

The Strange History of the Washington Consensus

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Source: *Journal of Post Keynesian Economics*, Vol. 27, No. 2 (Winter, 2004-2005), pp. 195-206

Published by: Taylor & Francis, Ltd.

Stable URL: <http://www.jstor.org/stable/4538920>

Accessed: 15-09-2017 23:37 UTC

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## The strange history of the Washington consensus

*Abstract:* The term “Washington Consensus” was originally used to describe a list of ten reforms that I argued were practically universally agreed in Washington to be desirable in most Latin American countries as of 1989. It acquired alternative meanings over the years, one of which was a summary of the policies toward their client countries of the Washington-based international financial institutions (IFIs), and another of which was what critics imagined the policies of those institutions to be (a list that tends to consist of policies that never did command a consensus, even in Washington). It is argued that in its original sense, the Washington Consensus consists of policies that still amount to a sensible—but incomplete—reform agenda, but that some of the deviations between my original list and what the IFIs have advocated are undesirable. However, even the original list needs to be supplemented in order to provide a policy agenda for Latin America today. The paper sketches the reform agenda recently laid out by a group of Latin American economists and published by the Institute for International Economics, which adds countercyclical macro policies, institutional reforms, and a concern with income distribution to the original emphasis on liberalization.

*Key words:* countercyclical policies, income distribution, institutional reform, policy reform, Washington Consensus.

In 1989, I presented a background paper to a conference that the Institute for International Economics convened in order to explore how extensive were the policy reforms that were then ongoing in Latin America. To try and ensure that the country papers addressed a common set of issues, I listed what seemed to me to be the central areas of policy reform that most people in Washington thought were needed in most Latin American countries at that time. I labeled this the “Washington Consensus,” sub-

The author is a Senior Fellow at the Institute for International Economics, Washington, DC. This paper was prepared for a symposium in the *Journal of Post Keynesian Economics*. Copyright 2004, Institute for International Economics. The author is indebted to Paul Davidson for a number of stimulating comments on a previous draft.

*Journal of Post Keynesian Economics* / Winter 2004–5, Vol. 27, No. 2 195

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0160–3477 / 2005 \$9.50 + 0.00.

lively oblivious to the thought that I might be coining either an oxymoron or a battle cry for ideological disputes for the next couple of decades.

In the present paper, I shall recall what my original agenda consisted of, as well as indicate some of the major changes that were incorporated in competing versions of what is meant by the term. While I have doubts about some of the changes that were introduced in these competing versions, I will argue that my original formulation described a sensible, if incomplete, reform agenda. Debating what else is needed in order to promote equitable development is an important and worthwhile exercise. In contrast, the sort of ideological debate in which the term is customarily bandied around has long outlived any usefulness it may at one time have had.

### **The original consensus**

My paper (1990) asserted that there was a wide measure of agreement in Washington that the following ten policy actions were desirable in just about all the Latin American countries:

1. Budget deficits . . . should be small enough to be financed without recourse to the inflation tax.
2. Public expenditure should be redirected from politically sensitive areas that receive more resources than their economic return can justify . . . toward neglected fields with high economic returns and the potential to improve income distribution, such as primary education and health, and infrastructure.
3. Tax reform . . . so as to broaden the tax base and cut marginal tax rates.
4. Financial liberalization, involving an ultimate objective of market-determined interest rates.
5. A unified exchange rate at a level sufficiently competitive to induce a rapid growth in nontraditional exports.
6. Quantitative trade restrictions to be rapidly replaced by tariffs, which would be progressively reduced until a uniform low rate in the range of 10 to 20 percent was achieved.
7. Abolition of barriers impeding the entry of FDI (foreign direct investment).
8. Privatization of state enterprises.
9. Abolition of regulations that impede the entry of new firms or restrict competition.
10. The provision of secure property rights, especially to the informal sector.

The list emphasized that policy was changing away from what had long been regarded as orthodox in developing countries—inflation tolerance, import substituting industrialization, and a leading role for the state—toward what had long been orthodox in OECD (Organization for Economic Cooperation and Development) countries—macroeconomic discipline, outward orientation, and the market economy. There was certainly a heavy emphasis on liberalization, which reflected the fact that, in 1989, most Latin American countries had large and inefficient state-owned enterprises and much repressive state regulation of private business, rather than some ideological belief in the minimal state that proscribed attempts to improve income distribution. In fact, none of the ten policy actions listed can be expected to systematically worsen income distribution, and one of them—the second—was formulated in a way designed to support an improvement. It is true that this was no more than a modest nod in that direction, which reflects the fact that the terms of reference I had set myself limited the list to items that would be consensual in Washington. And this was, after all, the Washington of George Bush—admittedly the first George Bush, but even he had not made his reputation as an advocate of soaking the rich in order to be able to benefit the poor.

