AN INTRODUCTION TO THE SYMPOSIUM

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INTRODUCTION

In January, 1999, after spending billions of dollars to defend their currency, Brazil devalued the real sending another economy into rapid decline. By March 1999 the problems were spreading to other Latin American economies; by June 1999, Peru, Columbia and Ecuador were experiencing major banking problems due partly to the regional downturn in the wake of the Brazilian crisis and partly to ill-conceived exercises in financial liberalization. The cost of bailing out the banking system in Ecuador is estimated to be 33 percent of the GDP (Financial Times, 30 June 1999). On the surface the growing infirmity of some countries in this region appears to be a continuation of the events that began in Southeast Asia in July 1997 and spread to East Asia and Eastern Europe throughout 1998.

However, these problems are only the latest manifestation of a deeper malaise that has been present since the ascendency and domination in the past two decades of a neo-liberal model within the realm of international policy making. Strategies for developing countries and for transforming former socialist countries have collapsed into a common focus on liberalization, privatization and stabilization that fails to distinguish license from equitable competition, with little regard to the stages, histories, organizational capabilities, and institutional settings of individual countries. The relationship between the various policy components has largely been ignored. Although there has been some discussion in the literature on an optimal orthodox sequence, in the few cases where it has been implemented there is little evidence that it has improved the impact of the neo-liberal model. (See note five.) Frequently, however, emphasis has been on expediency with little regard to issues of systems coordination, regulation and institution building.

Although liberalization engenders shifts in political and economic power the architects of reform failed to concern themselves with the potential implications to the social structures of countries. As Rosefielder argues in his paper, Russia’s transformation has been aimed at the creation of some ideal generally competitive world in which individuals make utility-maximizing choices and firms are atomistic and maximize...
profits in a fully informed world. By abstracting from the inherited power structures, the forces that were unleashed by liberalization and privatization democratized an array of perverse and illegal activities for well-placed elites from the Soviet era. Instead of reversing the microeconomic inefficiencies of the Soviet era, orthodox transformation has exacerbated them by removing the constraints on illegal personal accumulation, rent seeking and various forms of predatory anti-competitive behavior that have kept Russia in a state of hyper-depression for more than eight years.

Under the aegis of the World Bank and IMF (IFIs), some of the poorest developing countries have been floundering. In sub-Saharan Africa, structural adjustment loans began in 1980 in Kenya. By 1993 a total of 35 sub-Saharan countries had implemented structural adjustment programs. Primary enrollment levels have plummeted evolving literacy skills needed for a competitive labor force. Terms of trade have seriously declined in the 80s and 90s. Domestic savings and investment have fallen precipitously, contributing to a decline in GDP per capita (-1.1 percent per annum between 1985-95) and an erosion of domestic demand. Despite the emphasis on stabilization, inflation has actually risen over the adjustment period. Exchange rates have been extraordinarily volatile. Banking crises brought on by ill-conceived exercises in reversing financial repression have led to poorly functioning financial systems. Political instability has risen. Unbridled trade liberalization has encouraged imports rather than investment for production. IFI conditionality has deflected the ability of the state to provide the conditions and incentives to attract private capital [Stein, 1999b]. The development country portion of foreign direct investment to sub-Saharan Africa, excluding Nigeria and South Africa, had fallen to a pitiful 1.3 percent in 1997 from 5.6 percent in 1989. Under structural adjustment foreign direct credit flows to Africa have simply gone from bad to worse. Overall, over the adjustment period of 1984 to 1998, OECD country aggregate net private capital flows to sub-Saharan Africa excluding South Africa were virtually zero (only $79 million) [Stein, 1999a].

The papers in this collection begin to investigate the threads that run through the experiences with transition and reform based on the neo-liberal model. The remainder of the introduction will be aimed at concatenating the themes that run through the diverse experiences and regions.

PROPERTY RIGHTS

At the center of the reform in both developing and transitional economies has been the question of property rights. The classic work on property rights emerged in the 1960s from people such as Alchian [1985] and Demsetz [1964]. They emphasized that private property rights were central to economic efficiency and economic progress. Individual rights to use, sell, and transform property were paramount. Individuals must be free to enter contracts, and those contracts must be enforced. While there might have been some recognition of the potential abuse that could arise from the concentration of assets in a few hands, this did not seem to prevent others from inferring that any private property rights were better than state ownership.

