REPORT ON COLOMBIA COUNTRY DIALOGUE

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Initiative for Policy Dialogue
New York

An IPD delegation traveled to Colombia in March 2003 for an eventful and highly effective visit. The group met with Colombia's President Alvaro Uribe Velez and his economic advisors, as well as with the country's former Presidents and with members of Congress. IPD also held a conference in coordination with our local partner, **Fundación Agenda Colombia**. The conference was attended by more than 700 people including Colombia's most influential politicians and policymakers. It was broadcast live throughout the country to many Colombian universities, and featured an interactive question and answer session via the Internet. The conference, entitled "Towards a Sustainable Economy: Armed Conflict and Post-Conflict Process in Colombia," featured the IPD team members, Colombian policymakers, and international officials from both sides of the Colombian debate as its keynote speakers.

IPD and Fundación Agenda Colombia also organized four roundtable discussions on the role of government, long-term issues of growth and development, trade, and the relationship between economics and violence. One of the roundtables brought together trade union representatives and entrepreneurs to discuss labor market issues. Others included politicians, the media, NGOs, civil society representatives, economists, and political and social analysts.

The IPD team included Joseph Stiglitz, President of IPD; Jose Antonio Ocampo, United Nations Under-Secretary-General for Economic and Social Affairs and former finance minister of Colombia; Dani Rodrik, Professor at Harvard University; and Shari Spiegel, Managing Director of IPD.

The two days of meetings with political leaders, including the President, NGOs, academics, representatives of labor, commerce, industry, and agriculture enabled us to identify several areas in which there was a broad consensus.

- At the center of economic success are markets; but there is a real role for government to play in the economy, both in promoting growth (see below) and ensuring social equity. Neoliberal doctrines that have argued for a minimal role for government are particularly inappropriate for Colombia, where, if anything, the problem is that of a too weak state, rather than an overbearing state. While there is broad agreement that there is a need for an active role for government, there is not yet a consensus on all the elements of that role.

- There is a broad consensus that the Washington consensus has failed. Growth in Colombia, as in most of Latin America in the 90s, has been significantly below (just over half) what it was in the pre-reform era of the 50s, 60s, and 70s. Reform has not brought the growth that was promised. Indeed, the growth that appeared in the early part of the decade provided a false hope: it was partly based on short term capital flows, that, as elsewhere in Latin America, quickly reversed in the light of the East Asia and global financial crises. And while the Washington consensus policies did little to promote growth, they also did little to ameliorate poverty and inequality. As a result, inequality, the second highest in Latin America - the region with the highest levels of inequality in the world - actually increased.

- The experiences in Colombia, as elsewhere, have demonstrated forcefully that stabilization by itself is not sufficient: it may be a requisite for growth, but does not automatically lead to growth. An excessive focus on stabilization may indeed impair growth. The major recession of 1998-1999, the worst in recent memory, was attributable in part to excessively high interest rates, leading to overvaluation of the currency. While today there are few criticisms of current monetary stances, it will take a long time for the damage to be undone. The firms that were forced into bankruptcy will not become unbankrupt as interest rates fall. Even firms that have not gone bankrupt have seen a large fraction of their net worth disappear. Given their low net worth, they are reluctant to undertake risk. This is one of the factors that explains why there is so little investment, even in the presence of a seemingly lose monetary policy.

It was striking how resonant the chord of excessively tight monetary policy was, given the current situation; but it reflects a broad concern that the monetary authorities have too narrow a vision, and that, in the future, with a change in economic circumstances, this narrow vision will work to their detriment. There was broad sentiment that Colombia's Central Bank, like that of the United States, should focus on unemployment and growth, not just inflation - with perhaps an even greater focus on the first two. The hard issue, raised by several participants, was how to balance off the trade-offs, and how to decide when there was an "excessive" focus on inflation.

- Mistakes of the past put Colombia in a particularly tight bind. High levels of debt -- caused to a large extent by monetary and debt mismanagement[1]-- meant that the government seemed to have little choice but to have relatively tight fiscal policies. (Burgeoning debts would lead to ever increasing interest rates and would not be sustainable. There was little appetite on the part of most participants in the discussion for a default, though there was considerable support for some type of debt rescheduling.) But with tight fiscal policy, the only stimulus available has been a loose monetary policy. And as is often the case in an economic slow-down, monetary policy has been relatively ineffective - particularly given how earlier monetary policies have devastated the corporate sector.

