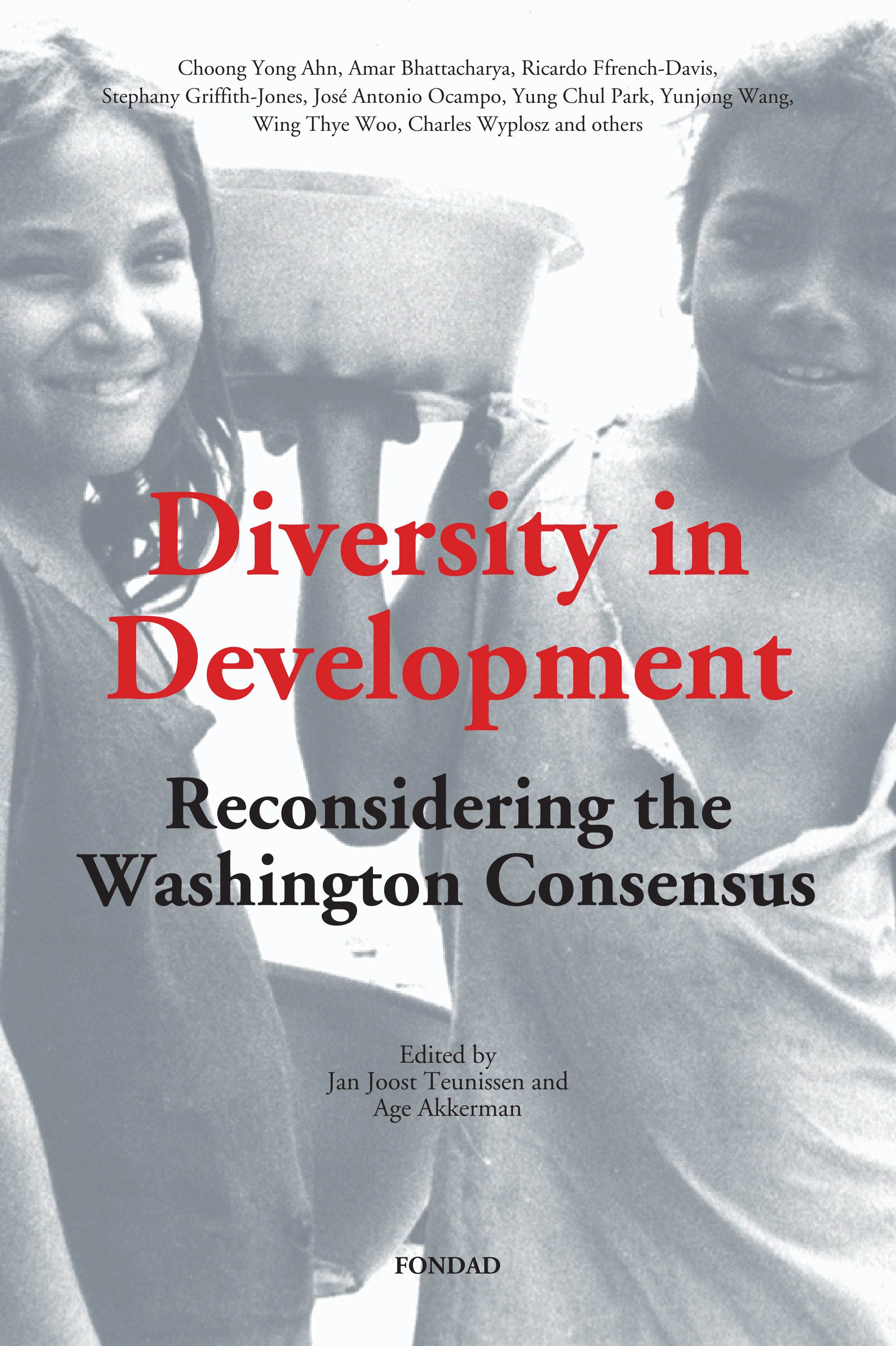

Choong Yong Ahn, Amar Bhattacharya, Ricardo Ffrench-Davis,
Stephany Griffith-Jones, José Antonio Ocampo, Yung Chul Park, Yunjong Wang,
Wing Thye Woo, Charles Wyplosz and others

Diversity in Development

Reconsidering the Washington Consensus

Edited by
Jan Joost Teunissen and
Age Akkerman

FONDAD

Forum on Debt and Development (FONDAD)

FONDAD is an independent policy research centre and forum for international discussion established in the Netherlands. Supported by a worldwide network of experts, it provides policy-oriented research on a range of North-South problems, with particular emphasis on international financial issues. Through research, seminars and publications, FONDAD aims to provide factual background information and practical strategies for policymakers and other interested groups in industrial, developing and transition countries.

Director: Jan Joost Teunissen

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Abbreviations

ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
AMS	Aggregate Measure of Support (WTO measurement of subsidy)
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South-East Asian Nations (Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam)
ASEAN+3	ASEAN and China, Japan, and Korea
BIS	Bank for International Settlements
BWIs	Bretton Woods Institutions
CAC	collective action clause
CCL	Contingency Credit Line (of the IMF)
CEPAL	see ECLAC
CEPR	Centre for Economic Policy Research
CIDA	Canadian International Development Agency
EBRD	European Bank for Reconstruction and Development
ECA	export credit agency
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
EEFSU	Eastern Europe and the former Soviet Union
EMS	European Monetary System
ERM	Exchange Rate Mechanism (European)
EU	European Union
FDI	foreign direct investment
FLACSO	Facultad Latinoamericana de Ciencias Sociales
FSF	Financial Stability Forum
FSAP	Financial Sector Assessment Programme
FTA	free trade area
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, UK, US)
G-10	Group of Ten
G-20	Group of Twenty (includes G-7 countries and a range of emerging economies)
G-22	Group of Twenty-Two (includes G-7 countries and a range of emerging economies)

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G-24	Group of Twenty-Four (includes African, Asian and Latin American countries)
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
HIPC	heavily indebted poor country
IDB	Inter-American Development Bank
IFC	International Finance Corporation (of the World Bank)
IFF	International Finance Facility (of the IMF)
IFIs	international financial institutions
IIF	Institute of International Finance
ILO	International Labour Organization
IMF	International Monetary Fund
IRB	internal ratings based
ISI	import-substitution industrialisation
KIEP	Korea Institute for International Economic Policy
LTCM	Long-Term Capital Management
MDG	millennium development goal
NAFTA	North American Free Trade Agreement
NEPAD	New Partnership for Africa's Development
NPL	non-performing loan
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
OORT	outward-oriented trade regime
PPP	purchasing power parity
PRS	poverty reduction strategy
PRSP	Poverty Reduction Strategy Paper (of the IMF)
ROSCs	Reports on Observance of Standards and Codes
SDDS	Special Data Dissemination Standard (of the IMF)
SDRM	Sovereign Debt Restructuring Mechanism
SME	small and medium-size enterprise
SOE	state-owned enterprise
SRI	socially responsible investment
TRIMs	Trade-Related Investment Measures (WTO Agreement)
TRIPS	Trade-Related Aspects of Intellectual Property Rights (WTO Agreement)
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
UNRISD	United Nations Research Institute for Social Development
US	United States
WTO	World Trade Organization

Preface

A discussion about stability, growth and the search for a new development agenda is very timely and opportune. Latin America and the Caribbean have lived through a period of deep economic reforms since the 1980s. Dramatic changes affected the action of the state and gave more room for private agents to work.

The Washington Consensus provided one of the best summations of this reform agenda, although it certainly did not reflect its most radical version, which called for a minimalist state. During the last few years, the wisdom behind this vision has been called into question.

Nearly one and a half decades of intensive and profound reforms in Latin America and the Caribbean has left a mix of successes and failures with a disappointing net outcome. The net balance, in terms of growth and equity, has been notoriously poor. Of course, there are clearly positive results in several areas: the eradication of hyperinflation, more balanced public budgets, a rise in the share of exports, less bureaucratism, and fewer centrally taken microeconomic decisions. But there is still much work to do in order to create a friendly environment for growth and equity.

Performance has been the poorest in precisely the most significant areas: economic growth and equity. In the past six years, which ECLAC has called the "lost half-decade", GDP growth was only 1.3 percent annually while population rose 1.6 percent per year, so per capita growth has been negative.

While annual GDP scarcely rose 2.4 percent between 1990 and 2003, the active population increased 2.6 percent annually; consequently, output per worker decreased in the period 1990-2003. This contributes to explaining why wages have stagnated since 1990. In terms of poverty, there are now 27 million more poor people than there were in 1990.

Distributive tensions in Latin America and the Caribbean are running high and are probably intensifying. Income disparities within countries and among countries of the region, and between developed and the least-developed countries continue to increase.

In recent studies, we identified at least four reasons why poverty has been increasing: first, low GDP growth; second, higher open unemployment; third, a low physical investment ratio (that is, productive investment) while population and the labour force keep increasing; and fourth, the underrated role of reducing the equity gaps in education, labour training and access to capital markets. The distribution of opportunities and of productivity has become even more skewed than before the reforms.

