Why are Latin American Free Markets Disappointing?

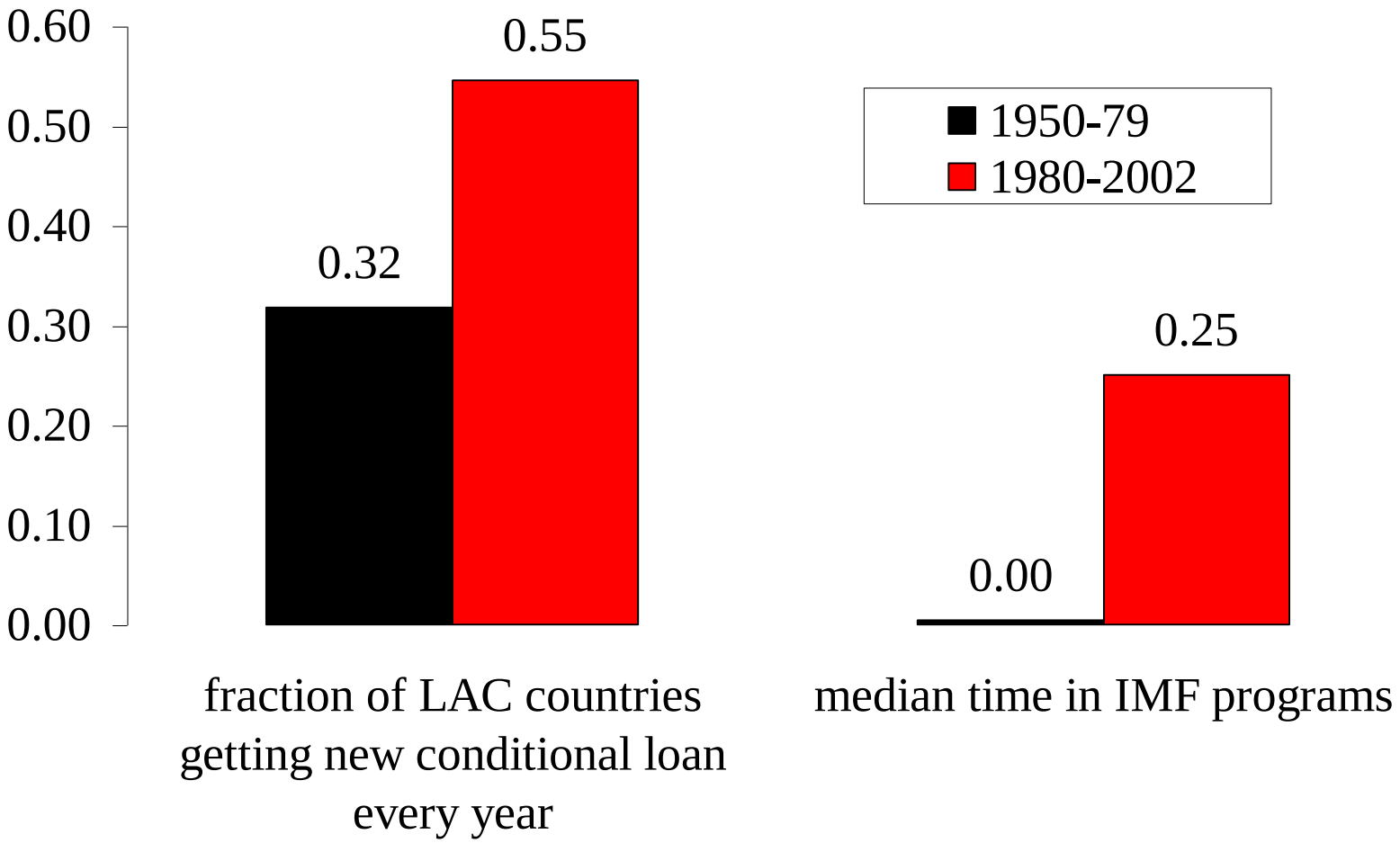
William Easterly
