Reform Fatigue: Symptoms, Reasons, and Implications

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The era of ambitious economic reforms in Latin America is over. Gone are the days of boldly slashing import tariffs, lifting interest rate controls, or opening large infrastructure sectors to private participation in order to boost competition and efficiency. True, most blatantly inefficient economic policies have been corrected in many Latin American countries. But this is not the only reason that the era of ambitious economic reforms is over. Much more could be done to introduce efficiency into infrastructure services, to improve the functioning of public administration, or to make labor markets both more flexible and equitable. The main reason for the hiatus is reform fatigue, both among public opinion at large and among all the major players in the difficult game of economic reform. Not only has public opinion become opposed to further promarket reforms, but fatigue is also affecting the views of policymakers, the opinions of international organizations, and the prescriptions of top international economic advisers. None of these groups of players are any longer unified around the idea that promoting a key set of reforms to even the playing field for investors and liberalize markets is essential to accelerate growth.

This paper aims to document and explain these signs of fatigue in order to explore the future of reform. The first section following this introduction uses a variety of statistical indicators, from opinion surveys to reform indexes, as well as more casuistic evidence to measure and describe the symptoms of fatigue in public opinion, policymakers, opinion leaders, and international organizations and advisers. The second section attempts to uncover the economic, social, political, and psychological reasons for the fatigue. A discussion of the reforms' economic and social effects draws from a review of existing literature, but new empirical research using opinion surveys data is also presented to analyze the mismatch between the actual and perceived consequences of the reforms. The third section discusses the implications of fatigue for the sustainability of reform. While political reasons are not a major reason behind the fatigue, they will probably be the key determinant of the future of reform because pursuing promarket reform has proved to be politically costly and will probably remain so.

Symptoms of Reform Fatigue

The sustainability of reform will hinge on the beliefs and attitudes of the main players: voters, policymakers, opinion leaders, and the international community. The purpose of this section is to gauge the symptoms of reform fatigue among the public at large and some of the key players of the reform process. Reform fatigue is defined as the lack of public support, the loss of confidence in the benefits of promarket reforms, or a less proactive stance toward reform.

TABLE 1

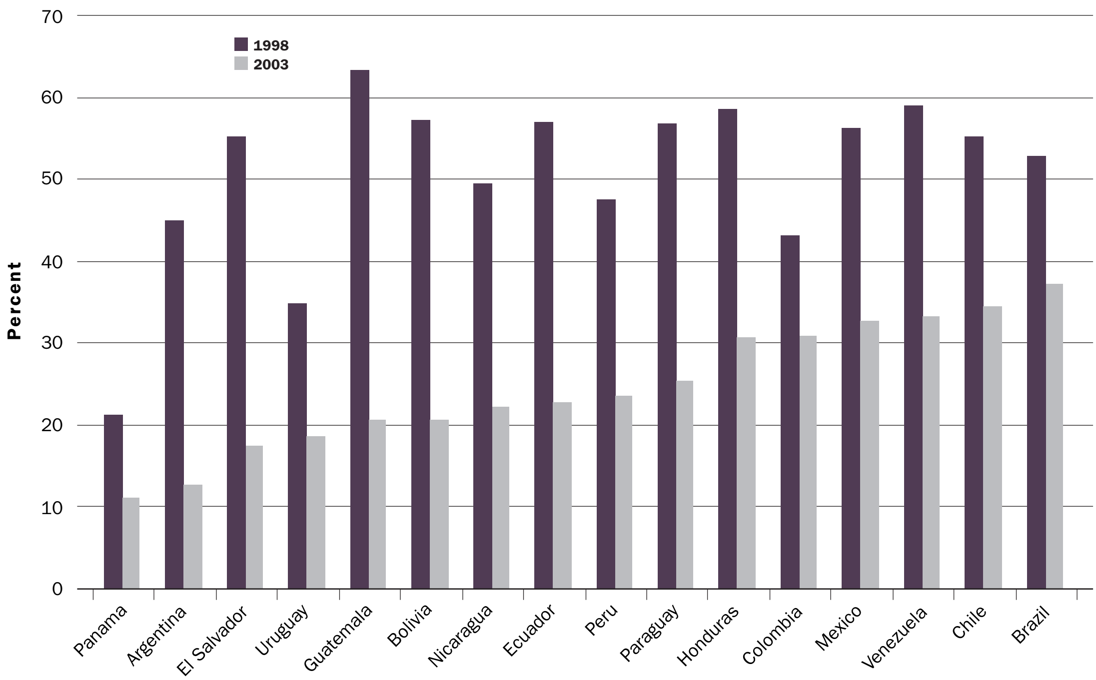
What Latin Americans Think of Promarket Reforms (Percentage)

	1996	1997	1998	2000	2001	2003
In favor of economic integration	74	87	88		84	
In favor of foreign direct investment			77			
In favor of privatization			52	38	31	25
In favor of the market economy			77	67		18
In favor of price freedom			63	57	59	
In favor of leaving productive activities to the private sector			56		50	

Source: Panizza and Yáñez (2003)

FIGURE 1

Public Opinion Support in Latin America for Privatization

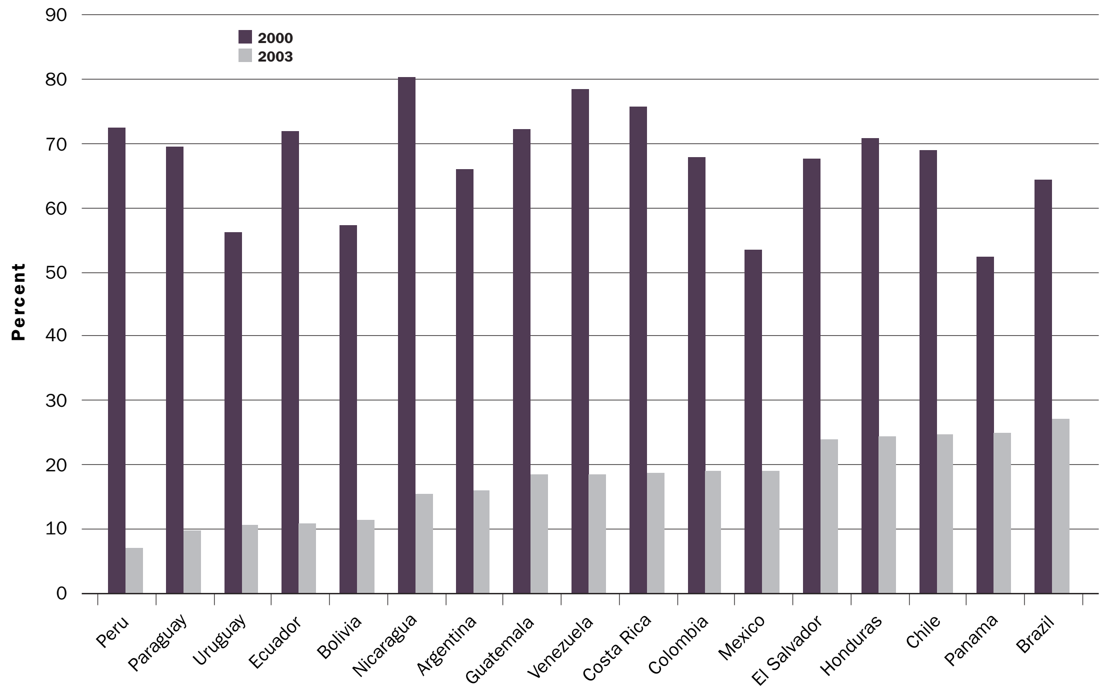


Source: Panizza and Yáñez (2003)

Public opinion. Promarket reforms stand accused of being one of the causes of the economic crisis that Latin America is suffering. The attitude of Latin Americans toward promarket reforms has become increasingly critical. In 1998 more than 50 percent of Latin Americans thought that privatization was beneficial for their country. This percentage dropped to 31 percent in 2001 and to 25 percent in 2003. At the same time, in 1998, 77 percent of Latin Americans thought that a market economy was good for the country. In 2003, the percentage of people who support a market economy dropped to 18 percent.[1] These results come from the Latinobarómetro annual surveys, which have covered seventeen Latin American countries since 1996.[2] These surveys also provide information on the attitude toward international trade and foreign direct investment and toward price controls and state intervention in productive activities. Table 1 shows the average values for the six aspects of market reform considered by the surveys. It indicates that more than 50 percent of Latin Americans tend to agree with the basic tenets of promarket reforms (the exception being privatization). However, the table clearly shows that the support for promarket policies has been decreasing since 1998.[3]

FIGURE 2

Public Opinion Support in Latin America for Market Economy, 2000–03



Source: Panizza and Yáñez (2003)

Figures 1 and 2 show that there are large cross-country differences in the support for reform. Figure 1 shows that support for privatization ranges between 37 percent (in Brazil) to just above 10 percent (in Argentina and Panama). Argentina, Bolivia, Ecuador, El Salvador, Guatemala, and Paraguay are the countries where the support for privatization dropped by the largest amount. Figure 2 shows a similar trend in the decline of support for a market economy.

Policymakers. Policymakers are of course key players in the reform process. To gauge whether their inclination to pursue promarket reforms is faltering, we first assess evidence from policy announcements during preelectoral periods by those elected and then discuss the record of actual policy decisions while the officials were in office.

In recent years, political leaders in Latin America have increasingly tended to blame free-market policies for low economic growth and high unemployment. During recent political campaigns in Argentina, Bolivia, and Ecuador, candidates critical of "neoliberal" economic policies performed well. In Argentina, Nestor Kirchner won the presidency in April 2003 campaigning against the neoliberal model and what he called "lamentable and disastrous" policies imposed by the International Monetary Fund (IMF); instead, he favored a greater role for the state in the economy. In Bolivia, Evo Morales, who came within a percentage point of winning the election in June 2002, described his electoral campaign as representing "the victims of neoliberalism." In Ecuador, Lucio Gutiérrez, who was compared to Venezuela's Hugo Chávez because

1. This drop may be partly due to the fact that there was a slight change in the question. For the years 1998 and 2000 the question was "Do you think that market economy is good for the country?" For the year 2003 the question was "Are you satisfied with the functioning of the market economy?"
2. The surveys comprise an average of 1,200 respondents per country-year. Although the Latinobarómetro data offer an unprecedented wealth of information, the survey has some problems—namely, that it focuses exclusively on urban population and especially that the early rounds of the survey tended to overrepresent individuals with relatively high levels of education (Gaviria, Panizza, and Seddon 2000).
3. Panizza and Yáñez (2003) show that the correlation between these variables, while positive and statistically significant, is also rather low, indicating that the different questions do capture different angles of the attitude toward promarket reforms.

of his military background and populist message, also spoke during his political campaign in November 2002 of how neoliberal policies had brought "disaster" to the country.

In Brazil, the prospect of Luiz Inacio Lula da Silva's election was also perceived by many as a general repudiation of market-oriented reforms. Despite Lula's moderate campaign rhetoric and his shift to the center, investors panicked and sovereign bond spreads soared prior to the October 2002 election. Canada's *National Post* remarked, "Brazil's presidential election represents a final unraveling of the so-called Washington consensus" (Samuelson 2002). Yet after Lula assumed office, markets regained confidence in Brazil once it became apparent that his administration would continue and even deepen the policies of the Cardoso administration.

The sustainability of Latin American economic reform will hinge on the beliefs and attitudes of the main players: voters, policymakers, opinion leaders, and the international community.

Of course, "antineoliberal" campaign rhetoric can fade once a candidate takes office. Lucio Gutiérrez is the latest elected leader to pull such an about-face. He won the presidency in Ecuador with the support of left-wing and indigenous groups, yet upon taking office he appointed an orthodox finance minister and signed an agreement with the IMF that promised large budget surpluses and opened the state-controlled energy sector. Gutiérrez is just the latest president to win a campaign based on populist antimarket rhetoric only to moderate the message once in office. During the 1989 Argentine presidential campaign, Carlos Menem supported a nationalist and redistributive state-led development model, but by 1991 he was advocating the free market orthodoxy of his opponent. In Peru, Alberto Fujimori followed the same pattern in his 1990 campaign against Mario Vargas Llosa: He attacked Vargas Llosa's plan for structural reforms only to adopt virtually the same measures once in office.

