Initiative *for* **Policy Dialogue**

COPYRIGHT NOTICE: No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, without the prior permission in writing of the publisher, except for reading and browsing via the World Wide Web. Users are not permitted to share this file though any network server.

1

Introduction: From the Washington Consensus Towards a New Global Governance

Narcís Serra, Shari Spiegel, and Joseph E. Stiglitz

The point of departure for this book is the Washington Consensus—the set of views about effective development strategies that have come to be associated with the Washington-based institutions: the IMF, the World Bank, and the US Treasury. John Williamson (1990) provided a brilliant articulation of that consensus. According to Williamson, 'The Washington Consensus was a . . . response to a leading role for the state in initiating industrialization and import substitution. The Washington Consensus said that this era was over' (Williamson 1990). Proponents of the Washington Consensus argue that the original conception had three big ideas: a market economy, openness to the world, and macroeconomic discipline.[1]

Since its inception in 1990, the term Washington Consensus has come to be used in ways that are both narrower and broader than what was envisioned in the original conception. The current interpretation is narrower in that it focuses primarily on privatization, liberalization, and macro stability—meaning price stability; it is broader in that it includes some forms of liberalization not included in the original definition, such as capital market liberalization. More generally, the Washington Consensus has come to be associated with 'market fundamentalism,' the view that markets solve most, if not all, economic problems by themselves—views from which Williamson has carefully distanced himself.

As Joseph Stiglitz points out in his contribution to this volume, advances in economic theory in the 1970s showed that market failures are pervasive, especially in developing economies rife with imperfections in information, limitations in competition, and incomplete markets. Under these conditions,

[1] See Williamson (2002).

there is a presumption that markets are *not* efficient. Stiglitz argues that these advances in economic theory had already removed the intellectual foundations of market fundamentalism before the Washington Consensus became fashionable. Accordingly, it should not have come as much of a surprise that the Washington Consensus prescriptions (as broadly interpreted) failed to work as promised, and that disillusion with the Washington Consensus grew throughout the developing world.[2, 3]

In the countries that followed Washington Consensus policies, economic growth was limited at best, and disproportionately benefited those at the top. In Latin America, for example, seven years of strong growth in the early 1990s were followed by seven years of stagnation and recession, so that for the period as a whole, growth under the Washington Consensus was half of what it had been from the 1950s through the 1970s when the region followed other economic policies, such as import substitution. Even in countries where Washington Consensus policies did appear to promote growth, such growth was often not accompanied by significant reductions in poverty.

Meanwhile, the countries of East Asia followed a quite different set of policies, and had enormous successes. For instance, governments played an important role in promoting particular industries. In some cases, government enterprises (such as Korea's national steel company) became global leaders in efficiency. To be sure, governments in the region did maintain macro stability, but they were slow to liberalize trade, and some countries, such as China, still have not fully liberalized capital markets. In short, both theory and evidence weigh heavily against what has come to be called Washington Consensus policies.

[2] The first chapter of this book contains a brief discussion of the relationship between the Washington Consensus as formulated by Williamson, and how that term had come to be widely understood. We have already noted one key difference: Williamson never elevated capital market liberalization as one of the key policies that countries need to pursue, but this was at the heart of the IMF's agenda. The IMF went so far as to try (unsuccessfully) to change its charter to allow it to push capital market liberalization on wary developing countries.

[3] Williamson's Washington Consensus centered on ten reforms: (i) fiscal discipline in order to eliminate public deficits; (ii) a change in the priorities of public spending: withdrawal of subsidies and increased spending in health and education; (iii) tax reform: broadening tax bases and reducing tax rates; (iv) positive real interest rates, determined by the market; (v) exchange rates determined by the market, which must guarantee its competitiveness; (vi) liberalization of trade and opening of the economy (Williamson did not attach any priority to the liberalization of capital flows); (vii) no restrictions on foreign direct investment; (viii) privatization of public enterprises; (ix) deregulation of economic activity; (x) a solid guarantee of property rights.

