**Institutional Changes in Financial Crises: lessons from Latin America.**

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Abstract:

Mainstream thinking seems to support the idea that once a financial crisis **ends** everything returns to normal. At the most, some regulatory changes on capital and reserves of the banks could be required. However, to understand what really happens during financial crises and the changes in overall economic activity that they produce, a postkeynesian institutionalist theoretical approach is essential. This paper discusses how several of the changes in funding relationships, driven by financial crises since the eighties, have cleared the way for money manager capitalism. The political and institutional diversity in Latin America allows us to observe not only the trajectory of change, but also its forms. These countries have made different choices regarding economic stabilization and financial regulation, with moderately different results in the distribution of income, wages and employment. In turn widespread difficulties, to slow or abolish policies of austerity, show the depth of the institutional changes that restrict monetary and fiscal policies within the context of financialization. We conclude that financial crises have changed the foundations of social organization.

Introduction

Since the eighties, the structural reform policies have dominated governments’ economic and political activities in the region, abreast successive financial crises. Although the reforms’ explicit objectives have been unsuccessful more often than not in most cases and countries, they have changed the economies and the societies.

One possible way to understand these changes and their political and institutional consequences is through the analysis of the changes in credit relationships, both as monetary and fiscal policies, and as institutional organization of credit and public spending.

The development of adjustment policies and structural reforms for over thirty years has followed meandering and twisting roads, materializing in the multiple ways in which the political and economic powers confront each other. In the last 10 years the electoral rise of leftist governments in some Southern countries is part of this process, with more elements of continuity than rupture, but things still never seem to quite work out in these countries (Correa, 2013).

However, it is possible to identify major trends of transformation, from the strong pull of liberalization and finance and trade opening of the 70s to financial crisis of the early 1980s and subsequent structural adjustment policies. More recent trends include the financial reforms driven by the banking crises of the 90s and methodical precision that have expanded investment funds in the less risky and more profitability activities.

The new organized expressions of the left, having political projects that are breaking formulas imposed by external creditors, were able to assume power democratically, have failed to or not wanted to leave the new consensus in monetary and fiscal policies. Also, these governments have not reorganized the structure of public spending and reestablished domestic credit. In that sense, this paper supports the idea that the construction of the money manager capitalism as Minsky (1996) described is ongoing and particularlywell advanced in Brazil and Mexico. Therefore it is difficult to detect any sector of economic activity in the region, including financial sector and government spending, that is not widely crimped to the axes of the global finance.

1. Economic stabilization and structural reforms

The IMF gently described the 80s as the "lost decade", although there was no loss to creditors; these were years of major institutional changes that altered among other things: the structure of employment and wages throughout the occupational pyramid; the fate of public spending, reduction in subsidies, social transfers and public investment; weakening of the bargaining power of labor organizations; reductions in domestic private investment in agricultural and industrial sectors; all paired with the creation of lucrative opportunities for foreign investment (Correa, 1992). At about the time of Williamson’s formulation (1989) of the Washington Consensus at the IIE (Institute of International Economy, founded in 1982) the Overseas Development Council published:

“The Coalition formed by governments, which are the major creditors, the IMF, the World Bank and commercial banks, has played a central role in the stabilization and liberalization efforts of the eighties (…) in much of Africa and Latin America, restructuring has been almost completely forced by events and outside agencies. Given the measures provided and the number of affected countries, the eighties have seen outside intervention in the internal economic policies to an unprecedented degree” (Nelson, 1991: 21-22)

 The financial crisis caused by external credit contraction could not be resolved through sovereign credit and directly required the partial or total repudiation of external debt. Continuing on the path of debt restructuring and adjustment policies impaired the governments’ capacity to manage the crisis and to contain its devastating effects on businesses and workers. Almost all countries in the region were moving toward structural reforms with the objective of improving productivity and competitiveness and growth with stability. However, the high inflation rate was due to high-income transfer; public spending contraction and the change in its utilizations had decreased productivity; and, domestic government debt had increased, but precisely as part of the management of the crisis. Structural reforms promoted by Williamson were systematized in the Washington Consensus. None of the Decalogue’s proposals were only technical proposals; these rather implied political and institutional changes. At the time the Decalogue was created, Nelson (1991: 9) established that:

The structural reforms designed to liberalize the economy pose threats to vested interests, different from those arising from the "stabilization packages" (…) liberalization involves a wide range of permanent measures that threaten various groups with severe losses in the long term. "

In Gramsci’s words (1972: 54):

“…liberalism is an act of will conscious of their own purposes ... is a political program, destined to change ... the leaders of an state economic program and the State as well, meaning changing the distribution of national income.”

