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# LATIN AMERICA: POST-ADJUSTMENT BLUES

*by Moises Naim*

One of the policy achievements of the 1980s was a new hemispheric consensus about the role of the state in the economy. In one country after another, reform movements tore down government-imposed obstacles to growth and trade, and it seemed that North and South America could end their bitter ideological disagreements about the roles of markets and government in economic development. But now, as Latin America moves toward the end of the 1990s, Washington may encounter some surprises to the south. Latin America, which has spent the last 10 years demolishing the state, will spend the next 10 rebuilding it.

The market-oriented reforms that almost all Latin American countries have adopted in recent years are showing strains: a fragile macroeconomic situation, lagging export growth, regulatory failures, and the epidemic of poverty. Those and other issues are pushing Latin governments into more activist roles. That does not mean that the pendulum will swing back: No regime in the area can afford, financially or politically, to resurrect the ways of the past. But the need for a new inter-American synthesis of the roles of market and state is rapidly becoming evident. While the practical difficulties of reversing many market reforms are obvious, the problems resulting from the absence or the incompetence of the state are also increasingly visible. Countries that have just discovered the market are now rediscovering the state and rehabilitating public agencies devastated by

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years of abuse and, lately, neglect. The danger, of course, is that many of the conditions that in the past made the state a powerful source of poverty and inequality will persist. Voracious business sectors, labor unions, military establishments, and other such groups continue to exert inordinate influence on government bureaucracies, where lack of resources, corruption, and institutional devastation remain the norm in most countries.

The outcomes of the rediscovery of the state will differ in each country. But the broadly similar factors that led to the adoption of market reforms throughout Latin America will remain important, limiting the scope and shape of state intervention. All countries are experiencing the same set of post-reform problems that erode enthusiasm for the market and increase demands for more vigorous state action.

In economics as in politics, events in Latin America have often caught observers by surprise. The region has gone from being the fuse of the debt bomb that threatened the international financial system to being a powerful magnet for global capital. Once plagued by dictators and authoritarian regimes, the continent is now almost entirely governed by elected presidents. Sweeping economic reforms have calmed the region's past macroeconomic shakiness. Episodes of hyperinflation are now rarer and the economy is slowly starting to grow after more than a decade of economic decay. Once the cradle of the import-substitution doctrine, Latin America has embraced export-led growth with the fervor of the East Asian dragons. Almost overnight, one of the most protectionist regions in the world has become one of the most open to trade.

All that happened quickly. In 1979, 12 out of 19 Latin American governments were authoritarian. By 1990, every country but Cuba had elected its president. Import tariffs that, on average, had reached more than 50 per cent in the mid 1980s were lowered to the teens in the early 1990s, while the extensive system of non-tariff restrictions to trade was also for the most part dismantled.

By the early 1990s, all of the region's countries—save Cuba—were liberalizing trade, pri-

vatizing state-owned enterprises, deregulating entire sectors of the economy, and fighting fiscal deficits. The pace and scope of reforms varied; the direction of change was the same everywhere: more markets, less state.

It was easy to interpret Latin America's break with its past as nothing short of an ideological revolution. Many articles and speeches extolled the new vision of markets and democracy that replaced the state-centered and authoritarian beliefs dominant in Latin America since the 1940s. Certainly, governments embellished their policies by launching them as new, all-encompassing programs for development. Undoubtedly, a major reconsideration of the region's economic ills and probable cures did occur among influential elites. But an ideological revolution it was not.

Not one of the democratic governments that launched market-oriented reforms ran on a platform of free trade, price liberalization, and privatization. The drastic reforms of elected governments almost uniformly surprised Latin American voters. The victories of Carlos Andrés Pérez in Venezuela and Carlos Menem in Argentina were influenced more by expectations nurtured by their past nationalistic and state-centered rhetoric and action than by the promise of free markets. Peru's Alberto Fujimori won by stridently denouncing such reforms, which constituted the platform of his main opponent, writer Mario Vargas Llosa. Once elected, however, Fujimori immediately adopted the same approach. In Brazil, Fernando Collor de Mello won on an anticorruption, antigovernment platform, and his successor, Itamar Franco, built much of his popular support by opposing Collor's attempts at economic liberalization. The Uruguayan government's privatization plans were stalled by a national referendum in 1992. A cursory reading of opinion polls and newspapers in the region shows that doubts about the market and hopes for a more activist state are still very much a part of public debate.

