Crisis and Reform in Latin America, From Despair to Hope. By SESBASTIAN EDWARDS. The World Bank, Washington, DC: Oxford University Press, 1995. Pp. viii + 364.

Emerging capital markets have attracted much attention from the finance community. Latin American equity markets have produced high returns relative to other emerging markets during the last twenty years (Barry and Rodriguez, 1997). These high returns have been accompanied by high levels of volatility. This book is rich in details on the economic conditions and initiatives implemented during the last two decades that contributed to this volatile stock market performance. Investors, researchers, policy makers, and others interested in Latin American capital markets can gain valuable insights from the macroeconomic history documented in this book. Anyone interested in capital markets in other parts of the world can also learn from the successful as well as unsuccessful initiatives undertaken in this region. This book may be useful as a supplementary text in an international finance, development economics, or political economy course. There are numerous historical examples for dis-

cussion. However, the book does not provide end-of-chapter questions that would facilitate use in the classroom.

Edwards does a masterful job of describing the circumstances leading up to the Latin American debt crisis and how reforms changed the region's economic landscape. The topics covered in each chapter are summarized below. The material in this book inspired several research questions on emerging equity markets which are provided in these summaries. Edwards should be commended for his coverage of Latin America as a region while highlighting the similarities as well as differences among individual countries in the region. Edwards provides abundant references facilitating further research.

Chapter 1 provides a brief overview of economic conditions during the post World War II era in Latin America. Edwards discusses how inward-looking growth policies of governments that sponsored protectionism and generalized controls produced a relatively high rate of growth of real gross domestic product along with a decline in exports, high inflation, and a relatively low savings rate. He points out that regulations created an economic structure that could not react quickly to changing economic conditions. He explains that large public-sector budgets combined with inefficient tax systems to diminish governments' ability to provide social services while producing one of the world's most unequal distributions of wealth. Edwards documents the large growth in the percentage of foreign debt to gross domestic product during the years leading up to the early 1980s. Historical stock market data such as that collected by Goetzmann and Jorion (1996) could be used to gain insights of how equity markets perform under various economic policies.

Chapter 2 begins with the announcement by Mexican officials, in August 1982, that Mexico could not meet its international obligations. This announcement marked the beginning of the Latin American debt crisis. Edwards provides bond yield evidence that, as late as the first quarter of 1982, the crisis was not anticipated. Interestingly, stock market returns based on International Finance Corporation data support the notion that equity markets may have anticipated the debt crisis. Barry, Peavy, and Rodriguez (1997) provide returns showing the Mexican stock market lost about 65 percent of its value from January through July 1982. This was followed by a 9 percent return for the month of August, suggesting a positive reaction to Mexico's acknowledging its problems. This chapter focuses on how Latin American countries responded to problems arising from a drastic reduction in new foreign loans, high real interest rates on existing foreign debt, and massive capital flight out of these countries. Despite expenditure reducing and switching policies, trade surpluses did not cover interest payments. Some heterodox stabilization plans are reviewed. Argentina's Austral Plan, Brazil's Cruzado Plan, Peru's APRA Plan, and the Mexican Pacto are described. Unlike the described heterodox plans, Mexico first focused on fiscal reform. Edwards reports the heterodox plans reduced inflation in the very short run, but after only a few months inflation returned to its original (or even higher) level. The poor results from these initiatives combined with the history of failed policies and reversals in policies produced much frustration, skepticism, and a disillusionment with the ability

of government programs to solve economic problems. Is the observed volatility in emerging equity markets a direct result of policy reversals? Bekaert and Harvey (1997) show that economies that are more open have significantly lower volatilities.

Chapter 3 describes the evolution and transformation of Latin American economic paradigms. Edwards describes how the merits of open market competition slowly replaced interventionist thinking. He first discusses how the effects of the Great Depression led to protectionistic policies and a focus on governments as producers. Next, he explains how a long history of ineffective protectionist policies followed by the failure of the heterodox programs, the success of East Asia's outward-oriented policies, the fall of the Soviet Union, the emergence of a large group of professional economists in the Latin American region, and the relative success of early reformers (Chile and Mexico) were important factors leading to what he calls the "new Latin American consensus." Edwards identifies four basic related elements of the new consensus: 1) The need for macroeconomic stability through the control of public sector deficits; 2) the importance of opening the external sector to foreign competition; 3) the need to reduce the role of the state in the productive process through privatization and deregulation programs along with the importance of government's role in monitoring economic activity, preventing abuses, and providing political stability; and 4) the need for policies that reduce poverty.

