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The Revival of the Liberal Creed:

The IMF, The World Bank, and Inequality in a Globalized Economy

by Ute Pieper and Lance Taylor*

Half the people and two-thirds of the countries in the world lack full control over their own economic policy. Expatriate "experts" managed by industrial country nationals and based in Washington DC regulate their macroeconomics, investment projects, and social spending. The principles guiding these instructions from afar are even known as a "Washington consensus" (after Williamson, 1989).

The foreignors who fly in with policy packages for developing and post-socialist countries staff two international agencies -- the World Bank and the International Monetary Fund. Arguably, many actions that the Fund and Bank "recommend" to governments are intellectually ill-founded and counterproductive in practice. However, their suggestions are heeded for several reasons. The two institutions are backed by the United States and other economic powers such as England and (less enthusiastically) Japan. Their emissaries arrive in local capitals with substantial hard currency

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credit lines in hand -- a strong incentive for the authorities to take their proposals to heart. Finally, the proposals are based on the "neoliberal" or "market friendly" brand of policy analysis that has become intellectually predominant over the past dozen years. In some cases -- notably Mexico's since 1982 -- local policy-makers have been even more enthusiastic about neoliberalism than their friends from Washington.

Such "globalization" of economic policy is not entirely new. Argentina's 1990s transformation of its central bank into a "currency board" replicates ancient monetary customs of the British colonies and the Princeton "money doctor" E. W. Kemmerer's missions of the 1920s closely resembled those mounted by the Fund today. Beyond Kemmerer, dramatic shifts in economic and social policy during the 1980s go far toward recreating the environment prior to the Great Depression; advocates of "neo"liberalism say little unfamiliar from debates now many decades past.

Progressive critiques also exist. The great social scientist Karl Polanyi provided one in *The Great Transformation*, ironically published in 1944, the year in which the Bank and Fund were founded: "Nowhere has liberal philosophy failed so conspicuously as in its understanding of the problem of change. Fired by an emotional faith in spontaneity, the common-sense attitude toward change was discarded in favor of a mystical readiness to accept the social consequences of economic improvement, whatever they might be" (Polanyi, 1944, p. 33). In the 1920s "economic liberalism made a supreme bid to restore the self-regulation of the system by eliminating all interventionist policies which interfered with the freedom of markets" (p. 231).

The catastrophic sequels to this "bid" in the 1930s and 1940s exemplify Polanyi's grand theme that a fully liberalized market system is socially and politically impossible. "Self-regulating" markets cannot endure, particularly in the key areas of labor, finance, and international trade.

Attempts at full deregulation give rise to unstable, speculative behavior or else to such concentrations of income and wealth that there is a social reaction leading to reimposition of the state's latent powers of market control. In Polanyi's phrase, there is a "double movement," first toward deregulation and then (as financial instabilities and social tensions mount) toward its reversal.

Polanyi's theories speak to the present debate on globalization under which national capacities to reconcile market and social contradictions are increasingly impaired by external economic and financial constraints. From the disaster of World War II emerged an international consensus for "economic collaboration of governments and the liberty to organize national life at will" (p. 254). The will to establish global coordination led to the formation of the Bank and Fund. Paradoxically, for developing countries these institutions today represent the intellectual backbone and political force behind the dismantling of the truly utopian ideas of the 1940s.

Globalization and the Institutions

The charters of the Bank and Fund were written at a New Hampshire ski resort, the reason why they are dubbed the "Bretton Woods institutions" or BWIs. Their histories after 1944 help show how they attained economic suzerainty over the Second and Third Worlds, why they adopted the policies that they support, and the reasons why the policies often fail in practice.

The goal of the Bretton Woods conference was a well-ordered international economic system. There was general agreement that governments should play a central role in regulating both national and international economic systems; the theoretical basis had been provided in the 1930s in the intellectual revolution led by John Maynard Keynes.

This attitude was to reverse over the next decades. One reason was the apparent inability of social democratic/Keynesian policies in the industrialized countries to deliver sustained output growth and high employment after the post-World War II "Golden Age" that ended around 1970. Thereafter, first transnational corporations (TNCs) and then international financial markets extended their domains, leading to increased pressures on poor economies to liberalize the current and capital accounts of their balances of payments respectively.

The international economic environment also changed dramatically. Many small, poor countries (especially in sub-Saharan Africa) were hit hard by the oil shocks and a long-term downtrend in the primary commodity terms of trade beginning in the late 1970s. At first, middle income countries benefitted from recycled oil rents, which they borrowed at low or negative real interest rates in the 1970s. But they were soon adversely affected by the world interest rate hikes after 1979 (engineered for anti-inflationary purposes by industrialized country Central Bankers and sustained by global capital market liberalization which encouraged financial investors aggressively to seek the higher bidders for their funds) and the debt crisis in 1982.

The outcome for both sets of countries was massive macroeconomic adjustment. In the wake of the debt crisis, for example, erstwhile borrowers were forced to switch from trade deficits of several percent of GDP to surpluses of the same magnitude as "fresh money" ceased to come in while interest obligations mounted. An external shock approaching ten percent of GDP is difficult to handle for any economy; inflationary, contractionary repercussions were observed worldwide.

Occam’s razor notwithstanding, mainstream economists attributed these problems not to macroeconomics but to past policy "errors" including the pursuit of import-substituting industrialization or ISI which was said to have distorted the price system so badly as to make the economy unmanageable. The increasing difficulties and final collapse of the Soviet system also meant that ideological backing for ISI and "planning" more generally along with political support for non-free market policies faded away.

As the residual intellectual claimant, neoliberalism took the center of the policy stage. It was directed there by the rich shareholders of the BWIs, on the basis of their own new economic predilections along with the objective interests of their TNCs as they integrated their operations worldwide and of their financial centers as they invested in "emerging" markets. The staffs of the Bank and Fund helped create the new policy line and have been adjusting it gradually. Whether they would be willing to accept major changes, however, is a question postponed to the final sections of this paper.

The Roles of the Institutions

Basically because the United States chose not to foot the bills, the IMF as it emerged from Bretton Woods has always been too cash-strapped to advance money for the long periods that many countries require for "soft landings" from big current account deficits. To make sure that it could restrain its borrowers, "conditionality" attached to IMF loans became standard practice. Policy limitations and "performance targets" tied to credit lines advanced under "standby agreements" were universal by the 1960s. The fiscal and monetary details have scarcely changed since they were worked out by the IMF’s (then) research director Jacques Polak in 1957. Costs and benefits of Polak’s "financial programming" techniques are assessed below.

In contrast to the IMF, the World Bank has changed its orientation several times. It was created to finance large public infrastructure projects, first in Europe and later in developing countries. In the 1970s when Robert McNamara became its President, the Bank responded to Washington’s spirit of the times by discovering that "trickle-down" from its investment projects was not benefitting the poor. Poverty alleviation became the Bank’s conceptual focus and in effect a moral goal. Its loans were redirected toward investments which were supposed to help targeted poverty groups.

In the 1980s, this vision was superseded by an emphasis on "market friendly" economic reform. Thinking among Bank staff began to focus on stimulating economic growth precisely to enhance trickle-down, because more directed anti-poverty policies did not seem to be having much impact. The means toward the growth stimulation end took the form of neoliberalism, in response to the ideological sea change represented by Prime Minister Thatcher and Presidents Reagan and Bush. The Bank moved alongside the Fund into the business of providing balance of payments support to countries afflicted by the debt crisis and falling export prices, adding newly invented "structural adjustment loans" to its project credits.

These policy gyrations informed the Bank’s contributions to the debate about economic development and growth. McNamara launched an eclectic research program. With Washington’s ideological shift of the 1980s, however, its main thrust switched toward papers "demonstrating" that government interventions in the market slow economic growth and similar neoliberal assertions.

This bias provoked reaction. For example, prodded by the Japanese delegation which circulated a paper stating that the Anglo-American influence on its thinking was too strong, the Bank reviewed the interventionist development strategies that Japan and its neighboring economies historically pursued. Contrary to Japan’s apparent intentions, the resulting *East Asian Miracle* report (World Bank, 1993) presents an interpretation of the role of the East Asian state which differs significantly from that of many scholars.

