CHAPTER 9

PLAYING BY THE RULES

The New Game in Latin America

GONZALO SÁNCHEZ DE LOZADA—known by the nickname Goni and president of Bolivia from 1993 to 1997—was always fascinated by the American bank robbers Butch Cassidy and the Sundance Kid. It had to do with his having been born Bolivian but then growing up in the United States—a consequence of his father's exile after a military coup. In Bolivia, coups were commonplace—189 took place in the 172 years after independence. At every New Year during their exile in the United States, Goni's family would make a toast: "Next year, may things change and we will go home." That year never seemed to arrive. But finally, after Goni had completed a degree in philosophy at the University of Chicago, the political situation did change sufficiently and in 1952 he went home.

It was not easy. Even the physical adjustment was difficult. La Paz, the capital, is eleven thousand feet high in the Andes, and walking just a block or two up one of its steep cobbled streets leaves one badly winded. Goni tried to get himself started as a filmmaker, which proved to be a whimsical pursuit in such a small economy. To make a living, he took up aerial photography for oil-exploration companies looking for promising terrain and then went into the business of delivering supplies to exploration camps in the jungle.

But the dramatic story of Butch Cassidy and the Sundance Kid maintained its hold on his imagination. The famous desperadoes had escaped to Bolivia one step ahead of the law, and there, still pursued, they perished. "America's Old West," Goni liked to say, "died in the mountains of Bolivia." He researched their story and wrote a film script, which MGM optioned for a few thousand dollars; but it never got made. When the version starring Robert Redford and Paul Newman came out much later, based on somebody else's script, he considered suing for plagiarism, but a lawyer persuaded him that the costs of fighting the case would be prohibitive. Disappointed, Goni gave up scriptwriting—it had been a sideline anyway—and instead went on to become a founder of a successful mining enterprise, as well as a campaigner for democracy. He also married Miss Bolivia of 1959.

Shock Therapy: Decree 21060

Years later, in the mid-1980s, Goni came to write another script—one called "shock therapy." It was not a movie but a program for a rapid and massive—indeed almost overnight—economic shift from a government-dominated economy to a market economy. Although the script has now been played out around the world, it began in Latin America, and Goni deserves credit as the original author. Moreover, he wrote it in record time, with a deadline imposed not by a studio but by looming disaster.

In the mid-1980s, Bolivia was in terrible crisis, its economy gripped by hyperinflation and in total disarray. At the time, Goni was a senator, and then he became minister of planning in a new government that came to power in 1985. Bolivia had a classic Latin American economic system: In the name of development, nationalism, and anti-Americanism, preceding governments had taken direct ownership of much of the economy. What the state did not own, it heavily regulated. But whatever the ambitions, government was not up to the task. The governmental machinery was incompetent and inefficient, blatantly open to corruption and favoritism. The spigots of spending were wide open. Workers were courted with large salary hikes and then lost their money through inflation, which was endemic. Almost no taxes were collected. Only 3 percent of government revenues came from taxes: The rest were from the central bank. The country groaned under its burden of international debt. Both poverty and inequality were increasing. With the added blow of the debt crisis, which had begun in 1982, hyperinflation had reached the rate of 24,000 percent, and there was fear that it could soon multiply to 1 million percent. Very little time was left to act.

Yet there was little agreement on what to do. Large-scale change in the basic organization of the economy was, for most people, unthinkable. Goni thought otherwise. "The hyperinflation was frightening," he explained. "A lot that seemed unimaginable became imaginable with hyperinflation and the debt crisis. No amount of intellectual persuasion could have gotten governments and people to take the steps they did without them. But what really influenced me was my experience as a businessman. I had been inside the system, and I saw that it didn't work. The private sector tried to profit from the public sector's workings, and the public sector was undermining the private sector. That experience, plus the long struggle for democracy, convinced me that the old system just couldn't work anymore."

But what were the alternatives? Goni saw himself as "left of center." He explained, "I always recognized that I live in a poor country and that you have to figure out how to address poverty." Still, he found something of an intellectual role model in Germany's Ludwig Erhard. Goni was a regular reader of *The Economist* and from its pages followed what was happening elsewhere in the world, including Mrs. Thatcher's Britain and the Asian economic miracles. Two things had a particular impact on him. "The first," he said, "was New Zealand, where, in order that the country could grow, a labor government had to dismantle the command-and-control economy that had been created many years earlier by a conservative government. The second was China. Mao had always been portrayed as the cutting edge. But I was impressed when Deng came to power and initiated changes. I was particularly impressed by his statement that he didn't care what kind of cat it was so long as the cat caught mice."

Goni took to quoting Deng on the subject of cats. And these examples reinforced his conviction that the only way to restore Bolivia's economic health was by eliminating statism—by taking dramatic steps. The first draft of his shock-therapy script was Decree 21060, in August 1985. It eliminated price controls, instituted drastic budget reductions, slashed tariffs to introduce competitive pricing into the economy, and began a radical restructuring of the public sector and a reduction in its spending. Goni and his colleagues took a huge risk in doing all this backed by only $1.5 million in the central bank—almost nothing. The reason they dared to take the risk was that the information system was so poor; he said, "We didn't know that was all we had."

Over the next several months of 1985, Goni and his team put the rest of the plan for shock therapy in place. They needed advice, but this was not the sort of help the World Bank was providing at that time. Some months earlier, however, in Cambridge, Massachusetts, Harvard economics professor Jeffrey Sachs had received a notice about a seminar on Bolivia. He was deeply interested in the bizarre phenomenon of hyperinflation, and Bolivia's was the first case in forty years. He wandered into the meeting and was mesmerized. Since he was also the only member of the economics faculty who had bothered to show up, he was drawn into the discussion and, like a good professor, ended up at the blackboard. After a while, from the back of the room, came a variant of a proverbial question: "If you're so smart, why don't you come to Bolivia?" He went.

At a cocktail party in La Paz, Sachs met Goni, who realized that the professor was just the man he was looking for. Sachs provided a good deal of the analytical work and expert guidance they needed. The objective was clear—to end inflation very quickly. Bolivia had 450 different taxes, most of which were never collected. Sachs helped Goni and his team reduce the number to 7 easily collectible taxes. He provided input about how to manage the central bank and what kind of financial controls were necessary. And he helped give them the confidence to stand by their convictions.

What unfolded in Bolivia between 1985 and 1987 brought stability to the country. The inflation rate was reduced from 24,000 percent to 9 percent. Government spending was reduced, subsidies were cut, prices and trade were liberalized, taxes were collected and the tax system reformed, and an emergency social safety net program was put in place. In 1987, Bolivia was able to implement the first debt-reduction program under IMF auspices. Altogether, the Bolivians had done something that was unthinkable in Latin America. "We created a market economy overnight," said Goni. "The issue was shock versus gradualism. But there was no gradualist solution; the system had broken down. There was only a brief time to act. Things that seemed impossible to do became possible."

Goni was not only taking on Bolivia's crisis but also helping initiate a radical turn away from what had been the traditional Latin American approach to state and marketplace. For decades, these governments had thoroughly dominated their national economies. Despite the obvious differences among countries, common features tied the region together: Militarism, Marxism, anti-Marxism, populism, and anti-Americanism were all intertwined in various ways. Some military dictators strutted around in quasi-fascist uniforms; others mouthed the slogans of socialism. Whatever the garb, the state controlled economic life through direct ownership, clientelism, and patronage; government was deemed the central engine of economic growth.

In the late 1990s, that model is being broken. No single system has emerged to take its place, but the general direction is clear—toward freeing markets, reducing and redefining the role of the state and removing it from production through privatization, taming inflation by constraining government spending, lowering trade barriers, and shifting traditional activities out of the state's hands. For the most part, this process has gone hand in hand with a remarkable rebirth of democracy in a region where military dictatorship too often seemed the norm in the past.[1]

Dependencia *Rules*

The traditional statist approach in Latin America was greatly influenced by what was known as *dependencia,* or dependency theory. It rationalized state dominance—high import barriers, a closed economy, and a general demotion of the market. And from the end of the 1940s right up to the 1980s, *dependencia* ruled. Its origins were in the late 1920s and 1930s and the Great Depression, when the collapse of commodity prices devastated the export-oriented economies of Latin America. Meanwhile, in line with the tenor of those times, "national security" became a justification for governments to take over "strategic sectors" of the economy to meet the needs of the nation, not those of international investors. This led, notably, to the founding of state oil companies in a number of countries. After World War II, the shift toward a much greater reliance on the state was propelled by the emergence in the West of both the welfare state and Keynesian interventionism and by the prestige of Marxism and the Soviet Union. One other thing motivated both Latin American economists and their governments: anti-Americanism—fear of the colossus to the north and antipathy to what were seen as exploitative American corporations operating in the Latin arena.

The *dependencia* theorists rejected the benefits of world trade. By the end of the 1940s, the essential elements of their thinking were already articulated and promoted by the United Nations Economic Commission on Latin America (ECLA)—and most notably by an Argentinean economist named Raúl Prebisch, who headed the commission from 1948 until 1962. He began his career, in his words, as "a firm believer in neoclassical theories." But "the first great crisis of capitalism—the Great Depression—prompted in me serious doubts regarding those beliefs." He had experienced the challenge firsthand as director of Argentina's central bank in the early 1930s, when contagion swept the Latin American banking system and Argentina teetered on financial ruin. Prebisch and those who joined him at ECLA propounded an international version of the inevitability of class warfare. They argued that the world economy was divided into the industrial "center"—the United States and Western Europe—and the commodity-producing "periphery." The terms of trade would always work against the periphery, meaning that the center would consistently exploit the periphery. The rich would get richer and the poor would get poorer. International trade, in this formulation, was not a method to raise standards of living but rather a form of exploitation and robbery, committed by the industrial nations and their multinational corporations. The victims were the peoples of the developing world. This belief became the received wisdom in universities across Latin America.

So instead, the periphery would go its own way. Rather than exporting commodities and importing finished goods, these countries would move as rapidly as possible toward what was called "import-substituting" industrialization (ISI). This would be achieved by breaking the links to world trade through high tariffs and other forms of protectionism. The infant-industry logic became the all-industry logic. Currencies were overvalued, which cheapened equipment imports needed for industrialization; all other imports were tightly rationed through permits and licenses. Overvalued currencies also discouraged agricultural and other commodity exports by raising their prices and thus making them uncompetitive. Domestic prices were controlled and manipulated, and subsidies were widespread. Many industries and activities were nationalized. A jungle of controls and regulations grew throughout the economy. The way to make money was by making one's way through the administrative and bureaucratic maze rather than by developing and serving markets. Overall, what guided the economy were bureaucratic and political decisions, not signals and feedback from the market.

Until the 1970s, the approach seemed to work. Real per capita income nearly doubled between 1950 and 1970. Over the same period, the role of the state continued to expand, as did state-owned enterprise. Tariffs and other trade barriers were raised. The biggest criticism at the time was that governments were not doing enough and that they should move closer to the centrally planned model of the Soviet Union and Eastern Europe. The deep weaknesses of this system were mostly hidden—until the beginning of the 1980s.[2]

The Lost Decade

The debt crisis hit Latin America very hard. The buildup in borrowing had been enormous. Between 1975 and 1982, Latin America's long-term debt almost quadrupled, from $45.2 billion to $176.4 billion. Adding in short-term loans and IMF credits, the total debt burden in 1982 was $333 billion. Yet no one was paying much attention to that ominous increase until August 1982, when Mexico teetered on default. What ensued was a double bankruptcy—financial and intellectual. The ideas and concepts that had shaped Latin American economic systems had failed; they could no longer be funded. *Dependencia* had caused them to go broke. The years that followed, in which Latin America struggled to reshape its economies, became known as the "lost decade." And with good reason. For at its end, in 1990, per capita income was lower than it had been at the beginning of the decade.

