
The Washington Consensus a Decade Later: Ideology and the Art and Science of Policy Advice

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In 1990 Williamson coined the term “Washington Consensus” to describe “the lowest common denominator of policy advice being addressed by the Washington institutions to Latin American countries as of 1989.” He now protests in an article in this volume that the phrase has “become a synonym for ‘neoliberalism’ or what George Soros (1998) has called ‘market fundamentalism’” This development should have caused no surprise, given the visceral hatred in many parts of the world for free markets. Because they view the U.S. government and its “lackeys”—the World Bank, the International Monetary Fund, and to a lesser extent, the Inter-American Development Bank—as the chief advocates of free markets, these opponents of free markets would have attacked anything called the “Washington Consensus.” Had he instead called it the “Williamson synthesis,” perhaps the package would have been a less inviting target for attack, although one cannot be sure: given the author’s association with the hated Washington institutions, he could not have credibly absolved them from responsibility for the synthesis.

More than a decade has passed since Williamson proffered the consensus package. It is tempting (following the advice of the late Senator George Aiken of Vermont, who suggested that the United States simply declare victory and withdraw from the then-raging Vietnam War) to announce that the policy prescriptions contained in the consensus package have been successful and are no longer contentious! Even though there is considerable evidence of the success of many elements of the package where appropriately implemented, unfortunately the top echelon of at least one of the institutions celebrated in the consensus—the World Bank—seems to be misinformed and confused about the contents of the policy package. Others doubt the appropriateness of some of the recommended policies and argue that other elements of the package never commanded a consensus. It is useful, therefore, to reexamine

the package for its contemporary relevance, taking into account the experience of the 1990s.

At the outset, let me say that I regard the policy package less as a consensus and more as a reflection of the author's synthesis of lessons from four decades of development experience. Indeed, Williamson's phrase "common denominator of policy advice" can mean only one thing: that the advice is based on policy implications that emerged not only from a number of studies of certain Latin American countries but also, more generally, from experience in many developing countries. In this sense, trade liberalization as a sensible policy was supported by studies published in the 1970s by the Organisation for Economic Co-operation and Development (Little, Scitovsky, and Scott 1970), the National Bureau of Economic Research (Bhagwati 1978; Krueger 1978), and the World Bank (Balassa 1970). (A later World Bank study, Papageorgiou, Michaely, and Choksi 1991, lent similar support.) But only the utterly naive would interpret this advice as unqualified in the sense of being appropriate regardless of the specific circumstances of an economy or the time horizon involved. Yet the studies covered many countries with varying socio-political-economic institutions and many different time periods, and almost all of them still found possible benefits from trade liberalization—a fact that testifies to the robustness of the policy advice. Be that as it may, it is common knowledge among economists that the response to any policy change, such as trade liberalization, that operates through price incentives depends both on nonprice factors and on the time horizon. For example, if domestic supply constraints (other than price received) are severe in the short and medium run, removing all price distortions would have only a limited favorable response. And, to the extent that tax revenues are largely derived from trade taxes, the government may be constrained as to how far it can liberalize trade by reducing trade taxes without compromising fiscal discipline. This constraint may not be binding, however, if the actual applied tariffs exceed revenue-maximizing levels, as is often claimed. In any case, one can enumerate many nuances and caveats to each of the recommended policies in the package. But only an ideologue or the utterly ignorant would conclude that because caveats apply, any attempt to change the status quo through the implementation of the recommended policies is undesirable.

Similarly, the advice to liberalize interest rates was a common conclusion from several studies of financial repression in developing countries. Williamson now concedes that it could be costly to liberalize interest rates before other elements of financial liberalization, such as prudential supervision of banks by capable and knowledgeable central bank authorities, are in place. Although this point is obviously valid, the scope of its applicability is arguable. For example, in many developing countries, most banks are publicly owned, and whether they would or could gamble for redemption if deposit interest rates were to be liberalized is open to question. At any

rate, as in the case of trade liberalization, the case for interest rate liberalization is likely to remain intact for many developing countries.

