

# *POST-WASHINGTON CONSENSUS TASK FORCE REPORT*

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## *REFORMING THE REFORMS OF THE WASHINGTON CONSENSUS FOR ACHIEVING GROWTH AND EQUITY*

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Latin America lived through a period of deep economic reforms during the 1990s, framed by what was called the Washington Consensus. Dramatic changes affected the relative importance of the State, which saw its sphere of action limited amidst deregulation, massive privatization, the reduction of public investment and expenditure, giving broader space for the working of private agents.

More than one decade of intensive and profound reforms has left clearly positive results in several areas: the eradication of hyperinflation, more balanced public budgets, a rise in exports, less beaurocratism. Actually, LACs achieved in average one digit inflation in 1999-2001; public sector deficits in the quinquenium before the arrival of the contagion of the East Asian crises had improved to a figure around 1.5% of GDP, quite positive compared to that of developed nations; exports grew vigorously 9% per year, 50% faster that world trade in the 1990s.

But performance has been poorest in precisely the most significant area, which is economic growth and equity. Table 1 shows that annual Gross Domestic Product (GDP) rose scarcely 2.4% during the thirteen years between 1990 and 2002, and 1.2% in the past five years, which **ECLAC** has called the 'lost half decade'. Since population rises 1.6% per year, per capita growth has been negative. Additionally, active population (the labour force, comprising all workers and entrepreneurs) increased 2.6% per year, generating a negative output per worker in the long period 1990-2002. That contributes to explain the poor performance of wages: they stagnated since 1990 (see table 2). But wages refer to the formal segment of labor markets. In terms of poverty, there are 14 million more poor people than there were in 1990, and income distribution remains very regressive. This is partly associated to the tightness of labor markets, which expelled workers from the formal to the informal segments, with more instability of jobs and falling average income of non-waged workers.

Tables 1 and 2.

Latin America needed tough, but pragmatic, reforms. We had economies that were over-intervened, with a restricted private sector and rules that were not transparent. The spirit of the Washington Consensus sought reforms that would generate 'right' prices and be 'market-friendly', two principles we fully share.

Results, however, are contradictory in those two features. For example, key macroeconomic prices -the exchange rate and the interest rate- have tended to assume "wrong" values (one US dollar per one

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Argentine peso is one of many examples), suffering from enormous real instability after the reforms of the 1990s. Other extremely relevant variable, aggregate demand has fluctuated wildly, led by the volatility of short-term capital flows. All this is not properly market-friendly, placing the productive sector under enormous tension.

Such “disappointing” growth, in the words of John Williamson (2003), the outstanding economist who coined the term *Washington Consensus*, in his well-known work of 1990, can be associated with many flaws. These include several interrelated issues. Here we will cover three of them, including policy proposals for improving performance. They refer to (i) productive investment (physical capital), (ii) effective macroeconomic balances (macroeconomics for growth), (iii) upgrading of fast rising exports (non-traditional exports intensive in ‘value-added’). Naturally, the international economic architecture, with its procyclicality and biases in favor of richer countries, has been part of the problem, but here we will focus on domestic policies.

### 1. Insufficient productive investment

One of the areas where the reforms have performed more poorly is that of investment in generating productive capacity. Productive investment or gross capital formation (GKF) includes equipment and machinery, infrastructure, commercial and residential building. In the 1990s, Latin America invested five points of GDP less, on average, than it did in capital formation in the 1970s, and just one percentage point more than in the 1980s of the “lost decade” (see figure 1).

Figure 1.

Not all GKF has been low. In general, it was vigorous in the production of exportable goods and services. That contributes to explain why the volume exports grew 8 or 9% per year. But the rest of GDP -that is, about of 85% or 6/7 of GDP- was stagnant and with notably low GKF. As a consequence, a higher investment ratio in non X-GDP is one key factor missing in the production function. An “unfriendly” domestic macro environment appears to be a crucial factor explaining that insufficiency of capital formation (Ffrench-Davis and Reisen, 1998); the “unfriendliness” is associated to persistent boom-and-bust evolution of the aggregate demand (see figure 2) and strongly cyclical behaviour of capital flows (see figure 3), and to “wrong” macroprices (like outlier exchange and interest rates which entrepreneurs and workers face).

Figures 2 and 3.

