

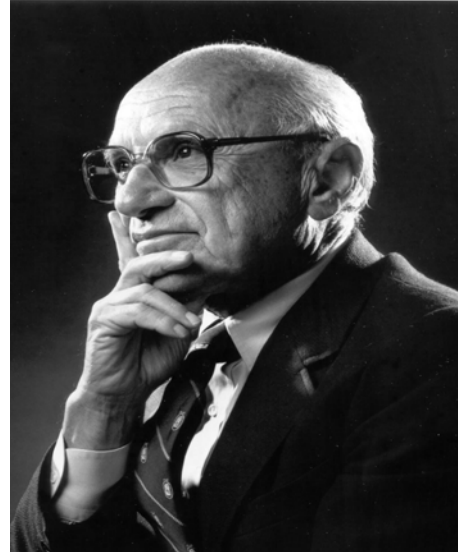


*Augusto Pinochet (1915 – 2006)*

April 11, 2009

To:  
Board of  
Directors,  
ShoreBank

From:  
David Oser



*Milton Friedman (1912 – 2006)*

## The Dictator and the Economist

All loans have terms and conditions. Thirty years, a 6% interest rate, and monthly payments are common terms and conditions for a home mortgage. But what if your mortgage lender prohibited you from having more than two children and required you to let your neighbors use your kitchen whenever they wanted? Metaphorically speaking, these are the kind of conditions the International Monetary Fund (IMF) has historically imposed on its borrowers. The IMF and the World Bank were created at the end of World War II to oversee the re-establishment of an international monetary system and restore global trade. As it evolved, the IMF developed a carrot and stick approach, with “phased disbursements” timed to insure that countries used its loans to achieve “the program goals that may lay the basis for economic stability and economic growth over the longer term—for example, containing inflation, reducing public debt, or strengthening financial systems.”<sup>i</sup>

But who defines “economic stability,” and what are the consequences of “reducing public debt”? Naomi Klein, a Canadian journalist and author, takes on these and similar questions in her 2007 book, *The Shock Doctrine: The Rise of Disaster Capitalism*.<sup>ii</sup> Ms. Klein builds a complex and ultimately convincing case to which no brief summary can do justice. The gist is that in the 1970s and ‘80s, the IMF absorbed and then put into practice an economic theory of unfettered free-market capitalism developed by Milton Friedman and others at the University of Chicago. The three pillars of the theory are privatization of state-owned enterprises, drastic cuts in social welfare programs, and elimination of “barriers impeding the entry of foreign firms.”<sup>iii</sup> This last goes far beyond reducing import duties that protect domestic industries from outside competition. Fully implemented, it allows foreign companies to gobble up indigenous companies and dominate a country’s markets, often with limited accountability for local laws and taxes, and no requirement for local ownership.

Klein argues that the Chicago School's economic package is so anti-democratic and destructive of human rights that it can only be imposed in the wake of an enormous shock, either natural or manmade. Even then, speed and ruthlessness are necessary for success. The first application of the shock doctrine was in Chile, following the violent overthrow and death of Salvador Allende. An avowed Marxist, Allende was democratically elected President of Chile in 1970. In response, the Nixon administration immediately set about undermining Chile's economy. It also provided covert aid and encouragement to Chile's military, which carried out a successful coup in 1973. The day following the coup, a group of University of Chicago-trained Chilean economists were given free rein to institute their free-market shock treatment of privatization, open borders, and reduced government spending. It was a disaster. Within a year, inflation hit 375% and unemployment was at a record high.

General Augusto Pinochet had emerged by this time as the leader of the ruling junta. Determined to retain power, Pinochet invited Milton Friedman to Chile for consultation. Friedman's critique was that Pinochet had not been ruthless enough. Chile should "cut government spending much further, by 25 per cent within six months...across the board, while moving toward complete free trade." The result was even greater suffering, with more unemployment, deep cuts in education and health care, and a virtual gutting of Chile's manufacturing sector.<sup>iv</sup>

Economic shock therapy, according to Klein, became popular with ruling elites for a simple reason: it enriched them and their supporters. Following Chile's lead, similar shock treatments were administered in Argentina, Bolivia, Uruguay, Brazil, Indonesia, Russia, and Poland, always with deleterious results for democracy and the welfare of ordinary citizens. Klein saves her most devastating criticism for the Bush administration, which capitalized on the shock of 9/11 to achieve its pre-ordained goal of attacking Iraq. Once the Baath regime was conquered, the first action of Paul Bremer, Bush's Director of the Occupation Authority, was "to immediately fling open the country's borders to absolutely unrestricted imports: no tariffs, no duties, no inspection, no taxes."<sup>v</sup> Bremer awarded all of the initial reconstruction contracts to multi-national firms. Simultaneously, 200 companies that had been owned by the Iraqi government were privatized for the benefit of foreign investors. They were allowed not only to own 100% of the companies but to take 100% of the profits out of Iraq.<sup>vi</sup> As is well known, the Iraq reconstruction effort was a fiasco. All the multinationals eventually fled the country, with nothing to show for the billions they received except an enraged and impoverished populace, wracked by sectarian violence and religious fanaticism.

