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A Market Driven Critique on the Role of the International Financial Institutions in the Development Process in Latin America

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A Market Driven Critique on the Role of the International Financial Institutions in the Development Process in Latin America

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Background

The International Financial Institutions (IFI) – the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) – were founded in 1944 as the ruling entities of the Bretton Woods System, which replaced the gold standard as a reference for exchange rates. The IMF would be in charge of prevention and mitigation of the imbalances created by the pegged exchange rate that means it would provide resources to finance balance of payment deficits. The World Bank was created to provide an adequate supply of capital to developing countries, in presumption that the private capital would not be interested in furnishing these necessities.

The original tasks of the IFI had been functioning for a short period of time, from the end of the Second World War until 1971[1], when the American Government stopped providing a formal support for the convertibility of dollars into gold and other currencies.

However, during the first 30 years the role of the IFI was questioned due to a series of failures, shortage of resources and the creation of new institutions to accomplish the same objectives, like the Regional Development Banks or the European Monetary System. Of particular importance was the Marshall Plan which provided the development aid to Europe for the reconstruction after the war. By the 1980's the role of IFI institutions had changed, providing several new goals to the founding members and recipient countries, like management of financial crisis in emerging markets, long term loans to developing countries and transition economies after the fall of the communist system, advise and counsel to many nations and collection of public economic and social indicators data.

Their role has ever been controversial particularly during the recurrent crisis in Latin America, the long term loans to Russia and their failures in the Asian countries crisis in the 1990's. After all, their role is now disputed because the importance of the private capital flows and the birth of a new range of private and national development agencies. This means that their budget is neither large enough to compete with the new agencies nor can it provide an adequate support in the case of an exchange rate crisis, due to the vast development of the international capital markets. The IFI institutions are today in the struggle to survive or compete in the global world they help to create.

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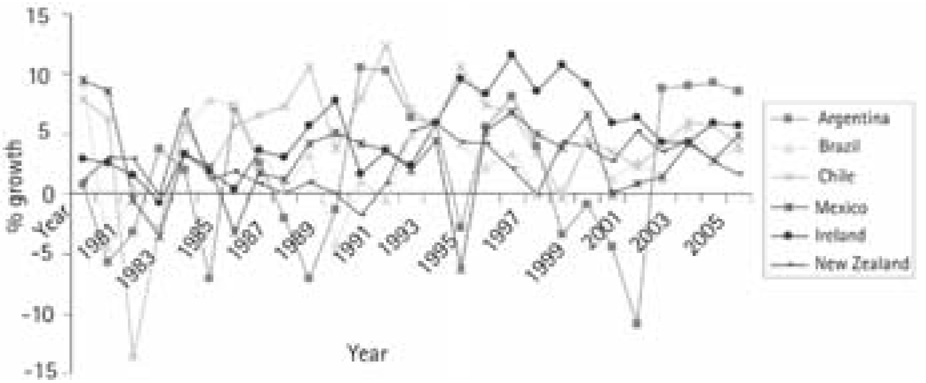
1 The formal termination of the convertibility was set on 1973, but it was clear that the convertibility of the dollar had been compromised in the international market since 1971. See Eichengreen, Barry. Globalizing Capital: a history of international monetary system. Princeton University Press. 1996.

The Latin American Recurrent Exchange Rate Crisis

During the 1950´s and 1960´s the Latin American countries achieved a tremendous success in economic growth due to macroeconomic pragmatism which was the practice in those days. Fiscal and monetary stability was preserved. However, a crisis broke out due to the adoption of the Import Substitution Initiative (ISI), which proposed the use of closed markets to develop internal markets. So one could be an exporter but not an importer; everything had to be produced internally, like an autarkic state. By 1972 there were signs of mayor imbalances in Mexico, Argentina, Brazil and other countries that had been practicing the ISI, and the crisis of the oil prices had led to a dead end. At that time Venezuela was the only mayor exporter of oil within the Latin American countries. The others had been net importers of oil. However in the late 1970´s Mexico discovered oil reserves, while Argentina, Chile and Brazil were in the position of being commodities exporters during a period of high prices. That situation drove to the loss of macroeconomic stability in the context of the new exchange rates regime, signalling a series of failures in the economic policies like expansionary fiscal and monetary instruments, the expansion of external accounts deficits, price controls, public monopolies and rigidities in the labor market. All of this misguided panorama drove the Latin American countries to the acquisition of massive external debts to solve their internal imbalances at a nominal low interest rate. This set up a kind of myopic behavior policy, better known as Macroeconomic Populism, driven by political thesis like the dependency theory, the ISI, the absurd idea of sharing the future wealth or the "abundance administration". No wonder why we call the 1980´s the "lost decade".

