REFORM OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

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In the year that has passed since this Committee met to discuss this subject matter, we have descended from the realm of theory to the flesh and blood world of political economy in which theory has real consequences. The event that illustrates this truism is Argentina.

Because the crisis was so long in developing, the financial markets have had time to absorb the Argentine financial default without significant consequences for other borrowing countries. In other words, financial contagion has been contained. We can then consider how to think about the lessons of Argentina in other than crisis conditions for the international financial system.

And yet Argentina remains in my opinion a watershed event. It conclusively demonstrates (i) the hollowness of the Meltzer Majority report of the Congressional Commission on International Financial Institutions (the Commission) recommendations for reform of the IMF; (ii) the limitations of the IMF/World bank neo-classical economic paradigm, what Joe Stiglitz, the former Chief Economist of the World Bank, and a recent Nobel prize-winner in economics, has referred to as market-fundamentalism, slightly modified in recent years as the Washington Consensus Lite, that has governed development thinking for the past fifteen years; (iii) and the excessively economic mind-set of both the Secretary and Under-Secretary of the Treasury, Messrs Paul O'Neill and John Taylor.

The Treasury proposal for additional grant funding for the IDA, the World Bank soft loan affiliate for dealing with the poorest of poor countries, while superficially appealing, as presently formulated by the Treasury, is ill conceived, impractical and probably harmful to any sustainable financing for development in the poorest countries. I would be glad to respond in more detail to questions on this subject, but in this testimony I will concentrate on the Argentine case as illustrative of the above three theses.

THE MELTZER MAJORITY RECOMMENDATIONS FOR THE IMF

The heart of the original Meltzer Majority proposal is to divest the IMF of discretionary authority with respect to conditions that attach to member country access to IMF financing. Such financing, after a suitable transition period, is made conditional on pre-qualification of countries: only countries with financial banking systems that have previously determined to be "sound" are eligible to draw upon IMF funding; key to assessing the soundness of the system is the openness to foreign investment, which, according to the Majority, is a guarantee against unsound crony capitalism in which financial decisions as to the allocation of credit are made on the basis of criteria other than arms length credit analysis. According to the Meltzer Majority, it was that crony capitalism which was the principal cause of the East Asian financial crisis of 1997-8.

Fred Bergsten, who came late to the Commission's deliberations, immediately identified the flaw in the proposal: a country with a sound banking system but unsound macro-economic policies would automatically be eligible for IMF funding but without any conditions that addressed the underlying policies that necessitated recourse to the IMF. In recognition of the validity of the Bergsten critique, the final report of the Majority contained a few sentences referring to the need for a sound macro-economic framework as an additional pre-condition for IMF financing.

Argentina takes the issue out of the realm of theory and into the real world of policy-making in imperfect circumstances. Argentina not only opened its banking system to foreign capital; it permitted the complete sale of the previously Argentine owned banks to primarily American and Spanish financial institutions. There are no banks of any stature any longer majority owned by Argentine nationals.

Nor are there any local cronies of any consequence to whom the banks can lend. Argentina has sold the previously state owned water, telecommunications and utilities to foreign capital, primarily state owned Spanish and French companies, a process less privatization than de-Argentization; the previously state owned petroleum company, YPFB, has been auctioned off to a combination of domestic private and foreign capital; similarly, Argentina has divested to private capital the previously state owned railroad system. The signature industry of Argentina–the meat- packing companies–have been sold to the major international groups in the industry: today there is no Argentine national owned meat-packing company of any size or importance. In light of this record, the statement by Secretary O'Neil that Argentina has not carried out significant economic reforms is simply incredible.

Argentina, which for most of the decade of the 1990's, had been acclaimed as a star of the international financial system, the country in Latin America, even more than Chile, which had most enthusiastically embraced the neo-classical economic paradigm promoted by the IMF/World bank and U.S. Treasury–privatization, openness to foreign direct investment, reduction of the role of the state in the economy--finds itself in intense negotiations with the IMF in the midst of a profound economic depression.

