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The Dogmatism of the Washington Consensus

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There is a quiet discontent in Latin America and the Caribbean today, after the lost decade of the 1980s and the policy reform efforts of the last 20 years. Growth rates are sluggish, unemployment is rising and poverty reduction is substantially lower than expected. Even though the reform efforts of the region in the 1980s were perhaps the basis of the now famous Washington Consensus, the region itself did not reap the rewards anticipated from this formula. Despite the articulation of the second-generation reforms of the Washington Consensus, various revisits to the 10 commandments and several attempts to fashion alternatives and additions, there is a need to re-think the vision of the future, to acquire one that is more realistic, effective and compelling.

The 10 commandments of the Washington Consensus, like the tablets given to Moses on Mount Sinai, were presented as a final product – not as the particular result of trial and error and deliberation. These 10 commandments were the decanted development wisdom of North-West Washington, between 15th and 20th Street and F Street and Massachusetts Avenue. In the Washington Consensus, the development policy establishment found a simple solution to the problem of development. The principles were to be adopted by developing countries – preferably by persuasion but when persuasion failed, through external pressures and IFI conditionality.

The ten commandments of the Washington Consensus can be briefly restated as: "You shall attain price stability" (note that the concern over stability does not extend to preventing falls in output and employment).

[1] The views expressed are those of the author and do not necessarily represent those of the G-24.

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In order to achieve price stability it is argued, "You should maintain fiscal discipline and avoid fiscal deficits", with three corollaries: "You should forgo subsidies", "You should privatise public enterprises" and "You should broaden the tax base".

The next commandment, number 5, would be to liberalise interest rates and, in further evolutions, attain total financial liberalisation in a broad sense, including capital account liberalisation; (6) adopt an equilibrium exchange rate; (7) eliminate protection; (8) liberalise foreign direct investment; (9) deregulate the economy; and (10) protect property rights.

Some versions of the Washington Consensus reduced it to the simple slogan: "Free market forces to get prices right". This was perhaps a little too simple. It is as if there is no role for governments in the search for economic development, in promoting social equity, health, education, the development of technology and industrial policy.

The Washington Consensus was intended to produce growth and the efficient working of the economy. The Consensus agenda was loosely associated with the doctrine of supply-side economics, monetarism and minimalist government that characterised the thinking in Washington at the time of Reagan and Thatcher. Some of these ideas are now discredited. The results predicted by the Consensus did not materialise. Making markets work requires more than low inflation. It requires government to enact sound financial regulation, competition policy, policy to facilitate the transfer of technology and policy to encourage transparency – just to mention a few things the Consensus neglected.

In Adam Smith's conception, the invisible hand does not devise the institutions that harness the self-interest of individuals for the social good. The invisible hand requires the guidance of good institutions and laws to regulate the way in which individuals pursue their interests. Smith believed that, in the pursuit of their self-interest, merchants and manufacturers seek political influence since "to narrow competition, is always in the interest of the dealers" and this "must always be against the interest of the public".[2]

Thus, the invisible hand requires sound institutions and laws that regulate how individuals pursue their interests. These institutions and laws are the outcome of government policy: in the view of Lord Robbins, the invisible hand "is the hand of the lawgiver, the hand

[2] Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations*, Clarendon Press, Oxford, 1976, pp. 266-7, 459, 467.

which withdraws from the sphere of the pursuit of self-interest those possibilities which do not harmonise the public good".[3]

The contrast between the Asian dynamic experience in the 1980s and 1990s and the virtual stagnation of Latin America, where the Washington Consensus doctrine was faithfully applied, is rather striking and should give rise to a good deal of analysis and reflection.

To be sure, some of the policies Asia pursued fall within the Consensus: low inflation, fiscal prudence and so forth, while some others do not: the emphasis on industrial and technological policies, for example, fall outside and are contrary to the spirit of the Washington Consensus. It has been argued that governments should not intervene in the economy, but I would submit that the Asian experience suggests that governments in Latin America have not done too much but rather too little to promote the institutions that favour development.

Let me discuss some of the items of the Washington Consensus.

Inflation

High inflation is, of course, bad. It is costly, and it provokes distortions and so forth, but it is not true that once it starts to rise, inflation has a tendency to accelerate. As Stiglitz has noted, there is no evidence for this; it is just a hypothesis. And it is not true that high inflation is very costly to reverse. These premises have been tested empirically, and there is abundant evidence to the contrary. Bruno and Easterly, Barro, Fischer (the deputy managing director of the IMF at the time), Mohsin Khan (who was deputy head of research, now head of the Middle East Department at the IMF) all failed to find evidence that inflation is costly. If you have 15 or 20 percent inflation, it does not seem to have high costs in terms of growth. In fact, Akerlof, Dickens and Perry[4] and others claim that a moderate rate of inflation even improves economic performance.

Budget Deficits

Again, huge budget deficits are detrimental since they can lead to crowding out and unsustainable levels of debt, but there is no simple formula for determining what is the optimum budget deficit. The

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[3] L. Robbins, *The Theory of Economic Policy in English Classical Political Economy*, Macmillan, London, 1952, p. 52.