NYU

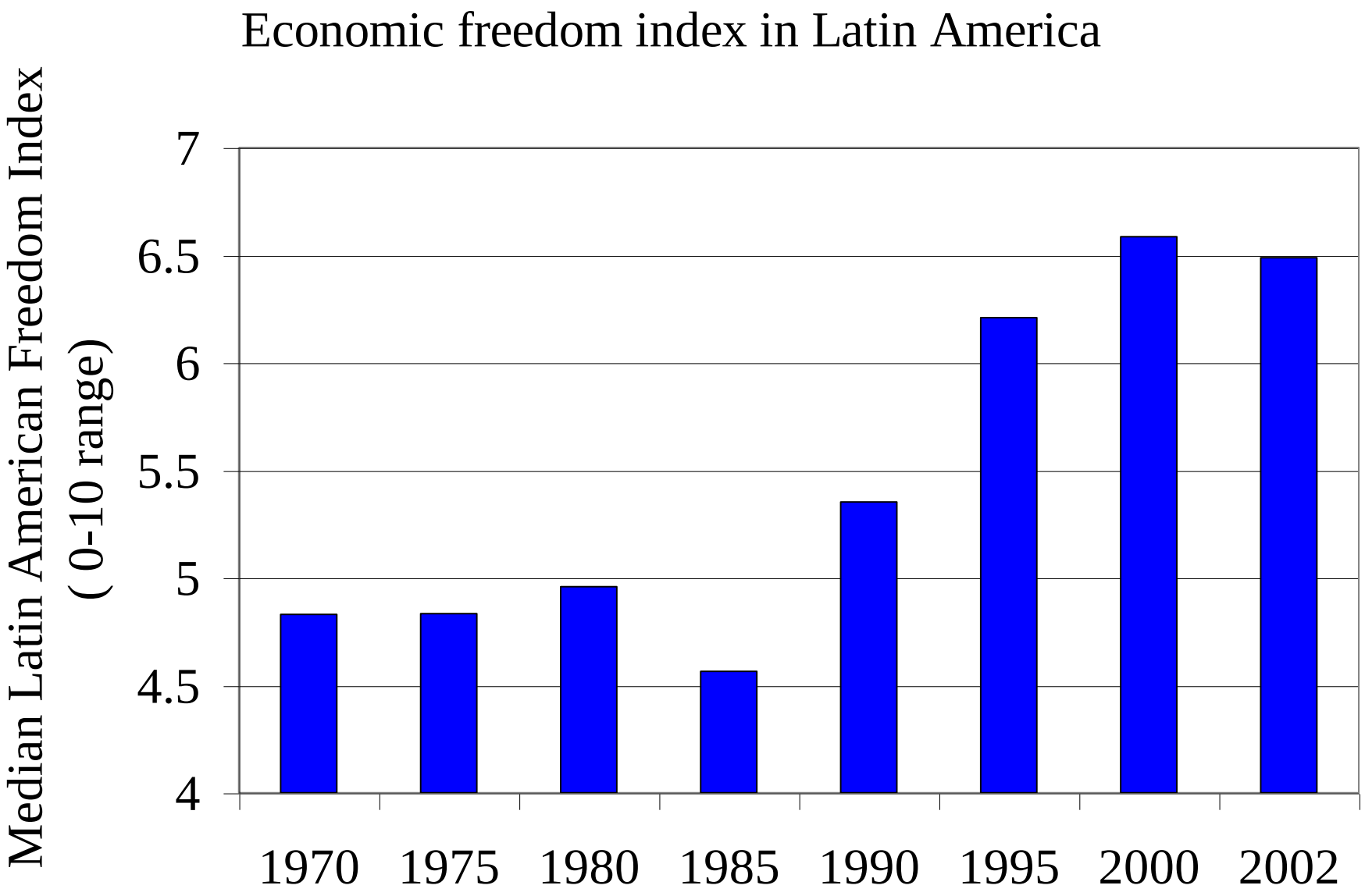
IDB Conference on Public Banks in Latin America

