

## **A Short History of the Washington Consensus**

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The term “Washington Consensus” was coined in 1989. The first written usage was in my background paper for a conference that the Institute for International Economics convened in order to examine the extent to which the old ideas of development economics that had governed Latin American economic policy since the 1950s were being swept aside by the set of ideas that had long been accepted as appropriate within the OECD. In order to try and ensure that the background papers for that conference dealt with a common set of issues, I made a list of ten policies that I thought more or less everyone in Washington would agree were needed more or less everywhere in Latin America, and labeled this the “Washington Consensus.” Little did it occur to me that fifteen years later I would be asked to write about the history of a term that had become the center of fierce ideological controversy.

The first section of this paper describes what I recollect about the background to my background paper for the 1989 conference. The second section retraces much more familiar ground, summarizing the ten points that I included in the Washington Consensus. This is followed by an account of the reception given to the term, and the analysis. The next section tries to account for the fact that the term became used in such different ways in different quarters and thus to be at the center of ideological controversies. The last substantive section is forward-looking and describes what I believe needs to be added to my original list in order to formulate a policy agenda for Latin America today.

### **Background**

The story started in the Spring of 1989 when I was testifying before a Congressional committee in favor of the Brady Plan. I argued that it would be good policy to help the debtor countries overcome their debt burden now that they were making profound changes in economic policy, along the lines advocated by Balassa, Bueno, Kuczynski, and Simonsen (1986). I encountered rank disbelief in the Congressmen before whom I was testifying that there were any significant changes in economic policies and attitudes in process in Latin America. After discussion with Fred Bergsten, the director at the Institute for International Economics, where I was (and am) professionally located, we decided to convene a conference to test the extent to which I was right and to put the change in policy attitudes on the record in Washington.

A few weeks later I gave a seminar at the Institute for Development Studies in England, where I made much the same argument. I was challenged by Hans Singer to spell out what I meant when I said that many of the countries were changing their policies for the better. This emphasized the need to be very explicit about the policy changes that I was thinking of. I decided that conference that we were planning for the autumn, which

we decided to call “Latin American Adjustment: How Much Has Happened?” needed a background paper that would spell out the substance of the policy changes we were interested in. That paper was entitled “What Washington Means by Policy Reform” and was sent to the ten authors who had agreed to write country studies for our conference to try and make sure that they addressed a common set of issues in their papers.

That paper said inter alia on its opening page:

Th[is] paper identifies and discusses 10 policy instruments about whose proper deployment Washington can muster a reasonable degree of consensus....The paper is intended to elicit comment on both the extent to which the views identified *do* indeed command a consensus and on whether they *deserve* to command it. It is hoped that the country studies to be guided by this background paper will comment on the extent to which the Washington consensus is shared in the country in question....

The Washington of this paper is both the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the U.S. government, the Federal Reserve Board, and the think tanks. The Institute for International Economics made a contribution to codifying and propagating several aspects of the Washington consensus in its publication *Toward Renewed Economic Growth in Latin America* (Balassa et al. 1986).

My opinion at that time was that views had pretty much coalesced on the sort of policies that had long been advocated by the OECD. I specifically did not believe that most of the “neoliberal” innovations<sup>1</sup> of the Reagan administration in the United States or the Thatcher government in Britain had survived the demise of the former (Mrs. Thatcher’s government was still in its death throes at the time). The exception was privatization, which was Mrs. Thatcher’s personal gift to the economic policy agenda of the world, and which by 1989 had proved its worth. But I thought all the other new ideas with which Reagan and Thatcher had entered office, notably monetarism, supply-side economics, and minimal government, had by then been discarded as impractical or undesirable fads, so no trace of them can be found in what I labeled the “Washington Consensus.” Of course, acceptance as relevant to the developing world of ideas that had long been motherhood and apple pie in the developed world was a momentous change. All through the Cold War the world had remained frozen in the 1950s’ classification of First, Second, and Third Worlds, each of which was assumed to have its own distinct set of economic laws. 1989 marked the end of the Second World, to the great relief of most of its subjects, and also the end of the intellectual apartheid that had so long assumed that citizens of the Third World behaved quite differently to those of the First World. But the globalization of knowledge never meant general acceptance of neoliberalism by any definition I know of.

