The Political Economy of Reform and Development of the Washington Consensus

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Abstract

The beginning of the 1980s represented for many developing countries a particularly critical period.
To escape economic and financial difficulties, these countries had to engage into economic and political reforms, often under the umbrella of international institutions. Such circumstances offered the chance to collect a wide range of comparable reform experiences and represented thus a big lab for testing existing theories on stability, growth, and development.
Focussing on the reform experiences of the 1980s and 1990s, this paper analyses their underlying economic wisdom and tries, according to their main results, to extrapolate some guidelines for reform. Overall, the analysis points at the need for a tailored approach to reform, which takes into account a country's peculiarities and its specific barriers to growth and development.

Keywords: Economic reform theory, development economics, Washington Consensus

The Political Economy of Reform and Development of the Washington Consensus

Economic reforms and their impact on growth, income distribution, quality of life, and development are controversial matters in economics and politics. From the last quarter of the past century it is hard to find a country, no matter its income level, which has not engaged in some kind of economic reforms. By the end of the 1980s liberalization, market opening and deregulation became urgent issues for many countries and were in general interpreted as keys to increase or maintain competitiveness on the global market. Accordingly, political economists have elaborated a broad spectrum of partly competing theories on which policies and manoeuvres to apply, when, in which sequence, and how.

The experience of the Latin American countries to escape the deep financial crises of the early 1980s, the transformation of the former communist countries, and the strive for modernization of the oil rich countries of the Middle East as a response to the difficult economic conjuncture and fall in the oil prices of the 1980s have represented particularly interesting cases of study. However, because of the complexity and high context-dependency of this matter, a unique theoretical framework for reforms is unlikely to be found. Nevertheless, different streams of thought have dominated the economic and political debate over time. A related matter, which is still somehow unsolved, concerns the measurement of the reforms' result, i.e. defining proper measures and indicators to compare performance pre- and post-reform. Besides, in the realm of reform policy there is often still confusion between means and ends: in particular concerning almost standard reform measures, e.g. privatisation and trade liberalization, it sometimes slips in the backstage whether such measures are aims per se or whether they are not but means towards the ends of rapid and more sustainable growth.

In order to approach the complex topic of the economic policy of reforms, the analysis begins by focussing on the political dynamics that might strive toward or against economic, social, and political changes and focuses hereby on the role of crises for fostering reforms as well as on the different time strategies (gradualism versus big bang) that can be considered by reformers. Then, the dominant economic wisdom underlying the reform experiences of the past decades will be reviewed and the paradigm of the Washington Consensus will be analysed with respect to its basic economic rationale. Main results from the reform experiences of different groups of countries will be shortly addressed, according to which main critique points and alternative approaches to reforms will be discussed. Overall, the analysis aims at rethinking possibilities and challenges of reforms in developing countries and points at the importance of understanding the specific impasses and needs of these countries in order to define a broader goal of change and development.

1 The Politics of Economic Policy Reform

The economic debate typically focuses on how, what, and when to reform, without arguing who is going to reform. The approach of public choice might help in dealing with such a thematic. The basic underlying idea is that politics is a competitive business (Downs, 1957, and Maythew, 1974) among individual wealth maximizers (Geddes, 1994). According to Geddes, policy-makers face the "politician's dilemma" between the short-run individual goals of political survival and re-election and the long-run collective goals of economic performance, stability, and regime survival. An immediate corollary of such a dilemma is the lack of incentives to promote the change from patronage to a merit-based system. In other words, the appointment policy of self-interested politicians will serve individual short-term benefits, i.e. re-election and political survival, rather than pursuing the long-run societal wealth which could be more likely promoted by nominating competent and qualified civil servants.

1.1 Motives and Sustainability of Reforms

Reforms may have short term adjustment costs and may yield long run benefits if they are able to raise national income and to improve living standards and wealth. From the point of view of a self-interested politician, reforms are politically costly, as they reallocate wealth among different groups of the population. However, if the citizens realize the improvements achieved by reforms, this will automatically enhance the politician's image and thus improve her re-election chances.

Political sustainability and the success of reforms decisively depend on consensus building as well as on their credibility. Building consensus on packages of reforms might be difficult to achieve even because the voters are typically status quo biased. The status quo bias (Samuelson / Zeckhauser, 1988 and Kahneman / Knetsch / Thaler, 1991) which can be defined as the frequent tendency to opt for already chosen alternatives and might result into innovation aversion (Porter / McIntyre, 1984), has been proven to be a quite robust behavioral effect. It applies to many situations of decisions under uncertainty and has been also discussed in the context of political preferences (Fernandez / Rodrik, 1991).

The aspect of credibility is particularly important (Olofsgard, 2003) as the citizens' beliefs and confidence in the reforms' implementation have a decisive impact on their sustainability and outcome. If there is uncertainty about the implementation of the announced reforms, even potential winners from reforms might be reluctant to support them, as without a credible political will reforms might get stuck in a partial state from which others might win (Hellman, 1998). Obviously, credibility also relates to the politicians' trustworthiness.

The credibility of reforms can be enlarged when specialized agencies, financial and economic institutions are put in charge of their implementation. Such authorities are independent or, at least, enjoy some margins of autonomy from the government, they are less sensitive to political pressures and are therefore freer to opt for slightly unpopular options and are more consequent in implementing the planned reforms (Haggard, 2000). However, at least from a theoretical

point of view, the strategy to delegate power and functions to technocrats is a self-limitation of power and presents as such some paradox aspects: why should a politician limit her competences and delegate part of her power to specialized authorities? From the politicians' point of view, the establishment of financial and economic institutions can be interpreted as a binding commitment (Bates, 1994) which enlarges the credibility of reforms and also as a way to relieve politicians of the responsibility of unpopular reforms.

Because of the potential political costs of reforms, rational self-interested politicians tend to avoid undertaking deep changes, as long as the electorate does not perceive them to be necessary. It is difficult to predict and understand within an analytical framework in which cases policy-makers do have incentives to reform and which depth the undertaken reforms will assume. Again, the basic argument is that in democratic societies politicians might be praised by successful reforms, e.g. by reforms yielding remarkable improvements in wealth and living standards of the majority of the population. Since it is not always straightforward that even well designed reforms succeed in making the majority of the population better off in a politically relevant time horizon (i.e. the short run), the approach of rational partisan theory seems to provide a suitable explanatory framework for reforms in cases in which the population is divided into different groups of interests (Hibbs, 1977, Alesina, 1987, and Kiewiet / McCubbins, 1991).