We can organize Williamson's ten items into two main groups: on one hand, the promotion of economic stability through fiscal adjustment and market orthodoxy; on the other hand, a dramatic reduction of the role of the state in the economy. It was a development strategy that markedly differed from the import substitution strategy that dominated in the 1970s.

The chapters in this book can be viewed as *revisiting* the Washington Consensus through an examination of its original formulations, how it has come to be interpreted, and what has been left out. The volume is divided into three parts. Part I introduces the debate on the Washington Consensus. It includes both a short history by John Williamson—in which he traces the origin of the term and argues that the original meaning of the Washington Consensus is very different from how the term has come to be used—as well as a discussion on the later usage by Joseph Stiglitz. The chapters in this section are more informal and less academic than chapters in the rest of the book, and we hope they'll give the reader an impression of the spirit of the debate, as well as the issues involved.

The chapters in this section also set the stage for a formulation of a post-Washington Consensus consensus. John Williamson argues that the reforms listed in 1990 are no longer adequate, and proposes a set of reforms to the original consensus. Stiglitz's chapter presents ideas for a framework on what a new consensus might look like, and how it might differ from the original Washington Consensus. Although not everyone at the Barcelona meeting agreed with all of Stiglitz's recommendations, his chapter sets a frame for the ensuing discussion on a new consensus. Despite their differing perspectives, the participants were able to reach a broad consensus as to what a new development agenda might look like. The details of the agreement, the Barcelona Development Agenda, are presented in the final chapter of Part I.

Part II of the book analyzes in more detail many of the issues that were discussed at the Barcelona meeting and included in the agreed-upon set of principles. The chapters in this section look at domestic policies (such as macroeconomic and industrial policies) as well as issues surrounding the international financial architecture, a topic that was not addressed in the original Washington Consensus. One goal of this section is to examine where agreements exist, as well as the limits of those agreements—where reasonable people might disagree with each other. Because of the different perspectives of the participants, some of the chapters in this section sometimes present different interpretations of the same problems, and give different solutions. For example, while Jeffrey Frankel and Martin Khor agree that the current trading system needs reforms, they disagree on the underlying benefits of trade agreements for economic development. We present both chapters in this volume.

The final part of the book looks towards formulating new policy frameworks beyond the Washington Consensus. Dani Rodrik, Andrés Velasco, and Ricardo Hausmann outline a new framework for domestic policy designs, and Joseph Stiglitz examines how global governance must be reformed to keep pace with economic globalization.

The Barcelona Development Agenda

The Barcelona Development Agenda is made up of seven general principles. Most starkly, in contrast with the old doctrines, the Barcelona principles emphasize a balanced role for the state and markets, experimentation as a tool for development, and the use of microeconomic interventions to redress market failures and promote productivity (combined with incentives for improved performance).

Several of the principles outlined represent longstanding views on successful development, such as the need to maintain macroeconomic discipline. These remain as important today as they were more than 15 years ago, when Williamson formulated the Washington Consensus. Others represent the continual evolution of our understanding of the development process—an emphasis on institutions and the importance of orderly and sequential reforms. And several represent a major departure from the past, such as the importance of income distribution, poverty reduction, and maintaining the environment, as well as the importance of tailoring policies to country-specific situations—issues that were not included in the Washington Consensus, but that after the debacles that marked the many crises of the 1990s and the early years of this century, are perhaps now self-evident. For example, John Williamson's chapter acknowledges that one of the major failings of the original Washington Consensus (even as it was originally formulated) is that it didn't include equity. In his contribution, Paul Krugman examines the key issue of income inequality in more detail and analyzes implications for a post-Washington Consensus consensus.

In many ways, the Washington Consensus was a consensus for liberalization and globalization rather than a consensus for equitable growth and sustainable development. After all, as we've pointed out, reducing poverty, equity, and sustaining the environment were not part of the Consensus. The Washington Consensus called for the opening of countries to the outside world.[4] As a result, the fortunes of developing countries have increasingly depended on what happens outside their boundaries, such as the access of developing countries to foreign markets, foreigners' access to their markets, and instability in exchange rates and capital markets, (which affect the availability of capital and the interest rates developing countries have to pay). Yet, the Washington Consensus didn't address the international architecture necessary to govern globalization.

