

I will not go over on the enormous and fascinating economic literature on the subject. Growth theory assumed macroeconomic stability. Why? May be because part of this literature is previous to Keynes' invention of macroeconomics. May be because macroeconomic stability seemed to have been achieved, in the post-World War II golden years, when a larger part of the contemporary literature on economic growth was elaborated. Now, that this illusion is long over, and keeping to the basics, we may summarize saying that economic growth or increase in general productivity depends essentially on capital accumulation, technical progress, and macroeconomic stability. Capital accumulation, on its turn, depends on one hand, on domestic savings, and, on the other, on favorable profit perspectives for businessmen. Technical progress depends on the level education, on the supply of entrepreneurial capacity, on the commitment of business enterprises to research and development (R&D), and on the rate of capital accumulation since new investments tend to embody new technology. And macroeconomic stability depends, or, rather, may be defined considering the 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 interests on it. Extra-savings means either extra profit

rates, if the private sector is the indebted one; or extra-taxes, if the state is the major responsible for the foreign debt. In both cases, it means smaller wages, and reduced consumption, that only can 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 circumstance, the cost has to be paid in terms of smaller wages got by workers and/or smaller salaries received by the new middle class. You can always ask that the extra burden be directed to profits, but the limits to such 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 create incentives to savings and to investment in physical and human capital and on competent reform design and policymaking, that is not automatically assured when institutions fitted.

The Basic Diagnosis

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

When, at last, in the beginning of the 1980s the debt crisis broke up and the Latin American countries had no other alternative but to adjust and reform, the task

[2] - In others papers I defined the twentieth 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".

they faced was formidable. If in 1973 market distortions caused by generalized rent-seeking and the unbalance of the public finances in Latin America was 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 led to an outrageously high foreign debt.[3]

Thus, Latin American macroeconomic instability is associated to the excessive and distorted growth of the developmentalist state, and to the acquisition of a high foreign debt. The import substitution strategy, which had been effective in promoting industrialization between the 1930s and 1950s, in the early 1960s was exhausted. The 1960s' economic crisis was a clear indication that time for change had arrived; that the infant industry argument did not hold anymore. But as fiscal adjustment would be protracted after the 1973 chock, before that 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 about this basic diagnosis of the crisis. The neo-liberal right will have difficulty in accepting that, for a period, the developmentalist state was successful, since it is in trouble with historical reasoning. The old left, on its turn, will insist that the reason behind macroeconomic instability was not the unavoidable distortions that evolve out of excessive protection of local industry and immoderate growth of state expenditures, but some conspiracy connecting local business and multinationals. But most will accept that the state, which, between the 1930s and the 1960s, was an active actor in promoting development and welfare, since the 1980s turned into a problem, requiring fiscal adjustment and reform. Public savings, that were positive and contributed to overall savings, turned negative. The budget deficit that previously financed investment, now chiefly financed consumption. State-owned enterprises, that had a major role in establishing an industrial infrastructure for the national economies, now were highly indebted. The state bureaucrats, who, for a time, were committed to a national project in which their role was clear, now were lost in their own crisis – a crisis that led many of them to recur to rent seeking if not to sheer corruption.

The Conventional Wisdom(s)

After 1982, when the debt crisis broke up, macroeconomic instability emerged as the central economic problem. Latin American countries had no other alternative but to adjust and reform. Pressed by the creditor countries and by the circumstances, they did that. But they did not achieve macroeconomic stability. What went wrong? Fiscal adjustment and reforms were just not effectively undertaken, or they were, but,

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3 - Ten years later, in 1990, the Brady Plan did not solve the debt crisis; it just permitted that the debt was restructured. In doing so, it gave room to new wave of international lending, and to the concept of "emerging markets".

nevertheless, did not perform? About this there is deep controversy. The right and the left have their own conventional wisdom.

