Published in the Journal of Post Keynesian Economics,
Vol. 27, No. 2, Winter 2004-5, pp. 293-314.

BEYOND THE WASHINGTON CONSENSUS:

WHAT DO WE MEAN?

José Antonio Ocampo

Abstract

This paper underscores the need to overcome the fundamental problems of the "Washington consensus", which have not been entirely solved in its recent reformulations calling for a "second generation of reforms". Such problems are: its narrow view of macroeconomic stability; its disregard for the role that policy interventions in the productive sector can play in inducing investment and accelerating growth; its tendency to subordinate social policies to economic policies; and, finally, its tendency to forget that it is citizens who should choose what economic and social institutions they prefer. The examination of the frustrating experience of Latin America under structural reforms provides the empirical backdrop for the analysis.

Introduction

The term "Washington Consensus" was coined by Williamson (1990) as a way to codify the economic liberalization policies encouraged by IFIs as part of their policy of structural reforms. However, it soon went beyond the list or intention of its original author to be used as synonymous of "neo-liberalism".

It is true, as Williamson argues in its contribution to this volume, that its use has been imprecise, as is true of "neo-liberalism", but this is characteristic of terms used in the ideological debates that underlie many economic controversies (even if denied by some participants in such debates). However, both concepts refer to the family of reforms aimed at increasing the role of market forces, which have been adopted extensively in recent decades, though certainly with variations, in the developing and transition economies. Indeed, these concepts are no less imprecise that others widely used in the development debate, such as that of "import substitution industrialization"; as argued by Cárdenas, Ocampo and Thorp (2000, chapter 1), this concept does not stand a close historical scrutiny, and propose "State-led industrialization" as a more appropriate

alternative.

By now, it is clear that the "Washington Consensus" agenda was incomplete. Even its defendants recognize that it disregarded the role of institutions in economic development and tended to minimize that of social policy. These concerns have led to a diverse set of policy proposals, which call for a "second generation of reforms". This is a welcome development, though specific proposals are debatable and it has been accompanied by institutional conditionality on top of previous layers of structural and policy conditionality. Furthermore, it has fallen short of recognizing that there is no such a thing as a universal path to development. It has also failed to notice that, in some cases, market-based reforms have generated some of the problems that must now be solved – i.e., that inadequate economic performance and inequitable development may itself be the result of market-based reforms.

This paper will argues that the fundamental problems of the "Washington consensus" lie in four areas: its narrow view of macroeconomic stability (an area where some advance has been made in recent years); its disregard for the role that policy interventions in the productive sector can play in inducing investment and accelerating growth; the tendency to uphold a hierarchical view of the relation between economic and social policies, in which "sound" economic policies have a primacy and social policies a subordinate role; and, finally, the tendency to forget that it is citizens who should choose what economic and social institutions they prefer.

Thus, rather than that focusing on the need for new "generations" of reforms, it may be much better to understand the "context-specific" dynamics that facilitates growth with equity in specific institutional contexts, on facilitating rather than suppressing institutional diversity, and on "reforming the reforms" (ECLAC, 2000; Ffrench-Davis, 2000; Ocampo, 2002a; Rodrik, 2001 and 2003). In this sense, going "beyond the Washington consensus" does not mean adding more areas of reforms to fill in the gaps of the original consensus, but rather overcoming the "reform fetishism" that has become deeply embedded in the development debate.

The paper is divided in five sections, the first of which is this introduction. As the original Washington consensus was largely formulated to overcome the allegedly poor

Latin American economic performance, the empirical references largely focuses on this region and are based on research by the United Nations Economic Commission for Latin America and the Caribbean, ECLAC. The second section thus reviews Latin American frustrations under structural reforms. The following two deal with the need for a broad view of macroeconomic stability and the role of productive sector policies. The last section focuses on the need to mainstream social objectives into economic policy and promote democratic diversity.

1. Recent Latin American frustrations

In recent decades, Latin America became the showcase of the "Washington consensus". The region undertook with enthusiasm ("ownership") economic liberalization beginning in the mid-1980s (earlier, in some countries). The frustrations with the results should thus be taken as a serious demonstration of the weaknesses on which the liberalization agenda was built (ECLAC, 2000 and 2001; Ocampo, 2004).

On the positive side, substantial progress was made in controlling inflation. Also, on average (and contrary to widespread perceptions), budget deficits were brought under control in the second half of the 1980s and remained moderate since then in most countries. Commitment to inflation control and budget discipline was reflected, in turn, in increasing confidence in the macroeconomic authorities, which include now independent central banks.

Most importantly, the region succeeded in boosting exports and becoming a magnet for FDI. Between 1990 and 2003, and even taking into account the strong slowdown of the early 2000s, the average annual increase in merchandise exports amounted to 7.8% in terms of volume, the fastest rates of growth in the region's history. Meanwhile, FDI flows to the region grew at an unprecedented rate, increasing fivefold between 1990-1994 and 1997-2001, though followed by a sharp decline in 2002-2003.

Integration into the world economy followed three basic patterns. In the first, which has been exhibited primarily by Mexico but also by several countries in Central America and the Caribbean, countries joined in the vertical flows of trade in

