



Review: Neoconservative Economic Experiments in the Southern Cone

Reviewed Work(s):

Free Market Conservatism: A Critique of Theory and Practice. by Edward J. Nell
Chile, 1973-1984. by Rigoberto Garcia

Monetarism and Liberalization: The Chilean Experiment. by Sebastian Edwards; Alejandra Cox Edwards

Latin American Experiments in Neoconservative Economics. by Alejandro Foxley

How the Financial Statements of Argentine Firms Reflected Stabilization and Reform Attempts: 1976-1981. by A. Humberto Petrei; James R. Tybout

Fragilidad Financiera e Inflacion. by Julio Dreizen

Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay: Applications of the Monetary Approach to the Balance of Payments. by N. Ardito Barletta; Mario I. Blejer; Luis Landau

La Politica Economica en el Uruguay, 1968-1984. by Jorge Notaro
Roger Betancourt; Miguel Kiguel

Latin American Research Review, Vol. 24, No. 3. (1989), pp. 224-239.

Stable URL:

<http://links.jstor.org/sici?sici=0023-8791%281989%2924%3A3%3C224%3ANEEITS%3E2.0.CO%3B2-W>

Latin American Research Review is currently published by University of Texas Press.

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NEOCONSERVATIVE ECONOMIC EXPERIMENTS IN THE SOUTHERN CONE

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FREE MARKET CONSERVATISM: A CRITIQUE OF THEORY AND PRACTICE.
Edited by EDWARD J. NELL. (London: George Allen and Unwin, 1984.
Pp. 263. \$27.50 cloth, \$10.95 paper.)

CHILE, 1973-1984. Edited by RIGOBERTO GARCIA. (Stockholm: Institute of
Latin American Studies, 1985. Pp. 223.)

MONETARISM AND LIBERALIZATION: THE CHILEAN EXPERIMENT. By SE-
BASTIAN EDWARDS and ALEJANDRA COX EDWARDS. (Cambridge, Mass.:
Ballinger, 1987. Pp. 233. \$29.95.)

LATIN AMERICAN EXPERIMENTS IN NEOCONSERVATIVE ECONOMICS. By
ALEJANDRO FOXLEY. (Berkeley and Los Angeles: University of Califor-
nia Press, 1983. Pp. 213. \$7.95 paper.)

*HOW THE FINANCIAL STATEMENTS OF ARGENTINE FIRMS REFLECTED
STABILIZATION AND REFORM ATTEMPTS: 1976-1981.* By A. HUMBERTO
PETREI and JAMES R. TYBOUT (Washington, D.C.: World Bank, 1984.
Pp. 65. \$5.00 paper.)

FRAGILIDAD FINANCIERA E INFLACION. By JULIO DREIZZEN. (Buenos
Aires: Estudios CEDES, 1985. Pp. 145.)

*ECONOMIC LIBERALIZATION AND STABILIZATION POLICIES IN ARGEN-
TINA, CHILE, AND URUGUAY: APPLICATIONS OF THE MONETARY AP-
PROACH TO THE BALANCE OF PAYMENTS.* Edited by N. ARDITO BAR-
LETTA, MARIO I. BLEJER, and LUIS LANDAU. (Washington, D.C.: World
Bank, 1984. Pp. 163. \$17.50.)

LA POLITICA ECONOMICA EN EL URUGUAY, 1968-1984. By JORGE NOTARO.
(Montevideo: CIEDUR, 1984. Pp. 316.)

Under the rule of authoritarian regimes in the 1970s, Argentina, Chile, and Uruguay all implemented economic programs intended to liberalize the economies and stabilize inflation. The Southern Cone programs, as they are now known, represented unique and controversial experiments that have become the subject of heated debate. The discussion has taken on significant ideological overtones because all three

programs were conducted by right-wing military regimes. The most comprehensive reforms were introduced in Chile, and from an economic perspective, the Chilean experiment was the most interesting test of monetarism's ability to control inflation and the potential role of free markets in restoring economic growth and efficiency.