Over those years, the full costs of the old system came to be reckoned. The industrial enterprises—both private and state-owned—that it had fostered were inefficient, owing to protectionism, lack of competition, and isolation from technological innovation. For the most part, they put little emphasis on quality and scale of service. Agriculture was seriously damaged. Budget deficits swelled. With inflation pervasive and deeply entrenched, family savings were devastated. As a result, people could not retire. Inflation rose to astounding levels, driven by the deficits and loose monetary policy. The domestic economies were denied the benefits of international trade, and there was no improvement in fundamental social inequality.[3]

The New Consensus: "We Asked Too Much"

In the first few years of the debt crisis, the urgent need was to pull the countries back from bankruptcy and stabilize their economies. Their balance of payments had to be restored, much of which was accomplished under the aegis of austerity and the "conditionality" of the International Monetary Fund. The IMF took the lead in implementing emergency programs of loans, credits, and debt reschedulings if the countries, in turn, would take steps to shrink their burden of debt, reduce their deficits, temper inflation, and make their exchange rates more realistic.

But in the late 1980s and into the 1990s, something more fundamental began to unfold throughout Latin America—a drastic reordering of the basic principles regarding the role of the state in the economy. The emphasis shifted from government to the market as the basic allocator of resources in the economy. One of the leading analysts of the new thinking described it as nothing less than a move toward "developing and using the market, rather than denouncing, repressing, and distorting markets." The retreat of government meant large-scale privatization and, in general, fewer controls. It also meant lowering the barriers to both trade and foreign investment, in order to replace the lending that had dried up with the debt crisis. Governments focused on reducing deficits and inflation, and reforming their tax systems. To the degree possible, public expenditures would be driven more by economic returns than by political exigencies. Exchange rates would be competitive and more predictable. Property rights were to be strengthened. And throughout the economy, competition, rather than monopoly and control, was to be encouraged.

Perhaps only those who had grown up in the old system could fully grasp the extent of the change. For many years, Enrique Iglesias was associated with ECLA, working closely with Raúl Prebisch. He is now the head of the Inter-American Development Bank. "I would never have imagined this much change," he said. "For forty years following the Great Depression and the Second World War, we looked to government to take on the task of reviving our economies. We asked the state to deliver the goods. We asked too much of government, for too long. We had to make a choice. Now we have taken a sharp turn back to the market economy. I could not have imagined this forty years ago."

Altogether, this new stock of ideas would shape the economies of Latin America in the 1990s. And like any such group of ideas, it acquired a moniker—in this case, the Washington Consensus. It is a term that its promulgator, the economist John Williamson, has regretted ever since. In the interest of promoting "policy reform in Latin America," he observed, "it is difficult to think of a less diplomatic label." It refueled all the old emotions and revived the specter of Yankee domination. As one critic of the Washington Consensus put it with good old-fashioned gusto, the term "was coming clean about who made policy in the late twentieth century—not governments, but Washington. 'Washington' . . . embraced not only the IMF and the World Bank but also their less than shadowy master—the U.S. government—and behind it, its shadowy masters, the American economics profession and Western business interests."

Good stuff for a conspiracy theory or a film. But such a diatribe missed the whole irony. The Washington Consensus was developed in Latin America, by Latin Americans, in response to what was happening both within and outside the region. Government failure was what now loomed before people's eyes, not market failure. The old system could no longer deliver economic growth. People struggled to live with hyperinflation and woefully inadequate basic services.

External factors also loomed large. As in many other parts of the world, the collapse of communism undermined Latin America's faith in socialism and central planning. Castro's Cuba no longer looked like the vanguard of revolution, or indeed the vanguard of anything, but rather like an archaic relic that had managed to stay afloat only on a sea of Soviet subsidies. Even as the failures of the Soviet model became completely apparent, Latin American economists began to focus on the economic success of Asia. It was really a process of discovery, for they had mostly ignored the region until then. The Asian economies were less regulated and much less inflationary, and their exchange rates were competitive and less volatile. Unlike the Latins, the Asians had rebounded quickly from their debt crisis. And in striking contrast to the strictures of *dependencia,* the Asians had manifestly anchored themselves in the world economy. By the late 1980s ECLA, formerly at the forefront of *dependencia,* began, in what was nothing less than a complete turnaround in thought, to talk about the necessity of "outward oriented" economies and a shift away from government control.[4]

The Technopols

The process of reconceptualization was made possible by the emergence of a group of market-oriented economists throughout the region. Many of them had gone north to earn their Ph.D.'s at institutions such as Harvard, MIT, Yale, Stanford, and Chicago. Their senior teachers had been shaped, to a large degree, by the market failure of the Great Depression. But the economic problem of the day for them, and for the younger faculty members, was government failure. In the mid-1970s, for instance, Pedro Aspe, Mexico's future finance minister, was doing his Ph.D. at MIT, where the future finance minister of Chile, Alejandro Foxley, was a visiting professor, while Domingo Cavallo, the future finance minister of Argentina, was writing his Ph.D. thesis at Harvard. They talked together and jogged together, and became friends of people like Lawrence Summers, former U.S. Treasury secretary, and Jeffrey Sachs, both of whom were doing Ph.D.s at Harvard at the time. They met MIT faculty members Rudiger Dornbusch and Stanley Fischer, former deputy managing director at the International Monetary Fund; and Harvard professors Benjamin Friedman, an expert on fiscal policy, and Martin Feldstein, who showed how high taxes function as disincentives.

When these Latin American economists went home, many of them not only took teaching jobs but also established research institutes of their own, went into government, and generally set about trying to implement the new consensus. They became known as the "technopols," in contrast to the "technocrats" of earlier years. They were not only making the machine of government work better; they also, if they were to be successful, had to be good politicians. After all, they were seeking to make massive changes in the workings of their economies, and with so many institutions and interests having so much at stake, that was a manifestly political task.

"To do a good technical job in managing the economy, you have to be a politician," said Foxley. "If you do not have the capacity to articulate your vision, to persuade antagonists, to bring people around on some unpopular measure, then you are going to be a total failure." He added, "Economists must not only know their economic models but also understand politics, interests, conflicts, passions." Foxley could speak with some authority on this subject. A highly trained economist, he was also one of the foremost critics of the Pinochet government during the years of dictatorship, and then he proved to be a very effective finance minister in the first democratic Chilean government that followed.[5]

Chile: The Ambiguous Role Model

Chile became a laboratory for an approach that was wholly at odds with the Latin American experience since World War II. But it was regarded with great ambiguity—and, indeed, suspicion and outright rejection—because its implementation was so entwined with repression and dictatorship. Yet over time, it became a role model for the rest of the region.

In 1970, the socialist government of Salvador Allende came to power and embarked on a program of massive nationalization and expropriation, along with price controls, that seemed aimed at creating an Eastern European–style economy in Chile. The result was economic chaos. The Allende government was toppled in a coup led by General Augusto Pinochet, who in turn established a repressive dictatorship. Obsessed with the fear of communism and internal enemies of all sorts, Pinochet enforced a harsh reign, suppressing trade unionists, journalists, students, and others deemed subversive.

Pinochet and his military colleagues knew little about economics. Beyond "national security" and repression of the left, they had hardly any program at all. But they had to do something. A program diametrically opposed to Allende's existed in a document called *El Ladrillo—The Brick*—a massive manuscript originally prepared by the economics faculty of the Catholic University of Chile for the Christian Democratic presidential candidate in 1970. It advocated a strong free-market approach. Its chief author later said *The Brick* had been composed as "something for our nerves, a kind of therapy. . . . We didn't see that it had any future."

But *The Brick's* program was what the Pinochet government adopted. And along with it came "the Chicago Boys"—market-oriented economists, many of whom had been educated at the University of Chicago under an exchange program with the Catholic University. The intellectual mentors of this group were two Chicago professors—Milton Friedman and, even more so, Arnold Harberger. The Chicago Boys set about to turn the program in *The Brick* into reality. But the task was hardly easy even for a regime that had centralized power in its hands. One economics minister said that he spent 90 percent of his time "trying to explain to the generals and the country what a free market was. This was a totally new experiment, and there was huge resistance." Tired and irritated by one long economics tutorial, Pinochet cut off the discussion by sternly reminding the economists that he was the one who held Chile's "pot by the handle." One of the leading Chicago Boys replied that if the economy continued to suffer, Pinochet would be left "holding just the handle." The general was furious. No one was supposed to talk to him like that. Nevertheless, the lectures continued.[6]

The Chicago Boys rapidly instituted a host of fundamental reforms. They freed prices, liberalized trade, and deregulated the financial sector. They privatized massively, reducing the number of state-owned companies from five hundred in 1973 to just twenty-five by 1980. They wanted to do everything as fast as they could. Their aim was to dismantle the "developmental state" that had run the Chilean economy since the end of the 1920s and mediated among the various strong interest groups. It was ironic that they used the power of a military dictatorship to try to impose what would be, in economic terms, a minimalist state.

The reforms produced results, and even though the Pinochet regime continued to be an international pariah, it won grudging respect. In 1982, however, the country went into a severe economic tailspin, owing to the overall debt crisis, errors in currency management, and inadequate supervision of the financial sector, which was shaken by scandals and failures. The entire program of the Chicago Boys appeared to be discredited. The military government was disoriented, and its efforts to adjust were not very successful. It had to take over so many banks that the period became known jokingly as the "Chicago road to socialism." A second generation of reformers took charge in 1985. They were less pure-bred than the original Chicago Boys—indeed, fewer came from Chicago and more from Harvard—and less austere in their policies. They succeeded in correcting many of the mistakes. And over the next several years Chile became the outstanding Latin American example of market reform. Growth rates were high, inflation was low, and exports grew and became more diversified. Quality Chilean wines found their place on the shelves of the world market.

Finally, at the end of the 1980s, the military, defeated in a plebiscite, stepped aside. What was most decisive about the presidential campaign of 1989—beyond the advent of democracy—was that all three candidates, including two who were outright opponents of the dictatorship, endorsed the reforms. The economics minister in the new government was Alejandro Foxley, who had created a think tank at the Catholic University that had become one of the leading sources of criticism of the military government, though garbed in the language of economics. In the early 1980s, he had still argued for the state to play a large interventionist role, including, among other things, "picking winners." "Truthfully," he later said, "I had less confidence in the free market and more confidence in the state." A decade later, as economics minister, he was intent on addressing the neglected social problems of poverty and inequality. But his fundamental objectives were to strengthen the consensus in favor of a market economy, make the new system work better, and consolidate and continue reform. He found that he had to defend the market reforms against newly victorious democrats, who wanted to dismantle any and all handiwork of the dictatorship. Simultaneously, in response to the Chicago

Boys' efforts to deconstruct the interventionist state, he sought to build what he called "the competent state." His goal, he explained, was to combine a "progressive social policy with an austere, some would say conservative, fiscal policy."

That course continued under the government of Eduardo Frei. "To understand Chile, you need a broad view," observed Energy Minister Alejandro Jadresic. "It is not easy. Many people were against the original reforms because they came from an illegitimate military government. How to preserve the reforms that were rational, and go further with more reforms? That was one of the reasons why people like me got involved in politics. We were afraid that the reforms would be undone. The democratic governments have made important modifications to the reforms. There is now a strong equity consideration, stressing social needs, housing, the health system, education, the environment. But let the market system create the wealth. Let markets develop."