- There was, accordingly, a need for the country to formulate a growth strategy. While some elements of such a growth strategy were receiving attention - such as the provision of credit for small and medium sized enterprises - there was a sense that it needed to be more comprehensive both in scope and instruments. While some emphasized the potential role for exports, others were less sanguine in the current economic environment, and called for a balanced approach, supporting as well domestic expenditures, such as housing. Some strategies, involving the promotion of exports and technology, might cost relatively little; for example direct government expenditures in East Asia in its high growth period were relatively modest.

- While Colombia's economic problems could not be discussed in isolation from violence and drugs, it seemed clear that solving the drug problem, or even the violence problem, would not solve the country's economic problems. The country's economic problems contribute to the problems of violence and drugs, while violence and drugs contribute to the economic problems; there is a two-way relationship between violence and economic performance.

Some suggested that growth might be as much as 2 percentage points higher without the violence. Others expressed skepticism: Colombia's economic performance has not been that different from the performance of other countries in Latin America. Given the low price of coffee, and the devastation from the financial crisis of 1998-1999, there is little reason to believe that Colombia's growth would have otherwise been as much as 2 percentage points greater than the rest of Latin America.

At the same time, it was clear that there was a connection between changes in economic conditions and violence. A correlation between the unemployment rate and kidnappings provided a remarkably strong fit, and causality tests showed that it was unemployment that led to violence. The marked changes in the levels of violence over the years suggests that there was nothing inevitable about the current high levels; indeed, even within the last decade, there have been periods in which it has decreased. Some participants linked the changes in violence to economic and political conditions, e.g. land reforms, or an increase in land concentration (there were significant increases in the years since the mid 80s. Many participants were not sanguine about the prospects of reducing violence without dealing with the underlying problems of inequality, alienation, lack of economic opportunity. While admitting that the drug problems pose special problems for Colombia today, even were it possible to solve the drug problem, problems of violence and social disorder might well continue, as they have in Venezuela, a rich oil country in which two-thirds of the population remains in poverty.

There was a concern that the government's strategy was unbalanced: one needs both carrots and sticks, to provide those involved in growing coca, for instance, an incentive to do something else. There needs to be a strategy of economic opportunity, targeted to where the problems are most manifest, rather than just a strategy for overall economic growth. Incentives matter, and without dealing with the problems of incentives, eradicating coca growing from one area would not solve the problem: it would just displace it to another area. Labor is mobile, given the huge returns, and land in Colombia is plentiful. One of the participants presented examples of large plantations that have helped workers gain access not only to land, but also to capital and technology that are needed to work it. In addition they provided education to workers and their children. These "experiments" provided an alternative strategy to one relying exclusively on force. It was claimed that in those areas where these experiments have occurred, violence has been reduced.[2]

- The inherited debt represents a problem. While at around 50%, it is not large by standards of many developed countries, even 50% has proved problematic for some developing countries: Argentina's was only around 50% when that country went into crisis. Argentina's circumstances (with its vastly overvalue currency) are markedly different from that of Colombia (see below); but still, Argentina shows the dangers of a high level of debt; the vagaries of international capital markets mean that even a country rated A plus by the IMF may find itself facing high interest rates, forcing it either into default or to severe cutbacks in social and other expenditures.

Preventing the increase in debt requires three sets of actions: (a) controlling the deficit; (b) managing the debt; and (c) creating the appropriate domestic regulatory environment. It is risky to hold too much of the debt in dollar denominated forms, since that means that every time there is an adjustment of the exchange rate, the ratio of debt to GDP increases. The ability of the economy to adjust is thereby undermined. Government can impose regulations that lead to lower domestic interest rates, lower interest rates facing the government, and a greater ability of the economy to adjust. For instance, pension funds can be required to hold assets that are denominated in local currency. Banks can be required to hold a certain fraction of their assets in government paper, and can be restricted in their exposure to foreign exchange risks, as can the companies to which they lend. Government intervention is required, because there are large externalities associated with the actions taken by the private sector.

- IMF lending represents a particular form of indebtedness, that provides increased flexibility in the government's budget constraint this year, but since the debt is short term, it can make matters worse in the future. Colombia should decide for itself which policies make sense for it. It should listen to the viewpoints of the IMF and international capital markets as well as long-term investors, but it should recognize that financial markets are more focused on the short run, and pay little attention to broader social concerns, while Colombia needs to focus on the long run. Given the high levels of inequality, distributional concerns should be paramount. To the extent that the policies that Colombia decides are best for itself coincide with the viewpoints of the IMF, so much the better. But there is little evidence that getting the IMF seal of approval leads to faster growth, lower unemployment, less inequality, or higher real wages.