Liberalization policies can be generally characterized as structural reforms aimed at allowing or inducing market mechanisms to play increasing roles in determining economic outcomes. Common association of these liberalization experiments with conservative ideologies is accurate in the sense that conservatives believe to varying degrees in the efficiency and optimality of markets. But this association can also be misleading because it obscures the point that liberalization policies are often directed at correcting fundamental economic problems, which span diverse ideologies and economic systems. Indeed, specific liberalization experiments similar to those conducted in the Southern Cone have been carried out at various times by leaders with such disparate ideologies as Ronald Reagan, Margaret Thatcher, Jimmy Carter, Fidel Castro, Mikhail Gorbachev, and Deng Xiaoping. Although the description "neoconservative" may fit the first two mentioned, it seems inappropriate to the other four, despite their espousal of airline deregulation, gray markets, *perestroika*, and the decollectivization of agriculture. Thus the structural reforms in the Southern Cone may be a relevant means of understanding when, how, and why markets perform or fail to perform as more efficient economic institutions than the alternatives.

Two critical areas where liberalization took place were capital markets (domestic and international) and the foreign-trade sector. In Chile liberalization of trade was fully implemented, in contrast to the other two countries, and the foreign-trade sector was liberalized before foreign-capital accounts; the inverse sequence of liberalization took place in Uruguay and Argentina. Moreover, in Chile these experiments were extended to other sectors as well. For example, the processes of privatizing and diminishing the role of the state in economic activity were more integral components of policy in Chile than in the other two countries. One novel feature of all these Southern Cone experiments was that liberalization policies were envisioned (albeit to a different degree in each country) as part of a comprehensive program, which included stabilization policies, for stopping inflation and improving the allocation of resources in order to stimulate economic growth. In conceptual terms, price stability and structural reform are two separate aspects of an economic program, even though most analysts recognize interactions between the two.

With respect to the stabilization programs, two distinct phases can be identified. When these three military regimes first gained power, stabilization policies were oriented toward shifting from multiple to sin-

gle exchange rates, and particularly in Chile, toward fiscal restraint and subsequent control of the rate of growth of the money supply. Dissatisfaction with the rate of progress in reducing inflation led to the second phase, which began around 1978 in all three countries. At this point, the most novel and controversial feature of the stabilization programs emerged: the introduction of the pre-announced exchange rate (the *tablita*). In this schedule, the government fixed the future values of the exchange rate. The rate of devaluation stayed below the ongoing rate of inflation, which led policymakers to expect that the *tablita* would be an effective instrument for controlling inflation. According to this strategy, the domestic rate of inflation was supposed to converge eventually to the rate of devaluation plus international inflation. This aspect of the experiments was supported by two main intellectual pillars, the monetary approach to the balance of payments and the law of one price. Given the association of conservatism with monetarism and with great faith in or enthusiasm for the law of one price, the label "neoconservative" has also been applied to the experiments because of the nature of the stabilization policies.

One major objective of the *tablita* programs was to stop the inertial forces working in the economy that tended to keep inflation at the prevailing levels. Inertial inflation is very likely to develop in an economy with overlapping nominal contracts. Such inertia could result from backward-looking contracts, as with full wage indexation, or it could develop in an environment where firms set their own prices before having full knowledge of price levels. Pre-announcement of the exchange rate was most useful in dealing with this second aspect of inertial inflation. Disclosure of future values of the exchange rate was an attempt to affect expectations of forward-looking contracts and thus provide a nominal anchor for future prices. The collapse of this second phase of the stabilization program by 1982 is viewed as the end of the experiments in all three countries, although this cut-off date is somewhat arbitrary regarding Chile, given the persistence of many liberalization policies there.

Review

Of the works under consideration, the broadest approach to the topic is taken in *Free Market Conservatism: A Critique of Theory and Practice*, edited by Edward Nell. This volume consists of a core of five essays that identify and critique the theoretical underpinnings (primarily the macroeconomic aspects) of three variants of conservatism: supply-side economics, monetarism, and rational expectations. This core is supplemented by the introduction, conclusion, Nell's thoughtful com-

mentary on Becker's *Treatise on the Family*, and three country case studies on the United States, the United Kingdom, and Chile.