Although as demonstrated by Wade (1995) the arguments are stretched, the gist is that East Asian governments "got the fundamentals right" by economy-wide, functional interventions such as providing ample public education and keeping the real exchange rate stable. Their selective actions such as aiding specific enterprises or undertaking sectoral interventions were allegedly counterproductive. In fact, Wade, Amsden (1989), and many others argue that both functional and selective policies played essential roles in supporting the region’s rapid economic growth.

So to speak, the Bank’s 1993 stand is more realistic than the extreme anti-state rhetoric that it emitted in the 1980s. But the half-way position is still disquieting. Rewriting history is tempting for any bureaucracy, and the Bank’s ability to affect the policy climate in developing countries makes the practice more than usually harmful. As Amsden (1994) observes, "What makes the Bank so powerful is that it has no real rival. The Bank has become a virtual monopoly, if not in its lending then in its research work." Disguising a multi-million dollar ideological marketing operation as research has not been a heartening trend over the past dozen years for the World Bank.

The Washington Consensus

This history shows that the Washington consensus is a phenomenon of a particular time and place. It amalgamates long-standing IMF macroeconomic stabilization policies, the World Bank’s adoption of the market deregulation and supply side economics ideas in vogue in Washington early in the Reagan period, and London’s zeal for privatizing public enterprises which crossed the Atlantic a few years later.

As the *East Asian Miracle* episode illustrates, the consensus has evolved over time, often away from originally extreme positions. The essentials, however, have not changed. Synthesized in the 1980s to attack problems in poor countries which are long-standing and largely stem from their insertion in the international economic order, Washington’s remedies have not been able to overcome these difficulties as they persist years later. To see why, we have to examine the strategy’s details.

The first one is that there is an explicit division of labor in market friendly packages. They try to assure economic "reform" with pay-offs in the form of faster output growth and rising real incomes by first "stabilizing" the macroeconomy and then "adjusting" the market so that it can perform more efficiently. This sequencing reflects concerns of the BWIs dating from long before the Washington package was assembled.

The IMF Contribution

Stabilization has always been the domain of the IMF. Unchanged over 40 years, its central policy prescription aims at reducing the trade deficit (especially the volume of imports) by cutting aggregate demand. Inflation may also be a target, but it is often less amenable to policy control. The most important components of Fund programs are the following:

Fiscal and monetary austerity, which causes lower GDP growth, perhaps slower inflation, and almost always a reduction in imports. Typical policies include cuts in public spending, high interest rates, and credit restraints (especially for the public sector). "Financial programming" based on the country’s balance of payments, fiscal, and monetary accounts is used to set "performance criteria" for indicators such as the permissible growth of the money supply and the proportion of the fiscal deficit to GDP. Polak’s macroeconomic model presupposes that reducing the fiscal deficit automatically leads to a lower trade deficit with no effects on output. Such projections frequently turn out to be false.

Exchange rate adjustment is the second main component of most Fund packages. It raises complex issues.

The nominal exchange rate is a key "macro" price because it affects the economy through many channels. In developing countries, three are especially important. A trade deficit can be attacked by devaluing (or weakening) the local currency, which is supposed to make production for export more profitable and imports more expensive. Complications are that exports may not respond rapidly, and that devaluation drives up internal prices of traded goods, cutting purchasing power and aggregate demand. These inflationary, contractionary side effects are rarely mentioned in IMF country documents, but in practice can be politically disruptive enough to derail a program.

The impact of exchange rate adjustments on the price structure is the second channel. One implication is that lowering internal prices of internationally traded products by strengthening the exchange rate can help control inflation. Using a fixed exchange rate as a "nominal anchor" for inflation has been a key component of Fund-backed stabilization packages (especially in Latin America and Eastern Europe) since the 1970s.

A typical outcome in the case of Argentina is analyzed by Chisari, Fanelli, and Frenkel (1996). After stabilization in the early 1990s the consumer price index (dominated by non-traded goods) increased by more than the nominal wage, which in turn increased by more than the wholesale price index (dominated by traded goods in an economy in which the current account of the balance of payments had been heavily liberalized). Hence, workers' real purchasing power declined at the same time as real labor costs for producers of traded goods went up. Both distributional conflict a la Polanyi and inadequate incentives are built directly into such a relative price regime. In Argentina the package has not (yet) collapsed in part because Brazil, the country's main trading partner, saw its Real become even more overvalued than the peso in the wake of its 1994 inflation stabilization.

When controls on external trade and capital movements are relaxed (more details below), the exchange rate becomes an asset price to which foreign investors pay close attention when deciding whether to direct funds toward the economy concerned -- this is the third channel. Rate movements either way can have violent repercussions in the thin capital markets of most poor economies, with potential adverse (or favorable) feedbacks into domestic interest rates and financial markets. In the case of real exchange appreciation, likely deterioration of the trade account means that steps have to be taken to secure capital inflows. One obvious move is to raise real internal interest rates, with consequent ill effects of investment demand and capital accumulation.

On the whole, Fund packages in small, poor countries tend to emphasize devaluation -- the aim is to improve the trade balance through the mechanisms discussed above. Devaluation may also be undertaken to "reassure" investors when they begin to pull money out of the country. This maneuver is tricky, because it reduces the foreign currency value of the national assets that investors already hold but makes future acquisitions cost less. Sometimes it is effective -- as in India in 1991 -- and at other times a disaster -- Mexico in 1994-95. The difference between the two cases may be that Wall Street suffered billions of dollars of capital losses because it had already invested heavily in Mexico before its economic authorities devalued.

Use of the exchange rate to fight inflation can also be a two-edged sword. Combined with its role as an asset price, the adverse trade and production effects of the exchange rate pegged as a nominal anchor can upset a stabilization effort. Especially when capital movements in and out of the economy have been decontrolled, a worsening trade balance under an appreciating (but nominally pegged) exchange rate can provoke capital flight leading to an unavoidable "maxi-" devaluation and associated price jumps and output losses. From Latin America’s Southern Cone in the late 1970s to Mexico in late 1994 and Argentina (again!) in 1996, the Fund and Bank have repeatedly supported combinations of exchange rate appreciation and capital market liberalization which were doomed to fail. Was it because the financial communities of their main shareholders were pushing them in that direction?

Despite such anti-inflationary misadventures, the basic aim of most Fund packages is still to reduce trade and fiscal deficits to "sustainable" levels of a few percent of GDP. Such efforts may well make sense -- an economy with large financial deficits on its external, government, or private sector accounts is skating on thin ice. In practice, however, the IMF moves fast and imposes several contractionary policies at once. The impact is often to slice imports by generating a recession -- this familiar outcome is the reason why the IMF is accused of policy "overkill." Historically, the IMF's chief target has been to cut the trade gap, and its policy package hits that mark. Whether it reduces inflation (sometimes) or leads to renewed, equitable economic growth (rarely) are altogether different questions.

World Bank Adjustments

The World Bank's specialty is "adjustment" aimed at raising GDP growth. Since around 1980 when it decided to fight poverty with market friendliness, the Bank's main thrust has been to improve the allocative efficiency of the price system. The basic idea is that removing price "distortions" will produce visible output gains, e.g. cutting "artificially high" real wages will induce companies to hire more workers who will make more goods. Such a negative correlation between wages and output is often not observed. Much more common is a positive correlation with both variables going down. Like devaluation, wage cuts can reduce effective demand and lead to more income concentration; the political reactions can easily sink an adjustment program.

In a bit more detail, attempts to improve resource allocation in Bank-sponsored adjustment packages include the following policy moves:

Foreign trade should be liberalized, beginning with replacement of import quotas by tariffs, and subsequent reduction of the tariffs and export subsidies. By driving internal relative prices toward world levels, these maneuvers are supposed to underwrite exports via cost reductions and efficiency gains, but there are few such cases on record (Helleiner, 1995).

Simultaneously or a bit later, barriers to external capital flows such as controls on foreign exchange transactions and profit remittances should be cut back, to make it easier for external suppliers of funds to invest in the local economy. The fact that foreign money (some of it "hot") can move out as fast as it moves in has not been stressed by the BWIs until very recently.