The advice on fiscal discipline was also based on the experience of many developing countries, particularly Latin American countries, that had previously undergone episodes of hyperinflation and stop-and-go sequences of stagnation and growth. India's experience in the 1980s, when it abandoned fiscal discipline to run deficits financed by costly borrowing at home and abroad, is instructive. The spurt in growth following the reckless fiscal expansionism proved unsustainable and ended inevitably in a macroeconomic-cum-balance of payments crisis in 1991. The fact that India did not experience Latin-style inflation before or after the abandonment of fiscal discipline is beside the point: because most of India's poor workers, particularly those in agriculture and informal service sectors, are not protected against inflation, even moderate inflation by Latin standards has serious consequences for the welfare of the poor in India.

The advice to redirect public expenditure toward health care, primary education, and infrastructure has long been part of conventional wisdom. A point that is not part of the conventional wisdom (and one that leading advocates of redirection such as Amartya Sen and his acolytes do not emphasize) is that failure to liberalize trade, to privatize inefficient public enterprises of dubious social value (such as airlines, hotels, and steel mills), and to reform the tax system eats away public resources that could otherwise be directed to the social sectors. Thus trade liberalization, privatization, and tax reform, which constitute three of the ten policies in the consensus package, are important not only in and of themselves but also because they make more resources available for social sectors.

The package called for "a competitive exchange rate," an unfortunate choice of words. An exchange rate is the price of one currency in terms of another currency or a basket of currencies. The word "competitive" used in the context of an exchange rate evokes painful memories of competitive devaluations by many countries in the interwar era. Under the classic Bretton Woods system of fixed exchange rates, one could interpret an "uncompetitive" exchange rate to mean one that is overvalued relative to its long-run equilibrium value. The operational significance of the interpretation is vastly diminished, however, by the fact that the long-run equilibrium rate is hard to define, that it was not defined in the Articles of Agreement of the International Monetary Fund, and that it is not simple to compute from available data in any case. Perhaps by a competitive exchange rate Williamson meant an undervalued exchange rate and that in fact Japan and the East Asian economies following Japan maintained competitive exchange rates in this sense.

Edwards and Savastano (1999) recently surveyed the empirical studies on exchange rate regimes in developing countries. They identified two camps: one group ascribes a key role to the exchange rate as a nominal anchor; the other stresses the perils of

relying on an asset price and therefore sees the exchange rate as a nominal anchor in a world of integrated global capital markets. In their view

... the differences between the two broad camps identified lie in their differing views regarding three key features of exchange rate policy in a context of high capital mobility: (1) the scope for (and effectiveness of) sterilized and unsterilized intervention as a means for attaining (and preserving) a degree of nominal exchange rate stability; (2) the costs that “excessive” fluctuations of the nominal exchange rate may impose on the economy’s performance; and (3) the *time dimension* of their analysis—i.e., the horizon over which monetary policy, the exchange rate, capital flows and the rest of the economy are assumed to interplay. All of these are empirical issues for which little, if anything, is known for the case of developing countries—not even for the relatively advanced ones. (Edwards and Savastano 1999:22)

Since the Asian financial crisis, a consensus seems to be emerging that the only two viable exchange rate regimes are either a system of rigidly fixed exchange rates implemented through a currency board arrangement or its opposite, a regime of freely floating exchange rates. Williamson, however, now prefers an intermediate regime between the two with limited flexibility. He does not explain why and how the limited flexibility of the regime could be credibly signaled to distinguish it, on the one hand, from the old-fashioned and now discredited crawling peg and, on the other hand, from a regime of transition to a free float. The advice to keep the exchange rate “competitive” has no operational content even if a competitive exchange rate could be defined in conceptual terms. Of course, allowing the rate to float freely obviates this problem.

