EFFECTS OF LIBERALIZATION PROGRAMS ON POVERTY AND INEQUALITY:

Chile, Mexico, and Peru*

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Programs of economic liberalization have many common features all over the world, but they do not necessarily have the same consequences. Differences in their effects reflect differences in the countries themselves along with accidental factors of timing and external events, and they can also embody systematic consequences of alternatives within the programs. The starting point in this discussion is that different versions of liberalization—alternatives consistent with the basic strategy—can have significantly different effects on poverty and inequality.

Liberalization programs are not usually aimed at social concerns, although the common expectation of their proponents is that greater efficiency and success in avoiding inflation should favor economic growth and thereby reduce poverty in the long run. Given the clear possibility that the immediate effects can be negative and can stay negative for years, most governments and the international development agencies have promoted direct social programs to moderate these programs' impact on the poor by methods that do not interfere with markets, to lessen poverty while pursuing efficiency through two separate but complementary channels.

Such social programs can surely help, but they leave open the possibility that negative effects from the side of market forces may outweigh gains from the social projects for many years. If the liberalization programs themselves can be shaped in ways that promote reduction of poverty and inequality, any social programs used with them might then become more effective than they would otherwise have been because they would not be caught in an uphill fight against market forces.

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The liberalization programs undertaken in Chile, Mexico, and Peru have shared many basic characteristics: all have been intended to favor efficiency, leadership by the private sector rather than the state, and relatively open and unregulated economies. Within this basic orientation, however, they have varied considerably. Chile's experiences can be interpreted in terms of three different versions. Mexico and Peru have combined the first Chilean model with social programs in some respects similar to the third Chilean model but unfortunately lacking the more positive features of the second.

All three countries went through an initial period of contraction and then recovered to achieve impressive results in terms of lower inflation and renewed growth. But just when the international financial community concluded that first Chile and then Mexico had achieved successful adjustment, each country fell into severe problems. Chile was considered a success story through the late 1970s and up to the last months of 1981, when it plunged into an extraordinarily deep depression. Mexico was widely regarded as having accomplished a convincing recovery from its debt crisis until December 1994, when it lost control and found almost everything going wrong.

Traumatic episodes need not last forever. Chile recovered after 1984 with a new and more successful program, and the democratic government that took office in 1990 turned it into a relatively egalitarian economic strategy as well. Mexico's drastic measures in response to its crisis at the end of 1994 greatly stimulated exports and may permit fairly rapid recovery in renewed output growth, although poverty has certainly worsened. Peru's more recent program has not hit any comparable crisis yet and could be revised to avoid or moderate such breakdowns. The question involves choices among competing objectives and also differences in understanding of how liberalization programs can be expected to work out.

It is always a treacherous business to draw general lessons from the experiences of particular countries. The more dependable side of these comparisons is that they bring out individual differences and common effects of the programs used in the three countries. Although extension beyond them is more doubtful, the common elements in these models and their consequences may help clarify alternatives for other countries as well.

The first section of this article will explain the basic hypothesis about the key economic variables within liberalization programs as well as some aspects of the relationships between structural adjustment and direct social programs. The next three sections will examine characteristics of the individual adjustment processes in Chile, Mexico, and Peru. The final section will interpret regularities and contrasts in these experiences, raising some questions about what is actually possible for these countries.

KEY ECONOMIC FACTORS INFLUENCING POVERTY AND INEQUALITY

If economists could all agree on the factors determining degrees of poverty and inequality, it would be a miracle—and probably a mistake. The causal processes at work are so varied and complex that they endlessly invite new attempts to understand and explain them. The limited purpose of this section is to clarify some of the key factors within alternative kinds of liberalization programs that can affect the consequences in these specific dimensions.

A pure form of liberalization, ruling out intervention of any kind as a contradiction of the basic strategy would leave no room for significant alternatives. The first model of liberalization used in Chile, and repeated so far in Peru, comes close to this position. But reality tends to undermine absolute prescriptions. Even the military government in Chile began in the second stage of its liberalization process to take some measures favoring employment and exports, making markets move in ways that they were not doing on their own. The question is, what kinds of measures might help lessen poverty and inequality without violating the constraints of an adjustment program that is fundamentally led by the private sector in an open economy?

The main economic relationships that work either in favor of or against equality are the balance between the demand for labor and the growth of the labor force, the distribution of assets, and the distribution of access to education, skills, and opportunities. Liberalization programs do not in principle rule out redistributing assets for the sake of equalization, but their spirit certainly goes against it. That leaves the growth of employment opportunities and the role of social programs affecting human capital as the main variables. The first key to the possibility of relatively egalitarian development is to follow a labor-intensive growth path.[1] The second is to stimulate personal learning and encourage social mobility for the society as a whole, but making a special effort to reduce the vast existing inequalities in access to education of decent quality, health care, and opportunities. These objectives involve three sets of variables at once: macroeconomic strategy, relative prices, and social choices.

On the macroeconomic side, it surely helps to keep output and employment growing as rapidly as possible within the limits of two critical constraints: that the rate of increase of production and spending is not so rapid as to provoke serious inflation, and that it does not raise imports so much faster than exports that continued growth becomes hostage to rising external debt. These constraints point directly to a crucial set of choices. Liberalization programs can be designed to allow

1. Samuel Morley uses a similar emphasis on employment opportunities as a central explanatory theme in his investigation of poverty and inequality in Latin America, although with different conceptions of how to promote them (Morley 1995).

private capital flows to determine the external balance on current account and comparative advantage to determine the structures of production and trade.[2] Alternatively, they can be designed to promote exports in order to raise the ceiling of sustainable rates of growth, to lessen dependence on external capital, and to favor diversification toward exports of manufactures and modern services. The first choice might be called the "standard model" in a double sense: it is the one that most fully embodies the logic of eliminating state intervention, and it has been the most common model in liberalization programs all over the world. The more activist second version might be termed a "competitive model" in the sense that it aims at building up the capacity of the country's modern sectors to compete in open international markets. Both orientations are consistent with liberalization of imports and internal markets. But the choice between them can make a great deal of difference for long-run trends in poverty and inequality.

On the microeconomic side, it should be helpful to foster labor-intensive techniques of production and products and therefore to avoid overvalued exchange rates that make imported capital equipment artificially cheap relative to labor. But this criterion also raises a familiar conflict: higher wage rates can reduce the income differentials between property owners and workers with regular employment, yet they can also discourage labor-intensive techniques of production and products. Under strong employment conditions, wage increases have a positive function: they help redirect production in ways that economize on scarce labor. But under conditions of widespread poverty associated with lack of opportunities for productive employment (as has been the case in Peru for many years, although not at present in Chile), higher wages can worsen poverty by reducing employment opportunities.

Emphasis on employment conditions and market forces is not meant to suggest in any way that they can be sufficient or that direct social programs are unnecessary or unimportant. Such programs are crucial for the health and nutrition of the extremely poor, and beyond that as channels through which the groups least able to respond to new opportunities can gain education, skills, mobility, and voice. The multilateral development agencies supporting the liberalization programs have done a great deal to promote and help finance social programs to accompany liberalization, and they have helped ease the strains of adjustment in many countries (Graham 1994; Glaessner et al. 1995).