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

According the new conservative view, what is necessary is "economic freedom" says the right. The think tank Economic Freedom of the World publishes an index ranking countries accordingly.[4] The Economist notwithstanding seriously takes this curious index, in which China is freer than Brazil, and Peru better ranked than Denmark, since it expresses rightfully the right's "truth". The magazine's editor, Bill Emmott (1999: 28), for instance, in a special survey, asks himself why haven't the more poor countries caught up in the twentieth century. He dismiss answers like lack of skills, lack of capital, lack of entrepreneurship, to conclude with a platitude: that what is lacking is economic freedom, is 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 is because reforms were not done or were incomplete.

Market oriented reforms are required in Latin America, and they have been undertaken: fiscal adjustment, trade reform, privatization, social security reform, and administrative reform. So, to say that reforms were not undertaken is just false. To say that they are incomplete, it 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, like 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 with growth in the 80s and 90s: the significant variables were capital accumulation and

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[4] - See Gwartney, James and Robert Lawnson (1999) and www.freetheworld.com. The organization uses 53 institutions around the world to arrive to its The Economic Freedom Network Index. In Brazil, where a practically unknown institution is in place, the 1997 freedom index, which can varies from 0 to 10, was 5.5, out of 119 countries surveyed...

macroeconomic stability.[5] The only policy which is directly related to macro-stability is fiscal adjustment, but that, although may partially depend on fiscal reform, is not itself a reform.

But, continues mainstream conventional wisdom, reforms were not done, or were insufficient, because they were and interest groups and populist politicians in Latin America oppose them.

Latin American politicians indeed engage in populist practices more easily than the politicians in the developed countries. This is also part of a developing country's definition. But, how can we explain that, counting upon the same politicians, Latin America was able to present reasonable macroeconomic stability and high rates of GDP per head 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 improved in the last 20 years. Democracy became the dominant political regime throughout the region. The Latin American democracies cannot be compared with the ones existing in the developed countries, but, anyway, are democracies. This means besides 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", "and incomplete reforms". Old facts that show improvement, since property rights are now better protected than before, politicians are more modern and democratic, and extensive reforms, although necessarily incomplete, have been accomplished.

The old left's conventional wisdom goes in the opposite direction, but presents 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. Since in the last quarter of twentieth century market coordination advanced, while state intervention first came to a halt and then was (moderately) reduced, the left blames this fact for the stagnation. The curious is that it shares with the right the belief that globalization inevitably leads to the reduction of state autonomy. In doing that it does not realize that the devious ideological aspect of globalization is precisely that: it is to say that the state definitively lost autonomy – and that there is nothing to do but to accept and adjust to this new reality.

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[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".

Together with globalization, continues the old left, came the neo-liberal reforms, which reduced even more state autonomy, leaving the developing economies at mercy of market irrationality. Thus, while for the right the lack of reforms that is to be censured, for the old left the excess and the distorted character of reforms explain Latin American economic problems. That in some countries reforms were misled there is no doubt. Consider, for instance, the mal-conduction of the 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 either globalization or reforms had come to age. Globalization in real terms (instead of in 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 was not yet dominant. And reforms came in the 1980s, as an answer to the crisis, and thus cannot be its cause.

The right's difficulty to think in historical terms is to me easy to understand. Its present intellectual religion is neoclassical economics and rational choice reasoning, which are notable scientific realizations, but are, by definition, a-historical, of an essentially logical-deductive character. But it is hard to me to understand that 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, 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 away history. Not because the historical method is a risky way of reasoning, prone to ideological distortion. But because it involves identifying change, coping with change. Or, this is always painful, to the right, or to the left. It requires real thinking, not just the application of stereotypes. It is fashionable to speak of the increasing pace technological and social change, but when interests and ideologies are involved, it is much easier to keep with an immutable conventional wisdom of a sort.

