From Reform Agenda

A short history of the Washington Consensus and suggestions for what to do next

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THE STORY of the Washington Consensus dates back to 1989, when the press in the United States was still talking about how Latin American countries were unwilling to undertake the reforms that might give them a chance to escape the debt crisis. It seemed to me that this was a misconception and that, in fact, a sea change in attitudes toward economic policy was occurring. To determine whether this was correct, the Institute for International Economics decided to convene a conference at which authors from 10 Latin American nations would present papers detailing what had been happening in their respective countries. To try to make sure that they all addressed a common set of questions, I wrote a background paper in which I listed 10 policy reforms that I argued almost everyone in Washington thought were needed in Latin America as of that date. I labeled this reform agenda the "Washington Consensus," never dreaming that I was coining a term that would become a war cry in ideological debates for more than a decade.

Indeed, I thought the ideas I was laying out were consensual, which is why I gave them the label I did. The 10 reforms that constituted my list were as follows.

Fiscal discipline. This was in the context of a region where almost all the countries had run large deficits that led to balance of payments crises and were experiencing high inflation that hit mainly the poor because the rich could park their money abroad.

Reordering public expenditure priorities. This suggested switching expenditure, in a progrowth and propoor way, from things like nonmerit subsidies to basic health care, education, and infrastructure.

Tax reform. The aim was a tax system that would combine a broad tax base with moderate marginal tax rates.

Liberalization of interest rates. In retrospect, I wish I had formulated this more broadly as financial liberalization, stressed that views differed on how fast it should be achieved, and recognized the importance of accompanying financial liberalization with prudential supervision.

A competitive exchange rate. 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 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 float "cleanly."

Trade liberalization. I acknowledged that there was a difference of view about how fast trade should be liberalized, but everyone agreed that this was the appropriate direction in which to move.

Liberalization of inward foreign direct investment. I specifically did not include comprehensive capital account liberalization because I did not believe that it commanded a consensus in Washington.

Privatization. This was the one area in which what originated as a neoliberal idea 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 privatization brings benefits (especially in terms of improved service) when done properly, and the privatized enterprise either sells into a competitive market or is properly regulated.

Deregulation. This focused specifically on easing barriers to entry and exit, not on abolishing safety or environmental regulations (or regulations governing prices in a noncompetitive industry).

Property rights. This was primarily about providing the informal sector with the abil-

to Damaged Brand Name

ity to gain property rights at an acceptable cost (inspired by Hernando de Soto's analysis).

One can, of course, ask several interesting questions about this list. One question is whether I correctly identified reforms that commanded a wide measure of consensus in Washington. With the exception of number 5, I like to think I did a good reporting job. An overlapping question is whether these were generally viewed as the 10 most urgent and important reforms for the region as of 1989. I would defend my list as providing a plausible answer to that more demanding question, at least if one is restricted to choosing from consensual reforms. Incidentally, I would also argue that 1989 was unique in that there was at that time wide agreement about which reforms were of particular urgency. A third question is whether this was a good reform agenda to advocate to the region. My own answer is that everything on it made sense, but that it omitted a number of reforms that should have been on the agenda, such as making macroeconomic policy cyclically stabilizing and correcting the appallingly unequal income distributions that afflict the region.

Alternative meanings

However, it is quite clear that, over the years, many people have come to use the term in a very different sense from mine. One can identify at least two alternative meanings. One of these equates the Washington Consensus with neoliberalism. Since I was a student of Fritz Machlup, who went to great pains to clarify how words were used so that disagreements would not be mere reflections of verbal ambiguities, I eventually discovered that neoliberalism is a term originally coined to describe the doctrines espoused by the Mont Pelerin Society, a scholarly group founded after World War II to promote the most right-wing version of a liberal agenda. While I believe that most members of the Mont Pelerin Society would endorse most of the policy reforms in my version of the Washington Consensus (it is, after all, in the nature of a consensus that most people endorse it), there are a number of distinctively neoliberal doctrines that are conspicuous by their absence from my list: monetarism, the low tax rates that are called for by supply-side economics, the minimal state that denies any responsibility for correcting income distribution or internalizing externalities, and free capital movements.