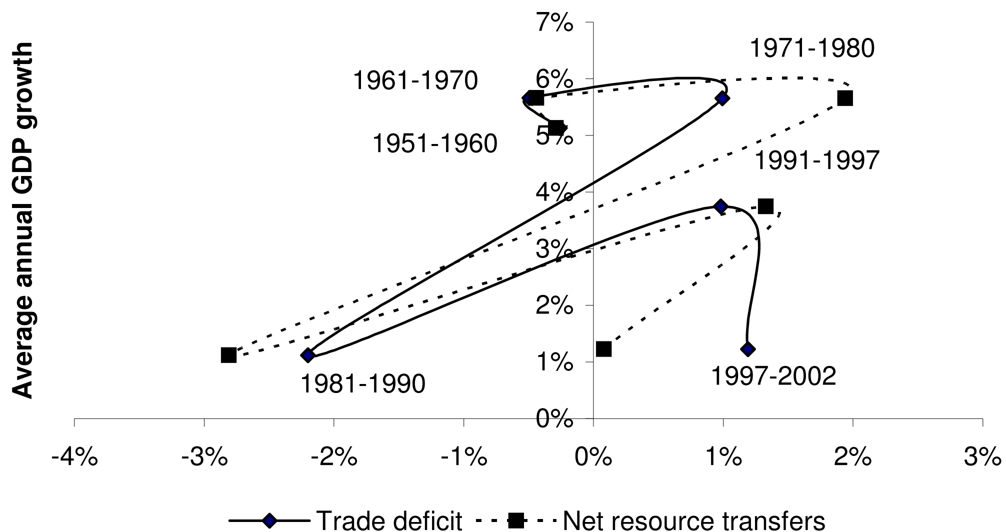
manufactures characteristic of internationally integrated production systems, concentrating their exports in the United States market. In the second, typical of South America, the countries integrated into horizontal global production and marketing networks, chiefly for raw materials and natural-resource-based manufactures. This group is also characterized by highly diversified intra-regional trade and by a lower concentration of destination markets. The third pattern is based on the export of services, mainly of tourism, but also financial, transport and energy services, and is the predominant pattern in some countries of the Caribbean, Panama and Paraguay.

The region's success in increasing its share in world markets and attracting FDI was not reflected, however, in rapid GDP or productivity growth. Indeed, the average growth rate in 1990-2003, of 2.6% a year, is less than half the record for the period of State-led industrialization, 1950-1980: 5.5% a year; even during the years where the new model performed best, 1990-1997, the growth rate, at 3.7% a year, fell sharply below the historical record. As part of this process, investment rates never recovered during 1990-1997 the levels of the 1970s and fell sharply after the Asian crisis. In turn, the weighted TFP of the ten largest Latin American economies increased at a meager 0.2% a year in 1990-2002 –and 1.1% in 1990-1997—vs. 2.1% in 1950-1980. Although there are many reasons –particularly the sweeping changes in the world economy—why it would be a mistake to resume the policies typical of the earlier historical period, clearly the burden of proof is now on those who characterized State-led industrialization as a major historical failure and liberalization as the key to rapid growth. Even supporters of economic liberalization now regard the period of State-led industrialization as a "golden age" (Kuczynski and Williamson, 2003, p. 305).

A major explanation for the mediocre recent performance is the structural deterioration in the links between GDP growth and the trade balance or (what is largely equivalent) between growth and external resource transfers. Figure 1 indicates that this link had already worsened in the 1970s vis-à-vis the 1950s and 1960s (dynamic growth continued only on the basis of a higher trade deficit and increasing resource transfers). It further deteriorated in 1990-1997 with respect to the 1970s (much lower growth was obtained with similar trade deficits and resource transfers) and, once again, in 1998-2002. This reflects a series of adverse trends in the productive structure: (i) a decline in import-

substituting activities that has not been counterbalanced by sufficiently high export growth; (ii) the high demand, in dynamic sectors, for imported capital and intermediate goods (a trait of internationally integrated production systems) which, together with the previous factor, has reduced production linkages; and (iii) the weakening of the national innovation systems inherited from the preceding stage of development, as engineering functions and research and development that used to be performed by local firms was largely transferred out of the region, with countervailing forces (e.g., the rapid spread of ICT) having a weaker effect.

Figure 1
GROWTH, TRADE BALANCE AND RESOURCE TRANSFERS



Source: ECLAC

As a result of these factors, the multiplier effects and the technological externalities generated by the high-growth activities associated with exports and FDI have been weak. In a sense, the new dynamic activities have operated as "enclaves" of globalized production networks –i.e., they participate actively in international transactions but much less in the generation of domestic value added. They have thus failed to fully integrate into the economies where they are located and, thus, in inducing rapid GDP growth.

In this context, the links between productivity and GDP dynamics has been contrary to what traditional neoclassical analysis would suggest. Thus, the productivity gap with respect to the US narrowed more quickly during the 1970s and 1980s than during the 1990s (this reflected, in part, the slower pace of technological change in US manufacturing during those previous decades). More importantly, at the sectoral level, the closing of the technology gap had more to do with the pace of economic growth in a particular sector and country than with patterns of technological catch-up induced by the reform process (Katz, 2001). For example, automobile production, for which selective instruments of protection were kept, experienced productivity increases just as large as the natural-resource-intensive export activities, with import-competing sectors challenged by external competition experiencing the poorest productivity performance. Thus, the corresponding dynamics is closer to a Kaldorian pattern, in which growth determines productivity (see Kaldor, 1978), rather than the opposite neoclassical link.

Productivity dynamics ran contrary to neoclassical expectations in still another sense. The expectations of economic reformers that rising productivity in internationalized sectors would spread throughout the economy, thereby leading to rapid overall economic growth, did not materialize. Productivity did increase in dynamic firms and sectors, and external competition, FDI and privatizations played a role in that process. However, these positive shocks did not spread out, but rather led to greater dispersion in relative productivity levels within the economies. This reflects the fact that labor, capital, technological capacity and, sometimes, land that were displaced from sectors and firms undergoing productive restructuring were not adequately reallocated to dynamic sectors, but led rather to increasing unemployment and, particularly, underemployment of those resources. This was reflected, in turn, in an increasing dualism or "structural heterogeneity": there are now many more “world-class” firms, many of which are subsidiaries of transnational corporations, but, at the same time, a growing proportion of employment is being concentrated in low-productivity informal-sector activities. This pattern also means that restructuring was not “neutral” in terms of its impact on different economic agents.