This view of property rights has greatly influenced World Bank and IMF policies. The emphasis on private ownership and the protection of private property rights has been at the core of the neo-classical strategy in both developing and transitional economies. Rapid privatization and deregulation and the security of property rights provide the incentives for entrepreneurs to undertake developmentally enhancing activities. The axiomatic belief in the superiority of private property in all circumstances has been firmly entrenched in the strategies used in transitional economies, even though policymakers should have, and did, know better.

Marshall Goldman demonstrates that too-rapid establishment of a private property regime can be a destructive force impeding economic growth and political stability. The contrast between the process of privatization in Russia and Poland makes clear the importance of the broader framework of power and the development of complementary institutions. In Russia, the state hurriedly semi-privatized 70 percent of the country's state enterprises in 1992. While recognizing that perhaps this might allow past inefficient managers, corrupt officials, or even mafia elements to gain control, policymakers implicitly believed that the discipline of the market or the self-interest of stockholders would eventually bring these enterprises around.

The opposite occurred. There were no rules, restraints or codes to impede the activities of the new owners (no "rule of law"). Markets were insufficiently developed to set up benchmarks for the value of property. Early ownership entailed enormous advantages for access to additional assets including the media. The new oligarchs quickly gained access to the government and influenced the election process. The old rules of constraint were abolished without a new set of institutions to influence the behavior of the new private sector. Instead of creating Schumpeterian entrepreneurs, the business sector was preoccupied with conspicuous consumption and rapid personal accumulation through foreign exchange manipulation and arbitraging former state assets. In this context private property rights entrenched a genre of ownership that was destructive and inimical to the long-term improvement of the Russian economy.

The example of Russia points to the greater problem: the need to move beyond the narrow definitions of legal property rights embodied in neo-liberal driven reform to the question of the legitimacy of property rights. Stein and Nissanka point to the complications of introducing private property rights in African rural areas. They argue that the legitimacy of existing property rights must be understood along with the transformative prerequisites of moving to new forms of legitimacy. In part, the success of privatization in Poland was achieved through the equitable allocation of shares and by providing professional investment funds managers to oversee their interests in the newly privatized enterprises. Ultimately the broadening of gains from new forms of property rights is legitimizing.

STABILIZATION

An additional difficulty with the neo-liberal model is linked to the problematic experience with stabilization policies in developing countries. As Katz argues in his paper, the reliance on the IMF as the main agent in assisting developing countries
and in blessing the Russian transformation created a fundamental mismatch between the policy focus of the IMF and the broader exigencies of development.

The experience with the Asia crisis illustrates other weaknesses in the IMF approach. The policies singularly assume that distortions and imbalances are caused by profligate governments with chronic public budget deficits, negative trade accounts, currency overvaluations, and flights of savings and investment. The standard prescription was to induce austerity through the reduction in government spending and raising interest rates while devaluing currencies. In the wake of the 1997 financial crisis in Asia, the same package of conditionality was imposed on all the Asian governments. However, the underlying macroeconomic picture was at variance with the conditions underlying the logic of stabilization. Government budgets had been in surplus, price inflation was modest, real interest rates were positive, savings levels were high, and the external accounts were in balance.

The problem began when, due partly to pressure from Japan, the United States, Europe, and the IMF, Asian countries in the 1990s began to liberalize their capital accounts (particularly short- and medium-term flows such as bank loans). Without adequate regulatory bodies, and with the availability of very low interest loans on the international interbank markets (due partly to the depressed conditions in Japan), domestic banks began to tap these sources to re-loan to domestic users. The ability to turn over short-term debt with regularity created a fundamental temporal mismatch as money flowed into the overexpansion of industrial capacity (more on this below) and speculative real estate ventures. With a downturn in growth rates and the bursting of the real estate bubble in 1996, capital began to flow out of the country and loans began to dry up.

With the depletion of its reserves used in defending the baht, by July 1997, Thailand was in a full-fledged crisis and was obliged to turn to the IMF for assistance. The IMF misdiagnosed the problem, which was basically one of private sector overborrowing. The standard IMF package exacerbated the downturn in the economy increasing the severity and duration of the crisis. Over time, in recognition of the lack of response, the IMF gradually modified the conditionality. By March 1999, the Thais had largely abandoned IMF support to implement expansionary fiscal and monetary policy to deal with an economy continuing to spiral downwards (Financial Times, 31 March, 1999).