A country cannot be frozen in time. Conditions change. Policy may not adapt. A crisis ensues, requiring the country to recur to the IMF for assistance, precisely the circumstances envisioned for IMF intervention. The need for judgement as to the appropriate policies to address the situation cannot be evaded. Argentina puts paid to the Meltzer Majority theory that recourse to the IMF can be automatic in accord with pre-established criteria, IMF judgements and conditions no longer relevant. The issue remains: what are the criteria for IMF assistance?

THE IMF AND ARGENTINA: POLITICAL ECONOMY VERSUS ECONOMIC TECHNOCRACY

Because the Meltzer Majority went off on the tangent of pre-qualification as a condition for automatic access to IMF resources, the Commission lost a great opportunity to illuminate and provide guidance for the Congress on this central issue of IMF operations: conditionality. For, if there was one issue on which **all** members of the Commission concurred, it was that IMF conditionality had become too intrusive and had expanded into areas in which the IMF staff had little or no comparative advantage.

That view was not limited to the Commission. A Council on Foreign Relations Task Force on which Commissioner Bergsten served came to the same conclusion. And the new Managing Director of the IMF, Mr Horst Kohler, gave every indication that he recognized the validity of this concern and wanted to return the IMF to a more traditional strategy of dealing with macroeconomic policies which is its area of expertise.

At the same time, there were profound differences within the Commission over the degree, if any, to which additional issues such as core worker rights, and, more generally, human rights, as well as income inequality, should be an integral part of the policy framework which is the necessary pre-condition for financial assistance from the Bretton Woods Institutions. The degree to which this is feasible or desirable is, in my view, the central issue in any discussion of the future of these institutions, and U.S. policy with respect to them. Despite extensive, and I would say illuminating in depth testimony on such issues as core worker rights and the importance or lack thereof of income inequality, you will find no discussion at all in the Majority report of these issues.

Again, Argentina brings the discussion down from the level of the merely theoretical to the often excruciatingly difficult decisions involved in policy-making in the real world of political economy. The history of the currency board arrangement in Argentina in which the peso was linked to the dollar in a one to one relationship has been too much commented upon to require any extensive recapitulation here. Suffice it to note (i) the arrangement was not imposed upon Argentina but decided upon by the government of Carlos Saul Menem and his Minister of Economy, Domingo Cavallo in the early 1990's for the purpose of bringing a raging hyperinflation to a halt; (ii) it largely achieved the objective and therefore initially had broad support in Argentine society; (iii) it also divested policymakers of any discretionary decision making authority with respect to the level of economic activity in the country which was determined by the amount of dollars available to the government from export earnings and international borrowing to back each peso in circulation; (iv) the currency board arrangement therefore was market-fundamentalism carried to its logical conclusion: the level of economic activity was vested in the financial markets, creating a powerful incentive for international borrowing; (vi) with the peso linked to the dollar in such a direct way, a strong dollar constituted a disincentive for Argentine exports which became uncompetitive, especially after the Brazilian devaluation of the real, the major trading partner for Argentina; (vii) the result was that the debt to export ratio became increasingly unsustainable and the international financial markets closed to Argentina.

Whatever the original purpose served of the convertibility plan, as it is known in Argentina, and in Argentina it did initially have a purpose, once in, there is no good way out. Not the Argentines, nor the IMF, nor anyone else for that matter, had an exit strategy. Indeed, the discussions in late 2001 between Minister Cavallo, who had been recalled as Economy Minister by President Fernando De la Rua , the successor government to Menem, and the IMF assumed a surrealistic character: the IMF staff realized that the convertibility plan was no longer feasible, but Cavallo, the author of the plan, denied that there was any problem with the arrangement, only market ignorance which could be overcome by IMF financing, which was not forthcoming.

Determined to maintain the convertibility plan at any cost, the De la Rua government proposed still further austerity measures in face of a four year recession/depression and 22 percent unemployment. Argentine society rose up in revolt and drove the De la Rua Government from office. Most comment in the U.S. has focused on the convertibility plan as the main culprit in the Argentine drama. The Washington Post, for example, held that the Argentine government stuck with the convertibility plan too long but that there was nothing inherently wrong with the market liberalization strategy.

