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Economic Reforms in Abnormal Times

In the first three parts of this book I examined the crisis Brazil and, more generally, Latin America faced in the 1980s—a crisis that has not yet been fully overcome. In this chapter I begin to examine the reforms and the attempts to reform and stabilize. Many reforms have failed or remain incomplete. I suggest a theoretical framework, deviating from conventional wisdom on the subject, to explain this fact. To back my argument I use one example from Latin America and another from Eastern Europe, whose problems may, in many instances, be paradigmatic to those in Latin America.

Price stabilization policies and balance-of-payments adjustments were initiated in Latin America immediately after the debt crisis became apparent, whereas economic reforms that acknowledged the crisis of the state were introduced only in the late 1980s. When the outcomes proved unsatisfactory, the standard explanation was a lack or insufficiency of political support for the required fiscal adjustment and reforms of the state. In Chapter 13 I will concentrate on the political obstacles. Now I propose that an additional and more meaningful explanation for the failures to stabilize and reform lies in the incompetence or inefficiency of those reforms, deriving mostly from the inability of policymakers to recognize that Latin America faced abnormal times. One basic problem involved in stabilization policies and market-oriented reforms is that they are designed to deal with normal situations, whereas in the 1980s developing countries in Latin America and Eastern Europe faced exceptional times that required exceptional remedies.

Until recently, the standard criticism of the IMF's stabilization programs and the World Bank's structural reforms was that they did not adequately consider the specificities of developing countries. Washington economists assumed there was only one type of economic theory, valid everywhere, and from it they derived standard policy recommendations. This criticism still holds water, but it is necessary to admit that the economic development the world has enjoyed during the past fifty years has reduced the weight of such criticism. Economies in which capitalism was just being introduced fifty years ago are today well-established industrial capitalist societies, even if still underdeveloped ones.

A second criticism is related to the fact that the IMF in particular and,

more recently, also the World Bank tend to use inadequate economic theories and to derive improper economic policies from those theories. Economic theories—neoclassical microeconomics and monetarist macroeconomics—are inadequate not only because they are based on false assumptions about the behavior and efficiency of markets but also because they often reflect neoliberal ideologies about the minimum state, something daily practice denies.

The third criticism has to do with imperialism or, more broadly and mildly, with conflicting interests. The IMF and other aid institutions in the First World often represented the interests and ideologies of the developed nations, which frequently conflicted with the national interests of the developing countries. This claim may still hold in some circumstances, as the debt crisis has shown, but the proposition that the national interests of the developed countries are essentially opposed to those of the developing ones is false. Mutual interests are more common than conflicting ones.

However, in an endeavor to advise the developing countries—and, lately, the formerly communist ones—the representatives of the developed world, particularly of institutions like the IMF and the World Bank, made serious mistakes. These mistakes may have originated in the "monoeconomic" assumption, which development economics strongly criticized; they may also have derived from the support for ideologically burdened policies that proved ineffective even in the developed countries; or they may have emanated from conflicting interests between the North and the South. A fourth and more important source of erroneous policy recommendations is the fact that Latin America and Eastern Europe are enduring abnormal times.

We have already seen that the crisis these two regions faced cannot be explained merely by "fiscal indiscipline" and "excessive state intervention," as the Washington consensus posited. Indeed, economic populism is a problem, but it is a normal problem that in Latin America coexisted with growth for many years. Since the early 1980s, however, a much more serious problem has emerged: the fiscal crisis of the state and the collapse of the former development strategy. In many Latin American countries the state lost credit and proved unable to guarantee the national currency. The ensuing economic crisis was related to excess state intervention, but its real cause was faltering or ineffective state action. In Latin America the country that suffered the most was Peru, which is a paradigmatic case of the crisis of the state. An informal process of privatization reduced the state apparatus to less than half its former size as the government was no longer able to collect taxes or to manage state-owned enterprises.

The crisis of the state in Latin America and Eastern Europe was translated into economic stagnation, high rates of inflation, and, in several cases, hyperinflation. In such a crisis the economic systems in these regions faced abnormal times and extraordinary, extremely difficult challenges. The state

had to be reformed. The fiscal crisis had to be overcome. Fiscal discipline had to be restored. Structural reforms aimed at reducing the state, privatizing, liberalizing trade, and deregulating became urgent. But these reforms must start from the assumption that in abnormal times remedies must be somewhat different from those suited to normal periods.