Indeed, that balance between markets and social equity was at the core of the presidential campaign of Ricardo Lagos, who was elected Chile's president in January 2000. The election of Lagos was remarkable: he became the first socialist to govern Chile since Allende. Lagos, who holds a doctorate in economics from Duke University, was a socialist, and, when Allende came to power, was tapped as Chile's ambassador to Moscow. Following the military coup, however, he was instead forced to flee the country and spent close to a decade in exile in the United States and Europe. A fervent opponent of the Pinochet regime, he returned to Chile in the mid-1980s, where his continued criticism landed him in prison. A leading dissident figure by that time, Lagos was released following an international outcry. Not long after, during a live televised interview, he looked straight into the camera and, pointing his finger as if addressing Pinochet personally, declared that the country had had enough of his repression, torture, and execution—and that Pinochet's time was over.

Lagos's election, as predicted, showed just how far the world had changed in the previous two decades—and how long a road Chile had traveled since Allende. Far from pursuing the traditional socialist agenda of the kind that Allende had espoused, Lagos continued with the free-market reform that had made Chile one of the most successful countries in economic terms in Latin America. Indeed, since the end of Pinochet's rule, Chile had experienced a decade of a close to 8 percent economic growth. (In fact, a short-lived decline in growth in 1999 was the first recession to affect Chile since the early 1980s.) In that decade, Chile became known as having the most open, stable, and liberalized economy in Latin America, with the private sector, not the state, driving growth.

For Lagos, the market was now the way to deliver better social results. "Market forces alone mean that society is going to be as uneven as the market," he said. "You can have a market economy but not a market society. If you're going to have a market society, that society is going to be uneven, and I want a more egalitarian society, so that every Chilean has an opportunity in this century." It is a view grounded in Latin America's experience of market reform. For Lagos, the lesson of that experience was that reform could be sustained only if it reached a broader spectrum of the population and if investments were made in the social infrastructure of health and education. But he is also aware of the boundaries of social spending.

Chile is still haunted by the ghosts of the past. When Pinochet was arrested in Britain on a warrant issued by a Spanish magistrate and then eventually returned to Chile, the question of whether or not to put him on trial became a complex national issue. But Chile is a much different country today. Since the end of the Pinochet era, Chile has had three democratic elections. The 1989 election in many ways proved decisive. Despite the bitter strife and deep pain of the previous two decades, few wanted to roll the market back. That—along with the economic achievement itself—has sent a powerful message to the rest of the region, particularly at a time when it needed a role model. A decade later, the election of Ricardo Lagos demonstrated how confident the country had become in its newly regained democracy and free market economy.

For Lagos, there is a great gap between the socialism of the early 1970s and socialism in the first years of the twenty-first century. "A socialist today," he said, "understands that the fall of the Berlin Wall means we live in a world in which the market is not leftist or rightist. It is simply an instrument to be used." And to do so requires a type of discipline when it comes to spending that would have seemed irrelevant thirty years ago. He summed it up this way: "A left-wing politician has to be tough enough to say no."[7]

The Paradox of Argentina

Argentina had long been an economic paradox. How did a country that was one of the world's richest in the first decades of the twentieth century end up in such economic disorder? A good part of the answer rested with Juan Perón. He is now best remembered, of course, as the husband of Evita, but in the years after World War II he was the embodiment of populism with an almost fascist tinge. Building on the prewar popularity of fascist ideas, Perón turned Argentina into a corporatist country, with powerful organized interest groups—big business, labor unions, military, farmers—that negotiated with the state and with each other for position and resources. He incited nationalist passions, stoked pretensions of grandeur, and pursued stridently anti-American policies. He nationalized large parts of the economy and put up trade barriers to defend them. He cut Argentina's links to the world economy—which had been one of its great sources of wealth—embedded inflation in the society, and destroyed the foundations of sound economic growth. He was also wildly popular—until Evita's death in 1952. Thereafter, however, the economy became so chaotic that he prudently went into exile.

The years that followed were characterized by a revolving door of elected presidents and military juntas. Perón returned from exile to become president again in 1973. He died shortly thereafter, leaving as president his new wife, Isabel, who was not really prepared for the job, having previously been a nightclub dancer in Panama. The country descended into further chaos. A new military junta took power, and it waged a vicious "dirty war" against the left and others, many thousands of whom were "disappeared" à la Chile—some simply thrown out of airplanes over the Atlantic. The military showed no competence in running the economy, which was mired in persistent inflation and a deep recession. In 1982, in a desperate gamble to restore its authority and popularity, the military attacked the British-owned Falkland Islands (known to the Argentines as the Malvinas). It was the same war that gave Margaret Thatcher the political clout to undertake large-scale privatization in Britain. The defeat of the Argentine military dictators undermined their authority. In the one thing at which they were supposed to be expert—warfare—they had proved quite incompetent. In 1983 they surrendered office to a democratically elected president, Raúl Alfonsín.

Alfonsín had campaigned on the slogan DEMOCRACY OR ANTIDEMOCRACY. Argentina had had an abundance of both. Between 1930 and his election in 1983, the country had gone through twenty-four presidents and twenty-six successful military coups and several hundred unsuccessful ones. Alfonsín's great contribution was the restoration of democracy and civic institutions. But with the beginning of the debt crisis, his improvised efforts to stabilize the economy failed. The country remained in a deep economic crisis, and his administration was in disarray. One of his economics ministers, who had ridden on the shoulders of the crowd in the first year of Alfonsín's government, was by the end of his term spit upon by his own neighbors when he dared to venture outside his home.

Alfonsín was succeeded by a flamboyant, almost improbable, white-suited provincial governor, Carlos Menem. Once described as "a psychoanalyst's nightmare," Menem was also pragmatic, quick to adjust to circumstances, and hardly wedded to any set of ideas. Indeed, his policies were initially described as "a mismatch of misunderstood notions, some from Mussolini, some from Maynard Keynes." He ran as a Peronist—he was described as "Perón with sideburns"—with a platform of populism, handouts, and spending. He derided his opponent, who advocated privatization and a freeing up of the economy. Once elected, Menem promptly adopted his opponent's ideas and launched one of the most radical, speedy, and all-encompassing market reform programs in Latin America.

There was really no choice. Argentina had run into a wall. Hyperinflation had reached 20,000 percent, the economy was contracting, and food riots were taking place in the streets. The debt burden stood at $58 billion when Menem took office, and there was no obvious way to pay it off. It was no longer possible to play the old Peronist game of inflationary wage hikes. "We have already seen that movie," Menem once explained. Meanwhile, next door, Chile demonstrated that there was an alternative. Yet even within Argentina an alternative could be found. In the late 1970s, a candy manufacturer and a building contractor had gotten together and endowed the Instituto de Estudios Económicos sobre la Realidad Argentina y Latinoamericana (IEERAL), an economic research institute in the inland city of Córdoba. Its members were sick of corporatism, with its wheeling and dealing among major interest groups. Smaller entrepreneurial businesses, they believed, were the poor relations, simultaneously ignored and smothered by the system. Researchers at this institute studied market reforms in the rest of the world and then, in their own work, related them to Argentina's experience. By the time Menem came to power, they had articulated and indeed legitimized a host of ideas for reforming the economy. Menem, who had the political momentum, was ready to accept any suggestions if he thought they would help solve Argentina's problems. But he lacked one thing—ideas of his own. He needed someone with ideas. And he found such a person at the institute in Córdoba.[8]

The Broom Maker's Son

The head of the institute, and the one who shaped its agenda, was the economist Domingo Cavallo, who would prove to be one of the most influential figures in recasting the relationship of state and marketplace in Latin America. He was born in 1946, the same year that Juan Perón took power. If he had one nemesis in his career, it was Perón, for many of his intellectual and political efforts were aimed at refuting and rejecting Peronism. Cavallo grew up in the interior province of Córdoba, which he would later say had inured him to Peronism. "It is in the provinces, away from Buenos Aires, where one most easily noticed the pernicious effects of an overexpanded and arbitrary economic system." His own origins were very modest; his father owned a small broom-making shop that was connected to the family house.

Cavallo did his undergraduate studies in Córdoba and then worked in the state government, where he found himself increasingly dissatisfied with what he had learned in university. "At the time, there was a lot of emphasis on market failure and the role of planning," he recalled. "I didn't have the feeling of the market economy." He began to educate himself. He was much influenced by *The Principles of Economics* by Raymond Barre, a French economics professor and later prime minister of France. Barre focused explicitly on "the rules of the game"—how an economy is organized, who the players are, how they behave. The rules of the game would turn into a lasting preoccupation—and an oft-repeated phrase—for Cavallo. He also plunged into nineteenth-century Argentinian thought on the constitutional basis for a market economy. "I could not relate those ideas to what I was taught in university," said Cavallo. "I decided to go to the United States to understand the market economy better."

Cavallo ended up doing his Ph.D. at Harvard in the 1970s. He focused on Argentina's persistent inflation and monetarism, out of which came the ideas that would shape his subsequent policies. Argentina's inflation had been created by the fiscal irresponsibility of political leaders, who would spend and intervene no matter what the cost—motivated in part by grandiose illusions. Cavallo believed that the way to check inflation was to rein in the politicians, not the money supply. He was contemptuous of the *dependencia* theorists. Argentina's long decline, he argued, was the result not of external forces—the terms of trade—but of the internal political culture. Instead of complaining about international trade, Argentina ought to have been expanding and diversifying it.

Returning to Córdoba, Cavallo organized IEERAL; the presidency of this new research institute gave him the platform from which to propound his ideas and develop a cohort of like-minded researchers. His objective was to understand why the Argentinian economy had gone so badly wrong. "Argentina had been the most successful emerging economy in the world in the trade system that Britain created in the second half of the nineteenth century," he said. "What happened?" The attempt to identify the rules of the game became the perennial starting point for any research project at IEERAL.

In the mid-1980s, Cavallo published a book entitled *Economy in Crisis.* He wrote it in four weeks, although it was based on a decade of thought and analysis. The book was a best-seller and made him a national figure in Argentina. His diagnosis of Argentina's ailment became famous; the nation's essential problem, he announced, was the coexistence of "a socialism without plans and a capitalism without markets." He got himself elected to Congress. Despite their differences, he and Carlos Menem became good friends. Menem recognized that Cavallo could be very useful to him.

Cavallo was the logical choice for finance minister when Menem won, but his appointment was strenuously opposed by powerful business interests, which wanted to preserve their position and feared competition and deregulation. And so instead, Menem made Cavallo foreign minister. After all, he did speak English very well. Meanwhile, the economy continued to sink further into crisis. Having gone through three economics ministers in his first nineteen months in office, Menem finally turned to the obvious choice, Domingo Cavallo, and handed the economy over to him.

Cavallo was often blunt, abrasive, argumentative, and tactless. Sometimes he could not resist calling in to radio talk shows to set the speakers and listeners straight. But he also demonstrated a remarkable skill at the required politics—identifying goals, communicating, folding groups in, creating and shaping a broad consensus in favor of reform, and building up relationships with the international institutions and financial community whose confidence would be essential. Of course, he was aided by a sense of desperation. No one could doubt that the country was in a severe crisis. The cost of failure was evident—hyperinflation.

Determined to implement shock therapy, Cavallo moved quickly on several broad fronts. First, he rapidly reduced trade barriers and introduced reforms to encourage competition and a new export orientation. Second, he pegged the peso, the Argentinian currency, to the dollar and restricted the money supply to the level of hard-currency reserves in the country. According to the Convertibility Law, the central bank was obliged to convert the austral into dollars at a fixed rate. This step decisively removed a classic form of sovereignty; no longer could politicians and the central bank feed inflation by manipulating the exchange rate and wantonly expanding domestic credit. The mandatory convertibility was of overwhelming importance in bringing down inflation. As Cavallo explained, "We needed to change the minds of Argentinians. That became very important in contributing to discipline. Before that, politicians and participants in the economy did not have any idea of a budget constraint."[9]

Privatization

The third element was privatization. The government owned an enormous portfolio of companies, ranging from the traditional utilities to the state oil company and a circus. Most of them, burdened with antique organizations and onerous labor regulations, racked up huge losses year after year, draining vast sums out of the national treasury. As such, they were one of the main sources of inflation. Privatization was intended to achieve several objectives. It would stanch such losses and get business off the public dole. It would help reduce Argentina's debt burden. It would also reduce the size of the state, decentralize decision making, and take government out of an economic role that was inappropriate. It would provide a way to improve the quality of woefully poor services in such areas as telephones and transportation. And finally, there was no hope in the long term of taming inflation without privatization.

