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Introduction: Debates, Performance, and the Politics of Policy Choice

JUST AS THE Great Depression of the 1930s triggered dramatic economic and political changes in Latin America, so too did the next major regionwide downturn—the 1982 debt shocks and the deep recession that persisted for the remainder of that decade. However, while the former crisis set the stage for nearly five decades of protectionism and populism in Latin America, the latter prompted the opposite response. Having found out the hard way that the world economy of the late twentieth century was a much different place to do business, a new generation of Latin American politicians and policymakers came to embrace deep market reforms by 1990. In turn, the steep reduction in barriers for trade and finance quickened the region's integration into international markets, where a boom in the flow of goods and capital had long been under way.[1] As a result, the total volume of Latin America's trade doubled through the course of the 1990s, and between 1990 and 1996 leading emerging-market countries like Argentina, Brazil, and Mexico saw a sixfold increase in net capital flows, including portfolio flows (bonds and equities) and foreign direct investment (FDI). This stands in stark contrast to the net negative outflows of capital that the region registered during the 1980s.

Despite this remarkable turnaround, the last decade has also shown that greater international exposure gives rise to more rigorous demands for coherent and credible macroeconomic policies. In short, whereas pre-1982

attitudes toward macroeconomic policy in Latin America basically amounted to a strategy of benign neglect, this option was foreclosed by the exigencies of the external sector in the wake of widespread market reforms.[2] Predictably, debates over macroeconomic policy became more politically charged. Decisions concerning trade negotiations or options for regional integration schemes became more contentious, as did efforts to resolve the kinds of currency crises and financial market stress that have intermittently plagued Argentina, Brazil, Mexico, and Venezuela—the four countries considered in this volume—since 1994. As Jeffry Frieden has observed, "increased levels of financial and commercial integration drive monetary policy toward the exchange rate, make the exchange rate more distributionally divisive, and lead to a more politicized context for the making of macroeconomic policy."[3]

This collection of essays examines the rise of a more politicized context for macroeconomic policymaking in Latin America from the standpoint of exchange rate management. Defined here as the price of a country's currency expressed in terms of other currencies or gold, the exchange rate has a direct impact on a wide range of relative prices. Admittedly, all macroeconomic policies are important, but under today's conditions of unprecedented commercial and financial openness in the region, changes in the level and stability of the exchange rate can more readily affect growth, employment, inflation, and other key economic indicators (for example, the relative price of goods, labor, and financial assets). Interestingly, despite a strong consensus regarding the importance of currency policy and the breadth of its impact, little attention has been paid to the role of politics in the choice and sustainability of a given exchange rate regime. Mexico, as the first Latin American country to experience a full-blown exchange rate crisis in the current era of market reform, has been most closely scrutinized. Given the prominent role that politics has been assigned in provoking that crisis, the purpose of this volume is to expand the analysis of exchange rate politics to other countries in the region.[4]

I begin with a fairly simple set of questions. What are the main debates that have surrounded exchange rate policy since the advent of market reforms in Latin America? In comparing economic performance across the four countries considered here, what political economy lessons can be gleaned from the standpoint of exchange rate management? If politics is indeed relevant, what are the main societal factors and institutional mechanisms by which it has been brought to bear on macroeconomic decision-making? These questions are briefly explored below.

The Main Debates

Two overlapping themes have characterized the debate over exchange rate policy in Latin America since the widespread implementation of market reforms. The first regards the kind of exchange rate regime that would best complement the new liberal economic model. Opinions differ widely, for the liberal economic paradigm offers no clear guidance.[5] For instance, two Nobel Prize–winning liberal economists, Milton Friedman and Robert Mundell, have argued respectively for a freely floating exchange rate and a rate fixed to the gold standard.[6] Debates about exchange rates have remained a steady feature of the post–Bretton Woods shift from fixed to flexible currency arrangements,[7] but Latin America's overt struggle with these issues in the context of more open economies has revived earlier discussions about policy choice in the region.

The radically changed development strategies of Latin American countries have also given rise to new challenges; a second theme to emerge over the past decade concerns how exchange rate policy can better cope with new pressures. Specifically, the liberalization of the current and capital account has created additional pressures toward exchange rate appreciation. When capital flows accelerate and the exchange rate fails to adjust accordingly, inflationary pressures mount and the real exchange rate will appreciate through higher domestic inflation. Within this scenario, a familiar regional pattern in the 1990s has been the growing tendency toward current account deficits and the increased reliance on portfolio flows and high interest rates to attract additional capital to finance those deficits. The pressure toward currency appreciation under these circumstances has remained steady regardless of the various exchange rate regimes that have been adopted.

The bottom line appears to be a given government's political commitment to implement the domestic policies necessary to sustain the currency at a competitive level.[8] At any rate, as these emerging-market countries have harnessed their economic fate more directly to the external sector through the active promotion of exports and FDI, exchange rate appreciation works to undermine efforts at more successful integration into international markets.[9]

The range of exchange rate options embraced by the leading Latin American economies over the past decade is mapped out in figure 1-1. As the figure shows, there are few alternatives that Latin American policymakers have not tried. The figure corresponds with the three main regimes

Figure 1-1. *Latin American Exchange Rate Regimes*

Argentina	Mexico (until 1994) Brazil, Chile (until 1998)	Venezuela	Mexico (1995–) Brazil, Chile (1999–)
Fixed rate	Narrow band (with inner band)	Managed float or average band	Floating rate
Exchange rate anchor	←	→	Monetary anchor

Source: J.P. Morgan, *Latin American Economic Outlook,* August 28, 1998, p. 11.

that Max Corden discusses in his overview chapter: the firmly fixed rate regime, the fixed but adjustable rate regime (FBAR), and the floating rate regime. The left end of this continuum can be characterized as the nominal anchor approach, where a fixed or crawling peg exchange rate is used to exert downward pressure on a country's inflation rate. At the right end of the continuum lies the real targets approach, where the nominal exchange rate is used to achieve such targets as higher employment or a turnaround in the current account. Corden cautions that "no regime has only advantages or disadvantages—trade-offs are always involved. . . . [M]any regimes are possible and can appear successful provided there is no major shock."