Other relevant explanatory variable is the scarcity of the ingredients required by a productive investor. There is a need of long term financing, access to technology and capacity to absorb it, and availability of well trained labor. It is what we call *completing* factors markets, since incomplete, under-developed or inexistent markets cannot work well.

### 2. Real macroeconomic imbalances.

Latin American firms and workers have been subject to enormous instability in domestic demand, exchange rates, and interest rates. It has become a roller coaster ride, discouraging productive investment, employment and equity.

Actual experiences of frequent macroeconomic crises, now not only in LACs but also in East Asia, reflect that the widespread recognition of the importance of comprehensive macro equilibrium is not matched by a better understanding of how to achieve it. Macro instability is very costly, for growth and for equity (Rodrik, 2001). If we adopt a comprehensive definition of macro-equilibria, including the rate of use of productive capacity, we have to conclude that recovery from financial crises has been slow. We are talking of Mexico, Argentina, Korea; countries praised before the emergence of the crises, as model emerging economies (EEs). In all cases, GKF has fell substantially. That leaves significant effects, for several years, on the growth of potential GDP and in the labor market. Even the Korean economy, an outstanding case of recovery of GDP, in 1998-2000, was placed in a plateau 12% below the trend GDP of the 1990s.

It is commonly argued that full opening of the capital account deters domestic macroeconomic mismanagement and encourages good macroeconomic "fundamentals". This assertion is partly true for *domestic* sources of instability, i.e., large irresponsible fiscal deficits, permissive monetary policy and arbitrary exchange rate overvaluation. However, lax demand policies or exchange-rate overvaluation tends to be encouraged by financial inflows during booms, whereas excessive punishment during crises may actually force authorities to adopt overly contractionary policies (Ffrench-Davis and Ocampo, 2001). Contrary to what is usually argued, this is not associated to inappropriate information. Indeed, even well informed market actors, such as credit rating agencies or investment banks, usually operate in a procyclical fashion because of the nature of their rewards and time horizon intrinsic of their job description.

Actually, the opening of the capital account may lead EEs to import external financial instability, with capital inflows leading to a worsening of macroeconomic fundamentals. In fact, the market may induce deviations of macroeconomic variables from sustainable levels: it is the market itself which, during financial booms, generates incentives for EEs to enter the *vulnerability zones* of appreciated outlier ER, high external deficits, stock market and real estate bubbles, large stock of short-term and liquid external liabilities.

Financial operators, perhaps without wishing to do so, they have come to play a role that has significant macroeconomic implications. With their herd-prone expectations, they have contributed to intensify the financial flows towards "successful" countries during capital surges, thus facilitating rapid increases in prices of financial assets and real estate, and sharp exchange rate appreciation in the recipient markets. Apart from the poor quality of prudential regulation and supervision in these markets, these macroeconomic signals contribute to prolonging a process that appears, wrongly, to be efficient and sustainable (in the short run, with good profits and loan guarantees, supported by high stock prices and low value in domestic currency of debt denominated in dollars). But in reality bubbles are being generated with outlier macroprices, which sooner or later, will tend to bust. Moreover, the typical situation has been that gradually the cost of external financing has fell (and risk rating grades improved) during the boom period, which implies that the market actually operates with a sort of a downward sloping mid-run supply of funds.

There is a consensus that "fundamentals" are essential. However, there appears to be wide misunderstanding about what is an adequate definition of "sound fundamentals". The inappropriate conventional definition, together with "irrational exuberance", is what led to high positive grades for Chile just before the crisis of 1982, to Korea and Thailand in 1996, and to Mexico and Argentina in 1994, and to all EEs in Latin America in 1996-97. Something "fundamental" was thus missing in markets evaluation of "market fundamentals"! Obviously, the sharp crises of those EEs were not pure cronyism or moral hazard or pure contagion. It was the result of a worsening of some crucial components of a comprehensive set of fundamentals, a worsening led by massive capital inflows.

An appropriate definition of fundamentals should thus include -alongside low inflation, balanced fiscal accounts and dynamic exports-, sustainable external deficits and net debt, low net liquid and short-term liabilities, non-outlier real exchange rates and strong prudential regulation, supervision and transparency of the financial system.

These facts imply that there is a need to establish a comprehensive set of *prudential macroeconomic policies* in EEs, but also there is an urgent need to reform the architecture of the international financial system (Ocampo, 2001).

