After the Washington Consensus: Latin American Growth and Sustainable Development

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A common view of Latin America is roughly as follows: The Washington consensus held sway in the early 1990s and only modestly revived growth even after the debt crisis was resolved and the "lost decade" ended. There followed another terrible half-decade of growth, from 1998 to 2002, until the sudden stop of capital inflows ended in 2003, permitting growth to resume. However, by this time, the voters had finally revolted against more of the same and begun moving left. Depending on whether one foams at the mouth when uttering the term "Washington consensus" or embraces it as a panacea, one may regard the resulting widespread advent of left-wing governments as promising a new dawn or condemning the region to continued failure.

I find this common view of Latin America difficult to reconcile with some salient facts about the region. The most telling is that at least five of the seven large countries of Latin America are following extremely prudent macroeconomic policies. These five may be compared with at best two of the seven about whom I would have said the same thing when capital was last flooding in and the Washington consensus was supposedly riding high. Look at table 1 to see what I mean. Growth is somewhat lower except in Mexico and the two countries, Argentina and Venezuela, that were recovering in 2004–05 from macroeconomic collapses, which presumably reflects a policy decision not to splurge this time around. But in five of the seven countries, inflation is vastly lower and comfortably in single digits, the fiscal balances are substantially more robust, the current account is everywhere much stronger, the proportion of short-term foreign debt has fallen (in some cases drastically) except in Argentina and Venezuela, and debt/export ratios have fallen dramatically. I see no sign here that the present expansion is destined to end in a regional crisis, like twice before.

Perhaps I do not read the Latin American press diligently enough, but (except in the case of Venezuela) I do not recall reading stories about financial repression increasing, or trade restrictions being toughened, or budget deficits being increased, or foreign direct investment (FDI) being restricted as it used to be. The trend to privatize utilities seems to have run into the sand, and there may even be some reverse movement (as there certainly is with Bolivian hydrocarbons). Certainly fewer leaders choose to emphasize their liberal policies, and it is indeed true that less liberalization is taking place, but this is at least in part because the economies are now much less dirigiste than they were. But I see no sign of a general attempt to turn the clock back.

A hopeful view of the present situation would hold that Latin America has now caught up with the rest of the West in no longer expecting to find simple solutions to complex problems. It is recognized that growth does not come from increasing capital formation without any need to worry about the quality of the investments. The claims of *dependência* theorists that salvation is to be found in curtailing relations with more advanced countries are not taken seriously. Import substitution is not looked to as the solution to balance of payments difficulties or demand deficiencies. No one now believes that growth will follow automatically if only their government implements the ten points that I listed in the Washington consensus—which surely does not imply that they believe that doing the reverse would be smart!

There is no less need to consider an appropriate set of policies just because one no longer believes that an ideological label can be affixed to the resulting package. What it does imply is that the discussion of policy options can take place with ideological labels in their proper role, which is that of markers that can help make a quick first appraisal of particular policies, not a final judgment.

The set of policies that I think would be helpful are essentially those outlined in a book that I coedited and that was published in 2003, called *After the Washington Consensus: Restarting Growth and Reform in Latin America*. I propose to outline these policies, amplifying what we wrote in 2003 in certain dimensions. In doing this, however, I hope that it will be clear that I am not claiming that these policies amount to a cookbook that absolves those applying them of the need to think, that they offer any sort of panacea, or that they should always be applied in the same way everywhere. I do believe that there are enough similarities between the various problems faced by different countries to make it useful to discuss solutions that may be relevant in a number of countries, but I also believe that there are enough differences to require policymakers to work out what is applicable and most urgent in their particular situation.

The Macroeconomic Agenda

Economic progress came to a halt during the lost half-decade because of the series of crises that engulfed the region. Foreign exchange crises, in which countries ran out of reserves and were forced to abandon exchange rate regimes on which they had based their stabilization policies, happened in Mexico in 1994, in Brazil and Ecuador in 1999, in Argentina in 2001, and in Uruguay in 2002. Debt crises, in which unstable debt dynamics made continued servicing of the public debt on contractual terms impractical, happened in Ecuador in 1999 and in Argentina in 2001, and almost occurred in Brazil in 2002. Banking crises, in which wide segments of the banking system had to be bailed out as the only alternative to being closed down, materialized in Mexico in 1995, in Argentina in 2001, in Uruguay in 2002, and in the Dominican Republic in 2003.