I disagree. The market liberalization strategy which Argentine followed since the early 1990's, strongly supported by the IMF/World Bank and U.S. Treasury was fatally flawed in two other respects: the basic theory of the IMF/World bank neo-classical economic strategy is that as the public sector is diminished in economic importance, a dynamic, export oriented industrial sector provides the motor for growth and employment but this did not happen in Argentina . Without a strong productive public sector to complement it, the private sector could not perform the role envisioned for it. Even in the years of relatively high economic growth in the mid-90s, unemployment never fell below 13-14 percent. Rather, throughout the decade of the 90's, the public sector was denigrated by both the Argentine governing authorities and the Bretton Woods institutions.

Since, under the convertibility plan, relative international prices could not be adjusted through the exchange rate, pressure mounted on the part of the IMF/World Bank for a more direct attack upon the cost structure of Argentine industry, particularly labor costs. The Menem government embraced the strategy. Strongly supported, indeed egged on by the Bretton Woods institutions, the Menem government tried to shift the balance of power between labor and capital in collective bargaining arrangements decisively in favor of capital.

The social gains for Argentine workers of the past fifty years were at risk. The basic compact in Argentine society through which the formerly despised working class, the descamisados, the shirtless ones, were integrated into Argentine society, in the age of globalization, was now declared too expensive. The unions reacted with fury, leading to general strikes of varying degrees of effectiveness and an increasingly embittered and disaffected working class.

Not strong enough by themselves to bring down the government, in December 2002 they were joined by an important part of an increasingly impoverished middle class, seeing no way out except more austerity, unemployment and loss of status. In both that middle and working class the economic model of the past decade was perceived to have disproportionately benefitted a small elite linked to international capital and business, widening income inequalities in a country which had not previously been notable for the exaggerated income disparities that permeate other societies in Latin America.

It is not too much to say then, that what is at stake in Argentina today are not merely economic policy choices, important as they are, but confidence that such choices can be made within the framework of representative political institutions. That is the situation which the government of Eduardo Duhalde faced when it came to power after the December 2001 political upheaval that dislodged from power both the De la Rua government and its immediate successor.

The best way, in my opinion, to understand the Duhalde government is to see it as the contemporary counterpart of FDR in 1933. FDR campaigned in 1932 on a platform of a balanced budget, but changed direction when convinced that such a policy followed by his predecessor, Herbert Hoover, would only deepen the depression and unemployment; he embraced the Keynesian prescription of using government spending to prime the pump and restart economic growth. This policy reversal was only one of a series of often bewildering stops and starts in economic policy-making as the Roosevelt Administration by trial and error experiments, determined what would work and what would not, what the political system could bear and what were the limits of social tolerance.

It had the great advantage, however, of not having an IMF and O'Neil Treasury looking over its shoulder. If asked to produce a coherent policy from its inception, it would have dismally failed; all of the creative energy which gave us the New Deal would have been strangled at birth. Indeed, it would have been told that social security was unacceptable and only private investment accounts could gain IMF/World Bank approval. The Wagner Act would probably have been rejected as an undesirable intervention in the labor market where the preferred objective of labor market policy should be not to diminish the disparity of bargaining power between individual workers and firms, but to maximize that disparity in favor of capital.

Duhalde faced with a similar crisis of confidence in the governance system itself has responded, like Roosevelt, with a trial and error approach. Confronted with the immediate issue of how to exit from the convertibility plan, the Dhualde government initially proposed a dual exchange rate plan, but then withdrew from it when faced with international and domestic criticism of its feasibility.

The Duhalde government has tried to allocate the burden of adjustment in Argentine society more equitably, placing the highest costs upon the foreign owned banks and utilities, who bought them on highly favorable terms: captive, monopoly market; repatriation of profits without limits; fixing tariffs in dollars, with an index linked to the U.S. inflation rate and virtually nonexistent state regulation or controls. Consequently, the majority of concession holders in recent years obtained high profits, in comparison with other Argentine companies and similar industries in other parts of the world. Duhalde is obviously gambling that the French and Spanish investors have too much at stake not only in Argentina, but also more generally in Latin America to walk away from their Argentine investments.