Nevertheless, the literature is full of arguments in defense of one strategy over the other. Given Latin America's strong and patently unsuccessful reliance on FBAR regimes throughout most of the post–World War II period, common wisdom in the 1990s has increasingly discounted this intermediate strategy as obsolete.[10] Such intermediate regimes are no longer viable under conditions of high capital mobility and tightly knit patterns of international financial integration, so the argument goes. In other words, countries are faced with the choice of fixed (Argentina) versus floating (Mexico) rates. Yet there are clear exceptions to this notion of a disappearing middle ground, the case of Chile being a main one.

With its longer timeline on liberalization, and its rock-solid macroeconomic fundamentals in the post-1982 period, Chile has been the region's stellar performer for nearly two decades. A main fundamental has been the

exchange rate, which until 1998 consisted of a nominal rate system based on a crawling band. Chile's exchange rate band, in conjunction with minimum stay requirements for FDI and nonremunerated reserve requirements for other forms of capital inflows, enabled the economy to withstand external shocks such as Mexico's currency crisis in late 1994. It also formed the linchpin of an economic strategy that sought quite effectively to promote high growth and low inflation through aggressive export expansion.[11] (The Chilean case was not included in this project because it has already been so thoroughly studied.)[12] Suffice it to say here that Chile's main responses to the Asian, Russian, and Brazilian shocks of 1997–98—the shift to a floating rate and the abandonment of capital controls—are testimony not to the discovery of a "better" exchange rate policy, but rather to policymakers' recognition that changing international circumstances warranted a different course of action on the domestic front.

Although the very diversity of options that have been embraced in Latin America under the intermediate banner (for example, crawling pegs, bands, currency baskets) makes it difficult to specify the trade-offs, these stand out more clearly at either end of the continuum in figure 1-1. On the side of fixed exchange rates, the advantages lie in the government's enhanced credibility by way of greater macroeconomic discipline and inflation reduction; the trade-off concerns the extent to which the welfare of the domestic economy comes to depend on trends in the external sector, especially under conditions of high capital mobility and volatile financial flows. As for flexible or floating currencies, the benefits lie in the exchange rate system's ability to adjust for shifts in competitiveness, to absorb real external shocks, and to mitigate both incoming and outgoing capital surges; the risks are a greater susceptibility to erratic exchange rate swings that place stress on the tradable sector, and the temptation for governments to ease up on fiscal and monetary discipline in the absence of a nominal anchor.

Again, these trade-offs make it difficult to argue for the superiority of one regime over another. The shifting policy choices reflected in figure 1-1 suggest that a regime that is deemed appropriate at one point in time may simply not be as viable at a later point. In this collection of case studies we argue that the moment of truth—to adjust or defend the exchange rate—is more than just a technical matter. Rather, it is also a political decision, and one that goes to the heart of a country's commitment to succeed in implementing the policies necessary to sustain the regime that has been chosen.

Macroeconomic Performance and Empirical Realities in the 1990s

The four countries included in this study were chosen for several reasons. First, as the four largest economies in the region, these cases are roughly similar with regard to their status as emerging-market, or middle-income developing, countries. Moreover, at the very least the term *emerging-market* implies that all four have made considerable headway in the implementation of liberal economic reforms. Although Venezuela's market reform effort was waylaid by domestic politics midway through the 1990s, as Javier Corrales points out in his chapter, policymakers still managed to preserve important institutional mechanisms that helped to rationalize exchange rate policy.

However, despite their similar status, the four cases differ considerably on the dependent variable: choice of exchange rate regime. As figure 1-1 shows, Mexico and Brazil are on relatively new terrain with their flexible exchange rate regimes, while Argentina is on fairly extreme ground with its exchange rate fixed tightly to the U.S. dollar under a currency board. Finally, Venezuela remains in the intermediate range with its exchange rate band. The main departure point for the analyses in this book is this variation in national policy responses, which is ascribed to the kinds of political pressures that affect domestic policymakers.

Just as the choice of an appropriate exchange rate system has elicited differing views, so too has the question of macroeconomic performance under a given currency regime. Chile's success under an intermediate exchange rate policy has drawn the widest consensus,[13] but after agreeing on this, policy analysts have quickly parted ways. From the extensive political economy literature on Latin America, it is possible to find convincing empirical arguments for each end of the exchange rate continuum presented in figure 1-1. For example, in defense of more flexible arrangements, one recent survey of some twenty-five stabilization episodes in the region found that only a third of those based on a nominal exchange rate anchor were successful; the more common outcome was for fixed exchange rates to give way in the face of continued inflation, as opposed to stabilizing prices.[14]

Yet the evidence is ambiguous. Recent studies conducted by researchers at the Inter-American Development Bank (IDB) reassessed the supposed benefits of greater exchange rate flexibility: on all fronts—from the ability to better absorb external shocks to greater ease in adjusting to shifts in competitiveness—a more flexible regime was found to be equally wanting. As

the IDB's former chief economist, Ricardo Hausmann, summarized the findings: "Flexible exchange regimes have not permitted a more stabilizing monetary policy and have tended to be more procyclical. Moreover, flexible regimes have resulted in higher real interest rates, smaller financial systems and domestic interest rates that are more sensitive to movements in international rates. Flexible regimes also tend to promote wage indexation. Worse yet, while flexible regimes are billed as a means of maintaining competitiveness, the revealed preference of Latin America is to allow very little exchange rate movement, even in periods of large real shocks such as 1998."[15]

In light of these trends, and in recognition that "fixed exchange rates are never fixed for long," the IDB project explores proposals for dollarization—the ultimate precommitment that a major devaluation will not occur. This volume tackles the question of dollarization only in passing. First, it is still too early in the game to speak definitively about this policy option. Some of the proposals coming from Latin America (Argentina, Ecuador, El Salvador, and several other Central American countries) in the wake of the Brazilian crisis show promise; in the event that they become a reality, the advent of dollarization in Latin America would warrant another collection of essays. But second, it is still not clear if the necessary political constituency exists within the United States to advance dollarization in the Western Hemisphere.