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<sup>1</sup> I use the word “neoliberalism” in its original sense, to refer to the doctrines espoused by the Mont Pelerin Society. If there is another definition, I would love to hear what it is so that I can decide whether neoliberalism is more than an intellectual swear word.

## Content of the Original List

The ten reforms that constituted my list were as follows.

1. **Fiscal Discipline.** This was in the context of a region where almost all countries had run large deficits that led to balance of payments crises and high inflation that hit mainly the poor because the rich could park their money abroad.
2. **Reordering Public Expenditure Priorities.** This suggested switching expenditure in a progrowth and propoor way, from things like nonmerit subsidies to basic health and education and infrastructure. It did *not* call for all the burden of achieving fiscal discipline to be placed on expenditure cuts; on the contrary, the intention was to be strictly neutral about the desirable size of the public sector, an issue on which even a hopeless consensus-seeker like me did not imagine that the battle had been resolved with the end of history that was being promulgated at the time.
3. **Tax Reform.** The aim was a tax system that would combine a broad tax base with moderate marginal tax rates.
4. **Liberalizing Interest Rates.** In retrospect I wish I had formulated this in a broader way as financial liberalization, stressed that views differed on how fast it should be achieved, and—especially—recognized the importance of accompanying financial liberalization with prudential supervision.
5. **A Competitive Exchange Rate<sup>2</sup>.** I fear I indulged in wishful thinking in asserting that there was a consensus in favor of ensuring that the exchange rate would be competitive, which pretty much implies an intermediate regime; in fact Washington was already beginning to edge toward the two-corner doctrine which holds that a country must either fix firmly or else it must float “cleanly”.
6. **Trade Liberalization.** I acknowledged that there was a difference of view about how fast trade should be liberalized, but everyone agreed that was the appropriate direction in which to move.
7. **Liberalization of Inward Foreign Direct Investment.** I specifically did not include comprehensive capital account liberalization, because I did not believe that did or should command a consensus in Washington.
8. **Privatization.** As noted already, this was the one area in which what originated as a neoliberal idea had won broad acceptance. We have since been made very conscious that it matters a lot how privatization is done: it can be a highly corrupt process that transfers assets to a privileged elite for a fraction of their true value, but the evidence is that it brings benefits (especially in terms of improved service coverage) when done properly, and the privatized enterprise either sells into a competitive market or is properly regulated.
9. **Deregulation.** This focused specifically on easing barriers to entry and exit, not on abolishing regulations designed for safety or environmental reasons, or to govern prices in a non-competitive industry.

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<sup>2</sup> I have seen it asserted that a competitive exchange rate is the same as an undervalued rate. Not so; a competitive rate is a rate that is not overvalued, i.e. that is *either* undervalued *or* correctly valued. My fifth point reflects a conviction that overvalued exchange rates are worse than undervalued rates, but a rate that is neither overvalued nor undervalued is better still.

10. **Property Rights.** This was primarily about providing the informal sector with the ability to gain property rights at acceptable cost (inspired by Hernando de Soto's analysis).

### **First Reactions**

The three American discussants whom I had invited to react to my paper were Richard Feinberg (then at the Overseas Development Council), Stanley Fischer (then Chief Economist at the World Bank), and Allan Meltzer (then as now a professor at Carnegie-Mellon University). Feinberg and Meltzer were intended to make sure that I had not represented as consensual anything that one or other side of the political spectrum would regard as rubbish, while Fischer would play the same safeguard role as regards the IFIs.

Fischer was most supportive of the basic thrust of the paper, saying that "there are no longer two competing economic development paradigms" and that "Williamson has captured the growing Washington consensus on what the developing countries should do." But he pointed to some areas that I had not commented on and where sharp disagreements remained, such as the environment, military spending, a need for more comprehensive financial reform than freeing interest rates, bringing back flight capital, and freeing flows of financial capital.<sup>3</sup> It was not my intent to argue that controversy had ended, so I would not take issue with his contention that there remained sharp disagreements on a number of issues (including the desirability of capital account liberalization). And my initial paper did indeed formulate the financial liberalization question too narrowly.

Meltzer expressed his pleasure at finding how much the mainstream had learned (according to my account) about the futility of things like policy activism, exploiting the unemployment/inflation tradeoff, and development planning. The two elements of my list on which he concentrated his criticism were once again the interest rate question (though here he focused more on my interim objective of a positive but moderate real interest rate than on the long run objective of interest rate liberalization) and a competitive exchange rate. The criticism of the interest rate objective I regard as merited. His alternative to a competitive exchange rate, namely a currency board, would certainly not be consensual, but the fact that he raised this issue was my first warning that on the exchange rate question I had misrepresented the degree of agreement in Washington.