Comparative research on the effects of structural reforms have tended to confirm that economic liberalisation in the developing world has failed to generate dynamic economic growth, whereas its distributive effects have generally been adverse. Latin America, the region where reforms have gone the furthest, provides the most interesting testing ground on both counts.

We need to reform the economic reforms to preserve achievements, while at the same time systematically correct the most severe failures. I will mention five of the changes required.

The first is macroeconomic policy for growth. Macroeconomic reforms are needed to achieve a more sustainable equilibrium, functional for productive development. We need to have a broad view of macroeconomic stability and the role of counter-cyclical policies. Some crucial, strategic, ingredients for a macroeconomic policy for growth are: (i) improving counter-cyclical regulation and supervision of the financial system; (ii) establishing counter-cyclical fiscal policy; and (iii) avoiding exchange rate appreciation during the next capital surges, with an efficient prudential regulation of capital flows.

The second is completing factor markets. We must improve systematic efforts to complete factor markets (labour training, technology, long-term financing, and infrastructure); all are policy variables related to systemic competitiveness. One strategic ingredient is making effective efforts to develop long-term segments of the capital markets, improving the access of small and medium-sized firms. Macroeconomic policies are not enough, so there is an urgent need to strengthen productive development strategies through active public policies.

Third is upgrading the quality of exports and their linkages with the domestic economy. Crucial ingredients include sustaining real macroeconomic balances (including, notably, a stable real exchange rate) and completing factor markets. There are severe flaws in the actual design and implementation of the Washington Consensus.

Making sustainable development an integral part of production strategies is the fourth change. The effective incorporation of the sustainable development agenda is an additional demand being placed on production strategies today. Indeed, the degree of environmental degradation generated by developing countries at intermediate or even low stages of development indicates that sustainability is hardly a luxury that can be postponed. This objective requires much more than conserving the natural resource base. In essence, it calls for the mobilisation of investment in dynamic production sectors that use clean production methods and technologies, and in which competitiveness is achieved through the accumulation of capital in the broad sense of the term (i.e. human, social, physical and natural).

Fifth, we need to improve social linkages. Social policy should be guided by three basic principles: universality, solidarity and efficiency.

To achieve these objectives, Mr. Ocampo, United Nations Under-Secretary-General for Economic and Social Affairs, reviewed some of the basic concepts underlying the call for a new development agenda in a recent paper on "Rethinking the Development Agenda". He stated that there are two intersecting themes that should be analysed. The first is the call for a new balance between the market and the public interest. Greater attention must be paid to equity, social cohesion and sustainable development as the main areas where a new balance of this sort should be struck. The second theme is that, rather than being restricted to state actions, the concept of public policy should be understood as any organised form of action that pursues objectives of collective interest. This definition of public policy is in keeping with an awareness of the need to build strong civil societies and to work to overcome a crisis of the state that affects the developing world and, indeed, the world at large. It thus aims at correcting both "market failures" and "government failures" and, more generally, at building and rebuilding institutions and organisations.

I believe that this book brings forward important insights about where to go and how to design a new development agenda.

Alicia Bárcena
Deputy Executive Secretary
ECLAC

1

The Need for Visions on the Economy: By Way of Introduction

Jan Joost Teunissen

> *"In every scientific venture, the thing that comes first is Vision. That is to say, before embarking upon analytic work of any kind we must first single out the set of phenomena we wish to investigate, and acquire 'intuitively' a preliminary notion of how they hang together or, in other words, of what appear from our standpoint to be their fundamental properties. This should be obvious. If it is not, this is only owing to the fact that in practice we mostly do not start from a vision of our own but from the work of our predecessors or from ideas that float in the public mind."*

The citation above is from Joseph Schumpeter's *History of Economic Analysis*, a book that is as interesting to read today as it was when it first was published by Oxford University Press in 1954.

We are living in a paradoxical world. According to many economists (and others), the fall of the Berlin Wall ushered in a non-ideological world based on sound economics. Other economists believe, however, that today's world is still highly ideological (with neo-liberalism as one of its major forces) and based on biased rather than sound economics.

This book discusses a specific set of policies, known by the shorthand phrase "Washington Consensus", which advocates a dominant role for markets both domestically and internationally. This "consensus" claims to provide "generally accepted" economic principles for achieving stability and growth in developing countries.

The book provides analyses of underlying assumptions and outcomes of development strategies applied over the last twenty-five years

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and raises the important question of what policies would work best today in Asia, Latin America and Africa by following – or not – the recipes of the Washington Consensus. The book also provides analyses of ways to increase financial stability beyond the Washington Consensus by focusing on innovative and practically applicable policies at both the national and international level. Paying attention to international measures is particularly welcome since policymakers often lack the political will to discuss what needs to be done at the global level. And in the rare occasions they do discuss it, they often lack the perseverance and domestic support to implement what has been agreed upon internationally. In brief, the book provides analyses of what is right and what is wrong with the policies prescribed by the Washington Consensus.

Following the tradition of FONDAD publications, this threefold challenge is addressed by both critics and advocates of the Washington Consensus. The contributors include high-level officials of the World Bank, WTO, IMF, United Nations and other organisations, former ministers and central bankers, as well as professors of economics from Asia, Latin America, North America, Africa and Europe.

Economics Is a Social, Not a Natural Science

Possibly as a result of economic jargon, mathematical formulae and impressive economic authorities, it is often forgotten that economics is, like psychology, sociology or anthropology, a social science and thus deals with a reality that is shaped by the "subjective" human mind – as opposed to the "objective" physical matter of the natural sciences. As a consequence of this subjective character, everything in economic life is affected by how people think and act and thus by psychological, biological, political, cultural, economic and social factors. Herding behaviour among investors resulting in speculative attacks against a country's currency is an outstanding and obvious example, but more generally, it can be observed that all economic activities are moved by habits, desires, expectations and ideologies as much as any other "normal" human activity.

It is natural that in formulating their theories and policy suggestions, economists make assumptions about economic "rationalities" of human activities and institutions, and about political "realities". However, in making such assumptions, it becomes necessary to discuss and make explicit what is taken for granted and recognise the fundamentally disputable character of economic analyses and policy recommendations.

Often this recognition is missing in debates among economists, and, what is worse, among politicians who apply the economist's advice as if it were solidly based on indisputable wisdom of economic science.

Normally, the economist's prescriptions are discussed by fellow economists. This is a useful discussion. But an even more useful discussion would be to popularise economic ideas and involve all agents and subjects of economic policies: politicians, union and business representatives, and other organised citizens. To use a fashionable term, "civil society" should be involved in economic debates, from the beginning until the end since they are both the subjects and objects of economic policies.

Ideally, democracy serves as a mechanism for discussing proposed economic policies. In practice, however, economic policies are seldom discussed by civil society. And, what is worse, the alternative economic policies suggested by the "non-business" or "non-technocratic" segments of civil society are generally dismissed by the policymakers as "non-feasible" or "wrong". Usually, this is done by arguing that laymen lack the economic insights of the professionals or simply do not understand basic economic principles.

Economists performing public duties such as ministers of finance or central bank governors sometimes take this line of defense against alternative policies that do not concur with their own philosophies. Such attitude reminds me of doctors who dismiss the patient's opinion as "unprofessional". Both doctors and economists would gain in knowledge and respect if they listened more carefully to what their "patients" have to tell them – obviously, without any need to "accommodate" their views to what the "patient" would like to hear.

In reading the chapters that follow you may wonder: Who is right, the critic or the advocate of the Washington Consensus? It is up to you to decide, but I would not be surprised to hear that some of you strongly agree with what the critics have to say while others equally strongly disagree and endorse, instead, the advocates' views.

Such disagreements corroborate my point: economic views and statements should be subject to debate – all the time.

The Need for Divergence of Visions and a Truly Democratic Debate About Economic Policies

A few years ago, I read an interesting speech by Roy Culpeper, experienced economist and president of the North-South Institute in Ottawa, Canada's independent, non-governmental research institute focusing on international development.[1] He said that it was ironic that the IMF was stimulating a democratic discussion about economic policies in poor, autocratic, developing countries, while such a discussion was virtually lacking in most or all of the developed, rich countries. The way the IMF is stimulating this discussion is that it requests governments of poor countries to draft so-called Poverty Reduction Strategy Papers (PRSPs) on the basis of careful consultations with their populations. Such drafting is, says Culpeper, also ironic since it brings back the concept of planning, "planning from below".

But it is even more ironic than what Roy Culpeper says. I happen to have inside knowledge of a developing country that, some 30 years ago, made an effort to carefully consult with its population and engage in "planning from below" and this effort was not particularly welcomed by the IMF and other financial institutions in Washington and elsewhere. I lived in Chile in 1973 and became aware of the orchestrated national and international campaign of "Washington-inspired" forces against the democratic government of Salvador Allende. This campaign contributed to economic and political destabilisation in Chile, the military coup of September 11th, 1973, and the ensuing 17 years of brutal dictatorship.

Would it be desirable to replace the Washington Consensus with a "Santiago Consensus", named after the city where the conference was held from which this book emerges? While I initially thought so, on second thought, I said to myself that the objective should not be the replacement of one consensus by another, but rather the replacement of the call for consensus with the recognition of diverging views or, if you wish, the call for non-conformity.