In the essay most relevant to the topic under discussion, Antonio Schneider juxtaposes the logic of financial liberalization of the domestic capital market with the logic of monetary restraint, two policies undertaken by the Chilean government in the early years of the experiment. This useful juxtaposition suggests that creating different financial assets (or near monies) through financial liberalization diminishes the effectiveness of the standard instruments of monetary control and the ability to reduce inflation. In addition, the two policies together tend to generate high interest rates. In the Chilean case, according to Schneider, the resulting situation facilitated the creation and growth in size of large conglomerates, or *grupos*, and a more general increase in the power of those having access to financial resources. Schneider pursues these ideas through the subsequent internationalization of the process to the eventual collapse of the tablita regime. He points out that by the end of this process, the Chilean regime had to increase the level of state interference in domestic financial markets, which he describes a bit hyperbolically as opening the "Chicago road to socialism."

Three of the remaining seven works under review also deal primarily or exclusively with the Chilean experiment. *Chile, 1973-1984* is a wide-ranging collection of essays presented at seminars sponsored by the Stockholm Institute of Latin American Studies and edited by Rigoberto García. Most of these essays provide thorough descriptions that are decidedly critical of the experiment. Specific topics include deindustrialization, foreign trade, external debt, military and social expenditures, foreign relations, trade-union experiences, agriculture, and a historical overview of the role of international trade in Chilean development prior to the experiment. These essays systematically document the dramatic transformation in various aspects of economic activity that has resulted from the experiment. Although some analysts acknowledge the limitations of the earlier development experience in Chile (which can be characterized as based on import-substituting industrialization cum mineral exports), the essays reflect nostalgia for some aspects of the earlier status quo as well as astonishment at the extent of the changes. They also express clearly the authors' disapproval of the economic philosophy underlying the experiment and the lack of democracy and human rights.

Typical of this attitude is Fernando Cordero's informative essay on military expenditures, which details the logic followed as well as the ups and downs faced by the military in pursuing arms from abroad. The essay also describes military efforts to develop industrial capabilities to produce equipment needed by the three branches of the Armed

Forces. In reporting on attempts to export equipment produced locally, Cordero notes that the naval industry, in contrast to the industries associated with the army and the air force, has been unsuccessful in exporting any products except those involved in repair services for merchant ships requiring aid in Chilean waters. Cordero goes on to compare overall expenditures on the military with those on social services and total government expenditures. Table 2 reveals that between 1973 and 1984, military expenditures almost tripled and expenditures on social services almost doubled while total government expenditures decreased by more than 20 percent. Although these numbers are not very reliable (for example, the sum of expenditures in these two subcategories in 1984 exceeds total government expenditures in 1984), the overall trends are so pronounced that they are likely to hold up even after correcting for large errors.

A work devoted solely to analyzing the Chilean experiment is *Monetarism and Liberalization* by Sebastián Edwards and Alejandra Cox Edwards, which will become a standard source on this period of Chilean economic history for several reasons. First, this study frequently documents the intentions of policymakers by citing their public declarations at the time when policy measures were being implemented. This useful practice, which is not all that common among economists, will appeal to Latin Americanists in other disciplines. Second, the book addresses its subject in modern economic terms, relying on conventional methodological approaches and even presenting some simplified models, thus guaranteeing its appeal for economists. Yet *Monetarism and Liberalization* is well-written enough to remain accessible to those with limited economic background, which means it could be used as a supplementary text in upper-level undergraduate courses on economic development or on Latin America. Third, the book was written well after 1982, an interval allowing for some historical perspective on the experiment. Finally, because the authors are Chicago Ph.D.s themselves and take a positive, although critical, attitude toward the experiment, their study can even serve as a convenient strawman for opponents of the Pinochet regime, who might easily (but unfairly) label the book as an economic apology for the regime.

Monetarism and Liberalization begins by providing an overview of the Chilean experiment that sets the stage for detailed analysis of policies in subsequent chapters. Chapter 2 covers both phases of the stabilization program and includes a noteworthy explanation of why the law of one price failed to apply, singling out wage indexation as the culprit. Chapter 3 discusses both domestic and international liberalization. Once again the authors tackle tough issues, as when explaining the lack of domestic savings and high interest rates during the period. Although alternative explanations are not considered in detail, these issues are

interpreted sensibly. The same thorough and authoritative approach is adopted on privatization and deregulation (Chapter 4), the liberalization of international trade (Chapter 5), a clever analysis of unemployment in terms of segmented labor markets (Chapter 6), the sequencing of liberalization reforms (Chapter 7), and in the concluding chapter (Chapter 8) on lessons from the experiment.