Feinberg started off by suggesting that there really was not much of a consensus at all, but his comment mellowed as it progressed, and he concluded by saying that there was convergence on key concepts though still plenty to argue about. His most memorable line does not appear in his written comment but consisted of the suggestion that I should have labeled my list the Universal Convergence rather than the Washington Consensus, since the extent of agreement is far short of consensus but runs far wider than Washington. He was of course correct on both points, but it was too late to change the terminology.

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<sup>3</sup> Interestingly, in the light of his position when first deputy managing director of the IMF, he wrote: "I fear rather that much of Washington does believe strongly that financial capital flows should not be constrained, but that it has simply not yet focused on the problem."

The point about how much more apt it would have been to refer to a universal convergence rather than a Washington consensus was rubbed home in a fourth comment, by Patricio Meller of CIEPLAN in Santiago de Chile.

In the months that followed I participated in several meetings where I not only argued that the policies included in my ten points were in fact being adopted fairly widely in Latin America, as our conference had confirmed, but also that this was a good thing and that lagging countries should catch up. I know that I never regarded those ten points as constituting the whole of what should be on the policy agenda, but perhaps I was not always as careful in spelling that out as I should have been.

The two points in my original list that seem to me in retrospect least adequate as a summary of conventional thinking are the two identified by Allan Meltzer, namely financial liberalization and exchange-rate policy. The agenda for financial liberalization went broader than interest rates, to include most importantly the liberalization of credit flows, and (as Joe Stiglitz has often pointed out) it needed to be supplemented by prudential supervision if it were not to lead almost inexorably to financial crisis. We already had the experience of the Southern Cone liberalization of the late 1970s to emphasize that point, so I clearly should not have overlooked it. On exchange rate policy I fear I was guilty of wishful thinking in suggesting that opinion had coalesced on something close to my own view, whereas in fact I suspect that even then a majority of Washington opinion would have plumped for either the bipolar view or else (like Meltzer) one of the poles.

In arguing that lagging countries should catch up with the policy reforms on my list, I argued on occasion that the East Asian NICs had broadly followed those policies. A Korean discussant (whose name I regret to say escapes me) at a conference in Madison challenged this contention; he argued that their macro policies had indeed been prudent, but also asserted (like Alice Amsden and Robert Wade) that their microeconomic policies had involved an active role for the state quite at variance with the thrust of points 4 and 6-9 of my list. I think one has to concede that some of the East Asian countries, notably Korea and Taiwan, were far from pursuing *laissez-faire* during their years of catch-up growth, but this does not prove that their rapid growth was attributable to their departure from liberal policies, as critics of the Washington Consensus seem to assume axiomatically. There were after all two other East Asian countries that grew comparably rapidly, in which the state played a much smaller role. Indeed, one of those—namely Hong Kong—was the closest to a model of *laissez-faire* that the world has ever seen. It would seem to me more natural to attribute the fast growth of the East Asian NICs to what they had in common, such as fiscal prudence, high savings rates, work ethic, competitive exchange rates, and a focus on education, rather than to what they did differently, such as industrial policy, directed credit, and import protection.

Incidentally, one should compare the policy stance of Korea and Taiwan with that of other developing countries, not with a textbook model of perfect competition. Most of the countries that failed to grow comparably fast were even less liberal. So even if it was wrong to treat the East Asian NICs as pin-up examples of the Washington Consensus in action, it is even more misleading to treat them as evidence for rejecting microeconomic liberalization. That controversy cannot be resolved by any simple appeal to what happened in East Asia.

But arguments about the content of the Washington Consensus have always been secondary to the wave of indignation unleashed by the name that I pinned on this list of policy reforms. Some of the reformers obviously believed that I had undercut their local standing by calling it a “Washington” agenda, and thus suggesting that these were reforms that were being imposed on them rather than being adopted at their own volition because they recognized that those were the reforms their country needed. When I invented the term I was not thinking of making propaganda for economic reform (insofar as I was contemplating making propaganda, it was propaganda for debt relief in Washington, not propaganda for policy reform in Latin America). From the standpoint of making propaganda for policy reform in Latin America, Moisés Naím (2000) has argued that in fact it was a good term in 1989, the year the coalition led by the United States emerged victorious in the Cold War, when people were searching for a new ideology and the ideology of the victors looked rather appealing. But it was a questionable choice in more normal times, and a terrible one in the world that George W. Bush has created, where mention of Washington is hardly the way to curry support from non-Americans. It was, I fear, a propaganda gift to the old left.