A meaningful and democratic consensus requires that policy plans be developed and proposed based on clearly defined and debatable (indeed, "debatable", by definition, I mean, depending upon each and every citizens' vision of man and society) economic ideas. Divergence of ideas, or, to use Schumpeter's words, divergence of Visions (indeed, why not with a capital 'V'?) is indispensable.

Economists have the challenging task of making existing Visions explicit and of developing new Visions. Only then can there be a truly democratic debate about economic policy alternatives. Therefore, I would welcome that economists at the IMF, World Bank, WTO, UN

[1] Roy Culpeper, "Development Economics: a Call for Action", Paper presented at the UNRISD Conference on The Need to Rethink Development Economics, Cape Town, 7-8 September 2001.

organisations, central banks, ministries of finance, research institutes, media and other organisations engage themselves more actively, or more visibly, in developing ideas not only about the world they would like to live in, but also about the world that others would like to live in.

And what is the task of "the laymen"?

In my view, they should involve themselves more actively in economics. Not only should they discuss what the economists are analysing and prescribing, but they should also envision the economic world in which they would like to live. Paraphrasing the famous French minister of war, Georges Clemenceau: 'Just as war is far too serious a thing to be left to the generals, the economy is far too serious a thing to be left to the economists.'

Among the laymen, psychologists, historians, political scientists, sociologists etc. – the economists' colleagues in social science – have a special responsibility. Since they, the psychologists *et al.*, are just like economists, trained to think about human behaviour, in both its individual as well as collective forms, their insights are indispensable.[2] Mutual interest in each other's viewpoints and analyses and more interaction between social scientists would considerably increase the quality of analysis of society and, thus, the quality of economic advice.

For the non-economists among you, some of the pages that follow may be tough to read. However, I would suggest that you do not skip them automatically. It is worth the effort to try reading the chapters and sections that are difficult to grasp because of technical language. My own experience, as a social scientist is that, if you are curious and willing to learn something, economics is much simpler and easier to understand than you think, despite the presence of mathematics and technical jargon. Moreover, the effort is rewarding: economic analyses can be fascinating once you become familiar with the economists' ways of looking at things.

This brings me to a personal note with which I would like to end this introduction. Not only is it regretful that still so few non-economists have developed an interest in economic analyses and policies, but it is also regretful that still so few economists have made an effort to popularise their economic insights. Breadth and depth of visions would increase substantially if such popularising were not left only to economists like Paul Krugman, Joseph Stiglitz and George Soros

[2] A nice example is the IMF's narrow and flawed approach to Russia's transition to a market economy. Social and political problems were seriously overlooked or not taken sufficiently into account .

(to mention just three successful authors who all happen to live in the US). There are more visions that deserve a wide audience. And there are visions that today just reach a limited audience of policymakers while a potentially much larger audience would be interested to be informed about them as well.

The book that lies in front of you is a proof of the wide range of visions that exists. It shows that critics and advocates of the Washington Consensus have diverging views, but it also shows that they have views in common. Examples of views they share are the necessity of fiscal prudence, the pursuit of low or at least moderate inflation, and the establishment of a well-regulated and supervised financial system.

To end with Schumpeter's plea for developing a Vision: I think that "acquiring a notion of how phenomena hang together" is not only needed in "every scientific venture", but also in every democratic venture. Visions of the future are a vital ingredient of the vigorous and well-functioning democracy to which both critics and advocates of the Washington Consensus seem to subscribe.

Part 1

The Washington Consensus: What is Right and What is Wrong?

2

Serious Inadequacies of the Washington Consensus: Misunderstanding the Poor by the Brightest

Wing Thye Woo[1]

1 The Karma of Development Economics

The post-World War II development experiences of East Asia, Latin America and Africa have been strikingly different. Latin Americans started off as the richest of the three regions, but they have now been surpassed by the best performing East Asian economies. Argentina remains the richest Latin American economy, but its per capita income is now below those of Korea and Taiwan.[2] The per capita income of Malaysia is lower than those of Mexico and Venezuela when measured using current exchange rates, but it is higher when using PPP exchange rates.[3] According to the Human Development Index, which is a better indicator of welfare than GDP per capita, Mexico's welfare went from

[1] I am very grateful to Hong Chang and Rebecca Woo for timely, excellent research assistance. This paper is part of the Economic Growth Project undertaken by the East Asia Programme within the Centre for Globalisation and Sustainable Development in the Earth Institute of Columbia University.

[2] Per capita GDP in 2001, measured using current exchange rates, was \$7,166 for Argentina, \$8,917 for Korea, and \$12,876 for Taiwan. The gap is even larger when PPP exchange rates are used e.g. \$11,320 for Argentina and \$15,090 for Korea. See Table 1.

[3] Using current exchange rates, per capita GDP in 2001 was \$6,214 for Mexico, \$5,073 for Venezuela, \$3,699 for Malaysia, but respective PPP-based figures are \$8,430, \$5,670, and \$8,750. This situation is also true for Thailand vis-à-vis Venezuela and El Salvador.

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0.684 in 1975 to 0.800 in 2001, Malaysia's welfare from 0.615 to 0.790, and Venezuela's welfare from 0.715 to 0.775.[4]

In general, the long-run prospects for East Asia seem brighter than those for Latin America because the former contained many more cases with sustained high growth rates. For example, while China is still much poorer than El Salvador (per capita PPP-based GDP being $4,020 and $5,260 respectively), China grew an average 8.2 percent annually during the 1975-2001 period whereas El Salvador only grew 0.1 percent annually. This sense of optimism about East Asia and pessimism about Latin America was already prevalent in the early 1980s when it was the intellectual fad to pontificate upon the causes of this regional difference in economic dynamism.

In 1990, John Williamson codified this litany of praise for East Asian economic management into Ten Commandments known collectively as the Washington Consensus to guide policymaking in Latin America. The Washington Consensus advocates the following policy stances:[5]

1. Fiscal discipline.
2. A redirection of public expenditure priorities toward fields offering both high economic reforms and the potential to improve income distribution, such as primary health care, primary education, and infrastructure.
3. Tax reform (to lower marginal rates and broaden the tax bone).
4. Interest rate liberalisation.
5. A competitive exchange rate.
6. Trade liberalisation.
7. Liberalisation of inflows of direct foreign investment.
8. Privatisation.
9. Deregulation (to abolish barriers to entry and exit).
10. Secure property rights.

Because Williamson formulated these ten commandments specifically for Latin America, and because he did not explicitly identify their intellectual ancestry, some commentators have assumed that these policy recommendations were derived solely from the Latin American experience. Such a conclusion is wrong in our opinion. First, Williamson stated clearly that

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[4] The Human Development Index for Argentina was 0.784 in 1975 and 0.849 in 2001, and for Korea was 0.701 and 0.879 respectively.

[5] This summary in the format of fortune cookie slips is from Williamson (2000). This retrospective summary was done after much criticisms about the soundness of the Washington Consensus.

he was collating principles that had general professional consensus, he did not say that these principles had professional consensus only in Latin America. Second, 1990 was preceded by a long period in which there were many widely publicised comparative analyses that included both Latin America and East Asia, and hence the professional consensus in 1990 Washington had to have been influenced by more than just the Latin American experience alone. The proof of the preceding statement is that one could very easily compile Williamson's ten recommendations from the works of Balassa (1982), Bhagwati (1978), Edwards (1989), Krueger (1978), Lal (1985), Lin (1989), and Sachs (1985).[6]

In the extreme interpretation of the Washington Consensus by its popularisers, as well as by its critics,[7] the unambiguous promise made by the Washington Consensus is that if a developing country were to implement conservative macroeconomic policies and liberal microeconomic policies to expand the role of the private market at the expense of the state in resource allocation, then it would achieve sustained high growth rates on its own.

What about Africa, which was mentioned in the opening sentence of this chapter? Compared to the mild pessimism about Latin American economic prospects, the African situation has been, and remains, downright depressing. Africa has not only remained the poorest region, a significant part of sub-Saharan Africa has actually gotten even poorer. Per capita income in sub-Saharan Africa declined 0.9 percent annually during the 1975-2001 period. Of the 175 countries ranked by their level of human development in the *Human Development Report 2003*, the 151st (Gambia) to 175th (Sierra Leone) places were occupied entirely by African countries.

What has been the growth experience of the developing world in the 1990-2001 sub-period when the Washington Consensus was increasing

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[6] For example, Lin (1989, p. 191 and p. 198) concluded that "many Latin American countries need to undertake a thorough re-examination of their basic approaches to economic development and price stabilisation in order to break away from the vicious circle of balance of payments crises, persistent inflation and sluggish economic growth ... [and to achieve an East Asian-type] virtuous circle of rapid export expansion, higher economic growth, and stable domestic prices." Similarly, Edwards (1989, Table 4.7) showed that the real exchange rates in Latin America were considerably more volatile than in East Asia, which means that inflation in Latin America was decreasing the reliability of price signals to producers, and hence decreasing their willingness to undertake investments in response to changes in relative prices.

[7] Williamson (2000).