In abnormal times normal remedies will likely be inefficient—that is, highly costly or simply ineffective. The rewards they offer, if any, are not proportional to the austerity they impose. In some cases they will be perverse, producing outcomes that are the opposite of the desired ones. Thus it is not surprising that reforms will often fail or be abandoned. When this happens, a standard explanation is offered: fiscal adjustment and structural reforms failed for political reasons. The economic programs are sound, but they are hindered by populist and nationalist politicians. This is only part of the truth: the political obstacles to economic reforms are obvious, but they are not the main problem.

The contention that economic problems are essentially political in origin has several sources. I emphasize only two interrelated ones here: the arrogant monopoly of rationality; and the naive confusion of economics with social engineering.

It is self-reassuring to believe and say we have the monopoly of rationality—the rationality imbedded in economic theory. It is rational to observe fiscal discipline, to limit expenditures to what is earned, to behave parsimoniously and 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 evil political interests.

Certainly, politicians are partly to blame for the crisis. But some questions must be asked. First, what do these political interests represent? Are they not usually the representatives of cartels of large businesses, of unions, or of middle-class interest groups? And are these cartels or economic coalitions not economic agents to be considered by economic theory and policy? Second, even when government economic policy decisions specifically represent political interests, when they reflect electoral politics, does this mean they are simply wrong and unacceptable, as the arrogant monopoly of rationality assumes? Or can we say they also reflect the resistance, if not the indignation, of the Latin American people aroused by the inefficiency of these supposedly rational policies—that is, their opposition to the unduly high costs involved in proposed economic reforms?

This question leads to the social engineering assumption. All economic problems will indeed be political if economic policy can be equated with or reduced to a branch of engineering—actually, of bad engineering. By reducing social science to engineering, we are able to abstract people from it. By downgrading it to bad engineering, we are able to ignore the costs involved. What matters are the outcomes: to honor debts; to stabilize prices and

achieve balance-of-payments equilibrium; and finally, whenever possible, to resume growth. Romania's former dictator Nicolae Ceauşescu, for instance, did not doubt the engineering content of economic policy. It was this belief combined with absolute dictatorial powers that enabled him to fully pay Romania's debt before the 1989 democratic revolution in Eastern Europe.

When the costs involved in a given economic policy are too high, the decision not to adopt it is rational rather than political. Reforms that are inefficient—whose costs are higher than their rewards—are simply wrong.

Three examples will illustrate my point: first, the debt crisis; second, the stabilization of economies that have high rates of inflation; and third, the "big bang" approach to Eastern Europe. In these three cases the IMF, the World Bank, and, more generally, orthodox economists were unable to provide appropriate policies as long as they tried to offer standard solutions when confronted with exceptional situations.

Washington economists' failure to realize the severity of the debt crisis when it emerged in the early 1980s and to offer solutions to it is well known. As late as 1984 some well-respected economists continued to insist that the debt crisis was essentially a liquidity crisis when it was fairly obvious that it was a very serious balance-of-payments problem coupled with a fiscal crisis of the state. And in 1988 the same economists advocated a fully voluntary solution aimed at reducing the outstanding debt when it was clear, as the Brady Plan partially acknowledged one year later, that debt reduction had to be administratively negotiated. The inability of these economists to assess and offer appropriate solutions to the debt crisis was derived essentially from the conflicting interests of the creditor and the debtor countries, but it also stemmed from the bureaucratic conservatism of multilateral institutions ill prepared to deal with exceptional situations.

The incapacity of the Washington economists to confront the high inflation that arose from the fiscal crisis of the state is another example. If we adopt as a parameter the intensity of the inflation rate, there are three types of inflation: regular or small inflation; high, chronic, or inertial inflation; and hyperinflation. Standard economic theory, taught in First World universities and used uncritically by the multilateral institutions, only has remedies for regular inflation, which is invariably a combination of fiscal and monetary policy. Economists also know something about hyperinflation but have little to say about it except that the remedy is essentially the same as that recommended for regular inflation, with the sole difference being the intensity of treatment. As for inertial inflation—inflation rates that remain chronically at 5, 10, or even 20 percent a month for a long time—this phenomenon only began to be recognized by the best macroeconomists in the First World in the late 1980s, whereas in Latin America the theory was fully developed in the early 1980s. But Washington and particularly the IMF continue to officially ignore it.