The very first ideas of adjustments and reforms from the creditors, think tanks, IMF, WB, US offices were becoming in a comprehensive prospective for transform the economy and societies in LA. The very first ideas of adjustments and reforms from the creditors, think tanks, theIMF, WB, and US officials were turning into a comprehensive prospective for transforming LA economies and societies. But where was the vision that promoted market economy driving to? As set forth in the following lines, it eventually led to the vast expansion of money manager capitalism (Minsky, 1993 and 1996)

2. Changes in credit relationships

More than the external debt restructuration, what changed the functioning of the economies of the region were the new flows of funds that returned to the region at the end of the 80s. This time it was not as bank credit but as acquisition of public and private securities driven primarily by deregulation in the U.S. market regarding the composition of the portfolio of investment funds. Furthermore, an expansion was observed, mainly from U.S. investment banks, in creating a market for assets that were not yet expressed in the financial markets. Thus, both the credit crunch of the late 70s and the new expansion at the end of the 80s were processes that have highlighted the relationship of internal and external financing.

The waves of global credit based on securitization and financial innovation required constant expansion and deepening of financial markets, until a truly global market was set up. The financial returns were being reconstructed, after their decline in 80s, towards the banks’ global operations, financial intermediaries and investment funds. The growth of unlimited private credit in the early 90s once again overwhelmed the regulated financial world covered by central banks and treasuries, and made it seem as if the market could solve eventuality of credit crunch by itself. As Minsky (1987) alerted, the financial crises refuted the faith in self-regulating markets.

Even before the steady succession of financial and banking crises of the 1990s, the alert was raised by the IMF and the WB, that the abrupt outflow of portfolio investment in some markets could trigger huge losses to the extent that would produce changes in assets prices due to the volume of liquidity in each market. However, instead of imposing regulations on capital flows after the financial crisis in Mexico in 1994, reforms were advanced to deepen the domestic financial markets of developing countries. Ofspecial interest among these has the initiative where the World Bank increased financial savings through workers’ forced savings, providing a regular and growing source of income to the market.

Thus, the workers’ retirement systems moved from defined-benefits to defined-contributions, from intergenerational solidarity to individual accounts and pension funds with private administration, as in Chile (1981), México (1997) Argentina (1994), Uruguay (1996), Peru (1993) Colombia (1994) Bolivia (1997); with the exception of Brazil. Basically it extended the financial savings and portfolios of securities of the investment funds. The forced savings of workers became liquidity support for security issuance and management by bank conglomerates. Later Pedro-Pablo Kuczynski (2003) described this privatization as the most important financial reform of the 90s.

Of course this was no social security reform but a financial reform. Proof is in the facts.Foralmost the last 20 years, the problems of social security have become ever greater: limited coverage, low amounts of pension pay, ex post parametric adjustments that increase the number of working years, reduce benefits and disappear other rights, such as the widower’s pension. Moreover, the macroeconomic objectives of higher growth and investment have not been met, despite the increased funding; financing **for** domestic investment has not increased and in some cases has fallen. While it is possible to corroborate the high commissions charged by the banks that manage the funds, the losses in the workers’ accounts areeuphemistically called writedowns.

This reform, analyzed as a financial reform, has had two fundamental results for financial markets: first, **it** changes the operations of domestic financial systems by raising liquidity and profitability, even if they are not financing local investment; second, it changes those markets, opening doors to all kinds of investment funds, which also participate with local firms, including sharing in privatization bonanzas. In the first decade of the XXIst Century, those funds and banks were creating markets for assets that then had no expression in financial assets such as public services, infrastructure and energy sectors.

As shown in the following section, other structural reforms completed the change in the funding relationships: the independence of central banks, fiscal responsibility laws, and budgetary decentralization. More important, though these may not be covered in this analysis, are the reforms to securities markets and public banking.

3. Monetary and fiscal policies for money manager capitalism

Many countries in the region adopted **the** IMF and World Bank’s idea on the independence of central banks. These countries were changing towards institutions guaranteeing price stability and operation under the criteria of the so-called new consensus in monetary policy: Brazil (1988), Chile (1989), Colombia (1991), Argentina and Venezuela (1992), Peru and Mexico (1993), Uruguay, Paraguay and Bolivia (1995) (Jacomé, 2001). Nearly twenty years later, the stagflationary trends are forcing to recognize that central banks have no ability to control inflation, unless by shrinking the economy. Even deflation is also beyond the capacity of monetary policy, which is verified by the last years of failed policies of credit stimulus. For the LA countries the independence of central banks has meant:

1) Prolonged recessions that reshaped all domestic business sectors, which them disappearing, moving to other sectors, or transferring their capital abroad

2) Sharp drops in average wage earners' income

3) Changes in the financing of investment conglomerates from local sources to external sources, and with investment funds as new partnerships.

