Washington consensus

The term *Washington consensus* was coined by John Williamson (1990) to encapsulate the set of policy reforms advocated with a reasonable degree of consensus by international financial institutions, the U.S. government, the Federal Reserve Board, and the leading think tanks based in Washington. Those policies were deemed necessary to achieve growth, low inflation, a viable balance of payments, and equitable income distribution in the developing world at large, and especially in Latin America, which was still recovering from the debt crisis that erupted in 1982. The policies that defined the Washington consensus included (1) fiscal discipline, (2) increased public expenditure on social services and infrastructure, (3) tax reform to broaden tax bases and reduce marginal tax rates, (4) market-determined interest rates, (5) unified and competitive exchange rates, (6) import liberalization, (7) openness to foreign direct investment, (8) privatization, (9) deregulation, and (10) secure property rights.

As the term evolved in the 1990s, it became synonymous with the main policies promoted consensually by the International Monetary Fund (IMF), the World Bank, and the U.S. Treasury, with an emphasis on macroeconomic stability through sound fiscal and monetary policies, and a wider role for markets in relation to governments in the allocation of resources through privatization, trade and capital account liberalization, and domestic market deregulation. The prescription to stabilize, privatize, and liberalize had gained traction among many policymakers in developing countries since the 1980s as import substitution and interventionist policies had led to bloated bureaucracies, grossly inefficient state-owned enterprises, unsustainable public indebtedness, inflation, and slow or even negative growth. The collapse of the Soviet bloc and the success of countries, such as Chile, that had already experimented with the new policies, contributed to their acceptance in the early 1990s. The limited role of government and the expanded role of markets have led some to refer to Washington consensus policies as "neoliberal" or based on "market fundamentalism," an expression that does not do justice to the scope and richness of the policies, especially those originally listed by Williamson (1990). This entry adopts the more recent and more widely used meaning of Washington consensus policies, in spite of its partial overlap with Williamson's list.

The Set of Policies For convenience, Washington consensus policies can be divided into macroeconomic and microeconomic, or structural, policies. The macroeconomic policies are mostly concerned with achieving price stability (more strictly, low inflation rates) and preventing foreign exchange or public debt crises. The cornerstone of macroeconomic stability is fiscal discipline. This need not imply a balanced budget, but rather a fiscal position that does not lead to a rising debt to gross domestic product (GDP) ratio, loss of international currency reserves, or (unacceptably high or rising) inflation (caused by monetary financing of the deficit), and therefore is "sustainable" without major policy adjustments.

Monetary discipline, a second key element of macroeconomic stability, is best achieved when monetary policy instruments (the intervention interest rate, open market operations, etc.) are aimed at controlling the supply of money and/or the price level and not at reaching other objectives such as accelerating growth or reducing unemployment. Central bank independence from government and other sources of political interference is additionally seen as facilitating monetary discipline.

Though no consensus exists in regard to the exchange rate regime most conducive to macroeconomic stability, it is well established that fixed or pegged exchange rate systems make monetary policy instruments ineffective in an environment of international capital mobility. Furthermore, fixed exchange rates insufficiently backed by international reserves may induce speculative attacks that often lead to abrupt exchange rate corrections. Nonetheless, fully floating exchange rates are seldom desirable, as central banks cannot allow exchange rates to freely fluctuate when a large portion of government or private sector debts are denominated in foreign currency and therefore exposed to exchange rate risks, as is the case in most Latin American countries (an attitude known as "fear of floating"). Thus international financial institutions often advocate for strong international reserve positions and limited reliance on external finance as precautionary measures to weather potential external shocks.

Given a sound macroeconomic framework, structural policies are primarily intended to stimulate and sustain growth by facilitating the functioning of markets and minimizing government interference in economic agents' decisions regarding investment, saving, consumption, and work. This entails lifting tariff barriers and other restrictions on international trade (*trade liberalization*); eliminating restrictions on foreign direct investment and on the free movement of funds in and out of the country (*capital account liberalization*); privatizing state-owned enterprises and opening to private investment industries previously controlled by the public sector, such as telecommunications, electricity, or mining (*privatization*); reducing bank reserve requirements and dismantling interest rate controls, subsidized loan programs, and directed credit systems (*financial liberalization*); simplifying the tax code, lowering tax rates, and widening tax bases (*tax reform*); facilitating labor hiring and firing, eliminating wage controls, simplifying the labor code, and reducing payroll taxes (*labor deregulation*); and lifting price controls and license requirements, and easing the procedures for entry and exit of firms (*goods markets deregulation*).

The Extent of Policy Reform Little reform had taken place in the developing world before 1989, but the launch of the Brady Plan by the U.S. government (an initiative to convert the nonperforming bank debts of the developing countries into long-term bonds to restore access by those countries to international finance) and the fall of the Berlin Wall that year signaled the beginning of ambitious macroeconomic and structural reforms in Latin America, Eastern Europe, and the former Soviet Union.