By 1981 the world was in a recession originating from the expansion monetary policy in the United States, high commodities prices, and the expansion of international capital movements, in the form of foreign direct investments or bank loans. The Latin American countries were affected by high interest rates and low commodities prices. The crisis started as an insolvency problem but was complicated by the medicine that the government administered in an attempt to resolve the problem of current account deficits: competitive devaluation, expropriation of complete industries (including banks), more expansionary monetary policies, more barriers to imports, and more external debt. The situation was turned into a mayor economic crisis with hyper inflation, bankruptcies, banking crisis, unemployment, political instability, and so on. As a result Latin American countries were in default, and they needed the help of the IMF to set the guaranties to initiate a process of external debt renegotiation. (See graph Latin America GDP Evolution Crisis to gain a picture of the economic instability of the region).

Latin America GDP Evolution



The first aid packages were set with severe conditionality, in two dimensions: first, a set of policies to mitigate the effects of the crisis, and second and ironically, another set of policies to guarantee the payments of the loans. That meant severe monetary policy to reduce inflation and extreme fiscal policy to ensure sufficient resources to serve the interest payments. But of course, the IMF then granted loans at a preference rate, the beginnings of the moral hazard practices. If the government did not complain about the conditions of the credit, new loans were granted to repay the first credit, signalling an end to the enforcement of conditionality. The IMF would never accept responsibility for the failure.

At that time there were other debt crises as well. Ireland and New Zealand had the same problem, but the IFI did not have money to lend to everyone, so they decided to leave those countries by themselves. And the solutions those countries took were different: they just opened their economies, took control of the deficits and imbalances, reduced the inflation, renegotiated their debts privately and took the way to a comprehensive institutional reform. As a result, today they are leaders in competitiveness, are some of the riches countries and have more stable democratic regimes than those countries that took the IMF medicine.

The course of the Washington Consensus

In 1994 a group of economists attended a seminar on the Latin American Crisis in Washington. One of them was tasked with categorizing the most common wisdom policies that IFI employees think were right to change the crisis scenario. These measures became established as the idea of the Washington Consensus, compiled by John Williamson. The consensus includes ten broad sets of recommendations:

- Fiscal policy discipline;
- Redirection of public spending from indiscriminate (and often regressive) subsidies towards broad-based provision of key pro-growth, pro-poor services like primary education, primary health care and infrastructure investment;
- Tax reform – broadening the tax base and adopting moderate marginal tax rates;
- Interest rates that are market determined and positive (but moderate) in real terms;
- Competitive exchange rates;
- Trade liberalization – liberalization of imports, with particular emphasis on elimination of quantitative restrictions (licensing, etc.); any trade protection to be provided by low and relatively uniform tariffs;
- Liberalization of inward foreign direct investment;
- Privatization of state enterprises;
- Deregulation – abolition of regulations that impede market entry or restrict competition, except for those justified on safety, environmental and consumer protection grounds, and prudent oversight of financial institutions; and,
- Legal security for property rights.

The "Consensus" wasn't official, but merely the result of an informal survey. However it was transformed into a kind of Rosetta Stone for those who are against free markets and for those who are in favor. Everybody has criticized these ideas, as recipes from the IFI, as the ultimate descriptions of "neo liberalism" or a set of policies not to take into account in running an economy, but these policies are anything but market driven propositions. Some, but not all, of them are part of the prerequisites for a free market economy, but they are not sufficient. A free market economy requires elements of institutional reforms that are not present within the policies included in the Washington Consensus.

