Off the Mark

The Misguided Policies of Washington Economists

BY LUIZ CARLOS BRESSER PEREIRA

Luiz Carlos Bresser Pereira is a former Minister of Finance of Brazil.

THE FUNDAMENTAL PROBLEM with recent adjustment programs of the International Monetary Fund (IMF) and the structural reforms of the World Bank stems from their design. While they are intended to deal with normal situations, most developing countries, particularly those in Latin America and Eastern Europe, face abnormal conditions.

The standard critique of IMF stabilization programs has been that they give insufficient consideration to the unique circumstances of developing countries. Washington economists assumed that there was one universal economic theory, applicable everywhere, from which they could derive standard policy recommendations. This critique, although still valid, has been rendered somewhat less credible by the successful economic development that has taken place throughout the world during the last fifty years. Economies into which capitalism was introduced just a half century ago are well-established industrial capitalist societies today.

A second critique of adjustment programs targets the tendency of the IMF, and more recently the World Bank, to use inadequate economic theory and to derive improper economic policies from it. Economic theory—neoclassical microeconomics, monetarist macroeconomics—is inadequate not only because it is based on false assumptions about the behavior and efficiency of markets, but also because it often reflects neo-liberal ideologies about the minimal state which everyday practice refutes.

The third critique of adjustment programs has to do with imperialism or, more broadly and mildly, with conflicting interests. The IMF and other aid institutions in the First World were viewed as representing the interests and ideologies of the developed nations, often in conflict with the national interests of developing countries. This fact may still be valid in some circumstances, as evidenced by the debt crisis, but it is false to assume that the national interests of developed countries and their institutions are essentially in conflict with the interests of developing ones. Interests coincide more frequently than they conflict.

But Representatives of the developed world, particularly institutions such as the IMF and the World Bank, are prone to making serious mistakes in their efforts to help developing and ex-communist countries. These mistakes may originate in the assumption of a universally valid economic theory that development economics has criticized. They may derive from the ideological adoption of policies that did not prove effective even in the developed countries. They may emanate from conflicting interests between North and South. However, a fourth and more important source of mistaken policy recommendations has arisen in the last decade from the abnormal conditions that Latin America and Eastern Europe continue to experience.

Abnormal Times

The crisis that these two regions face today cannot be explained simply by the "absence of fiscal discipline" and "excess state intervention" that the Washington consensus affirms. Lack of fiscal discipline and economic populism are indeed problems, but they are accepted problems that have co-existed with growth in Latin America for many years. But in the early 1980s, a much more serious problem emerged: the fiscal crisis of the Latin American state and the collapse of the former development strategy. The state lost credit and, as a result, its ability to guarantee the national currency. The model of state intervention and the strategy of import substitution that was effective for many years in promoting industrialization and growth became a major obstacle to the efficient allocation of resources.

Undoubtedly, the state became too large in Latin America and Eastern Europe. However, the real problem today is not excess state intervention, but the inability of the state to perform its economic role. The distorted growth of the state, the emergence of a fiscal crisis and the exhaustion of the old development strategy led to a deep crisis. Suddenly the governments that managed Latin American states became paralyzed. They were victims of a political plight that originated in the economic realm or, more specifically, in the economic-institutional sphere. The state was no longer able to perform its political and economic roles adequately; it could neither back the money it created, assure the proper functioning of markets, regulate them nor compensate for their failures.

The outcome was an economic crisis, usually attributed to excess state intervention, but actually due to faltering or ineffective state action. In Latin America the country that suffered most was Peru, a paradigm case of the crisis of the state. An informal, undesirable process of privatization reduced the size of the state apparatus by more than half, and the government lost its ability to collect taxes and to manage the state-owned enterprises.