Participants in the Barcelona Conference agreed that, in general, international arrangements are not working well. Several of the points of the

[4] As we have noted, the extent to which this was done differed in the 'narrow' conception (of Williamson himself, who rejected capital market liberalization) and the broader conception.

Barcelona principles addressed these failures, and several of the chapters in this volume focus on the facets of economic globalization (capital flows, trade, intellectual property, and labor) in which international arrangements and global governance have not kept pace with the changing world, or in which the arrangements significantly disadvantaged developing countries. There was agreement that multilateral trade negotiations and international financial arrangements need to be reformed. There was also a consensus on the need for a set of international rules and institutions to guide cross-border movements of people. Similarly there was an agreement that the worsening of the environment, including global warming, needs to be tackled globally as well as nationally.

Central Issues in Development

The Washington Consensus took stands on issues that many economists (who were not part of the policymaking circles in Washington at the time) disagreed on how both theory and evidence should be interpreted. Even those topics that remain high on the 'agenda,' such as macroeconomic stability, are open to alternative interpretations. While no one would have advocated macroeconomic *instability*, what constitutes 'good' macroeconomic policy remains contentious. In the first chapter of Part II, José Antonio Ocampo calls for a broader view of macroeconomic stability that includes not only price stability and sound fiscal policies, but also a stable *real* economy. It was natural in 1990, for example, after the episodes of high inflation and hyperinflation that Latin America experienced in the 1980s, to emphasize price stability. But *real stability*—variability in unemployment or real growth—is as, or arguably more, important. Price stability, as we have learned, may not lead to growth or full employment, and excessive zeal in pushing for price stability may stifle growth and lead to high levels of unemployment. Ocampo emphasizes the importance of developing a macroeconomic framework that includes an active role for countercyclical government policies, together with capital management techniques (including capital account regulations and prudential regulations).

In the next chapter in this section, Alice Amsden takes a closer look at industrial policy, an issue that the Washington Consensus took a strong stand against. The term 'industrial policy' lost credibility after the Latin American economic crises in the 1980s. But the argument against these policies is based on a naive reading of economic theory and a misreading of economic history. As discussed earlier, standard economic theory is based on perfectly competitive markets, which rarely exist, especially in developing countries. Modern economic research and recent experience have shown that markets do not always produce efficient outcomes by themselves, implying that there's a

role for government intervention. Standard theories of market efficiency also assume that technology is fixed.[5] Yet, it is the change in technology and the development and adoption of new modes of production and products that is at the center of economic growth. On the other hand, economic theory that recognizes the existence of asymmetric and incomplete information and markets has created a strong presumption for the role of government and industrial policies. Knowledge is a public good—in the technical sense that when another individual comes to know a particular piece of knowledge, it does not subtract from the knowledge that others have ('consumption is non-rivalrous'); and the production of knowledge, like the production of other public goods, will be below the optimal level if left to the private sector alone.[6]

Critics of industrial policy cite failures and abuses that existed in the past. However, countries in East Asia, such as Korea, were able to use forms of industrial policy to develop high technology industries, resulting in real economic growth. Amsden argues that the benefits of globalization can only be realized by developing countries that have their own nationally owned companies, which expand abroad. In her view, governments should promote private nationally owned enterprises.

The discussion of industrial policy at the Conference made it clear that the issue is still controversial and not all the participants at the Barcelona meeting agreed with this perspective, as we discuss below. There was, however, a general acknowledgement that many successful developing countries have used industrial promotion as a tool for sustained growth. The Barcelona principles included an agreement that carefully designed policies aimed at market failures can be useful tools for development.