A free market economy requires the creation of incentives for decision makers to allocate resources efficiently. This means that, in addition to some of the Washington Consensus reforms, developing countries need further reforms to enable the enforcement of contracts, to increase transparency, and to guarantee property rights, a commercial code, accounting standards and the rule of Law. All this is needed to achieve the conditions of the Hayekian framework[2].

Some countries, such as Mexico or Brazil, were committed to the reforms in the late 1980´s and early 1990´s. Yet despite having achieved some of the propositions of the Washington Consensus they were not isolated from crisis, rather they were stuck in negative cycles of growth and crisis. In the case of Mexico the crisis took place every electoral year that means that the fiscal discipline was dismal or broken those years. Others, like Argentina or Ecuador failed in their commitments and had recurrent crisis. The same could be the case in Thailand and Indonesia in the 1997 Asian Crisis.

The Tequila Crisis

1994 was a special year in Mexico: the North American Free Trade Agreement (NAFTA) was founded, elections took place and the Mexican guerrilla, the Zapatista's Army was born. However, the main problem was a combination of fiscal imbalances with a pegged exchange rate, which was actually a serpent model of preannounced correction of exchange rates. The Mexican government issued private debt bonds denominated in pesos, with a guarantee in dollar, the "Tesobonos". This system required confidence from the holders in order to function; and the Mexican government lost confidence due to the political problems of the electoral year. Further more the Central Bank had lost all international reserves, so there was no money to pay the Tesobonos. The liquidity shortage at the beginning of the Zedillo´s administration precipitated a default of the Tesobonos, a relaps in inflation and a devaluation process from which the country had been suffering in 1976, 1982 and 1988.

The IMF stepped into its role as lender of last resort and an agreement was set up for 17.8 billion dollars. This included certain innovations, such as the collateral on PEMEX future oil income notes, and the establishment of a schedule of reforms measures which had to be put into place in less than a year, for example raising consumer tax or reforming the Mexican government financial accounts.

2 Different authors have different concepts of this "Hayekian framework" but in general terms we can use this idea as institutional reforms enabling the economic agent to make rational and economic decisions.

However, the impact of the agreement on the Tesobonos tenders was not favorable. Interventions from the Federal Treasury of the United States were needed in order to secure a 20 billion dollar loan to Mexico as well as an agreement with a group of private banks for other 11 billion to regain confidence in the intentions of the Mexican government. Altogether 50 billion dollars were needed to renegotiate a debt of 28 billion dollars.

Mayor devaluation took place and the inflation process started; the internal interest rates skyrocketed, from 12 % a year in mortgages to 120 percent within one month. Many Mexicans failed to pay their dues and a process of rescuing the banks from defaulting was initiated. Some banks lost their property or money, some did not; but not one of the international investors lost money during the Mexican crisis. Remarkably, the Mexicans will be paying a bailout of 180 billion dollars due to the banking crisis during the next two generations, and this figure is still rising. The Mexicans were facing unemployment, inflation, high taxes and poor growth; the benefits are not clear for everyone, only the costs are visible. That's the course of the Washington Consensus: they loose credibility on the policies, whether they were correct or not, because those policies were not enough to protect the country from the crisis.

Taxonomy of populism

So far we have seen that there have been several types of populism and bad economic policies in Latin America since the 1960´s. However, we can categorize these policies in three different types: the classical, the micro and the populism of inaction.

The classical Latino populism from the 1960 ´s, 1970´s and 1980´s, was characterized by a closed economy to the world, an expansionist monetary policy, high public expenditure, low fiscal revenue, high taxes and a dominate role of the government in the economy, visible by state owned enterprises and public monopolies. Some of these ideas come from the Economic Commission for Latin America (ECLAD) as recommendations for the Import Substitution Strategy, once the golden rule of development in the region. However after all the stories and poor results of these strategies, only the governments of Venezuela, Argentina, Ecuador and Bolivia are pursuing these ideas in the world today.