Even under favorable employment conditions, many individuals are held in long-term extreme poverty by structural obstacles or personal

2. The current account is the balance between exports and imports of goods and services. A strong capital inflow normally creates or deepens current-account deficits: it encourages imports and discourages exports by increasing the supply of foreign exchange and causing the currency to appreciate.

handicaps that prevent them from responding to opportunities (Helwege 1995). The concept of chronic poverty provides a useful way to focus on them. The classification applies two criteria: that these individuals are below the poverty line in terms of consumption, and that they also lack the basic requirements for getting out of poverty. Among the basic deficiencies considered are illiteracy of the head of the household, children of primary school age who do not attend school, extremely poor conditions of health or housing, lack of sanitary facilities, and geographical isolation without dependable access to markets (Elias 1995; Reyes 1995). A Peruvian study for 1994 found nearly one-quarter of the national population in this category (Instituto Cuánto and UNICEF 1995, 31).

The social programs accompanying liberalization can assume an enormous variety of forms, but it might be useful to distinguish between two possible orientations that are particularly relevant to the present discussion. One form is the kind of social program that emphasizes emergency help to sustain nutrition or health standards for the extremely poor. A second kind of program aims at reducing the inequality of opportunities by such means as improving the quality of education for the poor, redistributing educational expenditures to lessen past biases toward higher education for the minority, providing worker training to increase job flexibility, developing communal leadership by inviting applications for local projects, and in general trying to correct structural obstacles that stack the cards against the poor. The first orientation is a logical and common complement to the standard model of liberalization. The second more nearly parallels in the social field the competitive model of liberalization. When a country combines the competitive economic model with the kinds of social programs that reduce inequality of opportunities, that powerful combination might well be considered a distinct third model of liberalization: a "competitive-plus-social model."

An appealing way to look at development and its goals is that it could and should be a process of opening up human capacities—for those whose lives have been blocked by poverty along with everyone else (Schuldt 1995). Improving employment conditions can surely help. Deteriorating employment conditions drove many families into needless poverty for many years under the first model of liberalization used in Chile; improving conditions under its second model helped many of them get out of poverty. But this is just one side of the issue: the side of demand for workers, creating opportunities for those able to respond. The other side remains crucial: raising the human and productive potential of the whole society and helping those initially not able to respond by attacking the obstacles that hold them back.

ASPECTS OF THE LIBERALIZATION PROCESS IN CHILE

The Chilean government has made significant changes in its liberalization programs several times, the first time by the military government in response to a major breakdown resulting from its original version, then by the newly restored democratic government in attempts to make the process more egalitarian. These different versions might be summarized as three distinct models of liberalization, or more simply three sets of "stylized facts" about different approaches to liberalization. All three remained within a steady orientation toward an open economy under careful monetary and fiscal control. But that does not mean that the second and third versions were essentially continuations of the original program. Chile's success in recent years would have been impossible without important changes away from some of the policies used in the first stage.

The first version, used until the collapse of 1982, exemplified the standard model just described. It left markets other than labor and foreign exchange almost entirely unregulated. Labor legislation was changed to weaken unions and give employers greater control over working conditions. Real wages were cut in half between 1972 and 1974, but thereafter they were indexed to the rate of inflation. The exchange rate was neither left free nor used to encourage exports: after an early period of devaluations, it became fixed from 1979 onward as an anchor against inflation.

The standard model succeeded in reducing inflation greatly and permitted several years of fairly good economic growth. But even before it led to crisis, this model worsened poverty and inequality. Comparing levels in 1978 to those a decade earlier, consumption by households in the highest fifth of the income distribution in Gran Santiago increased moderately, but that of the poorest 40 percent of households fell by nearly a third (table 1).[3] For the country as a whole, poverty clearly increased, although by exactly how much is difficult to state with full confidence. The standard reference estimate for 1970 is a poverty head count of 17 percent (Altimir 1994a, 121; ECLAC 1995, 145). If that figure were directly comparable to estimates for 1980, it would mean that the proportion of Chilean households living in poverty almost doubled over the 1970s. But it is not fully comparable because the minimal food basket used to define the poverty line in 1970 was changed subsequently to include more protein and fewer calories, at higher total cost. For comparison with later figures, the estimate of 17 percent is too low—but by how much? Discus-

3. The estimates of consumption in table 1 are derived from León Batista (1994). An earlier study shows a greater increase for the highest fifth and a lower decrease (24 percent) for the poorest (see Cortázar 1980, 10). The two studies are based on identical measures of the distribution of consumption but use different price deflators to calculate real consumption at constant prices.

TABLE 1 Estimates of Consumption by the 40 Percent of Chilean Households with Lowest Incomes and the Incidence of Poverty, 1968 to 1994

Period	Consumption Index, Poorest 40 Percent of Households Gran Santiago	Percentage of Households National Measures	
		Poverty	Extreme Poverty
Pre-Allende			
1968	100		
1970		20–22[a]	6[a]
Standard model, pre-crisis			
1978	68		
1980		32	
Competitive model in recovery			
1987		38	17
1988	65		
Transitional year			
1990		35	14
Competitive-plus-social model			
1992		28	9
1994		24	7

Sources: For consumption index, León (1994, 63); for poverty through 1990, Altimir (1994a, 121; 1994b, 271); for poverty in 1992 and 1994, Chile, Ministerio de Planeación y Cooperación (1995, 9).

[a] The standard published estimate for poverty in 1970 is 17 percent, but for reasons summarized in the text this figure must be adjusted upward to be comparable with later estimates.

sions with Oscar Altimir and Arturo León Batista at the Economic Commission for Latin America suggest that it should be raised by about 3 to 5 percentage points, yielding an estimate of 20 to 22 percent.[4] From this base, the proportion of Chilean households living in poverty increased to 32 percent by 1980.

Table 2 gives estimates for the distribution of consumption in Gran Santiago and for the distribution of income in the country as a whole. The figures for consumption, derived from studies carried out to revise the cost of living index, are more dependable than those for income, which involve inescapably uncertain corrections, notably for underreporting of incomes.[5] Given the necessary role of judgment in making such correc-

4. Altimir (1994a, 122–25) and information from my interviews with Oscar Altimir and Arturo León Batista in Santiago in October 1995.

5. The degree of underreporting is high. A comparison of reported incomes in 1987 with

TABLE 2 *Estimates of Households' Shares of Consumption in Gran Santiago and Income at the National Level, Chile, 1968–1994*

	Shares of Consumption		*Shares of Income*	
Period	*Lowest 40 percent*	*Highest 20 percent*	*Lowest 40 percent*	*Highest 20 percent*
Pre-Allende				
1968	19.4	44.5	12.1	54.5
1970			11.5	55.8
Standard model pre-crisis				
1978	14.5	51.0		
1979–1981			11.1	57.6
Standard model depression				
1982–1984			10.0	59.5
Competitive model				
1988	12.6	54.6		
1989			12.6	59.5
Transition				
1990			13.3	58.0
Competitive-plus-social model				
1992			13.6	55.5
1994			13.1	56.1

Sources: For consumption shares and 1968 income shares, León Batista (1994, 63); for income shares, 1970–1990, Labán and Larraín (1995, 123); for income shares for 1992 and 1994, Chile, Ministerio de Planeación y Cooperación (1995, 20).

tions, different agencies can report different results based on the same survey information. For 1987 ECLAC reported that the lowest 40 percent of households received 13.9 percent of total income, while Labán and Larraín reported 10.7 percent. For 1992 ECLAC reported 14.6 percent, while the Ministerio de Planeación y Cooperación estimated 13.6 percent (ECLAC 1994, 152; Labán and Larraín 1995, 123; Chile, Ministerio de Planeación y Cooperación 1995, 20). Joseph Ramos tried an alternative approach based on the ratio of labor income to national income (1986, 58–68). This method highlighted increased inequality too, although even this approach led to two divergent indexes.

national accounts for that year indicated that declared net incomes of employees needed to be adjusted upward by 27 percent, while "gains and profits" were so deeply understated that they required a correction factor of 55 percent (León Batista 1994, p. 101, t. 5.8).