Assuming the segmentation of the constituency this approach models changes in the political course (to which also reforms and the creation of financial and economic institutions for their implementation belong) as a way to serve particular interests. This perspective encompasses the possibility of rent-seeking which potentially leads a society into the so-called "public choice trap." This occurs *"because neither egoistic political operatives nor recipients of government largesse can expect to benefit from efforts to bring about changes in the institutional framework that are necessary to restrict rent seeking"* (Scrimgeour / Pasour, 1996, p. 259) and hinders therefore the reform process and in particular institutional reform.

In societies that are governed by more authoritarian regimes, rulers usually do not have to directly answer for their political choices in front of the whole citizenship, but mainly have to care on the opinion of certain interest groups and elites that are strategic for the regime's survival. Since the income distribution is typically favourable to those groups, they tend to be strongly biased toward the status quo and averse to reforms and changes that might threaten their privileges. The aversion of such groups to reforms might be particularly critical to the regimes and even threaten its survival. However, blockades to reform might be broken when the lobbies' segmentation changes, either because of new emerging groups, international pressure, or different economic conditions. In similar cases, a modified rational partisan theory might apply and rationally explain the rulers' decision to undertake economic reform.

1.2 Do Crises Cause Reforms?

Both for democratic and more authoritarian societies, resistance to reform by powerful interest groups can be more easily overwhelmed in times of crises, where changes in the system are perceived to be unavoidable (see e.g. Ranis / Mahmoods, 1992). Even though there have been

also cases in which reforms were not an immediate response to severe political and economic crises (as the case of the quite comprehensive, even though not really successful, supply-side reforms New Zealand undertook between 1984 and 1996. For more, see e.g. Dalziel, 2002), most of the countries undertook deep reforms during periods of instability and difficulties.

It is vividly debated in the literature (Ranis / Mahmoods, 1992; Bresser / Luiz / Maravall, 1993; Rodrik, 1996), whether a crisis is *"the instigator of reform"* (Rodrik, 1996, p. 26) and whether substantial reforms are possible without criss. Among the arguments supporting the so called "crisis hypothesis," which postulates a causal link between crises and reforms, are that crises make reforms become urgent and *"create the political imperative for better economic performance."* (Krueger, 1993, p. 109). In particular, since economic crises have costs that are higher than the economic and political adjustment costs of reforms (Bresser et al., 1993), they lower the "net" costs associated with changing policy,[i] and therefore provide sufficient incentives for changing the political course and reallocate economic resources. Observing history, it seems to be true not only that reforms follow crises - which is *"is no more surprising than smoke following fire"* (Rodrik, 1996, p. 27) -, but also that the depth of the changes is related to the severity of the economic and political conditions faced by a country. There is mixed empirical evidence in this regard, as the relation between the severity of a crisis and the depth of reforms is too complex to be interpreted according to a linear pattern and is also sensitive to the indicators revealing the crisis.[ii]

1.3 Gradualism Versus Big Bang

By undertaking reforms, their speed and pacing represent another critical political issue which might affect costs, efficacy, consensus building, and social impact of the whole reform process. Policy-makers have to choose between a big bang and a more gradualist approach to reform. They can namely either introduce whole packages of reforms rapidly in a concentrated time interval or implement them gradually, spreading them over a longer period of time (Wei, 1997). To be more precise, a gradual approach should be differentiated from a piecemeal approach. Rather than consisting in implementing reforms one after the other without considering possible interdependencies between them (Murphy / Shleifer / Vishny, 1992), gradualism implies the "sequential implementation of minimum bangs" (Wei, 1997, p. 1236) that are minimal bundles of interdependent reforms.

There is no consensus on which approach is more promising and also observing past reform experiences contrasting empirical results does not allow to definitely corroborate the one or the other strategy. While on the one hand reforms that are implemented as shock therapy might yield for faster benefits (World Bank, 1991) and enable to achieve coordination between single measures more easily (Murphy et al., 1992), on the other hand a big bang strategy might imply the risk of failure of the whole reform process just because of problems in certain domains (Rodrik, 1989). A further possible pitfall is that targets and instruments of different reform measures might be conflicting (McKinnon, 1973), so that the simultaneous introduction of reforms might even be counterproductive. Supporters of the gradualist approach, on the

contrary, underline that only gradualism allows adjusting the course of reforms by trials and errors (World Bank, 1991) and weighs less on the state budget (Nielsen, 1993).

Opinions are diverging with regard to which of these strategies minimize the adjustment costs of reforms: while some sustain that introducing reforms more rapidly lowers the costs associated with transition and allows therefore speeding up the resource reallocation (Mussa, 1984), others argue that diluting reforms over time enables to spread out their costs, make consensus easier to build (Gavin, 1996), and weaken resistance (Corbo / Fisher, 1991).

According to Wei (1997), "a 'good' reform program may not be able to overcome political resistance if it is implemented by a big bang, but it may become politically viable if it is implemented by a gradualist approach." (Wei, 1997, p. 1237). The counterargument is however that in case of a shock therapy, potential opponents to reforms might have no time to organize themselves to resist and oppose reforms with efficacy (Krueger, 1992). Furthermore, resistance might be higher in case of prolonged reforms. (Lal, 1987).

Contrasting arguments are represented also concerning the aspect of credibility of the reform process. While it might be argued that the speed of reforms fosters credibility (e.g. Lipton / Sachs, 1990), it is also plausible to sustain that a gradual implementation might enhance incremental credibility (Fang, 1992).

Considering that reforms imply choices under uncertainty, allow for flexibility with respect to time, and are at least partially irreversible, reforms have been also modelled in a real options setting.iii In this perspective, gradualism has an option value, offers higher flexibility, as well as larger possibilities of reversal. Also relying on this line of interpretation, policy recommendations are in competition and depend on the country's specific assumptions about costs and benefits of reforms as well as about their probability distributions (Katz / Owen, 1999).

Numerous alternative analytical models similarly conclude that under different conditions opposite prescriptions might apply. Modelling differences in the initial government's commitment, Fang (1996) shows the superiority of a gradualist strategy by low initial commitment to reform and that of a big bang by strong political commitment. Wei (1997) further argues and analytically models that if both strategies are politically feasible "i.e. either in the absence of a status quo bias in a democratic setting or in a benevolent-dictator setting" (Wei 1997, p. 1245) a shock therapy would have the advantage of sooner benefits and be therewith more efficient.