Despair, lack of alternatives, international circumstances, and political realism motivated Latin America's economic reforms—not fresh ideological commitments to capitalism and free trade. Newly elected governments had to re-

spond with new strategies to pressing problems that left them little room to maneuver. An emerging view among economists about how to avoid earlier failed experiments to tame inflation and restore growth helped shape the new policies, which were dubbed the "Washington consensus."

The situation had deteriorated to the point that governments could no longer afford to postpone unpopular economic corrections. High and persistent inflation, for example, paved the way for the unprecedented commitment of most governments to sound fiscal and monetary policies. Latin American countries learned from bitter experience that large fiscal deficits and a lax monetary policy were a recipe for inflationary levels that ravaged the poor, inhibited growth, and threatened the survival of any regime incapable of controlling spiraling prices. Privatization, in turn, was fueled by the realization that public funds desperately needed for other goals were being soaked up by the constant losses of state-owned enterprises. Moreover, the simple promise of working telephones and reliable garbage collection could build popular support for the sale of public utilities far more easily than ideological sermons about the private sector.

To restore consumer products to the shops and eliminate rationing, hoarding, and black-market profiteering, price controls had to be minimized or eliminated. But free prices in closed, cartel-dominated economies did not work. Therefore, import barriers had to be eased to inject a dose of competitive pricing in the system. Freer trade with an overvalued local currency is untenable. The aim was an exchange rate that did not facilitate imports but, instead, encouraged exports. Capital flight financed by borrowing locally at artificially cheap interest rates also had to be stopped. Therefore, interest rates had to be high enough to discourage borrowing for speculation, to reward deposits in local currency, and to stimulate capital repatriation. The disappearance of the abundant international credit that was available in the 1970s forced a change in attitudes toward export promotion and foreign investment. Hence, policies that relied on exports for growth and

foreign investment for capital, technology, and access to world markets were embraced across the region.

International experience also legitimized many of the changes. The success of East Asian economies showed that Latin American pessimism about the capacity of newcomers to compete in world markets was exaggerated. Spain's economic turnaround under Felipe González, Peru's debacle under Alan Garcia, Chile's success, and Mexico's progress generated strong —and culturally closer—demonstration effects. The collapse of the communist regimes in Eastern Europe and the Soviet Union also put Latin proponents of state intervention on the defensive. Finally, the only remaining suppliers of external credit to the region—the International Monetary Fund, the World Bank, and the Inter-American Development Bank—used their leverage bluntly, making loans contingent on comprehensive market-oriented economic reforms.

*Restructuring Latin America*

The failure of prior stabilization efforts in Latin America showed that trying to correct macroeconomic imbalances through slashing budget deficits, eliminating price distortions, and adopting tight money policies does not suffice. Those measures must be accompanied by more permanent changes in the structure of the economy. The core sources of fiscal imbalances—a bloated state, money-losing public enterprises, and low tax collections—must be addressed. Outward-oriented economic growth cannot be sustained without eliminating the export-impairing conditions and institutions left by decades of import-substitution policies. From ports and financial regulation to the trade regime and vocational training, fundamental aspects of a country's economic organization need to be reformed and integrated with the new export-led strategy.

Governments that adopted such a reform agenda have made rapid progress in correcting some of the worst problems. In most countries, after an initial and traumatic surge, prices, exchange rates, and the balance of payments began to stabilize. The cost of that gain was a

dramatic drop in economic activity and an increase in unemployment. Usually, however, the resulting stability, combined with deregulation, led to the return of foreign investment, mostly in the form of portfolio flows. Privatization stimulated direct, non-portfolio investment by foreigners. In many countries, economic growth eventually resumed, and employment and real salaries, which had been falling for a decade, halted their decline and in some cases began to grow again.