[4] George Akerlof, William Dickens and George Perry, "The Macroeconomics of Low Inflation", Brookings Papers on Economic Activity, No 1, 1996, pp. 1–59.

optimum deficit or a sustainable deficit depends very much on circumstances, including the cyclical state of the economy. What we have seen in Latin America is a dogmatic approach: countries with budget deficits of 0.5 or 1 percent have been reducing the deficit in the midst of a recession, just as countries with a 4 percent rate of inflation have been trying to tighten monetary policy to reduce inflation in the midst of a recession. This makes no sense. Stabilisation is certainly important, but it is a means and not an end in itself, and it should not be carried to the point where its effect is a net reduction of output over the long run.

Unemployment

Is the objective really stabilising prices or is it stabilising output? The social and economic cost of downturns can be devastating – the lives of people are disrupted, poverty increases, often giving rise to political turmoil and so forth. Moreover, all of these stops and starts have huge consequences for sustained growth. This has been completely neglected by the Washington Consensus.

Privatisation

Privatisation swept through Latin America and was presented as the solution to many problems. Latin America followed the UK with Chile and Mexico taking the lead. Most of the region's public enterprises were privatised, from banks to power plants, telecommunications, roads, and water transport systems. As a result of selling public enterprises, government revenues in Latin American countries reached 6 percent of GDP. Latin America's privatisation of infrastructure exceeded 360 billion dollars, more than twice of what Asia has done. While many privatisations can be considered successful, in that they freed governments from the provision of goods and services that could be provided more efficiently by the private sector, many others cannot. Privatisation has provoked a lot of political discontent, criticism, and demonstrations.

The private provision of public services has often led to conflicts over prices and over what is a reasonable return on investment. This is a difficult problem in periods of exchange rate instability and high inflation. If tariffs are indexed to exchange rates, and the exchange rate devalues 50 or 60 percent, tariffs cannot be adjusted by that amount because wages do not adjust. That is the real problem, and then government intervention is called in and often the government has to take back the privatised enterprise.

The approach has often been rather dogmatic. There is something to be said for increased competition, but what is the best way to increase efficiency and secure competition? Is it better to devote efforts at creating a regulatory framework and agencies to oversee the performance of the privatised enterprises or private sector, or should you make efforts to reform the state enterprises without necessarily changing ownership? China has done the latter. They appear to have established competition amongst public enterprises quite successfully.

Trade Liberalisation

The prescription is "Open up trade because this is good for you". This is presented as a prerequisite for development: only by dismantling the old policies of import substitution and by freeing imports will you allocate resources in an optimal manner. But historically, there is virtually no industrial country that has followed this path. Every country that I know of resorted to protectionism and subsidies for a long period. Even Britain, the pioneer of industrialisation, pursued protectionist policies between 1721 and 1846 during the period of the Corn Laws. They pursued a sort of infant industry policy with high tariffs, and they only accepted free trade when they had attained a large technological lead. The US had the highest tariffs in the world between 1860 and the Second World War, in addition to the high protection arising from transport costs and so on.

In fact, the history of these and many other industrial countries is rather different from the conventional wisdom of the Washington Consensus. It would seem that when you attain a certain level of industrial development, you rewrite the rules of the global system and call for the adoption of rules that fit your national interest. The concern over protection leading to poor resource allocation has to be balanced by the concern that you may reduce the policy space to the point where industrial development becomes difficult to achieve. The most successful experiences of development, countries that went from low income levels to high income levels in a generation, those of Korea, Taiwan and the current experiences of China, India, Vietnam and others, is not based on opening the economy to free trade and keeping government out of the economy. So often the opposite would seem a better prescription for achieving success.

The so-called level playing field is one where industrial countries and developing countries compete on equal terms, putting the latter at a disadvantage. In football, at least, you distinguish between amateurs and professionals, and you have different leagues and divisions.

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Technology

On technology, it is not simply catching-up. Japan and Korea have developed their own original technology, and any country that wants to develop technology should start by objectively analysing what successful countries have done to build research and industrial capabilities. However, the Washington Consensus denies that government has any role to play in assisting the growth of new industrial sectors, through any form of industrial policy.

A second point would be to create policy space for industrial policy. The move to wholesale liberalisation has great momentum, but it does impede the selection and support of special sectors. Despite all of the problems of growing poverty, marginalisation, Millennium Development Goals, and the like, the assumption on which international development policy is based today is that the industrial sector will develop best under Washington Consensus rules.

The next step would be to try and develop a capability to mount this industrial policy. There is a large body of material showing that selective interventions can and have worked. Government failure is avoidable when interventions are done very carefully. The experiences of South-East Asia and certainly of China bear this out.

The fourth step would be to develop strategies appropriate to the circumstances of each country. This does not mean returning to old-style import substitution. It means flexible, careful policymaking with clear targets aimed at a specific technology development. This is the most difficult step. Not only does it require skill, but it also requires industrial countries allowing it. Sanjaya Lall has written extensively on this issue.

Undervalued Exchange Rate and Unlimited Supply of Labour

Let me turn to Wing's chapter. Wing points out that export-led growth was perhaps the most conspicuous characteristic of the Asian development model. It seems that something of the Washington Consensus was lost in translation, so the Asians did not get it, and thus were very successful.