A third target is deregulation or "derepression" of the home financial market. The aim is to equalize rates of return to different financial assets. The view in the 1980s was that raising interest rates that had been held down or "repressed" as a subsidy to borrowers would stimulate saving. Such a response proved impossible to detect empirically, and is no longer emphasized. Rather, the current Washington view is that positive real interest rates lead to better resource allocation along standard neoclassical lines.

There was also little discussion in the 1980s about the need for prudential regulation of money and capital markets, in the form of careful audits by the authorities of the risk and performance of portfolios combined with sanctions on financial institutions in trouble. This omission is surprising, because liberalization packages that the agencies have supported have led to speculative booms and crashes all over the Second and Third Worlds (the Mexican crisis of 1994 and its Asian sequels in 1997 are only the most recent examples).

As Akyuz (1994) points out, simultaneously decontrolling two inherently volatile market systems -- for external capital movements and internal financial instruments -- is an explosive policy mix. The powder may be especially dry in the emerging stock markets that have been expanded by public enterprise privatization campaigns and an influx of portfolio investment from rich countries. A 1995 IMF report on *International Capital Markets* suggests that the BWIs are beginning to grasp this problem, but their learning curves even after the 1994 Mexican crisis have not been steep.

Fourth, there should be deregulation of labor markets and business decision making.

Fifth, taxes should be rationalized. In conditions such as those in sub-Saharan Africa, they may need to be raised to provide a financial base for badly needed civil service reforms. Despite Washington’s rhetoric (but in practice in programs that the BWIs support), growth in such "success cases" as Ghana and Uganda has been driven by states, not private sectors, and has been accompanied by visible increases in the size of the government.

Sixth, privatization of public enterprises began to preoccupy the Bank in the late 1980s, as doctrines put into practice by British Conservative governments drifted westward. This effort is based on the idea that privately owned enterprises are intrinsically more efficient than firms owned by the state -- a proposition which careful reviews of the evidence by scholars such as Chang and Singh (1993) fail to endorse. In practice, selling off state-owned firms often amounts to a fiscal stop-gap to close budget deficits opened by rapid tax reductions. As noted above, the new shares in the hands of the public also served to launch not necessarily stable stock markets all ‘round the world. The Bank enthusiastically supported this process.

Finally, by reducing state intervention and adding "transparency" to the economy, liberalization and privatization are supposed to reduce unproductive resource diversion due to corruption and seeking for "rents" or the returns garnered from an state-assured market position, e.g. the possession of an import quota. But as Boratav, Turel, and Yeldan (1996) observe, "... in most Third World countries the bourgeoisie itself is a creation of the state. This historical phenomenon has created cultural, sociological, and economic traits which do not disappear with changes in the policy model." They deduce that liberalization is not likely to do away with rents arising from advantageous positions of specific business groups, because "... the very process of rent-seeking emanates from the bourgeoisie, [and] not the state per se."

In countries undergoing adjustment, instead of disappearing under market friendly policies, corruption has surged over recent years, spawned by export incentives, speculative urban finance, privatization and stock exchange operations, and fiscal incentives -- the popular soap opera starring Mexico’s (ex-)Presidential Salinas family is just the best-known example. Such social developments are beyond the ken of the Washington model, which cannot absorb the fact that rents and corruption often rise instead of declining when old forms of market regulation are suppressed. In most coutries, these sins have not been absolved by notable accelerations of economic growth.

Country Experiences with Structural Adjustment Programs

What are the effects of market friendly interventions, combined with macroeconomic shocks? Numerous scholars have jumped into this contested terrain, with conclusions that vary widely. One reason for the disagreement is that the methodologies they have utilized are not compatible. Broadly speaking, three assessment techniques are in regular use:

Historically based, individual country analyses try to put the impacts of both macroeconomic shocks and policy initiatives into the context of the economy at hand. Examples range from simple "before and after" comparisons of purported policy effects to "thick descriptions" like the country papers collected in Taylor (1988, 1993, 1996) which serve as the basis for much of the following discussion.

Second, cross-country econometric studies try to make "adjusting vs. non-adjusting" comparisons of the impacts of policies and shocks, sometimes attempting to use control groups or other statistical ploys. In assessing structural adjustment, econometric analysis tends not to be very robust (different authors extract contradictory results from similar or even identical data sets), largely because time series are short and economic data from developing countries are far from precise (for examples, see Taylor and Pieper, 1996).

Finally, "counter-factual" explorations of the implications of pursuing alternative economic strategies can be pursued, asking questions about how the economy "would have" behaved if historically observed policies or macro perturbations were replaced by something different. The problem is that any counter-factual result depends on a specific model of the economy at hand. Alternative causal schemes giving diametrically opposite results can be easily be imposed on any given model’s macroeconomic accounting framework, e.g. devaluation can raise or lower the level of output depending on whether it is assumed to be broadly supply- or demand-determined. Without a careful, essentially historical analysis of how a subject country functions macroeconomically, the counter-factual methodology is unconvincing. This defect has not prevented it from being generously applied to the case of sub-Saharan Africa, for which counter-factual defenses of Washington-style policies which don’t seem to be working very well abound.

In using historical case studies to inquire about modes of structural change, one can pose two sorts of questions:

Have "successful" developing economies relied on market friendly economic policies?

Where the Washington blend has been applied, has it generated economic "success?" Why or why not?

Answers to such queries are never clearcut in economics, because policy outcomes are strongly affected by historical contingencies and sociopolitical dislocations. Still, one can learn by applying these questions to country experiences. We begin with one to which both sets are relevant.

Chile

Chile is often cited as the number one success case for liberal policy, on the basis of its rapid, export-led growth since the mid-1980s. However, its output surge was not solely due to orthodox stabilization attempts and market friendly economic reforms which national policy-makers as "owners" designed in close collaboration with the Bank and Fund. Targeted industrial policies and ample access to foreign exchange at critical moments played their parts.

The first point to observe is that the country paid a high social price through a prolonged transition toward sustained growth under a very tough military government -- General Pinochet took over in 1973. Despite their use of the best BWI medicines and generous official financial support, the General's economic teams did not contain inflation and curtail ouput losses for a dozen years until exports took off.

Thus even if Chile is taken as a testimonial for market friendliness, its history suggests that Washington's remedies do not work very fast. When it came, moreover, rapid export growth owed as much to state intervention as to market forces. Exports were led by copper mining in which the government undertook massive public (not private) investment, and forestry products, fishmeal, and fruits. In all three latter commodity groups, industrial promotion policies over several decades in the form of production subsidies, enterprise reform, and technological upgrading laid the base for ultimate export success. Trade liberalization, a centerpiece of reform efforts, did not play much of a role in stimulating exports although real wage reductions via currency devaluation early in the boom period certainly did.

Other historical factors were also favorable. Chile was hit less hard than its neighbors by the debt crisis. The state had good access to foreign exchange through its control of copper exports and was treated generously by the BWIs. In the crucial mid-1980s, for example, external finance permitted the economy to run trade deficits between 5% and 10% of GDP and the export terms of trade rose by almost 40% later in the decade.

Despite (because of?) this good fortune, however, the economic authorities botched several opportunities to stop inflation. Price stability did not precede adjustment (and in fact rested on the latter), contrary to the preferred Washington chronology. It was ultimately based on wage repression to the benefit of cost reductions and the profits of commodity exporters. Earlier programs relying on austerity and external and internal market liberalization failed to brake the price spiral, but provoked an output collapse in the mid-1970s and an import surge and an orgy of stock market speculation around 1980.

The speculation was abetted by "groups" of enterprises which formed when the government sold off firms nationalized by the previous Allende regime to its political allies at rock bottom prices, in one of the first privatization waves in the developing world. The stock market expanded in tandem, and group managers proceeded to borrow from banks under their control to bid up the prices of their own companies’ shares -- a now classic example of insider manipulation which adequate financial regulation could have ruled out. The BWIs did not push for any such action, but did provide loans to help pick up the pieces of the financial system after it crashed.