But the rapid pace of reforms proved impossible to maintain. With the exception of Chile and, to a lesser extent, Mexico, most governments encountered growing difficulties in attaining the deeper structural reforms. Many factors accounted for the slowdown. Stabilization programs are difficult and politically costly to launch, but their technical and administrative requirements are much simpler than those of structural reforms. In most countries, the executive branch of government has the power to cut public budgets unilaterally, liberalize prices, devalue the local currency, and tighten the money supply. In contrast to those "decree driven" measures, structural changes like privatization, the restructuring of social security systems, tax reform, and the institutional transformation of industry, agriculture, and higher education require more than the stroke of a pen and are immensely more complex. The public bureaucracy, Congress, the courts, state and local governments, political parties, labor unions, private sector organizations, and other interest groups all get involved in the process. The technical nature of structural changes makes for even more complexity. While foreign exchange controls can only be eliminated in a few ways, the debate about revamping the tax system or labor legislation can seem endless.

Structural changes also tend to take place at a very different political stage of the reform process. Stabilization measures typically are started within the first months of a new administration, when the opposition is disorganized and discredited and the government still enjoys a honeymoon with the electorate. The consequences of stabilization policies quickly eat up that political capital, however. When the time

comes to proceed with structural reforms, the opposition has usually regrouped and regained popularity and has more political power and institutional opportunities to block, delay, or water down the government's initiatives. Also, while macroeconomic stabilization tends to hurt everyone more or less equally, structural changes normally inflict the most harm on particular groups benefiting from the old policies. Farmers threatened with losing their subsidies or managers of public companies slated for privatization are more likely to organize effective opposition to reform than are consumers or workers surprised by countrywide stabilization measures. Moreover, the impact of such measures is, by definition, temporary. In contrast, structural changes are permanent.

**Not one of the democratic governments that launched market-oriented reforms ran on a platform of free trade, price liberalization, and privatization.**

The international context in which most Latin American countries are implementing their structural reforms is very different from the one in which they launched their stabilization policies. Euphoria about the collapse of communism and market-oriented reforms in the East has itself collapsed. Today, China's gradualism in economic reforms is widely praised, while Russia's attempts at shock therapy are constantly criticized. In the United States, the chief economist of the Clinton administration, Laura D'Andrea Tyson, has written that "free trade is not necessarily...the best policy." Ideas about "managed trade," "strategic industries," and "activist industrial policies" that Latin American governments had abandoned have begun to emerge as part of official U.S. economic doctrine, itself a reaction to similar policies practiced by the Japanese and Europeans.

Meanwhile, in Latin America itself, Haiti's coup, Venezuela's new political instability, the Fujimori administration's suspension of constitutional rule in Peru, its failed imitation by

President Jorge Serrano Elías in Guatemala, and the political obstacles to ratification of the North American Free Trade Agreement (NAFTA) have led to a more cautious mood about economic reforms and democracy. The 14 Latin American presidential elections scheduled between 1993 and 1995 are also bound to affect the pace of economic liberalization. As elections approach, unpopular decisions are postponed and calls from electoral contenders to "revise" or "rectify" the economic policies and "give them a human face" will become common. It remains to be seen whether the pattern of newly elected presidents pursuing economic policies they had disavowed as candidates will persist.

Governments in Latin America face a set of similar and important challenges. Some of the post-adjustment problems may undermine the benefits of successful efforts at stabilizing the economy. Others are creating political conditions that may impair the consolidation of democracy. The list of the burning issues for Latin American governments in the 1990s and beyond is long and varies in each country, but several areas of great concern have surfaced in almost all of them.

First, on the macroeconomic front, most countries continue to face enormous destabilizing pressures. Second, countries are experiencing growing difficulties in the management of their international trade policies. International protectionism and domestic obstacles to increased competitiveness inhibit export growth, while a unilateral liberalization of trade and a propensity for overvalued exchange rates lead to import surges. Together, those two factors create trade deficits and political pressures against freer trade. Third, states must meet the intense demand for sophisticated, and unprecedented, regulatory policies and institutions. Privatization, deregulation, and trade and financial liberalization impose new requirements for which governments throughout the region have little or no experience. Fourth, policymakers urgently need to upgrade the delivery of public services in general, and of health care and education in particular. None of those challenges can be met unless Latin America finds a way to

rehabilitate and strengthen the state without repeating the errors of the past.