The crisis of the state in Latin America and Eastern Europe translated into economic stagnation, high inflation rates and, in a few cases, hyperinflation. The emergence of this sort of crisis indicates that the economic systems in these regions face abnormal times and extraordinarily difficult challenges: the state must be reformed, the fiscal crisis must be overcome and fiscal discipline must be restored. Structural reforms aiming to reduce the state, to privatize, to liberalize trade and to deregulate have become urgent. However, these reforms should start from the assumption that, in abnormal times, remedies used in normal times are inappropriate.

The crisis that Latin America and Eastern Europe face today cannot be explained simply by the "absence of fiscal discipline" and "excess state intervention" that the Washington consensus affirms.

The Standard Explanation

Under such exceptional circumstances, normal remedies will most likely be highly costly or ineffective. The rewards they offer, if any, are not proportional to the austerity they impose; in some cases the outcome will even be opposite to that desired. Thus, it is not surprising that such reforms often fail or are abandoned. Yet when this happens, the standard explanation offered is that fiscal adjustment and structural reforms failed for political reasons—that the economic programs themselves were sound, but were hindered by populist and nationalist politicians.

This explanation is just part of the truth. Certainly, political problems exist, but they do not represent the main obstacle. The contention that economic problems have essentially political origins has many sources, but it is necessary here to emphasize only two interrelated ones: an arrogant monopoly of rationality and naive confusion of economics with social engineering.

It is reassuring to believe that there exists a monopoly of rationality embedded in economic theory. It is rational to maintain fiscal discipline, to limit expenditures to what is produced, to save, to limit state intervention and to preserve the efficient allocation of resources by the market. Thus, when these tenets are not obeyed, it is easy to attribute the deviant behavior to wicked political interests.

Politicians must certainly share the responsibility for the crisis, but these political interests are composed of cartels of business firms, unions and middle-class interest groups. These cartels and coalitions are economic agents to be considered by economic theory and policy. Even when a government's economic policy decisions specifically convey political interests, they are not automatically unacceptable, as the monopoly-of-rationality attitude assumes. Rather, decisions that reflect electoral politics also reflect the dissatisfaction of the people with the unduly high costs involved in proposed economic reforms.

All economic problems are indeed political if economic policy may be equated with or reduced to a branch of engineering—or, more specifically, bad engineering. By reducing a social science to engineering, we can abstract people from it. By downgrading it to bad engineering, we can ignore the costs involved. Only outcomes will matter: honoring debts, achieving price and balance-of-payments stabilization and, whenever possible, resuming growth. This mindset, combined with absolute dictatorial powers, allowed Nicolai Ceaucescu to pay Romania's entire foreign debt.

When the costs involved in a given economic policy become excessive, the decision not to adopt the policy is rational rather than "political." Reforms that are inefficient—whose costs are higher than their rewards—are irrational.

Debt and Inflation

One major source of the inefficiency, if not ineffectiveness, of monitored economic reforms in Latin America and Eastern Europe has been the limited capacity of Washington economists to recognize the prevalence of abnormal times as a primary cause of this ineffectiveness. Three examples will help to make this point clear: the debt crisis, the stabilization of high inflation and the "Big Bang" approach to Eastern European economic reforms. In these three cases, the IMF, the World Bank and, more generally, orthodox economists offered only standard remedies for exceptional situations.

When the costs involved in a given economic policy become excessive, the decision not to adopt the policy is rational rather than "political." Reforms that are inefficient...are irrational.

The failure of the Washington economists to recognize the weight of the debt crisis and to offer solutions when it emerged in the early 1980s is well-known. Still, some well-respected economists continued to insist as late as 1984 that it was essentially a liquidity crisis, when it was quite obvious that it was a very serious problem in balance of payments coupled with a fiscal crisis of the state. Until 1988, the same economists in Washington advocated a fully voluntary solution designed to reduce the outstanding debt, when it was clear, as the Brady Plan partially acknowledged, that debt reduction had to be administratively negotiated. The inability of the Washington

Industry continues to develop, slowly.

economists to recognize and offer appropriate solutions to the debt crisis derived essentially from the conflicting interests of the creditor and debtor countries, but it also arose from the bureaucratic conservatism of multilateral institutions, which were unprepared to deal with exceptional situations.