A work of equally high quality is Alejandro Foxley's *Latin American Experiments in Neo-Conservative Economics*, which differs substantively in several respects. First, Foxley attempts to take his analysis beyond the strictly technical economic issues. The first four chapters of the book try to answer such questions as, why did stabilization policies become more radical in the 1970s and 1980s than in the 1950s and 1960s, and what is the nature of radical conservative economics? The second four chapters take up the narrower technical question of the performance of the stabilization policies. Second, Foxley's analysis also discusses policies in Uruguay, Argentina, and to a lesser extent Brazil in the 1960s, but given his background, Chile still receives the lion's share of the attention. Third, Foxley's approach is less piecemeal and more consistent with what he calls "political economy" than with conventional economics, especially in the first part. Finally, as the author forthrightly asserts in the preface, his attitude toward the experiments is an objective, but negative, one.

Chapter 1 briefly reviews the earlier literature on the monetarist-structuralist controversy, setting the stage for Foxley to identify two elements new to modern conservative policies: the political framework of authoritarianism and the emphasis on long-term transformation of the economy as a condition for price stability. Chapter 2 explains the transition to more extreme conservative economic policies as a reaction to earlier domestic political circumstances and conditions created by the evolution of the international economy. Chapter 3 contains a rather long descriptive account of the experiment and its consequences. Chapter 4 interprets the structural reforms in Chile, especially the "seven modernizations," according to the ideology underlying the reforms. Chapter 5 focuses more narrowly on the evolution of monetarists' ideas on stabilization and provides aggregate data on macro performance in the four countries. This discussion provides the framework for an analysis of stagflation as a result of orthodox policies in Chapter 6. One interesting explanation for stagflation is the limited downward flexibility of prices and wages resulting from segmented markets (some of which have fixed prices while others have flexible prices). This interpretation is similar to the explanation of unemployment offered by Sebastián and Alejandra Cox Edwards. Chapter 7 evaluates the effects on stabilization of fiscal and monetary control, deregulation of prices, and liberalization of trade and capital flows. The conclusion unites the main

themes discussed earlier, including certain aspects related to a topic that has always figured prominently in Foxley's scholarly research: the negative consequences of neoconservative policies on income distribution.

Turning to the remaining books under review takes the discussion further away from the Chilean context and in the direction of narrower topics. The works of Julio Dreizen and coauthors Humberto Petrei and James Tybout deal with the interactions between macroeconomic policies and microeconomic behavior of firms. Both studies focus on financial decisions made in an inflationary environment characterized by frequent changes in relative prices.

Petrei and Tybout's *How the Financial Statements of Argentine Firms Reflected Stabilization and Reform Attempts during 1976-81* is based on a study of the statements of 153 industrial firms, classified according to whether they produced importables, exportables, or nontradables. The objectives were to examine the way that different sectors of the economy were affected by the macro-policies and to determine the financial strategies pursued by each group. The study corrects the standard financial statements to account for the effects of inflation on monetary assets and liabilities. The results established three overall findings. First, during the period of the tablita, earnings fell in all three sectors but recovered quickly as soon as this policy was abandoned. Within the overall reduction, differences emerged across sectors, with the largest relative earnings reduction occurring in exportables and the smallest in nontradables. Second, firms were very responsive to changes in the cost of credit in different currencies and substituted dollar debt for peso debt during the late 1970s, when external financing was cheaper. The study's final point is that sound financial management is crucial for ensuring good performance of earnings in high-inflation environments that are accompanied by substantial turbulence in the financial markets.