Overview

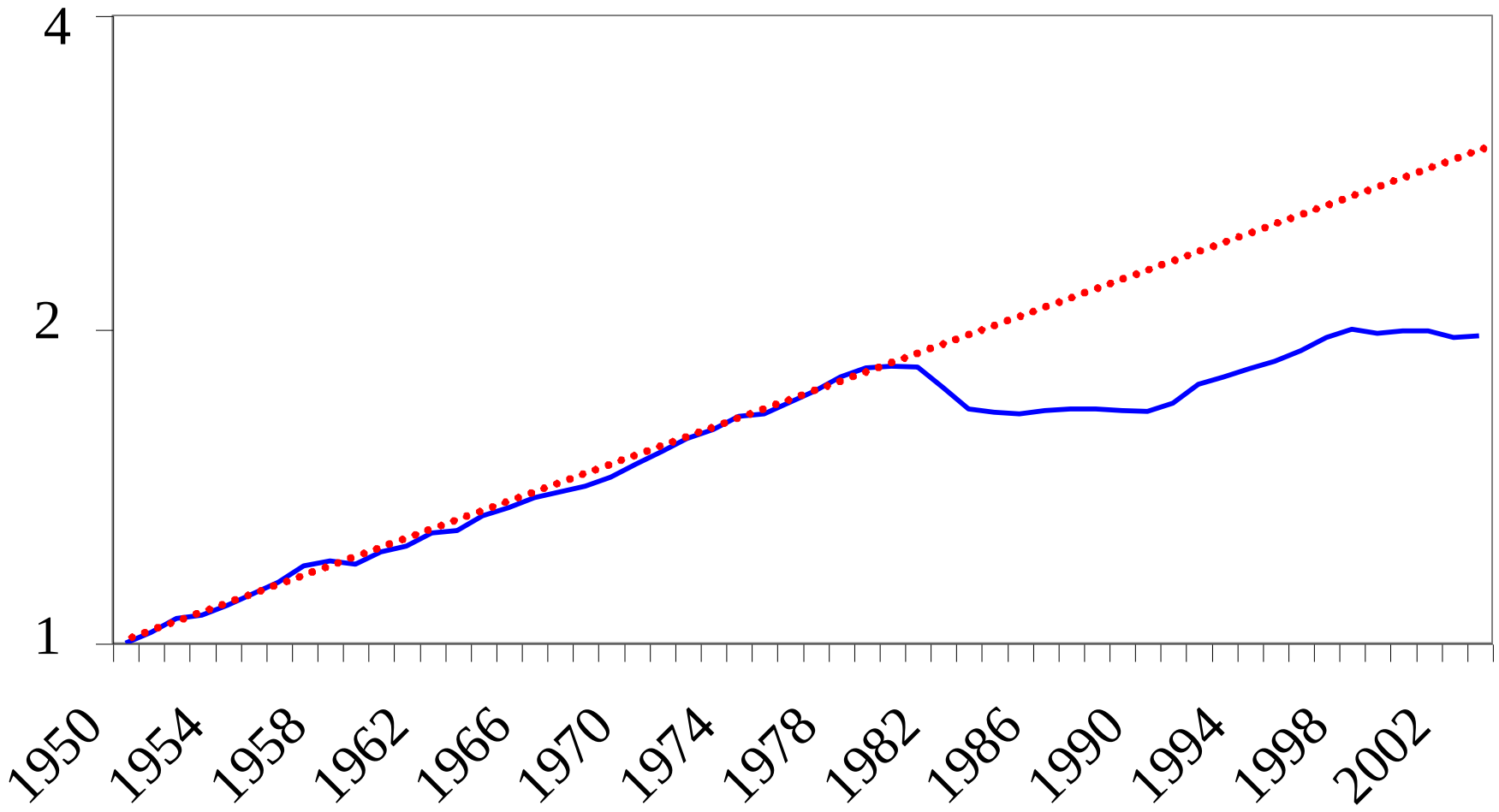
- Review of Free Market Reform Efforts and Results
- Example of Private Banking (with examples from Chile and Mexico)
- What makes financial markets work well?
- Top Down vs. Bottom Up Reform

Lending with conditionality to Latin America and Caribbean, 1980-2002 vs. 1950-79