### 3. *Export upgrading and productive linkages*

Exports quantum of LACs was dynamic in the 1980s and 1990s, growing much faster than world trade. But GDP growth has been low and external sector imbalances frequent.<sup>1</sup> How can we enhance the linkages of exports with the rest of the economy ?

Exports have grown vigorously, but with a low value-added over the natural resources content. Additionally, destination has been mostly to non-dynamic and fluctuating markets. This is the result of not being concerned about the level and stability of the exchange rate and the set of factors behind productive development or systemic competitiveness.

Exports have had unstable prices (we know with certainty) and (presumably) they have weak linkages with the rest of the economy (non X-GDP). There is a role for i) the level and stability of the real exchange rate (ER), ii) a sustainable macro for growth, and iii) for factor market completion in enhancing productive linkages. We know that ER instability deters non-traditional exports, and, hence, diversification. A fully free exchange rate will tend to be very unstable in a world of terms of trade instability and volatile capital flows: derivatives are not of much help in face of processes of capital surges.

There are lessons from East Asian success in export dynamism-cum-growth of non X-GDP. Present rules of the WTO pose serious obstacles to replicating their success: for instance, Chile has had to eliminate a market-based, transparent, efficient incentive to non-traditional exports, because of the new rules governing international trade. How the Uruguay Round reform should be reformed ?

There is a role for regional trade agreements (RTAs) in increasing the quality of exports. The composition of intra-regional trade is notably different to that of the rest of exports of LACs. A lot of research from ECLAC and IDB suggests that RTAs are performed in an environment of *open regionalism*. As a matter of fact, intra-regional exports grew in 1990-98 (before the East-Asian contagion) very fast, but extra-regional trade also expanded and with a gross income elasticity of 2. This last coefficient is a signal of *open regionalism* at work. However, trade of LACs is low (about 1/6 of value added or regional GDP); as said, reciprocal trade is rising fast but still was just 1/4 of the total (now fell to 1/5). So, in all, we are talking of about 4% of GDP. As a consequence, for overall economic growth, it is very crucial what happens with the rest of the economy. The actual effectiveness of productive linkages is much related with systemic competitiveness of non tradables and importables, and with the macroeconomic environment.

#### 4. *Closing remarks*

*Reforms to the economic reforms*, that preserve achievements at the same time as they correct the most severe failures, are crucial. Changes must build on what we have, improving it. The changes required include:

- a) Macroeconomic reforms to achieve more sustainable equilibria, discourage excessive borrowing, control the external deficit, and avoid exchange rate appreciation during next capital surges. Some crucial ingredients are (i) countercyclical regulation and supervision of the financial system, (ii) establishing strongly countercyclical fiscal policy, (iii) return to intermediate managed flexibility of exchange-rates, and (iv) prudential regulations of capital flows.
- b) Systematic efforts to complete factor markets (labor training, technology, long-term financing ,

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<sup>1</sup> Most trade reforms in the 1990s were performed with exchange-rate appreciation. Several trade reforms were implemented in periods of capital surges to developing economies.

- infrastructure); all are policy variables related to systemic competitiveness. Two strategic ingredients are (i) making systematic efforts to develop long-term segments of the capital markets, improving notoriously the access of small and medium-sized firms, and (ii) comprehensive national programs of labor and entrepreneurial training and technological spreading.
- c) Upgrading the quality of exports and their linkages with the domestic economy. Latin America is capable of achieving all this, with a pragmatic approach away from ideologic neoliberalism.

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**Table 1**  
**Latin America: Gross Domestic Product, 1971-2002**  
**(annual growth rates, %)**