The New Historical Fact

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

The failure in taking correct strategic policy decisions and well designing 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 that were in charge of taking policy decisions in Latin American countries, domestic and foreign economists – usually IMF and World Bank advisers – failed grossly in stabilizing Latin American economies. To achieve results either stabilization strategies, specifically price stabilization strategies, took too long or cost too much in loss of income. Some cost too much because, before succeeding, hyperinflation developed, like in Argentina. In other cases, they cost too much because involved extremely severe cuts in demand and particularly in wages, as it was the case of Chile. And in other cases, like Brazil, high costs were related with the time they took to succeed: starting to count from 1979, when the crisis began, twelve stabilization attempts failed – some heterodox, most orthodox – before the heterodox Real Plan was able to stabilize inflation.

But the same argument that I used to reject the conventional wisdom saying that populist politicians are to blame for the failure to stabilize applies to my argument blaming incompetent policymakers. The same economists – 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 historical new fact that changed the picture, and stirred poor decision-making.

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

Table 2: Outstanding Brazilian and Latin America Foreign Debt

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.

First, the debt crisis. This was effectively a new historical fact as we may see in Table 2: the increase in the debt outstanding of Latin America as a whole and particularly of Brazil was immense, from 1970 to 1980. This new fact, in this case, is supposed to have two qualities. It must have imposed a severe blow in the Latin

America economies. I will not offer evidences about that because they are well known. 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, in other occasion, I 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, policy decisions are not made in 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 nineteenth century, in the 1920s, but never in such amount. And, what is more important, since 1930s' crisis, when several developing countries had to restructure their debts, private loans to Latin America were closed, except the ones to finance trade. So, the relatively high rates of growth achieved between 1930 and 1969, and particularly between 1960 and 1969, have been secured without making use of long-term debt. Quasi-stagnation only came over after Latin American countries got indebted.

In the 1950s and in the 1960s Latin American economists and politicians longed for the possibility of obtaining long-term loans, believing that in this way they would speed up growth. When, in the 1970s, this possibility came to be true, giving the excess liquidity prevailing in the international financial markets, the Latin American countries got indebted, and a predictable, but not predicted, disaster ensued. Very few things are more dangerous to an 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 poorly spent 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, just bankrupt. Kept with a huge debt overhang, which had to be served out of current national income.

This is an old and well-known history. A history that the Brady Plan, from 1990 on, did not solve, but just got it into control, allowing for restructuring and limited discount. Here, the important thing is to understand the long run consequences it entailed. On the other hand, since I am assuming that the Latin American countries can only rely on themselves, the essential is to know how the debt affected growth and policymaking in Latin America. That it affected long-term growth negatively is not to be disputed. The problem, however, is that, additionally, it made policymaking, which is already a difficult and hazardous task, even more complex. If this is true for advanced economies, were macroeconomic problems seldom assume the dramatic

character, what to say of the developing countries which face practical insolvency due to the debt? A country enjoys macroeconomic stability when inflation rates are similar to the ones 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 the region could dispose of.[6]

Second, the more general new historical fact. Macroeconomic policy is a 50 years old phenomenon. Before Keynes and the rise of macroeconomics – or, before central banks became established and relative independent – one could hardly speak of macroeconomic policy. Governments adopt forms of economic policy, they strove for fiscal balance and trade account balance, but theory was so poor, and macro-data, so faulty, that governments were far from a real macroeconomic policy. Thus, it was perfect 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, 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 could be mostly ignored.

Not anymore, after macroeconomic policy, and, more recently, institutional reform strategy, turned into a usual and essential government process. This is a new historical fact. Economic policy became strategic and may, now, be made responsible for a substantial part of a government success of failure. Thus, policy decisions (right and wrong), besides interests, have to be taken into consideration by social scientists, if they want to understand what is going on.