The incapacity of Washington economists to confront the high inflation that arose from the fiscal crisis of the state provides another example. There are three levels of inflation: regular or small inflation, high or inertial inflation and hyperinflation. Standard economic theory, taught in First World universities and used uncritically by the multilateral institutions, provides remedies only for regular inflation—invariably a combination of fiscal and monetary policy. First World economists know about hyperinflation, but have nothing to say about it, except that the remedy is essentially the same as that recommended for regular inflation, only more intense. As for inertial inflation—inflation rates that remain chronically at five, ten or even 20 percent a month for a long period of time—the best macroeconomists of the First World only began to recognize it in the late 1980s. In contrast, inertial inflation theory had been fully developed in Latin America in the early 1980s, though it was virtually ignored by Washington and the IMF.

Hyperinflation is always connected to extreme financial crisis. The state is literally bankrupt, public debt is very high and public credit is non-existent. In these circumstances, the only option to end hyperinflation, besides adopting radical fiscal discipline, is to introduce a monetary reform that will include the cancellation and long-term consolidation of a large part of the public debt and the convertibility of new money. However, this type of shock treatment is not in the textbooks. It is not part of Washington's recommendations—especially with respect to the debt cancellation.

On the other hand, the essential characteristic of inertial inflation is that it derives exclusively from the phased character of price decisions in an economy where inflation is already high. Standard inflation theory usually relates inflation to excess demand and the increase of money supply. The neo-structuralist theory of inertial inflation attributes it to the informal indexation of the economy that economic agents tend to rationally adopt to protect themselves from ongoing inflation, affirms that it is autonomous from demand, and asserts that the money supply, in this context, is endogenous.

Consistently, the theory affirms that it is necessary to influence price decisions directly through some kind of income policy, in addition to reforming fiscal and monetary policy. When inflation is both inertial and high, a characterization of abnormal times, an unorthodox solution becomes necessary. High inertial inflation was controlled in Israel, Mexico and Argentina in this way. In the last case, since inertial inflation was combined with hyperinflation, it was necessary to include in the unorthodox shock treatment the cancellation of public debt and the freeze (legal convertibility) of the exchange rate. In Brazil, shock treatment failed essentially because it was neither accompanied by fiscal adjustment nor backed by a minimum social agreement on wages.

Nevertheless, the IMF continues to ignore these simple facts. In Brazil, where inertial inflation is particularly strong, the IMF supported informally in 1990 and formally in 1992 an orthodox stabilization plan that did not decrease the inflation rate but did cause a recession. Although a deceleration to ten percent in August and two percent in December 1992 was expected, inflation has remained stable at a 20 percent level for many months.

Afterwards, the blame for the recession was placed on the inability of the government to meet the monetary targets or to make sufficient fiscal adjustments. To be sure, fiscal adjustment could (and should) be more strict than it has been; there is much to be done in this area. But it is important to note that between March 1990 and August 1992 the Brazilian Treasury presented a cash surplus, and that the budget deficit target of the IMF was met in the first quarter of 1992. In summary, the economic stabilization program endorsed by the IMF in Brazil has been extremely inefficient; its costs were and are very high, while its results remain negligible.

"Big Bang"

The economic reforms in Eastern Europe deserve special attention. Again, the failure of reform programs proposed for the ex-communist countries is essentially a result of the inability to understand and find solutions when the economies of the targeted countries face abnormal times. In cases of foreign debt, inertial inflation and hyperinflation, the failure arises from the fear of adopting more radical measures. In Eastern Europe, the problem lies precisely in the temptation, quite understandable from an ideological standpoint, to restore capitalism with one stroke.

Eastern Europe, like Latin America, faces a debt crisis that has turned into a fiscal crisis of the state. The exhaustion of a statist strategy of industrialization afflicted Eastern Europe as well as Latin America. One might imagine that similar economic reforms will work in both regions. Theoretically, since control by the state went much further in Eastern Europe than in Latin America, liberal reforms aiming to privatize, liberalize and deregulate should be more radical, in the form of a "Big Bang."