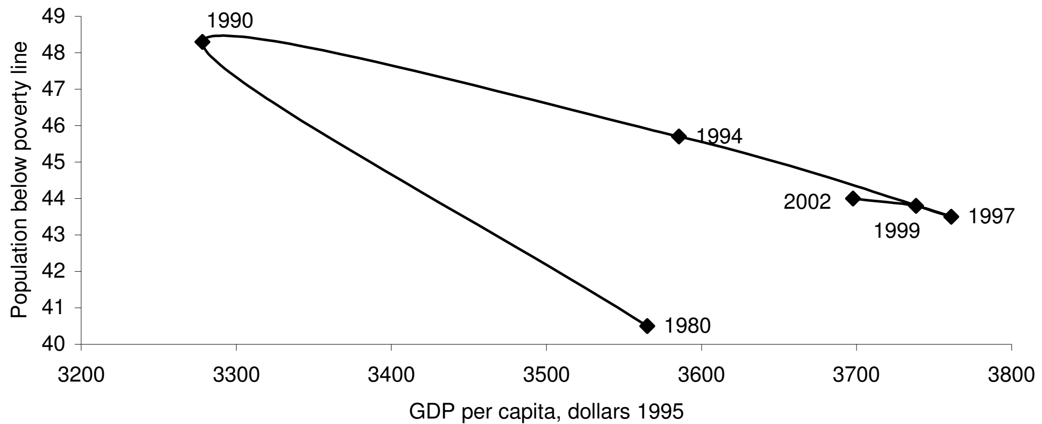
The structural deterioration in the links between growth and the trade balance has generated a strong sensitivity to external financing, which has been enhanced by financial

liberalization, pro-cyclical domestic financial systems and pro-cyclical monetary and fiscal policies. The tendency to use exchange rate anchors to stabilize the price level in post-inflationary environments and, more generally, during periods of abundant external financing, further contributed to dependence on such financing, and to exchange rate overvaluation. As a result of this dependence, economic growth has become increasingly sensitive to capital account volatility. Thus, the renewal of the net resource transfer in the early 1990s led to a recovery of economic growth, but capital account and other external shocks have interrupted growth three times in less than a decade (1995, 1998-1999 and 2001-2003). Overall, the weak renewal of economic growth during the years of booming capital flows, 1990-1997 (1995 being a partial exception), was followed by a “lost half-decade” –or, rather, a lost sexennial—in 1998-2003, when the Asian crisis generated a sharp reversal of capital (particularly financial) flows.

Slow and volatile economic growth and adverse structural patterns have been reflected in weak labor markets. Employment generation has been particularly poor in South America. Rising informality, increasing income gaps between skilled and unskilled labor and, as already indicated, increasing structural heterogeneity are broader regional trends. A major reflection of this is the fact that the poverty/economic growth link experienced a structural deterioration in the 1990s, as Figure 2 indicates. Thus, poverty rates remained significantly higher in 1997 than they had been in 1980, even though the per-capita GDP decline that characterized the 1980s had already been reversed. With the further decline in average per capita incomes during the recent "lost half-decade", poverty rates have increased.

In turn, the worsening poverty/growth link reflects the fact that about half the countries in the region experienced deterioration in income distribution during the 1990s, with only few of them experiencing the opposite pattern (ECLAC, 2004; World Bank, 2003). Despite this general trend, the World Bank (2003) has argued that there has been a slight overall improvement in the regional income distribution due to improvements in Brazil, a country for which no such positive trend has taken place according to ECLAC (2004).

Figure 2
POVERTY AND PER CAPITA GDP



Source: ECLAC, based on Social Panorama and Statistical Yearbook, various issues.

These adverse trends defeated the positive effects of rising social spending, which rose from 10.1% of GDP in 1990-1991 to 13.8% percent in 2000-2001, undoubtedly one of the major payoffs of the widespread return to democracy in the region. They also defeated major innovations in social policy, particularly improved targeting. Both outcomes indicate that relatively active social policies were unable to reverse the adverse social patterns induced by the economic transformations.

Furthermore, traditional social security systems and new social safety nets were unable to respond to the demands generated by the increasing job and wage instability. Increased levels of macro- and micro-economic risk have thus translated into greater social risks and greater demands for protection, which these systems were unable to cope with. Moreover, in some cases, the principles of universality and solidarity that should characterize social protection systems were put aside during the reform period, particularly in the area of social security (health and pension) reform. This fact, together with adverse labor market trends, has been reflected in the frustratingly slow pace of progress in the coverage of these systems.

Overall, therefore, the frustrating economic and social performance that characterized the reform period indicates that three basic assumptions of reformers proved entirely wrong. The first was the postulate that low inflation and better control of budget deficits would ensure stable access to international capital markets and dynamic economic growth. The second was the presupposition that integration into world trade and investment flows would generate positive externalities; in fact, due to the nature of the integration processes that were induced by liberalization, such externalities may have been, in net terms, negative. Finally, the assumption that higher productivity in leading firms and sectors would automatically spread throughout the economy, leading to a broad acceleration of economic growth, also proved wrong, as factors displaced from uncompetitive activities were not fully employed in the expanding, competitive sectors. Even a fourth assumption, typical of defenders of a "second generation of reforms", also proved wrong, that active social policies could counteract the adverse social effects of economic transformations.

2. A broad view of macroeconomic stability

The concept of macroeconomic stability underwent considerable changes in the economic discourse over the past two decades. During the post-war years dominated by Keynesian thinking, it was basically defined in terms of full employment and stable economic growth accompanied by low inflation and sustainable external accounts. Over time, fiscal balance and price stability moved to centre stage, replacing the Keynesian emphasis on real economic activity. This policy shift led to playing down and even, in the most radical views, suppressing altogether the countercyclical role of macroeconomic policy and even openly promoting procyclical macroeconomic policies.

Although this shift recognized that high inflation and unsustainable fiscal deficits have costs, it also entailed an underestimation of the costs of real macroeconomic instability –i.e., the fact that recessions entail a significant loss of resources that may have long-run effects, such as the irreparable losses of both tangible and intangible assets (tacit technological and organizational knowledge, social capital, the goodwill of firms) and the irreversible losses in the human capital of the unemployed or underemployed. Volatile

growth leads to a high average rate of underutilization of production capacity, and the uncertainty associated with variability in growth rates may have stronger effects on capital accumulation than moderate inflation, as it encourages "defensive" microeconomic strategies (i.e., those aimed at protecting the existing assets of firms) rather than the "offensive" strategies that lead to high investment rates and rapid technical change.

