### The Washington Consensus as Policy Prescription for Development

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The Washington Consensus as I originally formulated it was not written as a policy prescription for development: it was a list of policies that I claimed were widely held in Washington to be widely desirable in Latin America as of the date the list was compiled, namely the second half of 1989. Of course, development was the main objective of the countries in question; the point is that my agenda excluded policies even if I believed they would promote development unless I was also convinced that they commanded a consensus. But it has been widely interpreted—and by sympathetic observers like Fischer (2003), not just by critics—as offering a policy prescription (and as being of wider application than in Latin America). That is sufficient to make it of interest to ask whether it was a good prescription. Asking that question will also provide the occasion to ask what a good policy prescription would be.

### What Is (or Was) the Washington Consensus?

As I have complained on innumerable occasions, the term "Washington Consensus" has been used in very different ways. One can distinguish at least three distinct meanings:

- 1. My original usage: A list of ten specific policy reforms, which I claimed were widely agreed in Washington to be desirable in just about all the countries of Latin America, as of 1989. That is how it acquired the "Washington" in the title, which was unfortunate in that it suggested (a) to the conspiratorially minded that this was a list of policies that Washington was seeking to impose on the world, and (b) to some of the reformers that Washington was seeking to take credit for the reforms that they were implementing. One of the purposes of the conference (held in 1989) was exactly to explore how much beyond Washington views had changed: We concluded (focusing on Latin America) that there was indeed a big change of views in process (Williamson 1990). We at the Institute for International Economics like to think that we helped this process along, principally through the tract that Bela Balassa honchoed for us in his year off from the Bank (Balassa et al. 1986).
- 2. The set of economic policies advocated for developing countries in general by official Washington, meaning the international financial institutions (the IFIs, primarily the IMF and World Bank) and the US Treasury. Dani Rodrik (2002) has provided a convenient summary of what he conceived this to consist of in

- the year 1999 (see table 1). The original ten points were augmented with a further ten, with a heavy emphasis on institutional reforms and some recognition of the social dimension. This is also the flavor of the eligibility requirements for the Millennium Challenge Account, which is the principal attempt of the Bush administration to help low-income countries.
- 3. Critics' beliefs about the set of policies that the IFIs are seeking to impose on their clients. These vary somewhat by critic, but usually include the view that the IFIs are agents of "neoliberalism" and therefore that they are seeking to minimize the role of the state. An odd feature of this literature is that almost never does it include any citations to substantiate the charge that the IFIs actually hold the views that the author attributes to them. Many of these are out of touch with reality: for example, they often include the charge that the IFIs are pushing cost recovery in primary education, a terrible policy that was indeed pursued in the early 1980s but was progressively abandoned in the years following the admirable UNICEF report *Adjustment with a Human Face* (Cornia, Jolly, and Stewart 1987).

In this lecture I will use the term in the first sense, but let me comment briefly on the differences between the three meanings. To the extent that I was an accurate reporter of the Washington scene in 1989, the first two meanings should have coincided at that time. In fact, I have concluded that I allowed wishful thinking to cloud my judgment of what commanded a consensus in one respect, which concerns exchange-rate policy; I doubt whether even at that time the overwhelming bulk of Washington opinion would have endorsed a competitive exchange rate (which implies an intermediate exchange rate regime dedicated to limiting misalignments), rather than one or other of the two poles (free floating and firm fixity, both of which are prone to generate misalignments). This remains an issue between the original and "augmented" versions of the Washington Consensus. In subsequent years a further divergence emerged, as the IMF (supported by the US Treasury) often pressed its clients to dismember capital controls rapidly. I believed at the time that this was playing with fire, and after the Asian crisis this view is no longer sacrilegious, at least within the IFIs, whose position can reasonably be summarized à la Rodrik as favoring "prudent" opening of the capital account. Of course, there are also ways in which the position of the Bretton Woods institutions moved with the times in ways that I would want to endorse, of which the most notable was the emphasis on institution-building (the so-called second generation reforms).

I cannot say that I see any close connection between the third concept of the Washington Consensus and either of the other two. It seems to me that since the word "consensus" implies a wide measure of agreement, there is an obligation on those who use the term in this way (of whom the most intellectually eminent is Joe Stiglitz) to demonstrate that the views that they subsume under the term are indeed widely held in

<sup>&</sup>lt;sup>1</sup> Items 5 and 17 of Rodrik's list strike me as contradictory, rather than that the latter elaborates on the former.

<sup>&</sup>lt;sup>2</sup> However, to judge from its insistence that the bilateral free trade agreements between the United States and both Chile and Singapore emasculate their ability to use capital controls in the future, the US Treasury continues to believe in rapid capital account liberalization.

Washington, or at least in the IFIs. This they have notably failed to do, for the compelling reason that these views are not in fact widely endorsed even in the IMF, let alone in the World Bank. Accordingly, I regard this usage of the term as mischievous.

### **Evaluating the Ten Commandments**

As stated above, I concentrate on what I originally defined as the Washington Consensus. This was a list of ten policy reforms that were, I argued, widely held in Washington to be needed in most or all Latin American countries as of 1989. I discuss in turn whether each of them was in fact a good prescription for promoting development, and then—in very broad terms—how widely and where they were adopted. In the next section, I consider also whether they collectively amounted to an adequate program for accelerating development.

#### "Budget deficits...small enough to be financed without recourse to the inflation 1. <u>tax.</u>",3

The view was widely held that macroeconomic stability was an indispensable precondition for growth, that reasonable price stability was an essential aspect of macroeconomic stability, and that in most Latin American countries (the exceptions being Chile and Colombia) price stability had been undermined by excessive budget deficits. Ergo, the restoration of fiscal discipline was essential. My formulation focused on the need for sufficient fiscal discipline to avoid the need to resort to the inflation tax.