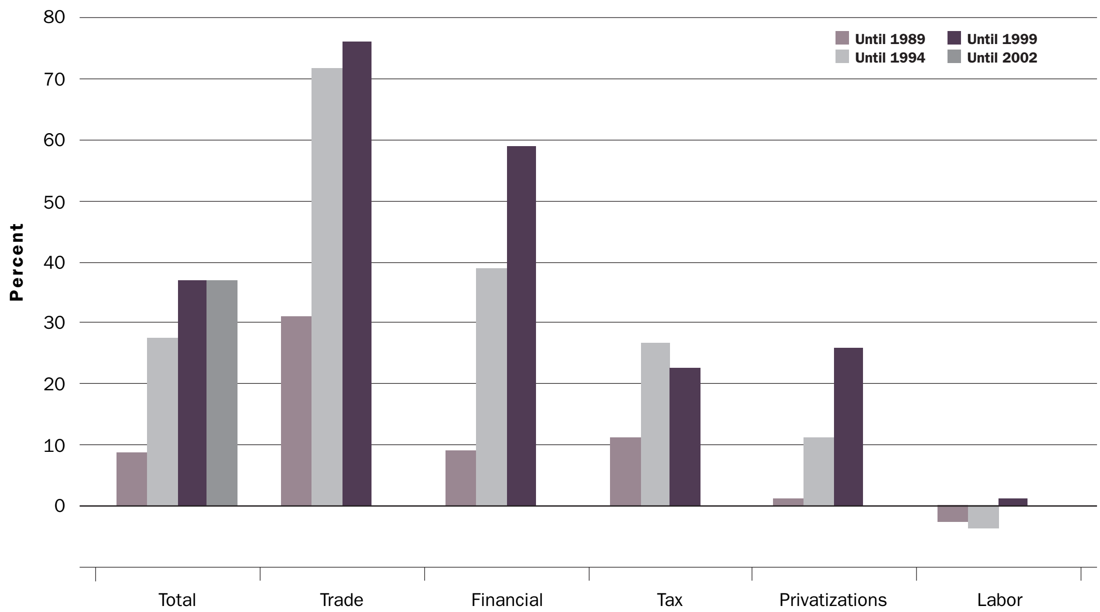
In other words, while the volume of the rhetoric is up, it has not yet translated into a regionwide trend of policy rollback. For example, while Argentina's President Kirchner may have rejected the neoliberal policies of the Menem era, his differences with the model appear to be one of degrees (economic policy in Argentina remains geared toward recovering from the disastrous default and devaluation in 2001–02). Hugo Chávez's populist policies have not spread elsewhere, and Lucio Gutiérrez continues to work with the IMF. Looking ahead, a more sincere antireform candidate could be elected in the near future. Frente Amplio leader Tabaré Vazquez will be a strong presidential candidate in Uruguay in 2005, while Alan García has undergone a political rebirth in Peru. Nevertheless, for now the gap between rhetoric and policy persists.

Can we offer more rigorous support to the claims that, while there is no regionwide retrenchment of promarket policies, recent governments are no more inclined than their predecessors in the early nineties to maintain or advance market-friendly reforms? To answer this question we can draw from the main conclusions by Lora and Panizza (2002b), who use a set of indicators that attempt to measure the extent of promarket reform in the areas of trade, financial, tax, privatization, and labor market policies. A composite index covering all these areas, calculated for seventeen Latin American countries, rose from 0.34 in 1984 to 0.58 by the late 1990s (on a scale from 0 to 1). This increase is significant in and of itself, yet it also suggests that many countries have a very broad margin of unexploited potential for the introduction of additional reforms, especially in the areas of privatization and tax policies, where the process of reform has been very uneven across countries, and in labor regulations and institutions, the least active area of reform.

Reforms expanded the most between 1989 and 1994, when an improvement of 0.12 points was registered out of a total increase of 0.24 for the entire period. In the second half of the nineties the gain was only 0.04 points, implying that the process has lost momentum (see Figure 3). Since this system of indexes is available up to 1999 only, we have complemented them with information from reports of the regular missions of the IMF in the countries.[4] On that basis, we have classified countries in three groups according to the extent of reform since 2000 (see Table 2). Ten countries have shown reform progress, seven have stalled, and two have had reversals. This pattern implies that although the process of reforms has continued in several countries, its pace has declined even further, and, for the first time since its inception in the mid-eighties, a few major setbacks have occurred. A rough calculation suggests that the overall reform index stayed put at 0.58 between 1999 and 2002 or went slightly up from 0.58 to 0.61 if Argentina and Venezuela are excluded.

FIGURE 3

Progress of Reforms in Latin America (Margin of Reform Put to Use)



Note: Progress in reforms is measured as that part of the potential for reform as of 1985 that was actually used by 1989, 1994, 1999, and 2002.

Source: Lora and Panizza (2002b), updated by the authors; details available upon request.

TABLE 2

The Progress of Latin American Reforms since 2000

Progress	Brazil, Chile, Colombia, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Peru
Stalling	Bolivia, Costa Rica, Dominican Republic, Ecuador, Paraguay, Trinidad and Tobago, Uruguay
Reversal	Argentina, Venezuela

Source: Lora and Panizza (2002b), updated by the authors; details available upon request.

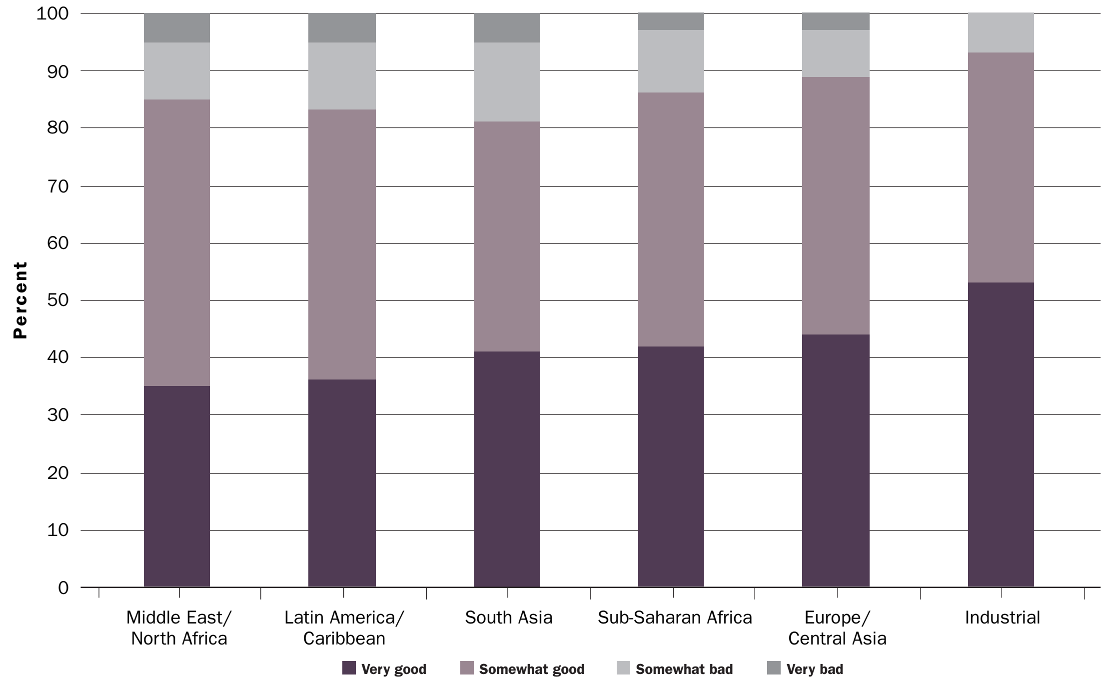
It is important to note that there are more differences than similarities in the reform reversals of these two countries. In Argentina, the policy reversals started as a last-resort response to a prolonged crisis that threatened (and eventually destroyed) the monetary and financial systems. In Venezuela, no such crisis was apparent at the beginning of the antireform process, which was initiated as a political strategy by the president against the opposition. As events unfolded in Argentina and the crisis reached its peak in 2002, public opinion moved strongly in favor of antimarket policies, which were then given additional impetus during the 2003 electoral campaign by several candidates, including the winner. In Venezuela, a severe economic crisis surfaced after the general strike in late 2002 that was aimed at removing the president, which gave him further leeway to deepen the antimarket policies. However, it is unclear that these policies have the support of public opinion at large while, unlike in Argentina, they are strongly rejected by the private sector.

The opinion leaders. Opinion leaders are a key group of players to be considered in the reform process. Opinion leaders' views are important for several reasons. First, leadership within the executive branch, and, to a lesser extent, the legislature, increases the probability that a reform proposal will be approved. Second, public opinion is subject to

4. Details are available upon request to the authors.

FIGURE 4

Worldwide Opinion Leaders' Support for Opening Markets and Trade, 2002–03



Source: The Global Poll, Princeton Survey Research Associates for the World Bank

considerable uncertainty when faced with reform proposals that attempt to substantially alter the status quo ante, and opinion leaders may be decisive in dispelling or reinforcing doubts about the convenience of reform (Graham et al. 1999). And third, ex post facto judgments are often biased and distorted (as we will see below) and may be susceptible to manipulation by the opinion leaders. Therefore, opinion leaders' views may influence not only the probability that a reform is introduced but also the way its effects are perceived by the public and therefore may make the difference between sustainability and rejection of the reform.

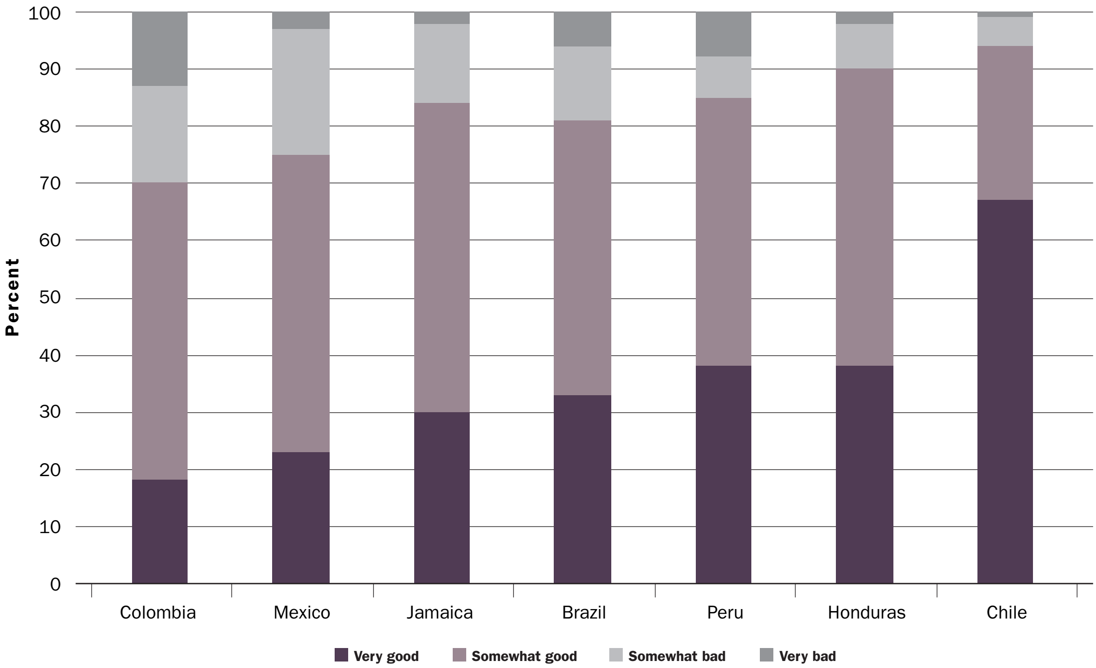
The Global Poll conducted by Princeton Survey Research Associates for the World Bank offers the most recent survey of the views of opinion leaders on globalization and promarket reform in forty-nine countries of all world regions, including several Latin American countries (Brazil, Chile, Colombia, Honduras, Jamaica, Mexico, and Peru). The poll was conducted between October 2002 and March 2003 through interviews of leaders from government, the private sector, the media, civil society, academia, and trade unions. For our purposes, the questions of interest are those related to trade liberalization, foreign direct investment, the "neoliberal model," and privatization. The first one is comparable to a similar question applied to the public at large in eight Latin American countries (although there are only four countries in common in both surveys). The two last questions were applied only in Latin America, and therefore the answers cannot be compared with those from other regions.