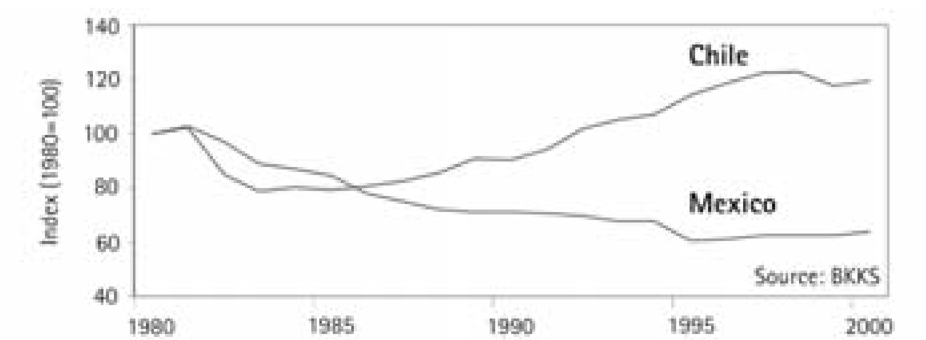
The Micro populism has been running for the last ten years as an unintended policy, and is still present in some countries that have benefited from the high price of commodities. It consists of short term policies to pursue long term economic objectives, like the artificially activated exports by the use of different exchange rates for various imports.

The third type of populism is the populism of inaction that has been operating across Latin America for a long time now and is characterized by a poor performance on the political sector to drive the governments to sustain the status quo. Thus, there are no changes and no crisis but also no growth.

Lessons from the crisis

However, some lessons have been learned from the past crisis: the Mexican government was forced to change the exchange rate regime from pegged to free floating, they were forced to maintain fiscal responsibility since the crisis, the international reserves have risen to 10 % of the GDP, inflation targeting is the new rule at the central bank, a limit has been introduced on savings deposits insurance, and further good policies. However, the reforms have stagnated; certain crucial institutional reforms must be passed in Congress but for multiple reasons this is not taking place. The fact is that Chile or China, Ireland, India and others are changing more rapidly than Mexico and that they are now more competitive. We are loosing the sense of urgency in the reform process, and we are leaving our labor productivity aside. (See graph on GDP growth Chile vs. Mexico)

Detrended GDP per working age population (2 % annual growth rate)



After the crisis the Mexican economy recovered quickly due to the growth of exports to the United States initiated by the NAFTA. Mexico regained access to international capital flows, once again became a destination for Foreign Direct Investment and it faced the challenge to macroeconomic stability. Some results were remarkable; for example, at one stage the inflation in Mexico was lower than in the U.S. for the first time in 50 years, the premium rate on Mexican bonds was less than 100 points and the current account has been under control. However, the economic growth is extremely low, and the conditions on income and poverty are changing slowly. These aspects brought a new political left to power in countries like Venezuela, Argentina, Bolivia and Ecuador.

The case of Chile is remarkable because it managed to instigate the proper "dynamics" of growth reforms which stimulated productivity growth. This resulted in an increase in "profitability", an increase in FDI, sustained economic growth, an increase in savings and higher capital accumulation. Thus, no other country in Latin America to date has achieved this virtuous cycle. Mexico, Peru and Costa Rica might get there in the future; however more structural and institutional reforms are needed to achieve the Chilean model.

Does Aid Help Poor Countries?

Some studies suggest that there is a shortage of capital and money to help the poorest countries exiting the poverty tramp. Some others find that the aid and development programs have a negative impact on the growth dynamics.

I will examin the evidence compiled by Djankov, Montalvo and Reynal-Querol[3], which shows how aid and development programs have a negative influence on the poorest countries:

- There's a negative influence on growth, because the aid loans may have the effect of delaying the reforms or throwing out the foreign direct investment.
- Negative effect on democracy, because the grant or loan could preserve the current governments in power or delaying the reforms.
- Grants promote government consumption not investment because they do not need to be repaid; there are no incentives to manage viable or productive projects.
- Conditionality does not work because the punishment (enforcement) lacks credibility, since the IFI cannot take responsibility for the failure; they manage the setting up of a new agreement and a new loan to pay default, and the country could be in a permanent conditionality or being dependant on the foreign aid.

3 Djankov, Simeon, Montalvo, Jose and Reynal – Querol, Marta. Does Foreign aid Help? Cato Journal Vol. 26 No. 1. Washington, D. C. 2006.