Argentina would in fact carry out one of the farthest-reaching and radical privatization programs of any country in Latin America. Cavallo and his colleagues learned as they went along. "The first privatizations brought us a lot of money but none of the benefits of competition," said Cavallo. "The most important thing we learned from the initial experiences was the need to maximize efficiency and benefits to consumers. We needed to improve the quality and quantity of services and to lower costs. All this would increase the productivity and competitiveness of the entire economy." Thus, Cavallo came to focus on deregulation as the necessary precedent to privatization.

The biggest privatization was that of YPF, the national oil company and the very embodiment of the Peronist state-owned enterprise. Menem and Cavallo selected José Estenssoro, an urbane executive with three decades of experience in the international oil-service industry, to run the privatization. Estenssoro presented two alternatives: Either dismantle the company and sell off the parts, or "rightsize" the company to its strategic core. The latter approach was chosen. As a first stage, noncore assets were shed, among them supermarkets, movie theaters, clubs, airplanes, and even churches. The second stage was restructuring—introducing an entirely new management organization and a host of new systems to support that structure. The central issue was employment. It was reduced by almost 90 percent, from 52,500 employees to 5,800. The extent of the reduction was evidence of how inefficient the company was. Unless it addressed employment, it could never cease being a loss maker. "The reduction in the labor force was the most painful decision," said Estenssoro, "but it took place without strikes, social unrest, or work stoppages." Indeed, it was handled with extreme care—with a mixture of early-retirement packages that included a year of retraining followed by generous severance packages, along with the transfer of employees with assets that were sold off.

The restructuring turned YPF into a firm that looked like a modern company, not a sprawling branch of government administration. Only then was it ready for privatization. The result was a stock offering in 1993—at $3 billion, the largest initial public offering up to that time in the history of the New York Stock Exchange. A lumbering, inefficient, inward-looking company dependent on protection had been transformed into a dynamic international competitor, operating throughout Latin America and, later, in the United States and Asia.

But the period of renewed growth soon came to an end. Mexico's 1994–95 peso crisis sent jitters through Latin American economies, and Argentina proved to be one of the most severe casualties of the "tequila effect." Argentinians rushed to withdraw their money from banks. Unemployment shot up to 18 percent. As capital fled the country, the currency board stretched to the limit. Yet Menem stuck to the arrangement, resorting to fiscal measures to fix the problems. The spending cuts pushed the economy into a deep recession. Still, Argentinians, for whom the memory of hyperinflation remained fresh, felt that preserving the currency board was the right thing to do. Despite the recession, Menem was reelected.

In Menem's second term in the office, the pace of structural, regulatory, and institutional reforms slowed. To make matters worse, Menem's relations with Cavallo deteriorated badly, and in 1996 Cavallo resigned. It did not take long for him to become an outspoken critic of Menem's administration and of official corruption. Spending grew, and so did debt. Another series of external shocks undercut Argentina's brief period of recovery. The first one came in August 1998, when Russia defaulted on its sovereign debt, further undermining investors' confidence in the emerging markets (which had suffered already as a result of the Asian financial crisis). But by far the biggest hit came from the devaluation of the real by Brazil—Argentina's main trading partner—in January 1999. With the real losing close to 40 percent of its value—at the same time as Argentina's dollar-bound peso strengthened—Brazil had to reduce its imports from Argentina. Compounding the problem was Argentina's dependence on exports of commodities, such as grain and meat, whose prices suffered a steep decline. By early 1999, Argentina's economy was once again in a recession—its second in four years. In an effort to boost growth and avoid further controversial reforms, national and state governments borrowed heavily, bringing its public debt to more than 50 percent of the GDP.

In the fall of 1999, Argentines elected Fernando de la Rua to succeed Menem. A former lawyer and mayor of Buenos Aires, the sixty-one-year-old de la Rua presented a striking contrast to Menem. He was moderate in his political views and not disposed to giving flamboyant promises. But it was precisely his seriousness, and indeed his lack of charisma, contrasting sharply with Menem's extravagance, that had appealed to the Argentinians. In an attempt to win back investors' confidence, de la Rua instituted a tight fiscal policy that was meant to counterbalance the lavish spending of Menem's last years in office. But the measure did not bring the desired result. After years of austerity, the country found itself in a deflationary trap. Argentina was teetering on the brink of a default on its $142 billion debt.

Undercutting Argentina's efforts at recovery was the very system that had once brought it stability and growth. The flip side of the tight currency board was the lack of flexibility. Devaluation, which would have boosted the competitiveness of Argentine exports, did not seem to be an option, even though Brazil's devaluation had put Argentina at a decisive disadvantage. "Convertibility" had been viewed by Argentinians as a bulwark against economic chaos for so long that the government viewed its abandonment as a political impossibility. Proponents of maintaining the currency board argued that since most of Argentina's debt—both public and private—was dollar-denominated, the benefits of devaluation would be only marginal and might lead to massive defaults by consumers and businesses.

A rescuer was waiting in the wings: Domingo Cavallo. Indeed, in early 2001, a newsmagazine had put Cavallo's picture on the cover, inside a fire alarm box, with the headline "Open Only in Case of Emergency." The emergency was now here. De la Rua made Cavallo minister of the economy in March 2001. Cavallo continued with the austerity measures, attempting to balance the budget by increasing taxes and sharply cutting some state salaries. Still the economy continued its slide. The difference from Cavallo's earlier tenure was striking. Instead of being greeted with applause, the way he had been wherever he went in the early 1990s, he was attacked with eggs by angry demonstrators (one such incident occurred as he was escorting his daughter to her wedding). Shortage of cash and fear of a 1994-like run on the banks led the government to take a drastic measure of limiting personal bank withdrawals to $1,000 per person. In an attempt to circumvent the cash shortage, individual provinces began issuing alternative currency—bonds that could presumably be exchanged for cash, at a high interest rate, at a later date. (Thus, the province of Buenos Aires—Argentina's most populous—floated a so-called *patacon,* to which the province's McDonald's franchises responded by putting up signs "I believe in my country: I accept *patacone.*" And, to affirm their patriotism, they began offering their customers a special "Patacombo" consisting of two cheeseburgers, medium fries, and a soft drink.)

The problems that beset Argentina's economy were all the more troubling, given that for many years the country had been held up as a model of market reform. Yet what the crisis showed was that a lasting market reform involved more than relying on a limited set of measures, however successful. The currency-board system and emphasis on convertibility had solved the problem of inflation and attracted foreign investment but overexposed Argentina to other problems. Devaluation and default would not only undermine savings but would also threaten to wash away the legacy that had once made Argentina the leader in reform in Latin America.[10]

Peru: The Agronomist and the Book Writer

During the "lost decade" of the 1980s, Peru experienced one of the most stunning descents into economic darkness of all the countries in the Western Hemisphere. From 1968 to 1980, it had been ruled by a left-wing military dictatorship. Influenced by Fidel Castro, proclaiming its commitment to social reform, and wrapping itself in nationalism, the regime took over much of the economy, strangled private enterprise, nationalized domestic and foreign businesses, and set the country back enormously. One simple example: By the end of the 1960s, Peru had built up a substantial fishing business, which provided many jobs; its fleet, in fact, was larger than Japan's. The military government nationalized the business and in due course it simply collapsed. Yet despite its nonperformance, the fishing business still continued to draw huge state subsidies. The beached, rotting hulls of the fishing boats told all.

The first postmilitary government in the early 1980s did not change much in the way the economic system operated. The second made things worse. It was the leftist government led by a young politician named Alan García. A charismatic and captivating orator, he was drawn to the balcony overlooking the square—but even more by the power that came with the balcony. García and his cronies used their positions to hand out favors and, in the process, to enormously enrich themselves. Their economic policy was a recipe for economic collapse. They slapped on price controls, severed Peru from the international financial community, promoted generous wage increases, cut taxes, and opened the floodgates for government spending. Toward the end of his presidency, García went out of his way to establish diplomatic relations with North Korea, a source of funds and weapons. Meanwhile, Peru was in deep economic crisis: Real wages of the army and government employees had declined by two thirds, the economy contracted 25 percent between 1988 and 1990, and by early 1990 inflation had reached 3,000 percent. The country was broke.

It was also in the grip of an intense political crisis, instigated by a civil war led by Sendero Luminoso, the Shining Path. Although often described as Maoist, the ideology of the Shining Path was almost impenetrable, but the way in which it sought to impose itself was all too clear—through violence, savagery, wanton bloodshed, and havoc. Led by Abimael Guzmán, a philosophy professor in the Andean city of Ayacucho, it had spread its control through sheer terror over much of the highlands and was waging war on the capital, Lima, through murder, bombings, kidnappings, and blackouts. By some estimates, half of the country was under its sway.

Yet in the 1980s, the country was afforded another path. Indeed, *El Otro Sendero—The Other Path*—was the title of a book that put forth a liberal alternative for Peru. The appearance of the book, written by the economist Hernando de Soto, reflected the percolation of reformist ideas among some intellectuals and businesspeople. Indeed, both Friedrich von Hayek and Milton Friedman were among those participating in the symposia in Lima that had laid the basis for the book. The researchers associated with *El Otro Sendero* concluded that there were over five hundred thousand laws and executive orders that applied to economic activity. They conducted an unusual experiment to discover how difficult it was to start a small business in such a highly regimented and complex system. They set up a small workshop in Lima with two sewing machines and then tried to register it as a business. "To register the workshop," they reported, "took 289 days and required the full-time labor of the group of four assigned to the task, as well as $1,231. . . . At the time, that was the equivalent of 32 monthly minimum wages. This means that the process of legally registering a small industry is much too expensive for any person of modest means." The system discouraged economic initiative or forced would-be entrepreneurs into illegality and the black market—what became known as the "informal economy."

But interest in the other path was restricted to little more than a small circle. That all changed at midday, July 28, 1987, when García delivered a speech announcing that he would nationalize all banks and financial institutions. The writer Mario Vargas Llosa, vacationing with his family at an isolated beach in the very north of Peru, heard the speech over an ancient portable radio. He was infuriated. The results would be more corruption, more poverty, more dictatorship. "Once again in its history, Peru has taken yet another step backward toward barbarism," he said bitterly to his wife. He said much the same in an article entitled "Toward a Totalitarian Peru." A manifesto followed, and then a demonstration that, instead of attracting a few thousand professionals, drew at least a hundred thousand—and caused Alan García, watching it on television, to smash the screen in rage. Mario Vargas Llosa became the leader of the Libertad movement, which intended to roll back the state.