Observe that I am not saying that there are no good economists in Latin America, or that there is a systematic explanation for macro-instability. Latin America probably counts today with more prepared politicians and economists than it counted in the past. Latin American countries are more democratic, and politicians learned to live with democracy. Since late 1960s economists started to make PhDs abroad, particularly in the more prestigious American universities, granting them more sophisticated economic techniques. But this does not imply that they improved their ability to make more correct and courageous decisions. Nor that they deteriorate this capacity. There is here a trade off between technical capacity and a more deep knowledge of the economic and political reality in each country. I will not discuss this

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6 - Domestic public debt in Brazil, for instance, that 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; in fact, as an easy form of financing budget deficits.

subject here.[7] Instead, I want just to emphasize that the debt crisis, and, more generally, the crisis of the Latin American states, made economic policymaking more challenging that it was before. And, more broadly, that the emergence of macroeconomic policy and institutional reform strategy, made decisions in this area more significant and more subject to error than they were before. Good institutions, as the ones existing in advanced countries, will limit costs involved in perhaps mistaken decisions, but, nevertheless, policy decisions are now more relevant and strategic than they were before.

Incompetent Strategic Decisions

But which were the mistakes? Have policymaking been so wrong, so unsuited, so misled, as I am suggesting? In order to respond these questions I will review basic macroeconomic policy decisions and decisions on the design of institutional reforms in the last twenty years, having in mind two questions: have they been competent, and successful? The success criterion is different in one and the other cases. Success in defining 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 here only refer to reform approval. Success in macro-policymaking is achieved when the economy, first, stabilizes, and then, grows. In the case of reforms we have a political success criterion, in the macro-policy decisions, a technical one.

Many institutional reforms were approved and implemented in Latin America. Anyway, when a reform does not pass in Congress, the usual explanation is simple: it was not because voters did not support it, or because adversary interest groups were too strong. Both are true answers, but there is an entirely different kind of answer to be also considered. An answer that I believe particularly important. Many reforms get not approved in parliaments because the reform design was not competent. Usually its proficient design is taken for grant. It should not. 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, and its costs, sized. All this must be part of the reform design, so that it can be easily understood and gain support of public opinion.

There is a growing literature about what is being called deliberative democracy. About a polity that "is governed by the public deliberation of its members". There are advocates of deliberative democracy, as Cohen (1989: 67), whose definition I just used, or Bohman (1998), who refers to "the coming age of deliberative democracy". There are critics, like Przeworski (1998), according to whom deliberation easily gets

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[7] - It should, however, said that today, in the case of Brazil, where local PhD programs in economics and political science are well established, I rather favor short term (one year) stages in foreign universities, than complete PhD programs.

transformed into indoctrination, since power agents make use of money and privileged information to persuade others. I will not discuss this matter here. Przeworski is correct when he underlines that the distortions in the deliberation process are usually great. Good laws do not necessarily derive from 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. Or, 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 is extremely necessary, particularly the reform of the civil servants' pension system, since the privileges and consequent costs are huge. According to the Brazilian constitution, civil servants are entitled to a full pension, corresponding to the last salary before retirement, and usually secure the benefit at an early age. In contrast, private workers' pensions system grants small privileges, if any. Reform is also required, but in a lesser extent. Thus, the right thing to do on political terms would have been to present two separate constitutional amendments. Instead, only one amendment was submitted, permitting that a few but powerful public officials were able to hide behind the mass of private workers, who, although not being deprived of significant entitlements, felt threatened. This threat was still more strongly felt because the reform had additional design flaws. It was complex and obscure. Ordinary law was supposed to regulate many issues. Or, although Brazilians admit that they have an excessively detailed constitution, they contradictorily require that their rights be clearly defined in the constitution. The consequence was that, notwithstanding the efforts the federal government applied in this matter, only a fraction of what was contemplated was approved.

In the case of the second major reform that the Brazilian government was committed to approve since the 1994 elections – tax reform – the design problem is still more serious. Up to now the Finance Ministry was not able to arrive to 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 to a conclusion.[8]

An interesting research project would be to survey other institutional reforms in Latin America so check in what extent they failed – when they did – for flawed design. I will now turn to macroeconomic policies, mark highlighting three areas: foreign debt policy, price stabilization policy, and exchange rate policy. I will not bring up

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[8] - On the subject se Melo (1998) and Bresser Pereira (1999).

decisions on the interest rate, because they are day-to-day monetary policy depending on the mentioned decision areas.