Thus, the issue of optimal pacing of reforms is a complicated and highly situation specific matter, as "in presence of multiple distortions […] policy is working in a world of second (or higher) best." (Corbo / Fisher, 1991, p. 7) Decisions on the optimal path and speed of the reform process are crucial in imprinting their results as there is the danger that "an inappropriate sequence may render the adjustment process more difficult or even contribute to the collapse of the whole reform program." (Funk, 1993, p. 337).

2 Towards the Definition of a Reform Agenda

As clearly emerges from its definition[iv] speaking about "reform" requires to codify what is meant to be an improvement and by whom. Whenever it comes to significant changes to the political economy of a country, it is hard to avoid vested interests trying to manipulate such changes and the reform process. The informational advance, which ruling elites and influential groups of power possess, might lead to the self-selection of reforms and to misguiding reforms to serve particular interests (on the self-selection of reforms, see Stiglitz, 2000, p. 551).

The prevailing economic orthodoxy which affirmed in the late 1970s gave priority to economic growth rather than to income distribution and social goals, and considered the social costs of reforms as short term inevitable side effects (Emmerij, 2007, p. 38). This way of thinking was surely inspired to the experience of the East Asian tigers and to the failure of protectionist policies in propelling industrialisation and sustainable growth (Rodrik 1996, p. 13). This "new" orthodoxy, based on condemning import substitution and massive state intervention not only "became the economic strategy of the West but, through its adoption by the World Bank and the IMF it became the conventional wisdom of practically the entire globe, whether voluntary or not." (Emmerij, 2007, p. 38)

Thus, a consensus emerged about what measures should be undertaken by a country willing to solve economic and financial shortcomings as well as to create the basis for more sustainable growth. Basic categories of reform packages were macroeconomic stabilisation and structural adjustment, which respectively depict measures and programs seeking to stabilize the fundamentals of an economy and promote its structural transformation by addressing the long term fundamental causes of a country's poor economic performance. In the short term, stabilization programs essentially focus on reducing fiscal deficit and restoring internal and external equilibrium by means of promoting a real devaluation and controlling inflation. Fiscal adjustment is a central issue, as it also creates the basis for long term reduction of inflation.

The key of structural adjustment lays in creating proper incentives to economic competition and rent-seeking avoidance. This requires the development of specific strategies for each country, which encompass their peculiarities. Considering the experiences of the 1980s, this translated into "deregulating domestic goods markets, reforming the public sector, liberalizing the trade regime, removing constraints on factor employment and mobility, and removing obstacles to saving and investments, and (on) strengthening institutional elements." (Corbo / Fischer, 1991, p. 2). Reform attempts originated a "movement away from state control to a market oriented economy" (Stiglitz, 2000, p. 551) and were inspired to the aims of "stabilization, liberalization, and opening up." (Emmerij, 2007), p. 38).

After macroeconomic stabilization and structural adjustment, which constituted the building blocks of first generation reforms, many less developed countries engaged into a second generation of reforms, addressing institutional design and trying to improve living standards. While first generation reforms "were intended to get macroeconomic fundamentals in place" (Corbo, 2000, p. 63), successive reforms extended to the public sector, to the judicial system, to

social security, education, and health, that were explicitly encouraged and supported by the international community and institutions, as they pursued the aims of promoting growth, improving equity and social mobility.

While first generation reforms were the response to the repercussions of the economic crises of the early 1980s, the reasons for many countries to undergo further transformation are more complex: on one hand, economic performance and growth were not up to the expectations and for the less developed countries were not sufficient to significantly improve the quality of life for the majority of society; on the other hand, insufficient institutional capabilities have been recognised to be a decisive factor undermining development and stability for many countries. As in World Bank (1997), institutional weaknesses can be considered to be essential responsible of low growth rates.

In many developing and middle income countries, this second wave of reforms can also be related to the ascension to power of young groups of technocrats with Western education and orientation (Corbo, 2000, p. 63). Second generation reforms are still an ongoing process for many countries and guidelines are to be collected from specific experiences. Unique prescriptions on how to achieve the ultimate objectives reforms aim at are still missing, even because there is no clarity about the dynamics underlying failures and underperformances.

2.1 In Search for a Reform Agenda

The global debt crisis of 1982 and the collapse of many Latin American countries represented a lab for testing existing theories on how to achieve stability, growth and promote development. The reform policies the Latin American countries undertook during the 1980s were moved by the urgent need to drag the crisis and were run under the supervision of international institutions, first of all the World Bank and the IMF.

Typical stabilization programs to escape the debt crisis comprehended fiscal consolidation, monetary contraction, exchange rate adjustment, and gave priority to inflation reduction, which had reached double-digits (see IMF World Economic Outlook Database, 2012) in almost the entire region and in Brazil, Argentina, Bolivia, and Peru had even risen to four-digit levels.

Restoring macroeconomic balance through the drastic reduction of inflation and current account deficits were motivated by considering macroeconomic stability an essential precondition for sustainable growth.

Due to the short-term trade-off between inflation and output, monetary policy yielding a predictable and low inflation creates a favourable climate for long-term economic growth (see Fischer, 1996). Awareness also grew that the benefits associated with the Phillips curve mainly refer to the short run. Further reasons to pursue price stability were that high rates of inflation have evident high political and economic costs (Corbo, 2000, p. 68) and especially penalize the poorest. Bulir / Gulde (1995) provide an interesting discussion of the link between inflation and income distribution.

Besides stabilization, reform packages aimed at improving resource allocation by pursuing reform in the domains of trade, privatization, public sector, labour, and financial system.

The leading principle was to let the markets work, crushing thus with the idea that had circulated up to that time that *"the developing countries came from a different universe which enabled them to benefit of (a) inflation (so as to reap the inflation tax and boost investment); (b) a leading role for the state in initiating industrialization; and (c) import substitution."* (Williamson, 2002).

The Bretton Woods institutions assumed a pivotal position in directing reform efforts and in providing financial support to developing countries. To encompass the *"desirable set of economic policy reforms"* (Williamson, 1990) which sifted from the prescriptions of the technocratic circles of the international financial institutions, of the US government and of the Federal Reserve Board, Williamson (1990) introduced the concept of "Washington consensus."