The estimates given in table 2 for the distribution of consumption in Gran Santiago show a sharp decrease in the share of the lowest 40 percent of households under the standard model, from 19.4 percent in 1968 to 14.5 percent by 1978. That increase in inequality in terms of consumption shares is more pronounced than the increase shown by the measures of income distribution. The greater decrease in consumption shares of the lowest 40 percent of households in Santiago may be explained partly by a steeper increase in poverty for urban households than for rural ones (ECLAC 1995, 145). It also reflects the fact that when incomes fall for all but the highest income groups, the poor are forced more directly to cut their consumption than are middle-income households.

Of the many factors responsible for increasing poverty under the standard model, the most direct and systematic was a great increase in unemployment. The rate of open unemployment in Santiago averaged 6 percent in the 1960s. Under the standard model, it averaged 16 percent even for the relatively prosperous years of 1975 through 1981, then jumped to an average of 28 percent during the depression of 1982–1983 (table 3). Econometric tests of the factors determining changes in the income share of the lowest four deciles underscore the significant and dominant role played by changes in unemployment (Marcel and Solimano 1994).

The depression starting in 1982 was directly related to the way that this model led to persistently rising deficits on external current account. Prior to generalized liberalization (during the first two years under the military government), external deficits were greatly reduced by a combination of monetary and fiscal restraint with active devaluation in order to curtail imports and raise exports. But the priority given to stopping inflation led to decisions first to slow down devaluation and then to fix the nominal exchange rate in 1979. With the rate fixed, the financial sector deregulated, and domestic interest rates much higher than foreign rates, the private sector began to borrow heavily abroad. Although inflation decelerated rapidly, it did not stop: the real exchange rate appreciated and the current-account deficit rose to about 8 percent of the gross domestic product (GDP), financed by the borrowing (see table 3).

Internally, deregulation of the financial sector led to a great deal of manipulation. A series of scandals and threatened bankruptcies broke out in late 1981. External creditors, suddenly worried, stopped lending abruptly. With external credit cut off, the financial system collapsed and the economy plunged into deep depression (Díaz Alejandro 1985; Ramos 1986, 22–23; Labán and Larraín 1995, 118–19), In the dimensions of most concern here, the standard model proved to be a failure: many Chileans paid a high price in terms of increasing poverty, and the economy proved deeply vulnerable to changes in the supply of external credit.

Chile's second adjustment program, the competitive model, began as an attempt to recover from the depression of 1982–1983 and continued

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TABLE 3 *Chilean Unemployment, Real Exchange Rate, Current-Account Balance in Dollars, and Net Exports of Goods and Services as Shares of GDP at Constant Prices, 1970–1994*

Period	Unemployment in Santiago[a] (%)	Real Exchange Rate[b]	Current Account: Million (dollars)	Current Account: Net Exports (% of GDP)[c]
Reference base				
1970	6.9	51.9		
Standard model pre-crisis				
1975–1979	16.3	66.0	−634	−1.9
1980–1981	15.7	50.4	−3,352	−7.8
Standard model depression				
1982–1983	28.4	57.6	−1,711	+3.8
Competitive model				
1984	24.4	65.6	−2,111	+3.9
1985–1987	16.4	84.2	−1,138	+4.9
1988–1989	7.7	98.5	−467	+2.4
Competitive-plus-social model				
1990–1992	5.8	96.2	−460	+2.9
1993	4.7	91.0	−2,093	−0.9
1994	5.9	89.2	−753	+0.1

Sources: For unemployment for 1970, *Colección Estudios CIEPLAN* (1985, 16, 128); for 1972–1992, Labán and Larraín (1995, 118). For real exchange rates, 1970–1984, Corbo and Fischer (1995, 32); for 1985–1994, IDB (1995, 65). For current account in dollars for 1975–1989, IMF (1992, 274–75); for 1990–1994, IDB (1995, 65). For net exports as a percentage of GDP for 1975–1979, World Bank (1983, 36–37); for 1980–1984, IDB (1990, 265, 268); for 1985–1994, IDB (1995, 263, 266).

[a] Includes emergency programs of public employment.
[b] An increase indicates a devaluation (improvement of competitive position). Index is based on 1990 = 100, with data for 1970–1984 converted from original base of 1977 by using the ratio in 1990 of the 1990 index to that of the earlier index.
[c] This balance is for nonfactor goods and services. It excludes interest payments on external debt. Constant prices of 1977 were used for 1975–1979, those of 1988 for 1980–1984, and those of 1990 for 1985–1994.

until the end of the military government in 1990. It was still a distinctly conservative model, but the government began to take responsibility for stimulating production, employment, and exports—not just for restraining inflation. The new approach proved more successful in terms of aggregate growth without rising external deficits and in its last years achieved a reduction in poverty and inequality as well. The percentage of Chilean households below the poverty line increased at first—from 32 percent in 1980 to 38 percent by 1987—but then came part way back down to 35 percent by 1990 (table 1). The share of income going to the highest 20 percent of households remained practically the same in 1990 as in 1979–1981, but the share of the lowest 40 increased from 11.1 to 13.3 percent (table 2).

The most characteristic of the changes that contributed to this more positive second program concerned interest rates and exchange rates. As in practically all countries undergoing liberalization programs similar to the standard version, domestic interest rates increased to extremely high levels when the financial system was deregulated under conditions of tight monetary restraint. In Chile, they began to come down as inflation fell in the late 1970s but then shot up above 30 percent again when signs of profound financial trouble appeared in 1981. The sequence of problems started on the internal side, although that sharp increase reflected rising interest rates on world financial markets as well. With interest rates rising steeply and the economy weakening, the Chilean Central Bank intervened temporarily by applying "indicative" rate ceilings and implemented a series of actions to take over bad debts and relieve pressure on the financial system. At the depths of the crisis, the government took direct control of the banks. As the financial situation eased, real interest rates fell to more reasonable levels: from above 30 percent in 1981 and 1982 to 11 percent in 1984 and to 8 percent in 1985 (Arellano 1988, 81). They have not gone back up to the earlier extremes since that time. The change helped reduce incentives for external borrowing while lessening the regressive impact inherent in the extraordinarily high levels of interest rates under the standard model.

In place of the costly policy of keeping the exchange rate fixed to stop inflation, the government began to devalue the currency aggressively to make the economy more competitive. The change led to a sustained rise in exports without worsening inflation. In addition to promotional use of the exchange rate, the government introduced direct measures to promote nontraditional exports, including tax advantages and rebates of import duties to exporters (Labán and Larraín 1995, 119). On the import side, tariffs were raised from a common level of 10 percent to 35 percent during the depression, then gradually lowered back down as the economy recovered. The competitive position of Chilean producers was also helped (although real wages were hurt) by ending the system of indexing wages to preceding changes in the cost of living. Real wages fell markedly from 1983 through 1985.