Eighty-three percent of opinion leaders in Latin America consider the greater opening of national markets to trade and business with other countries to be either very good or somewhat good. This percentage does not differ much from the percentages of other developing regions although it is somewhat below that in industrial countries (93 percent; see Figures 4 and 5). However, differences within Latin America are important: While 94 percent of opinion leaders in Chile are in favor of trade liberalization, only 70 percent in Colombia are. Furthermore, while in Chile two of three opinion leaders consider trade opening very good, in Colombia fewer than one of every five opinion leaders shares that view. Interestingly, opinion leaders are less enthusiastic about trade liberalization than those polled in the four countries where the comparison can be made (notice, however, that the wording of the question was not identical).

Seventy-seven percent of Latin American opinion leaders are in favor of foreign direct investment in the manufacturing sector. Again, that percentage is roughly similar to that of other developing regions but

FIGURE 5

Latin American Opinion Leaders' Support for Opening Markets and Trade, 2002–03



Source: The Global Poll, Princeton Survey Research Associates for the World Bank

lower than in the developed world, where the figure is 89 percent. Differences of opinion between countries are less pronounced than in the previous question but are still present: 40 percent of opinion leaders in Honduras consider foreign companies very good compared with only 12 percent in Mexico (Figure 6).

The majority of opinion leaders in Latin America is in favor of privatizing inefficient state-owned enterprises, from 90 percent in Jamaica to 70 percent in Chile and Honduras. However, this view is far from a blanket endorsement of privatization: Many of those in favor consider that the effect is only "somewhat positive," especially in Mexico, Jamaica, and Colombia.

Finally, opinion leaders in the region are divided with respect to the impact of the "neoliberal economic model" on poverty. In Jamaica and Peru a slight majority believe that the model, defined as liberal trade policies, privatization, fiscal discipline, tax reform, property rights reform, and deregulation, can pull people out of poverty. In Brazil, Colombia, and Honduras, those in favor and those against are matched, while in Chile and Mexico the majority does not believe that the model can pull people out of poverty.

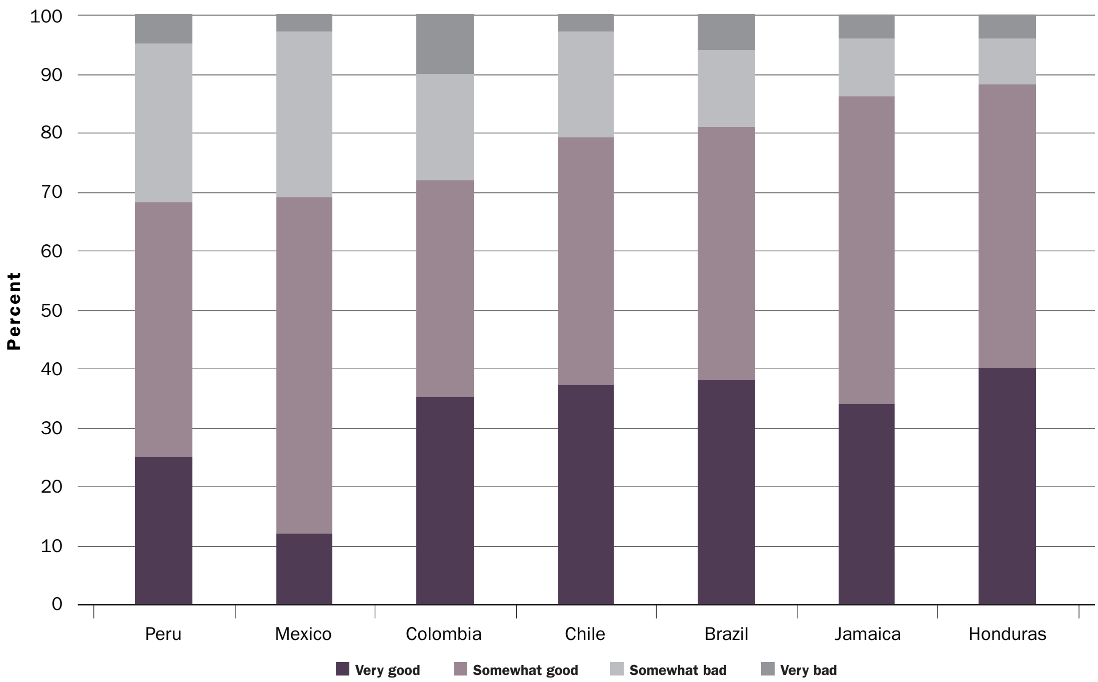
In synthesis, opinion leaders in Latin America on average have views similar to those of leaders in other developing regions with respect to trade liberalization and foreign direct investment although large differences can be found between countries within the region. Unlike the public at large, opinion leaders are supportive of privatization, but many consider that the effects are expected to be only "somewhat positive." Opinion leaders are clearly divided about the impact of the so-called neoliberal model on poverty. Since they do not oppose the core elements of that model, which they consider beneficial for their countries, their views seem to imply that the reform agenda should not be reversed but expanded, as has also been the trend among international organizations.

The international community. The international pressure to liberalize was ubiquitous during the early nineties. "Everywhere state leaders turned, they were bound to feel this pressure . . . : they encountered a battery of international scholars, policy advisers, financiers and investors who demanded market-oriented reforms as a condition for extending their blessing" (Corrales 2002, 3).[5]

5. Corrales (2002) cites the following references for discussions of international pressures on behalf of economic liberalization: Williamson (1994), Kahler (1992, 1994), and Frenkel and O'Donnell (1994).

FIGURE 6

Latin American Opinion Leaders' Support for Establishment of Foreign Companies, 2002–03



Source: The Global Poll, Princeton Survey Research Associates for the World Bank

Although much international advice and pressure are still in favor of promarket policies, such policies are no longer given the utmost importance in the policy agendas of the international organizations or in the views of international advisers or financiers.

During the 1990s the mantra of international organizations such as the IMF, the World Bank, and the Inter-American Development Bank was clearly aligned with the neoliberal model, as defined in the previous section—liberal trade policies, privatization, fiscal discipline, tax reform, property rights reform, and deregulation—and largely reflected the so-called Washington consensus.[6] However, as economic growth stalled and social indicators failed to improve, especially during the second half of the decade, the breadth and scope of the agenda of the international organizations expanded with four new reform items: crisis proofing, completing first-generation reforms, advancing second-generation reforms, and improving equity. Crisis proofing aims to reduce vulnerability to crises through such measures as accumulating budget surpluses and reserves, adopting a flexible currency, strengthening supervision and regulation, and increasing domestic savings. Completing first-generation reforms includes making labor markets more flexible and deepening privatization and free trade. Second-generation reforms include judicial, social security, regulatory, tax, education, and political reforms geared toward establishing an institutional foundation that can sustain economic growth. Finally, equity-improving policies comprise improved education, titling programs to secure property rights, land reform, and microcredit (see Williamson 2003a).

The expansion of the agenda represents an important change of attitude toward reform because priority is no longer given to the original set of reforms over the rest and because policy recommendations in the original neoliberal agenda have become more qualified. For instance, emphasis on privatization is now made conditional on the possibility of adjusting the institutional and regulatory environment to reduce the risk of inefficiency, corruption, and regulatory capture. In a similar way, much greater emphasis is now placed on the quality of supervision and prudential regulation as conditions for a successful financial liberalization process. However, as discussed below, this expanded agenda is not free from strong criticism for failing to provide solid foundations for growth while expanding the reform requirements beyond the political and practical capabilities of any government.

Furthermore, a growing number of leading international scholars have moved away from the notion that promarket reform is the essential precondition to

TABLE 3

Growth and Productivity in Latin America and the Caribbean

	GDP growth rate	Per capita GDP growth rate	Total factor productivity growth rate
1961–70	5.3	2.7	1.0
1971–80	5.5	3.4	–0.3
1981–90	1.2	–0.7	–0.2
1991–99	3.8	2.1	0.1
2000–02	0.6	–1.1	

Source: Loayza, Fajnzylber, and Calderón (2002); World Bank (2001b, 2003)

achieve economic development. Among them are four influential international advisers. Paul Krugman shocked the international community when, in the midst of the Asian crisis of 1997–98, he recommended the adoption of controls to international capital flows and other heterodox financial policies (Krugman 1998a, 1998b, 1999). Joseph Stiglitz followed suit with his strong criticism of the multilaterals' emphasis on several key ingredients of the standard stabilization package, such as interest rate increases and fiscal restraint. He has also criticized some core components of the promarket reform agenda, most notoriously financial liberalization and privatization (Stiglitz 1998, 2002a, 2002b; Chang 2001). In a similar vein, Dani Rodrik has advanced the thesis that the key ingredients for economic growth are macro stability (monetary, fiscal, and financial), strong property rights, the rule of law, and producer incentives aligned with social costs and benefits—universal principles that do not necessarily translate into the standard set of promarket policies and institutions recommended by Washington (Rodrik 2003). Jeffrey Sachs has emphasized the need for social protection and human capital accumulation over the standard stabilization-cum-liberalization approach. His views are partly motivated by his conviction that geographic limitations play a more important role in economic and social outcomes than is generally recognized in the profession (Sachs 2003). However, he has also criticized the lack of a basis for the standard stabilization package: "Indeed the phrase 'debt sustainability analysis' is truly Orwellian in scale of distortion. The IMF and World Bank procedures for measuring sustainability have absolutely nothing to do with ability to pay and 100 percent to do with the arbitrary limits on debt relief imposed by the G-7" (Sachs 2000).

Reasons for the Fatigue

After more than a decade of promarket reforms, symptoms of fatigue are evident: Public opinion considers the reforms not to have been beneficial; policymakers in a growing number of countries seem to have lost their reform zeal, and the process is now stalling in many countries; and both opinion leaders and the international community are no longer unified around the thesis that a set of core promarket reforms is the key to accelerating development. What are the reasons for the fatigue? In this section we discuss four alternative, though not mutually exclusive, explanations: (1) the economic effects of reforms have been modest, (2) reforms have failed to improve social outcomes, (3) political forces and public opinion have moved toward the left, and (4) perception biases and other psychological reasons may be behind the loss of appetite for further reforms.

Economic reasons.[7] Increasing productivity and growth was the main purpose of the promarket structural reforms. But, although economic growth in Latin America improved throughout the 1990s, it was disappointing and less than the averages for the 1960s and 1970s (Table 3). Indeed, whereas during the so-called lost decade of the 1980s annual growth in the region was only 1.2 percent and per capita income fell at a rate of 0.7 percent, in the 1990s those rates rose to 3.8 and 2.1 percent, respectively. However, in the 1960s and 1970s, average annual growth was more than 5 percent and per capita income increased by around 3 percent.

Something similar may be observed with regard to trends in total factor productivity. In the 1990s, total factor productivity contributed practically nothing to the average growth of countries in the

6. The term originated in a 1986 study issued by the Institute for International Economics titled *Toward Renewed Economic Growth in Latin America*, edited by Balassa et al. (see Williamson 2003b, 323).
7. This and the next subsection are an updated version of a survey contained in Lora and Panizza (2002a).