The resulting bail-out was a classic of its kind. The Central Bank issued interest-bearing liabilities to the tune of 35% of GDP to buy up assets of troubled financial institutions, over 40% of which were non-performing. The Bank then acquired a "big bond" of around 40% of GDP from the Treasury, with the proceeds being used to service its new liabilities. The Treasury in turn refinanced much of its big new obligation abroad, but in the final analysis Chilean taxpayers have to service the debt. Even after a decade of rapid growth, the payment flow amounts to a couple of percent of GDP.

Looking backward, Chileans in the upper income strata now say that their rapid output growth justifies the dozen years they spent engaged in such maneuvers. But had they been able to look forward in 1973 with foreknowledge of the difficulties that reform would create, it is not so clear that they would have chosen the market friendly path. Even after a decade of robust GDP expansion, real income levels for most households are not far above their levels of 1970, as an initially unequal income distribution became strikingly worse.

The summary answers to the questions posed above are that Chile’s "success" was not wholly due to Washington policies, which in some ways prolonged and worsened the transition (the economy suffered 15% output reductions in 1974 and 1982, in direct response to failed orthodox price stabilization attempts). Chile did emerge from its travails as a vibrantly capitalist primary product exporter, combining strong public and private sector partnership in an environment of free market rhetoric -- which does not fully describe the economy at hand.

Mexico

Since the debt crisis erupted in 1982, Mexico has been a laboratory for economic policy moves. Most of the experiments were orthodox and designed in collaboration with the BWIs, but there were heterodox elements as well. All were subject to historical contingency, with the main success being a heterodox anti-inflation program which took advantage of favorable initial conditions created by a previously orthodox phase. The great failure, of course, was the financial crisis of 1994, although it is fair to add other drawbacks such as increased income concentration and stagnant economic growth.

The roots of the disaster of 1994 trace back to well before the debt crisis. In 1982 Mexico was faced with the problems unleashed by loan-pushing on the part of commercial banks and the country's too-ready acceptance of foreign credits to undertake expansionary policies aimed at putting into concrete the jump in national wealth which the massive oil discoveries in the mid-1970s had brought about. At least during the 1970s growth was rapid, but more disquieting developments included real exchange appreciation under inflation rates which rose to 100% per year, capital flight, and a massive accumulation of external debt. Obscured by these fireworks, there were other questions pending -- were the benefits of the ISI strategy that had been pursued for decades finally running out, and should the economy be opened to foreign trade and financial flows to some degree?

After the debt crisis broke in August 1982, Mexico was forced to transform an external current account deficit of about 5% of GDP to a 3% surplus to compensate for the loss of "fresh money" in the form of new loans the commercial banks had cut off. The economic team achieved the current account adjustment using the IMF's time-tested tools. They induced a recession by devaluing the peso and cutting the fiscal deficit and monetary emission. Such actions usually have stagflationary consequences, as they certainly did in Mexico -- GDP growth averaged out at zero between 1982 and 1988, while by 1987 prices were rising 160% per year.

During the 1987-88 presidential transition, stagflation was attacked in two ways. One succeeded by breaking away from the Bretton Woods line. Despite IMF opposition, in 1987-88 an "Economic Solidarity Pact" aimed at stabilizing prices combined a wage freeze, a pegged nominal exchange rate, trade liberalization, and more austerity. This heterodox package did brake inflation, but at some cost. Real wages were reduced once again, and $10 billion in foreign reserves built up after 1982 was spent on supporting the fixed exchange rate and bringing in imports. The output growth rate, however, did not improve.

The authorities tried to stimulate growth by resorting to extreme market friendliness, answering in the affirmative the questions posed above about the desirability of abolishing mercantilism and pursuing openness in foreign trade and finance. They privatized state-owned industries, further liberalized foreign trade by dismantling export subsidies and an import quota system which had been built up over decades, and removed restrictions on inflows of direct and portfolio investment. The push to sign the North American Free Trade Agreement was the capstone of all these efforts.

Revenues from privatization helped secure the strong fiscal position prior austerity had put in place. However, as of mid-decade, there had been neither striking improvements in efficiency on the part of the firms concerned nor had newly vigorous entrepreneurs emerged at their helms. As in other countries such as Turkey and Russia where a bureaucracy in charge of distributing rents was not replaced by new forms of market regulation under a newly "liberal" regime, large-scale corruption (at least to judge by the anecdotes), had markedly increased without creating any spill-over into higher productivity or economic growth.

The macroeconomic outcomes of freeing external trade and financial flows were even less favorable, on at least seven counts:

First, foreign capital came in, letting the trade balance shift from a small surplus in 1988 to a deficit of about $20 billion in 1993; the current account deficit was around 6% of GDP in 1993 and 9% in 1994. Output growth rose to 4.4% in 1990, but tailed off thereafter. In the 1970s by contrast, Mexico combined external deficits of 5-6% of GDP with 6-7% GDP growth.

The capital inflows were partly enticed by a Mexico/USA interest rate spread exceeding 10% (and an internal Mexican real interest rate of about 5%). Perhaps an even stronger incentive took the form of capital gains on the stock market or bolsa. The share price index rose from around 250 in 1988-89 to over 2500 early in 1994, but then fluctuated erratically, as unnerving political events and interest rate reductions of a few hundred basis points around mid-year made Mexico a less attractive place to invest. Lustig and Ros (1993) suggest that the financial actors who determined movements of funds across the border comprised bulls (mainly foreign), bears (mainly Mexican), and "sheep" who followed in-between to generate a teeter-totter market with multiple equilibria -- a boom in the early 1990s, an unstable intermediate balance in 1994, and then a crash.

Third, while it lasted the external capital inflow had to enter the economy via the widening trade deficit already noted -- there was no other channel. The deficit was engineered partly by a steadily appreciating real exchange rate, and partly by trade liberalization. Measured pesos-to-dollars in Latin style, the real exchange rate in terms of both consumer and producer prices fell by about 45% between the mid-1980s and 1994, with most of the drop prior to 1991. One reason for depreciating the nominal rate more slowly than price growth was to restrain inflation, but Mexican authorities were also pushed toward a powerful peso by the outward-shifting supply curve in the foreign exchange market. Of course, in the midst of radical trade liberalization, allowing the peso to strengthen so markedly was a perilous policy to pursue.

Fourth, in contrast to external financial investment, real capital formation within Mexico did not rise much above 20% of GDP, despite increases in the early 1990s from the extremely depressed levels of the previous decade. From the side of demand, low domestic absorption was the basic cause of slow growth. Private investment was not robust for several reasons: real interest rates were high; profit margins of companies in the traded goods sector were held down in real terms by the strong peso; and public investment which historically had "crowded in" private projects was cut back as part of the liberalization/austerity program. For both consumption and investment spending, the import content shot up.

The macroeconomic "story" is that investment fell back from historical levels, but private saving dropped even more -- from roughly 15% to 5% of GDP in the 1990s, despite high interest rates. The resulting incremental increase in the private sector's financial deficit (or investment minus saving) was immediately reflected into a bigger "twin" trade deficit supported by the strong peso/high interest rate/trade liberalization policy mix already discussed. As in Chile before its financial crash early in the 1980s and Argentina and Brazil in the 1990s, somehow the allegedly beneficial effects of public sector thrift did not transmit themselves to private firms and households. Their thriftless saving shortfall had to be covered by the inflow of foreign funds.

Sixth, while the game lasted, foreign money did keep pouring in, blind to devaluation risk. The foundation for this house of cards was an ever-increasing stock of external debt. It began to crumble when prices on the bolsa stopped rising after the first few months of 1994 while American interest rates continued to increase. The collapse came with Mexico's devaluation the Tuesday before Christmas.

Finally, one can argue that "mistakes" in policy such as reduced interest rates in anticipation of the September 1994 presedential election worsened the situation by deterring capital inflows. But the more important point is that the balance of international financial power strongly influenced the endgame. When inflows slowed, the Mexican authorities issued a new instrument -- peso-denominated "Tesobonos" which were indexed to the dollar/peso exchange rate. Asset-holders switched en masse from non-indexed government debt to the Tesobonos, apparently on the belief that they could be cashed in for dollars freely. After the crisis hit in December, the US Treasury/IMF bail-out loans were made conditional on Tesobono convertibility. An alternative (permitted under Article 6 of the IMF charter) would have been for Mexico to redeem Tesobonos in pesos and impose controls to deter dollar flight. But that option was denied by Washington. The result was that

Tesobono holders on Wall Street were bailed out, while Mexico incurred tens of billions of dollars of additional debt to pay them off. The widely circulated assertion that Tesobonos were *dollar*-denominated was a follow-up public relations move by the US financial community to cover its players who had guessed badly wrong in increasing their Mexican exposure.