### **Varying Interpretations**

To judge by the sales of *Latin American Adjustment: How Much Has Happened?*, the vast majority of those who have launched venomous attacks on the Washington Consensus have not read my account of what I meant by the term. When I read what others mean by it, I discover that it has been interpreted to mean bashing the state, a new imperialism, the creation of a laissez-faire global economy, that the only thing that matters is the growth of GDP, and doubtless much else besides. I submit that it is difficult to find any of these implied by the list of ten policy reforms that I presented earlier.

One event that I found extraordinary was to learn that many people in Latin America blamed the adoption of Washington Consensus policies for the collapse of the Argentine economy in 2001. I found this extraordinary because I had for some years been hoping against hope that Argentina would not suffer a collapse like the one that occurred, but was nonetheless driven to the conclusion that it was highly likely because of the fundamental ways in which the country had strayed from two of the most basic precepts of what I had laid out. Specifically, it had adopted a fixed exchange rate that became chronically overvalued (for reasons that were not its fault at all, let me add), and—while its fiscal deficits were smaller than in the 1980s—it had not used its boom years to work down the debt/GDP ratio. Its fiscal policy as the crisis approached was not nearly restrictive enough to sustain the currency board system. None of the good reforms along Washington Consensus lines that Argentina had indeed made during the 1990s—trade liberalization, financial liberalization, privatization, and so on—seemed to me to have the slightest bearing on the crisis. Yet Latin American populists and journalists, and even a few reputable economists, were asserting that the Washington Consensus was somehow to blame for the Argentinean implosion. I am still hoping to learn the causal channel they have in mind.

One has to conclude that the term has been used to mean very different things by different people. In fact, it seems to me that there are at least two interpretations of the term beside mine that are in widespread circulation.

One uses it to refer to the policies the Bretton Woods institutions applied toward their client countries, or perhaps the attitude of the US government plus the Bretton Woods institutions.<sup>4</sup> This seems to me a reasonable, well-defined usage. In the early days after 1989 there was not much difference between my concept and this one, but over time some substantive differences emerged. The Bretton Woods institutions increasingly came to espouse the so-called bipolar doctrine (at least until the implosion of the Argentine economy in 2001, as a direct result of applying one of the supposedly crisis-free regimes), according to which countries should either float their exchange rate “cleanly” or else fix it firmly by adopting some institutional device like a currency board. As pointed out above, that is directly counter to my version of the Washington Consensus, which called for a competitive exchange rate, which necessarily implies an intermediate regime since either fixed or floating rates can easily become overvalued. Again, the Bretton Woods institutions, or at least the IMF, came in the mid-1990s to urge countries to liberalize their capital accounts, whereas my version had deliberately limited the call for liberalization of capital flows to FDI. Both of those deviations from the original version were in my opinion terrible, with the second one bearing the major responsibility for causing the Asian crisis of 1997. But there were also some highly positive differences, as the Bank and Fund came to take up some of the issues that I had not judged sufficiently major in Latin America in 1989 to justify inclusion. I think in particular of institutional issues, especially regarding governance and corruption, in the case of the Bank, and financial sector reform as reflected in standards and codes in the case of the Fund. And by the late 1990s both institutions had replaced their earlier indifference to issues of income distribution by a recognition that it matters profoundly *who* gains or loses income.

The third interpretation of the term “Washington Consensus” uses it as a synonym for neoliberalism or market fundamentalism. This I regard as a thoroughly objectionable perversion of the original meaning. Whatever else the term “Washington Consensus” may mean, it should surely refer to a set of policies that command or commanded a consensus in some significant part of Washington, either the US government or the IFIs or both, or perhaps both plus some other group. Even in the early years of the Reagan administration, or during Bush 43, it would be difficult to contend that any of the distinctively neoliberal policies, such as supply-side economics, monetarism, or minimal government, commanded much of a consensus, certainly not in the IFIs. And it would be preposterous to associate any of those policies with the Clinton administration. Yet most of the political diatribes against the Washington Consensus have been directed against this third concept, with those using the term this way apparently unconcerned with the need to establish that there actually was a consensus in favor of the policies they love to hate.<sup>5</sup>