I am unimpressed by Joe Stiglitz's argument that because moderate price inflation has no measurable growth effect (cf. Bruno and Easterly 1998) it therefore has no serious welfare consequences, so that one should be prepared to accept faster inflation and the larger budget deficits that it would permit. This is primarily because of evidence that, at least in Latin America, the inflation tax is regressive (see, for example, Cardoso, Pães de Barros, and Urani 1995). Since I am also persuaded by the evidence that the Phillips curve is vertical in the long run, permanent acceptance of more than a minimal inflation rate strikes me as misguided.

However, there are two other criticisms of my formulation that strike me as altogether more compelling. The first is that it focuses only on inflation as the ill consequence of an excessive deficit. In the circumstances of Latin America in the 1980s, where few countries had much capacity to finance deficits by issuing domestic debt, that may have been reasonable. But the crises of the past few years make it abundantly clear that this is by no means the only misfortune that a country risks by allowing an excessive fiscal deficit: Excessive debt creation can lead to unsustainable debt dynamics. Note that this criticism reinforces rather than undermines the case for fiscal discipline: It merely says that the criterion of fiscal discipline that I specified needs to be supplemented.

The second criticism is that my formulation focuses exclusively on stabilizing inflation and neglects the Keynesian case for stabilizing the real economy. In a previous

<sup>&</sup>lt;sup>3</sup> The description of each of the ten points is taken from Williamson (1994, pp.26–28).

lecture in this series, Alejandro Foxley (2003), the first finance minister of Chile after the restoration of democracy, described how the government of which he was part had run budget surpluses and used an *encaje* to limit the entry of foreign capital when the economy was booming and foreign capital was trying to flood in.<sup>4</sup> The democratic government inherited quite a high rate of inflation (over 20 percent a year); it neither decided to live permanently with this nor give priority to rapidly establishing price stability but sought to work inflation down gradually over the decade (as it did). I believe those wise policies were an important cause of the success of Chile in the 1990s, and I worry that the central bank's focus on nothing but stabilizing inflation that is now in vogue in Chile makes it unlikely that the country will enjoy similar success in the current decade. But note once again that this criticism does not generate any general case for looser fiscal policy; it says that fiscal policy should be tight during the boom so that it can be easy during recession.

Even if Robert Lucas (2003) is right in his argument that the welfare gains from better stabilization are derisorily small in the United States (and I will be surprised if he is not challenged on that contention), I doubt that anyone can argue the same in the context of developing countries. The waste of resources that are underemployed during recessions continues to be massive. But the potential benefit of keeping economies operating close to capacity is not simply the difference between an exogenous level of full capacity output and the actual path of output, unless one is seriously prepared to argue that the path of full capacity output is indeed exogenous. If one believes rather that investment raises output capacity,<sup>5</sup> and one also accepts the strong evidence that investment is responsive to the pressure of demand on capacity (the capacity accelerator), then successful stabilization will have the additional benefit of leading to a faster rate of supply-side growth. That is surely an important part of success stories like Chile and East Asia: Full employment and continued growth increased the incentive to invest and therefore reinforced growth.

2. "...redirecting [public] expenditure from politically sensitive areas [that]... receive more resources than their economic return can justify...toward neglected fields with high economic returns and the potential to improve income distribution, such as primary health and education, and infrastructure."

Note that my version of the Washington Consensus, contrary to the charges leveled by most critics, did not call for general cuts in public expenditure. I would not deny that there are people in Washington who share the *Wall Street Journal's* attitude to this question, but I did not feel that they commanded a consensus. By the late 1980s—after *Adjustment with a Human Face*—there was, rather, substantial support—especially in the World Bank—for redirecting public expenditure in a pro-poor and pro-growth way, from

<sup>&</sup>lt;sup>4</sup> See also Ffrench-Davis (2000) for an elaboration of the Chilean attempt to stabilize the real economy.

<sup>5</sup> Factorial (2001) gives the improved that investment is implement to small the fit was really true that

<sup>&</sup>lt;sup>5</sup> Easterly (2001) gives the impression that investment is irrelevant to growth. If it were really true that investment did nothing to raise capacity, then it would be a waste of resources. What Easterly presumably really believes is that higher investment is not a *sufficient* condition to permit higher capacity growth, a position that is not difficult to endorse.

things like nonmerit subsidies<sup>6</sup> to basic social services and infrastructure. So that is what I put in the Washington Consensus (although most of its critics seem totally unaware of the fact).

Subsequent events have only reinforced my belief that the attitude expressed in policy reform #2 is thoroughly correct. Unfortunately, this is not an area in which I see much evidence that there has been any great progress since 1989. The impact of the Bank's Public Expenditure Reviews never struck me as profound. I fear that many public expenditure decisions are not made according to what economists think of as rational criteria. And slashing reductions in public expenditure do not provide a technique for raising the average quality of spending and cutting out waste. On the contrary, I would conjecture that essential expenditures typically get cut more or less pari passu with waste. The key to an efficient pattern of public expenditure is, in my view, to establish a chain of command consisting of people who actually believe in the ends of the programs being pursued. I see no short cuts.

## 3. "Tax reform...[so as to broaden] the tax base and cut... marginal tax rates."

The ideal held up was based on the Bradley-Kemp tax act in the United States in 1986. Whether or not people believe that public expenditures are sufficiently important to justify relatively high taxes (as Bill Bradley did and Jack Kemp didn't), almost everyone who thinks about it can agree that those taxes that are needed should be raised efficiently, without a panoply of distorting exemptions that force high marginal tax rates on those things that are not exempted.