TABLE 4

Effects of Reforms on Growth in Latin America

	Simple average of selected countries	Weighted average of selected countries
Easterly, Loayza, and Montiel (1997)		
1991–93 versus 1986–90	2.2	1.7
Lora and Barrera (1997)		
1993–95 versus 1987–89	2.2	2.2
Fernandez-Arias and Montiel (2001)		
1991–95 versus 1986–90	1.6	1.7
Lora and Panizza (2002b)		
average 1988–1999	1.0	n.a.
Loayza, Fajnzylber, and Calderón (2002)		
1990s versus 1980s	1.3	n.a.

Source: From IDB (2003, chap. 5)

region after having fallen sharply in the 1980s (when it took away around 2 percentage points of growth). Productivity improvements typical of the 1990s were not substantially different from those typical (also very low) of the 1960s and 1970s.

These results could be taken as an indicator that the reforms failed to achieve their central objective of speeding up economic growth through more efficient use of productive resources. Yet this conclusion is far from warranted. First, it should not be forgotten that these averages conceal notable differences between countries in the region. In terms of per capita income, for example, ten of the twenty-six countries in question performed better in the 1990s than in the 1960s and 1970s. Some countries, such as Argentina, Chile, Guyana, and El Salvador, had significant increases in the rate of growth. An equal number of countries also registered improvements in overall factor productivity, which outpaced that of the 1960s and 1970s.

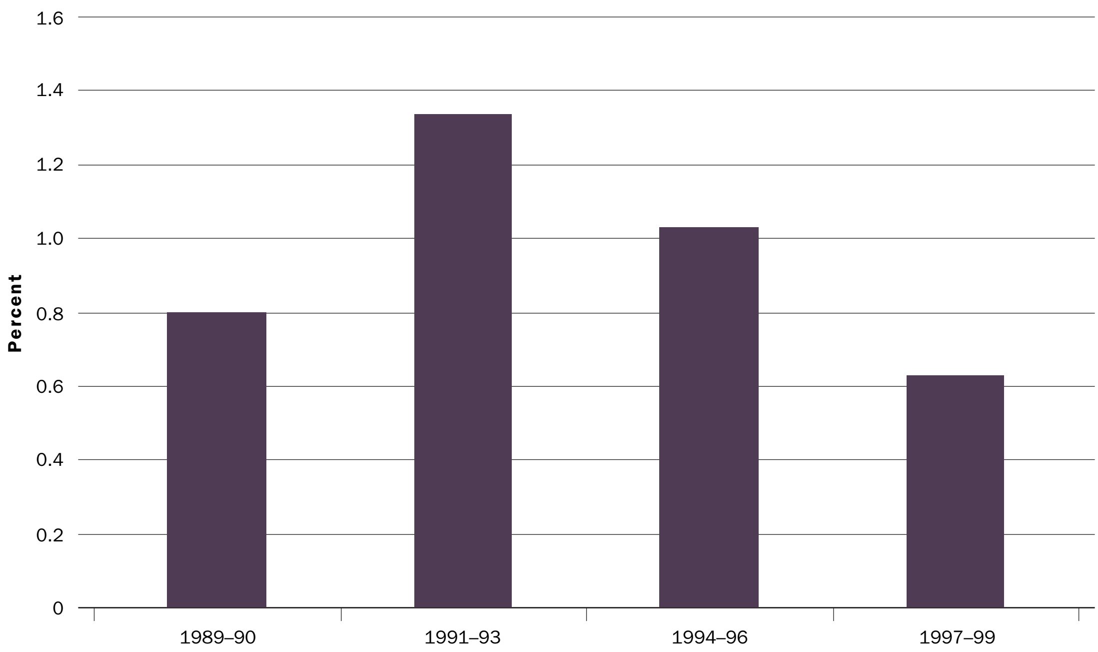
Second, structural reforms significantly differed from one country to another in terms of depth, pace, and manner of implementation. Finally, it should be kept in mind that structural reforms were not the only factors influencing productivity and growth in recent decades. In this regard, it should be emphasized that growth trends in developed countries and in the world economy as a whole, which had been encouraging in the 1950s and 1960s, fell in the following decades. In the 1990s, per capita income growth in the developed countries was the same as that in Latin American countries (1.5 percent per year for Latin America, 1.7 percent for the entire world), whereas in the 1970s it had been 4.3 percent (4.1 percent for all countries). The international context has also limited Latin American countries because of instability in the international prices of the region's typical exports and because of the major changes in the amounts and costs of capital resources for the region. Growth was also affected by the quality of macroeconomic policies and other circumstances specific to each country.

Given the multiplicity of factors that can influence growth and productivity, it is not surprising that experts have different opinions about the effects of the reforms. Until a few years ago, the prevailing opinion on the effectiveness of the reforms was quite optimistic. Table 4 presents the results of five studies that evaluate the effects of the reforms. The first three studies analyze the reforms up to the mid-1990s and have consistent results (Easterly, Loayza, and Montiel 1997; Fernández-Arias and Montiel 2001; Lora and Barrera 1997). According to these studies, the effects were positive and substantial. For example, using the previously mentioned indexes of reform, Lora and Barrera find that the reforms had a significant and ongoing impact on growth, productivity, and investment. According to their estimates, until the mid-1990s, the economic reforms raised Latin America's growth rate by 1.9 percentage points (that is, to 2.2 percentage points, including the impact of macroeconomic stabilization).

More recent studies point to less encouraging effects. Escaith and Morley (2001), who use a modified version of the same indexes for 1970–95, also find a positive effect although it is smaller in magnitude and less robust than those reported in previous articles. By using the same indexes for 1985–99, Lora and Panizza (2002b) make new estimates of the reforms' effects on growth. They find that the effects were more modest and of a transitory nature

FIGURE 7

Effect of Reforms on Growth (Latin American Average Annual Growth)



Source: Lora and Panizza (2002b)

because they seemed to be diluted after the reforms were in place for some time. For example, during their high point (1991–93), the reforms increased annual growth by 1.3 percentage points. When the reform period began to slow down, the growth effect declined considerably, and in 1997–99 it entailed only 0.6 percentage points of additional growth (compared with a hypothetical situation with no further reforms; Figure 7). The study also finds that the reforms' effectiveness depended crucially on the institutional environment in which they took place. In particular, the reforms seem to have had a greater effect in countries with good rule of law possibly because it lessened uncertainty about the new rules and limited the undue interference of interest groups in the design and implementation of regulations. Loayza, Fajnzylber, and Calderón (2002) also find more modest effects of the reforms in their update of the estimates of Easterly, Loayza, and Montiel (1997).

Opening up to international trade is an area of structural reform whose effects on growth have been the subject of debate. According to most studies that make comparisons between countries, there is a clear and positive correlation between opening to international trade and economic growth (Dollar 1992; Sachs and Warner 1995; Frankel and Romer 1999; Ben-David 1993; Edwards 1998; Dollar and Kraay 2000). Studies of domestic experiences reach the same conclusion (see a summary in Srinivasan and Bhagwati 2001). Although criticisms have been raised about the validity of some of these studies,[8] no study has suggested that opening up to trade has adverse effects on growth. Studies more

8. According to Hanson and Harrison (1999) and Rodríguez and Rodrik (2001), the literature that finds a positive relationship between liberalization and growth is plagued with problems of methodology and data errors, and the results are not particularly solid in comparison with alternative specifications and data series. Rodrik (2000) likewise asserts that, contrary to what is suggested by Srinivasan and Bhagwati (2001), the evidence for liberalization derived from country studies is far from overwhelming. Nevertheless, Jones (2001), commenting on the article by Rodríguez and Rodrik, shows that the standard results of a positive relationship between market opening and growth are quite solid and that few of the results commonly accepted in the economic literature would pass the strict evidence of solidity of Rodríguez and Rodrik. Wacziarg and Welch (2003) take up the discussion begun by Rodríguez and Rodrik and find that their criticisms are valid for cross-section analyses, from which it cannot be concluded that opening helps growth. Nevertheless, time series panel analyses do show high and robust effects of liberalization on growth.

specifically focused on Latin America also find a positive relationship between liberalization and growth (Lora and Barrera 1997; Stallings and Peres 2000; Loayza, Fajnzylber, and Calderón 2002).

Empirical research on the effects of financial liberalization has shown that while it does not contribute to an increase in savings (Bandiera 2000), it does increase financial deepening that, in turn, is associated with growth (Levine 2001).[9] In particular, cross-country analyses indicate that severe financial repression (measured by the presence of large negative real interest rates) adversely affects productivity growth. Country-level studies for Ecuador, Mexico, Chile, and Indonesia also indicate that

Promarket reforms stand accused of being one of the causes of the economic crisis that Latin America is suffering. The attitude of Latin Americans toward promarket reforms has become increasingly critical.

financial liberalization leads to a more efficient allocation of capital and relaxes credit constraints faced by small firms (Harris, Schiantarelli, and Siregar 1994; Jaramillo, Schiantarelli, and Weiss 1996; Gelos and Werner 1999; Gallego and Loayza 2001).[10] However, research has also shown that financial liberalization may lead to crisis because the previous system of interest rate controls and directed credit may have created weak bank portfolios and not promoted a good "credit culture." This possibility suggests that postliberalization financial crises are due less to the liberalization per se than to the preliberalization environment, the sequencing of financial reforms, and the legal, regulatory, and supervisory structures (Caprio, Hanson, and Honohan 2001).

Given that state-owned enterprises can correct market failures, one would expect that the advantages of public enterprises are greater in developing countries, where market failures are more pervasive than in developed countries. If such were the case, privatization would be less beneficial for welfare and growth in the developing countries. The empirical evidence, however, seems to suggest that the opposite is true,[11] implying that government failures have the upper hand over market failures even though, as in the case of financial liberalization, a successful privatization process requires an adequate regulatory framework and political and social institutions that direct and supervise the activities of the regulatory boards (World Bank 2001b; IDB 2001). Thus, reforms in the financial and infrastructure sectors have had positive effects when the reforms have generated a climate favorable to competition and an adequate regulatory system. When these conditions are met, the effect that the financial reform and the privatization of key infrastructure sectors have on growth can be substantial (Mattoo, Rathindran, and Subramanian 2001).

Despite the differences between the various studies, the conclusion that can be drawn is that the reforms have had a positive but modest effect on growth. Even considering the more optimistic calculations, which place the effect at close to 2 points of additional growth, the reforms by themselves could not have raised per capita growth from –0.7 percent in the 1980s to rates around 3 percent, like those seen in the 1960s and 1970s. One of the reasons for the modest impact of the reforms may have been that they were incomplete, did not have enough internal institutional support, and took place in an unstable international environment, especially in the realm of financing, which in turn may have compromised national macroeconomic policies. This debate suggests that the reforms changed the operation of the economy less than is generally assumed and hence their impact on productivity was muted.

This view has inspired the extension of the Washington consensus to several other areas of reform, as summarized above, an approach that is not immune to serious criticism because it places demands on reform that are beyond the political and practical possibilities of any government and it fails to convey any sense of priority and even direction. According to Rodrik (2003), jump-starting growth and sustaining growth are two separate enterprises. The former seldom requires such a wide array of policy changes, and it is unclear that the latter must be necessarily based on that combination of policies. He notes that several celebrated cases of economic success, most notably in Asia, seem to defy the standard policy prescriptions of either the Washington consensus or its extended version. Both South Korea and Taiwan relied upon public enterprises and utilized industrial policies including directed credit, trade protection, export subsidization, and tax incentives, while China grafted a market system onto its planned economy.

The fact that reforms had a modest impact on productivity and growth may be at the core of the reform fatigue even if its effects were positive.

Many people probably formed their expectations of reforms' benefits on the basis of the reformers' promises and announcements as well as the prevailing views at the beginning of the process, which were certainly overoptimistic, as we have seen. As people have later corrected those expectations according to the actual results, they may consider that there are better policy packages to deal with the problem of low growth. Therefore, even if they do not demand a reform reversal, they become less committed to the original reform process. If this view is correct, policymakers who oversold the potential benefits of the reforms could now be blamed for the reform fatigue. Interestingly, this phenomenon does not seem to be exclusive to Latin America. It is also happening in East European countries in spite of the fact that, over the last decade, some of them have had a very good growth performance (Central European University 2003). But it should be even more valid for Latin America because, contrary to the typical East European case, where the initial effect of the structural reforms was a decline in incomes (Merlevede 2003), reforms in Latin America produced initial growth gains that turned out to be temporary (Lora and Panizza 2002b).