Stein and Nissanka go beyond the apparent misdiagnoses pointed out by Katz toward more fundamental theoretical issues underling the IMF stabilization model. Stabilization arises from two types of macroeconomic models, the IMF financial programming model, which is basically modified monetarism à la Polak and a Salter-Swan two goods model consisting of tradable and non-traded commodities. The models problematically assume full employment, which is particularly absurd in the labor surplus economies of the developing and transitional world. Disequilibrium arises in internal and external balances because of the misalignment of domestic absorption levels relative to some hypothetical full employment equilibrium. Deflationary monetary and fiscal policy realigns domestic absorption while devaluation shifts production into tradables, helping to alleviate balance of payments problems.

The microfoundations of these models are very problematic. They are rational, deductive, and axiomatic. They view equilibrium as a natural state and assume that private individuals and firms interact to produce Pareto optimal resource allocation under perfectly competitive conditions. Prices are assumed to provide all the information necessary for a predictable shift to a new equilibrium state. Cases where ineficiency is observed must be due to price distortions imposed from exogenous factors such as profligate government spending and misaligned exchange rates. Even more problematic is the fact that the models are presented as universally applicable and therefore are abstracted from the vast permutations of social, economic, political, and institutional conditions found in countries with different developmental stages. An important part of the crisis has been linked to the exercise in financial liberalization. The underlying financial repression theory also suffers from similar weaknesses in its microfoundations.

FINANCIAL LIBERALIZATION

Arestis and Demetriades relate the problematic history of financial liberalization exercises in developing countries. Sparred on by the promises of the gains from reversing financial repression, the World Bank and IMF encouraged financial liberalization in the 1970s and early 80s. The results were almost universally negative with high interest rates, waves of bank failures and related bankruptcies, high asset volatility, and a variety of real sector imbalances. More recently liberalization through the early 90s has led to a similar experience in Nigeria, Venezuela, Russia, and a variety of other African countries (Stein et al., 2000).

Arestis and Demetriades point to a similar liberalization exercise in the 1990s as a precipitous element in the Asian crisis. A number of the Asian countries removed or loosened controls on company borrowing, abandoned coordination of borrowing and investment, and failed to improve bank supervision. At the same time most of the countries permitted the entry of a variety of new inexperienced banks and other financial intermediaries. In Korea, all interest rates were deregulated between 1991 and 1997 (except for demand deposits). Banks were given freedom to increase capital, establish branches, and to determine dividend payments in 1994. All restrictions on maturity limits on loans and deposits were abolished in 1996. The scope of the business of financial institutions was greatly expanded between 1990 and 1995. Banks began to sell securities and government and private bonds while securities companies were permitted to handle foreign exchange transactions. Policy loans, the government directed and subsidized lending to private companies, were phased out between 1993 and 1997 while government restrictions on foreign borrowing was significantly relaxed in 1995.

Following the McKinnon-Shaw view of the need to allow more banks for competition, Korea issued new licenses to nine merchant banks (see footnote four in Arestis and Demetriades) in 1994 and fifteen in July 1996. Up to 1993 there were only six merchant banks in total. To worsen matters, supervision of the merchant banks was virtually non-existent. Led by the new merchant banks foreign borrowing, with an emphasis on short-term loans on the interbank market, increased massively. Between
1984 and 1986 merchant bank borrowing increased at more than 60 percent per year with nearly two-thirds of the total in short-term maturities. The climate of liberalization without supervision permitted a terrible mismatch of terms with 85 percent of all lending from the merchant banks in long-term loans. Much of the lending went to the expansion of industrial capacity. With the growth of neo-liberal sentiments, Korea began to dismantle their industrial policy after 1989 which had carefully kept a check on the creation of overcapacity. By 1997 the temporal mismatch in maturity structures, excessive short-term international loans and the large overcapacity set the preconditions for the crises of November 1997 (Chang et al., 1998).