2.2 The Washington Consensus

The so called "Washington Consensus" comprehends the ten policy instruments that were at the time typically prescribed or advised for those countries of Latin America striving towards the *"standard economic objectives of growth, low inflation, a viable balance of payments, and an equitable income distribution."* (Williamson, 1990). Thus, *"many economists […] would see the Washington Consensus as a pragmatic distillation derived from some four decades of post-war experience in a host of developing countries."* (Harberger, 2000, p. 549).

A premise on the misuse of this concept may be due: in its original formulation by Williamson, "Washington Consensus" was intended to describe *"10 policy instruments about whose proper deployment Washington can muster a reasonable degree of consensus"* (Williamson, 1994) or *"a list of ten policies that I [Williamson] thought more or less everyone in Washington would agree were needed more or less everywhere in Latin America."* (Williamson, 2004, p. 1). Nevertheless, the consensus has been often interpreted as a normative benchmark to which reform attempts should refer. In this interpretation, the consensus has become the target of many critiques: in Williamson's own words *"the term is often being used in a sense significantly different to which I had intended, as a synonym to what is often called 'neoliberalism' in Latin America, or what George Soros (1998) has called 'market fundamentalism.'"* (Williamson, 1999), p. 1).

The concept of Washington Consensus gained great popularity. Among the reasons that played a role there was the ideological vacuum which was left after the collapse of Socialism. The downfall of central planning *"created an urgent need for an alternative set of ideas about how to organize economic and political life."* (Naim, 1999). The consensus conveyed prescriptions which were based on rather basic macroeconomic principles and which constituted a defined plan for action. It was advocated by prestigious institutions and endorsed by reputed experts, and, most of all, it was the key to get financial support from the international institutions and community. In its World Development Report for 2002 the World Bank recognises that most of

its programmes from the 1970s to the 1990s were actually inspired by the content of the Washington Consensus (World Bank, 2001, p. 62).

The ten policy instruments Williamson encompassed under the "Washington Consensus" will be listed as follows. If not differently specified, the analysis refers to Williamson (1989), (1990), (2003) and (2004).

Fiscal Discipline

It should be noted that opinions diverge whether fiscal discipline means a balanced budget or if it offers some margins for tolerance. In a period of crisis a too drastic reduction could run the economy into a recession, so that some analysts are prone to tolerate deficit as long as its share of GNP does not rise, while some others simply focus on a non increasing debt to GNP ratio. However, even though plausible of different interpretations, fiscal discipline remains an essential point of a reform agenda, as sound public finance also prevents inflation and capital flight. As a general prescription, by considering whether to run a fiscal deficit, policy-makers should carefully weigh the associated long-term costs and compare them with the expected positive effects of the enlarged spending programs and / or tax reductions.

Reorientation of Public Expenditures

Fiscal deficit can be reduced either by increasing tax revenues or by lowering expenses. By the end of the 1980s international institutions feared that the first way would further hamper economic growth and therefore almost consensually favoured the second way. This however *"did not call for all the burden of achieving fiscal discipline to be placed on expenditure cuts"* (Williamson, 2004, p. 3) but rather posited the question to discriminate between more and less important components of public expenses programs. In the technocratic circles opinions seemed to converge that while education, health and public investments should be encouraged, subsidies are a typical voice that has to be cut.

The possibility of saving by military expenditures is typically considered quite a delicate issue involving the state's sovereignty, so that there was the tendency to consider them out of the competences of economic policy advising. Military expenditures remain however a controversial and debated issue.

By the reorientation of public expenditures, cutting subsidies was a central prescription of the Bretton Woods institutions and became in many cases a condition for loan disbursal. Subsidies bias the price mechanism and create inefficiencies. Whether price distortions should always be blamed is a controversial matter and opposite views can be theoretically corroborated adopting respective a first- or a second-best approach. Cutting subsidies on basic goods and commodities has often encountered strong resistance from the poorest groups of the society, as the Karak's riot of 1989 in Jordan clearly showed.

Tax Reform

Even though the typical prescriptions on how to achieve fiscal balance centred on controlling expenses, the reform of the tax system has also been a pillar of Washington's advising. Hereby, the rationale of tax reform consisted in broadening the fiscal base and introducing moderate marginal tax rates which was among others the principle by which the 1986 US reform of the income tax was inspired.

Interest Rate Liberalization (Financial Liberalization)

With respect to the financial markets, the basic objectives were to increase transparency and discourage capital flight, two aspects that needed to be solved for Latin America but also apply for many other developing countries. Market-determined interest rates represent a way to tackle these aims, as they reduce the range of arbitrariness by mean of which credits are rationed and under which conditions. Furthermore, capital flight can be discouraged through positive interest rates, which tend at the same time also to stimulate savings.

Competitiveness of the Exchange Rate

Besides liberalizing interest rates, a "competitive" exchange rate was considered to be meaningful in order to achieve stability and enhance economic growth. The basic advice for a developing country was to bring the exchange rate at a level that does not discourage exports, but at the same time that does not excessively amplify the debt's burden. An appropriate exchange rate should improve the competitiveness of domestic production in international markets, favouring exports and creating suitable conditions to attract foreign investments. In Williamson's words, an appropriate exchange rate should be *"consistent in the medium run with macroeconomic objectives"* (Williamson, 1990) and reflect the concept of fundamental equilibrium exchange rate.

Trade Liberalization

A fundamental lesson by which the reform policies of the late 1980s were inspired was the failure of import substituting policies, so that trade liberalization was a sine qua non of reform packages. The switch to an outward oriented economy, which had to be pursued by a competitive exchange rate and by the removal of barriers to trade, aimed at capturing the growth benefit of integration in the international market. The positive correlation between economic growth and openness has been corroborated both by theoretical contributions and empirical evidence (Dollar, 1992; Lee, 1993; Sachs / Warner, 1995; Feenstra, 1995; Edwards, 1998; Harrison, 1996; Frankel / Romer, 1999).

Foreign Direct Investments

Foreign direct investments have often been interpreted as a propulsive force of growth and development. In the World Bank Statistical Database under "foreign direct investments" are

meant *"the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor."*

Besides the capital inflow, foreign direct investments contribute to the domestic economy in term of know-how, technical and administrative skills. For heavily indebted countries equity swaps have recently become a widely practiced way to reduce the debt's burden and attract at the same time foreign investments.