This is not, one has to acknowledge, the consideration that drove tax reform in most developing countries during the 1990s. The dominant form of tax reform was the introduction or extension of VAT, driven by a desire for a resilient, broad-based (thus relatively nondistortive) revenue source, in part to offset the loss of revenue occasioned by tariff reductions. The main problem with VAT is that it is regressive, and for reasons I have never understood the IFIs have tended to be hostile to correcting this by exempting basic necessities like food and medicines.

My basic remit today is to ask whether the recommendations in (my version of) the Washington Consensus make sense as a policy prescription for development. In view of the fact that my formulation missed the basic objective that drove tax reform, I find it difficult to give myself high marks, even though the point I made is a perfectly sensible one. A good policy agenda for development should have focused on the issue of how additional revenue should be raised, given the combination of the need to correct budget deficits, increase public expenditures (in many countries), and replace the revenue lost by trade reform. That would have compelled recognition of the danger that an increased use of VAT would be regressive and would have invited discussion of how to correct that.

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<sup>&</sup>lt;sup>6</sup> Using the admirable Indian terminology for subsidies that cannot be rationalized either in terms of offsetting externalities or in terms of improving income distribution (like the subsidies given by several Indian states to power consumption by farmers, which tempts the farmers to pump up excessive quantities of water from declining water tables in order to grow rice in semi-arid areas that become waterlogged).

# 4. "Financial liberalization, [involving] an ultimate objective...of market-determined interest rates."

By 1997, when Molly Mahar and I wrote a survey of the subject (Williamson and Mahar 1998), we distinguished six dimensions of financial liberalization: whether credit is allocated by government or the market, whether interest rates are set by government or market, whether government imposes entry barriers to the financial sector, whether government regulates bank operations or allows banks to operate autonomously, whether the government owns the banks, and whether international capital flows are regulated or liberalized. But in 1989, I still thought of financial liberalization primarily in terms of moving to market-determined interest rates, with what I saw as a corollary of allowing banks or markets rather than the government to determine who gets credit; i.e., in terms of the first two dimensions in my later taxonomy. I am quite clear that I was not intending to include liberalization of the capital account.

The case for financial liberalization had been persuasively argued by Ronald McKinnon (1973) and Edward Shaw (1973), but the first experiences in applying it, in the Southern Cone in the late 1970s, had been disastrous. The subsequent post-mortems by economists yielded two explanations. One was sequencing; conventional wisdom came to hold that one of the last things that should be done in a liberalization program is to open the capital account, and that one of several preconditions for this should be a liberalized and robust banking system able to intermediate a capital inflow efficiently to where the social return would be highest. This reasoning suggested that the Southern Cone countries had liberalized capital inflows prematurely. The second explanation concerned financial supervision. Because of the temptations posed by asymmetric information, a liberalization program that hands over the decision as to who is to get credit to the private sector needs to be accompanied by measures to ensure that lenders will make decisions based on where the return/risk trade-off is most attractive. Both insider lending and gambling for redemption need to be disciplined by imposing on bankers the potential obligation to rationalize their decisions to supervisors. This reasoning suggested that the Southern Cone countries had liberalized their financial systems before necessary institutional preconditions had been satisfied.

The last decade has witnessed accumulation of substantial evidence confirming that financial liberalization can yield a real social benefit in terms of an improved allocation of investment (Bekaert, Harvey, and Lundblad 2001; Caprio and Honohan 2001; Rajan and Zingales 2003; and Williamson and Mahar 1998), but also that it can be dangerous. The series of crises that have engulfed so many developing countries are testimony to that. This seems to me to imply that the objective of liberalization indeed makes sense, but that it needs to be qualified in two important ways. One is in delaying capital account liberalization until many other reforms have been successfully completed; since there was no call for capital account liberalization in my version of the Washington

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<sup>&</sup>lt;sup>7</sup> This concerns "matters such as how managers and staff are appointed and what they are paid, where branches may be opened or closed, and in which types of business the bank may engage" (Williamson and Mahar p.2), and not issues that are typically the concern of bank supervisors.

Consensus (see discussion of #7 below), I got that point right. Where I failed was in not emphasizing the need to accompany financial liberalization by the creation of appropriate supervisory institutions.

"...a unified...exchange rate...at a level sufficiently competitive to induce a 5. rapid growth in nontraditional exports."

This is the subject on which I feel I did the least adequate job as a reporter of the Washington scene. I regard myself as very much a disciple of Bela Balassa in believing that export growth is key to igniting a general growth process and that a competitive exchange rate is key to export growth, or at least to the growth of nontraditional exports.<sup>8</sup> If one worries about having an exchange rate sufficiently competitive to induce a rapid growth in exports, then one will be driven to support some form or other of intermediate exchange rate regime, since both fixed and floating rates imply governmental acquiescence in whatever real exchange rate happens to result from market forces. But in fact most of Washington, like most of the economics profession, seems content with one or other of the polar positions: Indeed, only a couple of years ago it seemed to be commonly believed that supporting anything else was a mark of mental imbecility.

While I fear that my version of the Washington Consensus was bad reporting of the Washington scene, I still think it was thoroughly admirable as a prescription for development. I do not believe that the Washington institutions, or the economics profession, did a service to development by their infatuation with the bipolar solution.

"Quantitative trade restrictions should be rapidly replaced by tariffs, and these 6. should be progressively reduced until a uniform low rate of 10 [to 20] percent is achieved."

