

George Irvin\*

## ***The Washington Consensus: Plus ca Change***

### **Intro:**

1. Everybody here has heard of Washington Consensus (phrase coined by John Williamson in 1990). The WC is based on: cutting state expenditure, privatisation, and deregulation.
2. We now speak of PWC (post-Washington Consensus) in which mainstream economists express qualified contrition for IMF sins, while WB now focuses on PRSPs (Poverty Reduction Strategy Papers) and participation.
3. Today, the Fund has a new Managing Director, Horst Koehler. Much is made of the WB & IMF's new transparency, co-operation with NGOs and civil society, the need to halve poverty by 2020, the new Poverty Reduction Facility (Millennium Development Goals) etc.
4. This is all doubtless a 'good thing', but I remain unconvinced. Exercises such as bringing the NGOs into Participatory Poverty Assessments, creating Millennium Development Goals, New Economic Partnerships and seem little more than sweeteners to help the medicine go down. Although HLSS and Poverty incidence data are vital in the poorest countries, only 26 countries have so far qualified for HPIIC debt relief, and even these have only had just over half their debt relieved----conditional on meeting traditional IMF goals of privatisation, liberalisation and wage market flexibility. Moreover, PR only makes sense within the perspective of a growth-orientated strategy. The IMF has had little to say about rich-country contributions to a poor-country growth strategy. Most talk of 'new financial architecture' has now vanished. With the collapse of the Cancun trade talks (a necessary part of the Doha round), the WTO is now deadlocked. Ann Krueger has replaced Stan Fischer at IMF, while at the WB much IDA funding has shifted to IDC.

PWC: In early 1998 Stiglitz signalled the need to move towards a PWC. As has been pointed out by Fine and others, the WC was already looking threadbare after a decade of debate over the Asian Miracle (WB), the 'developmental state' (Wade et al), 'getting prices wrong' (Amsden), the foolishness of Big Bang in Russia (Sachs's conversion) and so on.

PWC: has been criticised by various authors as ignoring sustainability (Gore), being intellectually non-rigorous, failing to address fundamental principles of distribution of wealth and power (Standing), and being all about 'getting institutions right' and similar to North's new institutional economics (Fine). Hence the need to move beyond it.

**Key question:** has WC really been defeated? Is US not reasserting neo-liberal paradigm (with a few good governance twists) as having universal validity?

**WB Chief Economist:** after Stiglitz, Nick Stern until this year (2003); now replaced by the Francois Bourguignon who has worked on poverty & relative deprivation

**A point on terminology:**

The terms 'market fundamentalism', 'neo-liberal policies' and 'Washington consensus policies' are today used nearly interchangeably.

---

\* George Irvin is UHD Professor of Economics at ISS, The Hague.

4. Below I want to do two things:

- a. Look at economic logic of traditional IMF measures in highly simplified economic terms;
- b. Given time, review some recent historical experiences; ie, the 2002 Argentinean fiasco.

### Logic of WC IMF Policy:

1. Prior to the early 1980s, most dev econ argued that the key problem was K and FE shortage to be overcome by 'aid' (Chenery & Gappery). What measures are involved in the neo-liberal WC:
  - Fiscal discipline: stabilising the macro-economy chiefly by cutting Govt expenditure thus fighting inflation; tax reform to broaden base and lower marginal rates;
  - liberalisation of prices and markets: ie, 'freeing' capital markets, letting i-rts (interest rates) float and making labour markets 'more flexible', chiefly through 'supply side' measures
  - trade liberalisation: dismantling tariffs
  - exchange rate liberalisation (though more recently use of currency peg)
  - streamlining Government (as above), mainly by privatising everything that can be privatised;
  - In summary: **Fiscal austerity, Liberalisation, Privatisation,**
  
2. There are several heuristics for examining IMF prescriptions, of which the most useful starts looks at the relationship between the so-called savings balances derived from simple Keynesian definitions (slide 1). I do not propose to examine the Polak model, except to say that it underlies the IMF's strong emphasis on fiscal austerity (usually at the expense of growth).