Highlighting the alternative views at the Conference, Guillermo Calvo and Ernesto Talvi argue that the reform agenda of the 1990s had a strong beneficial effect; they agree with much of what the Washington Consensus said. In their view, the problem is with what it left out—such as an adequate recognition

[5] The rigorous formulation of Adam Smith's 'invisible hand' conjecture, that the pursuit of self-interest leads as if by an invisible hand to economic efficiency, is due to Arrow and Debreu. They showed that competitive markets are only efficient under highly restricted conditions. Greenwald and Stiglitz (1986) extended their analysis, showing that whenever markets were incomplete (e.g., there does not exist a complete set of risk markets) or information is imperfect (always the case), then markets are not efficient. This changed the presumption: while earlier, the presumption was that *unless there was a limited set of market failures,* so long as one maintained competition, markets would be efficient. Now the presumption was that *even with competition*, markets would not be efficient, and that these problems were likely to be particularly severe in areas, like financial markets, where information was at the center of the analysis. All of these analyses, however, assumed *fixed* technology. But as Stiglitz (1975) argued, changes in knowledge were very much like changes in information—they were, in fact changes in information about how to organize and conduct production—so that markets would not work well when technology was endogenous.

[6] See Stiglitz (1999, 1987). This view has since become standard in the literature on innovation.

01-Stiglitz-c01 OUP179-Stiglitz-and-Serre (Typeset by spi publisher services, Delhi) 9 of 13 February 26, 2008 14:54

of the imperfections in capital markets. They argue that most of the failures of the late 1990s and early 2000s came from sudden stops in international capital flows, combined with domestic financial vulnerabilities. In contrast to Ocampo, who presents a compelling argument on the need for managing capital inflows through direct controls and regulations, Calvo and Talvi believe that capital controls are not effective tools. In their view, countries need to focus on fixing key points of financial vulnerability, and the international community needs to reform the international financial architecture to mobilize a stable source of capital flows to developing countries.

Daniel Cohen's chapter examines the failures of the international financial architecture from a different perspective. He focuses on the resolution, rather than prevention, of crises. In particular, he looks at how to resolve sovereign debt crises, and introduces an innovative proposal for the use of standstills on the debtor side, collective actions clauses on the creditor side, and a lender of 'first resort' by the international financial institutions.

The sense of unhappiness with the international financial architecture was reinforced by the inequities in the global trading regime. Not only was there an agreement that the overall international economic architecture is not working, but there was also a consensus that the system of international governance is biased against developing countries. This bias is most evident in the WTO trade regime, which has allowed developed countries to retain their agricultural subsidies, but greatly curtailed the use of trade policy by developing countries to promote their own development and to protect those who might be adversely affected by unfettered liberalization.[7] Though we did not achieve a consensus on reforming the system of global governance at Barcelona, the consensus that there was a need for reform—across a broad spectrum of participants, from the left to the right—was itself significant.

As we mentioned above, we include two contributions on reforming the global trading system. Both authors argue for the need for reform. Jeffrey Frankel argues that countries can still gain considerably from opening their markets and integrating into the global trading system. He questions the significance of non-economic effects of increased trade such as increased pollution, and argues that such issues need to be addressed through other multilateral institutions. Martin Khor, on the other hand, argues more broadly that the current trading system doesn't address development needs of poor countries. He is not convinced that countries necessarily gain from opening their markets. For example, he argues that inappropriate import liberalization can have negative effects on industry and agriculture in developing countries.

[7] Unfettered liberalization would, for instance, hurt farmers in both the north and the south. The instrument of choice in the north for protecting farmers is subsidies, but developing countries do not have the resources to subsidize their farmers. Money spent on subsidizing farmers is money that cannot be spent on education or investments in infrastructure. But the alternative, tariff protection or quotas, are not allowed under the WTO regime.