- Loans work better than grants because they have to be returned; giving charity could be prejudicial to the poor countries. The need to repay the loans is a constraint and a responsibility.
- Remittances and charity are mayor promoters of growth; in today's world, helping poor countries to develop has become a private business. Due to the shrinking size of capital resources the IFI has become irrelevant.

However, not all is wrong with aid and development programs; there are some cases of success. The IFI institutions need to focus on those cases and try to make it broader in the poor world, like the Mexican program of conditional demand side subsidies for schooling, called "Oportunidades"[4]. The program consists of a bi-monthly pay check for the mothers who send their children to schools, and there are some conditionalities like the obligation of the parents to bring their children to medical check-ups every two months.

Evaluating the role of the IFI in Latin America

The interventions of the IFI in Latin America were vast and sometimes unnecessary. They almost impeded the rescue, bailout or structural change programs they set up in the region. Yet at least they had some success as part of the programs that made the difference in Chile, México or Peru. We can characterize the common features of their actions:

- Multilateral public institutions loans to governments that displace private capital flows and make the credit vulnerable to political use.
- Moral hazard, when there's a crisis coming and the IFI just doesn't recognize that they are a part of the problem. Instead they give the countries that fail even more money and new programs.
- Discouragement of the use of private credit, by giving the government loans at a preference interest rates, with less commitments to discipline.
- Corruption is a well known problem. Some governments just use the IFI money to make themselves richer individuals, while the aid has never been available for the poor people.
- Conditionality: sometimes the IFI tries to impose a vision of the economy and the world, a particular set of policies, and more often the timing of the reform. The results of these conditions are well documented in the previous paragraph.

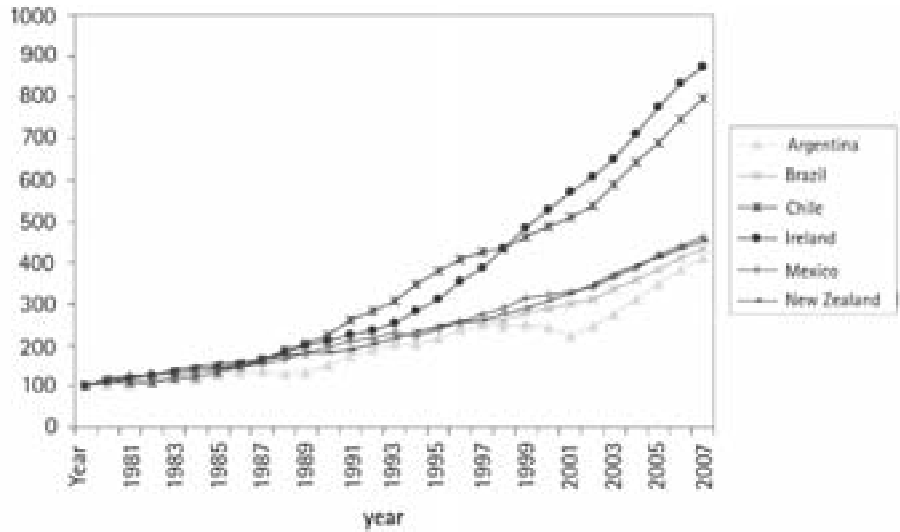
4 For more information: http://www.sedesol.gob.mx

- Poor growth record: all that money they invested, the conditions they set up and the policies they imposed have resulted in a poor growth record (see graph on the Evolution of GDP selected countries (1980 =100)).
- Overlapping policies: the World Bank, the IMF and the Inter American Development Bank have been engaged in the same policies with the same governments and financing the same type of programs for a long time.
- Delays on the reform: some studies documented a relation between the IFI programs and how they sustain governments in power, thus delaying political change and therefore the economic or institutional reforms.

Another common feature of the IFI interventions in Latin America is the opacity of the donor country's intentions and how they can manipulate the policies of the IFI in order to secure specific results. This is a recent finding so the documentation is limited, but I will try to categorize these opaque intentions:

1. Modifying policies in favor of the donor country's own interests,
2. Establishing contracts in favor of donors country's companies,
3. Preventing losses on the donors country's financial institutions,
4. Usage of the resources of IFI as illegal forms to obtain funds from the tax payers that will not be qualified by parliament and cannot be due to internal political reasons.