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This alternative interpretation of the term, which I have come to think of as populist, could never have arisen had others engaged in the sort of careful taxonomic analysis that Machlup inculcated in me. A plausible explanation for how this populist meaning arose is that opponents of reform decided to exploit the resentment that some reformers undoubtedly felt about the term, which they thought implied that they had adopted reforms because of pressure from Washington, not because of a rational calculation of national self-interest. If these reform opponents could also reinterpret the Washington Consensus as an extreme set of market fundamentalist beliefs, then the chance of discrediting reform would be enhanced. The likelihood of this was doubtless aided by the fact that the 10 reforms strongly emphasized liberalization, which was defensible given that the agenda was originally directed at Latin America in 1989, but it becomes grotesque when it is interpreted as an agenda for all countries at all times (as populist critics have done).

The second possible alternative interpretation is that the Washington Consensus represents the policies collectively pursued by the Washington-based institutions that dispense advice to developing countries: the Bretton Woods institutions (the IMF and the World Bank), the Inter-American Development Bank, the U.S. Treasury, and, perhaps, the U.S. Federal Reserve. Insofar as I was an accurate reporter of the Washington scene in 1989, there was an initial identity between my original concept and this second alternative, although I have already conceded that official Washington never did share my enthusiasm for pursuing a competitive exchange rate. But the two concepts began to diverge more significantly over time as the collective position of the institutions changed. One important respect in which they diverged relates to the enthusiasm that official Washington developed in the 1990s for promoting capital account convertibility.

Now inoperative

Things have changed again, and indeed I would argue that this second alternative interpretation of the Washington Consensus has now become inoperative. This is because there is no longer any agreement on the main lines of economic policy between the current U.S. administration and the international financial institutions. Consider, for example, recent criticism of U.S. fiscal policy in the IMF's April 2003 *World Economic Outlook*. Or consider the contrast between the Bush administration's disdain for any concern about income distribution and the World Bank's increased focus on the issue, for example, in the *World Development Report 2000/2001*. Again, there is now a critical difference in attitudes toward capital account liberalization in the emerging market countries, with the IMF having beaten a well-advised retreat since the Asian crisis (see, for example, Rogoff, 2002), while the Bush administration is still using bilateral free trade agreements to bully countries like Chile and Singapore into emasculating even the most enlightened capital controls. And even on trade, the international financial institutions have expressed strong criticism of U.S. policy on agriculture and steel. So, in this sense, any Washington Consensus has simply ceased to exist—a reflection of the chasm that the Bush administration has opened up between the United States and the rest of the world.

The way the term is most commonly used nowadays is clearly the second, or populist, sense. It is this fact that was reflected in Moíses Naím's assertion that the term had become a "damaged brand name" (Naím, 2003). It was demonstrated also in Brazil in the presidential election campaign last year of Luiz Inácio Lula da Silva, whose stump speech included a promise that, if elected, he would abolish the Washington Consensus and change the economic model from Day 1 of his term, at the same time that he was reassuring everyone that he would not allow inflation to return, that he planned to expand trade (even if he showed more enthusiasm for Mercosur than for the Free Trade Area of the Americas), and that he saw a key role for the Brazilian private sector. So, essentially, Lula had endorsed what I meant by the Washington Consensus while denouncing what is popularly meant by it.

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No "Consensus II"

When a term has come to acquire such different meanings, it is time to drop it from the vocabulary. So that is what Pedro-Pablo Kuczynski and I suggest in a new book we edited, *After the Washington Consensus: Restarting Growth and Reform in Latin America*, that tries to ask what the policy agenda for Latin America *should* look like in the year 2003, given the disappointments of recent years.

The book has four main messages. First, we argue that *the dominant reason for the disappointing performance of recent years has been the battering of the region by a series of crises.* This was not the first time crises hit Latin America, but it does point to a need to make the countries of the region less vulnerable, which is essentially a task for macroeconomic policy. One important step would be to make fiscal policy countercyclical instead of procyclical, as it has been in the past, starting with exercising restraint during boom times and periods of heavy capital inflows, to build up reserves and reduce debt ratios. This will give countries the scope to introduce expansionary policies when bad times come. That may be economically obvious, but it is politically difficult, for it means a finance minister urging fiscal restraint just when the constraints are least binding. To harden political resolve, we recommend the creation of a regional peer monitoring mechanism analogous to (though hopefully more sophisticated than) the European Growth and Stability Pact. Another important step in crisis-proofing is to adopt an exchange rate regime with sufficient flexibility to allow a currency to depreciate in response to a panic, as the Brazilian real did last year. That does not necessarily mean that we want to see countries resort to "clean" floating, since another important way of reducing crisis vulnerability is to maintain a sufficiently competitive exchange rate to limit debt accumulation when capital wants to enter. If that means measures like the Chilean *encaje* to repel excessive capital inflows, so be it. The last step is to increase domestic savings, so that capital inflows become icing on the cake instead of a prerequisite for growth. That again points to the need for a less expansionary fiscal policy on average over the cycle, plus pension reform.