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<sup>4</sup> For years I was oblivious to this obvious interpretation; I owe my enlightenment to Yaw Ansu of the World Bank. The fact that this usage is widespread was brought home to me vividly at a conference in Havana earlier this year. In my presentation to the conference I thought I had gone to pains to distinguish three concepts: my original one and the two variants described in the text. When my presentation was summarized by Fidel Castro, he told the assembled throng that Williamson had said he disagreed with the Washington Consensus in two ways, naming the ways (exchange rate policy and capital account liberalization) in which I had said that this version was inferior to mine!

<sup>5</sup> I find it ironic that one of the chairmen of President Clinton’s Council of Economic Advisers should have adopted this usage, since my understanding of the definition of the word consensus would preclude a

Why should the term have come to be used in such different ways? I find it easy enough to see why the second usage emerged. The term initially provided a reasonable description of the policies of the Bretton Woods institutions, and as these evolved the term continued to refer to what these currently were.

What puzzles me is how the third usage became so popular. The only hypothesis that has ever seemed to me remotely plausible is that this was an attempt to discredit economic reform by bundling a raft of ideas that deserve to be consigned to oblivion along with the list of commonsense proreform proposals that constituted my original list. This was doubtless facilitated by the name that I had bestowed on my list, which gave an incentive to anyone who disliked the policies or attitudes of the US government or the IFIs to join in a misrepresentation of the policies they were promoting.

In any event, surely intellectual integrity demands a conscientious attempt in the future to distinguish alternative concepts of the Washington Consensus. Semantic issues may not be the most exciting ones, but being clear about the way in which terms are being used is a necessary condition for serious professional discussion. The practice of dismissing requests for clarification as tedious pedantry should be unacceptable. Perhaps then more critics would follow the example of the Korean discussant to whom I referred earlier who laid out precisely which elements of my original agenda he objected to. Or if a critic chooses to use the third concept, then surely he should say that he is talking about a concept of the Washington Consensus that has never commanded a consensus in Washington.

## **The Future**

However much exception I may take to some of the assaults that have been made on the Washington Consensus, I have to admit that I too am uncomfortable if it is interpreted as a comprehensive agenda for economic reform. Even in 1989, there was one objective of economic policy that I regard as of major importance but that found only very tenuous reflection in the Consensus.<sup>6</sup> Since then fifteen years have passed, and it would be remarkable (and depressing) if no new ideas worthy of inclusion in the policy agenda had emerged. Hence there are two reasons why my policy agenda of today can differ from the Washington Consensus as I laid it out in 1989: because I am not limiting myself to doctrines able to command a consensus but am presenting what I believe deserves to be done, and because time has passed and ideas have developed.

A book that I co-edited last year (Kuczynski and Williamson 2003) addressed the issue of delineating a policy agenda appropriate for Latin America in the current decade. Note that this new agenda, like the original Washington Consensus, was aimed specifically at Latin America at a particular moment of history, rather than claiming to be

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Washington Consensus including anything to which he took serious objection while in office as either chairman of the US Council of Economic Advisers or Chief Economist at the World Bank.

<sup>6</sup> I am referring to equity, which did not play a larger role because I regret to say that I could not convince myself that the Washington of 1989 (or 2004, for that matter) agreed that equity was of any consequence. The one respect in which it did appear was in the second point, which said that public expenditure should be redirected from non-merit subsidies, defense, and administration toward things like primary education, health, and infrastructure that would be both pro-growth and pro-equity. This doctrine that had by then become well-established in the World Bank.

a text for all countries at all times as many critics have interpreted it to be. We identified four major topics that ought to be included.

The first of these is stabilization policy. The need for more pro-active policies to keep the economy on an even keel has been driven home with great force in recent years by the horrifying price that many emerging markets have paid for the crises to which so many have been exposed. When I drew up the Washington Consensus the overwhelming need, at least in Latin America, was to conquer inflation, so that was the macroeconomic objective that I emphasized. Had it occurred to me that my list would be regarded in some quarters as a comprehensive blueprint for policy practitioners, I hope that I would have added the need for policies designed to crisis-proof economies and stabilize them against the business cycle (the sort of measures that Ricardo Ffrench-Davis has advocated under the heading of “reforming the reforms”).