The extent of macroeconomic reforms in the following decade and their degree of success were remarkable. The incidence of high inflation rates among developing countries declined sharply, and median inflation rates among medium-income countries declined from 16 percent in 1990 to 6 percent a decade later. The overall fiscal deficit of developing countries, which had reached 7 percent of GDP in the early 1980s, has remained approximately 2–3 percent of GDP since 1990. By the end of the 1990s, the median developing country posted a primary surplus (the fiscal balance excluding interest payments). In addition, the volatility of key macroeconomic variables such as economic growth and real exchange rates declined in the 1990s, though partially in response to a more stable external environment.

The extent of microeconomic, or structural, reform since the late 1980s has also been substantial, especially in Latin America and the countries of the former Soviet bloc, although the effects of this reform remain a matter of intense debate. Aside from Chile, which slashed import tariffs and lifted other restrictions on international trade, liberalized the financial sector, privatized many state-owned enterprises, and streamlined the tax and labor codes under the Pinochet dictatorship (1973–90), no other country in Latin America had fully embraced structural reform until the late 1980s, when the Brady Plan created the opportunity of attracting much-needed external capital by adopting the "right" set of policies in the view of international financial institutions and investors. According to reform indexes computed for Latin America, trade and financial liberalization took off first and advanced furthest in the majority of countries. Privatization and tax reforms were more uneven in depth and timing, while labor reform was timid and erratic. Argentina, Bolivia, and Peru were among the most aggressive reformers, while Costa Rica, Ecuador, Mexico, Uruguay, and Venezuela undertook more cautious but nonetheless substantial reforms. Reform lost momentum in the second half of the 1990s, and major reversals took place after 2000 in Argentina, Bolivia, and Venezuela as governments reintroduced a variety of price controls and international trade restrictions. In some cases entire sectors were expropriated, as in the case of Bolivia's natural gas sector.

The reform process was no less turbulent in the former Soviet bloc countries, where it was part of the larger project of state formation that followed the breakup of the USSR (making it more difficult to judge the success of the new policies). Wage and price deregulation, two of the most important components of labor and goods markets deregulation, were undertaken in most countries at the beginning of the transition process, but then stalled and even reversed in some countries after the mid-1990s. A dozen years after the collapse of the Soviet bloc, domestic markets were still almost as heavily regulated as before in Belarus, Moldova, and Uzbekistan. The liberalization of external trade, investment, and finance, on the other hand, has represented a more gradual but sustained process, although as of the first years of the 21st century that process remained incipient in Azerbaijan, Belarus, Turkmenistan, and Uzbekistan. Although the transition from communist to market economies offered the former Soviet bloc countries ample opportunities for privatization, the reform indexes available suggest that only a handful of countries (Armenia, Bulgaria, the Czech Republic, Hungary, Macedonia, and Slovakia) have privatized the vast majority of their economic activity. As of 2001, the process had barely progressed in Slovenia and Turkmenistan and had suffered drastic reversals in Russia and Uzbekistan.

The process of microeconomic reform varied even more across time, country, and area of reform among the African countries. In the area of financial liberalization, Africa went from a completely dirigiste stance in the mid-1980s to freely moving interest rates and greater flexibility in bank operations in the late 1990s. State-owned financial institutions still intermediated a sizable portion of domestic credit, however, and restrictions on the allocation of credit abounded. Trade liberalization also advanced substantially, but many countries continued to impose high import tariffs and import and export licensing restrictions in the late 1990s. African countries were likewise reluctant to engage in capital account liberalization during the 1980s. Around the mid-1990s most countries undertook at least partial reforms, but many countries continue to require some form of authorization for the acquisition of firms by foreign investors and for portfolio investments by foreigners. Countries in Africa privatized less and more reluctantly than Latin American or transition countries. Less than 40 percent of Africa's state-owned enterprises were affected by privatization, and only four countries—Ghana, Côte d'Ivoire, Nigeria, and Zambia—accounted for a third of all transactions between 1991 and 2001, worth just $9.1 billion.

Assessment Washington consensus policies have been widely criticized for their ineffectiveness in delivering more macroeconomic stability and higher growth—their two main objectives—as well as for their social and distributional effects.

Although macroeconomic stability vastly improved in the developing world in the 1990s, it failed to reach developed-country levels, and countries remained vulnerable to extreme macroeconomic events such as banking crises, currency crashes, and sudden interruptions in capital flows, or "sudden stops." Argentina, a close follower of the Washington consensus recommendations, nonetheless experienced a severe economic crisis in 2001 and 2002: the exchange rate was devalued by more than 300 percent, the government defaulted on its debt obligations, and economic activity and employment collapsed. The inadequate policy conditions imposed by the IMF on the countries affected by the Asian crisis of 1998 are also offered as evidence of the failure of the Washington consensus to prevent macroeconomic instability.