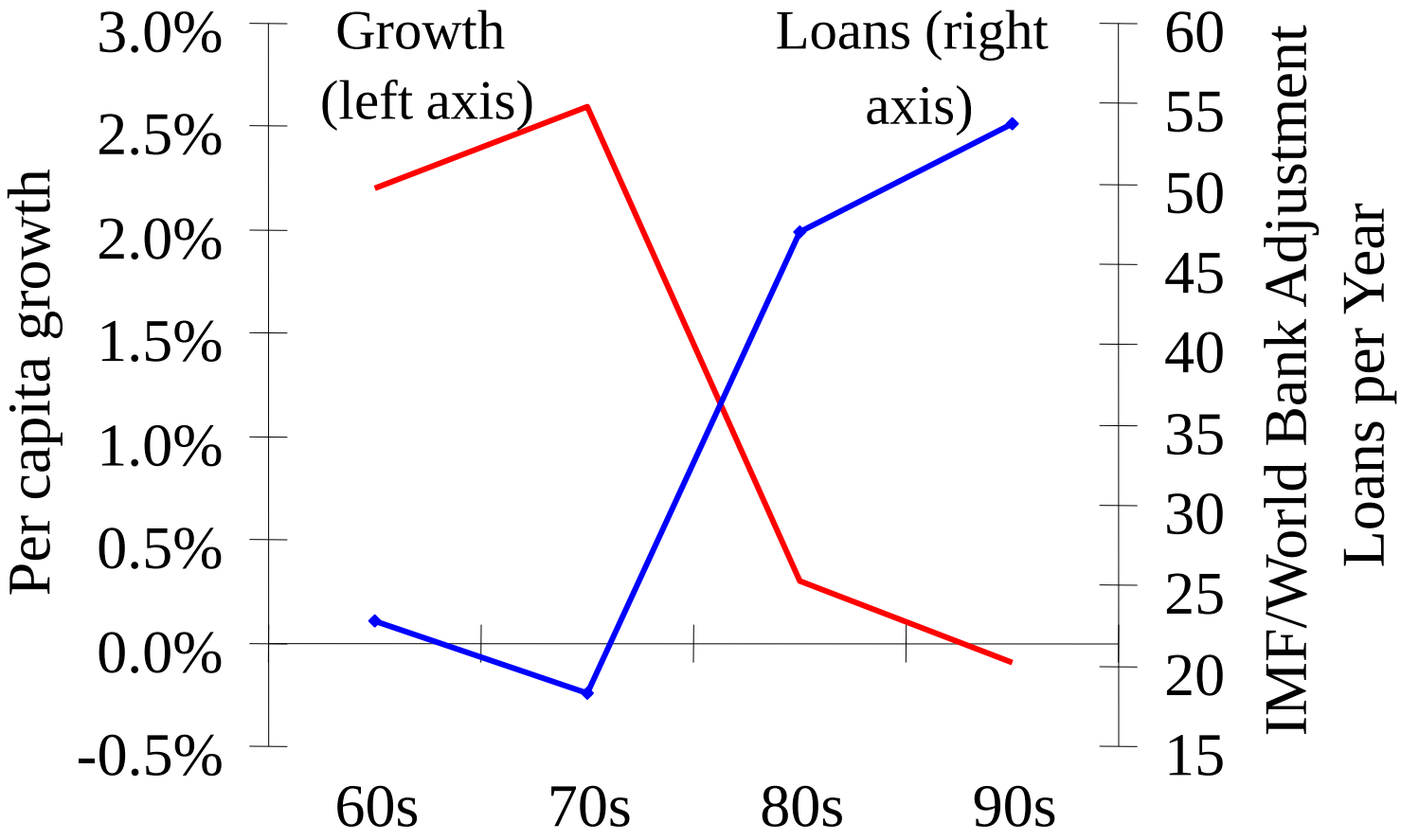



Economic freedom index in Latin America
Median Latin American Freedom Index
(0-10 range)
7
6.5
6
5.5
5
4.5
4
1970
1975
1980
1985
1990
1995
2000
2002

Per capita income index in Latin America (log base 2 scale, 1950=1): Actual and Trend, 1950-2003



IMF/World Bank Structural Adjustment Did Not Promote Growth in Recipients



A Scorecard on Economic Reform

	Shock therapy or Gradualism tried	Heavy IFI conditionality and foreign advisors	Economic growth per capita
Latin America	Shock therapy	Yes	Close to Zero
Russia	Shock therapy	Yes	Negative
Africa	Shock therapy	Yes	Zero
China	Gradualism	No	High positive
India	Gradualism	No	High positive

Why Free Market Reform Is No Panacea

- Many complex institutional requirements for private markets to work: clear property rights, contract enforcement, efficient judiciary, incentives to control private or public corruption
- Shock therapy: Introducing free markets from the top down (e.g. rapid privatization) into weak institutional environments can have disappointing or even negative results.
- Political backlash against free markets from disappointing results leads to reversion to populism and statism.
- Gradual reforms that correct most extreme distortions in sequence can bring high returns and build political support for continued free market reform.