Such a public relations "spin" cloaks but does not erase the basic contradiction: By the early 1990s, Mexico had come as close as practical politics permits toward adopting a fully orthodox package of fiscal, monetary, and external adjustments. The fiscal account was in surplus, there was adequate monetary control (the central bank was just acting as a traditional lender of last resort in partially sterilizing speculative capital outflows throughout 1994), and barriers to external transactions had been removed. Yet the foreign account was heavily in deficit because private savings had collapsed and hot money was flowing in.

All that an orthodox stabilizer could try to do to overcome such problems would be to increase the fiscal surplus (cutting back aggregate demand still more, and thereby private incentives for capital formation and capacity growth), raise interest rates (drawing in more short term external capital but amplifying macroeconomic pressures toward further recession, a stronger exchange rate, and a greater trade deficit), or depreciate the currency (dealing a capital loss to foreign investors and daring them to pull out -- as they did in December). In effect, an "adjustment" or "structural" problem of excessively high import demand derailed the entire stabilization-cum-liberalization attempt.

Most Mexicans would be better off now, had their government kept policy autonomy by not jumping into liberalization, and used it to spur investment and support wages and jobs for people in the population’s bottom 80% who lost real income steadily after 1982. A few simple but important lessons can be drawn from Mexico’s experience:

One is that there is no instant policy to promote productive efficiency of firms, e.g. the failure of privatization and liberalization to bear fruit in Mexico. Indeed, as illustrated by South Korea's experience discussed below, all successful industrializations in the past were based on directed state intervention, a degree of mercantilist semi-withdrawal from world system of relative prices, and some system of collaboration among the state, capital, and labor.

As already noted, rapid liberalization of either the current or capital side of the external accounts can provoke destabilizing reactions, e.g. the savings collapse in Mexico as the bourgeoisie opted for imported consumer goods and the capital withdrawal when Wall Street saw its ever-increasing capital gains on the bolsa come to an inevitable halt. As will be seen, Korea also suffered from similar effects of liberalization in 1997.

All standard economic policy tools have complicated effects, e.g. devaluation can be inflationary and contractionary in the short run, but required to sustain exports over the long haul. Moreover, the strength and direction of such effects is often extremely difficult to predict on the basis of historical experience.

Finally, large segments of the population can be left behind in attempted economic transitions, provoking political backlash. The roots of rebellion in Chiapas and elsewhere in Mexico are very deep, but recent events are not unrelated to the distributional changes provoked by the liberal policy stance of the 1980s. As of late 1997, orthodox hopes were pinned on an easing of social tensions to be induced by sustained export-led income growth spurred by the massive devaluation of 1994. It remains to be seen whether this expectation will amount to anything besides whistling past a graveyard.

Turkey

Through the late 1980s, Turkey was touted as an orthodox miracle. Now, in the wake of a financial crisis beginning in late 1993, it has become a prime example of the BWIs' neglect of the potentially destabilizing effects of the changes in the income distribution implicit in their programs. The miracle's reversal in less than a decade marked the rapid progress of a "double movement."

Exports shot up in the early 1980s after a fairly standard IMF-brokered stabilization which was supported by ample capital inflows responding to geopolitical factors. Moreover, the new economic team "owned" the package since its chief, Turgut Ozal, had spent years working around the BWIs. He cut real wages, peasants' incomes via adverse shifts in controlled agricultural prices, and government spending. The outcome was a sharp drop in domestic demand.

At the time, the saving grace was that Turkey had built up an industrial base over decades of statist, inward-oriented policies. With depressed internal markets, producers started to look for sales abroad. By happenstance, demand for the medium-tech manufactured goods that Turkey could supply soared in the region, thanks to the 1979 oil shock and then the Iran-Iraq war. Aided by currency depreciation and ample, targeted, and illiberal subsidies (up to one-third of the value of foreign sales), exports boomed and helped output to grow rapidly through the mid-1980s.

For several reasons, the miracle unraveled soon after. In the new economic environment, the provision of state support to enterprises was taken out of the hands of a relatively impartial bureaucracy and relocated in (by then) Prime Minister Ozal's office. Pay-offs and "rents" were passed out politically, angering elements of the entrepreneurial class omitted from the largesse. As discussed earlier, corruption flourished in the newly market friendly environment, contrary to all orthodox expectations.

More ominously, workers and peasants reacted against their income losses, and forced massive wage increases and pro-agriculture price shifts in the late 1980s. Inflation took off and the distributional framework for the miracle collapsed. The authorities responded by opening the economy to external financial inflows, many of them "hot," which paid for import-led demand and domestic speculative booms in 1992-93 (reminiscent of Chile's double booms 13 years before and Mexico's concurrent events).

The foreign money started to move out late in 1993, underscoring the foolhardiness of jointly liberalizing external and internal financial markets. Interest rates shot up to 15-20% in real terms per month, bankrupting financial houses and banks. A contractionary stabilization with the usual regressive consequences and large-scale financial bail-outs followed in April. Probably the economy will not grow again for several years, in the dying gasp of the program of the 1980s. Despite favorable external circumstances and its incorporation of (sometimes) shrewd market interventions, in the final analysis a reform package actively supported by the BWIs disastrously failed.

Post-Socialist Eastern Europe

Orthodox policy played a substantial role in worsening the macroeconomic disorder that now rules in Eastern Europe and the former Soviet Union, although it was underway well before communism's political collapse. The local versions of SAPs, moreover, may long postpone the renewal of industrial growth (Amsden, Kochanowicz, and Taylor, 1994).

During the late 1980s, the breakdown of socialist planning was associated with rising inflation rates and declining output levels in economies all across the region. These trends took a distinct turn for the worse when Western advisors helped local authorities apply Washington-style "global shock" stabilization and liberalization packages during the transition years of 1990-93.

The protracted or aborted BWI programs in Chile, Mexico, Turkey, and elsewhere were well known at the time. Nonetheless, the architects of reform promised that instantly liberalizing prices in global shocks would lead to rapid adjustment to a full employment, inflation-free macroeconomic equilibria while the invisible hand would painlessly reshape pre-existing industry along Western lines. As Kornai (1993) observes, no "... forecast of ... serious recession [can] be found in the early theoretical writings to outline the program for the transition ..."

In fact, many countries' real incomes and outputs fell by between 20% and 40% of GDP over a couple of years, while price increases accelerated to triple digit annual rates. Although inflations slowed into double digits and incomes stabilized outside the former USSR in 1992-93, output levels continued to decline or scarcely grew (the somewhat positive 1993-95 GDP growth rates in Poland and the Czech Republic are unique exceptions). Real incomes have yet to recover, poverty has risen sharply, and income distributions are becoming increasingly unequal.

The key problem with global shocks was their macroeconomics. Socialist economies had historically utilized administrative methods such as rations and queues instead of the price system to limit demand to available supply. A longstanding state preference for rapid capital accumulation and acquisition of goods by the military led to a "shortage economy" due to "soft budget constraints" for favored sectors, in a metaphor proposed by Kornai (1981). Consumers found their available supplies and budgets limited, leading to "repressed inflation" in their economic sphere.

When administrative restrictions in all markets were suddenly lifted in shock programs incorporating near total price liberalization, demand surged above supply. Some new restraining mechanism had to appear. With inflation no longer held in check by controls, price jumps were the only possible outcome, e.g. the triple digit inflation in Poland in 1990 and the many-fold price jumps in Russia in January 1992.

Mechanisms such as the "inflation tax" and "forced saving" kicked in to make demand plummet -- when prices jump up, households and enterprises simply have less real purchasing power to spend (Taylor, 1991). As a consequence, inflationary pressure did abate. However, there was no natural mechanism to assure that real incomes would stop falling just at the level required to support demand at the full capacity level. Under macro policies aimed at wage restraint (certainly the case under post-socialism) and with increasingly structural inflation, demand continued its trajectory downward.