The list focused exclusively on what Latin American countries could do for themselves, not on the world conditions that would give them a reasonable chance of prospering. In that sense, it is an unbalanced list, for—especially in the short run—the prospects of these countries will also be heavily influenced by whether the world economy is growing or depressed, whether international liquidity is provided by U.S. Treasury bills or special drawing rights (SDR), and so on. The reason for the lack of balance is simply division of labor: it is not intended to imply dismissal of the importance of international factors, although, as it happens, I would also argue that, *in the long run*, countries' progress is primarily dependent on their own efforts rather than on the international environment. I have many times, though elsewhere, written about the international system best calculated to promote development, which is a significant—though not dominant—factor.

I said at the time that there was nothing on the agenda with which I did not agree, and I still think that what is there makes sense, although, undoubtedly, I would word a number of the propositions somewhat differently today. For example, the focus on the inflation tax<sup>1</sup> as the cost of

<sup>1</sup> Evidence indicates that this is a highly regressive tax, at least in Latin America.

excessive fiscal expansion might not be what I would choose to emphasize today, but I would still subscribe to a need for fiscal discipline rather than a belief that bigger deficits are normally desirable because they lead to a Keynesian expansion. The main issue in tax reform has not been curbing exemptions so as to permit lower marginal tax rates on the Bradley–Kemp model that I used as the inspiration for the third point, but whether it is possible to curb the regressive impact of the introduction or extension of value-added tax (VAT). Had it occurred to me that there was a chance of my list being used as a cookbook, I certainly should have added an acknowledgment of the need to accompany domestic financial liberalization with a strengthening of prudential supervision of the financial system.<sup>2</sup> Privatization is unquestionably politically unpopular, presumably because of a belief that it has at times been undertaken in a corrupt way, but the fact is that the economic evidence that it has been beneficial in most dimensions is pretty strong (Nellis, 2003). My advocacy of liberalizing the inflow of FDI did not, quite deliberately, extend to liberalization of all capital inflows, or, for that matter, capital outflows, but I did not go out of my way to emphasize that at the time, as I surely would have done had I known that, in due course, it would be asserted that the Washington Consensus included capital account convertibility.

The more serious criticism of my version of the Washington Consensus concerns what it omitted rather than what it included. Some of the omissions were, as already mentioned, due to the fact that its origin dic-

<sup>2</sup> The case for financial liberalization had been persuasively argued by Ronald McKinnon (1973) and Edward Shaw (1973), but the first experiences in applying it, in the Southern Cone in the late 1970s, had been disastrous. The subsequent postmortems by economists yielded two explanations. One was sequencing; conventional wisdom came to hold that one of the last things that should be done in a liberalization program is to open the capital account, and that one of several preconditions for this should be a liberalized and robust banking system able to intermedicate a capital inflow efficiently to where the social return would be highest. This reasoning suggested that the Southern Cone countries had liberalized capital inflows prematurely. The second explanation concerned financial supervision. Because of the temptations posed by asymmetric information, a liberalization program that hands over the decision to the private sector as to who is to get credit needs to be accompanied by measures to ensure that lenders will make decisions based on where the return/risk trade-off is most attractive. Both insider lending and gambling for redemption need to be disciplined by imposing on bankers the potential obligation to rationalize their decisions to supervisors. This reasoning suggested that the Southern Cone countries had liberalized their financial systems before necessary institutional preconditions had been satisfied. This was widely understood by the early 1980s, but the fact is that I did not mention it in my original formulation of the Washington Consensus.

tated a limitation of its content to what was capable of commanding a consensus, so if something was not already consensual, it did not make it to the agenda, even if I personally thought it was desirable and important. Other omissions were recognized as such with the passage of time. In particular, the progress of development economics in the 1990s led to a major focus on the importance of institutional reforms, which were simply not on the agenda in 1989, when all the concern was with reforming policies. The Washington Consensus was a product of its time, and so there was little recognition of institutional issues. Furthermore, the success of one Latin American country (Chile) that did a number of other things (such as pursuing countercyclical policies à la Keynes) that helped it avoid crises and mitigated the business cycle has pointed to some aspects of policy that did not receive proper recognition in 1989. Introducing such an element into the policy agenda of the region is what Ricardo Ffrench-Davis (2000) meant by “reforming the reforms.”