It certainly seems sensible to start a process of trade liberalization by getting rid of quantitative restrictions and replacing them with high tariffs, since (a) this channels the rents to the government instead of privileged importers; and (b) it allows import quantities to expand in response to shocks that increase the need for imports. It also seems sensible to reduce tariffs progressively until there is ambiguity as to whether the benefit of freer imports may be outweighed by a terms-of-trade cost and/or the loss of bargaining power in the WTO. I asserted that this would happen with tariffs in the range of 10 or at most 20 percent, which was admittedly a guess but was intentionally above the zero that many trade economists would argue to be the appropriate number for a small country. Two issues on which my formulation deliberately did not take a stand are: how fast it is sensible to reduce protection, and whether it might be prudent to make the speed of dismantling protection endogenously dependent on the strength of the balance of payments, as in Western Europe after World War Two.

<sup>&</sup>lt;sup>8</sup> I have attempted to formalize these ideas in a recent paper (Williamson 2003). The basic idea is to ask what exchange rate will maximize the growth rate, given that a more competitive rate will promote investment but will also curtail the resources available for investment (since the current account deficit will be lower). A different (also important) question is whether the government commands policy weapons that would allow it to achieve the growth-maximizing exchange rate.

Critics have mostly been noneconomists who believe that reducing protection threatens jobs. There are of course two ripostes to this claim. One is that higher prices for protected imported intermediate goods will reduce jobs in the end-use industries even at a constant exchange rate, and that this effect may outweigh the direct effect of the increased number of jobs in the intermediate-goods industries. (The recent steel protection in the United States is an instance where analysis at the Institute for International Economics concluded this effect dominated; see Hufbauer and Goodrich 2003.) The other is that the (real) exchange rate may adjust. This is indeed the standard assumption implicitly or explicitly employed by economists analyzing this issue and implies that whatever else it may do, a reduction in protection will not cause a net loss of jobs. But of course one of the problems with trade liberalization in the 1990s, especially in Latin America, is that no attempt was made to ensure that this assumption was satisfied. Capital inflows were often allowed to appreciate real exchange rates to a point where there was indeed a net loss of jobs in the tradable goods industries.

Another common critique is that an obligation to liberalize trade precludes a country from using protection to nurture infant industries. I imagine that most of us here have at various times made cracks about infant industries that failed to grow up, and I believe that in most instances such remarks are well-justified. Nevertheless, I wonder whether we would not be wise to recognize that there are also occasional cases in which an industry was nurtured by protection and did grow up to be internationally competitive (the Brazilian auto industry is an example that comes readily to mind). There is of course an argument based on the theory of optimal intervention that any such support is better provided directly by a subsidy, but it is also a fact that many developing countries are subject to fiscal pressure that may preclude that possibility. Maybe there should therefore be a mechanism in the WTO whereby a developing country that wishes to nurture an infant industry through protection could announce and register its intention to grant temporary protection, provided it simultaneously announced and registered the timetable by which the protection would be phased out. Failure to abide by its declared intentions could be subject to similar sanctions as those that can be deployed to enforce the rest of the WTO's rules. (Perhaps it would also be necessary to craft rules to limit the extent of the temporary protection, in terms both of duration and the height of the initial tariff, but I will not enter into discussing how this might be done here.)

# 7. "Barriers impeding the entry of foreign [direct investment] should be abolished."

In 1989 there was still widespread reluctance to accept foreign investment, including FDI. This did not make economic sense. Even those of us who have emotional reservations about Mickey Mouse and McDonalds can also have sufficient respect for consumer sovereignty to accept that others should be allowed to consume their products if they so wish. Usually a company will only be prepared to invest abroad, with all the costs and risks of operating in an unfamiliar cultural and legal environment, if it commands some form of intellectual property that will compensate for its disadvantage vis à vis local competitors. Making that intellectual property available in a developing

country is likely to contribute to development (although perhaps least in the case of consumer products like those produced by Disney and McDonalds). That logic seems to have been generally embraced over the 14 years since 1989. The more important problem now is to restrain countries from competing for FDI by offering investment incentives, thereby handing an undue proportion of the benefits of FDI back to the companies that make the investments.

One of the advantages of FDI that has been strongly emphasized at least since the Asian crisis is that the flow of FDI is much more stable than that of portfolio capital and certainly of bank loans. Note that my version of the Washington Consensus spoke quite specifically of liberalizing the inflow of FDI, and not of general liberalization of capital inflows (let alone of capital outflows as well). That was because I did not believe there was (or, for that matter, that there should have been) a consensus as to the desirability of capital account liberalization. Stanley Fischer, in his comment on my original paper while serving as chief economist of the World Bank, queried my judgment on this. He asserted that there was in fact strong sentiment in Washington in favor of capital account liberalization. Whether or not he was correct on that in 1989, it certainly became true by the mid-1990s, with Fischer himself—who had expressed reservations about the wisdom of such liberalization in 1989—being perceived as strongly in favor of it in the position he then held of first deputy managing director of the IMF. Along with the bipolar exchange rate regime, this seems to me to be one of the key respects in which the second concept of the Washington Consensus—as the conventional wisdom of the Bretton Woods institutions—came to differ from the first concept—my original list. I believe that in both cases my formulation was a much better prescription for development than the advice proffered by the Bretton Woods institutions, or at least by the IMF. I hold premature capital account liberalization to have been primarily responsible for the catastrophe of the Asian crisis that overtook the tigers in 1997 and interrupted the East Asian miracle.

#### 8. "Privatization of state-owned enterprises."

Privatization was Margaret Thatcher's principal personal contribution to economic policy worldwide. It is the only doctrine for which one can trace a specifically neoliberal<sup>10</sup> origin that made it to my list of ten desirable reforms. Neither minimalist government nor supply-side economics, nor monetarism, nor the treatment of income redistribution as an assault on property rights or a threat to incentives made it to the Ten Commandments. These doctrines also were promulgated by the quintessentially neoliberal Reagan administration and Thatcher government, but my list was intended to include what had outlasted them and made it to mainstream thinking by 1989. (It was, after all, supposed to consist of doctrines about which there was a consensus.) I concluded that privatization fell in that category, so it got included, whereas the other doctrines with a neoliberal origin did not.