Latin American countries made a great mistake in getting highly indebted in 1970s – a mistake that I suggested to be the historical new fact that made macroeconomic policymaking considerably more difficult than before. Yet, one could argue that this is an old question. Indeed, it is. But what to say of so many Latin American countries engaging, in the 1990s, in new debts? The "growth cum debt" strategy, the fantasy that is possible to stir growth with foreign savings is back in Latin America.

Or, it is a serious mistake to rely on debt to grow. This might be reasonable if the countries were not already highly indebted, and if limits were severely defined. I did not forget basic economic theory that 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. In the moment a country opens its financial markets to foreign borrowing, be it short term, or medium term, it loses control of how the resources will be used.

There is a general condemnation of short-term borrowing – the so injured volatile capital flows. Medium term is certainly less hurting than short-term indebtedness. But both are bad. In the 1997-98 emerging markets financial crisis the countries that were not highly indebted – and were not tending to acquire more debt given their current account deficits – were not molested. A debt is always a burden over future generations. If the borrowed resources were well used, this burden could be justified. But the chances that this may 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, i.e., the local currency will be valorized. In the next section I will discuss how bad can this be to an indebted country.

In relation to inflation one could argue that it is also an "old problem", since most Latin American countries have been already able to control their inflation. But, incurring which costs? Take the case of Chile. Pinochet and his foreign adviser were, indeed, able to control inflation and stabilize their foreign accounts in the 1970s. Chile was the first Latin American country to accomplish 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 Chile resumed growth.

Brazil faced a different problem. Inflation, besides revealing the fiscal crisis of the state and the external unbalance 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 – as 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 advisers, particularly the IMF and World Bank advisers, knew little or nothing about inertial inflation. It is reasonable that they ignore 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 a year) inflation started, did not take into account the new theory one can understand without recurring 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, twelve stabilization plans failed, there is no other alternative but to say that incompetence is involved. Only one or two of these plans failed for lack of political support; most – orthodox plans in the large majority – failed for sheer economic theory ignorance, or for ignorance combined with fear or arrogance.[9]

In Argentina the costs involved in controlling inflation were still higher. Inflation also had an inertial character, although not so clear 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 about the theme was confirmed. But, differently from Brazil, Argentina did not have time to try many other stabilization plans. Giving the fragility of the Argentinean economy at that time – 1989 – high inflation soon turned into hyperinflation. And for two years Argentina lived 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 to Argentina, whose economy was caught by two torments: dollarization and hyperinflation. But the plan had an essential flaw: it started from an overvalued peso, that Roberto Frenkel denounced the day after the plan was stated. In accepting its currency overvaluation in order to unequivocally assure price stability Argentina was reproducing the same mistake in which Mexico was at that same moment incurring – a mistake in which Brazil would also incur 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 to exchange rate crisis and default. The Real Plan, overvaluing the Brazilian currency, gave a run for the Argentinean currency board, as Argentina was able to compensate 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

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[9] - I described these twelve cases in Bresser Pereira (1996).

devaluation of the Real, which is now in a floating exchange rate regime, Argentina will not have other alternative but to also devalue its own currency, making it also float.

The Exchange Rate

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

The exchange rate is 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 the one that balances the trade account. It is not. If the country may count with 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 honoring interests, the country may gradually, pay the principal. Thus, one might say that a highly indebted country, as are most Latin American ones, should have an "undervalued" currency – an exchange rate that produces a trade account surplus. In doubt the debtor countries should opt always for having its currency undervalued. As a trade-off, creditor countries should have "overvalued" currencies, i.e., a deficit in the trade account and in the current account, so that the debtor countries may pay, bit by bit, the principal.