The new policy orientation began to increase exports so rapidly that the net export surplus for nonfactor goods and services increased as output and demand recovered from the depression (table 3). Growth led by exports pulled up employment at the same time that it reduced dependence on capital inflows. Unemployment had been so high that wages continued to fall at first, despite the recovery, but they too began to rise from 1985 onward. From that point, with employment and wages both increasing, levels of poverty and inequality began to come down at last.

When the democratic government came into office in 1990, it stayed with the economic orientation of the competitive model but greatly increased and reoriented the country's social projects. The military government had maintained subsidies to support nutritional levels for the lowest income households, created a large-scale program of "emergency employment" to offset partially the high levels of unemployment persisting into the second half of the 1980s, and achieved remarkable success in a well-focused drive to reduce infant mortality. But the government also minimized or eliminated programs aimed at raising the productive potential of the poor (Graham 1994, 38–42). The reorientation of social programs by the democratic government increased levels of direct assistance to low-income households. But the most striking change was to introduce an array of programs to build up the human capital of the poor, including a drive to raise the quality of education in public schools in the poorest areas, training programs to increase labor mobility, and community projects to develop more independent capacities for local leadership (Graham 1994, 41–53; Raczynski 1995). The central purpose became an effort to reduce Chile's fundamental inequalities of access to education and skills.

Two supremely sensitive problems inherited from the military government were handled by direct negotiation among the government, private business, and labor: taxes on profits and regulations governing labor relations. Under the military government's pro-business orientation, taxation of corporations had been brought down to levels far below those of the rest of Latin America (Boylan 1996, 18–22). Similarly, labor organization was crippled, and employers had gained almost total control of working conditions and discharges. The democratic government immediately took up both sets of issues, but with conflicting objectives. On one side, the goals were to increase taxes to finance the new social programs and to make the tax structure more progressive, while correcting the lopsided dominance of the private sector in labor relations. On the other side, the commitment to continued liberalization argued against any steep increase in corporate taxes or radical changes in labor legislation. Further, the most crucial consideration for the Patricio Aylwyn government was the priority placed on restoring balance in a form acceptable to both business and labor, to strengthen Chilean democracy by seeking consensus rather than imposing the preferences of one side or the other.

Consensus implies compromise. The question is whether the compromises achieved on taxation and labor relations were reasonably balanced or were excessively one-sided in ways that mainly protected the interests of the private sector. Taxes on profits were raised from 10 to 15 percent in a complex set of negotiations that included many other changes in the tax structure (Pizzaro 1995). Achieving an agreement to raise taxes on profits in order to finance expanded social programs must seem something bordering on a miracle to anyone depressed by contrary choices in the United States. But Chilean corporate taxes remained much below those in the majority of Latin American countries. Delia Boylan has provided an illuminating analysis that mainly criticizes the government for letting the private sector off too lightly but concludes, "Precisely because of its moderate and risk-averse nature, this reform played a crucial role in soldering the fragile rule-making environment at the delicate moment of regime change" (Boylan 1996, 29).

The outcome for labor legislation closely paralleled that for taxation, with real changes in favor of labor but with significant limitations. These changes provided for much higher minimum wages, increased scope in forming unions and bargaining collectively, some restraint on the right of firms to fire workers without stated cause, and longer periods of coverage for severance payments. To satisfy the other side, the government and labor accepted the position of employers that they needed to keep more control over conditions of work and of discharging employees than they had prior to the upheavals of the 1970s (Paus 1994, 42–43; Labán and Larraín 1995, 136–37).

Criticisms of the results of these negotiations are readily understandable and useful. They were notably on the mild side, considering the anti-labor and inegalitarian biases and ruthless measures of the military government. But these outcomes are always subject to democratic processes of revision. Chilean democracy is still there, still able to take up the same questions and reconsider yesterday's compromises in terms of changing conditions and goals.

An old problem reemerged in 1990: increasing capital inflows began to foster appreciation of the real exchange rate. Combined with continuing growth in output and demand, the appreciation led to a major rise in the current-account deficit in 1993 (table 3). It would have been easy to finance a continuing deficit via external borrowing, but that recourse would have meant returning, at least to some degree, to the kind of dependence on external capital characteristic of the standard model of liberalization. The democratic government chose instead to tighten restraint on demand in order to slow the rate of growth slightly and to apply a variety of specific controls and taxes to limit the capital inflow—the more independent track of the competitive model (Ffrench-Davis, Agosín, and Uthoff 1995).

The "competitive-plus-social model" achieved striking reductions of poverty in its first years, although not in inequality. Between 1990 and 1994, the incidence of poverty was cut by nearly a third, from 35 to 24 percent, and that of absolute poverty by half, from 14 to 7 percent (table

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1). But the income share of the lowest 40 percent fell slightly, from 13.3 percent in 1990 to 13.1 in 1994. That outcome may have been related to the rise in unemployment in 1994, which resulted from the spending restraints used to limit the external deficit. Still, the income share of the poorest 40 percent remained well above its level under the standard model, and the poverty head count continued to decrease.

Oscar Altimir has calculated that the Gini coefficient of income concentration for 1992 remained 23 percent higher than in 1968. He concluded that the liberal economic model is inherently unfavorable to equality: "Income inequalities are clearly wider than before structural adjustment and are not being reduced by sustained growth" (Altimir 1995, 16). That interpretation is correct for Chile's first version of liberalization, but the estimates reported in table 2 indicate that the worsening stopped and partially reversed as Chile began to approach full employment in the late 1980s. Two conclusions seem jointly valid. One is that sustained growth in employment has not in any sense been futile: the improvements since 1985 offer a distinctly better picture than the deterioration under the standard model. The second conclusion is that about one-fourth of Chilean households remain in poverty despite improvement in employment conditions. Continued success with macroeconomic management should bring that share down gradually, but Chile still has a long way to go to make up for the military government's concentration of favors on the rich and neglect of efforts to improve the human capital of the poor.

MEXICO'S ADJUSTMENT AND RELAPSE

Mexico's liberalization program came to be regarded as highly successful from 1987 on until it hit a spectacular crisis in December 1994. Jeffrey Sachs and his colleagues have explained the crash in terms of particular political strains and monetary misjudgments in 1994 (Sachs, Tornell, and Velasco 1995). That explanation captures many relevant factors, but it seems to exclude a more fundamental consideration: Mexico was following Chile's standard model, and its crisis almost exactly replicated Chile's breakdown in 1982.

From its own earlier debt crisis up to late 1987, Mexico followed an adjustment program centering on strict monetary and fiscal restraint, tight wage controls that forced wages down, and aggressive devaluation. Although the government retreated from intervention in most spheres, it never abdicated its strong influence in wage setting. Between 1982 and 1987, the minimum wage was cut by 39 percent and average wages in manufacturing by a fourth (Sheahan 1991, 11). On the export side, many years of encouraging industrial exports by extra-market intervention prepared the ground for a strong response to the devaluations. With aggressive devaluation and restraint of demand working together to achieve

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external balance, accompanied by liberalization and privatization beginning in 1985, Mexico's strategy became temporarily similar to Chile's competitive model. But unlike the Chilean experience with that model, Mexico's series of devaluations repeatedly touched off increased inflation. That problem led the government to go backward at the end of 1987 to a version much closer to the standard model.