Hyperinflation is always connected with extreme fiscal crisis. The state is literally bankrupt, public debt is very high, and public credit nonexistent. In these circumstances the only alternative to hyperinflation, besides adopting radical fiscal discipline, is to introduce monetary reform that includes the cancellation or long-term consolidation of a large part of the public debt and convertibility of the new money. Yet such shock treatment is not found in textbooks. It is not part of Washington's recommendations, particularly not the debt cancellation aspect.

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 an increase in the money supply. The neostructuralist theory of inertial inflation attributes such inflation to the informal indexation of the economy that economic agents tend to adopt, quite rationally, to protect them from ongoing inflation. The theory holds that this type of inflation is autonomous from demand and asserts that the money supply, in this context, is endogenous. It consistently holds that in addition to fiscal and monetary policy, it will be necessary to influence price decisions directly through some kind of income policy. When inflation, except for inertial, is high—characterizing the prevalence of abnormal times—a shock, which has come to be known as "heterodox shock," is unavoidable. This is well known today. High, inertial inflation in Israel (1985), Mexico (1987), and Argentina (1991) led to such a shock. In Argentina, where inertial inflation was combined with hyperinflation, it was necessary to cancel the public debt and freeze (legal convertibility) the exchange rate. In Brazil all of the shocks that had been tried in the past failed, essentially because they were not accompanied by fiscal adjustment nor backed by a minimum social agreement on wages.

Nevertheless, the IMF continued to ignore these simple facts. In Brazil, where inertial inflation was particularly strong, the IMF supported—informally in 1990 and formally in 1992—orthodox stabilization plans that only caused recession and did not control the inflation rate. According to the 1992 IMF target program, inflation should have been reduced from 25 percent in January to 2 percent by December. Yet, as the theory of inertial inflation predicted, inflation remained fairly stable at around the 20 percent level for the entire year (see Table 12.1). The failure to reduce inflation was blamed on the inability of the government to meet the monetary targets and on the insufficient fiscal adjustment achieved. Admittedly, the fiscal adjustment could (and should) have been stricter than it was. Much remains to be done in the fiscal area. But it is important to note that between 1990 and 1992 the Brazilian Treasury had a cash surplus. In 1992, although inflation remained around 20 percent a month—contradicting the IMF inflation target—the budget deficit (public-sector borrowing requirements in real terms) target agreed upon with the IMF was met. The public deficit was $11,384 billion; the IMF target was $11,400 billion.

Table 12.1 Brazil: IMF Targets and Reality, 1992

	Inflation (percentage)	
	Target	Actual
January	26	26.5
February	23	24.8
March	20	20.7
April	17	18.5
May	14	22.5
June	12	21.4
July	10	21.7
August	8	25.5
September	6	27.4
October	5	24.9
November	3	24.2
December	2	23.7

Sources: For the target, Brazil's letter of intention to the IMF, December 1991; for actual inflation, the general price index from FGV.

In essence, the 1992 economic stabilization program in Brazil, endorsed by the IMF, was extremely inefficient. Its costs were very high in terms of a deep recession, whereas its results have been next to nil.

My third example relates to economic reforms in Eastern Europe. Here again, the failure of the reform programs proposed for the former communist countries is derived essentially from the inability to understand and to find solutions when the economies of the countries that are supposedly being helped face abnormal times. But whereas in the case of the foreign debt and of inertial inflation and hyperinflation this failure arises from the fear of adopting more-radical measures, in the case of Eastern Europe the problem lies in the temptation—fairly easily understandable from an ideological standpoint—to restore capitalism with one stroke.

Eastern Europe, like Latin America, faced a debt crisis that became a fiscal crisis of the state. The statist strategy of industrialization was exhausted in Latin America as well as in Eastern Europe; one could imagine that similar economic reforms would work in both regions. The only difference is the fact that statism is much more entrenched in Eastern Europe than in Latin America. Thus the liberal reforms aimed at privatizing, liberalizing, and deregulating the economy must be more radical; they should consist of a big bang.