<sup>&</sup>lt;sup>9</sup> See Fischer (1997) or his contribution to Fischer et al. (1998) for expositions of his position at the time. These statements suggest considerable enthusiasm for the goal, though qualified by caution about the potential danger posed by increased vulnerability of the economy to swings in market sentiment.

I use the term in its original sense, to refer to the doctrines propagated by the Mont Pelerin Society.

The bulk of the economic evaluations of privatization conclude that it has succeeded in two dimensions: in raising efficiency and profitability of the privatized enterprises, and in increasing coverage and access to privatized utilities. In other dimensions the results seem to be all over the shop: It appears to have had no consistent effect on wages, on prices, on output quality, or on employment (in some cases the firings due to higher productivity are more than compensated by increased output, and in other cases they are not) (Megginson and Netter 2001, Nellis 2003). Despite the fact that economists tend to regard this as providing an endorsement of privatization, the fact is that—at least in Latin America, where Latinobarometro provides regular and reliable evidence of public attitudes—privatization is intensely and increasingly unpopular. One can understand why in certain instances, where the process of privatization was suspected of being corrupt or the privatized enterprise was allowed to retain a monopoly and there was no adequate regulatory mechanism established, it evoked public hostility, but its unpopularity seems more general than can be explained this way. Part of the problem may be the arousal of nationalist sensibilities where enterprises have been sold to foreign buyers, especially those from neighboring countries who are seen as historic rivals. And perhaps we economists tend too readily to dismiss public concern about corruption in the process of privatization as fuss about "mere" distribution effects; 11 perhaps the public would actually prefer to see wealth destroyed rather than transferred to those who acquire it by illicit means. If we think that democratic proprieties oblige us to respect public preferences, we need to be extra careful that all future privatizations are squeaky clean.

# 9. "[Abolition of] regulations that impede the entry of new firms or restrict competition."

The word deregulation has sometimes been used to cover the emasculation of regulations intended to safeguard public health or the environment, or to protect consumers. This was not the sense that I intended when I included deregulation in the Washington Consensus. Rather, the purpose was to recommend the removal of constraints on entry and exit, so as to make the economy more competitive. The US model was deregulation of the trucking or airline industry, not gutting the Endangered Species Act.

Is this a reform that could be expected to travel well, i.e. to be appropriate if implemented in developing countries? There have in fact been some excellent examples of exactly such reforms in developing countries, such as India's deregulation of trucking in the 1980s, which was a big success (Williamson and Zagha 2002). I can think of few things that have struck me as more perverse when I have visited developing countries than discovering that the only legal passenger transport was that provided by a parastatal bus company than ran smoke-belching monsters three-quarters empty. One of the very best services that the Bank has done to the cause of development in recent years has been to create a website 12 where every developing country can see for itself how difficult it makes it for new firms to enter the formal sector compared to the obstacles faced in a

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Megginson and Netter (2001, p. 329) are typical in dismissing the importance of such issues: "...we ignore the arguments regarding the importance of equitable concerns such as income distribution..."

http://rru.worldbank.org/DoingBusiness/SnapshotReports/EntryRegulations.aspx

best-practice country (like Canada, where registering a new firm requires two procedures taking three days and 0.6 percent of the country's per capita GNP, and demands zero minimum capital). Besley and Burgess (2003, p.17) provide emphatic support for making "appropriately structured deregulation...part of the antipoverty agenda." So I think deregulation is an excellent candidate for inclusion in a policy prescription for development.

# 10. "The legal system should provide secure property rights without excessive costs and make these available to the informal sector."

This was the one institutional reform that got included in the original version of the Washington Consensus. The initial impetus to its inclusion came from Hernando de Soto (1989), who had made the case for granting secure property rights cheaply to Peruvian informal enterprises. He argued that allowing them to formalize cheaply was in their best interests because it would reduce the cost of defending their property and assure them they would benefit from their own investments, as well as empowering them to access credit from the formal sector. It would simultaneously increase the government's tax base, so it was in the wider public's interest too. Hernando de Soto (2000) has continued to develop this theme, and a study of Acemoglu, Johnson, and Robinson (2001) provides evidence that increased protection of property rights could be expected to have a strong effect in reducing poverty.

Shortly after I had written my 1989 paper, I began to get interested in the transition from communism to a market economy that was then in its early stages. It soon became clear that institutional issues were, or at least should be, at the heart of the transition, and that one of the most critical actions was defining property rights. Hence I have no doubt that this theme deserved a place in the Washington Consensus.

### The Extent of Implementation

I do not have time today to offer a systematic survey of the extent to which my version of the Washington Consensus was implemented in the past 15 years, but let me offer a few remarks by way of orientation. The regions that moved furthest in the direction of stabilization, liberalization and integrating with the world economy were Latin America and the economies in transition. East Asia moved much less, and in my view some of the movement it did was a mistake (I am thinking of the rapid capital account liberalization), but it is important to recognize that it started off with much less divergence from the OECD countries in its policy stance, especially on the stabilization front. China and South Asia both moved rather gradually, but the direction of movement was unambiguous. Sub-Saharan Africa moved spottily and grudgingly, too often under foreign pressure rather than out of conviction.

Argentina was often described as a poster-child for the Washington Consensus, and it did indeed do many excellent liberalizing reforms in the 1990s (for which it was rewarded by the fastest growth since at least the 1920s). But it also failed to do two crucial things, namely maintain a competitive exchange rate and get its fiscal policy in

order. Since both of these were included in my version of the Washington Consensus and it was precisely the failure to address these two issues that led to the crisis of 2001, I find it a bit rich to hear the Washington Consensus blamed for Argentina's implosion.