When do private banking operations work well?

- When either have (1) BOTH strong supervision AND deposit insurance or (2) NEITHER but good private sector monitoring.
- Unfortunately, in most political equilibria in Latin America, deposit insurance is presumed, but supervision of banks is weak – can lead to excessive risk-taking by banks or even looting.
- Even if above is not a problem, credit markets need strong property rights, contract enforcement, clean and efficient judiciary and efficient bankruptcy procedures to be able to make credit widely available.

Example of Chile with Bank Privatization 1974-83

- Over time, government gave signals that it would provide deposit insurance, but had very weak supervision and regulation of banks.
- Banks were privatized before firms, so some small grupos were able to buy banks then get loans to buy privatized firms.
- During period of fixed exchange rate but expected depreciation, big spread between peso and dollar interest rates.
- Banks were able to borrow at dollar rate and lend in pesos (often to firms in same grupo), generate big profits for grupo.
- Devaluation then led to bankruptcy of banks, generating huge losses for Chilean treasury (40% of GDP!).

Sources: De la Cuadra and Valdés, Akerlof and Romer, Ross Levine.

Mexico Bank Privatization 1991-2003

- Banks were privatized with deposit insurance and weak regulation.
- Buyers of banks sometimes financed part of purchase with loans from banks they were buying.
- Past due loans were rolled over with only interest arrears recorded as nonperforming.
- Banks engaged in insider lending to directors.
- Delay of dealing with bad loans allowed further abuses to take place, raising cost of eventual bailout to 15% of GDP.

Did banking reform then bring results in Mexico?

- Strengthened bank supervision, curtailed abuses, opened to foreign banks.
- However, banks cannot count on secure property rights for borrower, so are reluctant to accept collateral and make loans. For example, borrower can lease house to a family member who is then protected against eviction by rent laws.
- Bankruptcy procedures are very inefficient, so banks cannot collect on bad loans.
- So banks now are sound, but not lending much to private sector. (Share of private credit in banking assets declined from 49% in 1997 to 30% in 2003.)
- Mexico now trying to reform property rights and bankruptcy procedures, but it's a slow process.

Sources: Stephen Haber (2004), Ross Levine

How do good institutions come about?

- Old view: just write new laws, issue land titles, draft bankruptcy codes, create new enforcement organizations, all from the top down.
- New view: institutions evolve gradually from the bottom up, depending on things like distribution of political power, social norms, customs, social capital, legal tradition.
- In new view, policy will misfire if it tries to impose institutional solutions from the top that are incompatible with reality at the bottom. Have to build on what is already there at the bottom.