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its influence over policymaking? Because a large number (frequently, the majority) of the sub-Saharan African countries, and a significant number of Latin American countries, were under Washington Consensus-based conditionality programmes in any given year in the 1990s, it might therefore be appropriate to credit the Washington Consensus for the higher growth rates in the 1990-2001 period compared to 1975-1989; being -0.1 percent and -1.5 percent respectively for sub-Saharan Africa, and 1.5 percent and 0.06 percent respectively for Latin America and the Caribbean.[8] However, even if the Washington Consensus were the reason for the improvement in African and Latin American growth, one could be content with the Washington Consensus prescriptions only if one had dismally low expectations. The growth rates during 1990-2001 for sub-Saharan Africa (-0.1 percent) and Latin America (1.5 percent) were still not anywhere near the 5.5 percent growth rate in East Asia (which was already below its growth of 6.2 percent in 1975-1989).

Furthermore, even this low growth boost of the Washington Consensus might well be unsustainable and unreliable. The euphoric growth in Argentina was short-lived; it ended with the collapse of the currency board on January 6, 2002. Indonesia, Korea and Thailand implemented Washington Consensus type of policies to counter the Asian financial crisis, and they suffered deeper output losses for a longer period than Malaysia, which adopted capital controls instead.

It is the purpose of this chapter to argue that the Washington Consensus suffers from fundamental inadequacies, and that a more comprehensive framework of the economic process is needed to guide the formulation of country-specific development strategies. The following five propositions summarise the particular set of interrelated arguments that we will make in the remainder of this chapter:

1. The Washington Consensus was based on a wrong reading of the East Asian growth experience. This explains why Deepak Lal (1985) called the trade regimes of Korea and Taiwan in the 1965-1980 period "free trade regimes" even though they featured extensive import tariffs and export subsidies.

2. There have been two phases to the Washington Consensus doctrine. The mantra of the first phase (Washington Consensus Mark 1) is "get your prices right", and the falsification of this first mantra led to the emergence of the second phase of the Washington Consensus doctrine. The new mantra from the Washington Consensus Mark 2 is

[8] The 1975-1989 growth rates are calculated from Table 1.

Table 1 Growth and Development Indicators for Developing Countries and Regions
(in billions of dollars and percentages)

	HDI[a] rank	HDI Values		GDP per capita 2001		GDP per capita annual growth rate	
	2001	1975	2001	$	PPP $	1975-01	1990-01
Latin America & Caribbean			0.777	3,752	7,050	0.7	1.5
East Asia and the Pacific[b]			0.722	1,267	4,233	5.9	5.5
Sub-Saharan Africa			0.468	475	1,831	-0.9	-0.1
Argentina	34	0.784	0.849	6,166	11,320	0.4	2.3
Mexico	55	0.684	0.800	6,214	8,430	0.9	1.5
Venezuela	69	0.715	0.775	5,073	5,670	-0.9	-0.6
El Salvador	105	0.595	0.719	2,147	5,260	0.1	2.4
Korea	30	0.701	0.879	8,917	15,090	6.2	4.7
Malaysia	58	0.615	0.790	3,699	8,750	4.1	3.9
Thailand	74	0.612	0.768	1,874	6,400	5.4	3.0
China	104	0.521	0.721	911	4,020	8.2	8.8
Zimbabwe	145	0.544	0.496	706	2,280	0.2	-0.2
Gambia	151	0.291	0.463	291	2,050	-0.2	0.1
Zambia	163	0.462	0.386	354	780	-2.2	-1.7
Sierra Leone	175	n.a.	0.275	146	470	-3.3	-6.6

Notes:
[a] Human Development Index.
[b] Taiwan has a GDP per capita of $12,876 in 2001.
Source: Human Development Report 2003.

"get the institutions right". The danger is that an elastic definition of the term "institutions" will render the current mantra intellectually vacuous.

3. While central planning went overboard in suppressing the private market economy, the Washington Consensus runs the danger of denying the state its rightful role in providing an important range of public goods. The Washington Consensus also runs the danger of denying the limitations of self-help in the case of sub-Saharan Africa by overlooking the possibility of poverty traps.

4. The Washington Consensus does not understand that the ultimate engine of growth in a predominantly private market economy is technological innovation, and that the state can play a role in

facilitating technological innovations. The Washington Consensus is too focused upon trade-led growth to acknowledge that science-led growth is becoming even more important.

5. The Washington Consensus does not recognise the constraints that geography and ecology could set on the growth potential of a country. For example, the trade-led growth strategy of East Asia cannot work with the same efficiency for a landlocked country. Foreign direct investment is also less likely to go to places that are malaria-infested.

2 The Emergence of Washington Consensus Mark 1: Getting the State Out

In retrospect, Karl Marx's famous observation on world history, when paraphrased, applies very well to the evolution of development economics as an academic discipline: development economics has repeated itself, first as tragedy in the 1960s, and second as farce in the 1990s. The Washington Consensus is the farce that the development establishment in Washington foisted upon the developing world as universal science, a status that justifies a one-size-fits-all approach to the problems of the poor, regardless of where they are located.

Development economics had emerged with the decolonisation that followed World War II as the type of economics that was applicable to developing economies, just like Keynesian economics was recognised to be the type of economics that was appropriate for developed economies, and central planning to be the best resource allocation mechanism for the new socialist economies. First-generation development economics downplayed the applicability of neo-classical economics and emphasised discontinuity in economic structure and the generation of economic externalities as drivers of economic growth. The stages of growth hypothesis of Walt Rostow, the big push industrialisation strategy of Paul Rosenstein-Rodan, and the circular and cumulative causation of Gunnar Myrdal typified this genre of thinking. The overarching assumption that was based on the disastrous economic performance in the inter-war period was that "two hands were better than one". A *laissez faire* market economy was deemed to be incapable of timely self-correction and of adequate self-propulsion, and the visible hand of the state has to supplement the working of the invisible hand.

First-generation development economics started dying in 1970 from two main causes. The first cause was widespread disappointment with the growth outcomes in Latin America and Africa in the 1960s. The cycle of war-disease-low growth in many countries seemed undisturbed by the development projects implemented there.[9]

The second cause for the death of first-generation development economics was the appearance of several multi-country studies that concluded that countries that pursued development strategies based on the neo-classical principle of comparative advantage grew faster and saw improvements in their income distribution compared with the countries with trade regimes that deviated substantially from the comparative advantage principle.[10] These multi-country studies focused on the differences between economic management in East Asia and Latin America to provide three pillars of wisdom to serve as the foundations for a new generation of development economics.

Pillar 1: The average effective tariff rate in East Asia was significantly lower than in Latin America, i.e. Latin America was more protectionist than East Asia.

Pillar 2: The variance of the effective tariff rates was much smaller in East Asia than in Latin America, i.e. Latin America was more prone to creating winners and losers than East Asia. This is because the variance could be zero only if every importable had the same effective tariff, which means that the composition of importables produced was decided entirely by market forces. A large variance means that the state is actively influencing the production mix of importables, i.e. that the state has given a smaller role for market forces in resource allocation.

Pillar 3: In East Asia, the average effective tariff rate for imports was approximately equal to the effective rate of subsidy for exports, while in Latin America, the average effective tariff rate for imports greatly exceeded the effective rate of subsidy for exports. This means that the trade regime in East Asia makes East Asian firms indifferent between producing for internal market and external market, whereas the trade regime in Latin America makes it more profitable for the Latin American firms to sell in their domestic markets than to sell in the external markets.

The abovementioned implications of Pillar 3 can be more clearly seen when we consider equation (1) below, which shows the relationship between the domestic prices and the world prices of importables and exportables:

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[9] For example, see Hirschman (1981).

[10] Some of the most notable ones are Little, Scott and Scitovsky (1970), Bhagwati (1978), Krueger (1978), and Balassa (1982).

$$(P_I/P_X) = PW_I(1+t) \,/\, PW_X(1+s) \tag{1}$$

P_I = domestic price of importables
P_X = domestic price of exportables
PW_I = world price of imports
PW_X = domestic price of exports
t = effective tariff rate on imports > 0
s = effective subsidy rate on exports > 0

In a market economy with only these two goods, if the ratio (P_I/P_X) rises, say, because of a rise in t (or a fall in s), then producers will switch to making importables from exportables. So when the state sets $t > s$, then it is encouraging the production of importables – this is the case of Latin American. From pillar 2, we know that the Latin Americans were also varying the tariff rates across sectors in order to influence the composition of importables that was being produced.

In the situation where $t = s > 0$, which is the case of East Asia, then equation (1) reduces to:

$$(P_I/P_X) = PW_I \,/\, PW_X \tag{2}$$

which is the same situation of free trade where $t = s = 0$. Furthermore, Pillar 2 tells us that the low variance in the distribution of the tariff and subsidy rates in East Asia indicates that the state was allowing market forces to determine the composition of importables and exportables made by domestic manufacturers. The equality between s and t, and the limited dispersion in the values of s and t might be why Deepak Lal (1985) has described the East Asian trade regimes as "free trade" even though they had positive tariff rates and positive export subsidy rates.