Evolution of GDP Selected Countries (1980 = 100)



Future of the IFI

The world today is totally different from the world in which the IFI institutions were founded. For instance the private capital flows are far more important today, making the resources of the IFI almost irrelevant in a private dominated world. The boom of both private and public multiple aid and development agencies generate more competition which again means that the resources and certain functions of the IFI become irrelevant. Therefore, today the private sector dominates the aid and development in terms of resources, programs and presence. However, the IFI is still dominant in terms on political power, media coverage and technical capacity.

Yet this competition makes the work of IFI institutions more complicated by forcing them to have high operational costs, which means less money for programs and loans. As they do not have clear mandates they are experimenting with the overlapping of functions, thus initiating another problem. Today they are less accountable because it is not clear how many of them are pursuing the same objectives and how many are investing in the pursuit of the same goals. The result is a waste of resources in bureaucracy, almost 27,000 well trained, well paid people in the IFI alone.

The future of the IFI institutions is threatened. They have to change and adapt themselves to the current conditions. However, we known that the change of political institutions is a long term objective and a complicated process.

The conclusions of the Meltzer Commission

In 1999 the United States Congress formed a special commission to evaluate the role of the IFI. The Clinton administration requested raising the resources for them due to the Asian and Russian Crisis. The commission was led by Allan H. Meltzer, one of the most important monetary authorities in the world of economic science. The proposals formulated in the commission are known as the Meltzer Report, which I would like to summarize here. The intention of the presented results is not to propose a reform of the IFI institutions, but to have a dialog on that matter.

Reform of the IMF

- The IMF should serve as quasi lender of last resort to emerging economies.
- The Commission recommends that countries avoid pegged or adjustable rate systems.
- The IMF should cease lending to countries for long-term development assistance

(as in sub-Saharan Africa) and for long-term structural transformation (as in the post Communist transition economies).

- The IMF should write-off in entirety its claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy in conjunction with the World Bank and the regional development institutions.

Reform of the Development Banks

- In poor countries without capital market access, poverty alleviation grants to subsidize the user. Fees should be paid directly to the supplier upon independently verified delivery of service. Grants should replace the traditional Bank tools of loans and guarantee for physical infrastructure and social service projects. Grant funding should be increased if grants are used effectively.
- All resource transfers to countries that enjoy capital market access (as denoted by an investment grade international bond rating) or with a per capita income in excess of $ 4000, would be phased out over the next 5 years. Starting at $ 2500 (per capita income), official assistance would be limited. (Dollar values should be indexed.) Emergency lending would be the responsibility of the IMF in its capacity as quasi lender of last resort.
- This recommendation assures that development aid adds to available resources (additionally).
- Lending for institutional reform in poor countries without capital market access should be conditional upon implementation of specific institutional and policy changes and supported by financial incentives to promote continuing implementation.
- To underscore the shift in emphasis from lending to development, the name of the World Bank would be changed to World Development Agency. Similar changes should be made at the regional development banks.
- Development Agencies should be precluded from financial crisis lending.
- All country and regional programs in Latin America and Asia should be the primary responsibility of the area's regional bank.
- The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World Bank would also be the development agency responsible for the few remaining poor countries in the Middle East.
- Regional solutions that recognize the mutual concerns of interdependent nations should be emphasized.

- The World Development Agency should concentrate on the production of global public goods and serve as a center for technical assistance to the regional development agencies. Global public goods include treatment of tropical diseases and AIDS, rational protection of environmental resources, tropical climate agricultural programs, development of management and regulatory practices, and inter-country infrastructure.
- The World Bank and the regional development banks should write off in entirety their claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy under the Banks' combined supervision.