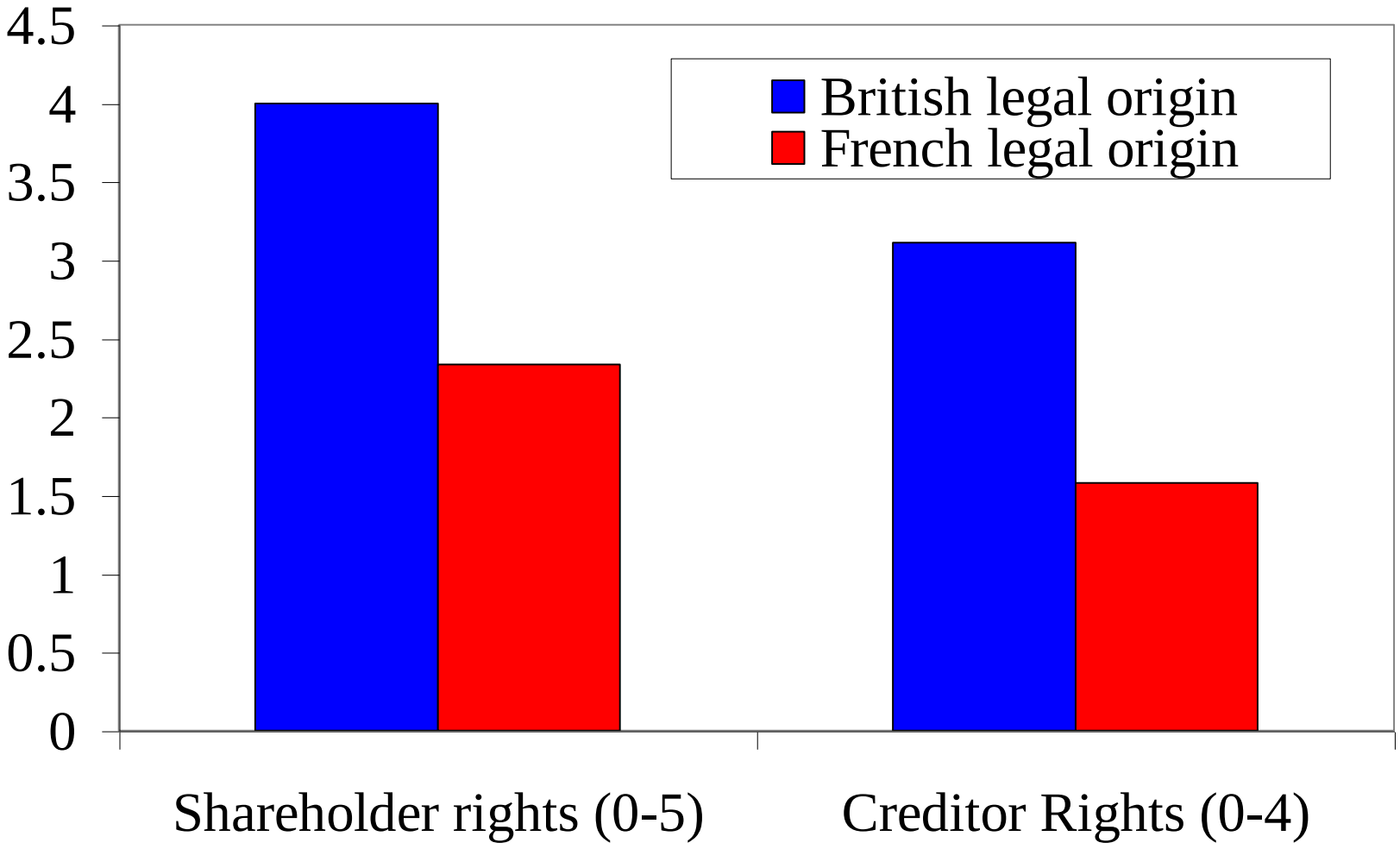
Example of Gradual Institutional Evolution: The Common Law Tradition

- Common law has proven adaptable to facilitate financial development.
- Civil law has not proven so adaptable.