*Life after Adjustment*

With the exception of Brazil, a country suffering from 1,500 per cent inflation in 1993, all Latin American countries have made impressive strides in putting their macroeconomic houses in order. Enormous fiscal deficits, once common, are now rare. Finance ministers in Argentina, Chile, and Mexico can even boast to their colleagues in the industrialized countries about their budget *surpluses*. Deep budget cuts, income from privatization, tax reform, and other such measures created a much sounder fiscal stance. As a result, inflation throughout Latin America has abated. But it has not yet been exorcised.

The single-digit inflation that was supposed to be a reward for the region's painful efforts has eluded all reforming countries. Even in Chile, which began its reforms more than a decade ago and has enjoyed immense macroeconomic success, yearly inflation runs at 12 per cent. For most countries, such persistent inflation can be traced to the legacy of indexation, which automatically adjusts salaries and other prices to inflation. Indexation is now deeply rooted in expectations, economic structures, and institutional and even individual habits. It takes time to eliminate this stubborn source of inertial inflation. The main threat, however, is that the newfound fiscal discipline, which in all countries has been a valuable ally in fighting inflation, will come under rapidly growing strains. Since the late 1970s, the region has accumulated a massive backlog of indispensable public investments that will be almost impossible to postpone for much longer. Thirty per cent of the population lacks electricity, almost a third have no access to public sanitation, more than a quarter cannot get safe drinking water, and about half of all the roads badly need rehabilitation or even reconstruction. The World Bank has estimated that it will take more than $7 billion per year over the next eight years to satisfy just the *current* unmet demand for electricity.

The regional decentralization that has accom-

panied democratization in Latin America adds further demands on public budgets as newly elected state and local officials stake their regional claims on national resources. Also, while the losses of once publicly owned companies no longer burden the state, the proceeds from privatization, which have contributed immensely to balanced budgets, will dry up as fewer companies are left for sale. Perhaps most important, public budgets will have to respond to the urgent need to expand social programs. Without measures to cushion the social impact of the structural reforms, people's fatigue from constantly adjusting to higher prices and lower budgets can easily develop into dangerous adjustment exhaustion. Under such circumstances, fiscal austerity becomes political suicide and governments lose their capacity or will to keep public budgets from bloating again.

Extremely high real interest rates throughout Latin America are also becoming a major source of macroeconomic stress. In countries with fiscal deficits, public borrowing is constantly pushing interest rates up. But paradoxically, in both Mexico and Argentina, which run fiscal surpluses and have crushed hyperinflation, misaligned exchange rates and other conditions have greatly stimulated imports, thus nurturing large, growing, and potentially destabilizing trade deficits. In Mexico, the current account deficit went from $6 billion in 1989 (3 per cent of GDP) to almost $23 billion in 1992 (nearly 7 per cent of GDP), and it will stay in that range in 1993. In Argentina, the current account deficit grew from $2.8 billion to $8 billion between 1991 and 1992. To make up for that imbalance, governments have pushed interest rates high enough to attract sufficient foreign flows of capital to partially offset their trade deficits. Mexico's $23 billion current account deficit in 1992 was largely compensated by the inflow of $18.9 billion of foreign funds, $13.6 billion of which was short-term portfolio investment—the kind least suitable for stable development. Similarly, in 1992 Argentina attracted $8 billion of foreign investment.

The precariousness of the situation is evident. Sooner or later, Argentina and Mexico will be forced to make complex adjustments. Their

inflation continues to exceed the U.S. rate, thus eroding their current exchange rate policies. Without broader reforms, high interest rates cannot maintain stability forever. The flow of foreign capital into Latin America is also likely to dwindle—at least temporarily—as investors see heightened devaluation risks and find fewer public companies to buy.