Even though the benefits of foreign direct investments are widely recognized, the inflow of foreign capital might be also associated with macroeconomic risks, both in the sense of transmission of international disturbances (Jansen / Stokman, 2004) and in relation to their inflationary risks.

Privatization

State owned enterprises have been a characteristic feature of many developing countries: public ownership represented a possibility to promote industrialization and development compensating for the lack of a strong domestic private sector. In the eye of a reforming government, privatization offers the benefit of helping sanitizing public deficit, both because of the revenues from the enterprise's sale and the reduced cash flow injection and investment in the firm. If for other reform measures it is possible, at least in principle, to discuss potential associated benefits and / or dangers, this is not the case for privatization. Privatization can be namely a beneficial process which helps promoting competition and efficiency, but can also turn into a *"highly corrupt process that transfers assets to a privileged elite for a fraction of their true value."* (Williamson, 2002).

Deregulation

As Balassa et al. (1986) observe for Latin America, numerous regulations were constraining the markets' mechanism, among which *"controls on the establishment of a firm and on new investments, restrictions on inflow of foreign investments and outflow of profit remittances, price control, import barriers, discriminatory credit allocation, high corporate income tax rates combined with discretionary tax reduction mechanism, as well as limits on firing of employees."*

Securing Property Rights

Whenever property rights are not sufficiently safeguarded, incentives to undertake entrepreneurial activities might fail. Therefore, it was widely agreed that governments concerned to promote growth and development should find mechanisms to secure private property rights at reasonable costs, in order to make business venturing profitable and improve the economic potential of a country.

3 Economic Reforms between Dreams and Reality

"Meant well, tried little, failed much" Krueger (2004)

In the 1990s, it was commonly believed among economists that countries reached economic growth due to economic reforms and that, correspondingly, countries that did not reform enough would fail to experience remarkable economic growth. The diversified evidence at the end of the 1990s contradicted this simple equation.

The whole approach to economic reforms which was embodied by the Washington Consensus was definitely questioned by the wave of deep financial crises that shook many countries (e.g. Mexico in 1994, East Asia in 1997, Brazil in 1998, Russia in 1998, Turkey in 2000, and Argentina in 2002) as well as by the fact that whereas most of the countries that followed the Consensus failed to achieve sustainable growth and economic development, some other countries that did not apply the consensus' prescriptions (e.g. China, India, and Vietnam) managed to achieve high economic growth.

As recognized by the IMF in its accurate report of 2005, in spite of promising initial results, the end of the 1990s was characterised by stagnation in the real per capita income and insufficient improvement in the social indicators, e.g. poverty rates and income inequalities. Overall, *"from an institutional and structural perspective, reforms were uneven and remained incomplete."* (Singh et al., 2005, p. xiv).

In Latin America, despite of the apparently positive trend of the first half of the 1990s the second half of the decade was characterized by economic slowdown. The huge capital inflows of the early 1990s, which were mostly due to international borrowing and privatization revenues, did not raise real investments but rather tended to sustain consumption (Stiglitz, 2003, p. 17). They did not reflect into sustained economic growth (cf. Fig. 1) and may have created, because of the volatility of capital flows and associated over-optimism on capital markets, some of the premises for the successive financial crises.

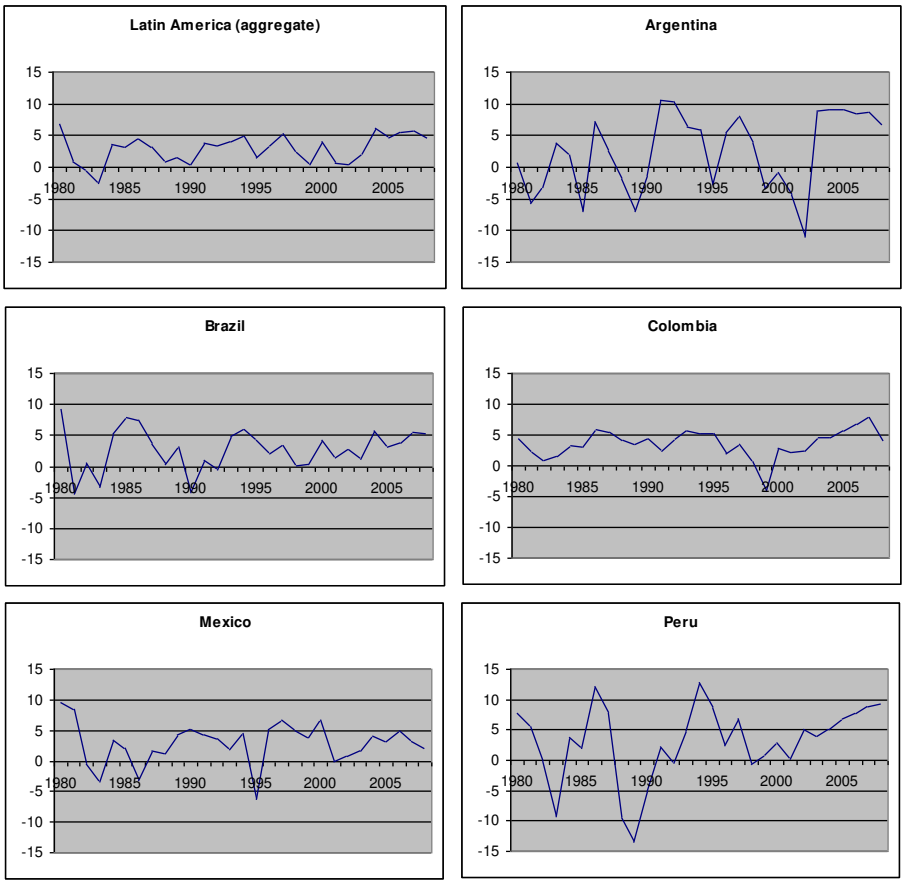

Fig. 1: GDP growth (annual percentage change at constant prices) for selected Latin American countries (Data source: IMF World Economic Outlook Database, October 2008)

Among the countries that did not conventionally apply the Washington Consensus, mixed results can be found: while high economic growth in East Asia ended in the unexpected deep financial crisis of 1997, China's and India's policy choices seem to have set the basis for more sustainable patterns of growth.