Dreizen's *Fragilidad financiera e inflación* provides an illuminating discussion of the ways that alternative financing strategies affect the ability of firms to confront different kinds of shocks in an inflationary environment. Following the approach of Hyman Minsky, financial fragility is measured as the ratio of financial services (interest plus principal) to the cash flow generated by the firm. The lower this ratio is, the sounder a firm's financial position. Dreizen then compares the fragility resulting from alternative financing mechanisms available in high-inflation economies. An important finding is that a firm whose price has a low correlation with the overall price level will avoid indexed loans because they are riskier than fixed interest rates, while those firms whose prices are highly correlated with the price level will do the opposite. Different degrees of financial fragility in various sectors of the economy would thus call for alternative lending schemes. Dreizen ar-

gues for creating a financial instrument that could simultaneously reduce financial fragility and risk to creditors. He proposes in particular adopting a lending scheme in which service payments are adjusted according to sectoral (or firm) prices while the amount of outstanding debt changes with the overall rate of inflation. This procedure would effectively reduce financial fragility but would also create a potential liquidity problem for the lending institutions.

One of the most thorough evaluations of the Southern Cone programs is presented in *Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay*, edited by Ardito Barletta, Mario Blejer, and Luis Landau. This excellent volume contains the proceedings of a conference on this topic organized by the World Bank in May 1982. The main objective is to present a comparative evaluation of country experiences and to extract policy lessons from the experiments. The book is divided into three parts, one dealing with the conceptual framework of the programs, the second describing economic developments in the three countries, and a third part evaluating and drawing lessons from the experiences. *Economic Liberalization and Stabilization Policies* displays a good balance between analytical issues and policy implications, which are addressed by academics, policymakers, and other analysts.

The conceptual section focuses on the underlying analytical framework for the stabilization strategy and the links between liberalization and stabilization. One controversial aspect of the programs, which is discussed at some length in the volume, is whether they represent a direct application of the monetary approach to the balance of payments. Rudiger Dornbusch, Dagnino Pastore, and others argue that the programs were mechanical applications of the law of one price and can be used to "test" the monetary approach to the balance of payments. But other participants, such as Blejer and Larry Sjaastad, strongly disagree. In their view, the monetary approach simply establishes a relationship between the money market and the balance of payments; it neither rests on the law of one price nor recommends the use of the exchange rate as the main instrument in a stabilization program. Sebastian and Alejandra Edwards's discussion of the Chilean experiment, however, suggests that at least some members of the Chilean economic team were firm believers in the law of one price (p. 41), although the evidence on this point is much weaker for Argentina and Uruguay.

The conference generated more consensus regarding the sequencing of liberalization. Most participants concluded that liberalization of goods markets should precede liberalization in the financial markets. James Hanson nonetheless presents an insightful dissenting view on this topic. He argues convincingly that before arriving at any conclusions, one must specify clearly the meaning of financial liberalization.

Although most participants identify liberalization of the financial markets with a relaxation of restrictions on foreign borrowing, Hanson points out that this policy also implies relaxation of reserve requirements and less intervention on credit allocations. It could be argued that to ensure an efficient allocation of productive resources, firms need access to capital markets and hence that domestic financial liberalization should precede or accompany trade liberalization.

Economic Liberalization and Stabilization Policies reflects widespread concern over the outcomes of the programs. The general view was that inflation did not fall as rapidly as anticipated by the authorities. The result in all cases was a sharp appreciation of the real exchange rate, which was accompanied by high real interest rates, mounting current-account deficits, and accumulation of foreign debt. The overall assessment of the conference participants was that the stabilization programs were not as effective as they were anticipated to be.

Jorge Notaro's *La política económica en el Uruguay, 1968-1984* examines the successive policies followed in Uruguay during that period and evaluates their macroeconomic impact. Unfortunately, this work lacks a clear conceptual framework and suffers from repetitious discussion and evaluation of different periods. Regarding the Uruguayan experience with the *tablita*, Notaro considers it an "anti-national model that consolidated the hegemony of international financial capital" (p. 104) and had a regressive effect on income distribution. He distinguishes two subperiods in the Uruguay experiment. From the end of 1979 until the end of 1981, the Uruguayan authorities concentrated their efforts on price stabilization, adopting lower trade tariffs and other liberalization measures for this purpose. In the second period, after 1981, the recession produced a shift in emphasis that led to a diminished stabilization effort, the abandonment of some of the liberalization measures, and a more expansionary fiscal policy. Notaro's book ends by presenting a rather bleak outlook. After almost two decades of trying different kinds of economic policies, Uruguay continues to be besieged by stagnation, inflation, capital flight, financial crisis, and foreign debt.