If neither the debates nor the data offer much in the way of lasting "empirical realities," the shift toward greater exchange rate flexibility is indeed an unmistakable trend across the developing world. Whereas pegged rates prevailed in 87 percent of developing countries in 1975, by the mid-1990s this figure had dropped below 50 percent.[16] In Latin America, where this shift has unfolded in two stages, the trend toward flexibility has been more pronounced. In the early stages of adjustment following the 1982 debt shocks, high inflationary pressures and extremely low credibility rendered a fixed or semifixed regime the more sensible choice. Yet as inflation subsided, growth recovered, and fiscal and monetary reforms were implemented, a more flexible system made better sense.[17] Apart from the costs and benefits reviewed earlier, the trend toward more flexible rates has been generally associated with the liberalization of trade and investment in the 1990s, and with the stronger emphasis on market-driven currencies and interest rates.

The data in table 1-1 reflect the macroeconomic trends that have underpinned this shift toward greater exchange rate flexibility in all but the Argentine case. As can be seen from the five-country comparison, by the

Table 1-1. *Comparing Economic Performance: Argentina, Brazil, Chile, Mexico, and Venezuela, 1993–2000*

Indicator	*Average 1993–97*	*1998*	*1999*[a]	*2000*[b]
Argentina				
Real GDP (percentage change)	4.4	3.9	–3.0	4.0
Consumption[c]	3.0	7.7	–2.8	3.7
Investment[c]	1.8	–3.8	–1.6	1.4
Consumer prices	3.7	0.9	–1.2	0.0
Percent (Dec.–Dec.)	2.6	0.7	–1.8	1.0
Government balance (percent of GDP)	–1.2	–1.8	–2.7	–2.1
Exchange rate (units/U.S.$)	1.00	1.00	1.00	1.00
Merchandise trade balance (U.S.$ billions)	–0.9	–3.1	–0.8	–1.5
Exports	20.2	26.4	23.3	26.3
Imports	21.1	29.6	24.1	27.8
Current account balance	–8.3	–14.6	–12.2	–13.5
Percent of GDP	–3.1	–4.9	–4.3	–4.6
International reserves (U.S.$ billions)	21.0	33.2	34.6	36.4
Total external debt (U.S.$ billions)	101.20	141.10	144.60	153.30
Short term[d]	17.6	20.9	21.4	22.4
Total external debt (percent of GDP)	36	45	51	51
Total external debt (percent of exports)[e]	339	357	416	391
Brazil				
Real GDP (percentage change)	4.2	–0.1	0.8	3.7
Consumption[c]	3.7	0.4	–0.8	2.3
Investment[c]	1.7	–0.5	–0.8	0.9
Consumer prices	290	3.2	4.9	7.4
Percent (Dec.–Dec.)	226	1.7	8.9	6.5
Government balance (percent of GDP)	–19.9	–8.1	–9.5	–3.6
Exchange rate (units/U.S.$)	0.82	1.21	1.81	1.90
Merchandise trade balance (U.S.$ billions)	1.6	–6.6	–1.2	4.3
Exports	45.9	51.1	48.0	57.6
Imports	44.2	57.7	49.2	53.2
Current account balance	–14.8	–33.6	–24.4	–23.3
Percent of GDP	–2.3	–4.3	–4.4	–3.5
International reserves (U.S.$ billions)	45.3	42.6	36.3	37.3
Total external debt (U.S.$ billions)	195.6	258.6	245.3	241.5
Short term[d]	55.6	38.0	32.0	30.0
Total external debt (percent of GDP)	29	31	45	37
Total external debt (percent of exports)[e]	330	364	406	337

(continued)

Table 1-1. *Comparing Economic Performance: Argentina, Brazil, Chile, Mexico, and Venezuela, 1993–2000 (Continued)*

Indicator	*Average 1993–97*	*1998*	*1999*[a]	*2000*[b]
Chile				
Real GDP (percentage change)	7.6	3.4	–1.1	7.0
Consumption[c]	5.9	2.7	–1.9	6.1
Investment[c]	5.2	–0.5	–9.2	5.0
Consumer prices	9.2	5.1	3.3	3.9
Percent (Dec.–Dec.)	8.4	4.7	2.3	4.5
Government balance (percent of GDP)	2.1	0.4	–1.5	–0.3
Exchange rate (units/U.S.$)	420	473	530	505
Merchandise trade balance (U.S.$ billions)	–0.3	–2.5	1.7	0.6
Exports	13.8	14.8	15.6	18.0
Imports	14.1	17.3	14.0	17.5
Current account balance	–2.7	–4.2	–0.1	–1.5
Percent of GDP	–4.5	–5.7	–0.2	–2.0
International reserves (U.S.$ billions)	13.8	15.7	14.7	15.3
Total external debt (U.S.$ billions)	23.1	33.5	35.0	37.6
Short term[d]	3.1	2.5	2.3	2.6
Total external debt (percent of GDP)	36	42	51	47
Total external debt (percent of exports)[e]	123	152	162	152
Mexico				
Real GDP (percentage change)	2.3	4.8	3.7	5.5
Consumption[c]	0.5	4.1	3.0	3.6
Investment[c]	0.7	1.8	0.3	2.9
Consumer prices	20.8	15.9	16.6	10.9
Percent (Dec.–Dec.)	21.0	18.6	12.3	9.5
Government balance (percent of GDP)	0.0	–1.3	–1.2	–0.8
Exchange rate (units/U.S.$)	6.35	9.91	9.48	9.90
Merchandise trade balance (U.S.$ billions)	–3.5	–7.9	–5.4	–11.2
Exports	79.7	117.5	136.7	160.7
Imports	83.3	125.4	142.1	171.8
Current account balance	–12.8	–15.7	–14.0	–20.8
Percent of GDP	–3.5	–3.7	–2.9	–3.6
International reserves (U.S.$ billions)	19.3	31.8	32.4	33.4
Total external debt (U.S.$ billions)	160.3	163.7	162.5	171.5
Short term[d]	45.8	39.9	40.1	40.6
Total external debt (percent of GDP)	43	38	34	29
Total external debt (percent of exports)[e]	162	112	102	91