What are Wing's assumptions, what is his starting point? These are not made clear in his chapter. To what extent is he assuming that there is an unlimited supply of labour? To what extent is he saying that this exchange rate policy has to do with the objectives that you have? Some countries in Asia, Korea for example, went for large enterprises, tried to create export brands, went for the production of capital goods and so forth. Others, such as Taiwan, went for small and medium enterprises, gradually raising the local content. Then there was a push into high-tech industries, particularly in Singapore. So there are nuances. Surprisingly, Wing's chapter has, as far as I can see, no mention of high rates of investment, virtually no mention of savings rates, credit policy, and virtually no mention of problems of keeping currencies undervalued and the accumulation of capital. If you have an undervalued currency and are a successful exporter, you are bound to acquire large inflows of capital and you need capital controls, otherwise things will get out of hand. There is very little mentioning of sectoral industrial policies even though Asia has been rather selective.

Wing has a number of equations, and they all lead to the conclusion that you aim for an undervalued exchange rate. There is nothing else to the argument. And an undervalued exchange rate is perhaps the main reason that Asia has grown faster than Latin America; another part of the reason is the fact that it lacks natural resources and had to resort to export-based industrial growth.

Essentially, the Asian secret as interpreted by Wing is based on a combination of two things: the classical Arthur Lewis model of development with unlimited supplies of labour and the undervalued exchange rate. This is exactly what China has been doing. China has pegged the exchange rate to the dollar at a very competitive rate, perhaps undervalued, as several other Asian countries have, and they have been growing like mad. There is a rush to absorb around 40 percent of the labour force that is underemployed in agriculture and to bring them to the modern sector. The second element is the development of industrial technology and attempts to develop an educated manpower to attract foreign investors and to bring highly profitable operations into their countries. This again is the strategy followed by China and a number of other countries.

The real limit is absorbing the unlimited supply of labour. The next limit to this model is the catching-up. Japan's experience is that they have been able to develop scientific and technical innovation and develop a wide range of innovative products. Maybe Japan's problems have more to do with other issues of the economy; the weakness of the financial system.

The Global Implications of the Asian Development Model

One thing that is not considered in Wing's chapter is what the global implications of this Asian policy are. What is the global aspect of trying to base industrialisation on an undervalued exchange rate in order to maintain an export-led development strategy?

Asian countries have maintained high rates of export growth and large trade surpluses, and this has attracted large private investment flows. They have a combination of large trade surpluses and large capital account surpluses. Since they do not allow their currencies to appreciate, they accumulate very high levels of reserves. These have been heavily invested in US Treasury paper and have been financing the US twin deficits making them sustainable, at least for the time being. The perpetuation of global imbalances gives rise to a number of risks or problems related to this development strategy.

First, the depreciation of the US dollar has become an impediment to the recovery of the EU and other countries that float their exchange rate such as Canada, Australia, and many Latin American countries. Second, the depreciation of the US dollar vis-à-vis the pegged Asian currencies has given rise to trade tensions and calls for protectionism in Europe and a number of other countries whose currencies have appreciated in relative terms. Third, the rapid growth of Asian exports has also given rise to calls for protection inside the US. All of this talk about outsourcing and loss of jobs increases the risk of rising protectionism in response to the unemployment and political pressures in industries that are unable to compete. A fourth risk is that at some point when the demand for dollars as a reserve currency collapses, the loss of value of the dollar will no longer be offset in countries like China by the higher rates of growth, higher rates of employment and higher rates of the expansion of the industrial sector. What happens then? Fifth, a disorderly depreciation of the dollar could lead to a sharp rise in interest rates, and this will put the brakes on the recovery of the US economy and the growth in Asian and many other countries that are dependent on the US market. Sixth, although flexible exchange rates contribute to adjustment, the volatility of exchange rates among major currencies discourages trade and particularly investment flows that require a medium-term planning horizon since there are no hedging instruments for longer maturities. Simply recall that the rates between the euro and the dollar have fluctuated by more than 50 percent in the last 3 or 4 years since the introduction of the euro.

Wing's chapter does not address the domestic problems for the countries pursuing the undervalued exchange rate policy either. The risks of sustaining an undervalued exchange rate over a long period of time are: overheating of the economy, leading eventually to an appreciation of the real exchange rate as a result of inflation, and the decapitalisation of the central bank as a result of the accumulation of reserves in foreign exchange currencies. Just look at Korea. The domestic yield on government paper was 5 1/3, the return on US Treasury bills was 1 1/3, so if you accumulate reserves of 125 billion dollars – as they had in December 2003, this meant an interest rate differential loss of 5 billion dollars. Five billion dollars a year is a big loss to suffer for a central bank, it becomes a fiscal deficit. This affects the burden of external debt payments; it depresses domestic standards of living and income.

All of these imbalances should be corrected in an orderly fashion. IMF surveillance should be much more effective and even-handed. But surveillance bites the countries that have IMF programmes; it does not bite the big countries and those who do not have IMF programmes and do not need Fund resources.