Vargas Llosa was Peru's most distinguished man of letters. A very adept literary critic, he had written his dissertation at Madrid University on the Colombian novelist Gabriel García Márquez. But it was his own novels—beginning with *The Time of the Heroes* and continuing with the likes of *Aunt Julia and the Scriptwriter* and *The War at the End of the World*—that had made him an international literary figure, equally at home in London, Madrid, and Paris as in Lima. In the way of so many Latin American intellectuals, he had flirted continually with politics since his student days, but he had gone through a much more thoroughgoing transformation than most. He had begun as a student communist and had staunchly defended the Cuban revolution. But when he dared to criticize Castro for imprisoning writers, a hail of invective from Castro and his intellectual defenders around the world fell upon Vargas Llosa. Increasingly, he came to see that communism meant repression and, at the same time, failed to deliver on its vaunted promises. He became a social democrat.[11]

Still unsatisfied, Vargas Llosa turned to the study of economics, and ended up settling on liberal economics as the best bet for both delivering economic growth and protecting freedom. Leftist intellectuals heaped calumny on him, and he returned it in kind. He denounced "cut-rate intellectuals," who went with the fashions and were profoundly ignorant of economics. "You cannot be a modern man and a Marxist," he declared. He mused endlessly on why intellectuals were so fascinated with state control and Marxism. Part of it was patronage, part of it was fashion, and part "their lack of economic knowledge." He reserved some of his greatest contempt for Latin American intellectuals who made a career, in his view, of denouncing the "imperialist" United States while at the same time finding much succor from professorships at its universities and grants from its foundations. Perhaps nothing so much brought home the distance he had traveled as when he encountered his old friend Gabriel García Márquez one evening at a theater in Mexico City. García Márquez had never abandoned Fidel Castro, and he was strongly critical of Vargas Llosa's repudiation of the left. They got into an argument, and Vargas Llosa ended up knocking García Márquez out, which is something that one hardly ever gets to do to the subject of one's doctoral dissertation.

Now, in the aftermath of Alan García's nationalization announcement, Vargas Llosa emerged as the leader of a political movement, Libertad, which became the vehicle that brought into Peruvian politics the reform ideas that had spread elsewhere on the continent. The more learned members argued about whether they should adopt the "market economy" or the "social market economy" and debated which path Ludwig Erhard would have endorsed. More immediately, Libertad's leaders methodically developed over three years a "white book" of ideas and plans for radically reforming Peru's economy. The reshaping of political discourse was almost unimaginable. "I see it but I don't believe it," Felipe Thorndike, a prominent engineer, said to Vargas Llosa. "You talk about private property and popular capitalism, and instead of lynching you they applaud you. What's happening in Peru?"

By 1990, Vargas Llosa was the front-running candidate for president. But he had to conduct his campaign under enormous pressure. There were simple things—like the daily phone calls threatening to kill his family. There were physical attacks. In addition to the risk of assassination by García's supporters, there was also the constant threat of the Shining Path, particularly in the Andes, where his campaign workers were gunned down. During all the months of campaigning, Vargas Llosa struggled to keep in touch with his intellectual interests. Every morning during the campaign, when he was in Lima, he withdrew to his study to read and reflect on Karl Popper and the open society. At night, for solace, he read the Spanish poet Góngora.

Vargas Llosa took a highly publicized trip to Asia in order to demonstrate the other path—what he described as "economic freedom, the market, and internationalization." Leftists, he noted, depicted Taiwan as "a semicolonial factory" of the United States. In the middle 1950s, Peru's economy had been superior to Taiwan's; both countries had per capita incomes under $1,000. Yet by the time of his visit, per capita income in Peru had slipped by half, while Taiwan's had risen to $7,530. He also visited Margaret Thatcher, who told him that he should press on. But there would be a cost. "If you continue," she said to him, "you will have to endure a great deal of loneliness."[12]

All this assumed that Vargas Llosa would win. What was not factored in was Alberto Fujimori, an agricultural engineer and university rector. It was very hard, at least at first, to take Fujimori seriously as a candidate; he was even harder to take seriously than a novelist candidate. He had no political following and belonged to no party. Insofar as he was known at all, it was as host of a television talk show that dealt with farming and socioeconomic issues. He was also an outsider, a member of Peru's small Japanese community, his family having immigrated to Peru in the mid-1930s. He identified with those excluded from Peruvian society—the poor and the Indians. And he was filled with anger at what he saw as the collapse, despair, and looting of his country.

Initially, he was hardly noticed, left vying for last place with the prophet Ezequiel of the Israelite Church of the New Covenant. Even his family told him that he was crazy to run. But Fujimori was determined. It is said that he sold his tractor and pickup truck to help finance his one-man campaign. He put together a coalition of evangelists and the dispossessed, who campaigned door to door for him in the shantytowns. He built support by criticizing Vargas Llosa's talk of shock therapy, privatization, and the slashing of government employment. He did not get into specifics; his slogan was "Honesty, technology, and work." Television viewers were treated to footage of him driving tractors over the Andean highlands.

Fujimori was attacked because he was Japanese, because his mother did not speak Spanish, and because none of his relatives was buried on Peruvian soil. He counterattacked with pictures of his son taking communion, and by observing that if Peru was going to emulate the Asian countries, then he was better prepared to implement it than was someone of European descent. Fujimori portrayed Vargas Llosa as the candidate of the small Peruvian elite—white, well off, privileged, and separated from the mass of the poor and the reality of society. Physiognomy became an issue—Vargas Llosa's striking European looks, evoking the Spanish conquest four centuries earlier, in contrast to Fujimori, whose facial features were closer to those of the Andean Indians.

In the initial round of the elections, Vargas Llosa and Fujimori came out first and second, respectively. After much soul-searching, Vargas Llosa offered to step aside if Fujimori would adopt his reform program. The offer was spurned. In the second round, Fujimori won handily, and the next day Vargas Llosa flew off to Paris, bitter and sick of politics, eager to return to his writing. But what he left behind was the detailed script for reform.

Fujishock

Within two weeks of taking office, Fujimori, who had run as a populist and had called for gradual reform, unleashed a program of shock therapy so much more far-reaching than anything Vargas Llosa had proposed that it became known as Fujishock. Public spending was slashed and the currency effectively devalued, the beginning of a very rapid and thoroughgoing reform program. Fujimori also demonstrated a style of governing that put little emphasis on coalition creation and institution building. He took his own counsel and kept decisions to himself.

Yet Fujimori was determined to do two things simultaneously—combat terrorism and implement the kind of reforms that had been laid out in Libertad's white book. "It was a very difficult problem to fight violence and at the same time to make economic reforms," he said. "It was very risky to do both of them at the same time, because any economic reform would bring some instability in the short term. But we ran the risk. It was the turning point for success in our economic program.

"My mind worked as an engineer's even on the Shining Path," he continued. "People, even the archbishop of Lima, were talking about fighting poverty before violence. That was a fallacy. We had to fight violence, and then poverty. I had a conversation in this room with some of the leaders of the business community. They had no hope. But I saw things completely differently. I was convinced that the strategy we established would be a success. I was not lonely. I was sure. In that sense, I have the Oriental patience. I wait for the result. I was very firm. Even stubborn."

The campaign against the Shining Path was reorganized and intensified; Fujimori involved himself directly. Now, instead of fighting on the periphery, they would go after the heart of the movement. It took two years. The police came to focus on a house in Lima. They observed that it was turning out garbage on a daily basis considerably in excess of what might have been expected to be generated by the two people living there. In September 1992, they mounted a raid, and in the ensuing attack, they found that it was indeed a safe house where Shining Path members were living secretly. Among them was the number-one quarry—Abimael Guzmán, the leader. Captured and paraded on television, Guzmán was no longer the fearsome philosopher-guerrilla; he implored his colleagues to lay down their arms.

The winding down of violence provided the context in which Fujimori could carry out the next phases of Fujishock. Labor and financial markets were deregulated, tariffs were reduced and simplified, privatization was initiated, and the tax base was broadened, while taxes themselves were reduced. Peru was reopened to foreign investment and, in complete reversal of Alan García's policies, reintegrated into the international financial community. Peru started to experience substantial economic growth, and in contrast to the fast-growing Asian countries, it began to be talked of not as a tiger but as a puma. "I tried to make a very fast pace," Fujimori explained. "My economic experts did not understand how far we wanted to go to the market economy. I wanted a real authentic market economy." Indeed, he jettisoned his original advisers and ended up with a cabinet composed entirely of people who had originally not supported him.

"The situation here was such a mess, with many kinds of controls that were against the poor consumer and favoring big political power," he said. "The role of the state is in fields like education, health, security, and the judiciary," he said. "I had this thinking, these ideas, because I was a full-time engineer and because I was independent. I make my own evaluation. That is critical for me. The way I think is not the way a politician thinks. My way of thinking is logical and objective. I see a problem as an engineer. Once an engineer sees a problem, he wants to find a solution, even if it is a limited solution." He recalled an incident that had fueled the anger that had led him on what had seemed an overwhelmingly quixotic presidential bid. "One day in 1988 I couldn't fly from Huancayo to Lima because of bad service. Aero Peru passengers would have to wait twelve hours in the terminal. Finally, I drove a car. I had to go very slowly because of rocks on the road, and because of the risks and dangers of the Shining Path, who would stop cars. It took me fourteen hours." He smiled. "Now you can do it in five."

The reforms were accompanied by many traumas. In April 1992, Fujimori dissolved the Congress, suspended the constitution, and dismissed much of the judiciary. Critics called it a coup and charged that Fujimori was making himself into a strongman. His wife unleashed a furious public feud with him, which culminated in her joining a dozen other candidates, including former U.N. secretary-general Javier Pérez de Cuéllar, in running against him for president. Nevertheless, Fujimori won a second term on the first ballot, with more than 60 percent of the vote.

His popularity soared further in April 1997 following his decisive strike against the guerrillas of the Castroite Túpac Amaru revolutionary group, who seized the residence of the Japanese ambassador during the huge annual party celebrating the Japanese emperor's birthday. But that surge in popularity would prove to be the last high point of Fujimori's presidency. Discontent grew over what was becoming his increasingly authoritarian style of rule and the wave of political scandals involving his security adviser, Vladimiro Montesinos. A poll in early 1997 reported the widespread belief among Peruvians that it was Montesinos, not Fujimori, who was really holding power. As Peru's economy took a series of external hits, including the particularly destructive effects of El Niño, low commodities prices, and the contagion effect from the Asian financial crisis, Fujimori reverted to his original populism.

Nevertheless, Fujimori decided to run for a third term (a highly controversial move for which he had to change Peru's constitution). The spring 2000 campaign culminated in a vote that *The Economist* called "the dirtiest vote in South America for a decade." One of the contenders, Alejandro Toledo, quit the campaign midway in protest. As Fujimori's third inauguration went on in the midst of tear gas and riot police, Toledo, who led a ten-thousand-strong march in protest of the election results, announced: "Democracy is dead."

But Fujimori's third term would last only a few months. In September, an independent television station broadcast a leaked videotape that showed Montesinos making a $15,000 payment to an opposition congressman in exchange for support for Fujimori. This would be the beginning of a stunning unraveling of an unprecedented web of corruption that involved the country's most prominent congressmen, ministers, and judges. Hundreds of videotapes would be seized from Montesinos's residence. Much of Peru's power elite seemed to have been tainted in the network of bribery, extortion, and blackmail. As the spellbound Peruvians watched the videotapes broadcast on national television, Fujimori, eventually resurfacing in Japan, applied for political asylum. He faxed his resignation letter as Peru's president from a Tokyo hotel room. Peru's Congress declined the resignation. Instead, it voted Fujimori "permanently morally unfit" to rule the country. It was a dismal political end for a president who had undoubtedly saved the country from chaos and a vicious guerrilla war—and who at one point was considered the greatest president Peru had ever had.

Market Economy "with a Human Face"

It was against this background that Alejandro Toledo was elected Peru's president in July 2001. He ran against Alan García, who, despite having previously devastated the country politically and economically, had returned to Peru after almost nine years in exile to try to regain the presidency. Toledo promised free-market reform and the cleaning up of corruption. Announcing that he wanted a market economy "with a human face," he said, "We are going to overhaul the budget so as to channel money into social investment without creating a fiscal deficit. Because on this I am very clear: I support the 'Third Way,' but as regards monetary and fiscal discipline I am a neo-liberal."