The shift toward procyclical policies was particularly sharp in the developing world where economic liberalization replaced automatic stabilizers with automatic destabilizers (Stiglitz, 2002). In particular, external capital market and domestic financial liberalization exposed developing countries to the highly procyclical financial swings characteristic of assets that are perceived by markets as risky and are thus subject to procyclical swings in the "appetite for risk". At the same time, monetary and fiscal policy management became increasingly procyclical. This was particularly true during downswings, when authorities were expected by markets and asked for by the IMF to undertake contractionary monetary and fiscal policies, whereas financial markets pushed them into equally procyclical (in this case, expansionary) policies during upswings.

Interestingly, the suppression of traditional instruments of trade and balance of payments interventions also eliminated countercyclical policies widely used in past in economies where the business cycle is largely of an external origin. This was the result of restrictions on the use of protection and export subsidies to encourage trade restructuring during periods of adverse external shocks –and, conversely, trade liberalization and reduction of export subsidies as instruments to reduce the expansionary effects of export booms. It was equally the result of the reluctance to use capital controls to manage procyclical swings in capital flows, though a countercyclical innovation in this regard was the use of unremunerated reserve requirements on capital flows by Chile and Colombia during the 1990s.

Thus, the exchange rate was left as the major and, in most cases, the only instrument of balance of payments management. However, although exchange rate variations can have a direct countercyclical effect on the trade balance, exchange rate volatility generates unstable incentives to international specialization, the real aggregate

demand effects have an unclear sign (they could be procyclical, as suggested by the literature on the contractionary effects of devaluation –see Krugman and Taylor, 1978) and they have clearly procyclical wealth effects in economies with net external liabilities in foreign currencies. Furthermore, in the most extreme view, exposed by defenders of polar exchange rate regimes, authorities should give up altogether the idea that the exchange rate is a policy instrument, and either adopt a hard peg –or give up the domestic currency altogether—or a totally flexible exchange rate. In the first case, authorities would give up monetary policy altogether. In the second, they would regain such autonomy but at the cost of more exchange rate volatility.

As Williamson argues in its contribution to this volume, a flexible exchange rate with inflation targeting offers some room for countercyclical monetary policy. However, the advantages of this policy option are clearer in economies where business cycles are generated by swings in domestic spending, which determine, in turn, domestic price dynamics. They are less clear in economies where business cycles have largely an external origin and where the nominal exchange rate plays a central role in domestic price dynamics. Both are essential features of developing countries. Furthermore, to the extent that a stable, real exchange rate is a crucial determinant of growth and employment in open economies, an element of "real exchange rate targeting" is an essential component of adequate macroeconomic management in developing countries; moreover, this is particularly true in countries that, as the result of liberalization, have given up their trade policy instruments. Such alternative targeting rule is implicit in the defense of intermediate exchange rate regimes, and may require the use of additional instruments, particularly some form of regulation of external capital flows (Williamson, 2000; Ffrench-Davis and Larraín, 2003; and Ocampo, 2002b and 2003).

The recognition that liberalized capital accounts and financial system tends to generate excessively risky private sector balance sheets has also led to the recognition of the need for preventive –i.e., prudential—financial policies. Although the lack of strong prudential regulation and supervision typical of the early phases of financial liberalization is part of such risky behavior, it is certainly not the whole story. Boom-bust cycles are an inherent aspect of financial markets. During such bouts of euphoria, economic agents tend to underestimate the intertemporal inconsistency of their spending and financial

strategies. Later, when crises lead to financial meltdowns, asset losses may wipe out years of capital accumulation and the socialization of losses may be the only way to avoid a systemic crisis, but at high fiscal (and quasi-fiscal) costs. Restoring confidence in the financial system takes time, and the financial sector itself becomes risk-averse, a feature that undermines its ability to perform its primary economic functions.

Preventive macroeconomic policies, which aims at avoiding the accumulation of unsustainable public and private sector debts during periods of financial euphoria, has thus become part of the standard macroeconomic recipe since the Asian crisis, together with strong prudential regulation and supervision of domestic financial systems. However, it is unclear whether the former can operate in the absence of some form of regulation of capital flows –given, among other reasons, political economy limits on the capacity to generate countercyclical fiscal surpluses during booms (Marfán, 2004). Furthermore, this view has only come half-way in the design of a truly countercyclical macroeconomic policy, as it misses the other half –countercyclical policies during crises.

Additionally, the traditional instrument of prudential regulations, Basle capital standards, does not take into account the association between financial risk and the evolution of key macroeconomic variables, and the particularly risks associated with the accumulation of short-term external liabilities (see, on the latter, Rodrik and Velasco, 2000). Also, their countercyclical effects during booms are probably weak, whereas their procyclical effects during downswings are strong and may induce a credit crunch. Under these conditions, their effectiveness depends on the ability to introduce some macroeconomic criteria into prudential policies (e.g., the exchange rate risks of nontradable sectors), some countercyclical elements into its design (particularly countercyclical loan-loss provisioning), and complementary capital account regulations aimed at avoiding an excessive accumulation of short-term external liabilities during periods of financial euphoria (Ocampo, 2003).

The menu of options in the area of macroeconomic policies has thus broadened in recent years. However, we have only come part of the way to the full recognition that macroeconomic stability involves several dimensions: not only price stability and sound fiscal policies, but also smoother business cycles, competitive exchange rates, sound

external debt portfolios, and healthy domestic financial systems and private sector balance sheets.

This indicates the importance of moving toward a broad view of macroeconomic stability that recognizes that there is no simple correlation between its alternative definitions and, thus, that multiple objectives and significant trade-offs are intrinsic to the design of "sound" macroeconomic frameworks. As the foregoing discussion makes clear, a major objective to such design is to rescue the role of countercyclical macroeconomic policies that are appropriate to developing countries, where cycles are largely of external origin and are increasingly transmitted through the capital account.