In terms of which reforms were widely implemented, there was a widespread attempt to tighten fiscal policy, extensive financial and trade liberalization, virtually universal elimination of restrictions on inward foreign direct investment, a lot of privatization, and quite a bit of deregulation. The things that got most widely neglected were reforming public expenditure priorities, maintaining a competitive exchange rate, and extending property rights to the informal sector. As already confessed, my formulation of tax reform failed to address the main issue. Let me emphasize that offering this summary is not intended to imply that the ten reforms in my list were everywhere the ten most important or urgent issues.

### What Would a Good Policy Prescription Look Like?

My review of the ten policy prescriptions that composed my version of the Washington Consensus has not, I trust, given the impression that I believe they embodied all the truth and nothing but the truth, any more than that I think there was a lot that needs retracting in the light of experience. Most countries would have benefited by doing more of these reforms rather than fewer, and by doing them of their own volition rather than because someone from Washington tried to tell them they needed to be done. The big changes in development thinking that underlay the Washington Consensus—recognition of the importance of macroeconomic discipline, trade liberalization rather than import substituting industrialization, development of the market economy rather than reliance on the leading role of the state—were as valid in developing countries as they had long been regarded in the OECD. The end of the intellectual apartheid that used to divide the globe into First, Second, and Third Worlds, each with its own economic laws, is something to be celebrated rather than mourned.

But that is not the same as saying that the Washington Consensus, either in my version or as the policy stance of the Bretton Woods institutions, provides an adequate policy agenda for development. In this section I want to outline how a group of colleagues and I have sought to update an agenda for development in the light of changing times and in the absence of an obligation to stick to proposals that we believed to be consensual. I shall then go on to discuss two of the leading critiques of the Washington Consensus: that of Joe Stiglitz in his WIDER lecture (Stiglitz 1998) and that of Dani Rodrik (2002, 2003). I shall ask how well our proposals stand up in the light of the criticisms that were directed at the original Washington Consensus.

### "After the Washington Consensus..."

I need first to outline what our new strategy, presented in Kuczysnki and Williamson (2003), suggests (Latin American) countries ought to do. I summarized our suggested strategy under four headings.

First, governments should aim to avoid crises and stabilize the macroeconomy. This still involves stabilizing inflation, the focus of most policy discussions a bit over a decade ago and the element that I included in the Washington Consensus, but it also requires an attempt to stabilize the real economy à la Keynes. We also discuss issues like exchange rate policy, where we emphasize the importance of flexibility in most cases while acknowledging that there might be specific circumstances in which fixed rates make sense, and the importance of avoiding currency misalignments and mismatches.

Second, we argue the desirability of completing rather than reversing the liberalizing reforms of the Washington Consensus. We place particular emphasis on the desirability in most Latin American countries of liberalizing the labor market, so as to price a larger part of the labor force back into formal sector jobs where they will get at least minimal social protections. We also argue the importance of complementing the import liberalization that has already occurred with better access to export markets in developed countries, and we urge the benefits of continuing the privatization program that has already been undertaken in Latin America.

Third, we join the general chorus urging reforming countries to recognize that strong institutions are needed to make good policies effective. For example, a reformed tax code will not be much use if the tax administration remains mired in corruption. We talk a bit about some of the institutional strengthening that we would like to see, but this covers a vast area and what is most urgent varies a lot from one country to another. This is of course an important change from the Washington Consensus, which was not ahead of its time in that it focused on policies rather than institutions. Recognition of the importance of institutions was perhaps the key innovation in development economics in the 1990s.

Fourth, we urge that the objective of economic policy should not be formulated just as increasing the growth rate, important as that is, but that governments should also recognize that it matters profoundly *who* gets an increase in income. We suggest that there might be some scope for pushing further the traditional mechanism for improving income distribution, namely levying heavier taxes on the rich so as to increase social spending that benefits disproportionately the poor, but acknowledge that it would not be practical to push this very far, because too many of the Latin rich have the option of placing too many of their assets in Miami. We therefore conclude that major improvements in the region's highly skewed income distributions will take a long time, since the alternative approach has to be to build up the assets that will enable the poor to earn their way out of poverty. That would require above all improved educational opportunities so that the poor can accumulate more human capital, but we also mentioned the potential of microcredit, land reform, and asset titling.

### The Critique in Stiglitz's WIDER Lecture

Joseph Stiglitz uses what I have dubbed the third concept of the Washington Consensus, interpreting it as a neoliberal manifesto. The "Post-Washington Consensus" that he

sought to sketch should not be based on Washington, for an essential feature is that it be owned by developing countries, but he evidently assumed that a new consensus might emerge and that is what he was seeking to help mould. This new consensus should be focused on achieving a broader range of goals than just economic growth: It should also pursue equitable development, sustainable development, and democratic development. To that end, it needs to encompass a broader range of instruments than those embodied in the Washington Consensus:

- It should aim at stabilizing the real economy as well as inflation;
- It should attempt to improve the regulatory framework of the financial system, rather than assume that liberalization is the only game in town;
- It should include a competition policy;
- It should consider various possible mechanisms for improving the efficiency of government, rather than seeking to minimize government's role (remember that Stiglitz interprets the Washington Consensus as advocating minimal government);
- It should focus on improving human capital formation; and
- It should seek to increase the transfer of technology to developing countries.