The important analytical difference is that the incentive system in East Asia is neutral toward the production of importables and exportables, while the incentive system in Latin America favours the production of importables. In a strange, asymmetrical use of terminology, these large-scale comparative studies labeled the seemingly *neutral trade regime* in East Asia with terms like "export-promotion trade regime" and "outward-oriented trade regime", and accurately labelled the biased trade regime in Latin America as "import-substitution trade regime" and "inward-oriented trade regime".

Since the economic growth in East Asia was higher than in Latin America, and was accompanied by fewer inflation and balance of payments crises, it was therefore quite natural that the superior performance of East Asia was attributed to the greater role that market forces there had in resource allocation. The operational principle lesson distilled by the World Bank and the IMF from these comparative studies is captured by the now famous mantra of Washington Consensus Mark 1 "get the prices right". At the macroeconomic level, the state should aim for general price stability by keeping the growth of money and the budget deficit low (say, at the rate of real GDP growth), and introduce exchange rate flexibility by deregulating balance-of-payments transactions, and allow market-clearing interest rates by liberalising the financial sector. At the microeconomic level, the state should not only remove restrictions on price-setting, and on entry and exit into businesses, but also reduce state subsidies and privatise state-owned companies. These policies are essentially the Ten Commandments of the Washington Consensus presented by John Williamson in 1990.

To be fair, it must be mentioned that the term "Washington Consensus" has now assumed meanings beyond what John Williamson might have had in mind in 1990 – he was certainly in favour of some withdrawal of the state in the economic sphere but he would not have favoured the total withdrawal of the state. For example, Williamson (2000) said that he had not mentioned capital account liberalisation in 1990, even though this was an operational objective that the IMF had been advocating at least since the late 1980s[11] (but, now, not with the same stridency). In any case, the term "Washington Consensus" has, in many popular discussions, come to be identified with what George Soros (1998) has called "market fundamentalism", and thus become the pejorative title of the second generation of development economics.

Unlike first-generation development economics that considered itself an alternative to neo-classical economics, second-generation development economics is happy to pronounce itself an applied branch of neo-classical economics.[12] This fate of development economics was also experienced by the other alternatives that had emerged or became more widespread after World War II. Keynesian economics has been overthrown by the

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[11] It therefore appears that the IMF was the practitioner of a more market-oriented version of the Washington Consensus than what Williamson was advocating. According to Williamson (2000), "[this version of] the Washington Consensus consists of the set of policies endorsed by the principal economic institutions located in Washington: the US Treasury, the Federal Reserve Board, the IMF, and the World Bank. I would argue that the policies these institutions advocated in the 1990s were inimical to the cause of poverty reduction in emerging markets in at least one respect: their advocacy of capital account liberalisation."

[12] The triumph of neo-classical economics over first-generation development economics is analysed in detail in Woo (1990).

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Monetarist Counter-Revolution led by Milton Friedman, and the New Classical Revival led by Robert Lucas. Central planning has disappeared not only in Eastern Europe but also in the land of its origin.

The tragedy about the demise of first-generation development economics is that some very good insights about the growth process were subsequently ignored in policy discussions and in the academic literature. Recent advancements in methodology and recent increases in empirical knowledge on a broad front in economic analysis have restored intellectual respectability to a few key propositions of first-generation economics. Andrei Shleifer has succeeded in formulating the big push hypothesis in a mathematically tractable form, and Paul Romer has revived the circular and cumulative causation mechanism to be the central piece of the new endogenous growth models. Jeffrey Sachs *et al.* (2004) have explicated the dynamics of development traps so convincingly that these ideas are now guiding the implementation of the just-initiated Millennium Development Goals (MDG) project of the United Nations.[13]

The farce of second-generation development economics, as exemplified by the Washington Consensus (especially the Mark 1 version), is occurring on two levels: in theory and in practice. As the farce is still an ongoing play at the moment, it deserves its own section to enable a more detailed discussion.

3 The Emergence of Washington Consensus Mark 2: Bringing the State Back In

The farce of second-generation development economics at the theory level is that Washington Consensus Mark 1 is based upon an incorrect reading of the evidence presented in the various multi-country studies on the effects of the trade regime choice. This incorrect reading arises from the fact that an economy produces non-tradable goods as well as the tradable goods of importables and exportables. This means that a rise in the tariff rate will not just mean the production of more importables at the expense of exportables, it will also mean a decline in the amount of non-tradables produced. Since changes in the tariff rates and subsidy rates will affect the production of non-tradables, this means that the

[13] The MDG project seeks to mobilise sufficient international aid to make drastic and self-sustained improvements in the living standards of the world's poorest people, e.g. halving the rate of absolute poverty by 2015.

allocation effects of the case where $t = s > 0$ (the outward-oriented trade regime case) will be different from the case where $t = s = 0$ (the free trade case). In short, it was wrong for Deepak Lal (1985) to equate the outward-oriented trade regime with free trade, and it was also wrong for the World Bank to call it "neutral incentive policy".

The preceding discussion can be formalised as follows, by first introducing the following notations:

P_T = domestic price of tradables
P_N = domestic price of non-tradables
PW_T = world price of tradables

and then making the following definitions in equations (3) and (4):

$$P_T = aP_I + (1-a)P_X \text{ where } 0 < a < 1 \quad (3)$$
$$PW_T = aPW_I + (1-a)PW_X \quad (4)$$

Using equation (1), we can rewrite equation (3) in the form of equation (5):

$$P_T = aPW_I(1+t) + (1-a)PW_X(1+s) \quad (5)$$

For the special case when $s = t > 0$ as in the outward-oriented trade regime (OORT), equation (5) reduces to equation (6):

$$P_T = (1+t)PW_T \text{ under OORT} \quad (6)$$

When we compare the ratio of price of tradables to the price of non-tradables under OORT and with the ratio of these prices under free trade, we find that the former is larger than the latter, as given in equation (7):

$$(P_T/P_N) \text{ under OORT} = [(1+t)(PW_T)/P_N] > [PW_T/P_N] = (P_T/P_N) \text{ under free trade} \quad (7)$$

The conclusion from equation (7) is that the OORT increases the production of tradables at the expense of non-tradables. It means that the alleged salubrious growth effects of the OORT come not from the effects of the import tariffs and export subsidies serendipitously cancelling each other out (hence producing a free trade outcome) but from the diminution of the non-tradable sector. It is therefore wrong, as has been frequently done, to use the empirical studies of Little *et al.*, Bhagwati, Krueger and Balassa to justify market fundamentalism.

The interesting question is why has the OORT been good for growth? Because the largest component of non-tradable activities in many developing economies is subsistence agriculture, OORT by increasing the profitability of the manufacturing sector accelerates the industrialisation process and hence quickens the absorption of surplus agricultural labour. Another possible growth mechanism is that by making activities in the tradable industries more financially rewarding, it focuses the minds of the entrepreneurs to participate more actively in the international product cycle, resulting in faster diffusion of foreign technology to these developing countries.

Perhaps what really did Washington Consensus Mark 1 in was that it was also a farce in practice. First, the application of second-generation development economics has not appeared to have effected more positive outcomes in Latin America (with the possible exception of Chile) and Africa. Macroeconomic storms in Latin America have continued unabated in frequency and in depth. And negative growth has continued to be the norm in Africa. The East Asians continued to have higher growth rates, albeit that they suffered a serious region-wide crisis in 1997-1999 thanks to the capital account liberalisation started in the early 1990s.

Second, the large-scale economic deregulation spurred on by the Washington Consensus backfired much more frequently than expected. The removal of interest rate ceilings and entry barriers into the banking system turned out to be very costly in many countries. The explosion in the number of banks and the total loan value often fuelled excessive speculation and created large amounts of non-performing loans, developments that bankrupted the banking system. In almost every case, the government stepped in to refund the depositors in order to prevent a meltdown of the economy, of social order, and of its political status. Equally egregiously, the privatisation of state assets many times meant sales at heavily discounted prices to political cronies of the ruling party, and the replacement of public monopolies by private monopolies. Basically, in some countries, the Washington Consensus was used to camouflage the looting of the state and the embezzlement of the general public.

The economic transition of Eastern Europe and the former Soviet Union (EEFSU) from centrally-planned economies to market economies that started in 1990, and the Asian financial crisis of 1997-99 also discredited Washington Consensus Mark 1 in public perception. Joseph Stiglitz, former chairman of the US President's Council of Economic Advisors, former Chief Economist of the World Bank, and Nobel laureate in economics, has excoriated the Washington Consensus-inspired IMF programmes for causing the sizeable output losses in both episodes. The collapse of the Argentinean economy in 2002 was particularly damaging because the IMF had taken credit earlier for the uncharacteristically strong growth that began with the establishment of the currency board on April 1, 1991.