This requires a combination of two sets of policy packages, whose relative importance will vary depending on the structural characteristics, the macroeconomic policy tradition and the institutional capacity of each country. The first involves a mix of countercyclical fiscal and monetary policies with intermediate exchange rate regimes and regulations of capital flows. The second, aimed at guaranteeing healthy private sector balance sheets, which include strong prudential regulation and supervision with countercyclical provisions that take into account the links between financial risks and macroeconomic variables, together with capital-account regulations aimed at guaranteeing sound public and private-sector external debt profiles (Ocampo, 2002b).

Managing counter-cyclical macroeconomic policies is no easy task, as financial markets generate strong incentives to follow procyclical policy rules. Moreover, globalization places objective limits on national macroeconomic policy autonomy. For this reason, it is essential that international cooperation in the macroeconomic policy area be designed with the clear objective of overcoming these incentives and constraints. This means that the first role of international financial institutions, from the point of view of developing countries, is to counteract the procyclical effects of financial markets. This can be achieved by smoothing out boom-bust cycles at the source through adequate regulation, and by providing developing countries with additional degrees of freedom to adopt countercyclical policies (e.g., adequate surveillance and incentives to avoid the build-up of risky macroeconomic and financial conditions during periods of financial euphoria, together with financing and debt management mechanisms to smooth out adjustments in the event of sudden stops in private capital flows). The second, equally

essential role is to counter the concentration of lending by providing access to those countries and agents that tend to be subjected to rationing in private international capital markets.

To facilitate economic growth, such interventions through the business cycle should aim at developing sound fiscal systems that provide the necessary resources for the public sector to do its job, a competitive exchange rate and moderate long-term real interest rates. These conditions, together with deep financial markets that provide suitably priced investment finance in domestic currency with sufficiently long maturities, are the best contribution that macroeconomics can make to growth. In the case of the financial sector, this may require public sector interventions to promote the emergence of new agents and segments in capital markets and, in their absence, to provide such financing through development banking.

3. The role of productive development strategies

Aside from the incapacity to guarantee adequate macroeconomic conditions, two common interpretations of the reasons why ongoing reforms have failed to spur rapid economic growth emphasize the role that institutional weaknesses and insufficient liberalization.

With respect to the first of these factors, it is hard to quarrel with the idea that some key institutions are essential for growth, in particular political arrangements that provide political stability and appropriate management of conflict, non-discretionary legal systems and practices that provide security of contracts, and well functioning State bureaucracies. The superiority of some institutions in terms of facilitating economic growth remains, however, a subject of heated debate. In any case, as Rodrik (2001 and 2003) has claimed, there are no reasons to think that there is a close association between growth spurts and extensive institutional reform efforts. In this sense, institutional requirements operate as "framework conditions" but do not play a direct role in determining specific changes in the momentum of economic growth –and those specific innovations that have played such a role in specific historical cases vary from one experience to the other.

This is clearly borne out by the Latin American experience. In particular, it is difficult to argue that the determining factor in the dynamics of economic growth during State-led industrialization and, on the contrary, its weakness during the recent period is the stronger institutions that characterized the former period. Indeed, by the criteria through which institutions are judged today (e.g., protection of private property rights, transparency, accountability and participation), the opposite is probably the case. However, as we will see below, the specific institutions for productive sector development were clearly superior during the former period.

Can we find the explanation to slow growth in how extensive the reform effort has been? Again, a cursory look at the experience indicates that the longest-lasting episodes of rapid growth in the developing world (e.g., the East Asian or, most recently, the Chinese and Indian "miracles" or, in the past, the periods of rapid growth in Brazil or Mexico) were not preceded by phases of extensive economic liberalization, even in cases where they involved the use of the opportunities provided by international markets (which is a more common, though not a universal, feature). In the case of Latin America, as we have seen, economic growth was much faster during the period of interventionist State-led industrialization, than during the recent phase of economic liberalization. Recent cross-country economic evidence about the links between growth and reforms is also inconclusive (Ocampo, 2004).

A more promising answer to the quest for an explanation for frustrating growth performance thus lies in the analysis of the specific features of productive sector development and whether they have been associated with a dynamic process of investment and technical change. The existing literature provides two interdependent ways to look at this issue.

The first underscores the fact that liberalized markets require full-fledged regulatory policies that facilitate their efficiency: competition policies, public regulation of non-competitive markets or markets with strong externalities, and the correction of market failures in factor markets, particularly the markets for long-term capital, technology, labor training and land. Correction of market failures in long-term capital and technology markets are probably the most important in terms of economic growth,

whereas correction of non-competitive market practices and of market failures in all factor markets are crucial for small firms.

The second emphasizes the links among structural dynamics, investment, technical change and economic growth. According to this "structuralist" view, economic growth is a process of persistent structural change, in which some sectors grow and other contract, in a repetitive phenomenon of "creative destruction", to use Schumpeter's metaphor (1962, chapter VIII). A successful structural dynamics can be described in terms of three basic processes: (i) the development of new activities –i.e., innovations, in the broad sense of the term (Schumpeter, 1961, chapter II); (ii) the capacity of innovations to transform the economic structure, particularly through the diffusion, learning process and externalities they generate; and, as a result of the strength of these processes, (iii) the reduction in the structural heterogeneity that characterizes developing countries. These three features determine what we can characterize as the dynamic efficiency of a given system.

In industrial countries, innovations are directly associated with technical change and the introduction of new products, but also with major changes in commercial or organizational arrangements. The major incentive is provided in all cases by the extraordinary profits of the innovator. In developing countries, on the contrary, innovations are primary associated to the spread of technologies, new products, commercial or organizational transformations previously created in the industrial centers. The extraordinary profits of innovators are generally absent and, indeed, production involves entry into activities with thinner or, indeed, thin profit margins. In the absence of specific government incentives, success in this process will depend on the exploitation of the opportunities to reduce costs to break into established marketing channels. This involves, in turn, the capacity to acquire knowledge and apply it to production. In this sense, even though technical innovations do not play the leading role, success in economic development is associated to the ability to create enterprises that are capable of learning and appropriating knowledge and, in the long run, of generating new knowledge (Amsden, 2001).