The recommendation to liberalize flows of foreign direct investment grew in part out of the need to have capital inflows that did not create debt and in part from the desire for other benefits such as technology transfers, which were believed to be associated with such investments. Such investment flows are not likely to be as volatile as short-term capital flows because a decision to invest in another country is probably based on the long-term fundamentals of the recipient economy. Even as late as 1989, private capital flows, including foreign direct investment, had not accelerated as much as they did in the 1990s. The financial crises starting with Mexico in December 1994 and ending with the most recent one in Brazil in 1998 have exposed several weaknesses in the domestic financial sectors of developing countries and in the international financial architecture. The crises have, if anything, reinforced the advice to liberalize foreign direct investment flows.

The advice to deregulate, in the sense of abolishing barriers to entry and, equally important, to exit, continues to be pertinent because it is based on age-old and proven virtues of competition. Indeed, benefits from removing price distortions will be limited

if firms not strong enough to compete in an undistorted market are not allowed to exit and if more efficient firms are denied entry.

The obverse side of deregulation is the need to ensure competition to firms that are privatized. For internationally traded goods and services (except possibly in wide-body passenger jet aircraft!), the world market is far larger than the minimum efficient scale of production, so that opening to trade is adequate to generate competition. In nontraded sectors where considerations of scale economies or network externalities preclude the possibility of more than a handful of firms operating on an efficient scale, a regulatory authority needs to be established and an appropriate set of regulations promulgated so that the few private firms operate in a socially desirable manner. Interestingly, technological developments have vastly eroded scale economies in electricity generation, telecommunications, and other nontraded goods and services that were once deemed natural monopolies.

In 1990, when Williamson published his consensus, regulation and privatization in developing countries were scarce, and there was none in Russia and the Eastern European countries, which were still part of the disintegrating Soviet Union. In the decade since then, privatization has taken off, particularly in the transition economies. It is fair to say, however, that the state of knowledge about appropriate mechanisms for privatization and regulatory frameworks (particularly for private financial intermediaries) is still in a state of flux. Nonetheless, the advice to privatize remains relevant, with a cautionary note about the need to ensure sufficient competition for privatized enterprises.

My brief evaluation of the Washington Consensus 10 years after its promulgation strongly suggests that its policy advice remains largely intact. In general, sound policy advice, while undoubtedly based on received theory and empirical evidence, necessarily has to involve judgment. Economic theorizing involves simplification and abstraction of complex reality; econometric analysis of empirical evidence often imposes restrictions on theory such as, for example, specific functional forms for utility and production functions, the nature of heterogeneity among firms and consumers, and distributional assumptions about stochastic terms. Simple and abstract theory (which in its “second-best” version could amount to saying that almost anything is possible!) and its highly restrictive econometric specification cannot deliver policy conclusions that can be directly applied to the situation of any given economy at a particular time. To advise on policy requires sound judgment on the part of the advisor—judgment that goes beyond findings for theoretical and econometric models. Such judgment will incorporate knowledge about history, particularly economic history, and about the specific socio-political-cultural features and institutions of the country involved. For example, cross-country regressions, even if they are not mindless, cannot deliver policy conclusions about the desirability of trade liberalization or capital inflows or about the effect of openness on growth. At best, such regressions are an efficient means for discovering patterns in the data from which capable re-

searchers can draw inferences after bringing to bear their knowledge about the economies involved while firmly eschewing attribution of causality. To say that judgment based on the specifics of the case is needed is not to argue either that there can be no robust policy conclusions of wide applicability or that only discretion, rather than rules, should govern policy choice. What it means is that formal analysis has to be supplemented by informally allowing for factors that by necessity have been excluded from the formal analysis. There is art as well as science in policy advising! An honest policy advisor will clearly indicate where his judgment enters and where theory and econometrics stop. It is not hard to isolate the theoretical and econometric bases and the astute judgment of Williamson in the Washington Consensus.

Note

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