Khor's chapter also addresses imbalances in the current intellectual property multilateral agreements. The debate on intellectual property in the 1990s and early 2000s tended to assume that stronger intellectual property regimes were better, for both rich and poor countries. But, as economists have long recognized, a stronger regime may not be better. Ultimately, it is not just a question of 'strong' or 'weak' intellectual property rights, but the design of the intellectual property regime that matters. Unbalanced rules can have huge implications for public health and global distribution, and can impede efforts to close the 'knowledge gap' between developed and developing countries by restricting the ability of domestic firms in developing countries to adopt modern technology. Yet, as Khor points out, the benefits of WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) primarily accrue to the wealthy countries while the costs (higher prices and royalties) are disproportionately borne by developing countries. His chapter concludes with proposals for making the intellectual property regime and the global trading system more development oriented.

The final facet of economic globalization covered in our volume is the flow of labor. We start by examining domestic labor policies. The Washington Consensus sent a standard message for countries to increase labor market flexibility. The reasoning behind this message was clear: *if* markets were in every other way perfect (e.g., perfect competition, perfect information, perfect capital and risk markets), then wage rigidities could give rise to unemployment—indeed, under the stated assumptions, they would presumably be *the* explanation for unemployment. The problem with this view, however, is that some of the labor market inflexibilities are *endogenous,* the response, for instance, to imperfect information and incomplete insurance.[8] When other markets are imperfect or inflexible, workers end up bearing the cost of economic adjustments through lower wages and unemployment, even when labor market problems are not the core of the problem facing the country. Private markets on their own have not done a good job of protecting workers. Olivier Blanchard's chapter examines domestic labor market institutions and explores unemployment insurance and protection schemes. He also analyzes what optimal structures of unemployment insurance would look like, and how different countries can implement these policies.

Somewhat ironically, labor market flexibility across borders—which could mitigate some of the costs associated with flexible domestic markets by allowing workers to leave when wages fall—was not addressed in the Washington Consensus. Enormous energy has been focused on facilitating the flows of

[8] This is the central point of the efficiency wage and implicit contract theories. For an overview, see, for instance, Stiglitz (1986). The classic paper on efficiency wage is that of Shapiro and Stiglitz (1984). An attempt to integrate implicit contract theory and efficiency wage theory is provided by Richard Arnott et al. (1988). Patrick Rey and J.E. Stiglitz (1993) show that more flexibiity may not result in increased welfare.

investment and capital, while movements of labor remain highly restricted. Whereas capital markets are one of the most integrated facets of economic globalization (as discussed above), labor markets are one of the least. Yet the gains to global economic efficiency from liberalizing labor flows are an order of magnitude greater than the gains from liberalizing capital flows. Indeed, liberalizing movements of short-term speculative capital has been associated with increased instability, but not enhanced economic growth.

This disparity between labor market and capital market liberalization has large distributional consequences. Capital can move easily; it can leave a country if it is taxed or if policies that threaten returns to capital are implemented. Workers, on the other hand, cannot threaten to move. This disparity is one of the reasons for the growing inequality in incomes that have marked most countries around the world, and is one of the reasons that globalization has often led to falling incomes for workers, even when it has brought increases in GDP. Deepak Nayyar's chapter explores the issue of international migration and the effects on economic development. He points out that migration has significant implications on development and that, similar to capital and trade flows, it is important to think of a multilateral framework for cross-border movement of people, one of the principles agreed to as part of the Barcelona Development Agenda.

Towards a New Global Governance

At the time the Washington Consensus was formulated, little attention was paid to the subject of governance—the behavior of public institutions. Since then it has come to the center of the stage. But it is not just governance of countries, but governance of the world economy that is of concern. In the first chapter of Part III of this volume, Joseph Stiglitz builds on the earlier discussion of global institutions to discuss the issue of global governance. He points out that economic globalization has proceeded faster than political globalization. The system of global governance is a patchwork of institutions, agreements, and arrangements that might be called global governance without global government. His chapter examines the structures of global governance, links their deficiencies (for example, their undemocratic nature) to the unsatisfactory observed outcomes, and looks to the forces that may lead to meaningful reform and change.