So the proposition that there is a need to supplement what I laid out as the Washington Consensus seems to me unobjectionable, indeed compelling. Yet this is not the form that most criticisms have taken. Rather, the Washington Consensus has been denounced as a policy agenda that has brought misery and ruin in its wake; for example, by causing the collapse in Argentina. This I find quite extraordinary, because the Argentinean crisis was clearly a consequence of hanging on to an unrealistic exchange rate (what Argentineans referred to as “convertibility”) combined with a reluctance to implement the extremely deflationary fiscal policy that would have been needed to stick with a fixed, overvalued exchange rate. Look at items 1 and 5 in the list above, and you will see why I resent people trying to blame the Washington Consensus for the Argentinean collapse.

### **Alternative versions of the Washington consensus**

One problem is that many people do not mean what I meant when they refer to the Washington Consensus. Indeed, to judge by the sales of *Latin American Adjustment: How Much Has Happened?* (Williamson, 1990), the vast majority of those who have launched venomous attacks on it have not read my account of what I meant by the term. Because other users do not offer any careful definitions à la Machlup, I have to try to figure out for myself what they might mean. I have concluded that there are at least two other interpretations of the term in circulation.

One alternative is to use it to refer to the policies the Bretton Woods institutions apply toward their client countries, or perhaps the attitude of

the U.S. government plus the Bretton Woods institutions. This seems to me a reasonable, well-defined usage. In the early days after 1989, there might not have been much difference between my concept and this one, but over time, three substantive differences emerged. First, the Bretton Woods institutions increasingly came to espouse the so-called bipolar doctrine toward exchange rates (at least until the implosion of the Argentinean economy in 2001, as a direct result of applying one of the supposedly crisis-free regimes), according to which countries should either float their exchange rate “cleanly,” or else fix it firmly by adopting some institutional device such as a currency board. This is directly counter to my version of the Washington Consensus, which called for a competitive exchange rate, which necessarily implies an intermediate regime, because either fixed or floating rates can easily become overvalued.<sup>3</sup> Second, the Bretton Woods institutions, or at least the International Monetary Fund (IMF), came in the mid-1990s to urge countries to liberalize their capital accounts, whereas (as noted above) my version had deliberately limited the call for liberalization of capital flows to FDI. Both of those deviations from the original version were, in my opinion, terrible, with the first being mainly responsible for the Argentinean crisis of 2001 and the second bearing the major responsibility for causing the Asian crisis of 1997. But, third, there was also one highly positive difference (or set of differences), as the World Bank and the IMF came to take up the institutional issues that I had not included in 1989. I think in particular of the World Bank’s major focus nowadays on governance and corruption, and the IMF’s extensive work on financial-sector reform as reflected in standards and codes. Moreover, by the late 1990s, both institutions (though the World Bank even more than the IMF) had replaced their earlier indifference to issues of income distribution by a recognition that it matters profoundly *who* gains or loses income.

If one interprets the Washington Consensus as including the U.S. Treasury as well as the Bretton Woods institutions, then it seems to me that it has become difficult by now to claim that any consensus still exists. There are at least three major issues—fiscal policy, capital account liberalization, and income distribution—with which the current stance of the Treasury is at loggerheads with the views expressed by the IMF and the World Bank. The IMF has been sharply critical of the Bush adminis-

<sup>3</sup> By a “competitive exchange rate,” I mean a rate that is either not misaligned or else is undervalued. My formulation implies a view that overvaluation is worse than undervaluation for a developing country, *not* that undervaluation is a good thing.

tration's fiscal profligacy (IMF, 2003), not because of the deficits realized in the recent cyclical downturn but because of the deficits that are going to materialize for the indefinite future without major tax increases. The IMF has also recognized that its past espousal of rapid capital account convertibility was a mistake, but the U.S. Treasury is still insisting on emasculating any ability to use capital controls in emerging markets such as Chile and Singapore as part of the U.S. price for signing bilateral free trade agreements with those countries. And to judge by the composition of U.S. tax cuts, the Treasury appears totally indifferent to issues of income distribution, whereas both the Bretton Woods institutions have come to recognize that this matters (as well as—not instead of—growth, it goes without saying). Hence, if one wishes to use the term in this second sense, I would argue that it should refer to the policies pursued just by the international financial institutions (IFIs) toward their client countries, because in a wider sense, consensus has evaporated.