Financial people in the creditor countries do not like to hear that debtor countries should start paying the principal. What will they do with the capital surplus they have to apply? The same is true for politicians and policymakers in the developing countries. Why would they have to pay a debt that was previously acquired? Why are they supposed to 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 use to hear often this kind of argument. Instead of the phrase, "in doubt, have an overvalued currency", there is a much more popular maxim among either debtors or creditors: "a debt is not to be paid, is to be rolled over".

Economists in the international commercial banks and in the IMF and the World Bank prefer rather to speak of the dangers of the 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, differently from a firm, cannot go thoroughly bankrupt and close, since the population and the territory are always there, the country is always "open for business". Or, the subsequent "business" of a country

that incurred in foreign insolvency will not just be an increase in risk premiums, but years and years of economic stagnation.

Before that, 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 on the relative size of domestic budget deficit.[10] Soon the loans, that were thought to finance investment projects showing a rate of return superior to the rate of interest being paid (despite the large risk premiums paid), are financing consumption. And the debt is accumulating. The crisis is just a question of time.

In the 1970s the reason behind overvalued currencies was the anticipation of higher rates of growth coming from debt financed investments. The outcomes are well known. In the 1990s a new reason popped up: to guarantee the hardly achieved price stabilization. Thus, in Mexico, in Argentina, and finally in 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, in fact, the exchange rate was the anchor. But in Mexico, in 1987, the price and wage freeze, partially neutralizing inertia, and the social agreement achieved with workers were crucial. And in Brazil, the URV, fully neutralizing inertia, was the significant variable in achieving price stabilization.

Yet, once stabilization achieved, and after a period of time – a few months, a year, maybe –, it would be reasonable to expect that the exchange rate came to equilibrium. But this did not happen. Why? Because, almost without noticing, Latin American countries were soon back to the 1970s. Debt is again a tool for growth. The international financial community's discourse to the country that 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, repeating 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] And we are back to our twin evils: increasing debt and exchange rate overvaluation.

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[10] - On the populist cycle see the classical papers of Canitrot (1975) and Sachs (1988). I edited a book on the subject in Brazil.

[11] - According, for instance, to Martin Feldstein (1995) who actualized a study about 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 in the top of the list: saves 34 and invests

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. This, on the supply side of loanable funds: loans will only continue to be rolled over if the interest rates pay these premiums. On the demand side, the local authorities are constrained to maintain high the interest rate for another reason: they must maintain aggregate demand – and so, imports – under control, in order to avoid increasing current account deficits and further international loss of credibility. High interest rates mean lower investment rates, potential growth loss.

What say economists in government and their advisers about all that? To answer this question, look, for instance, what happened with 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 one are not a question to debate: they just show economic ignorance. The proponents of the productivity increase argument forgot that the other countries also increase their productivity, and that you have no control on that. The fiscal adjustment proponents forgot that fiscal adjustment might only lead to devaluation if it is so drastic that provokes deflation. With deflation the prices of non-tradable goods, particularly wages, are reduced in relation to tradable goods, so accomplishing real devaluation. Or, this is not a rational form of devaluing. Besides the unavoidable reduction of wages, it produces widespread unemployment.[12] It was only after the Russian crisis, around three years after the moment 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.

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domestically 32 percent of GDP; United States, in the bottom: saves 18 and invests 19 percent of GDP. The other countries are dutifully distributed between the two extremes, maintaining the close correlation savings and investments.

[12] - In this period my official responsibilities made impossible to expose my views in public. But even so I was able to present these arguments in a short paper that had 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.

Reasons Behind

These were policy mistakes, i.e., unsuited policies or reform designs, which were adopted due to poor judgement or incompetence. Similar policies may have been adopted for rational motives, responding to self-interest, to the demands of pressure groups. I am not dismissing the relevance of interests. I am just saying that there is not only one – 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 reason behind is interest groups pressure or populism, one cannot say they were fruit of mistakes. In the second, however, mistake, 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 to the population and to elites. Thus, they were not either result of populism or pressure groups action. They were the consequence of ignorance, or of fear, or of arrogance, or of a mixture of all this. As observes Whitehead (1997: 11), over the past twenty 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. 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 be not automatically applied, be not transformed into a series of clichés, but be 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 existing between theory and practice – a gap that, I would add, makes mistakes unavoidable. In his words: "Specialists in economic theory do not reach to 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" (1996: 256).