The final chapters in this volume then look to the next steps for formulating a framework for domestic policy design. The Barcelona Agenda emphasizes the importance of allowing countries to define their own economic policies, and the importance of experimentation for finding successful development strategies. Perhaps more important than the Barcelona Agenda itself, however, is its recognition that while there can be general principles, how these

get translated into policies may differ markedly from country to country. Dani Rodrik, Andrés Velasco, and Ricardo Hausmann provide a framework for identifying the set of interrelated critical problems facing an individual country. Dani Rodrik's chapter complements this by outlining a way to think about growth strategies. He suggests that countries focus on where constraints to growth exist, devise imaginative policies to target these constraints, and then learn to institutionalize the process. As we discussed above, within this framework, participants at the meeting agreed that with individualized well-tailored policies, microeconomic tools can be useful complements for macroeconomic management.

The Barcelona Development Agenda is, in our opinion, an important starting point in the formulation of a new and better system of policies—policies that offer more flexible approaches to development, with broader concerns for *equitable* and *sustainable* development—and the creation of a better system of global governance. It provides the basis of a post-Washington Consensus consensus that is now emerging. The new consensus is different from the Washington Consensus in important ways. It emphasizes broader goals for macroeconomic policy (including long-term sustainable growth and equity), a wider range of economic policy instruments (including prudential regulations and other microeconomic tools—though the details of these tools is still being debated), and a balanced role for markets and government (as opposed to minimizing the role of the state).[9] It recognizes the importance of the international architecture and is based on a more democratic global governance with a fairer set of international agreements including better risk sharing between wealthy and poor countries. It further recognizes the need for countries to be able to define their own policies, and the importance of experimentation in policy design. But, this framework is only a starting point. Many questions remain to be answered, and many issues are still being debated. We hope that this book provides the opportunity to continue the dialogue and open up the discussion.

References

Arnott, R., Hosios, A., and Stigliltz, J. E. (1988). 'Implicit Contracts, Labor Mobility and Unemployment'. *American Economic Review*, 78/5: 1046–66 (December).

Greenwald, B. and Stiglitz, J. E. (1986). 'Externalities in Economies with Imperfect Information and Incomplete Markets'. *Quarterly Journal of Economics*, 101/2: 229–64.

Rey, P. and Stiglitz, J. E. (1993). 'Moral Hazard and Unemployment in Competitive Equilibrium'. Working Paper (October).

Shapiro, C. and Stiglitz, J. E. (1984). 'Equilibrium Unemployment as a Worker Discipline Device'. *American Economic Review*, 74/3: 433–44 (June).

[9] For more on the macroeconomic framework for development, see Stiglitz et al. (2006).

Stiglitz, J. E. (1975). 'Information and Economic Analysis', in J. M. Parkin and A. R. Nobay (eds.), *Current Economic Problems*. Cambridge: Cambridge University Press, 27–52. (Proceedings of the Association of University Teachers of Economics, Manchester, England, April 1974.)

____ (1986). 'Theories of Wage Rigidities', in J. L. Butkiewicz, K. J. Koford, and J. B. Miller (eds.), *Keynes' Economic Legacy: Contemporary Economic Theories*. New York: Praeger Publishers, 153–206.

____ (1987). 'On the Microeconomics of Technical Progress', in J. M. Katz (ed.), *Technology Generation in Latin American Manufacturing Industries*. London: Macmillan Press Ltd, 56–77. (Presented to IDB-Cepal Meetings, Buenos Aires, November 1978.)

____ (1999). 'Knowledge as a Global Public Good', in I. Kaul, I. Grunberg, and M. A. Stern (eds.), *Global Public Goods: International Cooperation in the 21st Century*. New York: Oxford University Press, 308–25.

____ Ocampo, J. A., Spiegel, S., Ffrench-Davis, R., and Nayyar, D. (2006). *Stability with Growth: Macroeconomics, Liberalization, and Development*. New York: Oxford University Press.

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

____ (2002) 'Did the Washington Consensus Fail?' Outline of speech at the Center for Strategic & International Studies, Washington, DC.