Several East Asian countries (namely Hong Kong, Indonesia, Japan, Malaysia, the Republic of Korea, Singapore, Taiwan, and Thailand) managed to achieve high growth rates, which were sustained from 1965 up to the first half of the 1990s, as well as equitable income distribution. Among the reasons for such a success, a mix of *"fundamentally sound development policies, tailored interventions, and an unusually rapid accumulation of physical and human capital"* (World Bank, 1993) can be mentioned.

The governments of these countries were able to calibrate and direct their intervention to foster the development of specific industries, among else by means of subsidizing and protecting domestic industries in strategic sectors and encouraging their export orientation, convert domestic financial savings in real investments, as well as encourage a rapid human capital growth (World Bank, 2003). The East Asian successes can be interpreted as *"miracles of accumulation rather than of productivity"* (Rodrik, 1996, p. 13) and might be ascribed to the joint effect of qualified labour force and exceptionally equitable income distribution (Rodrik, 1996, p. 20).

In this context, a financial crisis of the magnitude and severity like the one which exploded by the end of 1997 was fully unexpected. This was the result of the vulnerability of the financial systems, of corruption, and weak corporate governance (Radelet / Sachs, 1998a, p. 1) which had been underestimated also because the continuing economic growth prolonged the investors' confidence. In this setting, the first signs of the crisis generated panic reactions which further augmented its size (Radelet / Sachs, 1998b).

The take-off of China and India (which account for approximately 40 % of the developing countries' population) together with Vietnam also puzzled the conventional economic wisdom. These countries followed a heterodox gradual approach to reform, which was based on progressively opening up some sectors while maintaining protection on some others, and on fostering integration into the global economy reducing stepwise, but not fully eliminating, state intervention.

In particular, from 1978 China started a gradual but ambitious reform process, which followed a "learning by doing" approach and was inspired by the goals of *"reducing the dominance of the public sector; reducing the commitment to an egalitarian distribution of income; alleviating poverty and increasing material living standards; and maintaining macroeconomic stability and social order."* (Angresano, 2005, p. 484).

China's privatization policy started from the agricultural sector and small- and medium-size state owned enterprises. The privatization of large state owned firms was initiated in the late 1990s and was preceded by restructuring and more efficient managing (Chow, 2005). In essence, the Chinese privatization policy consisted in encouraging the private sector maintaining the scope of the public sector almost constant, also in order to minimize social tensions. Nevertheless, following this gradual strategy the private sector can now be estimated to represent almost 75 % of GDP (Angresano, 2005, p. 485).

Besides, by running fiscal deficits China also violated the dogma of macroeconomic stability. While in 1979, China had no public debt, only 20 years later debt has raised to 20 % of GDP. Fiscal deficit has been in particular due to the running costs of maintaining the large-scaled state owned enterprises. The increasing tax inflow from the grown private sector nevertheless ensures that fiscal deficits do not exceed 3 % of GDP (Angresano, 2005).

Overall, the adopted policy mix not only sustained long-term high levels of economic growth (cf. Fig. 2), but also enabled a significant reduction of poverty and improvement of living standards.[v] In 2001, because of its achievements concerning trade liberalization, China also became member of the World Trade Organization.

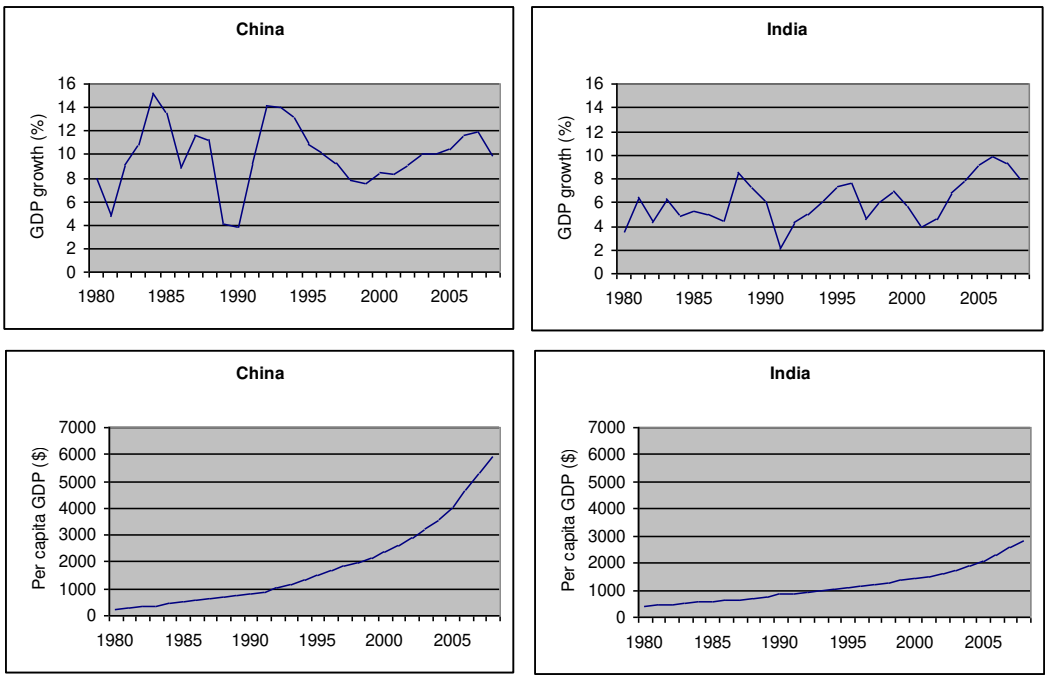

Fig. 2: China's and India's GDP growth rates (percentage at current prices) and per capita GDP (PPP in international $) (Data source: IMF World Economic Outlook Database, October 2008)

4 *Critique and Alternative Approaches to Reform*

In its attempt of prescribing a basic fixed set of policies on *"what a poor country should do to become more prosperous"* (Naim, 1999, p. 1) the Washington Consensus exclusively focused on a relatively narrow palette of macroeconomic variables and expected from their repositioning a trickle down effect in order to promote wealth at all levels of society.

Challenges to its prescriptions soon also came from changes in the international and political environment[vi] which signalised the limitations of the Washington Consensus as a suitable growth strategy because of its relative short term orientation. In this sense, it has probably been expected too much from its prescriptions, forgetting that they were first of all a contingent answer to the urgent need to help developing countries to escape the debt crisis of the 1980s. By the end of the 1990s it became clear that reforms did not bring about what they promised.