Among the main shortcomings of the policies advocated are sequencing problems (particularly the premature liberalization of capital flows without adequate financial regulation), excessive reliance on high interest rates to contain aggregate demand, price and exchange rate pressures (at the risk of worsening or precipitating a financial or a debt crisis), and inadequate fiscal adjustment that exacerbates busts and weakens economic recovery. The Washington consensus is further criticized for inadequate international financial architecture to respond to the needs of countries in crisis or facing speculative attacks and to prevent "sudden stops."

All of these objections, however, are subject to intense debate. There is no widespread agreement on whether capital controls are effective in moderating or stabilizing capital flows, or whether financial systems isolated from international competition can be adequately regulated. When fiscal sustainability is at risk (for instance, as a result of a sudden interruption in credit access or a decline in the country's terms of trade), interest rate increases or public expenditure cuts may be necessary in order to prevent further capital outflows, currency depreciation, and inflation. Finally, there is intense debate regarding the role the IMF and other international financial institutions should play in preventing and responding to crises, as bailouts and other forms of support may encourage lack of macroeconomic discipline.

The effects of Washington consensus policies on growth have been a contentious issue since their outset. The lackluster performance of Latin America in relation to other regions, especially the fast-growing countries of East Asia, is often offered as evidence of their modest effect. Econometric evidence for Latin America and the transition economies of the former Soviet bloc suggests that Washington consensus policies had positive, but only weak and transitory, effects on growth. The main explanations for this modest growth effect include insufficient depth and completeness of policies and reforms, excessive use of macroeconomic policies to achieve price stability rather than promote growth, sequencing problems (capital account liberalization, domestic financial liberalization, or privatization prior to the regulatory reforms needed to prevent financial instability and market manipulation), and a host of other implementation problems, due especially to lack of institutional support to administer trade reforms, facilitate resource reallocation, prevent corruption, and implement regulatory reforms. Other critics contend that stimulating and sustaining growth requires removing only the most binding constraints, rather than completing the ambitious list of reforms prescribed by the Washington consensus or its augmented versions, which incorporate a variety of institutional or "second-generation" reforms as well as social policies.

The view that Washington consensus policies have deleterious social effects is presently so widespread as to seem beyond discussion. But the empirical evidence is mixed at best. In many countries in Latin America and Africa, trade liberalization had a negative effect on employment in the sectors affected by import competition, which was not compensated by employment creation in the exporting sectors. Nonetheless trade liberalization and privatization produced both winners and losers among the poor, depending on their sectors of activity and their consumption baskets, and there is virtually no empirical support for the view that aggregate poverty was increased by these reforms.

Much more debate attends the distributional consequences of Washington consensus policies. The fact that trade openness may increase inequality in developing countries seems to go against standard economic theory (or at least theory rooted in the simplest version of the Heckscher-Ohlin model of international trade), since trade should increase the income accruing to the relatively abundant factor, presumably unskilled labor. This effect may be muted or even reversed, however, where trade protection before liberalization was focused on labor-intensive products, as in the case of Mexico, or where the most abundant factor of production is natural resources, as could be the case in Russia or some of the South American countries. Contrary to popular belief, privatizing utilities did not hurt the poor, as the quality and coverage of services improved, while the impact of privatization on income distribution was moderate in Latin American countries, but substantial in some of the ex-communist countries.

An Evolving Concept The terms *Washington confusion* and *Washington contentious*, among others, have been used to convey the state of disarray of the economic, institutional, and social policies advocated by international financial institutions more than a decade after the original Washington consensus. Among the international financial organizations and some Washington-based think tanks, the view prevails that the Washington consensus can deliver growth, stability, and equality if it is "augmented" with a variety of institutional reforms to strengthen state capabilities and with more encompassing and ambitious social policies. In academia, however, as well as in some segments of the World Bank and other organizations, it is argued that a more comprehensive list of policy requirements can hardly be a useful guide for governments short of political support, technical expertise, and administrative capabilities. Furthermore, although no one disputes the importance of macroeconomic stability, secure property rights, market-oriented incentives, outward orientation, and government provision of basic public goods, it is becoming widely accepted that there are no standard prescriptions for achieving these goals. If a new consensus is emerging it is based on the recognition that economic policy reform is always constrained by institutional and political economy factors, which are even harder to reform.

See also capital controls; economic development; evolution of development thinking; financial liberalization; Heckscher-Ohlin model; import substitution industrialization; International Monetary Fund (IMF); political economy of policy reform; sequencing of financial sector reform; trade and economic development, international; World Bank

FURTHER READING

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Stiglitz, Joseph E. 2002. *Globalization and Its Discontents*. New York: W. W. Norton. This worldwide bestseller should better be titled "The Washington Consensus and Its Discontents." The author is a Nobel Prize laureate who served as economic advisor to the U.S. government and as chief economist of the World Bank during the heyday of the Washington consensus (1993–2000).

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