Besides ignorance, fear and arrogance, there is a second argument to explain these policy mistakes or incompetence: "confidence building". In this case, we are in an area between self-interest and incompetence. Latin American elites are subordinate elites. They do not limit themselves to see 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 source of truth, and as natural leaders to be followed. This subordinate internationalism ideology, which was already called

"colonial inferiority complex" and "entreguismo", is so detrimental to the country as old time nationalism. With the industrialization of Latin America and the emergence of a 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 since the countries got highly indebted, and their economies come to depend more closely on financial markets credit, subordinate internationalism was back in place.

Now it had a "good" economic theory argument behind. As international financial markets and mainstream economic theory assert, economic policy must be endowed with "credibility". There is an extensive literature on the subject. In strict macroeconomic terms an administration has credibility when you decide that you will follow a given policy, and follow 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, as the country is viewed as committed to stability, it was able to build confidence and it will have credit.

The indebted developing countries need "credibility" and credit. So, the will faithfully and uncritically follow Washington's and New York's recommendations, which sometimes are specific, other times, vague orientations, which most of the time are reasonable, but often just mistaken. They will be followed as if ultimate macroeconomic truth was crystallized in Washington (the official views) and New York (the financial markets views). I may be engaging in some caricaturist simplification, but it 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.

On can say that there is no other alternative for the developing country. That World Bank and IMF have no other alternative than to define lock-in strategies, which, followed, will show the creditors that a particular country will honor its obligations. I am not discussing the developed countries' and their agencies' alternatives. I am not criticizing World Bank or IMF's "incompetence". On the average, they are quite competent agencies, counting with high-level personnel. As bureaucratic agencies, they are not well prepared to face abnormal times. But this is not my subject. I am speaking about the developing countries governments' alternatives. 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 was necessary, or they may just assume that it correct what the creditor expects you to do. When they choose the last alternative, as Latin American countries have being doing again and again, they will 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 engage 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 the negotiations with 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 policymakers is correct, good outcomes will soon spring up. Or, financiers, politicians and bureaucrats in New York and Washington are pragmatic: they only care for results. In the 1930s, while Argentina paid all its foreign debt, Brazil did not pay, got engaged in extensive negotiations, and more than once did not honor 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 irresponsible 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, that it "built confidence" and reduced interest rates paid by Mexico. Since that moment 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 just increased with the "strong" peso. After that, in other Latin American countries, this confidence building practice has been repeated again and again.

Saying that, I am not saying that it is bad to build confidence in international markets. Nor I am 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

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[14] - Remarks made by Faucher in an e-mail commenting a draft version of this paper.

[15] - See Abreu (2000).

have increasing mutual interests. Yet, in certain cases their national interests are in conflict; and more often than people in the rich countries are prepared to accept, economists and financial people in Washington and New York are just wrong in strategic issues, as we just have seen.

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

A Methodological Conclusion

But, one could argue that this is not a "well-behaved" explanation: to emphasize incompetence, and to relate it to ignorance, fear or arrogance. Instead, taking for granted that mistaken decisions were made, would not be more adequate to recur to conventional rational choice analysis? Rather than saying that people are incompetent, would not be more reasonable to ask which were the incentives and the punishments

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[16] - Writing on Russia, Fareed Zakaria (1999), for instance, asserts, although Russia bears most of the blame for their crisis, "advice given by thousands of advisers with billions of dollars and accompanying aid, has proved incomplete, ineffective or counterproductive, depending on whose analyst you accept". Although the Russian case is extreme, in Latin America the role of adviser 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 that have been advised by multilateral organizations and financial institutions – policies that contradict good and simple economic 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".

leading to the wrong decisions? Or, more broadly, according to all social science traditional way of thinking, would not be more acceptable to say that interest groups, social classes, or popular demand pressured for 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. Thus, there are right and wrong decisions. Good governments are governments that count with politicians and officials that take decisions mostly right, as good states are states that rely on institutions that help government leaders to make more secure investment decisions in the private and in the public sector. The history of a country is usually the history of how good governments pushed the country ahead, and how bad governments trailed it back. When we study history we are able to say that that country, in that given period, achieve peace and prosperity because it was well governed, while others failed for lack of good government.