The mechanics of Mexico's new orientation looked different. The basic change was introduced in the "Pacto de Solidaridad Económica." Business agreed to restrain prices, labor accepted continued restraint on wages (although with the understanding that real wages would be allowed to increase moderately), and the government agreed to limit further devaluation (Lustig 1992, 50–54; Sheahan 1991, 15–34). By this different path, Mexico began to follow the standard model in combining liberalization with appreciation of the currency in real terms. That combination led, as in Chile, to a rising current-account deficit. It averaged 4 billion dollars for 1988–1989, climbed to 24 billion for 1992–1993, and reached 29 billion in 1994 (table 4). Measured at constant prices of 1990, the deficit for nonfactor goods and services reached 10 percent of GDP in 1994. As in Chile, the standard model proved unfavorable for escaping from dependence on foreign capital. But then, escape was the last thing the Mexican government wanted: such capital was viewed as a necessary source of growth, not as a threat.

A deficit in the current account can indeed increase the resources for investment beyond the limits of domestic saving, making possible a higher rate of growth. But it also implies the need for rapid readjustment—almost invariably for sudden contraction—if anything happens to disrupt the flow. Something always does, something always will interrupt the flow. Adjustment need not be drastic if the current-account deficit has been 2 or 3 percent of GDP. But it becomes much more difficult when the economy has to adjust downward quickly to live with the end of a deficit more on the order of 8 to 10 percent. The Mexican strategy set up a serious problem well before 1994.

Explanations that emphasize bad fortune and mismanagement during 1994 rather than the nature of the country's development model have plenty of ammunition. From outside Mexico, the U.S. Federal Reserve's change to a policy of raising interest rates in the United States reduced incentives to continue lending to Mexico. On the domestic front, new evidence of political strains made everyone nervous: first the peasant revolt in Chiapas in January, and then in March, the assassination of the leading party's presidential candidate. From March onward, the capital inflow practically stopped. The problem then became what to do about the current-account deficit. The government could have raised interest rates, or raised the fiscal surplus to cut demand, or devalued the currency, or combined doses of all three (Sachs, Tornell, and Velasco 1995,

TABLE 4 *Mexican Real Exchange Rate, Current-Account Balance in Dollars, and Ratio of Net Exports of Nonfactor Goods and Services to GDP at Constant Prices, 1985–1994*

Period	*Real effective exchange rate (1990 = 100)*	*Current account (billions of dollars)*	*Net nonfactor exports as % of GDP (1990 prices)*[a]
Period similar to competitive model, average 1985–1987	112	+1.2	+6.2
Period similar to standard model,			
average 1988–1989	105	−4.1	+2.6
average 1990–1991	96	−11.2	−3.4
average 1992–1993	83	−24.1	−8.8
1994	86	−28.9	−10.0

Source: IDB (1995, 133, 263, and 269).

[a] Net exports of nonfactor goods and services exclude payments of interest on external debt.

7–21). In classic style, it chose "none of the above." The government simply began to use up international reserves to pay for a continuing uncorrected deficit. By December the reserves had fallen well below scheduled debt obligations. As that fact became known, capital flew out of the country, from Mexicans and non-Mexicans alike. The currency crashed, growth stopped, and price levels leaped upward. An emergency program adopted in early 1995 then began to cut down both production and employment.

As in Chile, Mexico's version of the standard model weakened employment conditions and increased poverty and inequality even prior to the crisis. But the deterioration does not seem to have been nearly as sharp. Data for open unemployment in Mexico do not inspire much confidence: reported unemployment remained almost unbelievably low (less than 4 percent every year from 1985 through 1994) in the face of many indications of worsening employment conditions. Of those reported as employed, the share working less than thirty-five hours a week increased from 13.9 percent in 1979 to 22.4 percent by 1988. The share of the urban labor force in the informal sector responds to many different factors, but its increase from 26 percent in 1985 to 36 percent by 1992 surely reflects a weakening labor market (García 1993, 77–78, 199–217; Tokman 1994, 178; Wise and Pastor 1995, 23–27).[6]

6. In Mexico (as everywhere else), many individuals choose freely to work in the informal sector, often based on a preference for independence. They are not all driven into it by lack

Poverty and inequality both increased in Mexico up to 1989, but different measures disagree as to what happened after that. The estimates by ECLAC given in table 5 indicate that the poverty head count increased from 34 percent in 1984 to 39 percent by 1989 and then fell back to 36 percent in 1992. Correspondingly, the income shares of the lowest 40 percent fell from 1984 to 1989 and then partly recovered by 1992. Carol Wise and Manuel Pastor have questioned the reality of the improvement after 1989, however, particularly with respect to the corrections used for income in kind (1995, 9–11). They directed attention to the distribution of money income alone, excluding adjustments for income in kind. On this basis, the Gini coefficient worsened in both periods.

The fact that both kinds of measures show deterioration for the poor from 1984 to 1989 produces a somewhat mixed message about the implications for poverty of the competitive model. From the Chilean experience, the model proved helpful in reducing poverty, once past the first few years of continuing high unemployment. But in Mexico, poverty apparently increased over a period similar to the competitive model (up to 1987). That difference may help place the model in better perspective: it can do little if anything to reduce poverty if macroeconomic restraints, combined with wage policies pushing real wages down, exert continuous negative pressure on both employment conditions and wages. The competitive model's power to help the poor in Chile from 1985 on derived from the effect of stimulating employment by raising exports fast enough to forestall any buildup of external deficits that would force contraction. This model did not help the poor in the first few years because unemployment remained high and real wages were still falling. The payoff came only when Chile managed to sustain rising production without worsening external deficits for long enough to come close to full employment.

Although the damage to the poor was serious in Mexico by any measure, even the more negative estimates presented by Wise and Pastor suggest that it was less severe than in Chile. Among the factors that helped moderate adverse effects were the government's decision not to engage in any massive discharge of public-sector workers, the fact that employment conditions did not deteriorate to anything like the degree in Chile, and the introduction of two extensive social programs: Solidaridad in 1987 and PRONASOL in 1990 (Friedman, Lustig, and Legovini 1995). In addition, starting in 1989, the Mexican government changed its wage policies to promote increasing real wages under the Solidarity Pact. As a

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of opportunities for employment in the formal sector (see Maloney 1996 for Mexico; Parodi 1986 for Peru). But a marked rise in employment in the informal sector almost invariably indicates worsening employment opportunities. The process can be seen operating in reverse when demand for workers in the formal sector improves, as it did in Chile from 1982 to 1990: the share of informal employment (in nonagricultural activities) fell from 29.1 to 23.6 percent (García 1993, 103).

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TABLE 5 Estimates of Changes in Poverty and Income Distribution in Mexico, 1984, 1989, and 1992

Category	*1984 (%)*[a]	*1989 (%)*[b]	*1992 (%)*[c]
Poverty[d]	34	39	36
Income shares by sector			
Lowest 40 percent			
Urban	20.1	16.0	16.6
Rural	20.3	18.7	19.4
Highest 10 percent			
Urban	25.8	36.9	34.8
Rural	26.4	27.4	28.9
Shares of monetary income[e]			
Lowest 40 percent	12.7	11.7	11.0
Highest 20 percent	54.3	54.9	56.9

Sources: For all except shares of money income, ECLAC (1995, 145–48, tt. 10 and 11); for money income, Wise and Pastor (1995, 10).