One pretty widespread interpretation of the output decline in EEFSU is that their comprehensive deregulation did not create the expected improvements in welfare because these countries lacked the institutional infrastructure that was necessary for the satisfactory working of a market economy.[14] To cite a few examples of the long list of necessary capitalist (or, capitalist-style) institutions, the EEFSU in 1990 had:

- no independent, qualified judiciary systems to settle commercial disputes, enforce contracts, protect the rights of minority share–holders, enforce competition policies more conscientiously, and oversee orderly restructuring of bankrupt companies;
- no corruption-free, competent securities regulatory commissions to monitor the integrity of transactions in the stock markets, and improve the transparency of corporate governance;
- no effective, honest financial sector oversight boards to formulate appropriate risk-exposure standards for the financial industry, strengthen prudential regulations, and supervise adherence to these standards and regulations;
- no higher education facilities that could impart to existing and new managers the skills (e.g. accounting practices that are in accordance with international norms) that are necessary to run their enterprises in the new market economies.

In many countries, the government was in complete disarray, not only because the operational procedures of the bureaucracy lagged behind the sweeping legal changes, but also because the accompanying political revolution caused confusion over the lines of authority within ministries and over the division of responsibilities across the re-organised ministries. Furthermore, during this chaos, many bureaucrats took the opportunity to grab the state assets that they had supervisory responsibility for, thereby worsening the economic disintegration.

With this calamity in EEFSU so recent in memory, it was perhaps inevitable that one common knee-jerk diagnosis of the 1997 Asian financial crisis was that it had been caused by crony capitalism. In particular, the lack of arm-length transactions between the Asian banks and their biggest shareholders and borrowers (a situation enabled by

[14] See Cornia and Popov (2001).

the patronage practices of the political systems in these countries) resulted in irrationally large amounts of investments directed to high-risk projects, prestige projects, and projects kept viable by regulations. The meltdown of the Asian financial crisis came when investors fled into foreign assets upon recognition that the contingent losses had exceeded the fiscal ability and political willingness of the state to bail out these projects. The claim, in short, was that the absence of market infrastructural institutions (e.g. an honest, capable state financial supervisory body) had caused the East Asian economies to implode in the same way that the EEFSU had earlier.

Once caught in the mindset of "institution mania", the reason for the collapse of the Argentinean currency board is a no-brainer: the currency board was obviously the wrong economic institution for Argentinean circumstances, the right institution (by definition) would not have failed. Institutional mania has continued to strengthen since; it has now in fact become the new linchpin in the revised Washington Consensus. John Williamson, the primogenitor of the Washington Consensus, had this to say ten years after reporting the apparent phenomenon of intellectual convergence in the discipline of development economics:

> I have a somewhat different view [from my critics e.g. Joseph Stiglitz] of what should be added to the Washington Consensus to make it a policy manifesto supportive of egalitarian, environmentally sensitive development ..... [My] emphasis would have been different; I would have focused much more generally on institutions .... The major advance of the 1990s stemmed from recognition that the central task of the transition from communism to market-based economies involved building the institutional infrastructure of a market economy. This realisation was complemented by a growing recognition that bad institutions can sabotage good policies. (Williamson, 2000, pp. 260-261).

The new mantra of the revised Washington Consensus (i.e. Washington Consensus Mark 2) is undoubtedly "get the institutions right". Washington Consensus Mark 2 might turn out to be no more correct than its predecessor but it is certainly much more ambitious in scope. It not only promises us a richer world but a fairer and greener one as well. Dani Rodrik (well-known for his rejection of the "get the prices right" approach) has vouched for the intellectual respectability of this new policy wisdom. He and his co-authors have produced empirical evidence to show that only institutions mattered for economic growth ("the quality of institutions 'trumps' everything else"); not trade regime, and not geography.[15]

This unearthing of the one variable that explains all that is about growth is certainly startling, especially since Dani Rodrik had always been on the forefront of reminding the development economics profession about how very much more remains to be understood, and how complex the world really is. However, what is equally startling about Washington Consensus Mark 2 but has received surprisingly little attention is that it has now reversed the role of the government. Washington Consensus Mark 1 concentrated on jettisoning the government out of economic life, and Washington Consensus Mark 2 now brings it back to the centre stage to be the conductor of the economic orchestra, providing and maintaining the infrastructure that enables a private market economy to operate effectively. The only crucial aspect on the state that Washington Consensus Mark 2 shares with Washington Consensus Mark 1 (in the literal sense) is: without the government, there will be no music to face.

4 A Critique of the Logical and Empirical Foundations of Washington Consensus Mark 2

In our assessment, Washington Consensus Mark 2 is founded on two non-existent pillars:

- the single-variable explanation of growth; and
- the absence of good capitalist-style institutions (i.e. software like bankruptcy courts, transparent accounting standards) as the reason for the output collapses in EEFSU during 1990-1993, and in East Asia in 1997-1998.

We think that it is reasonable to start with the premise that economic growth is difficult to understand. If this were not the case, the whole world would be rich already. One enduring lesson that painful experience has taught scholars of economic growth is that the dazzlingly bright idea of the moment about what specific factor really causes economic growth will inevitably turn out to be just another blinding insight, where the cleverness of the idea blinds us temporarily to the partial nature of

[15] Rodrik, Subramaniam and Trebbi (2002) wrote: "We estimate the respective contributions of institutions, geography, and trade in determining income levels around the world .... Our results indicate that the quality of institutions 'trumps' everything else."

the correctness of the explanation – applicable only to a small sub-sample of countries, and then only for a limited sub-period in their history. The one thing about economic growth that we can be reasonably sure about, despite our admittedly incomplete understanding of the phenomenon, is that no single variable, or two – or even three – variables, can constitute an adequate explanation. The most optimistic and kind remark that one can make about any big idea currently in vogue is that it deserves incorporation into the melting pot of ideas.

Assuming that we know at least four of the variables that influence economic growth, then one simple characterisation of economic growth could be equation (8):

$$y = a_1x_1 + a_2x_2 + a_3x_3 + a_4x_4 + e \tag{8}$$

where y = trend growth rate of output; x_i = factor i; a_i = (relative) impact that factor i exerts on the growth rate; and e = residual factors (a measure of our ignorance).

However, because many examples suggest that economic growth could be a more complex process than the simple weighted sum of each individual factor, economic growth could well be a non-linear function of the four variables, as given, for example, by the sum of three composite terms in equation (9):

$$y = \left[\sum_{i=1}^{4} a_i x_i\right] + \left[x_4 \sum_{i=1}^{3} b_i x_i\right] + c\left[x_1x_2x_3x_4\right] + \varepsilon \tag{9}$$

where b_i and c are technical coefficients, and ε is the new measure of our ignorance.

Specification (9) is interesting because it allows large output changes to occur for a tiny change in any one of the x_i; it also imposes pre-requisites in order for a high growth rate to occur. The second and third composite terms become influential only when x_4 switches from zero to a positive value; a real world equivalent of x_4 could, for example, be "law and order". The third composite term has no influence on growth when any one of the x_i is zero, denying economic growth the "synergy effects" from virtuous circle type of interactions.

In a context where many (say, n) variables determine the growth rate, one way that any single variable can be said to 'trump' all other variables is when the growth specification is of the form in equation (10):

$$y = x_{institution}\left[\sum_{i=1}^{n} b_i x_i\right] + \varepsilon \tag{10}$$

As long as $x_{institution}$ is zero, y will always be zero regardless of the values of any of the x_i. On *a priori* grounds, we reject equation (10) as lacking in intuitive appeal. On *a posteriori* grounds, we reject equation (10) on our past dismal experiences with single-variable explanations of growth, e.g. we have now gotten over the confusion that Confucian values constituted the cause of higher growth in East Asia vis-à-vis Latin America, and that class struggle is the only driver of history. In any case, it is certainly too early and imprudent to allow the single study by Rodrik, Subramaniam and Trebbi (2002) to resolve this single-variable issue.

The fact that China and Vietnam experienced rapid sustained growth upon their adoption of market-oriented reforms despite the same absence of effective capitalist-style institutions as in EEFSU shows that the institutional explanation for output fall in EEFSU might be of secondary importance. Let us quickly add that the growth performance across the two regions cannot be attributed to a difference in the speed of reform either. Both China and Ukraine implemented their reform gradually but output fell precipitously in Ukraine. Both Poland and Vietnam implemented "big-bang" reforms but output immediately soared in Vietnam.[16]

The real difference between the socialist states in East Asia and the formerly socialist states in Eastern Europe is that they had very different economic production structures at the time when they each initiated market reforms.[17] Vietnam and China were primarily subsistence peasant economies, with over 75 percent of their labour force in the agricultural sector, which was marked by widespread underemployment. Poland and Russia were on the other hand already urbanised, industrialised, fully-employed economies, with state subsidies maintaining an overly large heavy industrial sector. Less than 20 percent of the Russian labour force was engaged in agricultural activities. Finally, China's reforms did not start in a situation with a severe macroeconomic crisis and a severe external debt crisis that required the implementation of an austerity programme.

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[16] See Woo (2003).

[17] See Sachs and Woo (1994), and Woo, Parker and Sachs (1996).

When the economic reforms freed prices, cut state subsidies, and legalised the non-state sector, new rural industrial enterprises and new urban non-state service firms sprung up in China to employ the idle agriculture labour, while the artificially large heavy industrial sector in Poland and Russia collapsed because, first, the market-determined composition of demand did not require so much heavy industrial products, and, second, it was no longer receiving the same amount of subsidies as before.