> ***In abnormal times, both political reforms intended to institute democracy and macroeconomic reforms aimed at stabilizing prices and the balance of payments must be radical to be successful.***

This analysis makes at least two basic mistakes. First, although the crisis in both regions is essentially a crisis of the state, in Eastern Europe this crisis is more profound. It is incorrect to assume that the difference in government intervention is simply a question of degree. There is also a difference of quality. In most of Latin America, except Cuba, economic systems have always been capitalist. In Eastern Europe, the mode of production was not socialist or capitalist, but statist. The ownership of the means of production belonged collectively to the bureaucratic class that controlled the state. In contrast to Latin America, where the line between the state and civil society was always clear, no such distinctions existed in Eastern Europe. Not only production but the entire society was statist.

In abnormal times, both political reforms intended to institute democracy and macroeconomic reforms aimed at stabilizing prices and the balance of payments must be radical to be successful. However, microeconomic reforms intended to fully and change abruptly the whole economic and social system are senseless. The transition from statism to capitalism now taking place in Eastern Europe is revolutionizing the structure of economy and society. Structural reforms must be gradual to take into account the meaning and pace of this revolution.

The establishment of a capitalist system cannot be made overnight. First, it is necessary to create a distinct state and civil society by clearly separating the state from business. This may eventually be done through privatization, but at first it would be better to entrust the former state-owned enterprises to corporations controlled by autonomous institutions or foundations that would represent civil society. Second, it is necessary to increase the strength of the much smaller state that will remain after the state-owned enterprises are sold. The emerging states of Eastern Europe appear to be much weaker than their counterparts in developed countries. Thus, it will be particularly important to build the capacity of the state to develop its own inputs: the ability to tax and to maintain a small, competent bureaucracy and a representative political elite. A strong state will be essential not only to guarantee justice and order, to back the local currency, to assure balance of payments equilibrium, to supply education and health services and to promote technological progress, but also to institutionalize the markets in which business firms are supposed to operate. Since there has not been capitalism in Eastern Europe, there was no state in the capitalist sense, much less markets. The state must be reformed; the markets must be built from scratch. This is a long process that a "Big Bang" can only complicate.

Conclusion

The multilateral agencies of Washington perform a double role in developing countries and now in Eastern Europe: they finance and advise these countries on the road to stability and growth. The agencies' shortcomings in performing these roles must be publicized by developing nations. Unfortunately, the economic elites of the developing world tend to be so subordinated to the dominant ideas of the developed countries that it is difficult for them to criticize Washington's views.

In this paper I have added an additional criticism to the well-known critiques of the policy recommendations coming from Washington: that economists of developing countries have an enormous difficulty in adjusting their policies to deal with abnormal times. This critique is particularly relevant today because Latin America and Eastern Europe face a deep crisis of the state—a fiscal crisis and a crisis of state intervention strategy—that has led to high rates of inflation and economic stagnation.

In support of this theory, I have presented three examples: the attitude of multilateral agencies toward the debt crisis, toward high inflation in Latin America, and toward the transition from statism to capitalism in Eastern Europe. In Latin America, where the fiscal crisis of the state and high inflation require shock treatment, social agreement and debt cancellation or consolidation, Washington economists limit themselves to fiscal discipline and tight monetary policy. On the other hand, in Eastern Europe, where the transition from statism to capitalism implies a structural revolution, Washington tries to solve the problem with standard macroeconomics plus shock privatization and trade liberalization, ignoring first that it is necessary to define a much smaller state that is separated from the rest of the economy, and second, that the resulting state must be strengthened so that markets can eventually be created and developed. •

> ***The economic elites of the developing world tend to be so subordinated to the dominant ideas of the developed countries that it is difficult for them to criticize Washington's views.***