Inflation-induced real wealth and income losses were an essential aspect of this transition. Orthodox theory was blind to their inevitability because (as noted previously) it postulates inverse and not direct linkages between real wages and output. However, other factors were important as well. Traditional linkages among producers fell apart. This breakdown of previously planned commodity transactions reduced potential supply by squeezing intermediate inputs, forcing still more inflation to drive demand downward. On the demand side, high interest rates and other austerity measures led to a collapse of capital formation in economies which historically had been investment-led.

Against this backdrop, prospects for sustained recovery are not bright. High interest burdens and low wages have deindustrialized large sectors of manufacturing. Wage cuts are not key to profitability in the mid-tech industries that grew under socialism -- machinery and engineering products, chemicals, iron and steel, and even cotton spinning and weaving. Outdated technology and poor product quality, not excessive costs, make these branches suffer in international competition.

Aggressively marketed by the World Bank, the logic of shock therapy was to restructure worthy state-owned firms through privatization, not the credit subsidies and directed supports which have been used by all successful capitalist industrializing countries this century. Few foreignors have been willing to invest in Eastern Europe and the former USSR. The authorities have turned to domestic "voucher" privatization schemes instead. In the absence of injections of technology, skills, managerial know-how, and capital for restructuring, such cosmetic ownership changes will not reanimate potentially viable firms as the collapse of the widely-praised Czech voucher scheme in 1997 underlines. Technically advanced productive capacity will wither as Eastern Europe resumes its traditional role in the international division of labor -- a poor cousin supplying labor and cheap, labor-intensive exports to the rest of the continent.

Finally, stagflation coupled with unregulated privatization attempts have worsened "financial fragility" in the phrase of Minsky (1986). Investment is flat, in most countries there is still little economic growth, and income distributions have grown more regressive. Under such circumstances, new wealth-holders are tempted to look for big financial gains, since there is scant money to be made from simply producing commodities.

Chile’s, Mexico’s, and Turkey’s speculative adventures discussed above and similar episodes elsewhere (in Argentina, the Philippines, etc.) reflect such forces. In Eastern Europe, they have led thus far only to Ponzi games and pyramid schemes like the Caritas bubble in Rumania in late 1993 (multi-billion dollar losses in an economy with at best a $40 billion GDP) and Russia’s MMM affair a year later (in which millions of shareholders lost their wealth). As in the rest of the world, the designors of SAPs have been blind to such risks and have only recently begun to push for regulation of internal and external financial markets. If a Chile- or Mexico-scale financial crisis erupts in Russia, the implications for global political stability could be grave.

Sub-Saharan Africa

A few words should be added about the plight of sub-Saharan Africa, where only a handful of more than 40 economies have positive per capita income growth. The region has been under intensive BWI care now for more than a decade, with minimal returns even though many countries are receiving capital inflows on the order of 10% of GDP (not a large sum in absolute terms for a nation with, say, 5 million people at a per capita income of $300).

No one has a clear solution for Africa’s weak economic performance. Historically, "surplus extraction" from export agriculture to benefit urban-based industrialization was an important element of the region’s development strategies after World War II (Jamal, 1993). Although there were substantial internal resource transfers, several factors supervened to make the strategy unsuccessful.

Externally, trends in the export terms of trade for the food, beverage, fiber, and mineral exports it produces were consistently unfavorable. Internally, lack of investment in infrastructure and technological improvement hampered agricultural output growth while industrial strategies did not bear fruit. More recently, there have been continuing adverse shifts in the terms of trade, escalating interest obligations on its external debt, and donor proliferation. As described by Killick (1993) "... the volume of work in servicing ... negotiations [with donors] is colossal. The potential opportunity costs are hence large, especially since the brunt of the work is often borne by the same small group of key economics officials who would be best qualified to advise the government on economic policy if only they had the time."

Beyond excessive cross-conditionality and imposition of negotiation burdens, the Washington approach to policy creates other problems. First, if neoliberal policies take an extended period of time to work in places like Chile and fall apart in Mexico and Turkey, what is their promise for Africa? At the moment, African "success" cases like Ghana are basically being held afloat for demonstration purposes by continuing aid inflows. They finance intermediate imports to support selected investment projects and keep production going. Needless to say, these incoming loans are piling up substantial interest obligations for the future; in other words, a repayments crisis for offical debt is beginning to loom while private investment flows remain at levels of a few percent of GDP. World Bank initiatives in 1995-96 to roll over or "forgive" the bulk of this debt are more than welcome.

Second, until recently when it cut back on loans for additional production of tropical beverage crops, the Bank pushed all African countries to expand their primary product exports, even though an enhanced global supply of such commodities is bound to drive down their prices. Failing to recognize this "fallacy of composition" -- a staple of elementary economics courses -- is another example of how the BWIs can be slow learners. An easy thing for them to do would be to put resources into schemes via which collaborating national commodity producers could regulate and restrain supply to stabilize primary commodity prices at "reasonable" levels, although their liberal principles may preclude it.

Finally, as we will see in discussing South Korea, concerted state intervention in that economy was an essential part of its development strategy. Such an approach might well be inappropriate in Africa, for a variety of reasons. However, the degree of Bretton Woods control in the region is so great that no nation would be permitted to attempt the Korean model, even if a democratically chosen national leadership wanted to try it.

South Korea

One conclusion from these vignettes is that when SAPs put an economy on a path of sustained output growth (as they finally did in Chile), they do so thanks to contingent events and a dose of non-orthodoxy. By creating conflicts (at least latently and sometimes actively) and financial speculation as opposed to real investment, they run a strong risk of failing as in Mexico and Turkey, while the Eastern European experience demonstrates the rapid market liberalization can lead to medium-term stagflation as opposed to growth. In all cases, high interest rates to lure in foreign capital and a strong exchange rate to facilitate a trade deficit to accommodate the capital inflows make the prospects for investment-led expansion that much worse, and financial fragility is an ever-present danger.

Morals for alternative approaches to policy can be drawn from these observations. Before turning to them, however, it makes sense to address our first question above -- have successful developing economies generally adopted the Washington model? In one important case -- that of South Korea -- the answer is clearly "No" (Amsden, 1989; Chang, 1993).

Korea’s development strategy was consistent over several decades, emphasizing capital formation and technology acquisition to build production capacity. It did incorporate such orthodox recommendations as prudent fiscal policy and a stable, not overly strong real exchange rate. However (contrary to the interpretation in the Bank’s East Asian Miracle report) these "functional" policies were aggressively combined with "selective" actions to protect the domestic market, hold down consumption, and target credits via a nationalized banking system toward production sectors deemed "priority" at any time.

The state also intervened to support investment demand to mobilize the saving that its tight fiscal policies and consumption restraint created. Inflation was kept in check by targeted wage and price controls. Finally, distributional equity was maintained by devices such as farm subsidies supported by tariff barriers and consistent pass-throughs (at rates greater than zero but well less than 100%) of productivity gains into real wage increases.

Industrial strategy was pursued on several fronts. A theme continually developed in official documents was that "the market mechanism cannot be entirely trusted to increase competitive advantage by industries," so that branches likely to enjoy high productivity growth and/or income-elastic demand were to be promoted as "promising strategic industries" (Chang, 1993). They were given custom-designed financial, technical, and administrative support.

Corrective feedback to the selection process was provided by ongoing, broad reporting of activities of "priority" firms to the government. The economic bureaucracy thus had access to detailed business information, which proved essential for effective industrial policy. It used its acquired knowledge to weed out inefficient production operations in successive waves of rationalizations, mergers, and liquidations. Individual conglomerate firms (the famous chaebols) were clearly subject to discipline, even though as a group they had privileged access to state resources. Noise and static in dealings between the state and producers were reduced by the fact that large, centralized organizations were engaged on both sides of the dialog.

Second, intense effort was devoted to acquiring technology (a huge public investment in education was economically mobilized exactly in this fashion). Direct foreign investment was strictly regulated while foreign technologies were banned in sectors in which domestic counterparts were available. Firms were pushed into reverse engineering, along with licensing and purchase of technologies not available at home -- all under bureaucratic guidance.