[a] Gini coefficients for 1984, 0.32 for urban, 0.32 for rural households.
[b] Gini coefficients for 1989 were 0.42 for urban, 0.41 for rural households.
[c] Gini coefficients for 1992, 0.41 for urban, 0.34 for rural households.
[d] Percentage of households below the poverty line.
[e] Excludes income in kind.

result, average real wages increased 7 percent a year through 1993 (IDB 1995, 133).

PRONASOL (Programa Nacional de Solidaridad) was to some extent a partisan political operation meant to gain support for the governing party, but it also helped thousands of communities to implement local projects for schools, roads, housing, nutrition, and sanitation. PRONASOL thus stimulated employment while raising living standards of the communities involved (Dresser 1991; Cornelius, Craig, and Fox 1994). In terms of the Chilean models, Mexico stayed close to the standard version in most respects, but the new social program and wage policy made it more of a hybrid of that model combined with the social dimension of Chile's third model.

Although Mexico's adjustment program added direct measures to reduce poverty, it retained one central weakness of the standard model: external deficits on current account increased persistently. As already discussed, the cost came home with a vengeance at the end of 1994. As capital flew out of Mexico and the government lost all control of the exchange rate, the peso kept falling, the price index jumped upward, and the government was forced to adopt an emergency program calling for increased taxes combined with a 10 percent cut in public spending. In 1995, GDP per capita fell by 10.4 percent (IDB 1996, 107). The adjustment

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worsened poverty and inequality at least temporarily through loss of formal-sector employment, lower real wages, higher inflation, and big rewards for the wealthy who had managed to get their money out of the country before the value of the currency collapsed. The failure to limit current-account deficits swamped attempted improvements through direct social programs.

The positive side of the forced devaluation is that exports rose swiftly and turned the previously large deficit into a strong export surplus. Mexico's prolonged efforts to build up more diversified exports has given it a highly elastic capacity to respond to the stimulus of favorable exchange rates. That elasticity should permit growth to resume more quickly than would have been possible if the government had managed to continue avoiding devaluation. The question now is, will the government help Mexican industry hold onto the advantages of a stronger competitive position by avoiding renewed appreciation in real terms, or will it again allow appreciation and rising current-account deficits? The standard model calls for letting private capital markets do whatever they choose. And Mexico may not have much room for choice in the matter for the time being. Conditions for the emergency financing made available by the International Monetary Fund and the United States during the 1994–1995 crisis plus the always-edgy reactions of international investors may rule out any intervention to bring interest rates down to lower levels or the use of techniques included in Chile's current model such as controls and special taxes to restrict capital inflows. Evidently, prolonged reliance on the standard model can weaken a country's ability to choose a more independent course.

IMPLICATIONS FOR PERU?

Peru came relatively late to its liberalization program in 1990, just as it came late to protection and controls in the first place. Its quarter-century of active state intervention to promote industrialization (from 1965 to 1990) included some positive intervals but gradually turned into a miserable process characterized by falling income per capita, worsening inflation, a deteriorating state, and growing violence (Gonzales de Olarte and Sammamé 1991; Paredes and Sachs 1991; Paus 1991). The fastest-growing category of employment in Lima from 1970 to 1990 consisted of selling in the streets: shoelaces, pieces of stovepipe, purses or stereo sets stolen the day before, clothes hangers, anything. Street vendors multiplied from 2.5 percent of Lima's labor force in 1970 to 13.1 percent by 1990 (Verdera 1994, 21).

By 1990 Peru was in desperate straits, eager for almost any kind of change that might restore at least a minimal sense of order. The new government of Alberto Fujimori quickly delivered radical change. By early 1991, the new adjustment program had replaced the previous emphasis on protection and controls with a full-scale version of the standard model (Gonzales de Olarte 1993; Sheahan 1994). As in Chile in the late 1970s, deregulation of the financial sector under conditions of tight monetary restraint resulted in extremely high real interest rates and a capital inflow. Once again, the capital inflow made the currency appreciate in real terms (table 6). Under these adverse competitive conditions, combined with continued violence, output per capita kept falling through 1992.

The turning point toward recovery the following year did not result from any change in the economic program but rather from two major political events. In April President Fujimori eliminated congressional questioning of the liberalization program—and of violations of human rights by the army—by using the army to close down the congress. That move was highly popular, reflecting the public's deep distrust of traditional political parties and governmental institutions after the miseries of the 1980s (Roberts 1995). It was welcomed particularly by investors as evidence that the president would abandon neither liberalization nor macroeconomic stabilization. Their confidence was raised further by the government's sudden turn of good luck in dealing with Sendero Luminoso. In September 1992, the police in Lima captured the head of the movement and several of his closest associates. Sendero continued to mount sporadic attacks but lost its main thrust and its aura of invincibility. That change triggered a tremendous feeling of relief for most Peruvians—and for foreign investors. Direct foreign investment began to enter the country on a large scale and, combined with a revival in private and public construction, helped fuel a steep rise in output.

In contrast to the beginnings of the standard model in both Chile and Mexico, where prior devaluations had established an initially strong competitive position, Peru's version was implemented against the background of prolonged deterioration. The Peruvian real exchange rate had fallen severely from 1985 to 1990. That adverse trend for export incentives and for competitiveness against imports closed down the space available for expansion without increasing deficits on current account. Once the economy began to recover, the deficit started rising exactly as it had under the standard model in Chile and Mexico (see table 6).

Intervention by the central bank temporarily reversed the fall of the real exchange rate in 1993 and helped interrupt the growth of the current-account deficit, but the combination of appreciation and a rising deficit returned the next year. By 1995 the deficit had reached 7.2 percent of GDP, a rate below the danger levels that touched off the crises in Chile and Mexico, but not by much.

The possibility that Peru can avoid the severe shocks experienced by Chile and Mexico depends on both the course of economic policy and

TABLE 6 Peruvian Real Exchange Rates, Current-Account Balances, and Ratios of Net Exports of Nonfactor Goods and Services to GDP at Constant Prices, 1990–1995

Year	*Real Effective Exchange Rate (1990 = 100)*[a]	*Current Account*	
		millions of dollars	*% of GDP*
1990	100.0	−1,066	−3.4
1991	80.8	−1,320	−3.1
1992	78.3	−1,967	−4.5
1993	86.2	−2,145	−5.2
1994	79.9	−2,539	−5.1
1995	77.3	−4,223	−7.2

Sources: Real exchange rates on base of August 1990, and current-account data from Banco Central de Reserva del Perú (1996a, 184); conversion of real exchange rates to base 1990 from data in Banco Central de Reserva del Perú (1996b, 87).

[a] Real exchange rate converted from base of August 1990 given in source to base of year 1990.

the contribution of rising investment to the supply of potential exports. Jürgen Schuldt has argued that the high rents available from fishing, mining, and oil exports make them relatively immune to the negative effects of a real exchange rate that remains adverse for industrial exports (Schuldt 1994, 54–73). Foreign direct investment has flowed chiefly into mining, largely because it does not depend on a competitive exchange rate in the sense that the industrial sector does.