Authors who assail a political or economic ill often end their books by presenting a solution that, typically, is simplistic, unrealistic, or both. Not Klein. She declares victory. Countries that once embraced the Friedman prescription have repudiated it and many that haven't, wish they had. By 2007, Brazil, Nicaragua, Venezuela, and Ecuador had all refused new loans or were attempting to quit the Fund. In his 2007 State of the Union address, Argentina's President Néstor Kirchner related how his country's foreign creditors told him, "You must have an agreement with the International Fund to be able to pay the debt." His response: "No way in hell are we going to make an agreement

again with the IMF.” Ecuador’s President Rafael Correa claimed that “the World Bank had used a \$100-million loan to defeat economic legislation that would have redistributed oil revenues to the country’s poor. ‘Ecuador is a sovereign country, and we will not stand for extortion from this international bureaucracy.’”<sup>vii</sup> Between 2005 and 2007, the IMF’s international loan portfolio shrank from \$81 billion to a paltry \$11.8 billion, roughly the same as in 1975. Nearly all the remaining debt was owed by a single country, Turkey. The Fund was in serious danger of becoming irrelevant.

On August 28, 2008, the IMF published a “Review of the Fund’s Financing Role in Member Countries,”<sup>viii</sup> which began, “The objective is *not* to increase Fund lending, but to make sure the Fund has the right instruments and policies to help all its members.” Maybe so, but later on, the reports authors’ seem less certain. “Another view is that there is indeed a problem. While a decline in demand for Fund lending is natural and welcome, many members seem to shun the Fund. Indeed, many seek solutions to balance of payments-related needs, risks and contingencies from sources outside the Fund.” And, “Is the Fund overdoing conditionality? Many observers see conditionality as heavy handed, undermining ownership, and, in the extreme, interfering with sovereignty.”

The study led to a thorough overhaul of IMF governance. The conclusions were announced on March 24.<sup>ix</sup> The first major change was “modernizing conditionality.” The details were written in insiders’ code,

“This modernization is to be achieved in two key ways. First the IMF will rely more on pre-set qualification criteria (ex-ante conditionality) where appropriate rather than traditional (ex post) conditionality as the basis for providing countries access to Fund resources...Second, implementation of structural policies in IMF-supported programs will from now on be monitored in the context of program reviews, rather than through the use of structural performance criteria, which will be discontinued in all Fund arrangements, including those with low-income countries.”

In other words, IMF loans will now be made to countries because they need it (“ex-ante conditionality”) rather than because they agree to the IMF’s conditions for reforming their economies (“traditional ex post conditionality”). Borrowing countries will no longer be required to open their borders, privatize their industries, and slash social spending to get IMF loans. Second, phased disbursements will no longer be contingent on countries meeting IMF-imposed conditions (“structural policies”). Instead, the IMF will review how well a borrowing country is doing based on its own criteria. Milton Friedman must be rolling over in his grave.

Of course, every story has, at the very least, two sides. So far, we have heard Naomi Klein’s side. We conclude with another side, from an essay called “The Quiet Coup” published in *The Atlantic* this month by Simon Johnson, former chief economist of the IMF.<sup>x</sup> Mr Johnson argues that, rather than being the chief advocate for unrestricted free market economics, the IMF has been a bulwark against them. Countries suffering a financial crisis look “depressingly similar.” They are run by “a tight-knit—and most of the time, genteel—oligarchy, running the country like a profit-seeking company in which

they are the controlling shareholders.” (The use of the word “genteel” in this context is stupefying, especially if applied to the military juntas that ruled Chile and Argentina in the 1970s, the Mugabe regime in Zimbabwe, or thuggish Russian oligarchs.) Among his genteel oligarchies, Mr Johnson includes the major US financial institutions, whose executives thought they “knew better what was good for America than did the career civil servants in Washington.” (Presumably, these wise and benevolent civil servants include the employees of the IMF, which is based in Washington.) From the influence of these executives and the *laissez-faire* ideology they championed, “there flowed, in just the past decade, a river of deregulatory policies that is in hindsight, astonishing.” The first of these is the “insistence on free movements of capital across borders.” Others involve limitations or outright bans on regulation, which are the equivalent to privatization in an already-capitalist economy. In short, Mr Johnson’s position is that countries get into financial trouble for following precisely the policies Ms Klein accuses the IMF of requiring before it provides assistance!

The key to resolving the contradiction comes a few pages later, when Mr Johnson defends the necessity of shock therapy. “In a financial panic, the government must respond with both speed and overwhelming force. The root problem is uncertainty. Half measures combined with wishful thinking and a wait-and-see attitude cannot overcome this uncertainty.” For Naomi Klein, “speed,” “overwhelming force,” and no “half-measures” are code for shock, torture, and repression because they are fundamentally dictatorial. Countries with nascent or unstable democratic systems can easily slide into dictatorship when tough economic times are treated by shock therapy. Even long-established democratic governments cannot act in dictatorial ways without becoming more like dictatorships.

Democratic approaches to big problems are always messy. There are always half-measures, delays, even failures. Would-be solutions have to be tested in the public arena, not rammed down people’s throats. The reforms enacted by the IMF indicate that its governors have taken this lesson to heart. That’s a good thing, because the world needs the Fund now more than ever.

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<sup>i</sup> IMF Conditionality <http://www.imf.org/external/np/exr/facts/condition.htm>

<sup>ii</sup> Picador (New York: Henry Holt & Co., 2007)

<sup>iii</sup> Klein, p.204.

<sup>iv</sup> Klein pp 99-100.

<sup>v</sup> Klein, p.429.

<sup>vi</sup> Klein, p. 436.

<sup>vii</sup> Klein, pp 577-78.

<sup>viii</sup> <http://www.imf.org/external/np/pp/eng/2008/082808.pdf>

<sup>ix</sup> <http://www.imf.org/external/np/pdr/fac/2009/032409.htm>

<sup>x</sup> <http://www.theatlantic.com/doc/print/200905/imf-advice>