Overview

Various attempts have been made recently to evaluate the stabilization and liberalization policies, efforts that we will not attempt to duplicate here.¹ We will highlight instead the most controversial feature of the stabilization programs, the *tablita*, and a few neglected aspects of the liberalization policies.

Use of the *tablitas* was the most distinctive feature of the Southern Cone stabilization programs. Two considerations should bear on any evaluation of the strategy. First, this approach was a gradual one in

which price stabilization was understood as a lengthy process. The authorities, particularly at the beginning of the programs, proceeded cautiously by announcing small reductions in the rates of devaluation. Second, the strategy assumed that announcing the exchange rate in advance would affect price behavior in two ways (see Sjaastad's contribution to the World Bank collection). It would work directly by affecting the prices of tradables and the cost of imported inputs; and probably more important, this strategy would presumably affect expectations about future inflation. By announcing future reductions in the rate of devaluation, the authorities attempted to influence price increases in forward-looking contracts and to provide a nominal anchor for future prices. In Argentina and Uruguay, the authorities tried to make the package more credible by announcing targets for future values of wages and public-sector prices (see Pastore's contribution to the World Bank collective work and also Notaro).

As is well known, the programs failed to achieve stabilization and were accompanied by problems in implementation. Although the rate of inflation fell in all three countries during the tablita period (as documented by Sjaastad's contribution to the World Bank collection), the rate of inflation did not converge as quickly as anticipated to the rate of devaluation. In effect, the pre-announced rate of devaluation represented a floor for the rate of inflation. The immediate effect was an appreciation of the real exchange rate (drastic in some cases), which became a major obstacle to the stabilization effort and greatly complicated implementation of attempts at liberalization.

The reasons for the slow convergence of inflation to the target figures have already been discussed in great detail,² and they continue to be the subject of heated debate. Although the real appreciation of the exchange rate appears to be a feature of most stabilization programs, its magnitude and duration in the Southern Cone experiments were unequalled. Yet these disturbing results do not necessarily imply that this strategy was erroneous, nor do they rule out the potential usefulness of the exchange rate as a nominal anchor in stabilization programs. Nevertheless, the tablita approach has important limitations, and improper implementation of the policy can lead to catastrophic outcomes.

One key to any successful stabilization program is consistency among the objectives for the different macroeconomic variables. The various instruments of the programs must also be appropriately managed. The Southern Cone programs suffered from various kinds of inconsistencies. The most obvious was the lack of harmony, mainly in Argentina, between the target for the rate of inflation and the prevailing budgetary situation.³ Many analysts agree that the Argentine authorities failed to correct the budget deficit, thereby undermining the program's credibility and making low inflation unattainable (see the Blejer,

Hanson, and Sjaastad contributions to the World Bank collection and Corbo and de Melo 1987). A more subtle inconsistency can arise from erroneous management of nominal variables. The existence of different rules for wages and the exchange rate should eventually lead to a distorted structure of relative prices that itself could threaten the stabilization effort. Chile suffered from this problem, particularly after 1979, because at that time the economy had a fixed exchange rate and full backward indexation of wages (see Corbo and de Melo 1987, the Edwards and Edwards work under review here, and Sjaastad's contribution to the World Bank collection). A third kind of inconsistency inhered in using liberalization instruments for stabilization purposes. For example, on several occasions, the Argentine and Uruguayan regimes reduced trade tariffs in order to control what they viewed as unjustified increases in prices. In doing so, they used instruments that are primarily intended to improve the allocation of resources to "discipline" domestic producers. This evidently mistaken approach sends a confusing message to the market because the government is liberalizing for the wrong reasons and is thus undermining the credibility of the liberalization effort with a measure that has only a one-time effect on price increases.

What have we learned about the utility of pre-announcement of the exchange rate as a stabilization instrument? It proved to be an ingenious strategy when viewed as a means of dealing with inertia resulting from forward-looking contracts. The announcement of future values of the exchange rate can indeed serve as the nominal anchor for these contracts. This strategy nevertheless suffers from many of the problems of alternative approaches.