4) High financial returns with the governments’ budgetary support.

Years later, nowadays, it is easily understandable that the "fight against inflation" became a cornerstone of the structural reforms: as a mechanism to curb domestic competition and its profits, removing local firms as much as possiblefrom the market (Parguez, 2010); it was also an ideological formula that contributed to the destruction of the credit structure and therebuilding of a financial order dominated by expansionary global financial firms.

A second major area for reforms is related to the public debt and fiscal responsibility laws. The fiscal rules limiting borrowing and spending were mainly adopted in the late 90s: Argentina (1999), Brazil, Peru and Chile (2000), Ecuador (2002), Colombia and Venezuela (2003), Mexico (2006) and Paraguay (2013). The public credit borrowing ceilings were imposed on both central and state governments in: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Uruguay and Venezuela, among others. Public expenditure and debt limits were rules years before the laws, but the laws were adopted to prevent political change, particularly those less friendly with neoliberal policies.

Indeed, the laws were adopted to restrict the ability of local Congresses to increase public spending or deficits. In almost all countries constitutional changes were made, making it harder to reverse them. Broad powers were given to ministers of finance regarding the formulation and exercise of public budgets. These offices have the exclusive power to cut spending, reducing budgets step by step, and even spending less than the amount of approved funds.

All these reforms have had a devastating impact on the ability of governments to carry out the tasks assigned. Thus, both central and local governments have been losing economic leadership and the capacity for law enforcement and governance. This is the result not only of the capacity and possibilities ofredistributive spending but also the role in the expansion of production and corporate profits.

Public spending is one of the two main sources of funding for an economy (Galbraith 2011). Since the debt crisis of the 80s this remained limited in the name of servicing external debts. From the 90s onwards, it was restricted by balanced budget**s**. Thus, limited spending has reduced wages, employment, corporate profits and even the number of domestic firms. All of which open the space to the global firms.

Austerity policies are reinforced in each new recession, under the argument that

counter-cyclical policies generate inflation and instability. Thus, for decades, pro-cyclical fiscal policies have been implemented (Gavin and Perotti, 1997). For example, during the 2003-2008 expansion, Latin America countries had to maintain policies of fiscal constraint due to the high volume of capital inflows, while in the years of economic decline, as in 2009 and 2013, they had to maintain fiscal restraint policies to avoid damaging their credibility and fall into deficit.

A third process that has helped to restrict the financing sources is the decentralization of public expenditure. These policies attempted to create or expand the tax income of sub national governments, but at the same time, important lines of public spending were decentralized. We can find these reforms in México (1991) Argentina (1992), Brazil (1988) Bolivia (1994), Ecuador (1998) and Venezuela (1996) (Daughter and Harper, 2007).

The decentralization of public expenditure transferred government commitments to sub national governments and reduced the obligations of central governments, which has been assumed as a contribution to the objectives of balanced budgets. However, it resulted in successive crises at the sub national level, such as in Brazil, Argentina and Mexico. This forced local governments to: raise taxes and fees, and contract debt with private banks, which quickly created conditions of overindebtedness**.** The consequences are well known worldwide: raising prices and tariffs for public services, increased tax burdens, privatization of public services and infrastructure; sale of real estate, and budget cuts on basic items such as education and health. (Kaplan, 2002, Correa, 2007)

It was argued that decentralization would mean greater efficiency in the execution of public spending, but soon the international organizations that promoted such measures recognized the difficulties it entails, including overindebtedness and pressures that local bailouts create on central governments**.** (Daughter and Harper, 2007).

Restricting or canceling the credit capacity of the States has severe consequences on the institutions and responsibilities of the State. The elimination of public credit (which is invariably reactivated when bailouts are deemed necessary) has opened vast opportunities for private business affairs. The constraint of the LA States to restrict the worst effects of the instability, and to support the private investment, concomitantly reduced their capacity of government, law enforcement and national security. Indeed, it has opened spaces for illicit activities; poorly regulate territories (off-shore centers, for example); or where there are only the most primitive laws or rules (favelas, territories under the control of drug cartels etc.). It has created the conditions for the appearance of failed states.

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