A first implication is to use fiscal policy as a countercyclical tool, insofar as possible. The most effective way to do this seems to be to strengthen the automatic stabilizers and let them operate. (It seems unlikely that emerging markets would have more success with discretionary fiscal policy than the developed countries have had.) Most developing countries have been precluded from doing even this by a need to keep the markets happy, which has required deflationary fiscal policy during difficult times. The way to end this is to use booms to work down debt levels to a point at which the market will consider them creditworthy, which means that countercyclical fiscal policy can be initiated only during the boom phase of the cycle.

Obviously there are other tools besides fiscal policy that may help minimize the probability of encountering a crisis, and its cost if it nevertheless occurs. Exchange rate policy may be the most crucial, since many of the emerging-market crises of recent years have originated in the attempt to defend a more-or-less fixed exchange rate. For this reason most countries have abandoned the use of fixed or predetermined exchange rates in favor of some version of floating. However, there is still an important difference of view between those who think of floating as implying a commitment on the part of the government not to think about what exchange rate is appropriate, versus those who take the view that floating is simply avoidance of a commitment to defend a particular margin. In the latter view, which I share, it is still perfectly appropriate for a government to have a view on what range of rates would be appropriate, and to slant policy with a view to pushing the rate toward that range, even if it avoids guaranteeing that the rate will stay within some defined margins. In particular, I would argue that while a government should freely allow depreciation in order to avoid or limit the damage of a crisis, it should if necessary be proactive in seeking to limit appreciation in good times, when investors are pushing in money. If a country has a sufficiently efficient and uncorrupt civil service to be able to make capital controls (like the Chilean uncompensated reserve requirement of the 1990s) work (and not all countries do!), then it should be prepared if necessary to use capital controls to limit the inflow of foreign funds and hence help maintain a competitive exchange rate.

Monetary policy is also highly pertinent to countercyclical policy. Many countries, especially those that have abandoned a fixed exchange rate and were therefore seeking a new nominal anchor, have told their central bank to use an inflation targeting framework to guide monetary policy. This appears a sensible choice, provided at least

that it is not interpreted so rigidly as to preclude some regard for the state of the real economy when setting monetary policy.

Recent experience has demonstrated conclusively that the severity of a crisis is magnified when a country has a large volume of debt denominated in foreign exchange (see e.g. Goldstein and Turner 2004). This is because currency depreciation, which does—and should—occur when a crisis develops, increases the real value of the debts of those who have their obligations denominated in foreign currency. If the banks took the exchange risk by borrowing in foreign currency and on-lending in local currency, then their solvency will be threatened directly. If they sought to avoid that risk by on-lending in foreign currency, then their debtors' financial position will be undermined (especially if they are in the nontradable sector), and the banks are likely to end up with a large volume of bad loans, which may also threaten their solvency. If the government contracted foreign currency debt (or allowed the private sector to shield itself by unloading its foreign currency debt when conditions turned threatening), then the effect of a currency depreciation will be to increase public-sector debt and thereby undermine confidence at a critical time. Whatever the form of such borrowing, it can intensify any difficulties that may emerge. The solution is to curb borrowing in foreign currency. The government can perfectly well just say no when deciding the currency composition of its own borrowing and issue bonds in local currency (as more and more emerging markets are now starting to do). Bank supervision can be used to discourage bank borrowing, and lending, in foreign exchange. The more difficult issue is foreign-currency borrowing by corporations. To prevent that would require the imposition of controls on the form of foreign borrowing. Perhaps it makes more sense to content oneself with discouraging, rather than completely preventing, foreign currency–denominated borrowing. That could be achieved by taxation policy, which could give less tax relief for interest payments on foreign-currency loans, and/or charge higher taxes on interest receipts on such loans.

Obviously crisis-proofing an economy may require attention to other issues. For example, in many countries subnational government units face a soft budget constraint, which for well-known reasons is not good for stabilization policy. But the purpose of this section is to give an idea of the issues that are important in designing a policy agenda, not to write a comprehensive account of every issue that may face a policy practitioner, so I will leave this first issue.