	1971-80	1981-89	1990	1991-94	1995	1996-97	1998-2002 <sup>a</sup>	1990-2002 <sup>a</sup>
Argentina	2.8	-0.7	-2.0	8.0	-2.9	6.7	-3.3	1.7
Brazil	8.6	2.3	-4.6	2.8	4.2	2.8	1.7	1.9
Chile	2.5	3.0	3.3	7.4	9.0	6.8	2.3	5.2
Colombia	5.4	3.7	3.2	3.9	4.9	2.6	0.4	2.4
Mexico	6.7	1.5	5.1	3.5	-6.2	6.1	3.2	3.1
Peru	3.9	-0.7	-5.5	4.9	8.6	4.6	1.6	3.0
Uruguay	3.0	0.0	0.4	5.6	-2.3	5.2	-2.8	1.7
<b>Latin America (19)</b>								
<b>Total</b>	<b>5.6</b>	<b>1.3</b>	<b>-0.6</b>	<b>4.1</b>	<b>1.1</b>	<b>4.4</b>	<b>1.2</b>	<b>2.4</b>
<b>Per capita</b>	<b>3.1</b>	<b>-0.8</b>	<b>-2.5</b>	<b>2.3</b>	<b>-0.6</b>	<b>2.8</b>	<b>-0.4</b>	<b>0.7</b>
<b>Per worker</b>	<b>1.8</b>	<b>-1.6</b>	<b>-3.4</b>	<b>1.4</b>	<b>-1.6</b>	<b>1.8</b>	<b>-1.3</b>	<b>-0.2</b>

Source: ECLAC, expressed in US dollars at 1980 prices for 1971-80, at 1990 prices for 1980-89, and at 1995 prices for 1989-2002. <sup>a</sup> Preliminary data for 2002.

**Table 2**

Latin America: selected social indicators , 1990-2002

	Poverty <sup>a</sup>		Real wages <sup>b</sup>	Urban Unemployment <sup>a</sup>
	% population	Population (million)	(average annual change)	(% of labor force)
1990	48.3	200.2		5.8
1994	45.7	203.2	0.7 <sup>c</sup>	6.3
1998	43.5 <sup>c</sup>	203.8 <sup>c</sup>	0.6 <sup>f</sup>	8.0
2002	43.0 <sup>d</sup>	214.3 <sup>d</sup>	-0.4 <sup>g</sup>	8.9

Source: Author's calculations and official ECLAC data.

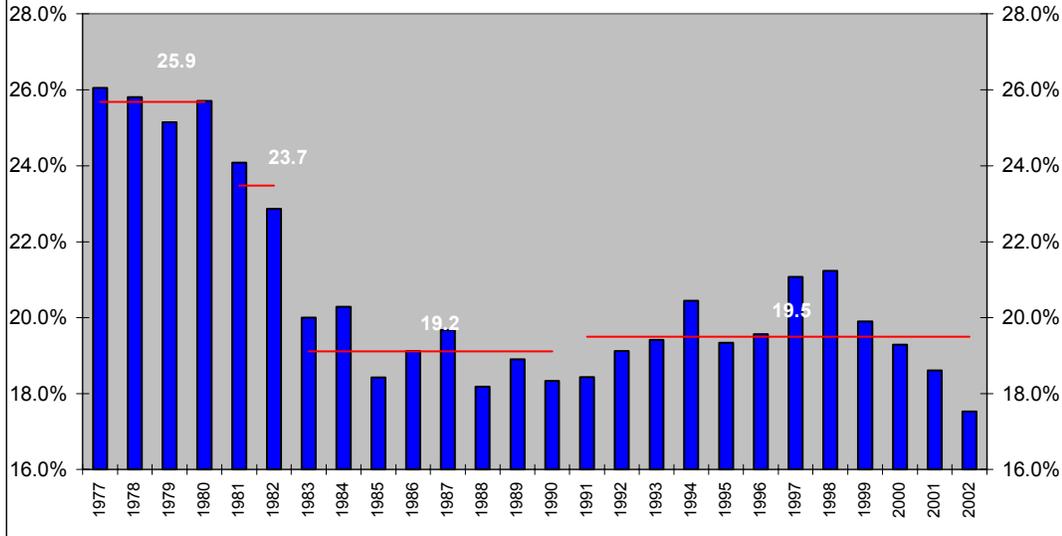
<sup>a</sup> 19 Latin American countries.

<sup>b</sup> Rates of change of 14 countries (94% of Latin American Labor force), weighted by Labor force.

<sup>c</sup> 1997. <sup>d</sup> 2001.