Given how easily crises blew up in the past, reducing the chronic crisis vulnerability of the region needs to be an objective of the highest priority. This requires, first and foremost, reorienting macroeconomic policy, so that it is less concerned with short-run growth maximization and more concerned with achieving and maintaining strong fundamentals—a sound fiscal position, low public debt relative to GDP, a strong current account position, substantial reserves, a low (or, if not, declining) ratio of foreign debt to exports and GDP, a small proportion of short-term debt, and so on. This is not to dismiss the importance of economic growth; on the contrary, elimination of crises and the resulting greater continuity of growth may be expected to increase the average growth rate because more is lost by having crises than is gained by intensifying the booms. A further bonus could come from the boost in the incentive to invest that would presumably come from curbing recessions, which could increase the long-run growth rate.

One feature of this policy revolution should be the introduction of a countercyclical fiscal policy, in which the budget runs surpluses in times of prosperity and deficits during recessions. But usually it is practical to start such a policy only during the boom, which provides a chance to reduce debt to a level where the public is prepared to buy more debt, so that a stabilizing deficit can be allowed to materialize when times are difficult. Similarly, if a country is receiving large capital inflows and/or large current account surpluses as a result of high commodity prices, then it should stash away a part of the temporary bonus in high reserves or a stabilization fund rather than rushing out and spending everything immediately.

Another way in which macroeconomic policy can reduce the danger of a crisis happening is by the adoption of a relatively flexible exchange rate regime. It is wrong to think that freely floating exchange rates will avoid all crises, and there ought to be other objectives to economic policy besides crisis avoidance—like avoiding an overvalued exchange rate so as to maintain the stimulus to export and invest in the production of tradables. Nevertheless, allowing a loss of market confidence to be reflected automatically in a higher exchange rate would eliminate the classic cause of foreign exchange crises. That could be reinforced by replacement of foreign-currency debt by domestic-currency debt, so that there is less currency mismatch to interact with any depreciation to increase the debt burden. The recent success of several Latin American countries in selling bonds denominated in their domestic currency on the international market makes clear that it is a mistake to argue that this is precluded by "original sin." Even better, the burden of debt service would vary in a stabilizing way if countries adopted the proposal of issuing growth-linked bonds (see, for example, Williamson 2005).

As suggested by table 1 and the discussion in the Introduction, I see Latin America as having made enormous gains in these dimensions during the current recovery. I sense little danger that the countries that have continued to eschew populism will get sucked into a new round of crises. By far the biggest danger confronting Latin America seems to be the likelihood that, along with most other regions, it will suffer from the world recession that would probably result from a sudden collapse of the dollar. But this danger cannot be reduced by accelerating short-run growth through the adoption of less prudent policies.

To congratulate policymakers on minimizing the danger of a new round of crises developing is not the same as to endorse every policy currently being pursued. Let me take the case of our host country, Brazil, as an example that will enable me to talk in more specific terms. I strongly welcome the stance of fiscal policy in recent years, and the large primary budget surpluses that have been achieved. The highly competitive level of the real from 2002 to 2005 resulted in a rapid growth of exports and the substantial current account surpluses that standard theory would lead one to expect. On the other hand, I believe that the necessary monetary tightening in response to the acceleration of inflation in 2004 overshot. The extremely high interest rates of recent months have produced a number of unfortunate consequences: a slowdown in Brazilian economic growth, a failure to reduce the debt/GDP ratio further since the budget deficit was swelled by high interest payments, an excessive appreciation of the real, and presumably a lower level of investment. A central bank is right to be cautious about inflation, but the Banco Central do Brasil should recall the precedent set by Alan Greenspan in 1996–98, when the Fed allowed the US expansion to continue even though the unemployment rate was below most estimates of the "natural rate." Since there are estimates that the control of inflation in Brazil requires a real interest rate of at least 9 percent, prudence will require caution in further cuts in interest rates once the real interest rate falls to that level. But at the moment, it is still significantly higher, and it seems that further cuts, or even an acceleration in the rhythm of reduction, can safely be implemented.