But the financial vulnerability brought about by the surge of foreign investment is not isolated to those two large countries. The combination of regionwide high interest rates, privatization, and deregulation pulled into Latin America substantial amounts of international capital, which was also pushed there by the industrialized countries' simultaneous slow growth and low interest rates. Flows of foreign direct investment to Latin America doubled in the last three years; since 1989 the region has drawn more foreign portfolio investment than any other developing region of the world. Latin stock markets have, since 1988, outperformed the Standard and Poor's index by 26 per cent in dollar terms. As a result of the inflows of capital, as well as of lower debt service payments, Latin America in 1992 amassed the highest accumulation of international reserves in history: $72 billion.

Nonetheless, the region's monetary authorities will in coming years confront new challenges associated with large inflows of capital—in particular, the vulnerabilities posed by short-term international money attracted by high interest rates. An immediate problem is that capital inflows are boosting the value of local currencies, thus damping exports. The major devaluations that accompanied the wave of reforms in the late 1980s created great incentives for exporters. But the competitiveness of exchange rates is constantly eroded by both capital inflows and the increasing attractiveness to governments of using a pegged, relatively fixed exchange rate to hold down inflation. For that approach to last, a country needs high international reserves and a tightly controlled fiscal situation. But as elections near—or impatience over resilient inflation sets in—governments will become more vulnerable to the seduction of exchange-based stabilization, re-

gardless of their capacity to meet its prerequisites. New ministers will soon discover that politics makes for slippery fiscal control but sticky fixed exchange rates; the former is hard to maintain while the latter are difficult to adjust quickly enough. Maintaining the new, painfully learned fiscal discipline will be a central preoccupation of Latin American policymakers as they strive to restore growth and manage the effects of political pressures on public finances. They will also face difficult choices in trying to balance the need to limit the inflationary impact of a constantly depreciating currency with the need to maintain the exchange rate at a level low enough to give new export sectors a chance in international markets. Without creating conditions for more exports, growth rates will probably sag, and with them the enthusiasm for market reforms and the governments that promote them.

*Coping with Trade Frustration*

Export growth will likely emerge as the issue where the expectations and promises of reforming governments are most unrealistic. The new policies have undoubtedly endowed most Latin countries with a greater potential to compete successfully in world markets than ever before. One surprise of trade liberalization is that the dream of regional integration that for centuries inspired more speeches than action is finally becoming a fact. As neighboring countries that historically kept each other at bay with high import controls eliminate them, cross-border trade and investment are soaring. Trade between Argentina and Chile went from less than $400 million in 1987 to more than $1 billion in 1992, while that between Colombia and Venezuela has been growing at double-digit rates. Total intraregional trade is climbing at unprecedented rates.

But trading with neighbors with a roughly similar mixture of exports has limits. The hope, therefore, is to move into world markets. Governments are quickly realizing that it takes much more than a major devaluation for their industries to become world-class players. Eliminating the anti-export bias embedded in the economic structure and in public and pri-

vate institutions will take much longer and be more traumatic than was generally anticipated. Years of underinvestment, protectionism, and technological backwardness have made Latin America's manufacturing firms utterly inadequate to meet the exacting requirements of international markets. Most local financial institutions have yet to learn how to handle export risks effectively, courts cannot be relied on to resolve commercial conflicts fairly and promptly, and the decaying physical infrastructure of the region sorely needs to be upgraded, as do health and education policies and the institutions that deliver them. In addition, labor legislation throughout the region still reflects the old schemes of protectionism and heavy subsidies. As a result, labor taxes are too high, dismissal costs are enormous, incentives for training are inadequate, labor mobility is restricted, and public employees tend to get automatic tenure. Meanwhile, the backward-looking indexation of wages is a source of inflationary inertia: In sum, the link between productivity and wages is absent.

