

Memorandum

To: The Secretary

June 11, 2007

From: Ms. Joyce Lawrence

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Subject: Venezuela's Proposal for a Banco del Sur

INTRODUCTION AND SUMMARY

Since Hugo Chavez's election as President of Venezuela in 1998, Latin American voters have increasingly turned away from the neo-liberal economic model endorsed by the U.S. and embraced a new wave of populism. Chavez has been a controversial figure, speaking out against President Bush and international institutions like the World Bank and International Monetary Fund (IMF). His latest proposal calls for a new international financial institution called Banco del Sur. While the mission of the bank has not been decided, Chavez has proposed it as an alternative to the IMF, World Bank, and Inter-American Development Bank (IDB). Participating countries currently include Venezuela, Argentina, Ecuador, Bolivia, Brazil, and Paraguay. The best U.S. strategy in response to this development is to actively engage with Latin America to encourage the use of the current international financial institutions.

DISCUSSION

Politics in Venezuela

Chavez, who after a failed military coup came to power through the electoral process in 1998, depends primarily on a base of voters from the marginalized class of the informal economy and poorer non-unionized workers in the formal economy. His military experience has increased his support among military officials. Chavez's

actions, while ostensibly related to the plight of the poorest groups in Venezuela, have primarily focused on consolidating his own power. He has maintained superficial levels of democratic participation for civil society while entrenching himself in a highly autocratic system. He has been successful in maintaining support by rallying public opinion around issues of race, gender, and class while baiting the right to take extreme positions.

He has used his oil money to fund left-leaning groups with political aspirations in countries like Nicaragua, Ecuador, and Bolivia. In 2004, he formed the Bolivarian Alternative for the Americas (ALBA), which guarantees that Venezuela will meet 100 percent of the energy needs of participating countries, which include Nicaragua, Bolivia, Cuba, and Haiti.

Relations with International Financial Institutions (IFIs) in Latin America

The current backlash against the IFIs originated with the debt crises of the 1980s, when many Latin American countries went through a difficult period of restructuring and adopted reforms under the “Washington Consensus.” Although growth in Latin America improved in the 1990s, there was a general sense of disappointment at poor results compared to emerging markets in Asia. Many countries, including Mexico, Brazil, and Argentina, experienced financial crises in the 1990s and received IMF funds that included conditionality. In Argentina, the IMF had given its public support to the currency board, and the failure to anticipate the crisis severely damaged IMF credibility in the region. Frustration with the IMF, and particularly IMF conditionality, has led many South American countries to pay off their debts ahead of

schedule. These early payments were made possible by the strong commodity prices, steady growth in recent years, and the availability of credit through private markets.

Along with the large IFIs, there are several smaller regional lending institutions including the Latin American Reserve Fund (FLAR), the Andean Development Corporation (CAF), the Financial Fund for the Rio de la Plata Basin (Fonplata), and the Brazilian Development Bank (BDNES). The CAF in particular has had significant lending growth, now accounting for over 50 percent of all multilateral development bank loans in the Andean region, surpassing the IDB as the region's largest source of development finance.

Negotiations and Governance over Banco del Sur

Although six countries have committed to joining Banco del Sur, the details of its governance and mission, and the criteria for lending have yet to be determined. The countries held a preliminary meeting in Ecuador and have agreed to sign the first manifest in June 2007. One of the primary issues to resolve is whether Banco del Sur will be another development lender along the lines of the regional development banks or become a crisis lender like the IMF.

While Venezuela has the most extreme view of the bank's role, which it sees as a replacement for the IMF, World Bank, and IDB, other countries have not committed to withdrawing from these institutions. President Lula of Brazil sees this as an opportunity to push forward with development projects in infrastructure within Mercosur. Argentina is trying to make sure than neither Venezuela nor Brazil can dominate the group. The smaller countries are primarily interested in an alternative to financing controlled by U.S.-influenced conditionality. Energy policy is a key area that divides the members,

since oil dependence helps Chavez while Brazil is a leader in biofuels. Competitive dynamics between Venezuela and Brazil may influence the organizational rules.

One option that has been discussed would tie votes to need, putting the power in the hands of borrowers. Others see this as an opportunity to insert democracy into the process, where each country would have a democratically accountable representative to the bank. This would likely force more transparency, but it would also politicize the bank decisions and slow down the decision-making process.

Potential Impact of Banco del Sur

The initial impact of Banco del Sur will be small compared to the IMF or World Bank. The six countries currently involved hold international reserves of \$164 billion, but the total contribution to the fund is expected to be \$7 billion. The total funds will be \$2 billion more than these countries currently contribute to the IDB, but still substantially smaller than the \$100 billion in operating capital of the IDB.

The ability for Banco del Sur to act both as a development lender and as a support mechanism for balance of payments crises is questionable given the limited funds. Were a severe financial crisis to hit Latin America, countries would almost certainly look to the IMF. While the scale of Banco del Sur is not large, it symbolizes the desire for an alternative to current IFIs and more regional financial cooperation. More than just another source of financing, which is already plentiful, Banco del Sur looks like a political project to increase the anti-imperialist credentials of Chavez. As such, it should be viewed as an attempt to draw Latin American countries away from the U.S. politically rather than simply another development project.

OPTIONS

1. Ignore Chavez and Banco del Sur

PROS

- Any comment provides legitimacy to Chavez, so ignoring him indicates that others should not take him seriously.

CONS

- The lack of a position may be viewed as tacit support.
- Reinforces belief that U.S. is not interested in helping Latin America.

2. Codemn Banco del Sur and Push Allies to Oppose It

PROS

- U.S. opposition would discourage some countries from joining.

CONS

- Active opposition makes the U.S. look imperialistic.
- Denouncing Chavez would help him appeal to his anti-U.S. supporters.
- Reinforces belief that U.S. is not interested in helping Latin America.

3. Actively Engage with Latin America to Improve Existing Financial Institutions

PROS

- Shows that U.S. is interested in helping Latin America.
- Opportunity to solidify alliances in the region.
- Improvements to IFIs may increase their longevity.
- If countries continue to use the IMF and World Bank for lending, the U.S. will maintain significant power in the international financial system.

CONS

- Any action by U.S. could still be construed as imperialism.
- Changes within multilateral organizations like the IMF and World Bank may be difficult to achieve without additional support.
- U.S. voters may not support changes to IFIs that help developing countries.

RECOMMENDATION

By either ignoring or overreacting to Chavez, the U.S. would only help his cause and alienate its neighbors in Latin America. However, full support of the bank is not realistic since its primary purpose is to undermine U.S.-supported financial institutions. Therefore, option 3 is the most realistic and beneficial for the U.S.

While the U.S. could easily sit back and wait for Banco del Sur to experience the problems that afflict any multilateral organization, it should instead take advantage of this opportunity to address at least some of the complaints of developing countries within the current institutions. The IDB could make significant improvements in transparency while allowing Latin American countries a larger voice. There will naturally continue to be conflict between borrowing and lending countries, but even some progress in incorporating the views of the borrowers could be viewed as a success. The U.S. should not support the elimination of conditionality, but showing some willingness to compromise on the strictness of the measures would be a positive sign. New voting rules including increased votes for developing countries would also be viewed favorably, although this may involve difficult negotiations with Europe.

Ultimately, small steps that encourage the involvement of Latin American countries in the future direction of the IMF would help reestablish the U.S. as a partner in the region. A policy of active engagement with Latin America to address concerns about conditionality and unfairness within the IFIs is the only way to change the root cause of the anti-Americanism that Chavez has so effectively exploited.