Another explanation, however, is that opinion on the effectiveness of reforms is not based on complete information on its expected and actual results but rather on a rough association between reform and macroeconomic outcomes, as illustrated in the oft-cited, though not very polite, quote: "It's the economy, stupid." Using Latinobarómetro data, Panizza and Yáñez (2003) find that several macroeconomic variables affect attitudes toward privatization and the market economy (the only two questions that have been included in at least four annual surveys). The variables tested are the deviation of GDP from its trend (a simple way of capturing the economic cycle), the depth of the economic crisis (defined as the deviation of GDP from its trend when it is below it and zero otherwise), the unemployment rate, and the inflation rate (computed as the loss of purchasing power of a domestic currency unit). Except for inflation, the other three variables influence people's attitudes in the expected way and are able to explain a substantial part of the loss of support for the reforms. As we have seen, support for privatization went from 52 percent in 1998 to 25 percent in 2003. One third of that decline seems to be associated with the economic cycle, according to their calculations. The case of Argentina is a striking example of the importance of macroeconomic factors. In this country, such factors explain a drop in support of privatization equivalent to 25 percentage points, which is about 80 percent of the observed drop (from 45 percent to 13 percent) in the support for privatization in that country.

In sum, economic reasons are clearly behind reform fatigue. Although the reforms seem to have increased incomes and growth, they did so in a modest way, probably below the expectations created by the reformers. However, as growth has recently faltered for short-term reasons, support for reform has declined because many people are probably unable to isolate the influence of the cycle from the permanent effect of the reforms.

Social outcomes as reasons for the reform fatigue. While a majority of economists agree that most of the structural reforms described above tend to increase average income, those who criticize these kinds of reforms emphasize their distributional consequences and claim that they generate a pattern of economic growth that benefits only the richest segments of the population.[12]

The most quoted papers holding the view that reforms tend to be beneficial for the majority of the population are Gallup, Radelet, and Warner (1998), Dollar and Kraay (2000, 2002), and a recent World Bank report (2001b). The basic point of these papers is that reforms (especially trade openness and globalization) increase economic growth without producing major income distribution shifts. Therefore, these authors conclude that the increase in average income brought about by economic liberalization is fully translated into an increase in the income of the poor.

While these authors present strong evidence in support of the fact that growth is distribution neutral,

9. Reforms that eliminate negative real interest rates seem to have the largest impact on growth.
10. Laeven (2000) supplies cross-country evidence for the fact that financial liberalization relaxes the financial constraints faced by small firms but does not affect large firms.
11. Shirley and Walsh (2000) survey fifty-two studies of the impact of privatization on economic efficiency and welfare and find that thirty-two studies concluded that privatization is welfare-enhancing, fifteen studies find an ambiguous effect of privatization, and five studies found a negative effect of privatization. However, out of twenty studies that covered developing countries, seventeen found that privatization is welfare-improving and three found an ambiguous effect of privatization, but no study found a negative effect of privatization in developing countries.
12. Given that some reforms emphasize greater international trade and capital account openness, very often the process of reform is identified with the term "globalization."

Ravallion (2001) shows that, by going beyond averages, one discovers that there are large differences among countries in how much growth benefits the poor. In particular, he points out that the drop in the poverty rate brought about by a 1 percent increase in the growth of average household income can range between 0.6 and 3.5 percent. At the same time, Foster and Székely (2001) show that when one uses an index that emphasizes the income of the poor, the latter does not grow one-for-one with average income but considerably less. This last result seems to indicate that reforms may hurt some groups with very low income and hence, while they do help in reducing overall poverty, they may worsen income distribution among the poor. There is, therefore, a role for policies that take into account the distributional impact of growth.

Eighty-three percent of opinion leaders in Latin America consider the greater opening of national markets to trade and business with other countries to be either very good or somewhat good.

The IDB (1997) finds that structural reforms led to a slight improvement in income distribution and that trade reforms were not regressive (in the sense that they did not contribute to worsening income distribution). However, Behrman, Birdsall, and Székely (2000) study wage differentials in Latin America and find that during 1980 through 1998 economic reform had a short-run disequalizing effect.[13] One of their main results is that, while domestic financial market reforms, capital account liberalization, and tax reforms widened wage inequality, privatization narrowed wage inequality. At the same time, they find no significant impact of trade openness on wage inequality. Spilimbergo, Londoño, and Széleky (1999) find that, on average, trade openness increases inequality and that the effect is stronger in countries where physical capital is relatively scarce.

The fact that economic reforms (especially trade openness) may increase inequality in developing countries seems to go against standard economic theory (or at least economic theory rooted in the simplest version of the Heckscher-Ohlin model of international trade), which suggests that trade openness should increase the income accruing to the relatively abundant factor of production. Given that most developing countries are abundant in unskilled labor, which is also the factor of production controlled by the poor, one would expect trade openness to improve income distribution and hence improve the relative (and not only the absolute) well-being of the poor. However, the distributional effect of reforms is extremely complex. In some countries external tariffs focused on labor-intensive products, as in the case of Mexico (Hanson and Harrison 1999); in other countries the most abundant factor of production is land or natural resources.

Much has been said about the short-run impact of trade liberalization and other structural reforms on employment and unemployment. Undoubtedly, the widely held perception that the reforms were detrimental to workers is behind the opposition of the public to the so-called neoliberal agenda. One of the best efforts to gather opinions on the labor and social impact of the reforms was recently undertaken by the Structural Adjustment Participatory Review International Network (SAPRIN) (2002), which used participatory methods to examine the experiences of nine countries, three of them in Latin America.[14] According to this study, the effects of the structural reforms on labor have been predominantly negative:

- "Domestic manufacturing sectors and employment have been hit hard by indiscriminate import liberalization [while] increased exports have failed to generate significant domestic economic activity and employment" (174–76).
- "Coupled with trade liberalization measures, financial-sector reforms have had a particularly devastating impact on small and medium-sized firms and the large number of jobs they provide" (175).
- "Unemployment and job insecurity have increased and working conditions have often deteriorated with the increase in privatizations and the introduction of flexibilization measures" (180).

Likewise, an ambitious participatory project (Narayan and Petesch 2002) recently carried out by the World Bank in twenty-three countries (four of them Latin American) gathered the opinions of poor people, who clearly stated their concern about the effects of the reforms on labor:

- "Depending on the country, poor people mentioned privatization, factory closures, the opening of domestic markets . . . and other related changes as having depleted their assets and increased their insecurity" (471–72).

- "In all four countries of Latin America and the Caribbean, people described the economic and social devastation of their communities in the wake of macroeconomic crises and policy reforms. They felt directly harmed by numerous plant closures, the shift to a service economy, and the rise of the informal economy" (474).
- "A common theme underlies the sentiments expressed by men and women . . . in Argentina: the quality of their lives has deteriorated. In urban areas, they attribute the decline mostly to unemployment and crime. In their words, a dramatic picture emerges of the personal and social consequences of market reforms and factory closures" (335).
- And in Ecuador, "many urban study participants say the 1990s brought deep declines in their well-being, and they express little support for the economic reforms made by the government" (400).

In spite of these opinions, no study has been able to provide support for the belief that import liberalization increases unemployment or reduces (aggregate) employment. If anything, the opposite is found. Interestingly, trade liberalization seems to have produced very little employment reallocation either between the tradable and nontradable sectors or within them (IDB 2003). The impact of privatization on unemployment has also been overstated. Even in countries where layoffs in privatized countries were massive, the effect on overall unemployment was small. The dismissal of nearly 150,000 workers in Argentina as a result of privatization between 1987 and 1997 can account for only 13 percent of the increase in unemployment during the same period. However, between 80 and 90 percent of the personal cuts were offset by new jobs in the same sectors, leaving a very small net unemployment effect. Similar results are obtained for other big privatizers, such as Bolivia, Mexico, or Peru (McKenzie and Mookherjee 2003). Furthermore, though work conditions in the privatized firms often deteriorated, wages seem to have gone up substantially, as has become clear at least in the cases of Argentina, Chile, and Mexico. Therefore, the social losses appear to concentrate in those laid off who were not reinstated directly or indirectly in the privatized firms. Many of the people laid off moved to the informal sector with earnings substantially below their previous wages (IDB 2003).

As we have seen, the social consequences of reforms can hardly be used as factual support for the reform fatigue. Although there is no consensus on some of the distributional effects, the prevalent view among the researchers is that these effects were mild. And in spite of all the fuss about the employment implications of trade liberalization and privatization, there is very scant evidence to support it.

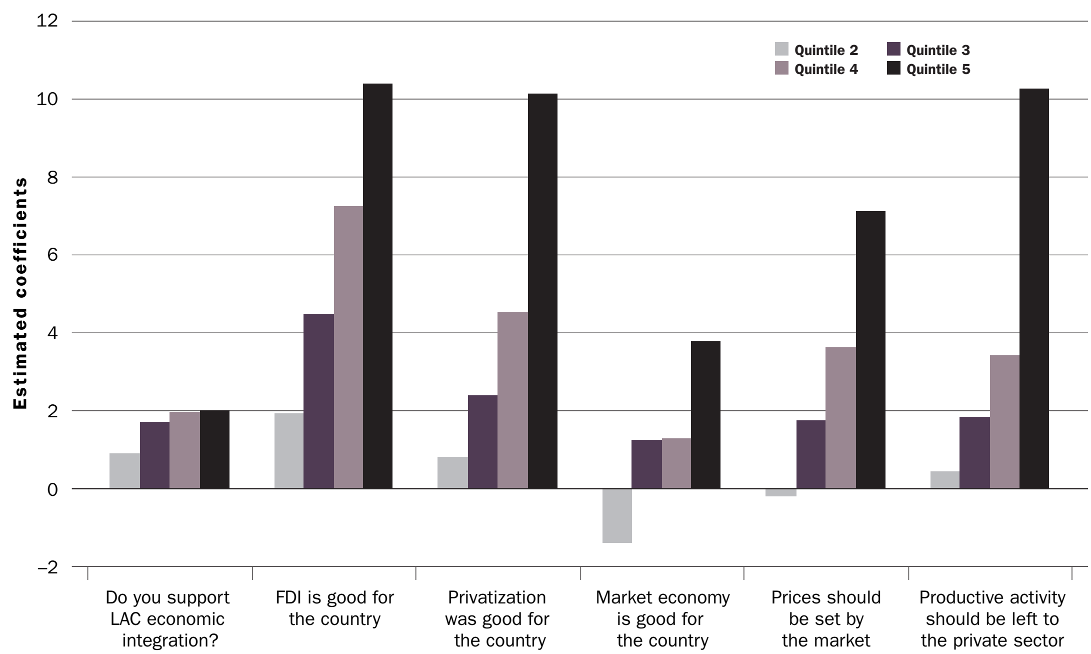
However, as discussed in connection with the economic reasons, people's views are not necessarily formed on the basis of the indicators and models used by economists. In forming their opinion about the social and distributional consequences of the reforms, people may attach important weight to some observations that may not be representative of the general outcome. This behavior stems from two reasons. First, people tend to compare their own economic situation with the situations of their immediate "reference group" (neighbors, peers, relatives, etc.) rather than with society at large. As a result of this "rivalry effect," people resent it when others in their reference group do better than themselves even if all are becoming better off or if income concentration for the society as a whole is improving. "That is why there was so little economic discontent [in Europe] during the Second World War. By contrast, the great inflation of the 70s created great discontent because throughout most of the year other people's wages were raising rapidly, while one's own wage was constant" (Layard 2003, 8). The second reason is the high visibility of the consumption patterns of those at the very top. In the "winner-take-all-society," a few at the top in some professions (especially arts, sports, and some other businesses) make astoundingly high incomes and consume accordingly, gaining the attraction of the media and the public opinion (Frank and Cook

Opinion leaders' views seem to imply that the reform agenda should not be reversed but expanded, as has also been the trend among international organizations.