• The Free Trade Area of the America was a subject of enormous interest. While a truly free trade area would offer enormous opportunities, several problems were discussed, some of which were illustrated by the recent trade agreement with Chile: (a) Trade agreements are likely to be asymmetric, with the U.S. refusing to eliminate its subsidies to agriculture or other restrictions to agriculture imports. Other commodity exports of Colombia (like coffee) already face no restrictions. (b) The U.S. refuses to eliminate non-tariff barriers, including dumping duties, which have often been imposed just as countries succeed in making inroads into the American market (as in the case of Chilean wine and salmon). There should be a single standard for judging unfair trade practices, regardless of where production occurs; the anti-trust laws provide such a standard. Mexico's experience under NAFTA is telling; after the signing, the U.S. tried to block exports of tomatoes, avocadoes, brooms, trucking, etc. (c) The U.S. has used trade agreements to restrict the ability of developing countries to pursue agendas that promote their own growth and stability, in areas unrelated to trade. In the case of Chile, restrictions on capital controls were included in the trade agreement. While those restrictions may not be germane at the current time, with a dearth of such flows, there may come a time when Chile finds such controls desirable, and it will not be able to use them.

There are three recommendations that follow from this analysis: (i) Colombia should take a cold look at the benefits and costs of any proposed trade agreement, areas in which it will gain, and areas which it will lose. It should not count on any ephemeral "confidence" that emanates from the signing of a trade agreement. It should also be aware that ten-year phase-in periods might only postpone the day of reckoning, as again Mexico is learning today. (ii) It should work hard to learn how to cope with trade agreements, e.g. using countervailing duties too offset American subsidies, using "CRA" lending requirements to promote lending to domestic small and medium size businesses. (iii) It should bargain hard, together with other Latin American countries, recognizing that in the bargaining process, the U.S. has an economic advantage, which is likely to be magnified if the countries bargain at cross-purposes.

• Another arena of considerable interest was the lessons to be learned from Argentina. Argentina's problems were brought about by an overvalued exchange rate, which made the true size of their debt to GDP look smaller than it really was. "Dollarization" made the adjustment process all the more difficult, when it actually occurred. Contractionary fiscal policies pushed by the IMF contributed to the country's problems, and the fiscal position was worsened by the privatization of social security (pensions.) The mismanagement of other aspects of privatization also contributed to that country's woes. The selling of a large fraction of the banking system to foreigners in the short run led to a scarcity of funds for domestic firms, especially small and medium size enterprises, and in the long run, did not enhance the stability of the banking system. The headquarters did not back up their local branches and subsidiaries. The growth in the earlier part of the decade, based on foreign borrowing, gave a misleading impression of how well the country was doing, and of the risks to which the country was exposed. The IMF, which had been its promoter earlier in the decade, turned out to be an unreliable partner; when problems emerged, it accused it of widespread corruption, and was unsupportive of unorthodox measures required to address the problems. Given the openness of the economy, IMF criticisms almost surely helped precipitate the crisis itself.

Even if there had been no corruption, even if provincial governors had not run deficits, the country would have eventually faced a crisis. Indeed, without the social spending provided by the provinces, the crisis might have occurred even earlier. For Colombia, there is another lesson here: high unemployment - Argentina had double digit unemployment since 1995; as the crisis broke out, open unemployment was exceeding 20%, with an additional 10 to 15% of disguised unemployment - made social and political turmoil almost inevitable.

After the crisis, the consequences were far different from what the IMF had predicted. There was not the predicted hyperinflation, and recovery began, even without an IMF loan, simply based on the support for exports and import competing activities resulting from the large devaluation. There was a credit problem, but there was also the recognition that any new IMF funds would mostly (or entirely) go to repay the IMF, not to addressing the problem of credit availability to enterprises. International long-term investors were more concerned about the state of Argentina's economy, than they were about any "IMF seal of approval."

More than a decade after reforms have been put into place throughout the developing world, it is clear that many of the assertions about their benefits were based more on ideology and interests, than on modern economic theory or evidence. Outside advisers should make clear the extent to which theory and evidence supports particular propositions and the positions that they advocate. There are some policies and propositions about which there is much more confidence than others, and advisers should delineate amongst these; for instance, there is broad consensus that hyperinflation and persistent large deficits are not good for long term economic performance; that short term capital flows expose especially developing countries to risks that are not commensurate with the rewards; that stabilization policies by themselves do not produce growth; and that the Washington consensus policies have failed to live up to their promises. There is far less consensus about how best to promote growth with equity. Advisers can share other countries' experiences and the latest research and analysis in these areas, but the political process within the country itself will have to define the policy choices.

[1] The high interest rates in the late 90s led to high debt; subsequently, with the debt largely in hard currencies, the devaluation increased its magnitude relatively to GDP.

[2] There was no independent verification of these claims.