All these processes require investment, both in physical capital and intangibles (technological learning and marketing strategies). Moreover, to the extent that innovative

activities are the fastest growing of any economy, they have the highest investment requirements. These facts, together with the falling investment needs that characterize established activities, imply that investment is directly dependent on the relative weight of innovative activities.

The capacity of a specific innovation to transform a given productive structure depends not only on the nature of the innovation itself –particularly the technical change that it brings with it and the learning process that it unleashes—but also on its diffusion through the system, the secondary innovations they induce, the reduction of the costs that additional firms have to incur to break into the market (e..g, through the reputation that the leading firms give to a specific location), and the demands it generates to associated industries (forward and backward linkages, according to the Hirschman, 1958). All these processes involve externalities. Indeed, to the extent that these externalities are important, the success of the innovation to take hold depends on the ability to overcome the "costs of coordination" that characterize the development of new activities (Chang, 1994). All in all, it is the system-wide features that matter and that determines the degree of "systemic competitiveness" of the production structures (ECLAC, 1990).

Finally, the underemployment of labor and the associated structural heterogeneity typical of developing countries guarantees an elastic labor supply that facilitates growth and, in turn, the success of the innovation to transform a given structure will be reflected in its capacity to reduce the extent of such heterogeneity. Alternatively, its failure will be revealed in the expansion of structural heterogeneity. As most innovations bring with it some "destruction" of existing activities, such success or failure will be also depend on the capacity of the expanding sectors to absorb the productive factors displaced from the contracting activities.

These ideas, and the associated call to promote dynamic efficiency, have been behind the call for a productive development strategy for the open developing economies of today, a long-standing theme in the "late industrialization" (or, more precisely, late development) literature. Thus, Rodrik (1999 and 2003) has made a strong argument for a "domestic investment strategy" to kick-start growth, and ECLAC (2000) has referred to the need for a "strategy of structural transformation".

Indeed, State-led industrialization in Latin America was such a strategy which, although based on high levels of state intervention and protection of domestic markets, was subject to rationalization and was making significant strides into international markets since the mid-1960s (Cárdenas, Ocampo and Thorp, 2000). Its demise was not associated to its dynamic features but rather to the macroeconomic vulnerability that it built up with the spread of private international finance in the 1970s and, we should certainly add, to the gross misunderstanding of its weaknesses by defenders of the "Washington consensus". The certainly more successful experiences of the Asian countries were also strategies of this sort, which have also been subject to misinterpretation (Chang, 2003).

On the contrary, the failure of Latin America under the "Washington consensus" can be traced to the absence of such a strategy and the dynamic inefficiencies that were analyzed in the second section of this paper: the excessive destruction of previous economic activities, the "enclave" character of many of the new dynamic activities, the limited capacity of rising productivity in leading firms and sectors to spread throughout the economy, the incapacity of these sectors to absorb productive factors displaced from uncompetitive activities and, as a result, the increase in structural heterogeneity.

This calls for the issue of dynamic efficiency of productive structures and the accompanying strategies of structural change to be brought back into the agenda, with its three major components: encouraging innovation and knowledge absorption and creation; facilitating the creation of the externalities that facilitate the development of the new sectors and their linkages to the rest of the economies; and reducing structural heterogeneity. Facilitating the orderly restructuring of contracting activities is also part of this process (Ocampo, 2005).

As the old apparatuses of intervention were either dismantled or significantly weakened during the phase of liberalization in most countries, a significant institutional and organizational effort is required in this area. In fact, it is only in relation to this issue that we can claim the period of State-led industrialization was superior in Latin American in terms of institutional development. Institution building in this area should be consistent with the open economies of today, and should give way to different mixes of private and public sector involvement, and of horizontal and selective instruments, through a learning

process. An effort must also be made to design instruments that tie incentives to results – "reciprocal control mechanisms" to use Amsden's (2001) terminology.

In turn, international rules should provide adequate "policy space" for such strategies, an issue that has come back with force in international debates, particularly during the recent XI United Nations Conference on Trade and Development. The international community should regard such strategies as an essential ingredient of successful development and should continue to search for instruments for implementing such strategies that do not degenerate into "beggar-thy-neighbor" competition for footloose production. Therefore, the reexamination of existing rules as well as new rules from this perspective is critical to guarantee appropriate opportunities for developing countries in the emerging global order.

Although some elements of this agenda have entered the policy discourse –e.g., rebuilding innovation systems, facilitating the creation of new firms, promoting small and microenterprises—, they continue to occupy a secondary space in the reform agenda. Indeed, the prominent absence of this issue in recent revisions of the "Washington consensus" (e.g., Kuczynski and Williamson, 2003) is an essential part of the problem, as has been its absence from the design of international trade rules in recent decades.

4. Mainstreaming social objectives into economic policy and democratic diversity

The initial formulation of the "Washington Consensus" contained only limited emphasis on social policy, and no concern for wealth and income distribution, or on the effects of reforms on distribution. Equity remained, however, a major focus of alternative proposals, such as those formulated by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC, 1990 and 2000). Also, as we saw above, rising social spending was a major dividend of the widespread return to democracy in Latin America. In the last few years, however, the concern with income and wealth distribution, the asset base of the poor, the need for a more comprehensive social protection system, and the effects of macroeconomic volatility on vulnerable sectors have enriched the policy agenda (see, for example, Birdsall and de la Torre, 2001, Kuczynski and Williamson, 2003, and World Bank, 2003).