When I review this list I must say that I am impressed at how much of it got incorporated in Kuczynski and Williamson (2003). We certainly focused on the desirability of stabilizing the real economy as well as inflation. Although we did not talk of amending financial regulation, we did talk of the need to strengthen prudential supervision, so despite taking a more charitable view of financial liberalization than does Stiglitz we too recognized that the state has a key role in making a liberalized financial system work. We did not specifically call for a competition policy, but we did emphasize that a privatized monopoly needs a strong regulatory mechanism. There are important parallels between our thoughts on strengthening institutions and his call for reform of the state. We certainly emphasized the importance of human capital formation. And our call for a national innovation system was intended to facilitate technology transfer. In terms of objectives, we clearly shared his concern that development should be equitable, and we acknowledged the importance of the environmental and democratic dimensions although we did not interpret our mandate as implying an obligation to focus on those issues. The main difference between us seems to be the semantic one of what we mean by the Washington Consensus and therefore whether we think it is a Bad Thing.

Where Stiglitz strikes me as sadly naïve is in imagining that the world is on the road to a new consensus incorporating concerns over equity, sustainability, and democracy as well as growth. One may want to discuss whether there was really a consensus in 1989 (indeed, more than one person has quipped that the very notion of a Washington Consensus is an oxymoron), but surely 1989 came closer to that than ever before or probably than we will ever see again (after all, that was the year that history was ending). To imagine that we are on the cusp of a new consensus embracing equity and sustainability when the leading economic power has unbalanced its budget by the most inequitable tax cuts in living memory and denounced Kyoto strikes me as fantasy.

### Rodrik's Critique

Dani Rodrik (2002, 2003) claims (just as Kuczynski and Williamson do, though we were discussing Latin America and the message of gloom is quite unjustified when one includes Asia) that economic developments in most developing countries have hardly been encouraging in recent years, in terms of growth, crises, income inequalities, poverty, and economic security. Those few countries that have done well (such as China, Chile, India, and Vietnam) "have marched to their own drummers and are hardly poster children for neoliberalism" (Rodrik 2002). He asserts that the augmented Washington Consensus is just as bound to disappoint as its predecessor because it offers too broad an agenda of institutional reform that is insensitive to local context and needs. It describes what advanced countries look like, rather than prescribing a practical path for getting there. He argues that the aim should be to provide an alternative set of policy guidelines for promoting development, while avoiding offering another impractical blueprint that is supposed to be right for all countries at all times.

With most of that, I wholeheartedly agree. <sup>14</sup> I applaud especially Rodrik's call to avoid jettisoning all the useful insights in mainstream economics, like the importance of property rights and the rule of law and incentives, the need to worry about debt sustainability, prudential principles, and sound money, the desirability of growth, and the benefits of globalization. He has a very interesting argument (although he carries it a bit too far, see below) that such "universal principles of good economic management" do not map uniquely into particular institutional arrangements or policy prescriptions. Debt sustainability, fiscal prudence and sound money are, he asserts without giving examples, compatible with many other institutional arrangements besides independent central banks, flexible exchange rates, and inflation targeting. The need to align private incentives with social costs and benefits does not translate into unconditional support for trade liberalization, deregulation and privatization.

He argues that transitions to high growth are usually sparked by a few policy changes and institutional reforms, which typically combine elements of orthodoxy with heterodox institutional innovations that are unlikely to travel well. Countries need both a short-run investment strategy to kick-start growth and a longer-run institution-building strategy to give the economy resilience in the face of volatility and adverse shocks and thus keep growth going once it has been initiated. The investment strategy needs to combine a carrot to promote investments in nontraditional areas with sticks to weed out investment projects that fail. The key challenge is to learn what a country is (or can be) good at producing: Investment that contributes to this has social value that can much

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He uses the word to describe the policy stance that has been dominant in the United States in recent years, not in its original sense to refer to the doctrines espoused by the Mont Pelerin Society.

<sup>&</sup>lt;sup>14</sup> In particular, I agree that countries can sometimes benefit by heterodox proposals. We at the Institute for International Economics once ran a conference when the ideas that ultimately flowered into the Plano Real first took form, with the objective of trying to make sure that if Brazil did implement the plan it would not be sabotaged by the IMF's dinosaurs: see Williamson 1985. To my mind the Plano Real was one of the most brilliant of those heterodox plans about which Rodrik enthuses, and was totally country-specific. (Its essence was *not* the use of the exchange rate as a nominal anchor, which was an unfortunate belated addon, but use of the indexation unit as the new monetary unit following a monetary reform. It is wrong to say that the plan was abandoned when Brazil devalued in 1999.)

exceed its private value and thus will be undersupplied in the absence of subsidies of some form or other. But countries also need a mechanism to terminate investment projects that do not pan out, such as the willingness of Korea to cut off companies that did not succeed in the export market. Latin America lacked that in the era of import substitution, and when it was introduced with the opening of the 1990s countries dropped the carrot, whereas the need is to run the two in tandem.

Exactly what form of institutions will best serve a country is not pinned down by economic analysis. Discovering what works in a country requires experimentation. Rodrik presses this point home with a brilliant thought experiment. He asks us to imagine the program that one of us Western economists would have recommended to China in 1978 if we had been asked, and it turns out to be the quintessential Big Bang. But fortunately that is not what the Chinese reformers did: Instead they introduced the household responsibility system, two-track pricing, and township and village enterprises. I was told over dinner in Beijing in October that in fact none of these was introduced as the result of analysis undertaken in a Beijing think tank: In each case it was legitimized by the leadership after emerging spontaneously at the local level, and working.

If reforms need to differ by country, then a general blueprint such as the Ten Commandments of the Washington Consensus sends a wrong message. Moíses Naím (2000) once explained the success of the Washington Consensus as providing an ideology for a world that was pining for something to replace the god of socialism that had just failed. An ideology, he went on to explain, is a thought-economizing device. Follow the Ten Commandments and thou shalt grow, I suppose. My immediate reaction was that the world needs policymakers who think rather than those who economize on thought (Williamson 2000). I now feel even more uncomfortable with the realization that I may inadvertently have encouraged people to think they do not need to adapt to local circumstances but can operate from the same blueprint everywhere.