13. Morley (2000) finds small regressive effects of reforms. He points out that while tax and trade reforms tend to be regressive, financial reforms are progressive.
14. See SAPRIN (2002). The countries included are Bangladesh, Ecuador, El Salvador, Ghana, Hungary, Mexico, the Philippines, Uganda, and Zimbabwe.

FIGURE 8

Public Opinion Support in Latin America for Reform, by Wealth Levels, 1996–2003



Source: Latinobarómetro survey data from Panizza and Yáñez (2003)

1995). Both the rivalry effect and the winner-take-all effects may have had deleterious effects on Latin Americans' opinion on reforms because economic liberalization created new opportunities, opened the way to greater social and economic mobility, and facilitated the adoption of conspicuous patterns of consumption by those able to afford them.

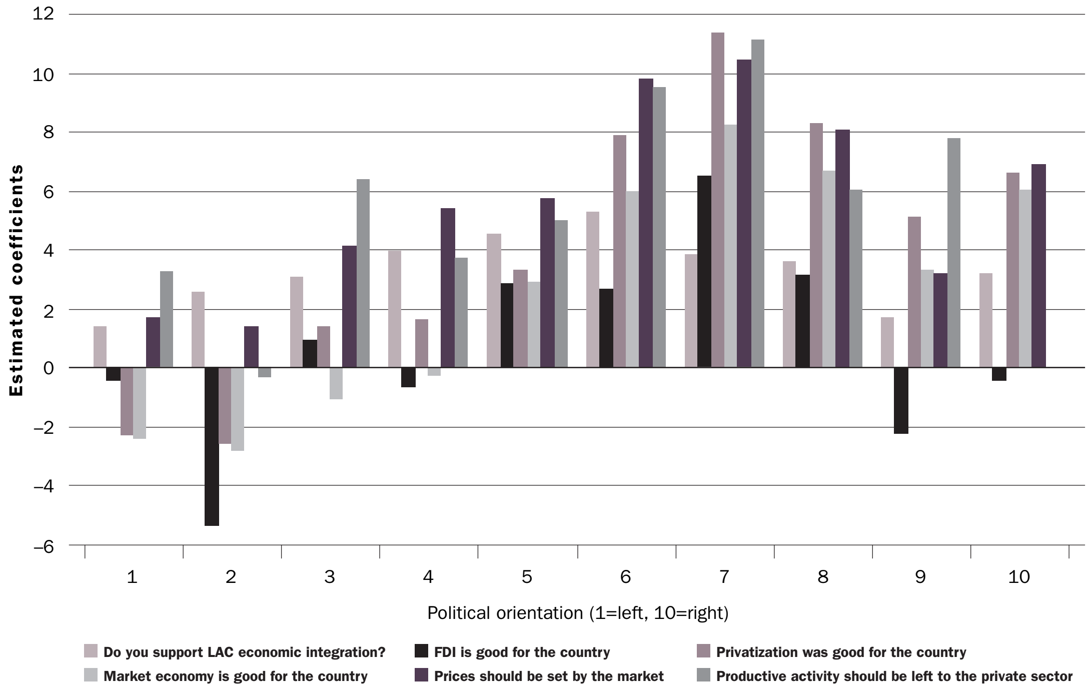
Political reasons for the fatigue. One possible cause (or consequence) of the decrease in support toward promarket reforms may be an overall movement of the population toward the left. This may be part of a global trend with the end of the Reagan-Thatcher era and the beginning of a new worldwide movement toward the left following, with a lag, the leadership of Bill Clinton and Tony Blair. Latinobarómetro allows us to investigate this hypothesis because it includes a question on the respondent political orientation. In particular, it asks: "On a scale of 0 to 10 how right wing are you?" (0 being the most left wing and 10 the most right wing). The results for this question do not point to any change in political orientation and, if anything, they would show a small movement toward the right.[15] Panizza and Yáñez (2003) have also used these data to study the behavior of extremists. They have found that the share of those who define themselves as being of the extreme left is more or less constant since 1996, but the share of those who define themselves as being of the extreme right increased during the two crisis years of 1998 and 2001. During the 1998 crisis, left extremism also peaked in Brazil, Colombia, and Ecuador.

To further explore the political reasons behind the rejection of reform, it is useful to look at the socioeconomic characteristics and the political opinions of those who are against reforms. From a political economy point of view, we are interested to see if the rejection is more concentrated among specific socioeconomic groups and if those who oppose reforms share other opinions or attitudes with respect to the political institutions.

To identify who is against the reforms, we draw from results by Panizza and Yáñez (2003), who have used the Latinobarómetro data to run a set of regressions in which the dependent variables are the indicators of attitude toward reforms and the explanatory variables are socioeconomic variables.[16] Their results show that men tend to be more supportive of promarket reforms than women (the difference ranges between 1 and 5 percentage points) and that wealth and education tend to be associated with more support for reforms (an individual who belongs to the top quintile of the wealth distribution and who holds a university degree is 20 percentage

FIGURE 9

Public Opinion Support in Latin America for Reform, by Political Orientation, 1996–2003



Source: Latinobarómetro survey data from Panizza and Yáñez (2003)

points more likely to support economic integration than an individual who belongs to the bottom quintile and has no education) (see Figure 8). However, education and wealth are only weakly correlated to the support for privatization and a free market.

With respect to political orientation, those who describe themselves as being just to the right of the center tend to be more supportive of promarket reforms than those who describe themselves as being left to the center or to either extreme of the political spectrum (even though those at the extreme right are more supportive of reforms than those at the extreme left; see Figure 9). Given this weak correlation between political orientation and attitude toward reforms, it is not surprising to find that changes in public opinion toward reforms were not associated with a net movement to the left of the electorate.

The support for reforms tends to be associated with other political views. Those who think that elections are clean are between 3 percent and 8 percent more likely to be in favor of economic integration and privatization. This finding is important because it may mean that a clean and well-working democratic system could make the reform process more sustainable.[17] Interestingly, those who perceive that corruption is a serious problem are more in favor of economic openness (they support economic integration and think that FDIs are beneficial for the country). This result supports the findings of Ades and Di Tella (1999), who show that openness can help in reducing corruption. At the same time, those who think that corruption is a serious problem tend to be more skeptical of the privatization process and the working of the private sector. This finding is in line with the conclusions of Lora and Panizza (2002b), who argue that privatization works better in countries characterized by low levels of corruption.

Whether the support for reforms has waned or not, there is the perception that those who oppose promarket reforms have been able to get their

15. The average values are 5.33 (1996), 5.53 (1997), 5.58 (1998), 5.33 (2000), 5.87 (2001), and 5.52 (2003).
16. All the regressions also include country-fixed effects and country-specific time effects. To make the results more intuitive, the regressions were estimated using a linear probability model. Probit estimations yield similar results.
17. However, this finding could also mean that those who benefit from reforms are also those who benefit from an electoral system that does not work well but that, in their opinion, is fair and clean.

message through and to gain influence in the decision-making process. To assess the validity of this perception, Panizza and Yáñez (2003) have checked whether there are differences in political participation between those who support and those who oppose reforms. In general, those who support reforms are more interested in politics than those who oppose reforms. This finding is not surprising because there is a positive correlation between interest in politics and education and, in turn, a positive correlation between education and support for reforms, but it should be noted that the positive correlation between support for reform and interest in politics is rather weak.

Emphasis on privatization is now made conditional on the possibility of adjusting the institutional and regulatory environment to reduce the risk of inefficiency, corruption, and regulatory capture.

Going beyond the declared interest in politics, Panizza and Yáñez (2003) have also explored whether those who oppose reforms are more likely to get involved in what they call "violent political activities."[18] Their results show that those who oppose reforms are between 1 and 2.5 percentage points (corresponding to a 10 percent difference) more likely to participate in this kind of activity. While this finding lends support to the idea that those who oppose reforms tend to "make more noise" than those who support reforms, it should be recognized that the difference is rather small. Furthermore, there is no evidence that those who are against reform have become more involved in this type of activity in recent years.

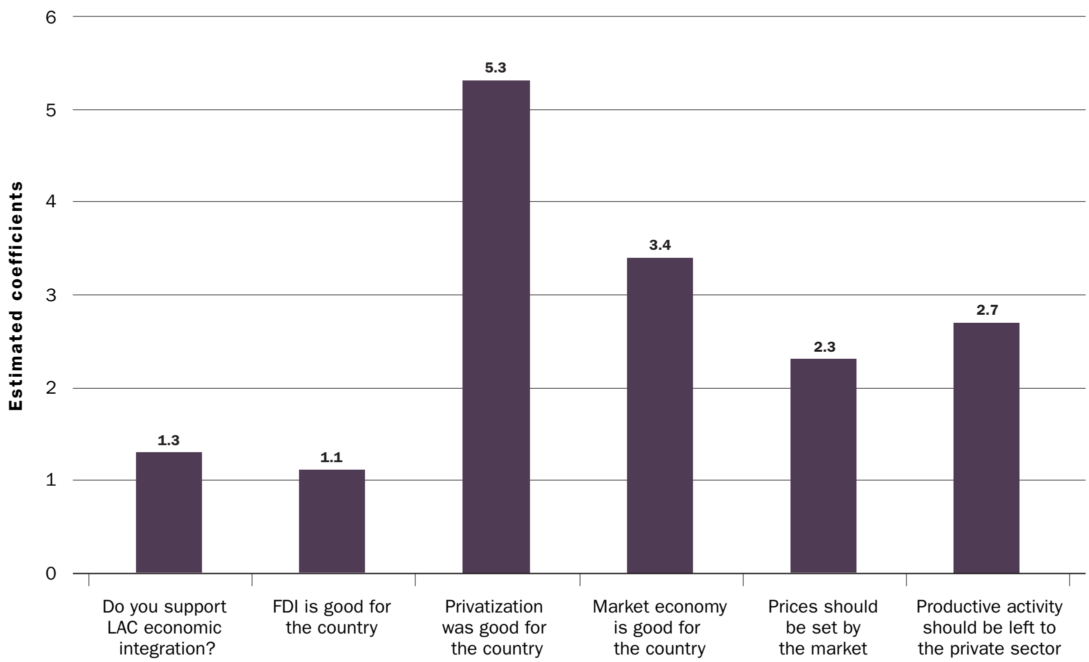
Loss of credence of political parties may be another political reason behind the lack of support for reforms. Scholars of economic development argue that political parties are important in the reform process because of their programmatic orientation and because they may facilitate the process of aggregating diverse views and striking compromises for the adoption of reforms (Corrales 2002; Graham et al. 1999). However, parties may also be important for the sustainability of reforms because they can help build credibility and reduce skepticism. "For economic agents to cooperate with the reforms, they must be persuaded that the state is fully committed to carrying through with them. . . . [Otherwise] they are hesitant to cooperate, not because they fear losing, but because they fear being cheated by other players who fail to do their part" (Corrales 2002, 32). Reforms are therefore more likely to lose the support of the public in countries where confidence in political parties is low and when implemented by personalistic governments or by unpopular or unstable parties. A related argument is that, since political parties do not reflect but rather shape the preferences and responses of the electorate, cohesive parties increase the sustainability of reforms, especially when aligned with the executive (Corrales 2002).

On the basis of this reasoning, Panizza and Yáñez (2003) have tested whether there is a relationship between support for reforms and trust in political parties. They have measured trust and identification with political parties with two variables taken from the Latinobarómetro. The first measures the level of trust in political parties on a scale from 1 to 4 (where 4 means a great deal of trust in political parties). The second measures identification with political parties on a similar scale (4 if the respondent feels very identified with political parties). Figure 10 shows that there is a strong and positive correlation between support for reforms and trust in political parties. The results indicate that an individual that fully trusts political parties is 14 percentage points more likely to support the market economy than an individual who does not trust political parties (and 20 percentage points more likely to support privatization). While there has not been a substantial drop in trust and identification in political parties, the association between trust and political parties and support in reforms (in particular, support for the market economy) has become stronger, marginally helping to explain the increased rejection to promarket reforms. As we will discuss below, the adoption of structural reforms has apparently taken a heavy toll on the parties that pursued them while in power, which is consistent with this result.