In political terms, although not popularly elected but selected by the Congress in accordance with the law and constitution, he has crafted a broad based government; supported by former President Raul Alfonsin, who was the first elected post-military President, and represents the more nationalist small and medium industry and public sector employees, he has recruited an important part of the Radical Civic Union Party to complement his own Justicialista (Peronista) party; additionally, he has incorporated members of the Frepaso center-left coalition that tried to offer an alternative to the two great traditional powers, the Radicals and Peronistas.

Duhalde, if not enthusiastically supported by the majority of the unions affiliated with the CGT, the Argentine confederation of Labor, can count on their tolerance because they know that the alternative of deeper market reforms will devastate them still further than has already occurred; similarly, the small and medium entrepreneurs know, like the unions, that the Duhalde/Alfonsin combination is their only salvation.

And Duhalde has departed from the top down Argentine style of governing: in a weekly radio address, in which he also answers call-in questions, he has not minimized the hard choices for Argentina. Not quite the fire-side chats of FDR, in Argentine terms they are a major innovation in participatory democracy.

The respected senior Justicialista politician, Antonio Cafiero, observed that the Duhalde administration was not only burying the convertibility plan, but the economic model of the past decade. That statement set off alarm bells in Washington and the Duhalde team has backed off from Cafiero's defiant observation, but it represents an accurate expression of the anger at and desire for an alternative to the neo-classical economic model attempted to be implemented in the past decade

The Duhalde government has finally forged an agreement with the provinces on revenue sharing and provincial expenditures, but has not yet obtained Congressional approval of a budget. We can expect hard bargaining in the Congress and probably considerable back and forth in economic policy making direction. What Duhalde is trying to do is create an economic policy which responds to the demand of a broad swath of Argentine society for a policy that more explicitly takes into account the income distribution effect of policy, minimizes rather than exaggerates income disparities, and preserves as much as possible of the social gains of working class Argentina so as to avoid creating a permanently disaffected urban working class.

Understood in these terms what he seeks to accomplish is not dissimilar to the task that confronted FDR: to assure Argentine society that within the framework of representative political democracy and a market economy there is room for a policy alternative that explicitly seeks a more just society and not just economic efficiency at the sacrifice of equity.

What then has been the response of the IMF and the U.S. Treasury? They demand of the Duhalde government that it adopt Herbert Hoover economics: in the midst of a devastating economic depression with unemployment approaching 25 percent, they seek budget cuts, labor market flexibility reforms to weaken still further urban trade union bargaining power, and a "coherent" economic plan, which apparently means assurances that it will not depart substantially from the prior neo-classical economic model followed by the predecessor Menem and De la Rua governments.

They are impatient with the messy and time consuming give and take of negotiation between the center and the provinces over revenue distribution and expenditures, that is to say with representative democracy in a context of agonizing choices. They are indifferent to the income distribution effect of the policies they advocate. There is no indication that they understand that the collective bargaining regime in a country grows out of the history of labor relations, often beset, as in Argentina, by past sharp class conflict.

The Deputy Managing Director of the IMF, Anne O. Krueger, in the midst of an economic depression, unemployment in the 25 percent range and unused spare capacity in the industrial sector, warns of hyperinflation. Surely, if the Duhalde government were to monetize the deficit without adding to capacity, as demand increases there would be a risk of inflation further down the line in perhaps a year. But hyperinflation in the midst of economic depression, massive unemployment and a consumer goods industrial plant with substantial underutilized capacity?

In a country with a history of inflation like that of Argentina, the caution of the Duhalde government is understandable, but I confess to being baffled as to why the Argentines have not requested and obtained a $1 billion credit from the IDB for small and medium enterprises. Unlike Salvador Allende in Chile in 1972/3 and Alan Garcia in Peru in the 1980's, the Duhalde government has the confidence of that sector; he can demand of them that as profits increase with employment and demand restored, they invest in additional capacity rather than send the money out of the country as occurred in similar circumstances with Allende and Garcia. But what I think is less important than that the Duhalde government formulate a policy in which they–and Argentine society-can have confidence and which reflects the Argentine social and political reality.