#### **Polak Model:**

The theoretical underpinning of the IMF's 'financial programming' is provided by the 1957 'Polak Model'. This very simple model in which exports and the exchange rate are exogenous contains one 'real' endogenous variable (imports) plus some simple monetary flow and stock variables.

In its 'monetarist' (MAB) version the model says: Reduce domestic credit → money supply drops → inflation and nominal Y falls → imports fall → external equilibrium achieved;

Good simple summary is:

<http://www.cebr.dk/upload/lecturenote2.pdf>

Nat Y identity:  $Y = C + I + G + (X-M)$

Disposition of Y identity:  $Y = C + Sp + T$

gives:

$$C + Sp + T = C + I + G + (X-M)$$

Cancelling the Cs and rearranging:

$$(Sp - I) + (T - G) = (X - M)$$

where:

( $Sp - I$ ) is private savings and investment;

( $T - G$ ) is the Govt current surplus or deficit;

( $X - M$ ) is a simplification of the CA balance

For the IMF, the **main cause** of a CA deficit (which is why countries have to go to the IMF in the first place) is a Govt deficit. To see this, let us assume  $Sp = I$ ; then is  $(T - G) =$  (say)  $-100$ , it follows logically that  $(X - M) = -100$ .

**Simple conclusion:** to cure a major CA deficit, either increase T or reduce G. (But T difficult to increase, so only cutting G will stabilise economy in short term)

### 3. More detailed conclusion:

Operate on other variables:

- ↑**Sp**: improve financial sector intermediation (end 'McKinnon-Shaw financial repression) thus enabling Sp to rise;
- ↓**G**: - a good deal of G is soaked up by subsidies to 'inefficient' PS enterprises; these should be **privatised**;  
- moreover, reducing G takes pressure off Government financial borrowing requirement (**PBR**), thus enabling i-rts to fall and reducing 'crowding out' of private Investment
- ↓ (**X-M**): end trade distortions, thus enabling switch of resources from non-traded to traded sector. In some cases, devalue---although IMF tends to believe in 'exchange rate anchor' as a bulwark against inflation

### 4. Foreign Savings:

How does international capital market fit into this picture? Traditionally, once a country had 'sanitised its public finances' and been given the IMF's Good Housekeeping Seal, it could resume borrowing (both from IFIs and private sector banks). **Borrowing means being able to finance a CA deficit (see next slide).**

The main threat to a country attempting to 'go it alone' without the IMF is that their access to all forms of foreign capital (including the WB) will be cut off.

**Today**, private capital flows have increased dramatically (world K-markets turns over \$1.6 trillion daily!). Liberalising an LDC's capital markets means potentially accessing a lot of investor's money. But to understand why 'hot money' is a mixed blessing, we first consider the spectrum of capital inflows from long to short-term. Broadly speaking, 'the shorter, the hotter'. (slide 2).

### 5. Cases:

Over the past decade, as many major financial crises have occurred: some – arguably, were aggravated by IMF (or IMF style) policies; eg,

UK (1992)  
Mexico (1994-95);  
Argentina(1995);  
Thailand (1997)  
Indonesia (1997)  
S Korea (1997)  
Malaysia (1997)  
Philippines (1997)  
Russia (1998)  
Brazil (1999, 2001)  
Ecuador (1999)  
Argentina (2001-2)  
Turkey (2002)  
EU (2003)

**In East Asia alone**, IMF-style policies led to falls in 1998 GDP of 14% in Indonesia, 10% in Thailand and 6% in S Korea; unemployment rose and real wages fell (-6% Korea; -7% Thailand; -38% Indonesia). In all cases the IMF prescription was the same; higher interest rates and rigid budgetary austerity. True, Thailand had a large external deficit and Thai banks had borrowed in dollars and lent in baht; when foreign investment dried up, the baht was forced to float---but the budget deficit was not large, and demanding a budget surplus plunged the economy into recession. In Korea, the internal and external balances were perfectly sound!

## 1. Spectrum of K-Flows



**Long-term:** DFI: **Direct Foreign Investment** (typically in bricks & mortar); can be wholly owned subsidiary, joint venture, management contract, etc.