(continued)

Table 1-1. *Comparing Economic Performance: Argentina, Brazil, Chile, Mexico, and Venezuela, 1993–2000 (Continued)*

Indicator	*Average 1993–97*	*1998*	*1999*[a]	*2000*[b]
Venezuela				
Real GDP (percentage change)	1.4	–0.1	–7.2	4.2
Consumption[c]	–0.5	0.2	–2.4	4.3
Investment[c]	–0.7	–0.5	–4.6	2.2
Consumer prices	60.5	35.8	23.6	17.8
Percent (Dec.–Dec.)	61.3	29.9	20.0	17.5
Government balance (percent of GDP)	–3.1	–7.0	–3.4	–1.1
Exchange rate (units/U.S.$)	309.2	564.5	648.8	750.0
Merchandise trade balance (U.S.$ billions)	8.3	2.7	9.2	10.2
Exports	19.5	17.6	20.9	26.8
Imports	11.1	14.8	11.8	16.6
Current account balance	3.0	–2.6	5.5	4.3
Percent of GDP	4.2	–2.7	5.4	4.0
International reserves (U.S.$ billions)	9.9	11.9	12.3	12.9
Total external debt (U.S.$ billions)	37.8	37.2	35.7	34.6
Short term[d]	5.0	4.0	3.7	3.7
Total external debt (percent of GDP)	54	38	36	33
Total external debt (percent of exports)[e]	167	169	148	115

Source: Morgan Guaranty Trust, "World Financial Markets," April 14, 2000, pp. 55–63.
a. Estimated.
b. Forecast.
c. Contribution to growth of GDP.
d. Debt with original maturity of less than one year.
e. Exports of goods, services, and net transfers.

mid-1990s inflation was finally under control (with the regional average below 9 percent by 1999), growth had been restored to varying degrees, and government finances were much improved in three of the five cases. Thus by mid-decade, Argentina and Mexico had joined Chile in achieving the goals of monetary stability and enhanced credibility that are most associated with a fixed or semifixed rate. At the same time, however, the running deficit in the trade balance and the current account reflects the continued pressure and volatility that these countries face on the external front. The tendency in all five cases has been to linger too long with an appreciated and artificially strong exchange rate, at least until unmanageable external shocks prompted a currency crisis.

This is just what occurred, for example, when Chile's exchange rate crashed under the force of the 1982 debt shocks, the Mexican peso fell in the face of reckless private borrowing and massive capital outflows in 1994, and the Brazilian real buckled in late 1998 under the weight of fiscal mismanagement and contagion from crises erupting in Asia and Russia. In these cases, as in Venezuela, a choice of greater exchange rate flexibility was the immediate outcome of financial crisis. As figure 1-1 shows, only Argentina has held the line in defending a fixed exchange rate in the 1990s, despite its exposure to these same patterns of financial contagion and volatility in international capital flows. Nevertheless, this clear shift toward greater flexibility should not be taken as an indictment against fixed rates: the data continue to confirm that currency misalignments and financial blowups are equally likely under fixed and flexible arrangements. For example, between 1975 and 1996, in a sample of 116 developing country cases where the exchange rate fell at least 25 percent in one year, nearly half of these major adjustments occurred under flexible regimes.[18] At the end of the day, success or failure seems to depend as much on policymakers' tenacity and the ability of political leaders to garner broad support for the chosen strategy as it does on the technicalities of macroeconomic policymaking.

Exchange Rate Politics

This study approaches the question of exchange rate politics from two angles. First, it considers the conflicting pressures that special interests exert on political leaders and policy officials in demanding that the exchange rate be maintained at a certain level. The exchange rate preferences of special interests in the four Latin American countries studied here tend to fall roughly along the following lines.[19] Traditionally, domestic producers in Latin America have been the most vociferous and the most divided in stating their currency preferences. Those producing for export prefer a depreciated but predictable exchange rate policy, while those involved in production for the home market are prone to push for a more flexible monetary policy overall, including an adjustable exchange rate. International investors clearly side with exporting interests in their demands for stable and predictable prices. In the wake of the high inflation rates that prevailed until the 1990s, workers and middle-class consumers have come to prefer overvalued fixed rates, which they associate

Figure 1-2. *Exchange Rate Politics in the 1990s*

	Exchange Rate Regime		
Politics	*Fixed rate*	*Intermediate rate*	*Floating rate*
Elite politics prevail	Mexico (1988–94)		
		Venezuela (entire decade)	
	Argentina (1991–94)		
Greater reliance on societal intermediation	Brazil (1994–98)		Mexico (1995–)
		Chile (until 1998)	Brazil (1999–)
	Argentina (1995–)		Chile (1999–)

with enhanced purchasing power (cheaper domestic credit and ready access to affordable imported goods).