In summary, there are linkages between socioeconomic characteristics and political support for promarket reforms. However, those variables do not go a long way toward explaining why rejection of reform has increased through time. The shift in public opinion is not due to a profound change in political views or to an increase in the ability of those opposed to push their position through but is due, as discussed before, to short-term economic circumstances. Although this explanation may be a good omen for the future of reforms, it is not entirely clear that acceptance of market-friendly policies

FIGURE 10

Public Opinion Support in Latin America for Reform by Those Who Trust Political Parties, 1996–2003



Note: The reference group is those who do not trust political parties.

Source: Latinobarómetro survey data from Panizza and Yáñez (2003)

will revive when and if these economies recover since negative attitudes will likely tend to linger, making the acceptance of further reforms difficult even when the current crisis subsides.

Psychological reasons. Neither the economic nor the social consequences of structural reforms can explain the attitude of the public toward them. Nor is there any evidence that Latin Americans are moving ideologically toward the left, which would imply a reduced appetite for the market vis-à-vis the state. The only evidence that helps explain to some extent the lack of support for reforms is the recent deterioration of macroeconomic conditions in the region. Given the insufficiency of our previous explanations, we conclude our exploration of possible causes for the reform fatigue with some very tentative hypotheses based on behavioral economics.

Some analysts have turned to cognitive psychology to explain why structural reform becomes bogged down. Pioneering research by Kahneman and Tversky (1979) found that individuals are more willing to take risks in order to recover a loss than when they are seeking to protect their gains. Weyland (2002) argues that this pattern can explain why presidents tend to back away from structural reform programs even after having administered a successful "shock" program of structural reform. If the initial reform overcomes an acute economic crisis and restores stability, presidents are less motivated in a stable environment to push for additional reforms than they were during the initial crisis. According to this hypothesis, once the recovery has taken place, leaders become less willing to take risks. Weyland suggests that this was precisely the case in the early 1990s in both Argentina and Peru: After both economies recovered following bold reforms, presidents Menem and Fujimori became more risk averse, and the process of structural adjustment slowed.

More recently, finance minister Fernando Henrique Cardoso introduced the *Real* plan when Brazil was suffering from high inflation in 1994, but once he became president the following year the reform process slowed considerably during his two terms in office. In Ecuador, President Mahuad initiated a process of dollarization during a severe crisis that helped stabilize the economy; however, the structural reforms that would enhance the viability of dollarization have not yet been achieved.

18. The index ranges between 0 and 1 and is built as the principal component of a set of questions that ask whether the individual has ever participated in violent demonstrations, occupation, lootings, etc.

Of course, a crisis is no guarantee that significant structural reforms will occur; Argentina since 2001 is an example. However, Weyland's point is that, in an atmosphere of crisis, politicians generally find greater public acceptance of reform, but once stability returns, that support can erode. During the past half decade there has been weak economic growth, but full-blown crises have occurred only in a handful of countries (Argentina, Ecuador, Uruguay, and Venezuela). Consequently, this relative stability, combined with growing dissatisfaction with reforms already in place, did not create a receptive climate for reform. On the contrary, the recent economic downturn in the region has created a fertile environment for political actors who oppose the process of structural reform.

According to most studies that make comparisons between countries, there is a clear and positive correlation between opening to international trade and economic growth.

Another psychological reason may help explain the rejection of promarket reforms when countries are away from the pressure of an economic crisis. Most people tend to prefer outcomes that are known with certainty to be positive over the uncertain possibility of a much larger benefit even when the expected value of the latter is much bigger (Kahneman and Tversky 1979). The popular saying "better the devil you know" implies a psychological bias in favor of the status quo ante, which can help explain popular resistance to any type of reform. However, in the case of promarket reform, this bias can also help explain the rejection of the reforms once implemented because a larger role for the markets vis-à-vis the state implies that people are faced with more risks (Rodrik 1997). Even if the aggregate outcome is welfare enhancing, many people may prefer the previous situation in which uncertainty was lower. Furthermore, willingly exposing people to risks without offering them the means of protection is considered unethical or at least unfair by many people (Schwartz 1998).

Psychology may offer another fundamental reason why, after a trial period, most people tend to reject reforms even when they are relatively successful: cognitive biases. Two types of cognitive biases are universal aspects of human behavior. One is "confirmatory bias," that is, the tendency to misinterpret ambiguous evidence as confirming existing hypotheses or beliefs. Experiments performed by psychologists show that if people have different initial beliefs when they receive the same additional information, their views tend not to converge but to become more polarized as they process that information selectively to confirm their initial beliefs. The second universal behavior is "self-serving bias," that is, people's tendency to believe the hypothesis that best serves their interests. An implication of this bias is the tendency to attribute success to one's own effort but failure to external forces, such as bad luck or ill-intentioned behavior of others (Pinker 2002, chap. 15).

The implications of these biases can be devastating for the sustainability of reform. Pernice and Sturzenegger (2003) have argued that, in the case of Argentina, these biases are at the root of the social resistance to reform. In spite of the initial success of privatization and foreign direct investment deregulation in the early nineties, even before the Tequila crisis of 1995, people were already focusing on the (alleged) negative outcomes of those reforms, such as unemployment and wealth concentration. A series of well-known events provided further ammunition to those antimarket beliefs, polarizing public opinion and reinforcing a deep-rooted position against both free markets and foreign influences. As the authors conclude, "it is then perfectly consistent with these cognitive biases that people will turn against a successful reform process if the principles of these reforms are at odds with their self-serving view of the world."

Therefore, cognitive psychology offers some hypotheses that may help explain the lack of support for reform. They are related to some principles of behavior toward risk—namely, that when confronted with losses, people are better prepared to assume risks than when they find themselves in a situation that they consider normal—and some universal cognitive biases: confirmation bias and self-serving bias. Since only casual evidence has been advanced in favor of these hypotheses, their actual relevance is an open question.

Implications of Reform Fatigue

Whether we can identify the causes for the reform fatigue or not, a major concern arises: The loss of popular support for promarket reforms and the lack of appetite in the political arena for the neoliberal model may be signaling an increasing risk of a backlash. Even if the reform process is not reversed, the economic and social benefits of what has been done so far largely depend on further reforms in order to give institutional support to previous liberalization measures (the so-called second generation reforms) and to advance social policy reform. The future of the reform process therefore depends on political support, not only to maintain the reforms already implemented, but also to pursue these additional reforms.

The political costs of promarket reform. This section explores the political implications of reform fatigue. We start by addressing a central question: What has been the electoral payoff of the reforms? If the electorate rewards parties that pursue promarket reforms, political selection will tend to deepen the reform process. But if the electorate punishes the reformers, those who want the process to be halted or derailed will stand a better chance of achieving that.

Theories of political economy provide strong arguments to explain why structural reforms may be difficult to implement and may carry political costs. Reforms must defy the status quo ante and reallocate income among different social groups (Rodrik 1994). Most likely, while those who stand to gain from the reforms are a diverse and disorganized group, the losers are a smaller group, often organized and politically vocal, intent on protecting its interests. Reforms are also opposed because their effects are uncertain, both at the macro and the micro levels. Uncertainty about the allocation of losses among the members of the group most affected can elicit ex ante opposition even if the overall payoff for the group is positive (Fernández and Rodrik 1991). These potential political costs can be outweighed by the benefits of the reforms, which come from the improvement in macroeconomic conditions (lower inflation, higher growth, less unemployment). According to political economy theory, the chances of reform improve when the expected benefits are large enough to tilt the political balance against those who oppose reform. For this reason, reform is more likely in the midst of a crisis (Alesina and Drazen 1991; Drazen and Grilli 1993; Rodrik 1994.).

Since these economic theories concentrate on the ex ante political costs of reform, their arguments are less adequate to explain the resistance to reforms already implemented. But political scientists have advanced several hypotheses to explain the ex post political payoff of the reforms. They argue that the payoff must be positive when the reforms have been implemented in response to a crisis and are followed by higher growth (and other desirable macroeconomic outcomes) that may be viewed by the public as a consequence of the reforms. The reasons for these hypotheses are the principles of behavior toward risk and the limited understanding by most people of the actual workings of the economy, as mentioned above. Using case studies for a handful of Latin American countries, Stokes (2001) finds support for these arguments. He also finds that the response of the electorate is not independent of the preelectoral campaign promises of the incumbent. The voters do punish the "switchers" who opt to implement promarket reforms after having campaigned against them. Therefore, lying may be a good bet ex post facto but only if the reforms do deliver substantially better macroeconomic results.

The perception of increased inequality may have reinforced the views opposed to promarket reforms in spite of the fact that the association between those outcomes and the reforms is extremely weak.

Lora and Olivera (2004) attempt to test the validity of these hypotheses with the outcomes of nearly forty presidential elections in seventeen countries between the mideighties and the end of the nineties. According to their results, a party that has been in power gains votes if the rate of inflation is reduced during its term but loses votes if promarket reforms are adopted. Their estimates suggest that if inflation is reduced, say, from 100 percent to zero during the term of the administration, the electoral payoff is a handsome doubling in the vote share for the party. Such large reductions in inflation are not common, however (the average reduction in the sample is just 9 percent). In contrast, when a government pursues aggressive structural reforms, say, an increase in the reform index of 0.24 points (which corresponds to the average increase in the index in the entire 1985–99 period, as we have seen above), the electorate punishes the incumbent's party by slashing about a quarter of its votes. (However, the typical amount of reform represents just 0.08 points of gain in the reform index, with a correspondingly lower electoral cost).

These results support the widely held view that aggressive liberalization policies are more easily pursued from a political point of view when combined with an anti-inflationary package, as happened in Argentina and Peru at the beginning of the nineties. The results are also consistent with the fact that virtually all governments have tried to protect price stability at all costs during the last decade. These results imply as well that promarket reforms, being politically costly, are bound to hit a political wall because the parties that backed them in the past may be in retrenchment and that the whole party system may now be more fragmented in many countries than it was a decade ago, partly as a result of those policies. As we have mentioned, case studies suggest that these political costs may be lower when the reforms are pursued in response to a crisis, when they are in line with the incumbent's preelectoral promises, and when growth picks up. That seems to be the case, but the evidence found by Lora and Olivera in support of these claims is tentative at best.

Politics is bound to play the decisive role in the future of reform because the parties that have pursued them have paid a hefty electoral cost.

Do all these results imply that the reforms are doomed to be stalled or, even worse, that a reform reversal should be expected? Not necessarily. First of all, it is not clear whether different types of reforms carry similar political costs. Lora and Olivera find that the costs seem to be much more clearly associated with the adoption of trade liberalization reforms than with any of the other four reform areas considered—financial liberalization, tax reform, privatization, and labor reform. Since trade liberalization happens to be the area where the potential for reform has been most exploited, deepening the rest of the first generation reforms or pursuing second generation reforms may turn out to be less politically costly or even beneficial. Second, our knowledge of the political costs of reform is based almost entirely upon the experience of reform adoptions and advances. It would be a big leap to assume that reform reversals produce correspondingly large political benefits. Remember that a basic tenet of the political economy theory of reform is that changing the status quo is politically costly. Today's status quo is based on a much larger role for markets than a decade ago, which implies that the stakes of investors and other market participants are also much larger.

This larger role of the market does not mean, however, that investors are always in favor of promarket, neutral economic policies. On the contrary, a real concern for the future of reforms is that the appetite of private firms for (and ability to get) interventionist policies seems to have increased in recent years. In their annual surveys of 100 firms per country, the World Economic Forum poses this question: "When deciding upon policies and contracts government officials usually: favor well-connected firms (=1) . . . are neutral among firms and individuals (=7)." Figure 11 shows the average responses in the eleven Latin American countries surveyed in both 1999 and 2002. In eight countries the responses signaled a significant decline in the neutrality of policies.[19] The only exceptions were Chile, Brazil, and Mexico. However, domestic firms are only one group of stakeholders in the reform process. International financial investors are another, and one of no little importance, given the high levels of external indebtedness of most Latin American countries. Have these investors also become more lenient?