Toledo's election was a landmark event. It was the first time in Peruvian history that a *cholo*—representative of the poorest, most disenfranchised class of Indian descent in Peruvian society—was elected as president. Born into a poor Andean family of sixteen children, Toledo had learned early on to stand on his own two feet. As a young boy, he shined shoes and worked as a street vendor. His writing talent won him school scholarships and a writing job in a local newspaper when he was a teenager. An American couple on Peace Corps duty in Peru helped him win a scholarship to the University of San Francisco. He went on to earn two master's degrees and doctorate from Stanford and Harvard and work for the World Bank. Returning to Peru in 1981, he decided to enter politics. It was not an easy ambition in the race-conscious Peru: when Toledo first moved back to Lima, people assumed he was his Belgian-born wife's driver. Nevertheless, Toledo became chief economic adviser at Peru's central bank, then served as the minister of labor. He made his first bid for the presidency at the height of Fujimori's popularity in 1995 but finished a distant third.

Toledo's election was also significant for whom it did not bring to power: in rejecting García, Peruvians also rejected García's old brand of state intervention. But although in electing Toledo they made an implicit vote for free markets and democracy, finding the right approach to building these will not be easy. Toledo has on his hands a country enervatated by the revelations of the excesses of the Fujimori/Montesinos era, which continue to spill over the wires. Protests have been rampant. Fujimori's rule had discredited the very institutions that were supposed to guard democracy: the judiciary, the police, and the army. Toledo will have to redefine reform to ensure that its benefits reach Peru's vast population of the poor and disenfranchised and build a new consensus for it, while reconstructing the institutions tainted by corruption. Restarting the economy presents a particular challenge. In the last years of Fujimori's rule, the economy stagnated. Toledo's economic team, headed by Economy Minister Pedro Pablo Kuczynski (an energy minister and investment banker, popularly known as PPK), has proposed a large package of privatization and liberalization measures. "What we've learned," said Kuczynski, commenting on Toledo's economic program, "is that if the government leaves things alone, the country will grow." At his election, Toledo promised Peruvians "a fairer country, with more jobs, without corruption, with more justice and equality for all." It will take a lot of time, commitment, and perseverance to fulfill this pledge.[13]

Brazil: **Dependentista** *Turned Inflation Slayer*

In Brazil, reform has been hampered by the very character of the country—its size, its diversity, the depths of its problems, its demographics, the federal structure and the multiplicity of interests, and the entrenchment of corruption. Democracy returned to the country in 1985 after twenty-one years of military rule, but Brazil inherited considerable economic problems. At the time the debt crisis broke, Brazil owed $87 billion, making it the world's largest debtor. A culture of inflation engulfed the nation. Inflation hit 1,500 percent by 1990. Indexation became a way of life. The price of virtually everything was linked to one of the many indices that were published in the newspapers. Prices changed every day; even bank accounts were indexed. The poor suffered the most. And corruption threatened to undermine the legitimacy of the new democracy; the first directly elected democratic president resigned in 1992 to avoid impeachment on corruption charges.

Yet despite all this, Brazil moved toward an open market economy, although more slowly than most of its neighbors. More than anybody else, the architect was the current president, Fernando Henrique Cardoso. There was more than a little irony in this, for Cardoso described himself as belonging to the "radical tradition" of Latin American thought and, indeed, was one of the premier architects of the *dependencia* theory and its critique of capitalism and the "center." He was an intellectual hero of the Latin American left and one of the most trenchant critics of capitalism and "imperialism." His personal transformation was more thoroughgoing than that of his country and dramatized how far the weight of ideas shifted.

Cardoso, strongly influenced by Marxism while a student at the University of São Paulo, was forced to go into exile after the 1964 military coup. He ended up in Chile, working under Raúl Prebisch, the father of *dependencia.* A sociologist, Cardoso ran a research institute affiliated with ECLA and coauthored a classic text on *dependencia.* He taught at other universities, including the radical Nanterre campus of the University of Paris, where the student uprisings of 1968 began. Cardoso returned to Brazil in 1969. He was promptly stripped of his university professorship by the dictatorship, but nevertheless managed to establish a research institute that turned out criticism of the military regime and its policies. He gravitated toward politics and, after the return of democracy, emerged as a leader of a new social-democratic party and won election as a senator. In 1992, he became foreign minister and then, the following year, finance minister.

It was as finance minister that Cardoso took the key steps to stabilizing the Brazilian economy. He slashed government expenditures and improved tax collection. He also reduced the transfer payments from the federal government to the state and local governments. And with inflation running at 7,000 percent, he acted decisively. The mechanism was his Real Plan, which, like that in Argentina, tied the currency to the dollar. It worked. Within a month, inflation plummeted to less than 10 percent. The plan brought respite to the main victims of inflation: the poor and the working class. It laid the basis for record foreign investment and spurred a rapid growth in trade. Cardoso became the hero of stabilization. On campaign tours, he found himself mobbed like a soccer star. In 1994, he was elected president.

His first few years as president did not go smoothly. There were banking crises and a botched devaluation. In any event, reform was not easy in a country in which the constitution, adopted as late as 1988, explicitly mandated government ownership of part of industry and in which the Congress is dominated less by parties than by interest groups. Nevertheless privatizations, some of them large, continued in Brazil, many of them at the state level. By late 1997, equity sales in such key sectors as steel, electricity, and telecommunications had raised $29 billion. Reforms of the civil service, the tax system, social security, and education have been slower.

Cardoso may have acted like one of the new breed of Latin American neoliberals, but he did not talk that way. His language was still that of a social democrat, with the focus on poverty and equity. But now he had a "regulated free market" and Western Europe's mixed economy as his model. The tenets of *dependencia* were overtaken by changes in the world economy, technological advance, and competition. The overweening, inefficient, intrusive state was a cause of economic problems, not a solution to them.

"In the whole world," Cardoso said, "the force of change-oriented utopia, of a socialist hue, has lost attraction." The traditional left has been left behind. Today, he asked, "what is the left? The left has lost its bearings. If the left identifies with what in history has materialized as the left, it is finished. Especially here in Latin America, the thinking of the left had been based too much on the idea that development was fundamental, that the state was the central agency for such development, and that collective instruments of action had precedence over individual ones. . . . It has to be more rational." But he also rejected the view that "the smaller the state, the better. . . . One cannot make the private sector the universal salvation, because it is not. The market does not solve the problem of misery. The problem of poverty has to be solved along the lines of coordinated actions by the state."

Yet this father of *dependencia,* formerly one of the leading intellectuals on the Latin American left, now finds that his main political opponents are on the very ramparts of the left that he abandoned. He has no doubt that the left helped restore "the rule of law" in Brazil. But even without the socialist goal, "the notion of a strong state as the main instrument of development is still alive," Cardoso said. "Reforms are needed."

By the autumn of 1998, as Cardoso stood for reelection, Brazil was threatened by the contagion crisis that had swept across Asia and Russia. Indeed, it had become the key battleground in the global ailment. Its growing deficit was under attack; its currency, under assault; and capital was fleeing the country. Cardoso stood his ground, announcing that he was going to defend the Real Plan and instead make further major cuts in Brazil's bloated budget. He had already presided over a privatization program that, in dollar value, was already double that of Britain under Margaret Thatcher. But now the high interest rates required to defend the currency (at one stage rising above 40 percent in real terms) virtually ensured an economic downturn.

In January 1999, facing a shortage of hard-currency reserves, Brazil took the radical step of adopting a floating exchange rate. The move was viewed with trepidation by the international community. "The fear was, if Brazil devalues, hyperinflation will return," recalled Stanley Fischer, at the time deputy managing director of the IMF. "But it was quiet. There was very little inflation, and that had a lot to do with the central bank; it had a lot to do with what Brazilian society had learned about inflation, after going through hyperinflation and deciding they never wanted that again." By March, Brazil's economy stabilized. Interest rates were quickly—and substantially—reduced, exports became more competitive. The cost-cutting measures necessitated by the crisis left companies more efficient than before. Foreign direct investment started returning to the country.[14]

But before long, a series of crises threatened Brazil's recovery. Foremost among these was the most serious power crisis that the country had experienced in decades. The crisis was set in motion by an acute and prolonged drought; but the real underlying cause was an incomplete and flawed deregulation that had left the power industry insufficiently restructured and chronically short of investments. Electricity shortages resulted in a dramatic decline of industrial output, leading to continued decline of the value of the real. Exacerbating the situation was the prolonged economic crisis in Argentina, which greatly reduced the flow of foreign investment into the region in general.

The crisis underscored the deeper problems of Brazil's economy: the heavy reliance on foreign borrowing in an attempt to cover the persistent budget deficit; the chronic shortage of investment in infrastructure; the insufficient regulatory oversight. But the country's response to the crisis also showed that its economy was stronger and more stable than had been frequently assumed. Indeed, Brazil has a streamlined and competitive private sector that has benefited significantly from the devaluation of the real. Owing in part to its size, the country is not nearly as dependent on exports as some of its neighbors, which means that it is less subject to external shocks and a global economic downturn, even if not at as rapid a pace as it would have otherwise.

Most important, despite the dramatic devaluation of the real, the country's most critical achievement—the conquering of hyperinflation—is still standing. It was on the strength of this achievement that Brazilians reelected Cardoso in 1998 for the second term in office—in a landslide and in the midst of an economic turmoil caused by the contagion effect of the Asian financial crisis. For Brazilians, the slaying of inflation counted more than anything else. Curtailing inflation meant that people could, for the first time in decades and many for the first time in their lives, plan—and save—for the future. And that is something of great magnitude on which to build.

Mexico: The Diffusion of Power

It always seemed that Mexico was different. Since the revolution of 1910, it had managed to avoid most of the political upheavals that the other Latin American countries had experienced—the populism, the military crackdowns, and the worst of the repression and violence. This relative peace came largely thanks to Mexico's unique political system, which set it apart from the rest of the region for most of the century. The consolidation of power that followed the revolution put government firmly into the hands of a single, dominant political party. Even its unusual name—the Institutional Revolutionary Party, or PRI—signaled the ambiguity of its mission, identity, and purpose. But its successive leaders managed to devise and apply the political tools that would grant Mexico relative political order and stability.

Mexico's presidents had a firm grip and did not tolerate dissension beyond a point. PRI was not the sole legal party, but it guaranteed its role by buying off potential opponents, co-opting faction leaders, and, when all else failed, controlling the outcome of elections. It took care to preserve, at base, a broad measure of bedrock popular support to give legitimacy to the process. A single trade union confederation, for example, mediated among workers, private business leaders, and the government. Its leaders, who were well rewarded for their efforts, helped take the rough edge out of industrial relations. Meanwhile, factions formed and re-formed within PRI, negotiating among themselves and dividing up positions of influence. PRI devised "rules of the game" to ensure something close to fairness within the confines of its one-party logic. The national constitution stipulated that the country's president could serve only one six-year term. And nobody could become president who had held a cabinet-level post within the previous six months. To conform with these requirements, PRI developed an unwritten but unshakable practice known as the *dedazo*—the pointing of the finger—by which the outgoing president would designate his successor, to be rubber-stamped by less-than-transparent national elections.

Not all was manipulation, payoff, and sleight of hand. *Priista* presidents also took measures to give the people a sense of welfare, improved living standards, and control over their country's economic destiny. Most notable was the nationalization of the oil industry in 1938 by Lazaro Cardenas, by most accounts the most popular and revered Mexican president of the century. And in the post–World War II era, Mexico's record of economic growth and social order stood in contrast to the hyperinflation, the recessions, and especially the civil strife and military dictatorships spreading in the rest of Latin America.