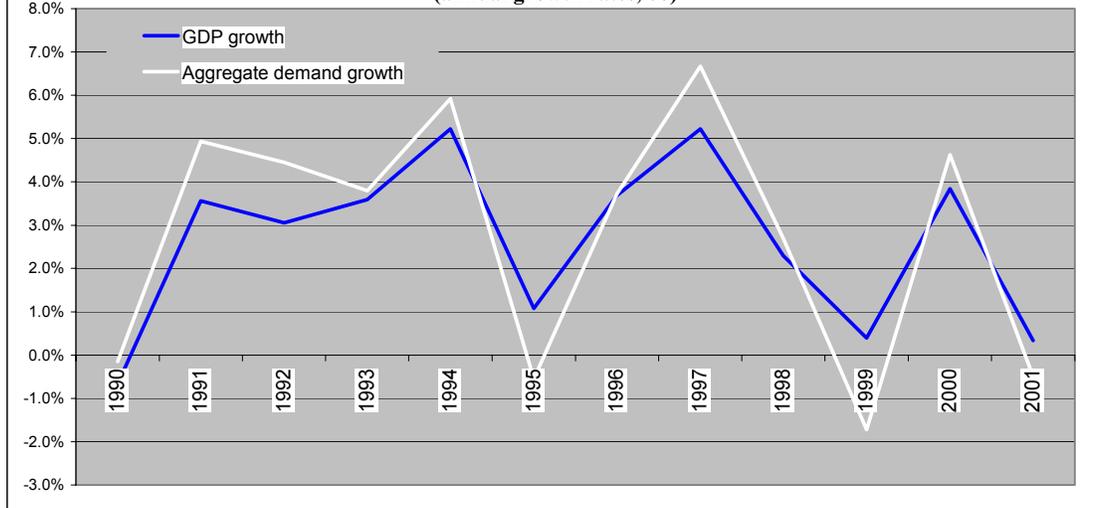
<sup>e</sup> Annual average rate 1990-94. <sup>f</sup> Annual average rate 1995-98. <sup>g</sup> Annual average rate 1999-2002.

**Figure 1**  
**Latin America: Gross fixed investment, 1977-2002**  
 (% of GDP)



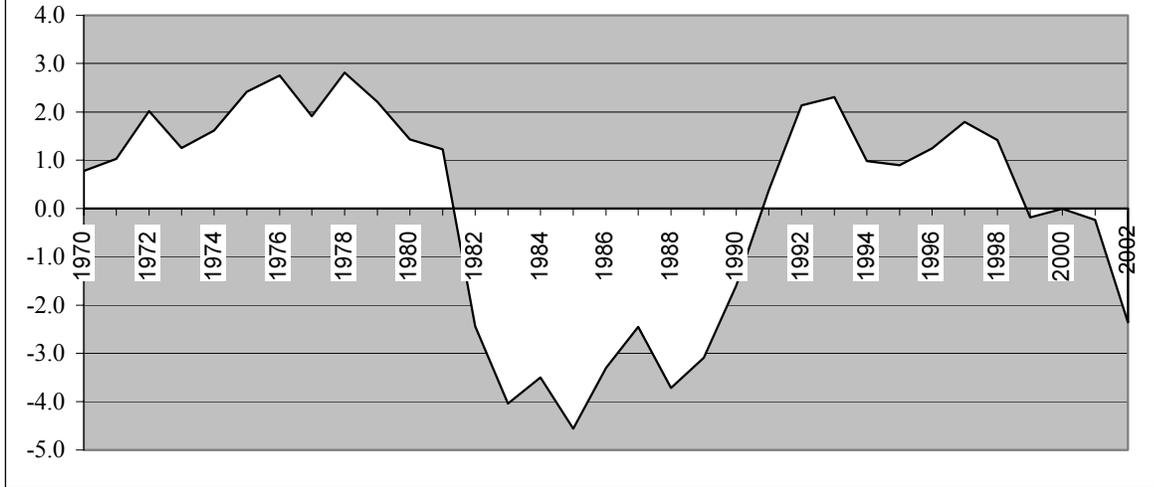
Source: Based on ECLAC figures for 19 countries, scaled to 1995 prices.  
 Preliminary data for 2002.

**Figure 2**  
**Latin America (20): GDP and aggregate demand, 1990-2001**  
 (annual growth rates, %)



Source: ECLAC, based on official figures in constant 1995 dollars.

Figure 3  
Latin America: Net Foreign Transfers, 1970-2002  
(% of GDP)



Source: ECLAC.

Net Foreign transfers are equal to net capital inflows minus net factor payments (interests plus profit remittances).