The Microeconomic Agenda

Foreign events usually generate the shocks that have a major impact on short-run economic performance. Macroeconomic policy determines the extent to which the economy is pushed below its potential output by those shocks, and (as pointed out above) that may in turn influence investment and thus long-run growth. But the major determinant of long-run growth is domestic microeconomic policy—whether businesses are given a chance to succeed in conditions where their success is going to help the society of which they are a part.

The region is once again confronting the age-old question of whether the market economy offers the best prospects of raising living standards. Unfortunately, I do not have anything particularly novel to contribute to this debate: I continue to believe that the Washington consensus got this question right. With the possible exception of a few oil-rich micro-states, every country that has ever achieved high per capita income has used the market as the basic principle of economic organization. When the 70-year experiment with communism finally collapsed, the contrast in living standards between neighboring geographical areas that had been on opposite sides of the Iron Curtain was dramatic and always favorable to the market: North versus South Korea, China versus Taiwan, Estonia versus Finland, the Czech Republic versus Austria, East versus West Germany. Within Latin America, it is market-driven Chile, not statist Cuba or Venezuela, that has made the most impressive progress in reducing poverty. None of these comparisons suggests that it makes sense to pursue the goal of a minimalist state, but they do suggest that the aim should be to use and develop the market (and, where externalities are present, to correct it), rather than to repress it.

The conclusion that a market economy offers the best hope of economic progress implies both good and bad news for Latin America. The good news is that the region already has in place the essential elements of the market economy. Property rights exist, and no country has faced the problem of building the institutions of a market economy from scratch, like the transition economies had to in the 1990s. (Cuba may some day face those problems of course.) History may have been unkind to Latin America in the colonial background it inherited, but it never imposed an attempt to extinguish the market economy. The courts that are supposed to enforce property rights are often corrupt or inefficient, and markets are often not as competitive as they should be, but the agenda is to get the courts and competition functioning well, not to introduce capitalism from the ground up.

The bad news is that public opinion in the region is extremely hostile to the market economy. This has been established most convincingly in a recent article of Eduardo Lora and Mauricio Olivera (2005). They find that some of the macroeconomic outcomes that one expects to result from adoption of "Washington consensus" policies, notably a reduction in inflation, are indeed electorally popular. But they also find that "structural reforms," calculated as an average of indexes for tax reform, financial liberalization, trade liberalization, and privatization, have a highly significant negative impact on votes in presidential elections. The incumbent's party typically lost 23 percent of its presidential vote on account of promarket reforms if it introduced a typical dose of such reforms (and still lost 15 percent when one allowed for the favorable indirect effects of those policies in reducing inflation or increasing growth). More aggressive reformers, reforming a standard deviation above the mean, sacrificed 40 percent of their vote, or 27 percent allowing for feedback effects. The negative electoral impact of promarket reforms is robust. Reformers need to steel themselves to the likelihood that doing good for their countries will cost them votes. A continued supply of reformers presumes that some politicians are motivated by more than the prospect of re-election as hypothesized by most political scientists or the desire to enrich themselves as posited by public choice theory.

Let me be optimistic and assume that there will continue to be a supply of politicians prepared to brave the electoral consequences of introducing promarket reforms. What should their priorities be? The answer will almost certainly differ according to the country, but my impression is that several issues are widespread. In the first place, it is important to the future of Latin America that it begins to give a far higher priority to technological advance. The way to do this is not to introduce industrial policies, with bureaucrats trying to "pick winners," but rather to build a national innovation system, which will help firms that want to innovate and will therefore benefit a self-selected group of enterprises that are capable of innovation. A second issue is one that Kuczynski and Williamson (2003) focused on, which is the sclerotic state of formal labor markets in many Latin American countries. There is too much regulation, for example of working hours, and it is so expensive to fire employees that employers are reluctant to hire them, at least in the formal economy. Certain elements of the "social wage," notably health insurance, protection against unemployment, and a pension, are of real importance in enriching lives, but if the social wage is set unrealistically high, then people are forced into the informal economy, where they enjoy none of these protections.