The other alternative interpretation of the Washington Consensus uses it as a synonym for neoliberalism or market fundamentalism. This I regard as a thoroughly objectionable perversion of the original meaning. Whatever else the term "Washington Consensus" may mean, it should surely refer to a set of policies that command a consensus in some significant part of Washington, either the U.S. government or the IFIs or both, or perhaps both plus some other group. Even in the early years of the Reagan administration, or during the administration of George W. Bush, it would be difficult to contend that most of the distinctively neoliberal<sup>4</sup> policies, such as supply-side economics, monetarism, or minimal government, commanded much of a consensus, certainly not in the IFIs.<sup>5</sup> Yet most of the political diatribes against the Washington Consensus have been directed against this third concept, with those using the term this way apparently unconcerned with the need to establish that there actually was a consensus in favor of the policies they love to hate.<sup>6</sup>

<sup>4</sup> The word "neoliberalism" means, I believe, the doctrines espoused by the Mont Pélérin Society.

<sup>5</sup> The one policy with a distinctively neoliberal origin that got incorporated in my version of the Washington Consensus was privatization.

<sup>6</sup> I find it ironic that Stiglitz (2002) should have adopted this usage, because my understanding of the definition of the word "consensus" would preclude a Washington Consensus including anything to which he took serious objection while in office as either chairman of the U.S. Council of Economic Advisers or chief economist at the World Bank.



Why should the term have come to be used in such different ways? I find it easy enough to see why the first alternative usage emerged. The term initially provided a reasonable description of the policies of the Bretton Woods institutions, and as these evolved, the term continued to refer to what these policies currently were. I can offer no similarly compelling hypothesis to explain how the other sense arose. One possibility is that this is what some people really believe the international financial institutions advocated. Another is the conspiratorial thesis that this was an attempt to discredit economic reform by identifying reformers with a pretty nutty set of doctrines. In either case, it would have led to a better debate if they had felt obliged to conform to the elementary academic good manners of citing support for their views.

### **A new agenda**

The economic performance of most Latin American countries (Chile aside) in the decade and a half since I first enunciated what became known as the Washington Consensus has been pretty disappointing, especially in light of the high hopes that the region might get firmly back on the road of catch-up growth that were widespread when the policy changes were first implemented. We at the Institute for International Economics therefore convened a group of Latin American economists and tasked them with writing about what they saw as appropriate elements in their respective fields for an agenda that would get the region back on the rails. The results are presented in Kuczynski and Williamson (2003). My own role was to summarize and synthesize the suggested strategy, which I did under four headings.

First, we argue that governments need to aim to avoid crises and stabilize the macroeconomy. This still involves stabilizing inflation, the focus of most policy discussions a bit over a decade ago and the element that I included in the Washington Consensus, but it also requires an attempt to stabilize the real economy à la Keynes. It is unrealistic to imagine that this can start by running expansionary fiscal policies in a recession: governments have to give themselves the scope for that by working their debt/gross domestic product (GDP) ratio down through fiscal surpluses in the good times. Chile was able to run a budget deficit in 2001, while Argentina was not, because of the very different policies they had run in the good times in the first half of the 1990s. In a growing economy with an excessive level of debt, one would look to something like budget balance over the cycle as a sensible target. Once the debt/GDP ratio has been worked down to a safe level (which may be as low

as 30 percent in the Latin American context), something like Gordon Brown's "golden rule" might be more apposite.<sup>7</sup> We also discuss issues such as exchange rate policy, where we emphasize the role of flexibility in coping with potential crises, while not denying that there might be specific circumstances in which fixed rates make sense, and the importance of avoiding currency misalignments and mismatches. We are sympathetic to inflation targeting as a rule to guide monetary policy under floating exchange rates, in part because we believe that this amounts to a sophisticated way of making monetary policy countercyclical without the danger of undermining confidence.

Second, we argue the desirability of continuing rather than reversing the liberalizing reforms of the Washington Consensus. We place particular emphasis on the desirability in most Latin American countries of liberalizing the labor market, in part so as to price a larger part of the labor force back into formal sector jobs, where they will get at least minimal social protections. We urge the benefits of continuing the privatization program that has already gone quite a long way in Latin America. We also argue the importance of complementing the import liberalization that has already occurred with better access to export markets in developed countries, which involves achieving trade liberalizing agreements with them (the Doha Round, the Free Trade Area of the Americas, or bilateral free trade agreements) and maintaining competitive exchange rates. This might conceivably have a terms-of-trade cost, although this seems less likely to be important in Latin America than in some of the African countries heavily dependent on the export of tropical beverages or a few other raw materials produced exclusively in the tropics, where a *collective* devaluation may indeed produce significant terms-of-trade losses. But even there, an overvalued exchange rate seems much inferior to an export levy (especially if collectively imposed by all producers) as a technique for limiting terms-of-trade losses.