This is a most welcomed development. However, it has not entirely overcome a basic problem of the social agenda during the reform period: its emphasis on the instruments –targeting, equivalency criteria between contributions and benefits, decentralization, private-sector participation—rather than on the principles that should guide the design of social policy –universality, solidarity, efficiency and integrality, according to ECLAC's (2000) formulation. This has been problematic in some cases, for example, when private participation in social security (health and pension) systems have not included solidarity principles in its design, when targeting has been used as an instrument for reducing public spending rather than for broadening access to some fundamental services in application of the principle of universality, or when decentralization has not taken full consideration of regional disparities.

Principles are important because they underscore the fact that social policy is a basic instrument of social cohesion, and thus that its design should be guided by much more than economic rationality. In any case, as the recent literature on the positive political economy links between income distribution and economic growth indicate (Aghion, Caroli and García-Peñalosa, 1999; Ros, 2000, chapter 10), the emphasis on social cohesion is not detached from economic rationality. A major corollary of this literature is that inequality is a major constraint to economic growth in Latin America as well as in other regions of the developing world with high levels of inequality (Africa) and is rapidly becoming an issue in some parts of Asia and, indeed that social cohesion may be a crucial competitive advantage in the global order, but one that is supplied in increasingly scarce quantities.

The major problem with recent formulations lies, however, elsewhere, and particularly in two areas: the inadequate recognition of the need to mainstream social objectives into economic policy, and the fundamental fact that, as economic and social institutions involve much more than economic rationality, their choice should be an explicit decision of citizens through adequately structured democratic institutions. Indeed, in a very fundamental sense, the institutions that facilitate such a choice are among the most important and thus that give a proper meaning to the concept of "ownership" of development policies. Of course, political voluntarism and populism have never been routes to economic and social progress, and thus such choices should not be

detached of some fundamental economic principles.

The idea that social objectives should mainstreamed into economic policy runs contrary to the "leader/follower" model that characterizes the design of macroeconomic policy, where such policy is determined first and social policy is left to address the social consequences (Mkandawire, 2001). The emphasis on "social safety nets" rather than the broader views of social protection, with their emphasis on universality and solidarity – and, for that matter, on building modern welfare states—is also a reflection of the continued view of social policy and outcomes as subordinate to market-based reforms.

This is also characteristic of many other debates, particularly that which concerns labor market institutions. The need for institutional designs that facilitate adjustment to changing economic circumstances is certainly an issue that should be taken into account in the design of labor institutions. However, traditional labor market flexibility is only one of the possible alternatives, and also one that can be applied in many different grades and modalities. Its basic weaknesses are the negative effects that it has on the accumulation of social capital of the firms, on the commitment of workers to the success of the firms in which they labor, and on harmonious labor-business relations. In recent debates, it is increasingly recognized that it should be accompanied by labor training schemes and strong social protection. Other alternatives include institutions that enhance labor-business cooperation to adapt to changing circumstances, both at the national and local levels (social dialogue) and within firms. Also, flexibility should never be seen as a substitute for adequate macroeconomic policies and, indeed, in an unstable macroeconomic environment, additional flexibility may lead to a sharp deterioration in the quality of employment with unclear benefits on the quantity of "formal" labor employment, its primary objective.

Given the crucial links between economic and social development, integrated policy frameworks should be designed that take into account both the links among different social policies and those between economic and social policies and objectives. The lack of appropriate institutions in this area has been emphasized by many analysts, including recently the World Commission on the Social Dimensions of Globalization (2004), which called for "policy coherence" initiatives along this line both at the national and international levels. Such frameworks should start by designing rules that facilitate

the "visibility" of the social effects of economic policies, by requiring macroeconomic authorities (including central banks) to analyze, on a regular basis, the effects of their decisions on key social variables (particularly employment and labor income), and Finance Ministries to include in any budget and tax reform initiative presented to Congress an analysis of their distributive effects. But this should be followed by more effective systems for coordination between economic and social authorities, in which social priorities are effectively mainstreamed into economic policy.

Beyond these considerations, it should be recognized that economic and social institutions have multiple dimensions, including some that go beyond their direct economic role. Thus, labor market institutions have implications beyond their effect on the quantity of formal employment. As pointed out, the quality of employment and labor-business cooperation are equally important objectives, as well as its distributive effects. In this regard, it has been argued that labor market liberalization has been one of the major forces behind the broad-based trend towards worsening income distribution in the world, and that centralized wage bargaining has been a defense against such trend in a few countries (Cornia, 2004). Labor unions are also a major mechanism of social participation.

Similar comments can be made about the role of public-sector firms. It is true that many of these firms became in several countries a source of inefficiency and budget deficits, but this is by no means a universal feature. Indeed, even reform-minded countries kept some public sector firms and some of them have had a very successful history. For example, CODELCO, the state copper company of Chile, has become a world leader and a source of important technical innovations and domestic externalities. Furthermore, badly designed privatization process, widespread corruption in some cases, decisions taken by the new owners (from eliminating their research and development capabilities to dismantling of the firms altogether), and rent-seeking in the regulation of privatized utilities, among other problems, have become major source of concern to citizens. Indeed, they explain why, after a decade of privatizations, only a minority of citizens in Latin America (22% according to Latinobarómetro, 2003) support them. This is also a major reason why citizens are generally disappointed with market based reforms (only 16% are satisfied, according to the same source).

This brings us to our second concern: economic and social institutions must be subject to democratic political choice. This reflects the fact that there is no such a thing a unique design of a market or a mixed economy. As some authors have put it, there are different "varieties of capitalism" (Albert, 1991; Rodrik, 1999) and it is unclear whether there is a superior form in terms of all relevant dimensions –not only economic dynamism and stability but income distribution and social cohesion. Furthermore, institutional development is essentially endogenous to each society, and depends on a learning process and a myriad of historical determinants. A successful endogenous dynamics of this sort is essential to guarantee the ability of institutions to fulfill some of its fundamental functions, particularly its capacity to guarantee social cohesion and manage conflict.

Controversies on the virtues of different economic institutions revealed the fact that economists are deeply embedded in ideological debates that should and can only be settled in the area of democratic politics. It is not the role of international cooperation or technocracies –or, for that matter, international markets—to predicate and least of all impose a dominant model of economic and social organization.