But Rodrik takes too far the argument that agreement on the characteristics of good economic management does not map into endorsement of particular policies or institutional arrangements. He appears, for example, to think that one can dismiss the case for trade liberalization because his graduate students are capable of writing down a model in which trade restrictions are welfare-enhancing. The argument in favor of liberal trade is essentially empirical, involving formal econometric evidence where available but also less formal attempts to make sense of what we see in the world around us. We need always to retain a mind that is sufficiently open to recognize that standard arguments may not apply, but we should also attempt to discover what the standard case is. Indeed, the basic purpose of thinking about development strategy is to identify regularities about policies and institutional arrangements that suggest what might be useful in other countries. We would seriously shortchange our clientele if we were to stop short with the sort of questions Rodrik poses, like "What is the appropriate regulatory apparatus for the financial system?" or "What is the appropriate exchange-rate regime?" We need rather to offer some answers, even if we expect these only to be standard answers, from which the actual answer may differ in some particular situations.

How adequate do the Kuczynski-Williamson proposals appear as a strategy for development in the light of the Rodrik Critique? First, I do not believe that this time round it will appear as a "neoliberal" formula, partly because it includes concern for income distribution and the social agenda, and partly because the summary version is in less danger of being mistaken for the Ten Commandments. But of course I never expected the last version to be interpreted that way either. And the new version still reflects a conviction that any country that wants to develop will be well-advised to seek to build a market economy rather than one in which the state plays the leading role in the productive sector. That will change when we observe a raft of centrally planned economies succeed in becoming high-income economies!

Second, I would maintain that it strikes a better balance than Rodrik's approach in terms of offering substantive advice on the strategic issues that confront developing countries. We do not leave the reader pondering questions like "What types of financial institutions are most appropriate for mobilizing domestic savings?" or "should fiscal policy be rule-bound, and if so what are the appropriate rules?" but outline what we believe the answers to be. We emphasize that we would expect the optimal sequencing of reforms to differ from one country to another, and suggest that successful reformers are less countries that identify the right reforms than those that correctly identify where the constraints are binding and thus implement the right reforms at the right time.

Third, however, it does not address the issue of igniting an investment boom that Rodrik regards as key, except by emphasizing the importance of a competitive exchange rate and the advantages of a national innovation system. Can one argue that in Latin America, as opposed to Africa, the countries have passed the stage where this is important? I think not; they may have had a healthy rate of investment at some time in the past, but investment rates now need boosting just about everywhere. Rodrik's argument that there is an important benefit external to the firm in identifying new export products that a country is capable of producing is persuasive, but this does not make a convincing case for subsidizing all investment, nor for thinking that governments will be capable of sorting out ex ante those cases where a subsidy is called for from the rest. Stimulating investment is a key to faster growth that probably got shorter shrift than it should have done both in the original Washington Consensus (cf the critique of Pedro Malan 1991) and in our new study, but that may be partly because the best way to stimulate investment varies even more than Rodrik acknowledges. For example, in Brazil today I would hate to see the government start subsidizing particular investments rather than get the real interest rate down from the double-digit stratosphere where it has been ever since the Plano Real, and indeed long before. So while it may be right to leave the door slightly open for measures to subsidize investment, the fact is that I have yet to observe such measures—beyond competitive exchange rates and national innovation systems—that I would feel confident in recommending to other countries.

### **Concluding Remarks**

Was the Washington Consensus a good policy prescription for development? I have argued that that depends critically upon how you interpret a phrase whose meaning has become hopelessly compromised in public debate. The specific set of proposals to which I originally applied the term describe a sensible, if incomplete, reform agenda. But I have also argued that two of the ways in which much of Washington subsequently departed from this agenda were misguided. Today I would go further and argue that in this second sense the Washington Consensus has evaporated because of the profound gulf between the Bush administration and the IFIs on fiscal policy (see IMF 2003, p.22), income distribution (contrast the 2000 *World Development Report* and the Bush administration tax cuts), and capital account convertibility (see note 3 above). And I can understand why anyone who has been brainwashed to think of the term in its third sense, as a neoliberal agenda, would reject it as unhelpful.

I have also sketched the outlines of the strategy for development that a group of us launched last year. I compared this with the critiques of the Washington Consensus made by Joseph Stiglitz and Dani Rodrik. So far as Stiglitz is concerned, it turns out that our new agenda incorporates most of his substantive points and our main disagreement is semantic. Rodrik's disagreement is much more with the notion of formulating a program intended to apply to many countries, rather than with the specific policy proposals. I have some sympathy with this critique: I certainly believe that sequencing needs to be decided by each country in the light of its specific circumstances, and I can conceive that countries may at times have good reasons for doing heterodox things. However, I believe Rodrik is altogether too nihilistic in implying that the most economists can usefully do is to spell out the questions to be asked, rather than marshalling the evidence for expecting a particular answer to be the norm. Sadder and wiser 15 years later, I no longer expect those particular answers to command a consensus.

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**Table 1: Rodrik's Augmented Washington Consensus** 

The Original Washington Consensus	The Augmented Washington Consensus
	The original list plus:
•Fiscal discipline	•Legal/political reform
•Reorientation of public expenditures	•Regulatory institutions
•Tax reform	•Anti-corruption
•Financial liberalization	•Labor market flexibility
•Unified and competitive exchange rates	•WTO agreements
•Trade liberalization	•Financial codes and standards
•Openness to DFI	•"Prudent" capital-account opening
•Privatization	•Nonintermediate exchange rate regimes
•Deregulation	•Social safety nets
•Secure property rights	Poverty reduction

Source: Rodrik (2002).