All this came under severe threat by the beginning of the 1980s. Despite its advantages and political stability, Mexico too had operated on the economic logic of import substitution, and it too felt the strain of that system. The collapse of commodity markets and the accumulation of debt and dwindling foreign reserves hit hard. And the time-honored ways in which PRI retained its grip did not help. After all, the bargain with organized labor came at the cost of a vast patronage system; and the bargain with the wealthy private industrialists of northern Mexico was based on protecting their markets from competition. The now-familiar array of massive state enterprises bred heavy expenses, and the Mexican president of the late 1970s, José López Portillo, made matters worse with his notoriously profligate spending habits.

Such was the situation when the debt crisis hit in August 1982. The bailout came with a heavy cost. Mexico's credit was shot, and it had to rebuild its reputation step by step within very tight constraints and during a deep economic slump. It was imperative that deficit spending and the public debt be reined in. And since much of the trouble was structural, inherent to PRI's way of running the country, that too would have to be questioned. The political implications were daunting, and an influential faction formed within the old guard of PRI—they would later be called the "dinosaurs"—to ward off such dangers. Against them was a small set of reformers scalded by the shock of the debt crisis. Over time, they would come to transform the political landscape and turn the Mexican economy inside out, from import substituter to participant in continental free trade. But the transition was to be far from simple, and punctuated by several dramatic pauses and reversals.

It would take several shepherds as well. First among them was Miguel de la Madrid, who became president, according to schedule and the rule of the *dedazo,* in December 1982, amid all the financial torment. Although he had once been López Portillo's budget minister, he sought very rapidly to distance himself from his predecessor. He had ample opportunity to prove himself, as he had to assume responsibility for very tricky debt renegotiations. In these, he succeeded in conveying to the bankers the sense that something had changed. He also did the unheard-of politically: Within his first year in office, he allowed the opposition to win a series of local elections. This, however, was felt to be too much, and in the next set of local elections PRI returned to its old ways.

De la Madrid set to work with the help of two key ministers. His finance minister was Jesús Silva Herzog, the scion of a political family, whose father had played a central role in the oil nationalization of 1938. The planning and budget minister was Carlos Salinas, a young, slight economist who had studied at Harvard's Kennedy School of Government. Of the two, Silva Herzog was certainly the more cautious and Salinas the more adventurous. But both knew something had to change. "It was not easy to find another country with as high a deficit as ours," Silva Herzog recalled. "We needed to bring it down and to get rid of debt service." Their job, as Salinas explained it, was "the taming of the budget dinosaur." They clamped down on spending with ferocity, moving the budget from a deficit of 7.3 percent of GDP to a surplus of 4.2 percent. They devoted every possible resource to repaying the debt. And most of all, they began to unravel the tangled web of public enterprises. "At the end of 1982, there were over eleven hundred public companies," said Silva Herzog. "Some were top priority, like electricity or the railroads. But we also owned hotels, restaurants, a bicycle factory, and a blue jeans factory. We even owned a nightclub in Mexico City. It was probably the only nightclub in the world losing money."

To take on this complex was nothing short of revolutionary. If they had the courage to take tough measures, they were not, however, helped by luck. A devastating earthquake in Mexico City in 1985 caused damage estimated at 2 percent of GDP, and was followed soon after by a fall in the price of oil, which generated more than half of Mexico's total export revenues. These obstacles, combined with the difficulties of keeping internal opposition at bay, meant that by 1988, when de la Madrid stepped down, inflation remained very high (upward of 100 percent per year), and the real incomes of ordinary people had plummeted. The budget deficit had crept up again. And the early emphasis on privatization had its pitfalls, too. "Overnight billionaires" had sprung up. "Most people were convinced there were many cases of corruption," said Silva Herzog. "It was a question of moral credibility." At the same time, Mexico had joined GATT, the General Agreement on Tariffs and Trade, which meant removing the protections on a number of privileged sectors. All this portended the unknown and threatened the confidence of working people.

Perhaps for this reason, the election to succeed President de la Madrid in 1988 looked to be more contested than most. A powerful alternate candidate had sprung up to rival PRI. He was Cuauhtémoc Cardenas, who attacked the

PRI's economic policies from the left. His name said it all. He was the son of the legendary President Lazaro Cardenas; his first name was that of an Aztec emperor. A gifted orator, toured the country as the candidate of the Party of the Democratic Revolution (PRD), lambasting corruption and raising hopes that there was an alternative. It was up to de la Madrid to designate the PRI candidate. Silva Herzog was the leading contender, but de la Madrid instead picked Salinas. This seemed an unlikely choice: Salinas was young and unpopular with the public, seen as technocratic and close to foreigners. When the results of the July 1988 election were announced after a week of suspicious silence, Salinas had 50.4 percent of the votes—winning by the lowest margin in Mexico's modern history, so low as to lead to charges that Cardenas had been robbed of victory.

Whatever the merits of his election, Salinas surprised Mexicans by soon winning them over. In a lightning strike with a military squadron, he defeated the dictatorial boss of the oil workers' union, gaining respect as a tough leader, not just a technocrat. He moved privatization forward, selling off majority stakes in major industries such as telecommunications. He sold off the banks, which López Portillo had nationalized in 1982 as a parting shot. The receipts went to pay off the debt. He also balanced the budget, and in this way helped bring inflation down to wholly respectable levels, considerably increasing the real value of wages. The motor of this economic drive was his finance minister, Pedro Aspe, who led a team of experts once called "the most economically literate group that has ever governed any country anywhere." A member of the original crop of technopols, Aspe studied first at the Technical University in Mexico, a privately funded institution set up to rival the public National University. He went on to MIT, where he earned his doctorate in 1978. Returning to Mexico, he joined a *camarilla,* a group of civil servants loyal to a central figure, which was a prerequisite for advancement. Usually *camarillas* served patronage functions. The difference with Aspe's was that its central figure was Salinas and that its membership was exclusively composed of brash young economists, all of them appalled at Mexico's recent economic history. In time, Aspe would form his own group of loyalists, and once he became finance minister, he was able to disseminate them among the various ministries, greatly facilitating coordination. He also showed his political skills by designing a "social pact" on wages and prices that helped drive down inflation.

By mid-1993, the Salinas government seemed to have achieved the impossible—turned Mexico around—for good, it appeared. Public finances were fundamentally sound for the first time in decades, and a real political opening seemed to be under way, with the center-right National Action Party (PAN) in power in some states in the industrial heartland of the north. In a major achievement, Salinas negotiated the North American Free Trade Agreement with the United States. The acceptance of free trade represented a turning inside out of Mexico's once desperately inward-looking economy. It also carried profound psychological weight, setting Mexico, at least in the minds of some, on an equal footing with its northern neighbor.

Yet extraordinary events were to call the entire process into question. On New Year's Day 1994, masked rebels took over the town center of San Cristóbal de las Casas in the impoverished southern state of Chiapas, which was remote, heavily populated by Indians, and had little to show for the reform process. There they "declared war" on the Mexican state. It was a dramatic reminder of the distance to be traveled and the range of interests to be considered in reform. It was also a reversion to the debilitating peasant wars that had festered in previous decades all over Central America. Although localized, the Chiapas conflict was to flare up and down, and to be placated by uneasy compromises over land rights and improved infrastructure and services. Then, in March 1994, in Tijuana in Baja California, former budget minister Luis Donaldo Colosio, Salinas's designated successor, was assassinated as he addressed an electoral rally. It was Mexico's most shocking political murder in sixty years. Although a suspect was identified and rapidly tried, most Mexicans felt there was more, much more, to the story. In due course the investigation would become enmeshed with other inquiries in a complex weaving of political and financial scandals that appeared to involve Salinas allies and relatives and corruption and drugs. (Later, Salinas would prudently remove himself to Ireland, with which Mexico had no extradition pact.)

To replace the murdered Colosio, Salinas selected yet another unlikely dark horse, Ernesto Zedillo Ponce de León, who assumed office after an apparently clear election victory, although he became known in the process as the accidental president. He was born to a modest family in Mexico City but grew up primarily in Mexicali, on the United States border, a rough town at the crossroads of industry, immigration, and shady dealings. A gifted student, he studied economics and went on to become another of Mexico's new generation of technocrats, in the process earning the reputation of being dull and gloomy. He wrote his Ph.D. thesis at Yale in 1981, presciently arguing that Mexico's debt predicament should be blamed on the government and not on the banks that had provided the loans. That earned him a job, after the debt crisis began, at the central bank, whose head shared his views. It also set out an economic stance that he pursued unwaveringly, if quietly, in various technocratic positions under de la Madrid and Salinas.

As Mexican presidents often did, Salinas left his successor with a financial crisis on his hands. The peso had been overvalued for some time, but Salinas had refused to adjust it for reasons of politics and prestige, preferring instead to defend the currency by dipping into the country's foreign reserves. By the time Zedillo was sworn in on December 1, 1994, Mexico's economy was teetering on the verge of a default. Zedillo's government announced a devaluation. Unfortunately, it turned out that it had miscalculated the effect on the unsuspecting financial markets. Mexico's stock exchange fell dramatically, setting off the domino reaction around Latin America that was dubbed the "tequila effect." It was another unfortunate sullying of Mexico's financial reputation. It proved much less grave, however, than the debt crisis. The United States mounted a $20 billion bailout in short order, which served to stabilize confidence, helping to prevent what might otherwise have turned into a major emerging-market contagion.

But by the end of Zedillo's term six years later, Mexico was, in some fundamental ways, quite a different country. Thanks to NAFTA, the economy was booming. Dramatic changes had taken place in the political realm as well. Zedillo's determination to push forward the investigations of Colosio's death, despite the possible political entanglements, earned him respect as a champion of the norms of justice. Most strikingly, he had allowed the political arena to open up substantially, ending the PRI's effective monopoly of political power. In January 1995, amid the peso crisis, Zedillo called for all political parties to negotiate electoral reform. His efforts were rewarded in mid-1996, when new electoral legislation was signed into law. He entrusted elections to an independent commission, effectively distancing the operations from the PRI old guard. In the midterm elections of 1997, the results—remarkably—confirmed the opinion polls: PRI lost its absolute majority in the National Assembly, as well as in several states. The more market-oriented, center-right Partido Acción Nacional (PAN) emerged as a strong opponent to PRI in the 2000 presidential election. Its candidate was the governor of Guanajuanto, Vicente Fox.

"We Must Change Things"

By all measures, the 2000 presidential election was extraordinary. In voting for Fox, Mexicans brought to an end seventy-one years of PRI rule, in effect ending the tradition of a one-party state—and did so in a free and democratic election, unmarred by the instability that traditionally accompanied Mexico's transitions of power. "It really was the first time in Mexican history that power passed from one group to another through the ballot box," said Jorge Castaneda, a leftist intellectual who was drawn to Fox because of the way he incarnated the possibility of change and became foreign minister in Fox's cabinet. Adding to the extraordinary nature of the election was the president-elect himself. Standing six feet five and proudly wearing rancher's boots embossed with "Vicente Fox Quesada" and a belt decorated with a cowboy buckle, Fox projected a rough-hewn, rugged image that projected charm and charisma. His background was business, not politics, and he addressed political issues in the straightforward, down-to-earth style of someone accustomed to dealing with business problems. He was a self-made man, born and raised on a farm in a family of immigrant descent (his father was the son of an Irish-American immigrant; his mother came from the Basque country in Spain). At age twenty-two, Fox joined Coca-Cola's Mexican operation. "I started as a salesman, right from the bottom," he would recall later. "And I learned that discipline, hard work, and talent is the way to succeed." There was an additional benefit to the job: "It was a job that didn't require a suit and tie; I've always had an aversion to them."