Schuldt's picture reveals a country returning to comparative advantage under conditions in which the advantages are squarely on the side of primary exports and against diversification into industrial exports. The implication for the medium term is that Peru may not hit a crisis in external finance. The longer-run danger is that the country risks being restricted to a primary exporter's role that is adverse to diversification, learning, development of human resources, and employment.

Employment conditions in the first two years of the liberalization program were weakened by macroeconomic stagnation and by drastic cutbacks in public-sector employment. The recovery of 1993–1994 stimulated moderate growth in private employment in the formal sector, although not enough to reduce the rate of open unemployment or to stop the persistent decrease in the share of the labor force holding regular jobs in the formal sector. The informal sector grew from 46.7 percent of the labor force in Lima in 1990 to 51.5 percent by 1994 (Infante 1995, t. 5).

Comparison of the recovery through 1994 with the preceding period of recovery (1984–1987) highlights a considerably weaker effect on employment under the liberalization program. The elasticity of employment growth in the urban private sector relative to growth of production was only half as high in the preceding recovery (Infante 1995, 3). The change could be explained by trade liberalization: increased competition from imports placed firms under great pressure to cut costs and raise productivity. That pressure to raise productivity should be helpful for future growth of income, but the immediate effect was to restrain employment opportunities. The negative effect on employment could have been moderated or even reversed by an offsetting increase in the real price of foreign exchange. To allow the real exchange rate to fall instead of raising it subjected all producers of tradable goods to unnecessarily severe competitive conditions. Some failed to survive at all, while others held employment down harder than they would have or than economic efficiency would have dictated at a competitive exchange rate.

The social component of the Peruvian adjustment program in its first two years was given neither financing nor attention (Figueroa 1993 and 1995). From 1993, the multilateral agencies supporting the adjustment program promoted and financed a variety of projects to help, and the government began to implement a social program of its own. Its Programa de Apoyo a la Pobreza Extrema amounted to 0.8 percent of GDP in 1993 and was budgeted for 1.7 percent for 1995 (Instituto Cuánto 1995, 884). That commitment promised real help for the poor but also led to much the same problem as PRONASOL in Mexico under the government of Carlos Salinas de Gortari (1988–1994): the president's personal control over the programs was used to direct many of the projects toward his own political objectives. The business executive in charge of the main program in Peru, FONCODES, resigned in 1994 in protest against the political manipulation of social spending (Roberts 1995, 105). Still, one of the main strands of President Fujimori's intervention was to shift social funds away from Lima toward the poorer rural areas where his support had been relatively weak, a change in the direction of public expenditures that made them distinctly more egalitarian. That double edge to the social programs—genuine help for the poor combined with political manipulation—probably weakened the basis of meaningful democracy but may also have "made the electoral process in Peru more responsive to the traditionally marginalized rural population" (Graham and Kane 1996, 8).

Poverty grew worse in the first period of adjustment through 1991 but then lessened considerably in the strong recovery of 1993–1994. The Cuánto index of "critical poverty" worsened by 39 percent over the course of 1990 and 1991 (Instituto Cuánto 1994, 369). That index began to lose significance in the latter year, however, because of one of the very factors worsening poverty. It had used the minimum wage as one of several indicators of the incomes of the poor, but the minimum wage itself lost meaning because it was cut so deeply that it practically ceased to apply to anyone. A direct measure of the percentage of households below the poverty line, available for Lima only, showed an increase of 9 percent between early 1990 and late 1991, for a new high of 49 percent (Yamada 1996, 32).

According to the evidence of a major new study in 1994, the poverty head count decreased greatly in comparison with 1991, although it remained far higher than in the previous survey taken in 1985 (table 7). In this important respect, the standard model of liberalization yielded better early results in Peru than it did in Chile or Mexico. Its negative consequences for employment relative to output were outweighed by the positive effect of the rapid recovery of production in 1993–1994.

Table 7 includes one significant departure from the overall picture of decreasing poverty in the period 1991–1994: chronic poverty did not decrease at all. This concept, discussed briefly in the first section, applies to those living in poverty who suffer persisting handicaps that limit their capacity to respond to improving employment opportunities. By this measure, the reductions in national poverty head count between 1991 and 1994 register no progress in reducing the core of persistent poverty.

Studies of inequality in this period, using data from inequality in the distribution of consumption expenditures rather than the distribution of income, suggest that any changes were modest. One analysis concluded that the decrease in poverty was slightly less than would be expected from the growth of total income. The share of spending by households in the lowest four deciles decreased, although only from 16.7 to 16.5 percent (Medina 1996, 80–82). Another study emphasized instead that the Gini coefficient for overall inequality of consumption spending fell slightly, from .414 in 1991 to .405 in 1994 (Escobal D'Angelo and Agüero 1996, 51). Although these results point in opposite directions, the changes shown by both were so infinitesimal that they give a consistent picture of a constant degree of inequality in the distribution of consumption.

Alternative kinds of indicators suggest that inequality in the distributions of assets and income probably worsened. Wage earnings fell severely relative to capital values and to national income. Wages and benefit payments fell by 15 percent (in terms of constant prices) between 1990 and 1994, while the stock market index multiplied five times. Wage and benefit payments fell from 20 percent of GDP in 1990 to 15 percent in 1994 (Instituto Cuánto 1995, 559).[7]

In response to concern about the possible inflationary effects of the dramatic growth in output in 1994 and early 1995, the Peruvian government decided to slow down the growth of demand by applying tighter

7. These estimates of the wage share of national income refer to employment in the formal sector; estimated earnings of self-employed workers in the informal sector are not counted as wages. It is possible that self-employed workers' share of national income went up as their proportion of the labor force increased, while the share of workers in the formal sector went down. Regularly employed workers in Peru are becoming something of an endangered species.

TABLE 7 *Estimates of Poverty in Peru for 1985, 1991, and 1994*

Category of Peruvians	*1985 (%)*	*1991 (%)*	*1994 (%)*
Peruvians below the poverty line			
National estimate for comparable regions[a]	37.9	55.3	48.2
National estimate for all regions	—	—	49.6
Rural sierra	49.2	72.7	68.3
Peruvians in extreme poverty			
National estimate for comparable regions[a]	14.9	24.2	18.3
National estimate for all regions	—	—	20.2
Rural sierra	32.3	54.5	45.6
Peruvians living in "chronic poverty"[b]			
National estimate for comparable regions[a]	—	22.3	22.9
Rural sierra	—	47.8	45.2

Source: Instituto Cuánto and UNICEF (1995, 28–35).

[a] The study for 1991 omitted the rural coast and the jungle regions; the national estimates for comparable regions make the same omissions.
[b] "Chronic poverty" includes persons below the poverty line who also lack one or more basic requirements, a combination "blocking development of their capacity to escape from poverty" (Instituto Cuánto and UNICEF 1995, 31).

fiscal restraint. The recovery was at least temporarily stopped. In the first half of 1996, GDP per capita fell again (Banco Central de Reserva 1996b, 70). Fiscal contraction can help avoid the drama of a Mexican-style crisis, but it also hurts employment and worsens poverty without correcting the basic problem.