In my point of view it is advisable that the world economy needs some international financial structure. Therefore institutions that are in charge of the rules, enforcement, assistance and resources are needed. However, the past experiences in Mexico and the Latin America region support the idea of a comprehensive reform of the IFI. Some of the Meltzer commission proposals would be useful; some of the conclusions that have been drawn from the recent data analysis will be useful too. Unless credibility in the reform processes within the IFI is restored and unless substantial changes in terms of the leadership of the institutions responsible for the success of the development process are made, little will work.

Lessons for the future

During the last decade the Latin American countries had to learn to achieve economic stability, growth and development the hard way. The privatization process is still suffering from a lack of credibility, accountability and transparency. Some countries were successful, some were not, but at least the telecommunication and banking experiences were a mayor hit for the consumers. We achieved macroeconomic stability, but at a high cost - real interest rates within the national markets and low growth rates. In this context of high social and economic cost and a relatively low growth it is no surprise that many Latinos and the Latino politicians are disappointed with the economic reform process and the International Financial Institutions that have been the promoters, at least in some fields, of the reforms.

In general terms the Latin American countries have to face a list of problems that need mayor comprehensive reforms, not the return to the old ideas that have been probed in the past. We can categorize the actual problems as low productivity growth, dismal educational system, lack of efficiency in the financial sector, dependency on the commodities prices, the prevalence of a non competition environment in some sectors and the idea of a managed external trade (mostly free but with certain strategic sector highly regulated). In order to move from this situation to a new virtuous cycle of growth and development, the governments of Latin America will have to manage the so-called structural reforms differently. The first generation of reforms was hard to introduce and the results were not spectacular in some cases, but there were conditions to return to the stability. The second generation of reforms is even harder to manage since it involves comprehensive and transversal reforms requiring both the efforts of the politicians to pass laws and bills to modify or establish new conditions for the economic sector, and also for the efforts of the private, social and political sectors to change the cultural conditions and conducts. We mentioned before the idea of a Hayekian framework that entails the Latin American countries facing reforms of the complete judicial branch, the property rights system, bankruptcy law as well as a complete reform of the fiscal systems, both income and expenditures. That's not an easy job and of course it is more comprehensive than the former conditions established by the IMF or the complete Washington Consensus[5].

The future of Latin America

We know that the development process comes from good economic policies, the integration of those economic areas that are growing and the prevalence of the rule of law. After all of these years of economic instability and poor growth the obvious question is why we do not change?

The answer to this question could be difficult or simple. It is obvious for the countries that have achieved economic development in the recent years to take the proven ideas and make a comprehensive economic reform; however in the actual context of Latin America that it not possible. Carlos Alberto Montaner says that we have to reproduce the reforms that Chile established during the 80´s, but to do that we have to arrive to the age of political and economic sense, and today not all the Latino countries have arrived at that age. We have a special case today: since we have high commodity prices, there is no necessity to change the conditions; since we have no crisis we don't need to reform; since we have no consensus on good economic policies we cannot improve. It is worth noting that the politicians are in a kind of comfort zone, they don't have to deal with unpopular reforms, and they are sharing the income from oil or copper with the poor

5 Moises Naim mentions not a series of reforms but conditions that could make the difference and he calls that: Second Wave of Reforms in the famous article: *Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?*

by expanding the government expenditures – a complete case of myopic behavior. The crisis is not here but by doing nothing to prevent it we risk having one in the future, but the politicians are comfortable with this current situation.

However each country in the region has its own particular scenario. Chile is doing well, Peru is on verge of the age of reason after almost 10 years of growth, Brazil and Mexico are divided geographically, socially and economically. In these countries the reforms are going to take more time. Venezuela, Argentina and Bolivia are on the opposite side completely: the governments there are using the commodities income to grow the state and establish the old forms of populism in their countries.

In this context the idea of a more integrated region in America is almost dead. Mexico, Chile, Canada and United States favor free trade for the Americas, but Argentina and Brazil favor a more integrated South America via Mercosur. Venezuela and Bolivia want the integration in the political arena, not the economic. For this reason they formulated the proposal of the Banco del Sur, an international financial institution that is against the ideas of the IMF, World Bank, Inter American Development Bank, and any other development agency. Actually we don't have a clear idea of what the obligations and objectives of this bank would be. One thing, however, is clear. The integration of the region is not easy and is not feasible in the coming years.

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