He rose to become president of Coca-Cola Mexico but left the company soon after to help run his family's businesses—a boot-making concern and a ranch. His entry into politics was almost accidental: he joined PAN in 1987 at the suggestion of Manuel Clouthier, a businessman and PAN's candidate for president, who was looking to reinvigorate the party through attracting apolitical businessmen (and who was later killed in a mysterious and suspect highway accident). The following year, again at Clouthier's urging, Fox ran for Congress—and won. Soon thereafter he would have an opportunity to display for the first time the direct, no-nonsense approach to politics that would become his trademark—and in the process generate some publicity for himself. Following the announcement of Salinas's victory in an election that was widely perceived as rigged, Fox marched over to the podium, took a pair of voting ballots, tore holes in them, hung them over his ears, and proceeded to walk around in protest. Fox's next ten years in politics would be punctuated by similarly unusual episodes, earning him a reputation for having an "outlandish" personality. But Fox's behavior served to draw attention to his message: Mexico needed change.

In many ways, the Mexico that Fox inherited was already undergoing rapid change. Six years after its introduction, NAFTA was proving to be a bigger success than its creators had ever imagined. The export boom it generated was unprecedented, leading to the tripling of Mexico's exports between 1994 and 2000. Significantly, the share of petroleum exports, which contributed more than 60 percent of Mexico's export revenues in 1980, fell to less than 10 percent by 2000, displaced by manufacturing exports. By far the biggest effect was on Mexico's trade with the United States. Exports to the United States grew to account for 25 percent of Mexico's economy—up from 13 percent in 1993—and to make up 80 percent of Mexico's export revenues. By 2000, 70 percent of Mexico's foreign investment and 80 percent of tourism was coming from the United States *Maquiladoras* (the export-oriented assembly factories largely concentrated on the border with the United States), which contribute half of Mexico's exports and which were NAFTA's most immediate beneficiaries, were employing 1.3 million people, compared with 546,000 in 1993. The legal framework provided by NAFTA had led to a resurgence of the investment community's confidence in Mexico, bringing in billions of dollars in foreign investment. Wages had risen as well. It was a new era in Mexico—the era of expanded trade and increased participation in the global economy—and in voting for Fox, Mexicans had elected a leader for that era.

The complexity of the changes that the country is undergoing cannot be overestimated. With the first truly democratic transition of power, Mexico is learning for the first time about the complexities of running a pluralistic society, in which the government is accountable to its citizens and where each decision made by the government is subject to public scrutiny and vigorous discussion. "It's not just that you are having a rotation in power between different parties or groups," said Castaneda. "It's that it's taking place this way for the first time." Mexico's economic challenges are enormous. The NAFTA-generated growth remains unevenly spread—geographically as well as across the various sections of the population—and reduction of poverty is the central issue for the country. "Inequality is the foremost challenge that this administration has," said Castaneda. "The first thing to do is to acknowledge that this is an ancestral problem in Mexico. This is not a problem that emerged with Salinas or with NAFTA or with PRI. It's been around for centuries. This was a tremendously unequal society since the Conquest at least." Close economic cooperation with the United States also means that Mexico is extremely sensitive to the performance of the U.S. economy, as was demonstrated by the U.S. economic downturn in 2001. Border crime, illegal immigration, and drug trafficking remain contentious issues between the two countries. In what might be very surprising to the critics of NAFTA, the increase in wages and incomes means that Mexico is facing tough competition from lower-wage countries. Entrepreneurship is hampered by bureaucracy. "We have to deregulate," said Fox. "We have to end with red tape, and we have to give all the facilities and the flexibility to entrepreneurial efforts, and this is part of things that we are trying to accomplish."

Today's Mexico is a much more outward-looking country, poised to become a full-fledged participant in globalization. One afternoon, Fox sat down in a small room in Los Pinos, the presidential palace in Mexico City, to talk about how his thinking had evolved. He was wearing his signature cowboy boots and no jacket, and the long sleeves of his shirt were rolled back up almost to his elbows. "I have always seen globalization as an opportunity," he said. "Mexico is the only country in the world that has a trade agreement with United States and Canada and at the same time has one with Europe. These are the two largest markets in the world." He continued after a pause: "Mexico has been one of the losers of the twentieth century. We tried many different alternatives, and unfortunately we have forty percent of the population poor, we have a per capita income that is extremely low. So we must change things."

"Now we want to go further," he said, commenting on the extraordinary effects of the increased trade between Mexico and the United States. "I'm talking about a NAFTA plus. A NAFTA that takes us to a further integration. In the long term, what we are looking for is convergence of our two economies. Convergence on the basic fundamental variables of the economy. Convergence on the income of people. Convergence on salaries. Of course this is a ten-, twenty-year program. But when we reach that level, then we can just erase the border, open up that border for free flow of products, merchandise, capital, as well as people."

Mexico has learned from its own experience that economic reform can truly flower only in a democratic environment. "If you don't have political stability and you don't have democracy," said Fox, "it's very difficult to develop economically or push human development. Today we have democracies in Latin America, we have new leaderships. I dream of putting together these four machines of Chile, Argentina, Brazil, and Mexico, working for a purpose of growth in Latin America. Those four machines will move the rest of Latin America."[15]

Rediscovering the State

The character and responsibilities of the state are at the top of the agenda in Latin America. With the economic rules converging across the continent and the ghosts of *dependencia,* import substitution, and military dictatorship laid to rest, policy makers are starting to consider the challenges ahead. Their countries remain plagued by deficiencies in infrastructure, human welfare, and the standard of education. In all of these areas they fare far worse than do the Asian tigers. In Latin America, the rates of economic inequality, the gap between rich and poor, are among the world's highest—and have been, by some measures, for centuries.

After decades of state ownership of the core industrial sectors that for so long made up the commanding heights, the change has been great but incomplete. By privatizing airlines, telephone systems, and electric utilities, governments have stopped the financial hemorrhage and relieved the state of a considerable burden that carried high political stakes. The subsequent record of these privatized companies has, however, been uneven, and in some countries it is quite mixed. As privatization spreads across the continent, it also takes on different forms. In all of this, governments face a new challenge: regulating the new private firms that provide politically sensitive services, in some cases on a monopoly basis. Having repudiated the old state-owned firms, governments now sometimes lack the skills, the staff, the information, and the experience to ensure that private owners and contractors maintain high standards of service and are not allowed to collude to keep prices high or service inadequate.

The "technicity" of the technopols—a blend of education and credentials, professionalism and motivation, and a measure of luck and opportunity—does not spread deep in bureaucracies. These have been stripped of much of their means, and civil servants are underpaid and often demoralized. Provincial administrations and the agencies responsible for decentralized services such as primary health care and education do not enjoy the clout and efficiency of the central Finance Ministry. Tax collection is anemic. Local authorities are subject to corruption and cooption.

"The discovery of the market," said Moisés Naim, a Venezuelan economist and trade minister, "will soon force Latin American countries to rediscover the state," for the market cannot work with a malfunctioning state. In many ways, this rediscovery has already started. The new generation of leaders coming into power in Latin America is bringing in a new vision of their role. They view their central task as that of ensuring market reform and providing the right framework and the right institutions for the markets to function properly—but also of alleviating poverty and making their societies more equitable. This includes ensuring more equitable access to the health and education infrastructure.

"We have made a terrible mistake in not investing in human capital," said Vicente Fox. "The education levels of Latin America are extremely poor. We're ranging on the levels of seven years' average of education, when Asia moved up to twelve, thirteen, and even fourteen years' average of education—same as Europe or the United States. We cannot compete, we cannot win in globalization if we don't move fast on education. We are learning from our mistakes, and now we are moving education in Latin America." There is a growing realization among Latin America's leaders that without correcting the vast divergences in income and opportunity that plague their societies, economic reforms will not hold. This new generation of leaders is increasingly converging toward what they frequently refer to as the "third way"—a model that is closer in spirit to the European form of social and economic organization, combining social-democratic aspirations with market economy.[16]

The political environment facing Latin American leaders today is vastly different from the one encountered by their predecessors. Most Latin American societies are democracies, and it is a testimony to the achievements of the last two decades that these democratic political systems are very nearly taken as a given by their citizens. With some exceptions, peaceful, democratic transitions of power are increasingly regarded as a norm throughout the continent that for decades lived with military coups, rigged elections, and dictatorships.

Democracy brings its own challenges. Building consensus for reform in a democratic society is far more difficult than in an authoritarian state, particularly as countries begin to tackle the more controversial aspects of reform. Yet what is striking, given the tremendous disruptions that many of them suffered along the road of reform, is what Moisés Naim calls these countries' "reform resilience": "There has been no wholesale backlash in fiscal and monetary discipline, no renationalizations of privatized companies, no resurgence of trade protectionism, and no introduction of capital controls. Such reform permanence is particularly remarkable in light of the consolidation of democratic governments in most of the region. Under freer political regimes, citizens have more room to protest poor economic conditions, and opposition leaders face few inhibitions against denouncing government policies that fail to deliver positive economic results quickly. Even in this less patient setting, the reforms have endured."

It does not mean that the process is irreversible. For reform to continue and democracy to endure, the ideas of inclusiveness and fairness have to become a permanent feature of the discourse. These ideas must be "incorporated into the capitalist or free-market argumentation," said Hernando de Soto, a Peruvian economist best known for his book *The Mystery of Capital.* "Because if we don't bring them in, the traditional leftists will come back. I'm thinking about Latin American leftists who have no problem of carrying out reforms with no democracy whatsoever. If we don't incorporate all of these humanitarian values, all these humanistic values, all of these democratic principles within the capitalist agenda, it'll be born again in some other form that may not be the traditional Communist one but will bring with it the same and many other dangers."

Perhaps the most important achievement of the last decade has been the fact that reforms, in the words of de Soto, have allowed Latin America "to change the subject": "Hyperinflation and inflation are no longer the main challenge in Latin America. The main challenge in Latin America now is fighting inequality and poverty. Now Latin America is more capable of at least looking at policies and institutions to deal with the horrible poverty and the very, very damaging inequality it has. At least it has a fighting chance to deal with it. With hyperinflation and the debt crisis and the other things that were crippling Latin America, there was no hope of even making a dent on this."

De Soto himself has moved beyond the traditional left-right dichotomies by focusing on the institutional constraints that keep people poor—that prevent them from capitalizing on what they own. For the poor, as de Soto discovered in his research, in fact, own a tremendous amount: "Even in the poorest countries, the poor save," he wrote. "The value of savings among the poor is, in fact, immense—forty times all the foreign aid received throughout the world since 1945." They own homes and plots of land on which these stand; they make clothes and grow produce. "The inhabitants of these countries possess talent, enthusiasm, and an astonishing ability to wring a profit out of practically nothing." But bureaucratic legal systems and convoluted institutional frameworks prevent them from documenting the rights to their possessions and thus turning these assets into capital that would allow them to gain full economic benefit of ownership. "Markets and capitalism is about property rights," said de Soto. "It's about building capital and loans on property rights. And what we've forgotten, because we've never examined the poor—we've sort of thought that the poor were a cultural problem—is that the poor don't have property rights. And when you don't have the rights, you don't have a piece of paper with which to go to market." Reviewing the existing rules of the game within their societies and creating institutional foundations for the new rules are challenge and opportunity for the Latin American governments as they search for new ways to take their societies to a higher level of development.

The current Latin American experience demonstrates that implementation of the new rules of the game is the beginning, not the end. The exchange between the hardship of reform and the promised rewards of an open and efficient market will continue to be tested by every economic downturn and every election. The state that Latin America is rediscovering in the process is no longer the controlling, suffocating state of the previous decades, nor the state as business manager. It is the competent state that can play an appropriate role of fair regulator—and address the heavy legacy of human needs. That script is still being written.[17]