### Short-term:

- **Portfolio investment** is essentially investing in stocks & bonds of host country;
- **Money market investment** is investing in short-term private or public paper, or simply placing money on deposit account drawing high i-rate. Such money is called 'hot money' because it can flow out as quickly as it flows in.

### Foreign Savings:

In slide 1 we saw:  $(Sp-I) + (T-G) = (X-M)$

Rearranging we get:  $I = Sp + T-G + (M-X)$

$Sp$ : **domestic private savings**

$(T-G)$ : if the term is positive, this is **government**

### savings

$(M-X)$ : if  $(X-M)$  is negative (as we assumed), the  $(X-M)$  must be positive; this is called **Foreign Savings**, sometimes represented by letter F.

## Implications for Policy

1. Opening up the K-markets of the large developing countries to International Private Finance has become a strategic aim of IMF policy; the stakes in China, SE Asia and parts of LA are enormous;
2. 'Market credibility' has become increasingly important; if markets no longer 'believe' in sustainability of macroeconomic policy (eg, Mexico 1995), a capital outflow will ensue---resulting in a self-fulfilling prophesy.
3. The greater the capital flows involved and the more 'liberalised' the markets, the greater the threat of instability. 'Hedge funds' are merely very heavily leveraged private capital funds engaged in betting on currency movements; as such, they help spread 'contagion'.
4. The IMF has in several cases engaged in massive bailouts (rather than let exchange rate collapse) chiefly to ensure that foreign investors could get their money out;
5. 'Fiscal austerity' (what the IMF calls 'financial programming') is not part of some plot designed to keep the poor impoverished; it has become a vital tool in helping to convince international financial markets that unstable countries will become stable----unfortunately the cost of IMF-induced recession is often very high.
6. Much was made of 'cronyism' and 'moral hazard' in banking as an explanation for E Asian crisis (ignoring the financial bubble in the USA). Fiscal austerity and high i-rt's lead to corporate bankruptcy---and the collapse of one company has a knock-on effect. Loans go bad (become 'non-performing') and banks increasingly reluctant to lend. The extreme case is Japan where a decade of stagnation has led to 'deflationary expectation'.
7. As companies collapse and governments are forced to privatise, international mergers and acquisitions increase; eg, GM buys Daewoo and so on. After 1997, there was an understandable (if sometimes paranoid) suspicion in Asia that IMF had acted to pry open Asian economies for US capital.
8. The 'least exposed' countries have been those such as China, Vietnam and Malaysia which have refused to fully liberalise their financial system; by keeping some measure of control over international K-flows, they have been least vulnerable to speculative attack.

## A brief case study: Argentina (slide 3)

### Slide 3

#### Argentina's Crisis in Brief:

- in 1991 after the 1989 hyperinflation, Argentina (backed by IMF) adopted a currency board (hard peg) to dollar, making peso convertibility fixed at 1:1 in the belief that this would end speculation; Argentina's trade with US is only about 12% of total
- throughout the Menen/Cavallo years it followed IMF prescriptions; privatisation of public utilities; of banks, dismantling protection and so forth
- following Asian crisis of 1997-98, Argentina's exports lost competitiveness as dollar rose and Brazilian real fell; growth stagnated, external borrowing rose and interest rates went to 20%; De la Rúa comes to power in 1999;
- internally, Argentina hoped to get IMF loan by following austerity programme; fiscal contraction and interest rate hikes forced recession, producing growing unemployment; world slowdown of 200-01 made things worse; public anger rose;
- April 2001: Cavallo returned as Finance Minister, Sept 2001 IMF refuses further lending and Argentina defaults on most foreign debt; Dec 2001 'corralito' deposit freeze introduced; run on banks followed; rioting and trashing of supermarkets; several changes of President (Duhalde emerges in Jan 2002); floating of currency which destroyed middle-class savings (oligarchy had already sent savings abroad); crisis goes on, IMF refuses bail-out; Argentina defaults on WB debt. May 2003: Kirchner elected
- today: Sep 2003 new \$21 bn pgme with Fund requires primary budget surplus of 5%; but unemployment 25%, GDP has fallen 15% pa (03Q1, Q2) ; a quarter of all children suffering from malnutrition etc.
- **conventional explanation:** stresses failure of Govt to establish fiscal balance earlier (cutting provincial spending); non-prudential banking regulations which allowed loans to non-traded goods sector ever as RER rose, and failed to provide banking insurance; increasing reliance of public finances on domestic markets drove up interest rates thus compounding internal debt burden; by 2000 peso was already greatly overvalued and crisis of confidence loomed; Carvalho's 'heterodox' policies and sacking of Central Bank president worsened situation. Argentina should have dollarised which (as in Ecuador) stopped the run on banking system; instead, pesification nearly destroyed banking system.
- **alternative view:** from the mid-90s, instead of organizing a gentle retreat from the currency board, the IMF tightened its lending terms, demanding increasingly draconian measures. That is, until the population rose up against insane austerity, bringing down the government; observing that their prescription had just about killed the patient, the free-trade doctors recommended doubling the dose. More "structural reform," less social protection, this time an almost total dismantling of the Argentine welfare state, and handing over all autonomy to international bankers.