The labour for the new Chinese enterprises came entirely from the agricultural sector. Workers in state-owned enterprises (SOEs) did not shift to the non-state enterprises because, thanks to various subsidies from the government, SOEs paid higher wages. SOEs provided generous pensions, and heavily-subsidised housing, medical coverage, child-care, food and recreational facilities. The Chinese peasants, receiving none of these benefits and consuming only one-third of what urban residents consumed, were hence only too glad to shift out of low-income agricultural activities to the new higher-income jobs (which paid less than SOE jobs but higher than agricultural jobs).

In Russia, over 80 percent of the population were urban residents and SOE employees. Furthermore, Russian farmers receive the same income as SOE workers. So when the new non-state sector was legalised, a SOE worker or farmer shifting into it would experience a drop in income because he would no longer receive the various subsidies and would pay taxes to support the subsidies to the SOEs. The point is that unless the subsidies to the SOEs are ended, there will be no voluntary movement by workers from the state enterprises to the new non-state enterprises.[18]

The very different results that we see in China, Vietnam, Poland and Russia immediately after the implementation of economic reform programmes came more from their differences in economic structure than from the presence of effective capitalist-style economic institutions in China and Vietnam, and their absence in EEFSU. China's reform problem is the classic development problem of moving surplus agricultural labour into industries, while Eastern Europe's and Russia's reform problem is the classic adjustment problem of moving employed

[18] The fact is that, unlike in Russia and Poland, there was no flow of workers from China's SOEs to the new non-state enterprises. The proportion of the Chinese labour force employed by state-owned units was 18 percent in 1978 and it was still 18 percent in 1992. This means that there were 32 million more Chinese working in state-owned units in 1992 than in 1978.

labour from uncompetitive industries to newly-emerging efficient industries. The fact is that economic development is easier than economic adjustment, both practically and politically, even in the absence of efficient capitalist-style institutions.

How about the "inadequate institutions (soft rot)" explanation for the Asian financial crisis? Well, there is an alternative to it: the financial contagion (speculative mania) explanation. The claim of this alternative explanation is that just as external creditors had been excessively optimistic about economic prospects earlier in 1994-1996, they became overly pessimistic at the end of 1997.[19] If irrational exuberance exists, as Alan Greenspan warns, then irrational melancholia must also occur occasionally.

The simultaneous nature and the regional nature of the financial crisis suggest that weak internal economic fundamentals cannot be the only significant explanation of the crisis. It is hard to believe that the soft rot in the different countries would coincidentally cause these neighbouring economies to collapse within a few months of each other. Such coincidence would be as plausible as the facetious suggestion that the warranties for Asian capitalism had simultaneously expired in mid-1997. We think that it is more reasonable to conclude that while soft rot existed in different degrees in all Asian countries, it was a financial contagion that brought about the crisis.[20]

Enough time has passed that we can now say with greater certainty that financial panic is a better explanation for the Asian financial crisis than the soft rot explanation. This is because if the crises were caused by soft rot, then economic rebound would occur only after fundamental economic restructuring has been largely accomplished. In short, the soft rot explanation would necessitate a U-shape movement in GDP. On the other hand, if financial contagion were the primary reason for the economic collapse in these countries, then their output would rebound right after the panic is over. This was the experience of Argentina in 1995, Mexico in 1995, and Turkey in 1994 when they

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[19] The facts are that foreign capital inflows into these four countries had been increasing every year since 1991, and heavy capital outflows from Indonesia, Malaysia and Korea started only in the last quarter of 1997. The outflow was so large in the last quarter that the net inflow for the whole year was negative. The reversal in capital flows between 1996 and 1997 amounted to about 10 percent of their pre-crisis GDP.

[20] The existence of speculative mania does not mean the violation of the rational expectations assumption (that agents exploit their information sets optimally and know the economic structure). Woo (1987) gives evidence of rational speculative bubbles in foreign exchange markets.

experienced financial panics. The financial contagion explanation would predict a V-shape in GDP movement, and this is exactly what happened in Korea, Malaysia, and Thailand in 1999-2000.[21]

We have examined the flawed institutions explanation for the output losses in EEFSU and in the Asian financial crisis, and in each case we have found more convincing alternative explanations. This implausibility of Washington Consensus Mark 2 at the intuitive *a priori* level, and as the explanation for the EEFSU and Asian crises of the 1990s leads us to conclude that the complexity of the world cannot be usefully understood by constantly searching for the single truth that would set us free in a richer, fairer and greener world.

5 Beyond the Washington Consensus to Misunderstand the Poor

It is a rather big mystery why economists have generally paid very little attention to the role of geography in economic development even when, on a global scale, the wealth of nations is well characterised by two geographical divides. The first geographical divide emphasises differences in ecological conditions: the temperate zone versus the tropical zone. The second geographical divide emphasises differences in the ability to conduct international trade: the coast versus the interior.

The empirical validity of the temperate–tropical divide is supported by the fact that over 90 percent of the world's poor lives between the Tropic of Cancer and the Tropic of Capricorn. The result is a GDP per capita (PPP-adjusted) of $3,326 in 1995 for tropical economies, and $9,027 for non-tropical economies. This strong correlation between ecological zone and income level is not a new observation in economics, e.g. Lee (1957) and Kamarck (1976), but it has not been a major analytical organising principle in development economics.

The coast-interior dichotomy highlights the importance of transportation costs in determining a country's participation in the international division of labour. In the industrial age, water transportation has the lowest cost for moving goods over extended distance. The growth effects of trade are well known, beginning with Adam Smith's observation that productivity improvements are enabled by the greater division of labour that, in turn, is enabled by the expansion of the market. The clear policy lesson here is that investments in physical infrastructure

[21] See Woo (2000a, 2000b), and Woo, Sachs and Schwab (2000) for details on the Asian financial crisis.

and transportation technology can change the comparative advantage of a region.

The above configuration of spatial inequality suggests to us the possibility that both of these geographical divides are a combination of independent causes of economic wealth and of proxies for some important determinants of economic prosperity. For example, there could be a "biological" dimension to the growth phenomenon as proposed by natural scientists. In the book, *Guns, Germs and Steel*, the physiologist Jared Diamond (1997) has demonstrated that many types of innovation (especially those in agriculture and construction) are not transferable across ecological zones. So, in ancient times, while improved varieties of crops and beasts of burden could spread from Northern Asia in the East to Europe in the West (and vice versa), they could not be transmitted from the temperate zone in North America to the temperate zone in South America because of the intervening tropics. Biological endowments also matter. Most areas of Asia and Europe have more naturally pliable livestock (horses and cows) that can be harnessed to help in war and production. The African equivalent of those animals, for example, zebras, hippopotamuses, antelopes, and wildebeests, have proved themselves, up to today, resistant to efforts to turn them into beasts of burden. Even the African elephant is temperamentally uncooperative compared to its Asian cousin.

Some economists, Landes (1998), Engerman and Sokoloff (1997), and Gallup, Sachs, and Mellinger (1999), have begun to incorporate the new insights on physical geography to explore whether physical geography was an overarching explanation of economic performance. For example, Bloom and Sachs (1998) presented rigorous statistical testing to conclude that the virulence of diseases and the limited potential for large gains in agricultural productivity in the tropics are the key obstacles to economic development in most areas of Africa.[22]

This biology-based analysis is of course not the only recent attempt to explain the upward income gradient that begins at the equator. Institutional mania has struck here as well. Hall and Jones (1999) have suggested instead that the distance from the equator proxies for the relative

[22] It is therefore noteworthy that the southern border of China extends only a few miles beyond the Tropic of Cancer. Is it more than coincidental that after one thousand years, 800 B.C. to 200 A.D., of aggressive southward expansion from the Yellow River valley, the Chinese southern border has not changed for about one thousand eight hundred years? The borders stooped at approximately where the tropical zone, i.e. the malaria zone begins.

penetration of European economic institutions and that European-style economic institutions are the ultimate engines of growth.

How plausible is the explanation of the institutional fundamentalists? Well, if they are right, then it is quite inscrutable that Japan is considerably richer than Nigeria and Mexico. Japan is further away from Europe and North America than Nigeria is from Europe, and, furthermore, Nigeria, being a former British colony, had direct transfer of institutions from Britain. Mexico is right next to the United States, and it had also undergone a total transformation to European institutions three centuries before the 1868 Meiji Restoration in Japan.

There is clearly no shortage of explanations for spatial income disparity and its durability. The great surfeit of views is suggestive of inadequate understanding about this phenomenon and of confusion about what to do about it. What is clear, however, is that the successful development strategies of some countries cannot produce the same salubrious results when implemented in other national settings. When China opened some coastal pockets for foreign direct investment, these Special Economic Zones (SEZs) quickly blossomed into vibrant export platforms and created backward linkages with the immediate hinterland. When landlocked Mongolia turned the entire country into a free trade and investment zone in the late 1990s, however, the inflow of foreign capital was a mere trickle compared to China's experience. The specific lesson in this case is that the time-tested effective growth policy package for a coastal economy, and minor modifications of it, are unlikely to work for an interior economy.