The economic performance of countries which followed the prescriptions of the technocratic Washington was to a large extent disappointing (Krugman, 1995): not only the reforms failed to catalyze sustainable growth and foster long run stability, but liberalisation policies neither resolve misallocations, nor effectively combat rent-seeking. Reforms also failed to remarkably enhance living standards, smoothen inequalities, and serve democratization. The sensitivity on these issues grew and a more articulated conception of development in which social objectives such as democracy and human rights play a central role started to affirm. Also the aims of inequality and poverty reduction, which were not explicitly encompassed by the Washington Consensus and by its interpretation of reforms, progressively turned into essential principles of

the debate on growth and development, as commented, e.g., by World Bank's "Poverty Reduction Strategy Papers" of 1999.

The debate on the results of the wave of reforms of the 1980s and 1990s inspired the search for alternatives and improvements to the Washington Consensus. Thus, new sets of policies and new labels trying to correct and / or improve the prescriptions of the consensus and interpret emerging approaches to development were created, such as the "Post Washington Consensus" (Stiglitz, 1998), the "Augmented Washington Consensus" (Rodrik, 2002), the "After the Washington Consensus" (Kucznynski / Williamson, 2003) and the "Barcelona Consensus."[vii] Besides, several attempts have been made to define an agenda for the so-called "second generation reforms" which *"may be seen as the set of measures needed to enable a country to attain, in a sustained way, high-quality growth"* (Camdessus, 1999).

Early critique to the paradigm of the Washington Consensus mainly referred to the social and political costs of reforms which were not considered as serious drawbacks of market oriented policies. Further important critique to this paradigm targeted the tendency of underestimating the economic costs of the reform process believing their size to be negligible and their impact to be confined to the short term.

The original mistakes of the intellectual basis underlying the Washington Consensus were that reform packages were set to be universally applicable and that their formulation relied on a neoclassical conception of the economy, thus characterized by complete markets. Rethinking on the results of reforms, also the World Bank recognizes that *"there is no unique universal set of rules"* (World Bank (2005), p. xiii) and signalizes thus the need to *"to get away from formulae and the search for elusive 'best practices' and rely on deeper economic analysis to identify the binding constraints on growth."* (Idem).

The Washington Consensus erroneously believed that market oriented reforms could have been achieved following a standardized bundle of policy actions. Macroeconomic stabilization, liberalizing and opening up the economy *"have been interpreted narrowly to mean 'minimize fiscal deficits, minimize inflation, minimize tariffs, maximize privatization, maximize liberalization of finance,' with the assumption that the more of these changes the better, at all times and in all places - overlooking the fact that these expedients are just some of the ways in which these principles can be implemented."* (World Bank, 2005).

The Washington Consensus offered a technical solution to the complex problematic of sustainable growth and development and this together with the simplicity of its underlying economic doctrine may have been some of the reasons for its success. It can be however argued, that to its simplicity also the failure to promote the broader goals of development, stable growth, and improvement of living standards might be ascribed.

In particular, *"the 'one-size fits all' policy reform approach to economic growth and the belief in 'best practices' exaggerated the gains from improved resource allocation and their dynamic repercussions, and proved to be both theoretically incomplete and contradicted by the evidence."* (World Bank, 2005, p. 11). The advantages of a more targeted approach to reforms

have in-between become clear. Such a tailored approach *"requires recognizing country specificities, and calls for more economic, institutional, and social analysis and rigor rather than a formulaic approach to policy making"* (World Bank, 2005, p. xiii).

Further critiques which have been posited to the Washington Consensus are both the sufficiency and necessity of many of its dictates, the imbalance between goals and objectives, the misunderstanding of many of the reforms' possible complementarities and interactions, as well as the underestimation of the importance of the political economy of reforms. Reforms were formulated relying on a too stylized and simplistic interpretation of real economies, which conceived them like idealized market economies. The underestimation of the institutional framework and of the need to secure private property and competition in order to manage the transition to a market oriented economy was one of the consequences of such a simplistic belief. The goals of macroeconomic stability, trade liberalization, and privatization became aims in themselves and not just means and steps towards the more ambitious objectives of sustainable equitable growth and development. These goals were somehow reductive but at the same time not easy enough to achieve as intermediate objectives.

The main guideline which can be derived from the critique to the Washington Consensus is that reforming should perceive the centrality of institutions in determining the results from changes. The institutional framework should in particular care to strengthen the social safety net to compensate and protect the disadvantaged for eventual costs associated with the transition as well as to safeguard property rights and regulate bankruptcy and contracting.

The Washington Consensus essentially aimed at eliminating regulatory frames and state intervention in the economy. In doing that, it failed to pay attention to the theory of the second best, according to which in presence of market imperfections the abatement of certain distortions does not necessary yield positive effects for the economy. The theory of second best highlights the importance of calibrating reforms considering markets' imperfection and incompleteness as well as the existing institutional frames and conditions and also points at the centrality of the relations among reforms. Relying on these considerations the importance of designing economic reforms targeting ambitious goals which have to be reached stepwise following a series of reasonable intermediate objectives has been emphasized (Stiglitz, 2000).

The Washington Consensus also did not pay sufficient attention to the delicate issues of sequencing and pacing of reforms. The idea that reforms had to be rapid was spread and there was a clear preference for shock therapy, as gradualism tended to be interpreted as a *"lack of reforming virility."* (Williamson / Zagha, 2002). This way, however, reforms' complementarities cannot be sufficiently exploited. Almost everywhere, reforms which could be fast and easily undertaken were pushed ahead, and those which would have required more time and / or would have affected more sensitive interests have been postponed. For example, the success of privatization also decisively depends on more demanding institutional reforms. All too often, however, even in order to fulfil loans' conditionality, just easier steps of reforms have been accelerated and their embedment in the institutional specific framework and / or synergies with other reforms were left to the backstage.

A related matter is that also the adverse effects of reform should have been encompassed in a second-best perspective: the impact of market failures might be different in developing than in industrialized countries in which welfare and social safety nets, as well as living standards might help coping with reforms' adverse effects and mitigate distributional consequences. The Washington Consensus failed to pay sufficient attention to the impact of reforms on capital asset values, as well as on social and organizational capital. In particular considering the reality of the less developed countries, distributive aspects have been just marginally considered, as it has been mostly concentrated on national income as a measure of the reforms' results. In most of the cases, changes have not been Pareto improvements and the necessary compensation mechanisms to protect the most disadvantaged by the transition have not been created.