### General points:

1. **In past decade, there has been growing chorus of opposition to IMF-style policies and ‘market fundamentalism’** sometimes attributed to certain high-profile individuals (eg, Joe Stiglitz and George Soros in ‘The Crisis of Global Capitalism’). Soros is one of the growing number of advocates of some form of ‘Tobin tax’. **Contrary to those who argue that a PWC has been established and needs to be rejected/amended, my own suspicion is that the WC is alive and well.**
2. **Economic discourse has slipped into pre-Keynesian mode:** the IMF neo-liberal language of fiscal austerity, privatisation and deregulation (strongly influenced by US Treasury doctrine) is not merely used in ‘letters of intent’ with LDCs but has now spread to all parts of the globe. Thus, Eurozone countries are forced to follow fiscal orthodoxy (SGP) despite a decade of stagnation, in the process **greatly damaging the EU ‘social market’ model.** Gordon Brown boasts that Britain’s orthodoxy (rules based monetary policy, labour market deregulation) explains its success. Japan is still in recession, and the US threatens EU and China with competitive devaluation.
3. The **political mirror-image of IMF orthodoxy** is the widely-held belief in the universality of the Anglo-Saxon model of free-market capitalism. See for example Phillip Bobbitt’s ‘Shield of Achilles’ for the argument, in essence, that the ‘nation state’ is being replaced by a ‘market state’ with the minimalist function of guaranteeing property rights and a legal and judicial framework. The alternative is argued, *inter alia*, in John Gray’s ‘False Dawn’

### Readings & Resources:

Bobbitt, Phillip (2003) ‘The Shield of Achilles; War, Peace and the Course of History’, London: Anchor Books.

Eiras, Ana and Brett D. Schaefer ‘Argentina's Economic Crisis: An "Absence of Capitalism"’ Backgrounder #1432; Washington DC: The Heritage Foundation

Gray, John (2002) ‘False dawn: the delusions of global capitalism’ London: Granta.

Griffith-Jones, Stephanie (2001) ‘The Argentinean crisis: IMF must act immediately’ <http://www.ids.ac.uk/ids/news/Archive2001/Argentina.html>

Kagan, Robert (2003) ‘Paradise and Power’ London: Atlantic,

Krueger, Anne (2002) Crisis Prevention and Resolution: Lessons from Argentina Conference on "The Argentina Crisis" Cambridge, July 17, 2002

Krugman, Paul (1994) ‘Peddling Prosperity’ New York: Norton.

Roubini, Nouriel (2001) ‘Should Argentina Dollarize or Float? New York University: <http://www.imf.org/External/NP/ieo/2003/arg/>

Stiglitz, Joseph (2002) ‘Globalisation and its discontents’ London: Penguin Books.

Third World Network Home Page: <http://www.twinside.org.sg/index.htm>