Third, we join the general chorus urging reforming countries to recognize that strong institutions are needed to make good policies effective. For example, a reformed tax code will not be much use if the tax admin-

<sup>7</sup> One interesting question is how such rules would translate into IMF fiscal targets. It may well be that a high-debt country would need to maintain a primary fiscal surplus throughout the cycle. If the recent suggestion of Argentina and Brazil that the IMF target should distinguish capital from current public expenditure were to be adopted, then the target for the primary surplus on current expenditures would need to be larger than the present primary fiscal surplus targets if the aim of reducing the debt/GDP ratio were not to be compromised.

istration remains mired in corruption. We talk a bit about some of the institutional strengthening that we would like to see, but this covers a vast area, and what is most urgent varies a lot from one country to another. This is, of course, an important change from the Washington Consensus, which was not ahead of its time in that it focused on policies rather than institutions. Recognition of the importance of institutions was perhaps the key innovation in development economics in the 1990s.

Fourth, we urge that the objective of economic policy should not be formulated as just increasing the growth rate, important as that is, but that governments should also recognize that it matters profoundly *who* gets an increase in income. We suggest that there might be some scope for pushing further the traditional mechanism for improving income distribution—namely, levying heavier taxes on the rich so as to increase social spending that benefits disproportionately the poor—but acknowledge that it would not be practical to push this very far, because too many of the Latin rich have the option of placing too many of their assets in Miami. We therefore conclude that major improvements in the region's highly skewed income distributions will take a long time, because the alternative approach has to be to build up the assets that will enable the poor to earn their way out of poverty. That would require, above all, improved educational opportunities so that the poor can accumulate more human capital, but we also mentioned the potential of microcredit, land reform, and asset titling.

### Concluding remarks

Would such an agenda be subject to the same barrage of criticisms that were directed at the Washington Consensus? Surely some of the objections are to the whole notion of eliminating the intellectual apartheid that used to hold that there were different economic laws applicable to developing than to advanced economies, and these will not be stilled by the new agenda. The old left will presumably object to the continued emphasis on liberalization in general, or to particular aspects of that, such as any attempt to liberalize labor markets. Those who used the term in a different way than I may not object to this agenda, but that will not necessarily lead them to speak any more charitably about the Washington Consensus. Others may be placated by the recognition that disciplined macroeconomic policies should be directed to permitting a Keynesian countercyclical policy, not just to controlling inflation. And those who felt that distributional issues were shortchanged in the original agenda (as they were) will, I hope, be mollified to see their promi-

ment placement this time around, when we had a group of economists expressing their own views rather than being constrained by what was politically acceptable in Washington.

One of the more interesting objections to the Washington Consensus was that best articulated by Rodrik (2003). He argued that any list of *x* policy reforms is bound to disappoint, because it offers an agenda that is insensitive to local context and need. The problem with the Washington Consensus was that it listed what became regarded as “ten commandments,” with an implicit promise that a country that did these ten things would grow. I have some sympathy with this critique. At a minimum, I believe that the order in which reforms are undertaken should vary between countries, and I suspect that successful reformers are characterized more by an ability to recognize the particular constraints that are binding and therefore best tackled next than by the design of novel solutions. But Rodrik goes a bit too far in rejecting the notion that economists can hope to lay out general principles that can be helpful in designing reforms. We can surely do better for our clients than pose questions such as “What types of financial institutions are most appropriate for mobilizing domestic savings?” or “Should fiscal policy be rule-bound, and if so what are the appropriate rules?,” but actually suggest what sort of answers we would normally expect to give.

It is in this spirit that my colleagues and I offered *After the Washington Consensus: Restarting Growth and Reform in Latin America* (Kuczynski and Williamson, 2003). While there will undoubtedly still be some economists who will reject our agenda for the reasons laid out above, I would hope that their number would be much diminished from those who objected to the original. This is not only because it contains an explicit endorsement of countercyclical policies and actions to promote less inequality in income distribution but also because the four major themes outlined above are in less danger of being mistaken for a cookbook. We indicate the direction we think policy should go without trying to tell countries exactly which reforms are needed, or most urgent, or how they should be done. Those are tasks for national policy-makers, whom we aim to assist, but not absolve from thinking, with our new agenda.

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