For years, the IMF staff from the top on down has been trying to convince critics that it does not have a cookie-cutter approach in which one size fits all. Yet, we are now told that it is bringing in a new lead negotiator for the Argentine negotiations from the Asia region, an individual–and team-- with no background in the region, unable to speak the language, ignorant of the history, culture, and all of the complex bargains, formal and informal, that make up a country's social compact.

Apparently the IMF feels the need to be tough because of past failures of Argentine governments to fulfill commitments, but those failures are also a reflection of an unreality among the IMF staff as to what the political and social traffic would bear in Argentina. They were so infatuated with the Menem government commitment to the neo-classical model they were promoting they lost sight of the fact that the Menem government had lost its political and social base, a situation replicated with the De la Rua government.

Increasingly, the IMF is coming to resemble the mad-hatter's tea party in Lewis Carroll's Alice in Wonderland: night is day, day is night, white is black, black is white, knowledge is vice, ignorance is virtue.

Nor is this excessively technocratic mind-set mitigated at the political level by a U.S. Treasury leadership that understands that we do not start from ground zero, that there is a history here, an often tragic one at that, and that decision-making in political economy is different from pristine economic theory in controlled laboratory conditions. Instead of a largeness of vision to complement the so far impressive social and political sophistication of the Duhalde government, both the Treasury and the IMF top leadership evidence a small bore mind-set unworthy of the stakes that are at issue in Argentina.

President Ricardo Lagos of Chile contends, it is possible "to fight the region's gravest problem−gross income disparities between the wealthy and vast under classes−without violence and within the confines of the free markets and parliamentary democracies established over the past two decades."

I know that the Lagos formulation of the issue is not generally accepted here in Washington, or in important parts of American academic thinking where income inequality and equity issues are dismissed as irrelevant. We saw that view exhibited in the deliberations of the Commission: Professor Charles Calomiris, a Republican appointee, expressed the majority sentiment : "What I care about is poverty...and I don't care very much about inequality. I don't think it's part of our objective as a Commission to be talking much about inequality." (Calomiris, Transcript, January 4, 2000, p. 78). Or , with respect to core worker rights: " There simply is no basis aside from gross violations of human rights for a country to be told that they cannot participate as a trading partner with the rest of the world...denial of freedom of association and collective bargaining are not such gross violations: they don't come close." (Calomiris, Transcript , December 14, 1999, p. 135). Of course in a capitalist economy, collective bargaining is a critical element in determining the distribution of income in society.

The issue is not confined to Argentina. The research department of the IDB, the oldest and largest regional development bank, in a report last year notes that based upon extensive public opinion polling, despite economic growth, albeit modest in the past decade, 86 percent of the people in the region believe the distribution of income is unjust. The report notes that " income inequality has swept away many of the benefits of recent economic growth for large sectors of society. A prime example of this phenomenom is Mexico. Between 1996 and 1998, GDP per capita increased by 9.7 percent in real terms, which is a spectacular gain... However, poverty barely declined. The huge increase in median income was due entirely to income gains among the richest 30 percent−particularly the richest 10 percent−of the population. " It further notes that, “ [n]o country in Latin America for which data on income distribution are available can boast a decline in inequality”.

Last week, I participated in a workshop on Argentina in Bonn, Germany. At breakfast, a Brazilian participant told me how impressed he was with the comments of a senior former high official of the Argentine government. That individual stated that Argentine had become an “indecent” country in which poverty was now endemic and the gap between the rich and poor had become a chasm. My Brazilian friend observed that the Argentine commentator really seemed to care about such things. In Brazil, he said, poverty has been endemic and income distribution has been among the worst in the world for centuries and no one in the Brazilian elites really cares.

Perhaps these are random unrepresentative comments, but in my opinion they reflect an increasing disconnect between a Washington and American academic elite indifferent to equity and income distribution issues and a social and political reality in much of Latin America in which these issues are increasingly coming to the fore as central political questions.

So, for me, when we talk about reform of the IMF and the World Bank, organizational gimmicks and questions of process take a decidedly secondary importance to rethinking the economic paradigm they are inflicting upon their borrowing member countries.