The second general heading of our policy agenda consisted of pushing on with the liberalizing reforms that were embodied in the original Washington Consensus, and extending them to areas like the labor market where economic performance is being held back by excessive rigidity. One does not have to be some sort of market fundamentalist who believes that less government is better government and that externalities can safely be disregarded in order to recognize the benefits of using market forces to coordinate activity and motivate effort. This proposition is such a basic part of economic thinking that it is actually rather difficult to think of a work that conclusively establishes its truth. But there are a variety of indirect confirmations, from the universal acclaim that meets the abandonment of rationing to the success of emissions trading in reducing pollution at far lower cost than was anticipated.

It is certainly true that the move to adopt a more liberal policy stance in many developing countries over the past two decades has as yet had the hoped-for effect of stimulating growth in only a few countries, like India. The results have not been

comparably encouraging in, say, Latin America (Ocampo 2004, Kuczynski and Williamson 2003). But the blame for this seems to me to lie in the misguided macroeconomic policies—like allowing exchange rates to become overvalued and making no attempt to stabilize the cycle—that accompanied the microeconomic reforms, rather than in the latter themselves. The same was true in the United Kingdom under Mrs. Thatcher and in New Zealand when Roger Douglas was finance minister; both undertook far-reaching microeconomic liberalizations that can now be seen to have arrested and even reversed the relative decline of those countries, but their peoples saw no benefits for the best part of a decade because of the primitive macro policies that accompanied the micro reform.

When we asked what is today most in need of liberalization in Latin America, we concluded that it is the labor market. Around 50 percent of the labor force in many Latin American countries is in the informal sector. This means that they do not enjoy even the most basic social benefits, like health insurance, some form of safeguard against unemployment, and the right to a pension in old age. What people do get is the right to maintain through thick and thin a formal-sector job if they are lucky enough to have one, and a wide range of social benefits that go along with all formal-sector jobs. Not all these benefits appear to be highly valued, to judge by the stories of workers taking second jobs to supplement what they can earn in their guaranteed maximum of 40 hours, or taking another job during their guaranteed summer vacations. So we proposed to flexibilize firing for good reason and curtail the obligation to pay those elements of the social wage that appear less appreciated, in the belief that this will reduce the cost of employing labor in the formal sector and so lead to more hiring and greater efficiency. There is an abundant economic literature that concludes that the net effect of making it easier to fire workers is to increase employment net.

The third element of our proposed policy agenda consists of building or strengthening institutions. This is hardly novel; the importance of institution building has in fact become the main new thrust of development economics in the 15 years since the Washington Consensus was first promulgated. Which particular institutions are most in need of strengthening tends to vary from one country to another, so the possibility of generalizing is limited, but archaic judiciaries, rigid civil service bureaucracies, old-fashioned political systems, teachers' unions focused exclusively on producer interests, and weak financial infrastructures are all common.

One institutional reform that we certainly did not advocate was introduction of industrial policy, meaning by this a program that requires some government agency to “pick winners” (to help companies that are judged likely to be able to contribute something special to the national economy). As argued before, there is little reason to think that industrial policies were the key ingredient of success in East Asia (see also Noland and Pack 2003). But we did have a lot more sympathy for a cousin of industrial policy usually referred to as a national innovation system. This does not require government to start making business judgments; it instead has government seek to create an institutional environment in which those firms that want to innovate find the necessary supporting infrastructure. A national innovation system is about government creating institutions to provide technical education, to promote the diffusion of technological information, to fund precompetitive research, to provide tax incentives for R&D, to encourage venture capital, to stimulate the growth of industrial clusters, and so on. While

there is still ample scope for productivity to increase in Latin America by copying best practices developed in the rest of the world, it may need an act of Schumpeterian innovation—and therefore the sort of technologically supportive infrastructure that comprises a national innovation system—to bring world best practice to Latin America (ECLAC 1995, part 2).

The final element of the policy agenda is intended to combat the neglect of equity that was as true of the Washington Consensus as it has long been of economics in general. We suggested that it is important for governments to target an improved distribution of income in the same way that they target a higher rate of growth. Where there are opportunities for win-win solutions that will both increase growth and improve income distribution (such as, maybe, redirecting public education subsidies from universities to primary schools), they should be exploited. But the more fundamental point is that there is no intellectual justification for arguing that *only* win-win solutions deserve to be considered. One always needs to be aware of the potential cost in terms of efficiency (or growth) of actions to improve income distribution, but in a highly unequal region like Latin America opportunities for making large distributive gains for modest efficiency costs deserve to be seized.