Second, this book considers the broader political coalitions and institutional mechanisms through which monetary policy is mediated. The approach to this second question is portrayed in figure 1-2, which suggests a shift toward increased reliance on societal intermediation over the past decade—through legislatures, business chambers, labor organizations, political parties, and consumers-at-large—in the execution of exchange rate policy. In essence, during the initial phase of market reform in Latin America, policymakers moved swiftly and somewhat autocratically in launching stabilization programs that sought to combat prohibitively high inflation rates through the use of fixed exchange rates. As the goals of a nominal anchor were gradually achieved (price stability and greater credibility) in Argentina, Brazil, and Mexico, along with the completion of crucial first-phase market reforms based on liberalization, privatization, and deregulation, the tasks of economic management changed.

By the mid-1990s, although Venezuela had yet to fully advance on these first-phase reforms, the other three countries faced two kinds of second-phase reform challenges: the need to further deepen market initiatives in areas that lagged (labor market reforms, fiscal modernization at the munic-

ipal level), and the need to strengthen the institutional backdrop that supports market reform (more stringent defense of property rights, more authentic regulatory and oversight mechanisms).[20] With regard to exchange rate management, the advent of second-phase reforms meant that the overall economic fundamentals were now sound enough to signal a lasting commitment to low inflation. Despite the heated debates in the literature over where to proceed from here, and the failure thus far to identify a graceful exit strategy from the nominal anchor, some argued convincingly for greater flexibility on the grounds that "after these initial objectives are achieved, and once the fiscal and monetary sides are under control, a switch of anchor will be called for, and a more flexible system—either a managed float or a crawling peg—should be adopted."[21]

But paradoxically, while greater exchange rate flexibility, or the process of allowing the market to determine the relative value of the currency, may imply a hands-off political strategy, just the opposite is true. If anything, politicians and policymakers have been increasingly careful to woo special interests and to offer a wide range of compensatory perks in order to maintain political support over time. This compensatory imperative stems both from the more intense levels of economic competition to which all segments of civil society have been exposed in the era of market reform (and thus the need to offer some respite to the losers in the reform process) and from the inability of flexible rates to fully buffer and absorb the highly volatile external shocks that have occurred in rapid fire beginning with Mexico's 1994 crash.

The four case studies in this volume probe the ways in which domestic politics has tipped the balance in favor of a particular exchange rate regime in the 1990s. Although Mexico and Brazil indeed opted for greater exchange rate flexibility, as one prominent strand of macroeconomic thinking has recommended they should, why did it take a massive financial crisis to wrest an anchored regime from the hands of policymakers in both countries? Conversely, how is it that Argentina has held the line on a fixed rate regime, despite the costs of austerity, deflation, and double-digit unemployment? Finally, why has Venezuela dragged its heels for so long in maintaining a defensive macroeconomic strategy that no one recommends, mainly because of its strong association with the lackluster prereform period in Latin America? In all four of the country chapters, the role of special interests, domestic institutions, and old-fashioned statecraft in shaping these diverse responses to similar external contingencies are explored.

In his chapter on Mexico, Tim Kessler attributes the Salinas administration's rigid policy stance to the numerous political-economic contradictions that the ruling party (PRI) had itself cultivated over the course of Salinas's term (1988–94). On the domestic front, the anchoring of the nominal exchange rate in conjunction with an aggressive structural adjustment program helped trigger a long-sought-after economic recovery led by exports and the return of capital flows to Mexico. Moreover, by locating this stabilization-cum-liberalization strategy within a series of ongoing social pacts negotiated between the state, capital, and labor, PRI policy officials were able to project an image of greater public input and accountability.

Hindsight shows, however, that beneath this veneer of *concertación*, the PRI was mainly up to its old tricks of securing political survival regardless of the potentially devastating economic costs. As Kessler argues, the maintenance of an overvalued exchange rate appealed to a broad domestic constituency composed of financial, industrial, and consumer interests. By containing inflation and the cost of mounting dollar-held debts, and by superficially pumping up consumer purchasing power, the prevailing macroeconomic strategy may have been unsustainable in the long run, but it did position the PRI for a political comeback after the beating it took in the 1988 presidential elections. Thus in terms of domestic politics, the refusal to adjust the exchange rate even though the 1993 year-end economic indicators had set red lights flashing can be partially blamed on the electoral cycle and the PRI's determination to prolong its seven decades of control over the Mexican presidency.

But there were also new kinds of pressures on the international front that favored a fixed and overvalued exchange rate. Almost unwittingly, Mexico had become the test case for what David Hale calls the first "post–Cold War surge in securitized capital flows" to the developing countries since before World War I.[22] International and personal investors, who held an unprecedented $34 billion in Mexican equities in 1994, were especially adamant in demanding that the Salinas team hold the line on the exchange rate. Furthermore, Washington viewed the U.S. trade surplus with Mexico in the early 1990s (largely a result of the strong peso) as a main selling point in favor of Mexico's entry into the North American Free Trade Agreement (NAFTA). The PRI used this combination of booming capital flows and the prospect of NAFTA entry, both of which were contingent on Mexico maintaining its macroeconomic status quo, to further bolster its political standing in the 1994 presidential elections.