Third, there was a constant emphasis on attaining economies of scale.

This goal was reflected in many mergers of small firms initiated by the government, e.g. in the chemical, automobile, fertilizer, and other sectors. Entry and capacity expansion were regulated to curtail "excessive competition" in the form of big swings in investment and price wars in industries with decreasing costs.

Fourth, within the generally expansionary macroeconomic environment, credit allocation was aggressively practiced (aided by tight foreign exchange restrictions). "Policy loans" with subsidized interest rates and/or priority rationing accounted for over half of the loans granted by the state-controlled banking system in the 1960s and 1970s.

These features of Korean industrial planning suggest several conclusions relevant elsewhere. One is that there can be a bargaining solution among the state and enterprises to restrain rent-seeking, with rapid output growth and the government's power to punish recalcitrants in the background. Rents were certainly created for the chaebols by their privileged position, yet they became production powerhouses and not leeches thriving on public largesse.

The economic bureaucracy was an essential Korean player. In contrast to BWI staff members flying in, in Polanyi's fashion it was "embedded" in the society (Evans, 1995). It could act autonomously for the public good as it saw fit, without completely being taken over by patronage and rent-seeking. Planners often sacrificed short-term allocative efficiency ("getting prices right" along Washingtonian lines) to attain long-term productive efficiency or rapid productivity growth.

Finally, the institutional basis for the Korean miracle was invented over a relatively short time. Chaebols, trading companies, the planning bureaucracy, and the macroeconomic policy mix all emerged in the early 1960s in a creative burst. Obviously, such institutions cannot be transferred without modification to other national contexts, but partial functional equivalents could prove relevant elsewhere.

The Korean Crisis of 1997

Given its successful production system, why then was South Korea hit by a huge external shock in late 1997? The answers will be hotly debated for years, but Chang (1997) argues that they may well center around a badly designed attempt at liberalization. His analysis goes as follows:

Korea's "fundamentals" in 1997 were far sounder than Mexico's three years before. The won was overly strong, but even so the current account deficit was only about 3% of GDP. Furthermore, most foreign loans were financing investments in export sectors rather than speculative asset positions and imports of consumer goods, as was the case in Mexico. The Korean budget was largely in balance and gross public debt amounted to only 3% of GDP. There was little significant inflationary pressure. The main substantive change from the past was government emphasis on "deregulation," undertaken in part from intellectual conviction but also in response to international (especially American) pressure.

In one key area, the government abandoned its traditional role of coordinating investments in large-scale industries to avoid "excess competition." It allowed excess capacity to emerge in sectors such as automobiles, shipbuilding, steel, petrochemicals, and semiconductors, which eventually led to a fall in export prices and a run up of nonperforming loans.

Second, in the name of financial liberalization, the government failed to monitor foreign borrowing activities, especially by inexperienced merchant banks. This resulted in a rapid buildup of $150 billion of external debt, with 60% of the obligations having less than one year to maturity and over 25% at 90 days. The major similarity with the Mexican crisis lies here -- the private sector acted in destabilizing fashion while the government had its fiscal house in order.

Third, the authorities were sold on the ideas that inflation control was the most important objective of macro policy and that the exchange rate should be the principal anchor. The predictable real appreciation damaged export performance.

Finally, the government committed "mistakes" and suffered a run of bad luck as its economic troubles worsened. It dithered over the fate of the third largest car manufacturer, Kia, unnecessarily undermining confidence. As the crisis grew, it wasted $10 billion (more than one-third of foreign reserves) trying to defend an indefensible exchange rate, exacerbating the foreign exchange shortage. External events also came into play. Southeast Asia’s doldrums reduced demand for Korean exports and dealt a blow to financial companies which had been speculating in that region’s capital markets. The entrance of new Taiwanese semiconductor manufacturers drove down the prices of memory chips, which accounted for nearly 20% of Korean exports when their prices were high. But the main problem was a failure of oversight by a government priding itself on deregulation.

The IMF package the Koreans were forced to accept at yearend came with the usual fetters. Its contractionary bias made the credit crunch that firms were already facing even worse, leading to a chain of bankruptcies and possibly driving the economy toward depression. In previous crises such as the one from external bank debt in 1982, the Koreans had actually expanded credit. The IMF’s 5% inflation target was already too strict, given that the economy had to deal with a big rise in import prices due to devaluation; with the excess liquidity released by financial sector bailouts and the further depreciation likely, 5% inflation looked unattainable. Consequently, in a common problem with Fund packages, nominally set fiscal targets would become tighter in real terms than had originally been foreseen.

More worrying than the contractionary bias of the program was the IMF’s insistence on financial liberalization. Bad debt abounded, and needed to be cleaned up along Chile’s early 1980s lines before the banks could be granted more freedom. The Fund also wanted a quick opening of financial markets to foreign participation, potentially exposing the economy to high volatility and the enterprise sector to politically risky external takeovers. Washington's Christmas Eve bail-out package protected (among others) US banks which had been lending to Korea at the cost of an increased debt burden for the nation, but that's a familiar story.

Together with a sharp expected increase in unemployment over 1998, these developments were leading to widespread talk of national humiliation and foreign trusteeship. One possible outcome is that the IMF program will be met by massive social resistance. As this is being written in January 1998, Korea's economic and political future is in jeopardy, largely because of a misguided attempt to restructure its economic system along neoliberal lines. The problem that its newly elected government faced was how to circumvent the Fund and reinvigorate the coordinating and regulatory mechanisms of previous regimes without their negative features such as corruption, nepotism and growing bureaucratic rigidity. Meanwhile, it had to keep the private sector's tendencies toward cutthroat competition and destabilizing financial behavior under control. In a globalized economy, more than just their own country's fate may ride on how successful the Korean authorities turn out to be.

Policy Outcomes and the Distribution Matrix

To summarize, Korea shows that the state can effectively intervene in the economy -- at least until it abandons its previous principles. The examples discussed earlier suggest that an attempt by the authorities just to stabilize, liberalize, and privatize so that all economic decisions will be taken by the market can backfire for reasons not just confined to the sphere of economics. The more unfavorable consequences include the following:

Contractionary, possibly inflationary impacts of stabilization efforts which can hold down output growth rates for extended periods of time -- overkill, in the jargon.

Badly unbalanced relative price structures, especially in the wake of exchange rate-anchored attempts at stabilizing inflation coupled with external liberalization: high domestic interest rates, overvalued exchange rates, reductions in the purchasing power of the real wage combined with labor cost increases in the traded goods sector.

Financial instability, often centered around stock markets which have been created to accompany public enterprise privatization. This fragility is exacerbated by violent movements of external capital in and out of the local economy via a liberalized capital account.

Visibly increased corruption, even though liberalization is supposed to abolish rents arising from state intervention and associated rent-seeking.

Rising unemployment and/or regressive income redistribution and deeper poverty which in some cases have provoked political reactions strong enough to derail BWI adjustment packages completely.

All these are problems which market friendliness is supposed to overcome. In their presence, what sorts of political coalitions are likely to back economic reform? In Chile, Mexico, Turkey, Eastern Europe, and elsewhere, a Washington style policy mix has been supported by the Bretton Woods institutions and other foreign actors, industrialists in a position to gain from liberalization and an export push (by no means comprising the total of national firms), financial speculators, households in the top 10-20% of the income distribution who can afford an ample array of new consumer goods in a liberalized trade regime, and a local economic technocracy which put the new policy packages in place.

The losers included people in the bottom 80% of the distribution, some important industrialists, and old political elites. When all the problems just mentioned began to rear their heads, the reform coalition came under pressure. Observed political outcomes have differed according to circumstance, and surely will change over time. It is safe to say that the political economy of all reforming countries remains highly uncertain, especially when mounting social tensions are brought into the discussion.

Reforming the Institutions

What can the foregoing institutional and country descriptions tell us about prospects for reforming the BWIs? As has been observed, there have been recent improvements in the policy stance: recognition of the importance of at least functional public interventions and the need to provide supporting revenues; growing but still inadequate realization that controls on external capital movements and prudential regulation can help contain financial fragility; abandonment of the doctrine that raising the local interest rate will stimulate saving and thereby growth; initiatives to roll over or forgive the bulk of official debt owed by the poorest economies. Whether there will be further steps toward policies truly supporting economic development will depend on political and ideological conjunctures.