We know very well that often inflation was not controlled because these or that interests groups would lose with macroeconomic stability, or would suffer with the hard policies required to achieve it. But when we come to high inflation and almost everybody is severely losing with it, this type of reasoning loses a large part of its explicative power. A strong political support emerges for harsh policies fighting inflation. If, in these circumstances, policymakers are not able to control inflation, interests cease to explain what is taking place, and we have no alternative than to look for incompetence.

I said in this paper that the strategy of using foreign savings to grow mutually interested creditor 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, so, should I conclude that the policymakers that made the wrong decisions were not incompetent but dishonest, protecting their own interests or 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 will be particularly useful to understand the quasi-stagnation Latin America underwent in the last 20 years if the wrong policy decisions and the mistaken reform designs do not involve vote in Congress, as most do not. Or, in the case they involve parliamentary decision, if the required majority was not too big.[18] Most of the wrong macroeconomic policy decisions and all the faulty reform designs I referred in this paper did not depend on vote in the parliament. In many cases,

[18] - An excessively large required majority is, for instance, the existing in Brazil to reform the Constitution: three-fifths.

previous popular support was not necessary, and interest groups were divided or just not involved. If the decisions were wrong, inept, the only explanation is incompetence.

But, the questioning could go on, why, in several crucial stands, policymakers have been incompetent and misled? Because the new problems, the high debt overhang particularly, were too difficult to tackle. Because, being ideologically subordinate, they gave up their own judgement and recurred to confidence building. Because absent good institutions did not facilitate their job – institutions that in Latin America never have been fitted. Because right decisions require courage not only to assume the consequences – this is a rational choice problem – but also courage to think by himself, and demand humility that makes you to hear, to learn from error. Or, in government, among officials, fear and arrogance are pervasive emotions. These were 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 if it would not be more reasonable to explain the crisis with historical or structural arguments? The crisis of the state, the debt crisis, globalization. Well, I did that. The method is powerful in explaining why the crisis broke down, but limited in informing why governments were not able, for so many years, to overcome it. Why, for so long years, policies failed do recover macroeconomic stability.

But, can one still question, 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 only sustained through high interest rates. Maybe sometime they will learn the dangers involved in the growth cum debt strategy. The problem, however, with macroeconomic policy, is that new problems are emerging, requiring new solutions. The problems may be less dramatic than the ones confronted by the Latin American countries in the last 20 years. That is the case of the advanced countries, where macroeconomic stability prevails for many years. But this does not mean that developed countries policy-markers' are exempt from mistakes. They probably are less serious, less evident, but are there.

In synthesis, the failure to stabilize and resume economic growth after the debt crisis in Latin America was attributed to incompetent macro-policymaking, and to a "confidence building" strategy that subordinates 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 because they were excessive, and more because they were flawed. And they were so less due to interest groups pressures – although these are also relevant – and more because they were marked by serious policy mistakes, because they were incompetent, the outcome of bad judgement. Incompetence and mistakes in

Latin America were magnified or made more frequent due to two new historical facts. One, which 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, which has a broader reach: the fact that macroeconomic policy is a historically recent, 50 years old phenomenon: before that policy decisions could be viewed as relatively irrelevant, mistakes compensating right options, and none having much impact in the economy. Not anymore: with the growth of the state in this century and the emergence of macroeconomic policy and more recently institutional reform strategy, decisions cannot anymore be ignored, good and bad governments, yes, matter.

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