Arestis and Demetriades tie the financial crises to a series of theoretical weaknesses of the neoclassical assumptions underlying the financial repression hypothesis. First the approach assumes the existence of perfect information. However, in reality imperfect information is endemic to financial markets. The information of borrowers and lenders is inevitably asymmetric and leads to adverse selection and moral hazard problems. Higher interest rates associated with liberalization might actually exacerbate these problems by only leaving high-risk borrowers in the borrowing pool.

Perfect competition is also assumed in the world of McKinnon-Shaw. In reality, however, the financial system tends to be highly oligopolistic. Liberalization frequently increases the spread between deposit and lending rates with little impact on financial deepening. Moreover, even if more banks enter into the financial system oligopolistic behavior might arise in the loan market given the importance of long-term relationships in increasing access to some borrowers at lower rates relative to other borrowers.

McKinnon-Shaw also tends to be institution free. Uncertainty is ubiquitous in a market economy. Societies tend to adopt conventions and other institutions to deal with risk. Many of those, such as the regulatory system, the rule of law and the stability of money as an asset, are typically supported by the state. The institutional context of banking systems must be firmly in place in order for financial systems to operate. Premature liberalization has led to the type of pathologies observed precisely because the exercise has largely ignored this broader institutional context.

Finally it should be noted that all of these real-world limitations are present in all economies but are particularly acute in the immature markets and institutional settings of developing countries. This points to the need for prudence based on a careful understanding of the conditions of developing countries before implementing financial sector changes. As Arestis and Demetriades point out, the relationship between banking sector liberalization, stock market development, and short-term capital account regulations must also be carefully considered. Unfortunately, as we have seen in recent decades, this has seldom been undertaken and has frequently led to very costly financial reorganizations in the wake of liberalization exercises.

IN SEARCH OF ALTERNATIVES

Stein and Nissanka raise serious theoretical doubts about using the neo-liberal model in the design of reform in developing countries. Adjustment has relied on exi-
arising from standard neoclassical trade theory, financial repression theory, and public choice arguments. Stein and Nisan introduce the theoretical basis of the neo-liberal model and its associated weaknesses in their paper in this collection.

3. World Bank have been relegated to these themes in documents throughout the era of neo-liberal inspired adjustment and reform. For instance, in the context of Africa the Bank argued in 1990 that the best method of increasing entrepreneurship "is to remove undue regulatory constrains, protecting property and contract rights and improving the public image of entrepreneurship" (1990, 136). In the context of agriculture, the same report argued that farmers must be given incentives to change their way of living to permanently cultivate land and to bequest it upon death (ibid., 104). The emphasis is not only on the privatization of property rights but in the speed with which it is undertaken. The 1997 World Development Report on the state argued the "larger privatization is delayed the more entrenched management of state enterprises can become" (World Bank, 1997, 403). Clearly this was the thinking in Russia with the terrible consequences outlined in Marshall Goldman's paper in this collection. For the complications created by pushing private ownership onto a setting of competing social claims and obligations in the African countryside see Stein (1999).

4. There is a growing criticism in the Russian literature of the neo-liberal strategy in transitional economies. See for example, Chavance (1999). Here is also some recognition in Russia, that the post-communist property rights regime has become a major impediment to progress in the country (Radigyn, 1999).

5. The work of Ronald McKinnon (1985) has become more relevant with some discussion of sequencing and organizational prerequisites that would allow liberalization exercises to be more successful. As Arestis and Demetrescu point out, the more modern versions of orthodox liberalization theory, such as proper sequencing, when followed, seem to have significantly altered the outcome. These problems are much more fundamental and are to the assumed world of McKinnon- Shau and its modern incarnations relative to the reality of poorly housed institutions and markets in developing and transitional economies. Moreover, there is some question of the extent to which even this more recent orthodox literature has influenced the thinking of the IPE at the operational level. Through 1990 the IMF has continued to demand rapid financial liberalization and banking privatization often as part of the conditionality of loans with much regard to the sequence or the strength of the regulatory system or private sector. This has clearly been the case in Uganda, Kenya, and Ethiopia, which Howard visited in May 1999. Only Ethiopia, which has argued that its regulatory ability and private sector capacities were still too weak to undertake privatization, refused to succumb. However Uganda and Kenya undertook the IMF advice. Both countries are currently in full-fledged banking crisis.

REFERENCES


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