In the final analysis, despite the tenacity of Mexican policymakers in honoring their exchange rate commitment at home and abroad, the Salinas administration had, in fact, lost control of the macroeconomic fundamentals. Mexico's credibility plummeted as the PRI found itself wedged between the various domestic and international interests that it had so actively courted but could no longer please with a sinking currency. From the standpoint of exchange rate debates, it does appear that the shift to a more flexible regime after 1994 has enabled policymakers to better coordinate macroeconomic policy under much higher levels of trade and financial integration. Yet despite Mexico's impressive economic recovery, under way since 1996, Kessler notes that the PRI has in recent years faced greater levels of political contestation and electoral competition than ever before. This is because of the numerous multiplier effects from the peso crisis—a massive bailout of the domestic banking sector, ongoing allegations of PRI corruption, a relentless wave of urban crime, and an explosion in poverty rates. Ironically, although the PRI has long stalled in the implementation of political reforms that would allow for greater societal intermediation and public accountability, a main legacy of the 1994 crisis has been the ruling party's loss of political control and—as the 2000 presidential victory of National Action Party (PAN) candidate Vicente Fox confirms—the advent of more open politics in Mexico.

Like Mexico, Brazil has landed on a path of exchange rate flexibility through no choice of its own. In both cases, policymakers were overwhelmed by the task of reconciling domestic political demands and international pressures in the context of an anchored exchange rate regime. By early 1999, Brazil's exchange rate was just one of many to come unhinged in the era of post–Cold War securitized capital flows. Thus Brazilian policymakers were certainly more aware than their Mexican counterparts had been of the dire global repercussions of slack macroeconomic policy management. This, unfortunately, did not mean that they were able to exert the necessary political control over economic policymaking. A main difference between the two cases was the more chaotic political backdrop that had prevailed over time in Brazil, where the conflicting and uncontrolled claims of various special interests had fueled high inflation and economic stagnation for more than a decade. This accounts for the cause of Brazil's January 1999 devaluation—chronically high fiscal deficits (see table 1-1)—in contrast to the Mexican crisis, which was triggered by reckless private sector spending and borrowing.

In her chapter on Brazil, Eliana Cardoso begins by asking why policymakers opted in 1994 to target the exchange rate to stabilize inflation when this strategy had already failed in Mexico. The answer: after a string of unsuccessful stabilization plans that began in 1986, it was no longer possible to accommodate inflation through the pervasive use of price indexation and a competitive exchange rate policy. Just as Mexico finally devised the right combination of anti-inflation policies in 1987, and Argentina in 1991, Brazilian policymakers found their way toward price stability with the launching of the Real Plan in late 1993. The plan, based on fiscal adjustment, monetary reform, and the setting of a nominal exchange rate anchor, fostered an average GDP growth rate of 4 percent from 1994 to 1997 and reduced annual inflation to less than 2 percent by 1998. However, as noted, Brazil's fiscal adjustment never gathered steam, and Cardoso attributes this to the end of inflation, which made fiscal problems more transparent but also more difficult to handle.

In terms of exchange rate policy, the coupling of deep market reforms with a fixed and appreciating currency set the stage for a boom in imports and durable goods consumption. Domestic demand was further spurred by several increases in the minimum wage and in government salaries between 1993 and 1995. Exporting interests, long accustomed to a low exchange rate that favored tradable goods, were not happy with the exchange rate's antiexport bias. But they were readily compensated by the government's offering of subsidized credit and tariff increases for the hardest-hit sectors. Predictably, the government's efforts to juggle these demands within the confines of the Real Plan were thwarted by volatility in the external sector. In the absence of the necessary fiscal tightening, the burden of adjustment fell disproportionately on monetary policy. High interest rates helped to attract heavy capital inflows, but they also exacerbated the mass of bad debts that had accumulated within the state banks. By the time the Asian and Russian crises had unfolded, Brazilian policymakers could no longer count on high interest rates to attract the magnitude of capital flows needed to cover the fiscal and trade deficits that had burgeoned under the Real Plan.

As in Mexico in 1993, in Brazil in 1998 it was clearly time to adjust the exchange rate. At first glance, the main political constraints were the upcoming October 1998 presidential elections and the reluctance of President Fernando Henrique Cardoso to upset his strong prospects for reelection. In the period following that election, however, when it had

become apparent that there were simply no more substitutes for a sound fiscal policy, the very worst aspects of traditional Brazilian politics again were manifested.[23] Fiscal policy continued to be held hostage to a congress that housed a highly fragmented party system, to regional governors who had long derived political power from their control over state budgets, and to numerous constitutional loopholes that had effectively undermined fiscal reform under the Real Plan. In what had now become a familiar emerging-market scenario, international investors quickly fled Brazil in late 1998, escaping economic indicators that were no longer credible. Brazil's rapid recovery under a flexible currency regime suggests that the macroeconomic fundamentals are back on track; the challenge now lies in the crafting of a viable pro-reform political coalition that can cut through the numerous parochial interests that converged to provoke the 1999 crash.

In the case of Argentina, the shadow of the past and the evolution of political coalitions in the 1990s worked in a direction almost opposite to that of Brazil. From the outside looking in, it is perhaps a toss-up whether Argentina or Brazil was most lacking in credibility by the early 1990s. While the latter had been the slowest to come around to market reforms, both had been plagued by high inflation and extremely poor macroeconomic performance for years. Yet Argentina has steadfastly held to a fixed exchange rate under a currency board since 1991—notwithstanding Corden's observation that "Argentina is not an obvious candidate for a firmly fixed rate regime"—while Brazil has moved to a floating rate.[24] What explains Argentina's relative lack of confidence in its own credibility, and hence its determination to stick with a nominal anchor even after the impressive inroads that have been made with market reform over the course of the past decade?