The major shareholders of the Bank and Fund are the nations comprising the G-7 (or more to the point the G-3 or the G-1 made up of the United States only). Their management of the institutions demonstrates that they are committed to the principle of conditionality; hence it will remain. This is one "given" which has to be accepted in considering ways to improve the performance of the BWIs. History also strongly suggests that the agencies will not be granted large increments in their resources relative to the size of the world economy. As will be noted, however, it would make sense to extend their financial base selectively in certain directions.

Perhaps less securely given is the present trend toward globalization of financial markets, which among other developments underwrites the huge capital flows which have gone to Turkey, Mexico, economies in Asia, and elsewhere. Along "double movement" lines, a serious question arises as to whether private capital markets can be counted on to supply finance to developing countries reliably in the long run. Kindleberger (1985) pointed out that there have historically been 20- to 40-year cycles in lending from rich nations to poor colonies or countries. In this century, there were flows of bond finance to Latin America in the 1920s and the bank loans of the 1970s which led to the debt crisis. Now fresh money takes the forms of direct foreign investment and portfolio allocations by mutual funds. In all previous cases, there was a wave of "loan-pushing" followed by "revulsion" as the market turned soft.

Of course, this past pattern need not recur -- whether Mexico ‘94 and Asia ‘97 are precursors of greater financial turmoil or just aberrations remains to be seen. But there is at least some chance that developing and post-socialist economies will face a wave of revulsion over the next few years. If it occurs, then the Bretton Woods institutions will be virtually the only sources that they can tap for credits in hard currency. Specifically, the Bank could enhance its role as an intermediary between developing country borrowers and global capital markets. The Fund could dust off its long-underutilized machinery for creating SDRs to the benefit of debtor countries, a proposal frequently mooted but never addressed seriously over the past 25 years. More radically, one could think of means for "disciplining" economies with chronic trade surpluses, even though such notions were dropped from serious policy discussion even longer ago.

Another not-so-given may be the ideological underpinnings of the Washington consensus -- a piece of patchwork with straining seams in the best of cases. The Fund will presumably hew to its demand-limitation package, which does improve a country’s external position once it gets into trouble. But after the IMF applies its performance criteria and conditionalities, will it and the Bank relax their insistence on neoliberal verities which often don’t seem to apply? Can the two institutions be pushed in new directions?

Such changes are more plausible for the Bank. Its governance runs from the top -- the President has great reserved powers and if he or she does not wield them then activist Vice-Presidents can. The Fund is more hermetic and staff-driven, and its policy focus far narrower. Even so, when it has had more resources on hand, conditionality has been correspondingly less draconian.

Beyond the institutions, forecasting politico-ideological trends is an even less exact science than economics, but perhaps some leeway will emerge. The background is that over five decades, the rich countries have pushed consistently for increased integration of poor countries into the world economy, for reasons discussed above. In the earlier decades there was more tolerance for planning and "developmentalist" states like those in Japan and South Korea, with neoliberalism being the recent trend. Conceivably, the range of acceptable policy behaviors could swing back to include more dirigisme, especially if market friendly packages continue their unexpected delivery of slow per capita income growth (true believers, both inside the outside the BWIs, really thought that the outcomes would be different). If the ideological (and to a degree, the rich country interest) constraints are relaxed, there are obvious modifications to the Washington package which have been suggested, many by developing country economists (for example in the papers collected in UNCTAD, 1994):

First, there could be much less conditionality -- less nit-picking by the Fund and a full scale withdrawal by the Bank from micro-management of investment projects and price formation via its policy matrixes. Certainly in Latin America and Asia and increasingly in Africa, country economic teams are better qualified technically than the lower rung PhDs from American and European universities to whom the BWIs entrust their missions. Local economists can run through financial programming and the Bank’s standard macroeconomic model (known as the "revised minimum standard model" or RMSM) as well as or better than the people from Washington can; they also know how to do investment project analysis. They should be given a chance to apply their knowledge of their own economies to the fullest extent.

Indeed, it might make sense to institute "reverse conditionality" in which countries would propose economic programs to the BWIs, instead of the other way around. Disagreements between BWI staff assessments and those of the country concerned could be resolved directly, or conceivably via mediation or arbitration by management or third parties (teams of independent economists with experience in developing countries have been proposed for the latter function). The scope of macro conditionality could also be restricted, for example just to a balance of payments target while the country could pursue its own agenda regarding inflation, income distribution, and growth.

Second, BWI resources could be extended and redeployed toward their original intent of supporting countries in difficulty with the external account. Specifically, efforts could be devoted to providing long-term and cheap (in terms both of the interest rate and degree of conditionality) finance to countries exporting raw materials and widely traded agricultural products, in Africa and elsewhere. A tax or voluntary contribution along the lines of the "Okita plan" for recycling Japanese trade surpluses (Okita, et.al., 1986) could usefully be deployed to such ends.

Given their downward international price trends since the 1970s, trade specialization in primary products appears to be a dead-end street for countries lacking the endowments necessary to produce a diversified and widely demanded primary product mix (as do Malaysia, Chile, and Brazil). But that does not mean the street is easy to back out of. Financial and technical opportunities for export diversification should be provided, if only because rich countries forced their trade specializations on many poor countries in the past, and benefit from their continuing enslavement to low commodity prices. The Third and Second Worlds would also benefit greatly if steps were taken to restructure the commercial debt overhang from the 1970s, for once and for all. With regard to debt from official sources (mostly owed by very poor countries), the recent write-down proposals originating from the Bank are a development full of hope.

Third, over the past couple of decades the BWIs deserve credit for making countries aware of the dangers of fiscal imprudence and the benefits to be gained from alleviating balance of payments restrictions by aggressively pushing exports (ideally not of primary products!). They have pointed out that growth may be retarded if prices such as the agricultural terms of trade and real exchange and interest rates are extremely distorted. At the micro level, they have aided enterprise reform.

All these are positive steps, but they have to be offset against the institutions' errors as catalogued above. Spokespersons for the Bank and Fund claim that they have "learned" from their mistakes. Within their hierarchical, structured bureaucracies, many staff members do push for changes in the institutions' neoliberal policy stance, at times putting their own careers at risk. However, there is a fundamental contradiction in the way that the BWIs respond to their errors. They don't pay the costs.

A staff member flying business class back to Washington in a chastened frame of mind represents one sort of personal response to a market liberalization attempt which collapsed; a local health worker trying to help malnourished infants recover from the effects of a drastically lower national income is quite another. In the between-World Wars "calculation debate" about the merits of central planning, von Mises (1935), a patron saint of neoliberals, criticized socialism on the grounds that "as if" planners could never improve upon capitalism because they would just "play" a market game without being disciplined for their mistakes. The same doubts apply to

Washington-based bureaucrats "playing" at running national economies with their attention focused on career advancement in the institutions back in the United States.

With regard to research and the intellectual debate more generally, creation of alternative centers of thought about developing and post-socialist economies are essential to break the Washington near-monopoly. Relatively isolated university and United Nations researchers cannot match the Bretton Woods' big batallions, not to mention their access to centers of power and the media. A well-managed United Nations-wide research effort could help redress the balance. Given the diversified and under-funded nature of the UN, however, such an initiative would have to be paid for and aggressively pushed from the top. Since the days of Dag Hammarskjold, Secretaries General (and their bosses in G-3 governments) have been unwilling to undertake such a task.

Finally, there is a lot to be said for decentralization. BWI staff are grossly overpaid in comparison to their counterparts in developing countries and earn more than Ivy League professors. When on missions they interact with each other more than with the economists of the country they happen to be visiting, and they communicate virtually only among themselves in the office.

Why not use the BWIs' huge salary base to send one or two thousand professionals from each institution to work at the country level, earning generous local wages while undertaking relevant research and participating on equal terms in national policy debates? The benefits from intellectual stimulation and cross-fertilization of ideas could be enormous in comparison to bureaucratic self-absorption in Washington DC.

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