No one benefits by denying these hard truths. Another area in which regulation has in many countries (including Brazil) become so burdensome as to be counterproductive concerns the requirements for establishing a new enterprise in the formal sector.[1] And as Hernando de Soto (2000) argues, it is often impossible or needlessly expensive for anyone in the informal sector to acquire property rights, without which one cannot expect a market economy to function properly.

A topic that has recently generated a certain amount of discussion, and to my mind misguided antagonism, is corporate social responsibility (CSR). The basic notion of CSR is that an enterprise should endeavor to take into account a range of social issues, not just profit maximization, when it makes business decisions: issues such as the safety and well-being of its employees, the prosperity of the communities in which it operates, the environmental impact of its actions, and charity. If this is just arguing that a well-run business will recognize that refraining from exploiting opportunities to increase short-run profits by cutting corners may pay off in the long run, then it is hard to object to CSR; but it is also pretty trivial. Support of CSR surely implies that one can envisage situations in which one would want a firm to accept lower long-run profits because it decides to give priority to some stakeholders other than the shareholders and does not accept the view that its social duty is satisfied by obeying the law. My own view is that firms have an impact on the community in many ways, and where those impacts are important and/or frequent it is right to legislate to make it legally obligatory to take those effects into account. But it would be prohibitively expensive to pass regulations governing all those impacts. CSR seems to argue that the world is better off if firms voluntarily make an effort to weigh costs and benefits than it would be if they ignored those effects and single-mindedly pursued profit maximization or attempted to legislate for every conceivable effect. That seems to me pretty convincing.

Institutions

The major innovation in development economics in the past 15 years has been acceptance of the notion that economic outcomes depend importantly on institutions as well as policies (and circumstances like technology and endowments of course). To give my favorite example, it is not much use having an admirable tax code if the tax administration is riddled with corruption. (In principle, what economists mean by "institutions" is the customs that govern how people interact, but in practice, "institutions" tend to mean organizations. Since these can be influenced most readily by policy, little harm is done by this semantic inconsistency.)

The next important question is which institutions are important to economic success. A succinct list that seems to have got it largely right is that recently offered by John Nellis (2005, 14–15):

- definition and protection of property rights;
- contract enforcement and commercial dispute settlement through credible, predictable, peaceful means (more broadly, court decisions that are timely and based on law, not payments or social precedence);
- independent, well-staffed agencies to regulate the natural monopoly elements of natural utilities (that deliver timely, law-based decisions, predictable and credible for both investors and consumers);
- functioning bankruptcy/insolvency regimes for firms operating in competitive markets; and, in general,

[1] In the most recent World Bank study, Latin America and the Caribbean scores worse than all other regions in one dimension, worse than all except sub-Saharan Africa in a second (probably the most important) dimension, and worse than all except two regions in a third dimension. Only with respect to the required minimum capital of a new enterprise does it compare favorably. See www.doingbusiness.org/ExploreTopics/StartingBusiness/.

- a public administration that meets modicum standards of predictability, competence, and probity and promotes and enforces rules enhancing competition.

Everyone agrees that property rights are essential to a functioning market economy. Nellis is surely right to assert that there are two distinct needs in order for property rights to be enjoyed: to define who owns something and to enable them to protect what is theirs. The second bullet likewise deals with essential conditions for market exchange to occur. The parenthetical comment makes it clear that a functioning judicial system is a *sine qua non* for this, as indeed it is for the protection of property rights. The third bullet states a truth that was sometimes overlooked in Latin America during the rush to privatize utilities in the 1990s: that private monopolists may be worse than public monopolies unless there is a proper system of regulation in place and that the agencies charged with regulation need to be able and willing to act in a quasi-judicial manner. The fourth bullet recognizes that enterprises will not all succeed and that there need to be agreed procedures for exit by those that don't, so as to prevent them from continuing to squander resources. The fifth bullet is perhaps the least satisfactory, because it does not try to spell out the range of things that the public administration should do. In addition to enhancing competition, the public administration needs to secure the rule of law, to defend the country and provide an environment with little crime, to ensure macroeconomic stability, to provide public goods, to supervise the financial system, to internalize externalities, and—many of us think—to provide some protection for the least fortunate. One could write a treatise about some of the institutions, like independent central banks or well-staffed fiscal offices or laws enforcing hard budget constraints on subnational governments, which experience has suggested may help to secure those objectives.