Like other gradual programs, pre-announcement of the exchange rate requires much discipline and persistence in pursuing its objective. Because the stabilization period is bound to be long, the government must keep the basic instruments of the package in place for an extended time in order to withstand any nominal or real shocks that might threaten the stabilization effort. This requirement itself might be problematic for regimes that need to produce quick inroads into inflation to justify adopting restrictive policies. In addition, this approach implies greater exposure to the uncertainties associated with changes in the international economy.

The Southern Cone stabilization programs also raise important questions regarding use of the exchange rate to achieve stabilization and the amount of intervention that may be needed to ensure its success. A consensus has now emerged, based on empirical evidence (such as Morande 1986), that the law of one price does not hold in the short run. Some theoretical work can even be used to question its validity in the long run (for example, Betancourt and Gautschi 1988). Thus no

mechanical and direct relationship exists between the rate of devaluation and the rate of inflation. Nevertheless, the exchange rate continues to play an important role as a nominal anchor, even in very recent stabilization programs. A few examples of the strategy are the Austral and Cruzado Plans and the Bolivian and Israeli programs of 1985. Employing this approach does not require any firm belief in the law of one price. The central idea is that a program's success requires a commitment on the part of the government to maintain the nominal value of widely followed variables. Because the exchange rate and public-sector prices are readily observable (unlike the money supply), they become the natural targets in many programs.

Although having a goal for the exchange rate could be an important means of providing a nominal anchor for the system, a policy of stubborn adherence to that target, regardless of the prevailing circumstances, is dangerous and potentially destabilizing. This approach constituted a major problem in many stabilization programs based on exchange rates and was particularly evident in the Southern Cone experiments. Instead, regimes can increase the chances for success by remaining flexible in pursuing their targets and by considering the use of additional variables as anchors for the system. Once it becomes clear that the value of the exchange rate is not sustainable, the government should devise a mechanism (either a maxi-devaluation or a crawling peg) to change the exchange rate. Sticking with preestablished rules is likely to lead to a balance of payments crisis.⁴ The Southern Cone programs made serious mistakes by blindly adhering to the pre-announced path for the exchange rate, which created large external and internal imbalances with only limited gains on the inflationary front.

Following the collapse of the Southern Cone programs, inflation again became a serious problem in Argentina and Uruguay. Chile, in contrast, experienced only a short burst of inflation in 1982, as a result of the massive devaluations, and now enjoys one of the lowest inflation rates in Latin America. The lesson is that fiscal discipline and persistence can eventually succeed in reducing inflation.

Finally, the Southern Cone programs have demonstrated the existence of important interactions between structural adjustment and stabilization. Stubbornness in pursuing the pre-announced exchange rate and the resulting appreciation of the actual exchange rate undoubtedly undermined the trade liberalization effort. Similarly, liberalization of certain areas of the economy undermined the success of the stabilization program. For example, opening the foreign-capital account diminished the ability to control the money supply (Corbo and de Melo 1987). Likewise, liberalization of the banking system created new restrictions on deficit financing and built an inflationary bias into the economy (see Calvo and Fernández 1983). In sum, although liberalization and stabili-

zation are conceptually two distinct policy objectives that in principle require separate instruments, in practice they are very much interrelated and often require policy coordination for their overall success.

Evaluating the liberalization policies themselves is more difficult because their long-run microeconomic orientation allows for disparate interpretations. Many if not most Western-trained economists would view the Chilean trade liberalization as an unqualified success, especially when compared with earlier attempts in developing countries (including Chile), as analyzed in such works as Krueger (1978). Moreover, criticisms of the liberalization are based on weak arguments: the supposedly nefarious effects of expanding the service sector; the result that in an intertemporal world removing an imperfection now need not improve welfare if the imperfection is reimposed in the future; or the inappropriateness of evaluating policy in piecemeal fashion. The first argument has no conceptual foundation and presumably derives from bias favoring industry. The other two arguments are logically correct in the sense that one can always find situations in which the arguments apply in a context of general equilibrium, but in practical terms, these arguments do not apply in the case under discussion.