Most of those obstacles are slowly being removed. But the lag in the reforms crimps the international competitiveness of Latin American exporters. As a result, the total export of goods from 1985 to 1992 increased only from $92 billion to $126 billion, while imports grew from $58 billion to $132 billion, thus creating in 1992 the first trade deficit for the entire region in many years. Notwithstanding some stellar performances like Chile's, since the 1950s Latin America has seen a steady decline in its export performance that the reforms have yet to reverse. The region's share of world exports sank from more than 12 per cent in 1950 to 3.6 per cent in 1992, the lowest in the century. Part of the reason is that the prices of the commodities like oil, sugar, coffee, and tin that still constitute the bulk of exports plummeted in the 1980s and have not recovered. But Latin exporters have also had to cope with extraregional trading partners that are lowering trade barriers much more slowly. The Japanese markets continue to be largely impenetrable to manufactures, and the European Community's Common Agriculture Policy and other obstacles

severely hinder the expansion of Latin American exports. NAFTA's dimming prospects are also being taken in Latin America as evidence that if free trade with Mexico is politically difficult in the United States, enacting a free trade agreement between the United States and any other Latin country would be close to a miracle.

Those domestic and international obstacles to export growth are already prompting industrialists to pressure governments to more actively support their foreign expansion. The region's press is full of businesses' complaints about how hard it is to compete when phones do not work, interest rates are so high, workers are not well trained, new technology is inaccessible, and foreign competitors enjoy support from their governments. Moreover, unilateral trade opening makes the region vulnerable to dumping by overseas exporters, common in certain industries such as clothing. Under these circumstances, trade liberalization and industrial policies that do not target specific sectors for governmental support become increasingly unpopular.

Latin America's experience with targeted industrial policies was disastrous. They mostly enriched the few shareholders of companies in "priority" industries and a few public bureaucrats. The policies also neutered any competitive instincts that might have existed in those industries. Nonetheless, given the widely publicized success of Japan and other East Asian countries with that approach, the attempts of the Clinton administration to resurrect it, and the difficulties of Latin governments in achieving the export success crucial to much of their political platforms, the political tide toward a more activist state role and targeted industrial policies is rising. But the conditions that earlier made such policies fail in Latin America remain. The private sector has not lost its enormous influence to steer public action to its benefit, while the public sector still lacks the capacity to resist. Without a more autonomous state, capable of interacting with the private sector more effectively, state support for industries will only bring back the corruption and the disincentives to compete that have prevailed for decades.

*Rediscovering the State*

The need to increase the autonomy of Latin governments' economic decision making goes well beyond export-promotion policies. Market reforms have created an overwhelming, mostly unprecedented demand for public regulation. When telephone or electric power companies were in the public sector, governments felt little pressure to develop an effective regulatory framework and a competent cadre of public regulators to oversee their operations. Privatization, however, creates an immediate need for such public services. The stock market can be liberalized with the stroke of a pen. Building the equivalent of the Securities and Exchange Commission takes much longer—especially since an effective competition policy and reliable antitrust agencies and courts were never a top priority under the state-centered, import substitution industrialization policies.

Governments will have to develop these new capacities as fast as possible, though the effort is bound to lag behind needs and expectations. Institution building is inherently a cumbersome process whose complexity, in this case, is amplified by the lack of experience, trained personnel, and financial resources as well as by the general weakness of the state in Latin America. It should come as no surprise that market failures and scandals resulting from poor regulatory frameworks and agencies will periodically rock all reforming countries. In some cases, such problems may accelerate remedial action and strengthen regulatory agencies. In other cases, however, regulatory failures will create a political backlash against reforms. A privatized utility's disappointing performance may increase the government's direct interference in its operation and erode public support for privatization; insider trading scandals in stock markets could spark a public reaction against their deregulation; the concentration of corporate ownership in a few economic groups might induce the state to intervene; and bankruptcies in the financial sector can lead to backtracking in reform there. Any government would have to react to such mishaps. But inexperience and political expediency are likely to lead to impro-

vised reactions influenced by old habits in society, the bureaucracy, and the political system. Economic reforms will not be reversed because of localized regulatory failures. But they will add to the heavy political burden that reformers in the region have to carry.

Latin America's extreme poverty and social inequities have been a fixture for centuries, as have government attempts to alleviate them. In most cases, such actions backfired, increasing poverty and further skewing income distribution. Too often, extensive price controls and generalized subsidies ended up subsidizing the rich, discouraging investment in the basic goods used by the poor, and encouraging the smuggling of underpriced "social products" (milk, bread, corn, sardines, beans, and basic medicines) to countries where they could fetch higher prices. Shortages of those goods often became chronic, burdening the public budget and fueling inflation.