A second message of the book is that *countries should complete the liberalizing reforms embodied in the original version of the Washington Consensus.* The outcome of these reforms may have been disappointingly small; nonetheless, most serious evaluations conclude that their impact was positive, despite the fact that, in some cases, one can criticize the way they were implemented. For example, trade liberalization focused exclusively on import liberalization, without sufficient attention to improving export market access and establishing a competitive exchange rate, to ensure that the resources freed up in the import-competing sectors would flow into the export sector. Financial liberalization often occurred without the appropriate complement of prudential supervision that a liberalized financial system demands. Privatized enterprises too often did not sell into a competitive market, nor were they properly regulated. So, in completing privatization and trade reform, it is important that these oversights be remedied. In addition, there is one market where little liberalization has happened, namely the labor market. The result is that as much as half the labor force works in the informal sector. We believe that it would be far better if the bar required by formal labor contracts were lowered to a realistic level, so that a larger proportion of workers received basic benefits like health insurance, pension rights, and some form of unemployment safeguard, and deterrents to expanding the formal sector were reduced.

But it would be wrong to give the impression that the only task at this juncture is to complete what were often called "first-generation" reforms, and this is part of our third message. *The major new thrust of development economics in the 1990s was recognition of the crucial role of institutions in permitting an economy to function effectively.* The importance of institutional reforms in complementing first-generation reforms in Latin America was first emphasized by Naím (1994), who dubbed these "second-generation" reforms, while a paper by Ross Levine and William Easterly, published in 2002, concluded that the state of institutional development furnishes the *only* variable that reliably predicts how developed a country is. (Incidentally, some may argue that the term "second-generation" is a misnomer, inasmuch as decently functioning institutions (for example, a system of financial supervision) may be a precondition for certain liberalizing reforms (such as financial liberalization), which implies that the second generation ought to precede the first.)

Our book argues that such reforms are liable to involve political confrontation with some of society's most potent and heavily entrenched interest groups, such as the judiciary and public school teachers. The judiciary in Latin America is notorious for ignoring economic considerations, for example, by overriding creditor rights to the point where creditors are reluctant to lend. Or, worse still, it is so corrupt that judges have to be paid to permit money to be recovered. Similarly, many teachers' unions have been captured by small groups with political agendas unrelated to the teaching profession. The answer, we argue, is not to initiate a campaign to "break the unions," but, rather, to seek to professionalize teaching so that teachers will want their unions to become positive partners for reform.

Second-generation reforms are liable to involve political confrontation with some of society's most potent and heavily entrenched interest groups, such as the judiciary and public school teachers.

The final message of the book concerns income distribution, a topic of major importance in Latin America, which has the most unequal distributions in the world. The starting point is recognition that there are two ways poor people can become less poor. One is by increasing the overall size of the economic pie from which all members of society receive their income. The other is by redistributing the existing pie, so that the rich get a smaller proportion and the poor get a bigger proportion. Since a country where the poor receive a very small proportion of income needs to reallocate a relatively small part of the income of the rich in order to make a big dent in poverty, it is sensible for Latin America to make an effort in this direction. Traditionally, income has been redistributed through the fiscal system: imposing progressive taxation on the rich and using the proceeds to finance social expenditures that benefit the poor disproportionately. We see some scope for this, especially through a greater use of property taxes (which are progressive) to finance the subnational governments that have become important in recent years in many Latin American countries. But we also argue that *the key innovation for improving income distribution will come from empowering the poor by giving them access to assets that will enable them to work their way out of poverty:* education to increase their human capital, titling reform to allow their micro enterprises to operate in the formal sector, micro credit to allow them to buy physical capital, and, in some places, agrarian reform to provide access to land.

We hope that this agenda will not be labeled "Washington Consensus II." It is not the work of Washington insiders. It makes no attempt to report a consensus (we did not even reach complete consensus among ourselves). The phrase has become so hopelessly ambiguous as to constitute an obstacle to clear thought. Let the agenda instead be assessed on its merits, as a contribution to a much-needed discussion of where economic reform should be heading as (hopefully) we leave behind the stale ideological rhetoric of the 1990s. ■

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