The quandary for those in the Peruvian government who would like to move to a more competitive exchange rate or to adopt any alternative means of promoting export growth is that they fear a resurgence of inflation. This fear is well founded. The process by which inflation was reduced from 1990 through 1995 included the kind of borrowing against the future that used to be associated with old-style populism: domestic prices were held down by allowing imports to grow much faster than exports. Is it possible to get out of this imbalance without at least a one-shot jump in prices? Probably not. But a gradual correction might be managed under the protection of careful monetary and fiscal restraint, without forcing any drastic cutback in imports and production of the magnitude that hit Mexico. Under such an approach, an initial rise in prices need not be followed by continuing high inflation. Alternatively, the need for correction could be delayed indefinitely by holding down economic growth to fit the performance of an export sector left to struggle against adverse incentives. The first option promises better prospects for sustained growth and reduction of poverty; the second promises to stave off the day of reckoning by accepting lower rates of growth and greater poverty.

The Peruvian adjustment program looks much better after the expansion of 1993–1995 than it did during its first years, and it has made some headway in reducing the kind of poverty associated with weak employment conditions. But employment conditions did not strengthen as much as in the previous recovery period, external deficits have been increasing, and the structure of export growth led by mining and other primary products offers little promise for learning, development of human capital, or reductions in inequality.

REGULARITIES, CONTRASTS, AND QUESTIONS

All three of the liberalization models discussed are consistent with noninflationary growth in relatively open economies with reasonably high allocative efficiency and favorable conditions for private enterprise. The purest version, the standard model, is adverse to reducing poverty and inequality. But this model is not a necessary choice. The second alternative developed in Chile gradually began to change the country's development path toward less poverty and inequality, and the third has improved on that trend.

What makes the consequences of the models so different? Is it truly possible for a country to choose any one of the three? If so, what explains the preference for the standard model in Mexico and Peru after Chile demonstrated its negative effects?

Many factors shape the differences in consequences of the alternative models, but two are central and closely related: the ways that they affect employment and trade. If employment can be raised steadily to the point of making it possible to achieve something close to full employment in periods of prosperity, then market forces can begin to operate in favor of wages. Similarly, opportunities will improve for workers to move from low to higher productivity occupations and to gain new skills. Liberalization becomes more favorable to such objectives if it is based on methods that stimulate export growth, particularly the growth of industrial exports: a more competitive exchange rate increases incentives to use labor-intensive techniques of production, favors the chances of raising employment through industrial exports, stimulates learning through participation in world markets, and can increase both the stability and the rate of growth by moving the structure of production toward markets less volatile and faster growing than those of most primary products.

In Chile the standard model blocked this process. It led instead to extraordinarily high unemployment, even in years that were relatively prosperous, and then made things worse by setting up conditions of crisis and depression. The more competitive second model started from such high levels of unemployment that it did not help the poor at first, but it kept increasing employment in a style sharply different from the first version until both poverty and inequality began to fall as consequences of jointly increasing employment and wages. The increases in poverty and inequality in Chile were clearly aggravated by other policies of the military government that were adverse to labor and favorable to investors. Yet despite that orientation, inequality began to decrease as employment conditions improved.

Mexico compiled a somewhat better record with respect to employment under the standard model than Chile, up to the crash at the end of 1994. Inequality and poverty then worsened, although not to the extreme degrees experienced in Chile. That record—not great but not as bad—was helped by Mexico's success in continuing to raise industrial exports, even in the face of the standard model's effect of a deteriorating real exchange rate. Employment was further supported from 1990 onward by large-scale social spending under PRONASOL. The combination of the standard model with a social program similar to that component of Chile's third model proved less damaging than Chile's first version. But the basic weakness of the standard model remained. Its systematic current-account deficits grew so large that the economy became vulnerable to the first signs of shock in response to domestic political strains.

Peru's experience with the standard model may turn out to be more expansionary than those of Chile and Mexico, but it too has had a weak record of employment. That was to be expected in the first two years of severe macroeconomic restraint, but even when output grew rapidly in 1993–1994, employment in the formal sector failed to respond at anything like the pace of the country's preceding recovery period. Open unemployment failed to decrease, and the informal sector continued to grow relative to the formal sector. A major factor fostering this weakness has been the combination of trade liberalization with an exchange rate adverse to successful competition by Peruvian industry. The same combination has led to a rising current-account deficit, following the same path as Chile up to 1982 and Mexico to late 1994. Peru may be able to avoid the resulting crises that set back the other two, but even if it does, this set of incentives is adverse to equality because it favors a capital-intensive structure of production, discourages industrial exports, and pulls demand away from domestic industry toward imports.

Can governments or countries actually choose freely among these alternative models? Not entirely freely because internal as well as external pressures can operate against moving from the standard model to the competitive one, and resistance to Chile's third version may be even stiffer. But both kinds of moves have been accomplished and are clearly not impossible. The pressures in favor of adopting and holding onto the standard model come from several directions, some related to current strains and some more fundamental. The standard model helps stave off inflation more effectively than the competitive model unless pursued so long that it leads to a breakdown from the side of external consequences. Delaying devaluation can also help the government's fiscal position by holding down the domestic-currency cost of foreign exchange needed for debt service. And it puts off the fateful day when firms in the private sector that have relied on external credit suddenly find that their obligations shoot up in terms of domestic currency. Getting out of the trap of the standard model after it has been pursued for any length of time can become a nightmare.

The more fundamental questions concern the way open economies are related to the international financial system. A central premise of financial liberalization is that capital should be allowed to move freely among countries and that each country's current account should adjust to that flow. Current-account deficits can be seen as the positive counterpart of capital markets that function well. During a period of increased hope for Latin American economies in a political environment much more favorable for private investors, the capital flows have moved inward, favored currency appreciation, and financed large current-account deficits (Calvo, Leiderman, and Reinhart 1993). For many economists, for international investors, and apparently also for the multilateral financial agencies at present, these effects are natural and desirable. According to this view, it would be a mistake to interfere with the capital inflows, or with the exchange-rate stability that international investors greatly prefer, or with the structure of exports that results. The logic of this position points directly toward the standard model. This logic appeals to many. The costs, unhappily, fall hardest on the poor.

Would Chile's evolution into its "competitive-plus-social model" have been possible without the political consensus that formed following the experiences with the two prior models?[8] In any ultimate sense, one cannot be sure. It seems clear that Chile could have moved to the competitive model much earlier and avoided a good deal of poverty by doing so. Political consensus might be built up by shared success. Why should it require prolonged misery? But to get to something like Chile's third model and stay with it requires a rare kind of willingness to take competing

8. This question is taken directly from the comments of an anonymous *LARR* referee who read an earlier draft of this article.

interests into account. A private sector willing to accept higher taxes in order to finance social-welfare programs—even when the resulting level remains low compared to most other countries—is not something one finds everywhere. And to have two successive administrations able to combine active social concern with careful macroeconomic management is not common either.

The ability to compromise on acutely sensitive issues in a society that was for many years notable for the intensity of its social conflict is an amazing change. That achievement must owe a great deal to the harrowing experiences of the 1970s and 1980s. But where does that thought lead? Surely not to any wish that other countries go through what Chile experienced. Yet the idea impels recognition that to get to an egalitarian model of liberalization is more than a matter of governmental choice: it requires a rare degree of social consensus. This course may be impossible in some countries, at least in the present historical context. But it would not seem to be out of the question to move from the standard model to the competitive and by promoting a more inclusive and more sustainable kind of economic growth, improve the chances for constructive social consensus.

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