There are at least two basic mistakes here. First, although the crisis in both regions has been and partially remains a crisis of the state, in Eastern Europe this crisis is more profound. The differences in state intervention are

more than merely ones of degree; there is also a difference in quality. In Latin America, except for Cuba, the economic system has always been capitalist; in Eastern Europe, it has been statist. In Eastern Europe the mode of production was not socialist nor capitalist but statist. The ownership of the means of production belonged collectively to the bureaucratic class that controlled the state. Unlike Latin America, where the distinction between the state and civil society was always clear, in Eastern Europe no such distinction existed. Production and the entire society were state-controlled.[1]

In abnormal times macroeconomic reforms aimed at stabilizing prices and the balance of payments, as well as political reforms directed toward restoring democracy, must usually be radical to be successful. Microeconomic reforms—reforms dealing with the property system and the resource allocation system—intended to change fully and abruptly the entire economic and social structure make no sense. Eastern Europe's transition from statism to capitalism was revolutionary. It changed the structures of both the economy and society. In this context structural reforms such as privatization must keep control of the revolution by being implemented as gradually as possible.

The objective, to establish a capitalist system in the region, cannot be achieved overnight. First it is necessary to clearly separate the state from the business enterprises. The goal is not only to create a private sector, a civil society, but also to build a state—a state apparatus that effectively protects property and contracts, and promotes social welfare and economic development. A civil society and a market system will be created through privatization, but privatization does not need to be universal. In the case of very large corporations, at least in a first stage, it is more expedient and less conflictive to transfer the control of state-owned enterprises to foundations that represent civil society.

Regarding the state, it is necessary to increase—rather than decrease—the strength of the much smaller state that will remain after the state-owned enterprises have been excluded from the old state. The new state emerging in Eastern Europe is proving to be much weaker than its counterparts in the developed countries because it remains plagued by a fiscal crisis and the lack of definition of its real role. This is not what these countries need. They need a state with a small but competent bureaucracy able to raise taxes in the amount necessary to push forward with the required economic and social reforms. They need a state whose government is representative of civil society. A strong state is 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. Because there was no capitalism in Eastern Europe, there was no state in the capitalist sense, much less markets of the type found in the West.

The state must be reformed and the markets built from scratch. This is a long process, during which a big bang would only increase the risk of failure.

To understand why economic reforms and stabilization policies have been so costly and have often failed in Latin America since the onset of the economic crisis in the early 1980s, it is necessary to consider that the lack of political support was a problem, but not the only nor necessarily the main one. Another explanation is that these reforms were incompetently or inefficiently defined because they ignored the abnormal times Latin America (and also Eastern Europe) faced.

The multilateral agencies in Washington played a decisive role in these reforms. They had a double role: to both finance and advise the developing countries on the road to stabilization and growth. This role was and continues to be plagued with shortcomings. It is the task of the developing countries to refuse inappropriate advice. Their economic elites, however, tend to be so subordinated to the dominant ideas in the developed countries that it is difficult for them to criticize those views.

In this chapter I have added to the well-known criticisms of the policy recommendations coming from Washington an additional one: they fail to deal with abnormal times. This criticism is particularly relevant because Latin America has faced a deep crisis of the state—a fiscal crisis and a crisis of the strategy of state intervention—that has led to high rates of inflation and economic stagnation.

To support my contention, I presented three examples of the attitude of multilateral agencies: (1) toward the debt crisis; (2) toward high inflation in Latin America; and (3) toward the transition from statism to capitalism in Eastern Europe. In Latin America, where the fiscal crisis of the state and high inflation required a shock treatment and a substantial debt reduction, Washington policymakers limited themselves to proposing fiscal discipline and a tight monetary policy. Contradictorily, in Eastern Europe, where the transition from statism to capitalism implied a structural revolution, Washington tried to solve the problem with standard macroeconomic policies combined with big bang privatization, ignoring the fact that it is necessary first to build a much smaller state, separated from the rest of the economic system, and second to strengthen this state so that markets can be created and developed.