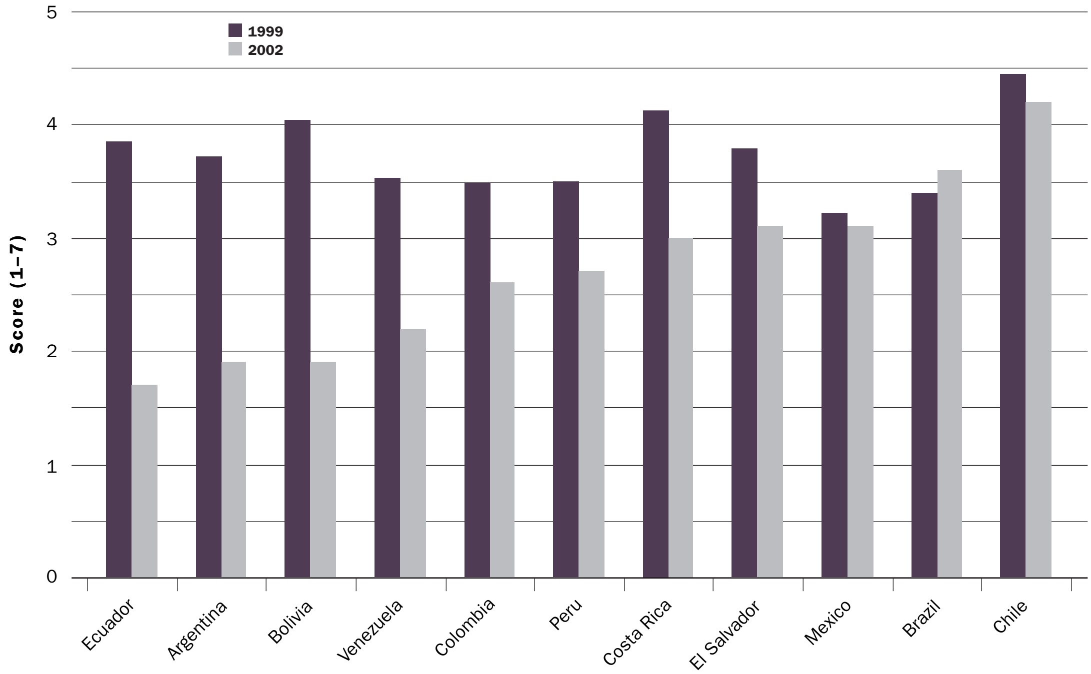
International financiers' sensibility to reform retrenchments. Have international markets become more tolerant of unorthodox economic policy announcements? How do international markets respond to presidential elections when leading candidates promise to halt or reverse the process of structural reform? A brief survey of the region's most recent elections—in Argentina, Brazil, and Ecuador—is not conclusive but suggests that investors have become more tolerant to those announcements. To analyze the linkages between international market sensitivity and preelectoral uncertainty, we look at the country risk premia.[20]

The economic collapse of Argentina in 2001 and the subsequent ineffectiveness of the Duhalde administration led to a general perception that only a new government could begin to resolve the country's problems. This perception exists despite the fact that the leading candidate for president, Nestor Kirchner, promised a greater role in the state economy and fiercely criticized Argentina's neoliberal economic path. After Kirchner's election, bond spreads fell from the 7,000 trading range to the 5,000 range, indicating some hope that the debt situation would be resolved under his leadership.

In Ecuador, as the political campaign heated up in 2002, bond spreads widened only slightly. The response of the bond market was minimal despite the fact that the winner, Lucio Gutierrez, a 2000

FIGURE 11

Businesspeople's Perception of Favoritism in Government Policies



Note: Lower numbers imply more favoritism.

Source: *Global Competitiveness Report*, 1999 and 2002, World Economic Forum

coup leader and an admirer of Hugo Chávez, reached the second round after running a populist campaign against banana tycoon Alvaro Noboa with the support of the left and indigenous groups. With bond spreads already hovering at around 2,000 basis points, it appears that financial markets had already discounted the risks posed by fiscal and foreign debt constraints.

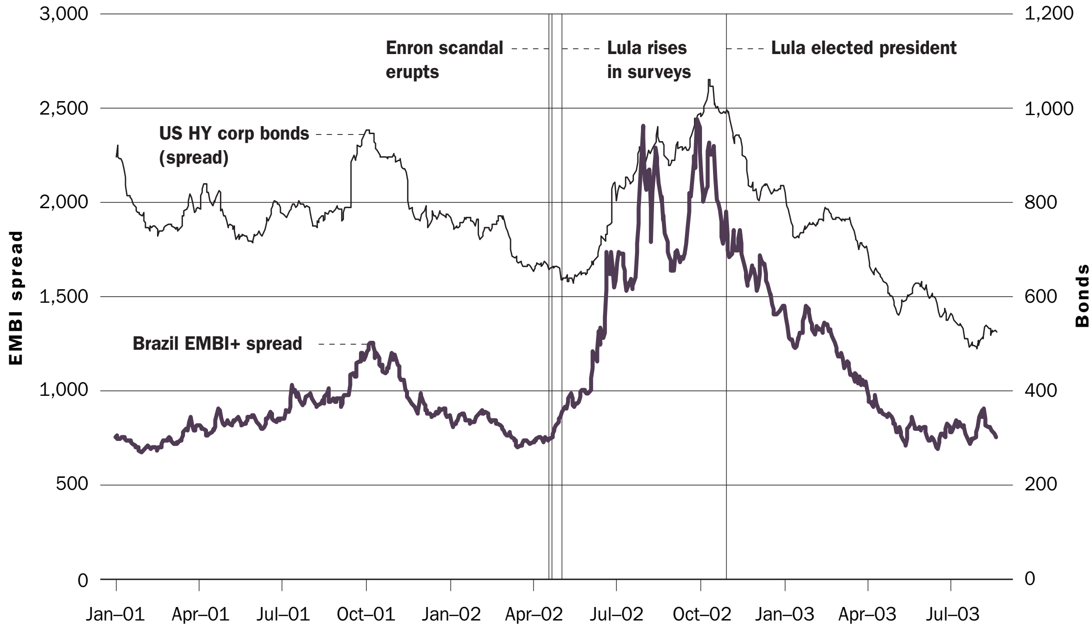
Prior to the 2002 election in Brazil, the *real* weakened, the stock market plummeted, and bond spreads soared to over 2,000 basis points amid fears of an imminent Lula victory. In August, spreads narrowed by 500 basis points as investors were cheered by the presidential candidates' pledges to honor the $30 billion loan package from the IMF. However, as Lula gained strength in the polls in September, bond spreads again surpassed the 2,000 basis point level. After the elections, market sentiment improved as investors gained confidence in Lula's commitment to respect fiscal constraints, and by October 2003 bond spreads had fallen to the 750 basis point level.[21]

This brief preliminary survey of country risk suggests that Brazil is the exception, rather than the rule, in that international financial markets strongly reacted to unorthodox economic policy announcements. But is Brazil really an exception? If we compare the performance of Brazilian sovereign bonds with U.S. corporate high-yield bonds, we see a similar movement of bond spreads, suggesting that, more than a "Lula effect," there has been a recent "Enron effect" (Calvo and Talvi 2002). Since high-yield U.S. corporate bonds and sovereign bonds are perceived as high-risk investments with some degree of substitutability, their performance shows a positive correlation.[22] However, that comovement

19. The change in those eight countries was more than twice the standard deviation of the eleven values in 1999, suggesting that there was a real change of perception, not just a random change in the responses in the different countries.
20. The indicator for country risk is the interest rate spread in basis points between the country's emerging market bond index over thirty-year U.S. treasuries.
21. For an analysis of the "Lula effect," see Martinez and Santiso (2003).
22. As part of preliminary research on financial market sensitivity to political and economic uncertainty in Latin America, Quispe-Agnoli (2003) ran regressions where the country-risk premium was the dependent variable and the exchange rate and corporate bond spread were independent variables.

FIGURE 12

U.S. High-Yield Corporate Bonds and Brazil EMBI+ Spread



Source: J.P. Morgan and Bloomberg

became much stronger following the eruption of the Enron scandal (see Figure 12), which put into question the reliability of balance sheets of major corporations. This atmosphere reduced the appetite for foreign direct investments in emerging markets, where the lack of accounting transparency may be an even more serious issue than in the United States.

Whatever the explanation for the recent strong comovement, on close inspection the Lula effect might be less than initially supposed. This preliminary survey on country risk suggests that international investors have become very lenient with the threats of reform backlashes, which may increase their likelihood. However, this evidence is still very inconclusive. The casual evidence just reviewed may be consistent with other hypotheses. For instance, investors may have learned to distinguish between political noise and real threats to the sustainability of structural reform. In fact, Lucio Gutiérrez and Lula da Silva have proved to be much more orthodox than expected, while it is debatable whether Kirchner has substantially altered the course of structural policy decisions. Furthermore, in all three cases debt spreads were already at excessively high levels, indicating that international investors were all too aware of the flaws of the economic situation and the structural policies. More research is clearly needed to know whether international investors have become more or less lenient with unorthodox economic policies and what effect this change may have on the future of reforms.

Conclusion

If the sustainability of reform hinges upon the beliefs and attitudes of public opinion and the main players, there are serious reasons for concern in Latin America because symptoms of reform fatigue are plentiful. Public support for promarket policies has been waning since 1998, and currently only a minority of those surveyed declare themselves in favor of privatization or free markets. As policymakers have also become less enthusiastic, the reform process is now stalling in many countries, and two countries have experienced major setbacks. Unlike the public at large, opinion leaders are supportive of privatization, but many qualify their support, and they are clearly divided about the impact of the so-called neoliberal model on poverty. Even international organizations and top economic thinkers are no longer unified around the need and convenience of pursuing a core set of promarket reforms to improve the chances of economic and social development.

This paper has explored a variety of hypotheses that may help explain the increasing rejection of reform. Economic hypotheses gain the upper hand. Although positive, the effect of reforms on productivity and growth seems to have been moderate, largely transitory, and certainly below the expectations originally created by the reformers. Granted, reforms in most countries have been incomplete and have lacked institutional and regulatory support, but the political and practical demands these reforms would imply put them beyond the reach of those countries in most need of them. However, what seems to have influenced public opinion the most is the short-run macroeconomic situation of the countries rather than complex analyses about what makes reforms more or less successful. The recent deterioration of some social indicators and the perception of increased inequality may have reinforced those negative views in spite of the fact that the association between those outcomes and the reforms is extremely weak.

Political explanations cannot account for the increased rejection of reform. There is no evidence of an ideological turn toward the left or of a greater ability on the part of reform opponents to spread their views in the political arena. However, politics is bound to play the decisive role in the future of reform because the parties that have pursued them have paid a hefty electoral cost. This cost has been mitigated only when the reforms have been packaged with ambitious anti-inflationary policies, but other circumstances do not seem to have affected the reaction of the electorate.

Since a large part of the increased rejection of reform is associated with the recent growth slowdown in many countries in the region, an eventual recovery could be expected to facilitate the reinitiation of the process. This outcome is far from guaranteed, however, for at least two reasons. One is the fragmentation of the political system and the disarray of the political parties in many countries, partly a consequence of the reform process. The other is the nature of public opinion. If, as cognitive psychology maintains, people form their opinions to support their previous beliefs and serve their own interests, economic recovery will not necessarily restore confidence in reforms. Though this possibility does not bode well for the likelihood of further ambitious pro-market reforms, it must not lead to the conclusion that reform reversals, such as those in Argentina and Venezuela, should be expected in other countries. A more likely scenario is that, especially where pro-market reforms are well advanced, the eventual recovery of economic growth will lead to further institutional and social policy reforms that buttress the original reforms. Of course, this good scenario would probably not materialize if the incipient recovery aborts, particularly in the case of Brazil.

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