In all three countries, domestic financial liberalization can be viewed as a qualified success by those who prefer to view the glass as half-full rather than half-empty. The standard caveats warn that banks need supervision and high interest rates can be associated with higher savings (as in Uruguay) but need not be (as in Chile). Once again, most Western-trained economists would endorse some variant of these financial liberalizations. There is, of course, room for creativity in defining the preferred variant, given that deregulating and supervising are in some sense contradictory. Some aspects of this issue are discussed in Fry (1988, chap. 12, sect. 8). Liberalization of the foreign-capital account was one of the less successful liberalization policies. A leading proponent of financial liberalization in general warned in advance about the pitfalls of liberalizing the foreign-capital account (see McKinnon 1973, chap. 11). His warnings were certainly validated by the Southern Cone experience, and many economists now agree that this issue is a difficult one because of the velocity and size of the capital movements that can take place. Finally, the evidence on the "seven modernizations" in Chile is still too fragmented and preliminary to derive any general conclusions.

Now to consider the liberalization policies from a broader perspective. First, the liberalization policies implemented in the Southern Cone were part of a broader process of liberalization that was taking place in developed countries (see de Menil and Portes 1987) and also in other developing countries. Second, fundamental economic issues have

been raised by the type of experiments carried out in the Southern Cone and by liberalization attempts in general.

In the United States, for example, substantial attempts at liberalizing various markets (airlines, banking, and telecommunications) occurred during the 1970s and 1980s. Some of these policies are in the process of being adopted in most developed countries, such as the liberalization of airlines and banking by the European community in connection with unification of the market in 1992. South Korea and Taiwan pursued liberalization policies vigorously and with positive results that were visible by the early 1970s. At the same time, the role of large firms and the degree of government participation in private-sector decision-making has been quite different in these two countries (see Lau 1986). The Korean experience resulted in the development of large groups similar to the Chilean *grupos*. The Korean government, however, participated actively in "guiding" industrial development (see Pack and Westphal 1986), in contrast with the largely hands-off approach of the Chilean government, which resembles that of the Taiwanese. The fact that the Southern Cone liberalization experiments were taking place in this broader context is usually ignored in the literature under review here, perhaps because the experiments in the Southern Cone were inextricably linked with the fight against inflation through stabilization policies.

The existence of variants of liberalization experiments across systems as diverse as those mentioned above reflects a continuing search for appropriate means and scope of government interference in the actions of individual economic agents in an uncertain world. Perhaps the most important feature underlying this search is the inherent uncertainty associated with many economic decisions and their consequences. Individual economic agents can rely on markets to acquire information and appropriate the rewards of adapting to changing environments, but even in a capitalist society, agents can also use other mechanisms. For instance, as Coase pointed out long ago, the essential role of firms is to supplant the coordinating functions of markets, and uncertainty plays a key role in this process (Coase 1937). Firms have different organizational systems, and different ways of bringing together the decisions of individual economic agents can affect the nature of economic outcomes. For example, the type of errors made by agents in a system with respect to the approval or rejection of projects with uncertain outcomes will depend on whether this system has a form of organization that is polyarchical (marketlike) or hierarchical (commandlike) (Sah and Stiglitz 1986). Hence the questions of when, how, and why to rely on markets raise important issues that unfortunately receive limited attention in the works under review here. As the "new

institutional economics" develops in such works as Langlois (1986) and Nabli and Nugent (1986), these questions will be pursued more vigorously, and the liberalization experiments in the Southern Cone will likely be reassessed from a different perspective.

Last but not least comes the question of whether the seamier side of the regimes associated with these economic policies in the Southern Cone must be taken into account when evaluating the policies. We have obviously followed a long tradition in economics of not doing so, mainly because we believe these aspects are conceptually separable from economic issues. Conceptual separability, however, does not necessarily imply disagreement with the judgment that in any one country at a particular time, a large subset of these policies could only have been implemented by an authoritarian government. Conceptual separability merely suggests that things do not have to be that way everywhere all the time.

NOTES

1. Readers are referred in particular to Corbo and de Melo (1985, 1987) and Corbo et al. (1986).
2. See, for example, Calvo (1983a, 1983b), the Edwards and Edwards work under review here, Corbo and de Melo (1985, 1987), and Kiguel and Liviatan (1988).
3. This was not the case in Chile, where the government undertook a fiscal adjustment very early in the stabilization programs. By the time the tablita program was implemented, the government was running a budget surplus.
4. For a full discussion of this aspect of the problem, see Krugman (1979) and Kiguel and Liviatan (1988).

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