I doubt if it is possible to go a lot further than this, by specifying which institutions are most deserving of reform at the present time. My impression is that this differs so much between one country and another that useful generalizations are not possible.

However, one other comment does seem to be called for. It is sometimes suggested that the conclusion that institutions matter is fatalistic, because institutions are given by history and cannot be changed in any meaningful time frame. There is an element of truth in this contention; the institutions that a country inherits are certainly given by history, and changing them is usually difficult and slow. However, it is quite wrong to regard it as impossible: History is littered with examples of changes that happened, from the establishment of communism in the Soviet Union after 1917 to its replacement by a capitalist economy after 1991. When a government seeks to change its institutions, the policies that it puts in place may only impact ΔI (the change in the institutional environment), but over time that will cumulate in a first-order impact on its institutions. Policymakers need to be long-sighted and not expect instantaneous results. In that sense, institutional reform is more difficult than policy reform, but—unless the accumulating evidence showing that institutions matter is wrong—these are among the most vital reforms in transforming Latin America.

The Social Agenda

There was not much hint of a social agenda in the Washington consensus as I formulated it in 1989.[2] That was because my aim was to provide a factual account of the situation in Washington and not because I agreed the subject to be unimportant. Had I guessed that my Washington consensus would be treated as a policy agenda, I should have given the social agenda far more attention. There is no excuse for not giving it a proper emphasis today. The fact that Latin America has a long history of discussing the subject and doing little does not imply that the right action is to stop discussing it. As

[2] It is not actually true that it was entirely omitted. In point #2, where I talked of public expenditure priorities, I asserted that there was a strong view (especially in the World Bank) that education and health (and infrastructure investment) constituted good expenditures that should be expanded (at the expense of things like indiscriminate subsidies).

long as there remains a problem (as there most certainly does), it will be right to talk about it—though hopefully with action following.

A country that already has high tax rates and a relatively egalitarian income distribution (or, it seems, a low income level—see Perry et al. 2005) has good reason to focus largely on raising growth rather than redistributing income. Our host country, Brazil, has a pretty high tax rate, but most Latin American countries do not. No Latin American country has an income distribution that could by any standard be regarded as egalitarian. A few countries, notably Bolivia, Guatemala, Guyana, Haiti, Honduras, and Nicaragua, are sufficiently poor that it may make sense for them to focus overwhelmingly on growth. But at this stage, most countries of the region should be asking themselves how they can raise more taxes from their more affluent citizens in order to increase public spending designed to benefit primarily the poor. In many countries, higher property taxes seem to be a good candidate. Any cost in terms of slower growth—and whether such a cost materializes depends in large part on how the money is spent—will be outweighed for the poorer citizens for many years as they obtain a larger share of the pie.

It makes sense to improve the current pattern of spending in all Latin American countries. At the cerebral level, there seems to be a lot of agreement on what needs to be done. Latin American governments have found effective ways of channeling resources to poor families, through programs like *Oportunidades* or *Bolsa-Família*, that also have the virtue of strengthening the human capital of the next generation. But they still spend a large part of their resources on programs that primarily benefit the better off, whether through free education in public universities or pensions of several times more than the minimum wage. A redeployment of spending could increase equity and, by stimulating investment in human capital, might well increase the growth rate. The obstacles to such change are not intellectual doubts about the benefits of the changes but the natural human inclination to defend vested interests and the political muscle of those who have an interest in the status quo. Challenging that is, once again, going to require political courage.