Chapter 4 describes efforts made to achieve the first element in the new consensus, macroeconomic stability. Edwards identifies four issues to arrive at macroeconomic stability: 1) The need to reduce massive foreign debt; 2) the need for fiscal programs to reduce public sector deficits; 3) the need for consistent domestic credit policies that do not crowd out the private sector; and 4) the need for exchange rate policies consistent with the anti-inflationary efforts. The first part of this chapter reviews the restructuring of foreign debt based on the secondary market for foreign debt and programs sponsored under the Brady Plan after 1989. Participation in the Brady Plan required evidence of serious intentions to undertake particular economic reforms. Next, a description of tax reform, expenditure reduction, and credit policy efforts implemented to address the need for fiscal reforms are described. Finally, the chapter describes exchange rate policies implemented in the region. In the long run, a flexible exchange rate policy is superior to a rigid one. However, Edwards explains that during the transition to disinflation, the exchange rate may be used as a nominal anchor to guide inflation downward. Edwards points out that care should be taken to avoid real exchange rate overvaluation and that, ultimately, fiscal policy has to provide the nominal anchor to the system. Have emerging equity markets reacted in a timely manner to initiatives for macroeconomic stability? The December 1994 Mexican peso collapse provides clear evidence of how emerging equity markets react to the problem of exchange rate overvaluation. Why was this problem largely unanticipated by participants in the Mexican stock market?

Chapter 5 discusses the trade reforms to accomplish the second element in the new consensus, the opening of Latin American markets to foreign compe-

tition. The debt crisis brought an immediate need to reduce imports leading to protectionist trade policies. Edwards reports that by 1987–88, the inadequacy of these policies was evident. He elucidates how import tariffs, quotas, and prohibitions increased the cost of imported goods including intermediate materials used to produce exports. Furthermore, protectionist trade policies perpetuated the existence of inefficient industries. Edwards explains that recent Latin American trade reforms are characterized by the reduction of nontariff barriers, the reduction of import tariffs, the reduction in the degree of dispersion of the tariff structure, and the reduction or elimination of export taxes.

Chapter 5 provides data on intraregional exports. Several multimember and bilateral trade agreements are reviewed. The adequate speed of reform is discussed. Edwards documents how previous gradual reforms lowering tariffs allowed firms negatively affected to successfully lobby against reductions in tariffs. He cites research supporting the notion that faster reforms are more credible and have a better chance to be sustained in the long run. However, little is said regarding the hardships incurred by the citizenry (especially the poor) during periods of fast transition. Evidence is provided supporting the view that open trade increases productivity growth. If productivity growth is crucial to long-run economic performance, then equity investors should evaluate policies related to open trade while making asset allocation decisions in alternative emerging markets. Is the productivity growth cited in this chapter evident in firm performance in the corresponding equity markets? A reduction in protectionist policies should hurt inefficient firms, and raise opportunities for other firms. Is the performance of affected industries consistent with this theory? What are the implications of the discussed trade agreements for investor diversification opportunities? Will there be higher contagion effects in the future? Will these markets become more integrated with global markets? Bekaert and Harvey (1995) report time-varying integration for some emerging markets.

Chapter 6 concentrates on part of the third element in the new consensus, the need for reducing the state's role in the productive process through privatization and the importance of government's role in monitoring economic activity. First, policy options and modes of privatization are reviewed. Edwards reports that, overall privatization initiatives have had a positive fiscal impact in most Latin American countries and produced efficiency and welfare gains in a number of cases. He explains the importance of establishing a credible regulatory framework for privatized firms. This will not only protect consumers from potential abuses from natural monopolies, but also increase the offers made for firms being privatized due to reduced uncertainty as a result of knowledge of the environment in which the firms will operate. Edwards provides dates for a number of privatizations along with sales technique and industry sector information. The chapter concludes with a review of privatization programs in Chile, Mexico, and Argentina. Tremendous growth has been documented for emerging equity markets; part of the growth has come from privatizations. Will emerging markets that are at early stages of

privatizing experience relatively faster growth than other markets? Several privatizations resulted in conglomerates controlling many privatized firms. Little is known regarding the advantages and disadvantages offered by these conglomerates. Which reforms allow stockholders in these conglomerates to participate in monopolistic rents, and which reforms produce returns below those expected in open markets?