References

Aghion, P., E. Caroli and C. García-Peñalosa (1999), "Inequality and economic growth: the perspective of the new growth theories", *Journal of Economic Literature*, vol. XXXVII.

Albert, Michel (1991), *Capitalisme contre capitalisme*, Paris, Éditions du Seuil.

Amsden, Alice (2001), *The Rise of "The Rest": Challenges to the West from Late Industrializing Countries*, New York, Oxford University Press, September.

Cárdenas, Enrique, José Antonio Ocampo and Rosemary Thorp (2000). *Industrialisation and the State in Latin America: the Post War Years. An Economic History of Twentieth Century Latin America*, vol. 3, New York, Palgrave Press /St. Martins.

Chang, Ha-Joon (2003), "The East Asian Development Experience", in Ha-Joon Chang (ed.), *Rethinking Development Economics*, London, Anthem Press.

______ (1994), *The Political Economy of Industrial Policy*, London, Macmillan, and New York, St. Martin's Press.

Cornia, Giovanni Andrea (ed.) (2004), *Inequality, Growth, and Poverty in an Era of Liberalization and Globalization*, Oxford, Oxford University Press/United Nations University World Institute for Development Economics Research.

ECLAC (Economic Commission for Latin America and the Caribbean) (2004), *Una década de desarrollo social en América Latina, 1990-1999*, Santiago, Libros de la CEPAL, No. 77.

_____ (2001), *Una década de luces y sombras: América Latina y el Caribe en los años noventa*, Bogotá, Alfaomega/CEPAL.

_____ (2000), *Equidad, Desarrollo y Ciudadania*, Bogotá, Alfaomega/CEPAL.

_____ (1990), *Changing Production Patterns with Social Equity*, Santiago.

Ffrench-Davis, Ricardo (2000), *Reforming the Reforms in Latin America: Macroeconomics, Trade, Finance,* London, Macmillan, and New York, St Martin's Press.

_____ and Guillermo Larraín (2003), "How Optimal are the Extremes? Latin American Exchange Rate Policies During the Asian Crisis", in Ricardo Ffrench-Davis and Stephany Griffith-Jones (eds.), *From Capital Surges to Drought: Seeking Stability for Emerging Markets*, London, Palgrave/WIDER.

Hirschman, Albert O. (1958), *The Strategy of Economic Development,* New Haven, CT, Yale University Press.

Kaldor, Nicholas (1978), *Further Essays on Economic Theory*, Londres, Duckworth.

Katz, Jorge (2001), *Structural Reforms, Productivity and Technological Change in Latin America*, Libros de la CEPAL, No. 64, Santiago.

Krugman, Paul and Lance Taylor (1978), "Contractionary Effects of Devaluations", *Journal of International Economics*, No. 8.

Kuczynski, Pedro-Pablo and John Williamson (2003) (eds.), *After the Washington Consensus: Restarting Growth and Reform in Latin America*, Washington, Institute for International Economics.

Latinobarómetro (2003), *Informe-Resumen: La democracia y la economía, Latinobarómetro 2003,* www.latinobarometro.org, octubre.

Mkandawire, Thandika (2001), "Social policy in a development context", *Social Policy and Development Paper* no. 7, United Nations Research Institute for Social Development.

Ocampo, José Antonio (2005), "Structural dynamics and economic growth in developing countries", in J. A. Ocampo (ed.), *Beyond Reforms: Structural Dynamics and Macroeconomic Vulnerability*.

_____ (2004), "Latin America's Growth and Equity Frustrations during Structural Reforms", *Journal of Economic Perspectives*, Spring

_____ (2003), "Capital account and counter-cyclical prudential regulations in developing countries", in Ricardo Ffrench-Davis and Stephany Griffith-Jones (eds.), *From Capital Surges to Drought: Seeking Stability for Emerging Markets*, London Palgrave/WIDER.

_____ (2002a), "Rethinking the Development Agenda", *Cambridge Journal of Economics*, Vol. 26, No. 3, May.

_____ (2002b), "Developing Countries' Anti-Cyclical Policies in a Globalized World", in Amitava Dutt and Jaime Ros (eds.) *Development Economics and Structuralist Macroeconomics: Essays in Honour of Lance Taylor*, Aldershot, UK, Edward Elgar.

Rodrik, Dani (2003), "Growth Strategies", Harvard University, John F. Kennedy School of Government, processed, June.

_____ (2001), "Development Strategies for the 21st Century", in Boris Pleskovic and Nicholas Stern (eds.), *Annual World Bank Conference on Development Economics 2000*, The World Bank, Washington, D.C., July.

_____ (1999), *Making Openess Work: The New Global Economy and the Developing Countries*, Washington, D.C., Overseas Development Council.

_____ Andrés Velasco (2000), "Short-Term Capital Flows", *Annual World Bank Conference on Development Economics 1999*, Washington, D.C., The World Bank.

Ros, Jaime (2000), *Development Theory and The Economics of Growth*, Ann Arbor, The University of Michigan Press, septiembre.

Schumpeter, Joseph (1962), *Capitalism, Socialism and Democracy*, third edition, New York, Harper Torchbooks.

_____ (1961), *The Theory of Economic Development*, Oxford, Oxford University Press.

Stiglitz, Joseph A. (2003), "Whither Reform? Toward a New Agenda for Latin America", *CEPAL Review*, No. 80, Santiago.

Williamson, John (2000), *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option*, Washington, D.C., Institute for International Economics, Policy Analyses in International Economics, 60, September

_____ (1990) "What Washington Means by Policy Reform", in J. Williamson (ed.), *Latin American Adjustment. How Much Has Happened?*, Washington, D.C., Institute for International Economics.

World Bank (2003), *Inequality in Latin America and the Caribbean: Breaking with History?*, David De Ferranti, Guillermo E. Perry, Francisco H. G. Ferreira and Michael Walton (eds.),Washington, D.C., Advanced Conference Edition.