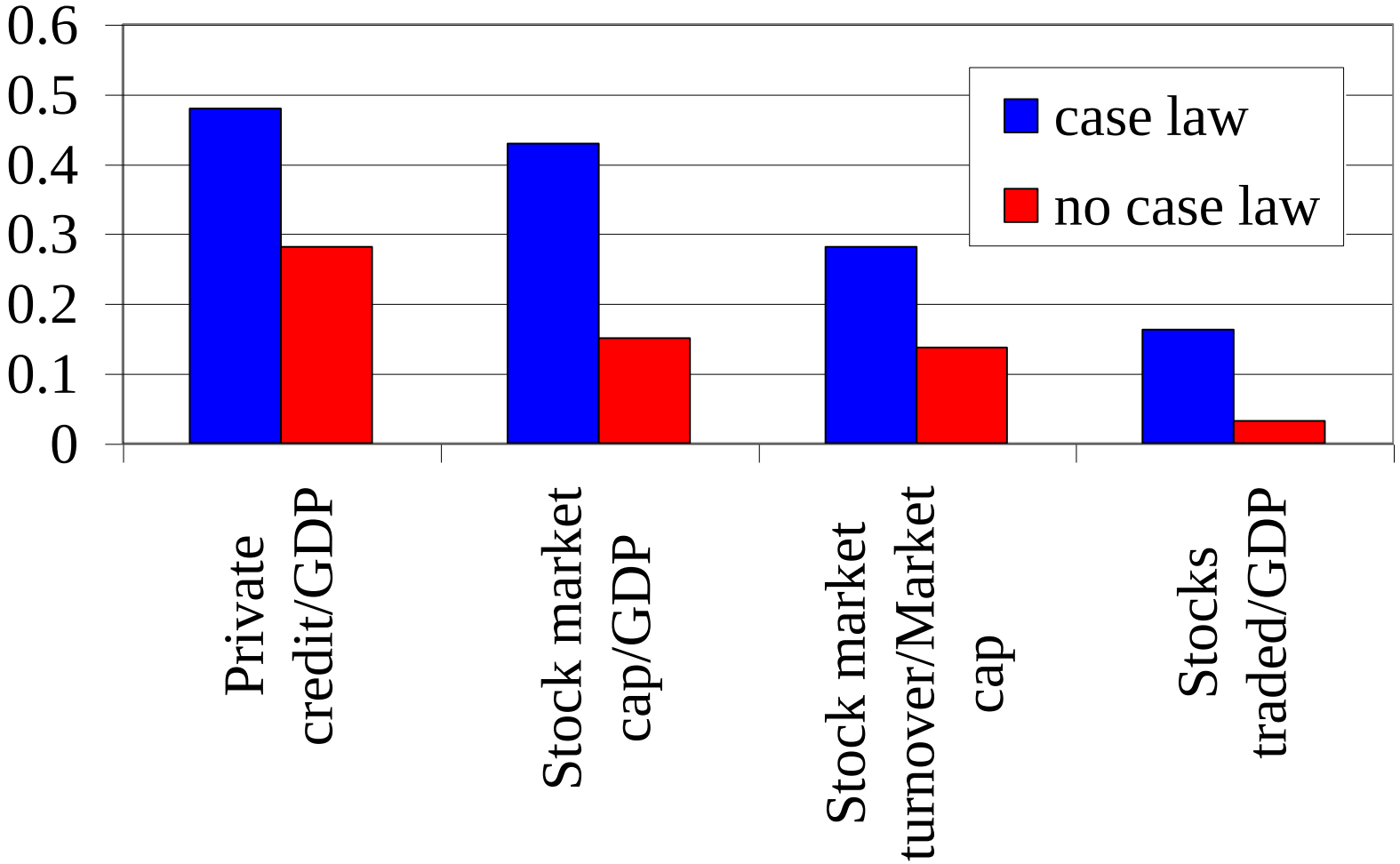
Two Measures of Legal Adaptability

- British legal origin vs. French legal origin (La Porta, Lopez de Silanes, Shleifer, Vishny 1998). Former relied on common law precedents highly skilled judges to make law in response to new situations. Latter relied on written civil code to cover all situations, judges were just clerks to apply laws, less adaptable to new situations
- Case law tradition (Beck and Levine 2004): same idea as British legal origin but directly measures use of case law precedents.
- Correlation between two measures is high: .71

Legal origin and Financial Institutions (source: La Porta, Lopez de Silanes, Shleifer, Vishny 1998)