This, together with the insufficient attention paid to the sequencing of reforms, also badly affected credibility and sustainability of the reform process. As it emerges from this discussion, pacing the reform process and eventually revising its intermediate objectives according to the economic and political conditions and responses would have helped encompassing and minimizing the adverse effects of transition.

A further aspect which needs to be carefully considered but which has been often neglected by the Washington Consensus is the confidence in the reform process. Confidence in the reforms was among others undermined by inconsistencies between action and advise, by corruption, by the existence of hidden agenda, and by the pressures of strong influence groups which sometimes misguided reforms. More basically however, the non participatory nature of many of the reform experiences seriously compromised their implementation and results. Thus, some of the reforms failures can also be ascribed to the political process by which reforms were administered and promoted. Governments could not convince the people that reforms would have made large groups of the society better off and, in particular in developing countries, the reform agenda did not always capture the population's real problems and needs. Reforms have rather been perceived like dictates from the international community. The prescriptions of the Washington Consensus did not catch the importance of understanding the particular political dynamics of the different countries, looked uncritically at the existence of vested interest supporting part of the reform program, and underestimated the centrality of consensus building for the political sustainability of reforms.

Even though it is correct that reforms should also aim at eliminating economic rents emerging from misallocations, the approach followed by the Washington Consensus mistook rents' elimination and efficiency promotion for a sufficient growth and development strategy and underestimated the dangers of wrong sequencing and timing.

5 Conclusion

Economic and political reforms are still a debated and controversial issue in technocratic, political, and academic circles. Designing effective reforms is not a deterministic task, but involves modelling the economic, political and social system and formulating a certain conception underlying economic and social development.

Even though it is hard to find a country which has not engaged in some kind of economic reforms during the last three decades, there is still uncertainty concerning what a country should do in order to promote economic growth, reach a more equitable income distribution, improve living standards and foster development. What is still to many extents unclear is what are the most suitable measures and whether there is an optimal reform agenda in order to achieve these aims.

In the course of time, such questions have been differently answered, also depending on the respectively dominant economic doctrines. The reforms of the 1980s and 1990s have been decisively inspired by the economic wisdom which affirmed in the late 1970s. This gave top priority to economic growth rather than to social aims, relying on the principle that stable macroeconomic fundaments and high economic growth would mirror into a trickle-down effect and improve therewith the quality of life and living standards for the majority of the population. These principles lead to elaborate the precise reform agenda of the so-called Washington Consensus.

From the analysis of the reforms' main results, it emerges that the Washington Consensus essentially failed to achieve its aims. Its approach was flawed, as it relied on a too stylized interpretation of the economy and narrowly focussed on the economic goal of fostering competition in order to promote growth. It moved from a first-best conception of the economy and underestimated therefore the importance of strengthening the institutional and legal framework. In this sense, the Consensus referred to a macroeconomic paradigm which is not really apt to describe real economies and in particular the reality of developing countries.

Giving top priority to economic issues, the typical agenda of the Washington Consensus neglected social goals and also insufficiently considered the systemic nature of the reform process.

Besides, the Consensus followed a 'one-size fits all' approach to reform and believed in the existence of an universally applicable formula for growth and development. It is now widely recognised that there is no such an equation and that there is no standard way to reform.

This means that each country and the international institutions should think of tailored reform agenda, which take into account each country's peculiarity and address its specific needs. Reforms should further rely on participative mechanisms and include all layers of the civil society in order to increase acceptance and reduce resistance to reform. This implies, in particular for developing and transition countries, the need to promote democratization and not to picture economic reforms as something unrelated to political reforms and social transformation.

Pointing at the failures and recognizing the inadequacies of the Washington Consensus does not mean however that everything was wrong or that what has been done has to be reverted. The reform movement also had merits, first of all that even less developed countries perceived the need to change, and to set up means and coordinate efforts to pursue a specific agenda to foster growth, promote development, and enhance living standards, in order to integrate in the

global economy and correct, rather than reject and oppose, globalization.[viii] Furthermore, it can also be mentioned that reforms yielded important intellectual advances concerning the understanding of growth and development as they represented a sort of “hothouse” for testing the existing wisdom and paradigms.

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Endnotes

[i] According to Drazen and Easterly (2001), p. 133, the net cost of reforming is *"the cost of changing policy relative to remaining with the status quo."*

[ii] Drazen and Easterly (2001), considering the magnitude of the post crisis recovery in term of economic performance as proxy for the depth of reform, provide evidence that whereas hyperinflation and high black market premium induce deep changes, high current account and budget deficit do not.

[iii] One of the first approaches in this regard is the one elaborated by Dewatripont and Roland (1995).

[iv] To "reform" means *"to put into a new and improved form or condition; to restore to a former good state, or bring from bad to good; to change from worse to better […]"* Cf. the entry "reform" of the Webster's Revised Unabridged Dictionary, Stand of 11th Nov. 2009.

[v] While from 1981 China almost halved its poverty headcount ration at 2 $ a day (cf. World Development Indicators Database), in Vietnam *"30 percent of the population has moved out of absolute poverty"* (Cf. World Bank, 2005, p. 39).

[vi] Besides the collapse of the centrally planned economies, Camdessus mentions that *„there has been another major development during the past decade, quieter perhaps, but of tremendous long-term portent: the acceleration of globalization."* Cf. Camdessus (1999).

[vii] The Barcelona Consensus emerged from the joint efforts of Olivier Blanchard, Guillermo Calvo, Daniel Cohen, Stanley Fischer, Jeffrey Frankel, Jordi Galí, Ricardo Hausmann, Paul Krugman, Deepak Nayyar, José Antonio Ocampo, Dani Rodrik, Jeffrey D. Sachs, Joseph E. Stiglitz, Andrés Velasco, Jaime Ventura, and John Williamson gathering for the Barcelona Forum 2004 (http://www.barcelona2004.org/eng/forum2004/portada.htm).

[viii] The underlying idea is that *"globalisation is to be rejected, but that its agenda should be corrected."* Cf. Rodrik (2002), p. 3.