First, in contrast to Brazil and Mexico, successive Argentine governments never managed to orchestrate a sustained period of "miracle" growth rates after World War II. Moreover, unlike the Brazilians, Argentine policymakers failed to accommodate inflation in ways that at least kept the social peace. The final outburst of hyperinflation between 1989 and 1991 was a last straw of sorts as well as the event that triggered the installation of a currency board under the Convertibility Plan. In the Argentine chapter, I begin by identifying the crucial turning points (the Mexican crash, the Asian and Russian shocks, and Brazil's crisis) at which the currency board could have easily come undone, but did not. In almost textbook fashion,

Argentine officials pursued the tight fiscal and monetary policies that were essential for maintaining the currency board, including a major overhaul of the domestic banking system. While the pressures for exchange rate appreciation and economic volatility have been a continuous challenge in the 1990s, the currency board has clearly succeeded in stabilizing prices and signaling to investors the desired image of a modernized and restructured Argentine economy.

Technicalities aside, perhaps the most compelling lesson from the Argentine exchange rate experiment is the degree to which domestic politics was transformed in the process of maintaining the currency board. The ruling Peronist party, which held the reins of government for the entire decade of the 1990s, had never been known for its modernizing tendencies, but rather for its sectarian and divisive tactics. This all changed with the 1989 election of President Carlos Menem, who acted quickly in renovating the Peronist party and updating its agenda to tackle the formidable reform tasks at hand. Menem moved masterfully in drawing in a new base of constituents that clamored for economic stability, and in neutralizing reform opponents through compensatory perks that did not directly threaten the goals of macroeconomic stabilization or convertibility. Organized labor, historically the backbone of Peronist support, was appeased by the slow pace at which Peronist politicians walked labor reform measures through Congress; exporters hurt by exchange rate appreciation were given lucrative opportunities to shift to services and nontradables in the process of privatizing state assets; and the Peronist-controlled provinces were spared the full force of fiscal adjustment until the tequila shock hit in 1995.

Thus, through wily statecraft, and by bringing technocrats quickly up to speed in sustaining a fixed exchange rate under conditions of high capital mobility, the Menem administration was comparatively successful in reconciling domestic politics with very volatile international trends. The main trade-offs have been at the level of the real economy, where the prolonged effects of exchange rate appreciation have taken a toll on employment and export expansion, in particular. As currency overvaluation has favored services and nontradable goods, the dominance of these less dynamic sectors has detracted from the country's competitiveness and its ability to generate adequate job growth. The imperatives of fiscal restraint have worked against the reduction of business taxes and high nonwage costs for employers. The resulting double-digit unemployment rates and ongoing distributional stress prompted voters to exit the Peronist camp in 1999 and to elect

a new coalition of parties that promised to address these shortcomings more aggressively.

Interestingly, any discussion of the currency board became taboo during the numerous electoral contests that took place in the 1990s, as politicians quickly found that to debate the exchange rate was to talk it down. This confirms that, while credible, Argentina's fixed rate is far from infallible. The outgoing Menem team sought to further bolster the peso's credibility by floating proposals for dollarization, which the current Alianza Democrática government has quietly shelved. To sustain the currency board indefinitely, as policymakers say they intend to do, will require faster progress on a range of efficiency-enhancing measures (business tax reductions, further deregulation, competition policy) that can work to adjust relative prices in the absence of an outright devaluation. This has effectively shifted the reform challenges into the microeconomic realm, presenting a set of tasks that will require the cementing of a new political coalition—the earlier grand alliance, which formed around the goals of macroeconomic stabilization, had resisted these very challenges.

Finally, Venezuela is a case in which nearly all of the lessons just reviewed have been inverted. Since domestic politics continued to take precedence over economic policymaking in Venezuela during the 1990s, this is the starting point for the chapter by Javier Corrales. So far, this analysis has shown that exchange rate policy choices were ultimately challenged by domestic politics in Brazil and Mexico; in Argentina, domestic politics rose to the occasion, as the stringent demands of sustaining the currency board required that political coalitions pull together in a more cohesive and constructive manner. In Venezuela, however, a thirty-year-old competitive party system has virtually collapsed under the weight of the country's emergent status as a "reform laggard." To put this another way, the maintenance of a muddling-through exchange rate strategy has triumphed, at least for the time being, over traditional party politics and enabled an elite executive-level coalition to prevail in the setting of a less-than-optimal macroeconomic policy.

What accounts for the ability of Venezuelan policymakers to fend off a devaluation and full-blown Brazilian-style crisis when they were faced with the same volatile contagion from the Asian and Russian disruptions? This question is doubly pertinent, given the 35 percent decline in the price of Venezuelan oil exports that occurred in 1998 and the fact that oil had provided Venezuela with 80 percent of its export revenues and more than

60 percent of its fiscal income in 1997. Corrales argues that the ability of policymakers to defend the country's quasi-fixed exchange rate was due to the nature of central bank–government relations, namely, the emergence of the bank as one of the few modernized state institutions to survive the thwarted market reform program that had been launched by the Carlos Andrés Pérez administration (1989–93). With its autonomous legal status and strong hold over the supply of foreign exchange, the central bank succeeded in using its leverage to stabilize the exchange rate.

Yet Corrales cautions that "although the central bank won the battle, the battlefield was left in shambles." In essence, the country's long-standing political parties were brought down by their own intransigence, and by their resistance to the kinds of market reforms that had now become commonplace in the other emerging-market cases considered here. While Venezuelan leaders have essentially closed ranks and opted for the time being to reject the kinds of market reforms that will be required to reverse the mediocre macroeconomic performance reflected in table 1-1, the experiences of the other three countries suggest that there are no shortcuts to sound political economic recovery in the era of high capital mobility and securitized capital flows.