Concluding Remarks

The Inter-American Development Bank's latest *Report on Economic and Social Progress in Latin America* (IDB 2006) starts:

> The history of economic and social development in Latin America is dominated by the search for new paradigms: simplified ways of understanding how the economy and society function. . . . Latin America has ridden the wave of successive paradigms from the State-run, inward-looking development of the postwar era to the macroeconomic discipline and trade liberalization of the Washington Consensus in the 1990s. As with other paradigms, the region's enthusiasm for the Washington Consensus has waned, and it is now in search of a new paradigm that offers better economic results, more stability, and greater equity.

This report questions the logic behind this search. The Fountain of Youth and the City of Gold were fantasies, and so are magic formulas for accelerating growth and eradicating poverty. Sadly, there are no shortcuts to the Promised Land of sustainable development and prosperity for all.

The IDB is right. Latin America needs to move beyond the search for simple solutions that can be encapsulated in a slogan such as the "Washington consensus." I do not see this as a cause for regret, because I do not believe that it reflects a desire to reverse the policy changes that I tried to reflect in my definition of that term. By and large, the region has got its macroeconomic policies in order, even if in a couple of countries current policies are dangerously dependent on continued high oil prices, and one fears that in the long run, countries that have resorted to debt restructuring may pay a price when they next encounter debt vulnerabilities. The importance of reforms encompassing institutions as well as policies is now widely appreciated, even if ample institutional reforms still need to be implemented. Certainly the social agenda occupies a much more prominent place than in the past, and recent Brazilian statistics showing declining poverty and improving income distribution suggest that some pay-off is beginning to show.

I regard the biggest source of concern as the evident hostility in the region to the idea of using the market economy as the basic mode of economic organization. Good macro policy is not of much consequence without vibrant supply-side growth. Reformed institutions primarily allow the public sector to play its important role in supporting the private sector efficiently. Distribution has often been wrongly derided, but nonetheless it remains true that one needs to have a lot of output before one can worry about how to distribute it. All the evidence suggests that one needs a thriving private sector nurtured by a competitive market economy for rapid and sustained increase in output. Yet this view is not dominant in Latin America. That is a threat to the future.

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Table 1 Economic performance in seven major Latin American countries 1993–94 and 2004–05

Measure	Growth of real GDP		Inflation (CPI)		Fiscal balance as percent of GDP		Current account balance as percent of GDP		S-T debt as percent of foreign debt		Total debt/XGS	
Period	**1993–94**	**2004–05**	**1993–94**	**2004–05**	**1993–94**	**2004–05**	**1993–94**	**2004–05**	**1993–94**	**2004–05**	**1993–94**	**2004–05**
Argentina	6.1	8.3	7.3	7.0	–0.7	2.2	–3.9	1.7	11	22	334	348 (2)
Brazil	5.4	4.1	2002	6.7	–7.7	–3.0	–0.2	1.8	21	9	304	162
Chile	6.4	6.0	12.1	2.0	1.7	3.1	–4.2	0.9	17	21	156	103
Colombia	5.4	4.1	22.6	5.6	–1.1	–0.8	–4.0	–1.4	20	17	175	133
Mexico	3.2	3.7	8.4	4.5	–1.4	–0.3	–6.4	–1.1	28	7	186	60
Peru	8.8	5.2	36.2	2.8	–3.4	–0.8	–6.6	0.2	25	9	461	180
Venezuela	–1.0	12.9	49.5	19.2	–3.9	–1.2	0.6	14.3	11	15	201	85
***Average* (1)**	*4.8*	*5.0*	*849*	*6.4*	*–4.1*	*–1.2*	*–2.9*	*1.4*	*21*	*11*	*265*	*146*
Sources:	September 2005 IMF WEO		September 2005 IMF WEO		Economist intelligence Unit/September 2005 IMF WEO		September 2005 IMF WEO		Economist intelligence Unit		Economist intelligence Unit	

Notes: (1) Population weighted average. (2) After the 2004 debt restructuring the ratio of total debt/XGS fell to 277 percent.