Progressive taxes are the classic instrument for redistributing income. One of the more questionable aspects of the reforms of the past decade in Latin America has been the form that tax reform has tended to take, with a shift in the burden of taxation from income taxes (which are typically at least mildly progressive) to consumption taxes (which are usually at least mildly regressive). While the tax reforms that have occurred have been useful in developing a broader tax base, it is time to reverse the process of shifting from direct to indirect taxation; effort should now focus on increasing direct tax collections. For incentive reasons one may want to avoid increasing the marginal tax rate on earned income, but that still leaves at least three possibilities:

- The development of property taxation as a major revenue source (it is the most natural revenue source for the subnational government units that are being spawned by the process of decentralization that has rightly become so popular).
- The elimination of tax loopholes, not only so as to increase revenue but also to simplify tax obligations and thus aid enforcement.
- Better tax collection, particularly of the income earned on flight capital parked abroad, which will require the signing of tax information-sharing arrangements with at least the principal havens for capital flight.

Increased tax revenue needs to be used to increase spending on basic social services, including a social safety net as well as education and health, so that the net effect will be a significant impact in terms of reducing inequality, particularly by expanding opportunities for the poor.

With the best will in the world, however, what is achievable through the tax system is limited, in part by the fact that one of the things that money is good at buying is advice on how to minimize a tax bill. Really significant improvements in distribution will come only by remedying the fundamental weakness that causes poverty, which is that too many people lack the assets that enable them to work their way out of poverty. The basic principle of a market economy is that people exchange like value for like value. Hence in

order to earn a decent living the poor must have the opportunity to offer something that others want and will pay to buy: those who have nothing worthwhile to offer because they have no assets are unable to earn a decent living. The solution is not to abolish the market economy, which was tried in the communist countries for 70 years and proved a disastrous dead end, but to give the poor access to assets that will enable them to make and sell things that others will pay to buy. That means:

- **Education.** There is no hope unless the poor get more human capital than they have had in the past. Latin America has made some progress in improving education in the last decade, but it is still lagging on a world scale.
- **Titling programs** to provide property rights to the informal sector and allow Hernando de Soto's "mystery of capital" to be unlocked (de Soto 2000).
- **Land reform.** The Brazilian program of recent years to help peasants buy land from *latifundia* landlords provides a model. Landlords do not feel their vital interests to be threatened and therefore they do not resort to extreme measures to thwart the program. Property rights are respected. The peasants get opportunities but not handouts, which seems to be what they want.
- **Microcredit.** Organizations to supply microcredit are spreading, but they still serve only about 2 million of Latin America's 200 million poor. The biggest obstacle to an expanded program consists of the very high real interest rates that have been common in the region. These high interest rates mean either that microcredit programs have a substantial fiscal cost and create an incentive to divert funds to the less poor (if interest rates are subsidized), or (otherwise) that they do not convey much benefit to the borrowers. Macro policy in a number of countries needs to aim to reduce market interest rates over time, which will inter alia facilitate the spread of microcredit.

In the best of worlds such policies will take time to produce a social revolution, for the very basic reason that they rely on the creation of new assets, and it takes time to produce new assets. But, unlike populist programs, they do have the potential to produce a real social revolution if they are pursued steadfastly. And they could do so without undermining the wellbeing of the rich, thus holding out the hope that these traditionally fragmented societies might finally begin to develop real social cohesion.

### **Concluding Remarks**

Some may ask whether it matters whether people declare themselves for or against the Washington Consensus. If the battles are essentially semantic, why don't we all jump on its grave and get on with the serious work of pursuing an updated policy agenda?

Good question, but perhaps there is a serious answer. When a serious economist attacks the Washington Consensus, the world at large interprets that as saying that he believes there is a serious intellectual case against disciplined macroeconomic policies, the use of markets, and trade liberalization—the three core ideas that were embodied in the original list and that are identified with the IFIs. Perhaps there is such a case, but I have not found it argued in Stiglitz (2002) or anywhere else. If the term is being used as a pseudonym for market fundamentalism, then the public read into it a declaration that the

IFIs are committed to market fundamentalism. That is a caricature. We have no business to be propagating caricatures.

Everyone agrees that the Washington Consensus did not contain all the answers to the questions of 1989, let alone that it addresses all the new issues that have arisen since then. So of course we need to go beyond it. That is the purpose of this conference, to which I hope the penultimate section of this paper will contribute.

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