Chapter 7 centers on parts of the third element in the new consensus, the need for deregulation programs and political stability. The focus is on initiatives related to improving the capital markets, savings, and investment rates in Latin American countries. The deregulation of capital markets is supposed to affect economic growth by stimulating higher savings rates and improving investment allocations. The first part of this chapter discusses how a maze of regulations produced an inefficient financial sector in Latin America. Edwards provides empirical evidence on how political instability is negatively related to economic growth. He reports that one of the most important determinants of foreign direct investment across countries is the soundness of economic policies. Similarly, political stability is likely to influence the capital flows to emerging stock markets. Edwards suggests the role of foreign direct investment to be of limited importance given its low magnitude relative to GDP, and he supports efforts to promote domestic savings. Contacts with new techniques and management styles are listed as important by-products of foreign direct investment. Only a few comments regarding the equity markets in Latin America are provided. One interesting claim that Edwards makes is that in the 1980s speculators could easily manipulate stock prices. How was this accomplished? The fact that Latin American equity markets have not had a consistent history of growth in capitalization or stocks listed is also highlighted. The potential benefits from foreign direct investment and equity market capital should not be disregarded. Bekaert, Garcia, and Harvey (1995) discuss how a stock market can be an important part of a well-functioning financial system and have a positive impact on economic growth. For example, these authors discuss how efficient stock markets create conditions for venture capital to work through initial public offerings, and how venture capital-funded companies can be engines for growth. Potential reductions in firms' cost of capital leading to higher investment and faster economic growth should also not be overlooked.

The next part of Chapter 7 discusses deregulation efforts aimed at increasing the degree of financial intermediation and raising investment efficiency. Unlike what was followed in East Asian economies, Latin American countries are reducing the government's role in credit allocation. Edwards reports low savings rates in Latin America and explains the virtuous circle experienced in high growth East Asian economies. High growth increases disposable income, encouraging private savings. Higher savings produce a higher level of capital accumulation and reinforce higher growth. The development of new social security systems is increasing the savings rates above historical levels. The diversification benefits of allowing retirement assets to be invested outside the

local markets is not mentioned by Edwards, but should not be overlooked. The reforms undertaken produced a decline in public investment in the 1980s. Edwards reports that as a consequence of the decline in public investment, infrastructure in the region has deteriorated. He then discusses how investment in infrastructure can increase growth. Increases in public savings that give rise to growth and then to higher private savings is seen as a possible way to get the virtuous circle going. Governments therefore face contradictory guidelines in regards to their direct involvement in the economy. Edwards recommends rigorous evaluation on a case-by-case basis instead of blindly following a strategy of investing in infrastructure.

Chapter 8 addresses the final element in the new consensus, the need for poverty-reducing policies to alleviate the serious problems of inequality and social conditions in Latin America. The bottom 20 percent of the Latin American population receives less than 4 percent of total income. The poor are the most vulnerable to macroeconomic imbalances. Edwards reports that overvaluation of real exchange rates negatively affects the poor, as do increases in the level and variability of inflation. Edwards explains that satisfying the needs of the poor for education, nutrition, and health will produce more available human capital, increasing productivity, and economic growth. Edwards reports other problems related to human capital arising from labor market distortions such as high costs of dismissals, payroll taxes, and costly settlement procedures. These distortions discourage increases in employment and therefore further hurt the poor. Edwards explains that only if poverty is reduced will the structural reforms of the last decade be sustained. If new reforms only maintain (or increase) the degree of income inequality, then social unrest may lead to policy reversals severely jeopardizing progress made toward macroeconomic stability.

Chapter 9 discusses policy lessons from the Mexican Peso crisis of December, 1994. The main cause of the Mexican peso crisis was an unsustainable current account deficit that had been financed by very large capital inflows. Edwards outlines how to evaluate potential problems of this nature. Market confidence did not return until after the Mexican government unveiled a tight macroeconomic program. The need for continued reforms consistent with the new consensus is reviewed.

The macroeconomic history documented in this book provides many valuable insights. Both scholars and investors interested in Latin American capital markets should find the factors leading to the new Latin American consensus interesting. Individuals desiring to help shape policies for emerging markets in other parts of the world can learn from the reviewed successful and unsuccessful policies undertaken in Latin America. I highly recommend this book to investors, researchers, and policy makers active in emerging markets.

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