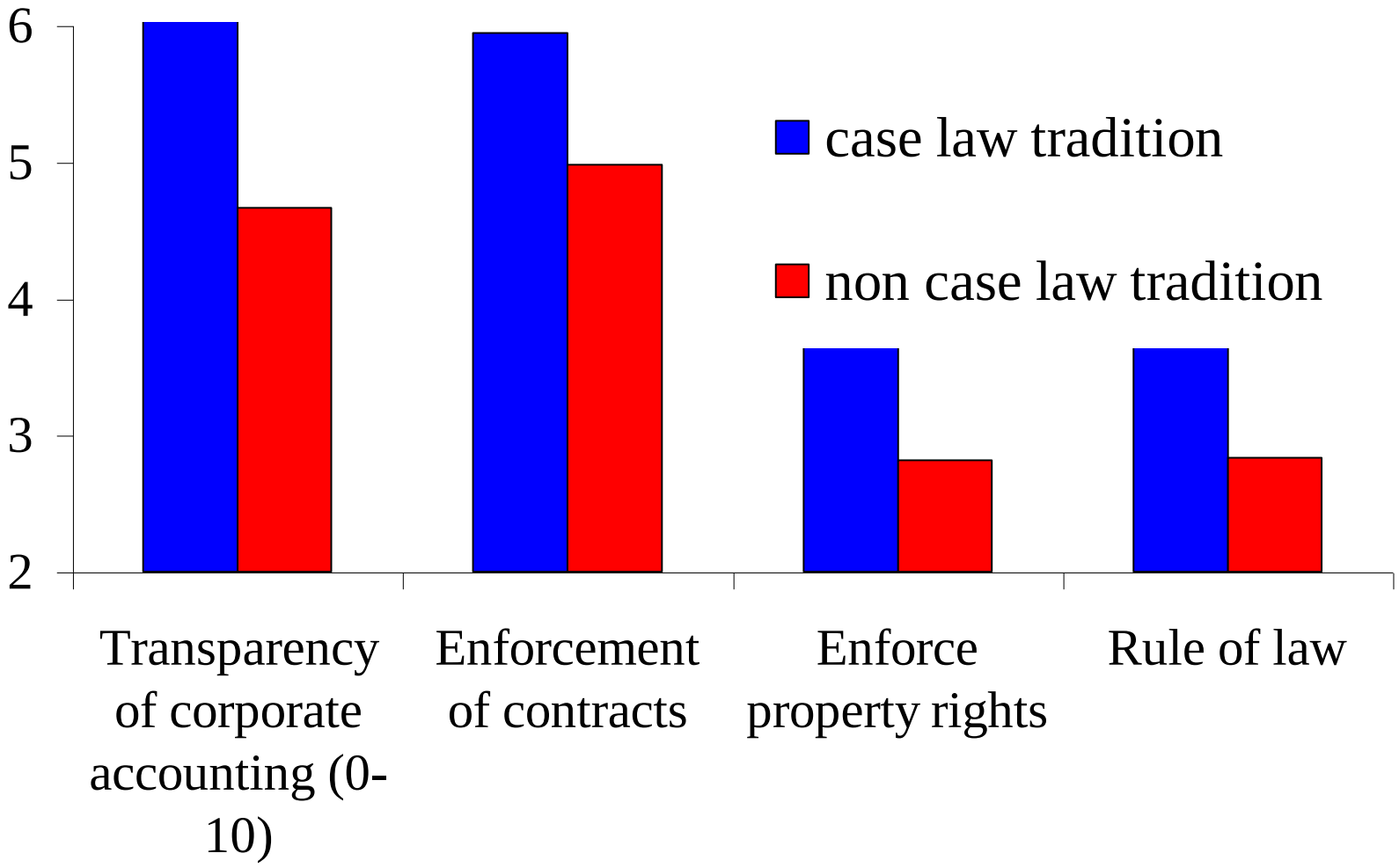
Legal adaptability and financial market outcomes (source: Thorsten Beck and Ross Levine 2004)



Examples

- High private credit relative to income, case law countries, and British legal origin: USA, Malaysia, Singapore and South Africa
- Low private credit relative to income, not case law countries, and French legal origin: Brazil, Venezuela and Mexico

Institutional outcomes and legal traditions



Examples

- Strong property rights relative to level of income, British legal origin, and case law tradition: New Zealand, Canada, Australia, Pakistan, Uganda
- Weak property rights relative to level of income, French legal origin, and non case law tradition: Colombia, Haiti, Nicaragua, Algeria

What are policy implications?

- Do I know!?!?
- Just have some vague principles that others will have to fill in with more detail.
- Match top down legal system to bottom up reality of social norms and tradition, proceed slowly and step-by-step. Shift legal system toward case law precedents, allowing law to evolve to match circumstances?
- Unexpected institutional forms can emerge (like town and village enterprises did in China).

Piecemeal Approach: Karl Popper, 1957

- The piecemeal engineer knows, like Socrates, how little he knows. He knows that we can learn only from our mistakes. Accordingly, he will make his way, step by step, carefully comparing the results expected with the results achieved, and always on the look-out for the unavoidable unwanted consequences of any reform.
- He will avoid undertaking reforms of a complexity and scope which makes it impossible for him to disentangle causes and effects, and to know what he is really doing.
- Holistic or utopian social engineering, as opposed to piecemeal social engineering…aims at remodeling the 'whole of society' in accordance with a definite plan or blueprint.

James C. Scott, 1998

- “In an experimental approach to social change, presume that we cannot know the consequences of our interventions in advance. Given this postulate of ignorance, prefer wherever possible to take a small step, stand back, observe and then plan the next small move.”

Conclusions

- We have learned shock therapy, structural adjustment, big comprehensive economic reform packages do not work.
- Top down introduction of free markets led to disappointing or negative results with weak institutional environment.
- Take small steps to reform incentives, markets and institutions.
- Small is beautiful!