**In 1992 Latin America suffered the first trade deficit for the entire region in many years.**

Another preferred way to deal with the social situation was through labor legislation. But those laws only covered the small portion of the urban labor force formally employed. By offering generous conditions and benefits often superior to those in industrialized countries, the laws made employment so costly that employers had strong incentives to evade them. The supply of jobs in the formal sector was sharply limited. And even the most generous labor laws failed to protect workers from the harsh declines in real wages the region experienced in the 1980s. That sort of legislation uniformly reduced competitiveness in the private sector.

But labor legislation hurt the poor perhaps most by devastating the capacity of governments to deliver the services they need most. State agencies in charge of health, education, housing, public transportation, and social security typically are the largest employers in the country. Therefore, they must deal with the most powerful unions. By capturing ever larger shares of government social spending in the

form of wages, and by creating formidable obstacles to institutional reform, organized labor greatly contributed to the inefficiency of social agencies. The administrative expenses of social security in Latin America are the highest in the world and normally make up the largest component of total social security outlays. Thus, contrary to common misconceptions, governments in Latin America have paid plenty of attention to social programs; overall budgetary limitations alone cannot explain the region's dire social conditions.

Recent economic reforms have had mixed consequences for the poor in Latin America. The recessions usually triggered by the launching of adjustment policies obviously hurt the poor. But at the same time, lower inflation and, subsequently, increased economic activity help. Also, governments have largely scrapped indirect subsidies, replacing them with compensatory social programs directly aiding the most vulnerable groups of society. In most countries, new public institutions and programs channel sizable resources straight to mothers, children, the elderly, and those living in "critical poverty." Until now, such innovations have avoided the deep operational problems that plague most other social initiatives. Maintaining the efficiency of the new "social emergency funds" and expanding their coverage will be a crucial task, and a daunting one. The direct delivery of goods and services to people in a specific group requires a sophisticated distribution and logistical network along with effective coordination and control systems. When the target population is hard to pinpoint and then reach systematically, that task is particularly hard. Expanding the population covered by direct subsidies will stretch to the limit the managerial capacities of new, inexperienced agencies.

But Latin America's social situation cannot improve through compensatory programs alone. Without major improvements in governments' capacity to deliver education and health care, progress in poverty alleviation and income distribution will be stunted. While in the late 1980s Latin countries could deal with their macroeconomic disarray through "shock therapies," without "institutional shocks" aimed at

transforming policies and institutions in charge of helping the poor, the social situation will stagnate and continue to breed instability.

In all countries, a principal aim of economic reforms is "to get prices right," from exchange rates to eggs. But the price that is seldom corrected in time, if at all, is that of the pay scale of managers in charge of getting all the other prices right. The always wide salary gap between public and private sector managers, which robs the state of skilled personnel needed to run it, has been wrenched open further by economic reforms. Fiscal austerity depresses government salaries, while economic liberalization boosts the demand—and the salaries—of managers in private business.

That is happening as states tackle the difficult post-adjustment challenges, which all generate political pressure for a greater role for governments. The regulation of business activities, trade and investment promotion, the direct distribution of goods and services to the poor, and macroeconomic management—all pull the state into new policy arenas.

The expansion of the state will not take the same forms or go as far as it did in the past. Financial realities, the painful lessons of macroeconomic instability, international trends, and the evident success of the new policies in certain areas will mitigate against that. But the problems of reform will begin to unleash political forces in Latin America that will slow the pace of reform and force midcourse corrections. Economic performance and political circumstances will determine how those contrary forces will balance out in different countries.

It is a paradox that after a decade of shrinking the role of the state economically, the future of Latin American market reforms will rest on the speed with which the state is rehabilitated and strengthened. Throughout the hemisphere reforms will stand a much better chance where governments can improve their performance and give institutional reforms the same priority macroeconomic stabilization has received in the recent past.