The following chapters reveal that politicians and policymakers in Latin America are indeed on new political-economic ground. The four cases confirm that, while there may be no single blueprint for the choice of an exchange rate regime, what appears to count most is how governments actually manage their currency policy. Similarly, while the imperatives of sound political management apply across the board, success or failure in the crafting of pro-reform coalitions can come in all shapes and sizes. Mexico, for example, with its strong-willed single ruling party and tight grasp on the various sectors of civil society, appeared at the outset to be a perfect candidate to survive the challenges of its FBAR policy. Argentina's fixed rate experiment, on the other hand, did not look especially promising in 1991, given its Peronist sponsorship and the intensity of past policy failures. Yet the latter's political fortitude and policymakers' tenacity in pursuing the necessary macroeconomic fundamentals worked to reverse these odds. In Brazil, the implementation of deep market reform against a politics-as-usual backdrop drove home the lesson that technical expertise is a necessary, but not entirely sufficient, condition for macroeconomic success. Domestic politics must play its part in ensuring this success, a lesson that Venezuelan leaders seem determined to learn the hard way.

Notes

1. DeAnne Julius, "International Direct Investment: Strengthening the Policy Regime," in Peter B. Kenen, ed., *Managing the World Economy* (Institute for International Economics, 1994), pp. 276–77.

2. On this point, former Panamanian president Nicolás Ardito-Barletta has observed that up until the mid-1970s, most Latin American countries "had very little use for macroeconomic policy instruments. Exchange rates were fixed relative to several of the main hard currencies. Import controls were part of the import substitution policies. Reserves were normally kept low and were not built up with favorable movements in the terms of trade. Fiscal policy consisted in deciding how much of the government deficit would be financed domestically because this would determine the increase in the quantity of money and inflation. Monetary policy was used mainly to keep interest rates low, producing an excess demand for credit and allowing governments to direct credit to priority sectors, which they defined." See Nicolás Ardito-Barletta, "Managing Development and Transition," in Kenen, ed., *Managing the World Economy,* pp. 183–84.

3. Jeffry A. Frieden, "Exchange Rate Politics: Contemporary Lessons from American History," *Review of International Political Economy,* vol. 1 (1994), p. 87.

4. Good summaries of the political underpinnings of Mexico's 1994 crisis have been written by Peter Smith, "Political Dimensions of the Peso Crisis," Denise Dresser, "Falling from the Tightrope: The Political Economy of the Mexican Crisis," and Jeffry A. Frieden, "The Politics of Exchange Rates," all of which can be found in Sebastian Edwards and Moisés Naím, eds., *Mexico 1994: Anatomy of an Emerging-Market Crash* (Washington: Carnegie Endowment for International Peace, 1997).

5. See Richard J. Sweeney, Clas Wihlborg, and Thomas D. Willett, "Introduction," in Sweeney, Wihlborg, and Willett, eds., *Exchange-Rate Policies for Emerging Market Economies* (Boulder: Westview Press, 1999), p. 2.

6. This debate is summarized in Jeffrey A. Frankel, "Real Exchange-Rate Experience and Proposals for Reform," *American Economic Review,* vol. 86 (1996), pp. 156–57.

7. Fixed exchange rates prevail when governments agree to maintain the value of their currencies at preestablished levels; floating rates allow the market to determine the relative value of currencies.

8. Frieden, "Politics of Exchange Rates," p. 87.

9. Currency appreciation makes tradable goods cheaper in the domestic market but more expensive on international markets, and thus detracts from the goal of achieving competitive gains via export-led growth.

10. Jeffrey A. Frankel, *The International Financial Architecture,* Policy Brief #51 (Brookings, June 1999), p. 5.

11. See Sebastian Edwards, "Capital Inflows into Latin America: A Stop-Go Story?" Working Paper 6441 (Cambridge, Mass.: National Bureau of Economic Research, March 1998).

12. See, for example, Barry P. Bosworth, Rudiger Dornbusch, and Raúl Labán, eds., *The Chilean Economy: Policy Lessons and Challenges* (Brookings, 1994).

13. An excellent update on the Chilean experience has been done by Andrés Velasco and Pablo Cabezas, "Alternative Responses to Capital Inflows: A Tale of Two Countries," in

Miles Kahler, ed., *Capital Flows and Financial Crises* (Cornell University Press, 1998), pp. 128–57.

14. Pamela Martin, Jilleen R. Westbrook, and Thomas D. Willett, "Exchange Rate Based Stabilization Policy in Latin America," in Sweeney, Wihlbor, and Willett, eds., *Exchange-Rate Policies for Emerging Market Economies*, pp. 141–63.

15. Ricardo Hausmann, "The Exchange Rate Debate," *Latin American Economic Policies,* vol. 7 (1999), pp. 1–2.

16. Francesco Caramazza and Jahangir Aziz, *Fixed or Flexible? Getting the Exchange Rate Right in the 1990s* (International Monetary Fund, 1998), pp. 2–3.

17. Banco J. P. Morgan S. A., "Making Latin fx Regimes More Flexible," *Latin American Economic Outlook*, August 28, 1998, pp. 11–18.

18. Caramazza and Aziz, *Fixed or Flexible?* p. 5.

19. For a full elaboration of the constellation of special interests vis-à-vis exchange rate policy, see Frieden, "Exchange Rate Politics," pp. 83–86.

20. Manuel Pastor and Carol Wise, "The Politics of Second-Generation Reform," *Journal of Democracy,* vol. 10 (July 1999), pp. 34–48.

21. Sebastian Edwards and Moisés Naím, "Introduction: Anatomy and Lessons of Mexico 1994," in Edwards and Naím, eds., *Mexico 1994*, p. 20.

22. David D. Hale, "The Markets and Mexico: The Supply-Side Story," in Edwards and Naím, eds., *Mexico 1994*, pp. 201–45.

23. See Riordan Roett, "Brazilian Politics at Century's End," in Susan Kaufman Purcell and Riordan Roett, eds. *Brazil under Cardoso* (Boulder: Lynne Rienner, 1997), pp. 19–41.

24. The "classic criteria" for a currency board include small, open economies with flexible labor markets.