Hereby, we see another fundamental flaw in the Washington Consensus development paradigm touted by the international financial and development institutions. Their development paradigm is most effective for small economies like Hong Kong and Singapore and for mid-size economies like Korea, Malaysia, and Taiwan (with easy access to shipping) which can participate fully in the international division of labour, and which had earlier accumulated relatively high level of human capital stocks (measured in education and health terms). When we review, in the context of Swiss economic history, the largely dismal growth performance of landlocked Bolivia, Burundi, Laos, Mongolia, Nepal, Rwanda, and Zambia, it appears that their fates are very much dependent on the growth rates and prosperity levels of their surrounding neighbours. But then these countries are all surrounded by other poor countries. In the absence of high demand by the neighbours for their products, we think that dealing successfully with the developmental changes arising from physical isolation and local disease vectors are just as important as "getting the prices right" and "getting the institutions right".

However, it is also clear from history that geography need not be destiny. Our guarded optimism is based on the fact that every geographically large country in the world has enduring pockets of regional poverty, e.g. Northern Shaanxi in China, Chiapas in Mexico, Madura in Indonesia, but the United States has been successful in reducing this problem. Despite the great geographical diversity of the United States, the per capita income in different states has actually been converging to a common income level; or, in technical parlance, there is unconditional convergence of income within the United States. Even more optimistically for the developing world, the process of unconditional convergence of income has also been verified for Western Europe.

Our optimism, however, is tempered by the knowledge that the process of absolute convergence of income is not operating within China. Most studies on China's regional growth have found the existence of conditional convergence instead, which is that China could be described as a collection of regions each with a different long-run equilibrium income level, and provinces within each region are converging to its own region-specific equilibrium income level. There are, however, also studies, e.g. Démurger, Sachs, Woo, Bao, Chang, and Mellinger (2002), that found no reliable evidence of any kind of income convergence, whether unconditional or conditional.

There was nothing automatic about the catching up phenomenon in the United States, it occurred because of the massive state investments in the poor regions, e.g. rural electrification, an extensive national transportation system, large-scale water works projects implemented through the Army Corp of Engineers, the widespread land grant university system at the state level. The establishment of land grant universities in the poorer states was particularly important because it not only increased human capital formation but also mobilised science to overcome the ecology-specific barriers to higher productivity yield in agriculture and to better health within the local populations.

This comparative regional development experience in the United States and China reveals two more fundamental flaws in the Washington Consensus development prescriptions: (i) no recognition of the poverty trap phenomenon; and (ii) no acknowledgement of the importance of technical innovations.

The Washington Consensus believes only in self-help, it has no mention of foreign aid at all. Presumably, its position is that foreign assistance might accelerate the income convergence process but the country's actions alone will be enough to initiate this process. To see that the Washington Consensus position is wrong, we ask: why hasn't China already undertaken the same large-scale regional investments that the US did in the early parts of the 20th century? The answer is straightforward: China has not been able to afford to make these investments until recently. China had to wait until the economic deregulation, and the resulting integration of the coastal provinces into the international division of labour had created so much new wealth (not at the expense of the inland provinces) that it finally had the fiscal ability do so. China is solving its regional poverty through self-help only in the sense that the richer provinces are subsidising the poorer ones (as the US did in the past), it is not relying on each province to pull itself up by its own bootstraps solely through the tonic mix of right prices and right institutions.

If we now consider an extremely destitute medium-size country that has no vibrant income growth in any of its provinces, the scope for cross-region subsidies is non-existent. It is therefore conceivable that some desperately poor countries are caught in poverty traps from which they cannot escape because they are too poor to make the critical amount of investments that will free them from the interlocking vicious cycles of illiteracy and poverty, and of disease and poverty.[23] Unless the rich nations are willing to live up to their moral obligations and grant sustained aid to change what Ocampo (2004) has called the "framework conditions" of these penurious societies, these societies will remain mired in misery.

We suspect that many sub-Saharan countries, especially the land-locked ones like Malawi, Burkina Faso, and Zambia, are caught in the bind of poverty traps. Good internal governance (with both prices and institutions being right) alone will not generate a satisfactory rate of sustained growth; it has to be supplemented by adequate external aid in order for faster growth to happen. The self-help logo of the Washington Consensus, when used indiscriminately, can serve as a cover for moral callousness.

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[23] One side of the disease-poverty circle is that people fall sick, incur expenses that thrust them into debt, possibly lose their jobs because of sickness-induced low performance or absenteeism, and finally sink into poverty. The other side is that poor people cannot afford the required medical care and preventive screening, and fall sick more frequently (and, possibly also become sick more seriously) compared to the non-poor. The illiteracy-poverty vicious cycle can operate across generations rather as well as within a generation. The extremely poor cannot afford to educate their children, and in the absence of work skills these children obtain only the lowest-paying jobs or become subsistence farmers.

The second fundamental failing of the Washington Consensus revealed by the US-China comparison (particularly, the founding of the extensive land grant university system) is its static view of the economic process. This failure of the Washington Consensus can be characterised as "seeing the forest but not the trees". Specifically, while the Washington Consensus imputes numerous positive growth effects to increasing the degree of trade openness as measured by the export-GDP ratio, and points out that East Asia is more trade oriented than Latin America (see Appendix, Figures 1 to 3),[24] it has not noticed, that the export composition of East Asia shows even greater economic dynamism than the rise in the export-GDP ratio (see Appendix, Figures 4 to 11).

In East Asia, higher value added manufactured exports have been displacing lower value added manufactured exports (and, in some cases, agricultural exports) very rapidly, whereas in most of Latin America, the composition of manufactured exports has been stable even when there is the rise in the export-GDP ratio.[25] Mexico is the only large country in Latin America that shows the East Asia trait of the rise in the export-GDP ratio being driven by high value added manufactured exports – a development that began in 1987 and intensified in 1993 when NAFTA was established.[26]

The rapid evolution in the composition of manufactured exports in Korea, Taiwan and Malaysia reflects the steady and dramatic pace of industrial upgrading in these countries. This continual transformation of their production structures reveals the effectiveness of the technology policies adopted there. These countries have adopted aggressive concessionary policies to incubate high-tech firms, and to attract high-tech investments by multinational corporations. The upshot is that the

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[24] The average export-to-GDP ratio for East Asia went from 35 to 63%, for Africa from 22 to 29%, and for Latin America from 9 to 20%, see Appendix, Figure 1. For this calculation, East Asia consisted of Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand; Africa of Gabon, Ghana, Cote Ivoire, Kenya, Nigeria and Senegal; and Latin America of Chile, Colombia and Mexico. Taiwan, Argentina and Brazil were excluded because of missing data.

[25] For example, see Appendix Figure 4, when (Manu/Total) of Argentina rose from 11% in 1970 to 30% in 1997, (Manu A/Total) went from 6% to 13%, and (Manu B/Total) from 5% to 13%. The result was only a minor change in Argentina's composition of manufactured exports. Whereas in Korea's case, as (Manu/Total) stayed about the same over the 1970-1997 period (76% in 1970 and 71% in 1997), (Manu A/Total) fell from 54% to 22%, and (Manu B/Total) climbed from 22% to 49%.

[26] See Appendix, Figures 2 and 11.

typical Latin American country is richer than the typical East Asian country, but the technology level of the former is lower! For example, Table 2 shows that the sample of Argentina, Brazil, Chile and Mexico is 48 percent richer than the sample of Malaysia, Thailand, and Philippines, but the technology level of the former is 24 percent lower than that of the latter. So the usual image of East Asia being more *laissez faire* than Latin America is certainly not true. Latin America either does not have a technology policy, or has one that does not work as desired, e.g. the standard import-substituting industrialisation policy is a *negative* technology policy because it discourages participation in the international product cycle.[27]

In short, what has been described as trade-led growth in East Asia could instead be called science-led growth. For many of the least-developed economies, where agriculture would continue to be the mainstay of their economies, employing the bulk of the population, the developed countries should focus a large part of their increased aid on raising agricultural productivity and demand for the agricultural output through the application of science, establishing regional agriculture research centres for each of the distinct ecosystems in the least-developed countries (e.g. tropical monsoon region of East Asia, high plateau area of Latin America, and tropical grassland territory of Africa) to:

- conduct research on new seed varieties (including agro biotechnology), new approaches to water and environmental management, and new approaches to agricultural mechanisation;
- improve the local livestock through cross-breeding, and through better access to veterinarian services;
- enhance agriculture extension services to assist farmers in adopting new technologies;
- develop new processed-food products (e.g. new fruit drinks, new vegetable stuffing) from the agricultural products of these least-developed countries.

A key component of a science-led growth strategy for the developing countries is the mobilisation of their universities to be drivers of growth. The donor community should expand and upgrade these universities, especially their agricultural, scientific and technical departments. The universities should adopt incentive schemes to promote university-business partnerships that improve production techniques, and develop

[27] For a recent discussion about the state of innovation systems and technological development in Latin America and the policies required to strengthen them, see Chapter 7 in ECLAC (2002), and Chapter 6 in ECLAC (2004).

Table 2 Technology Levels in East Asia and Latin America

	GDP per capita in 2000 (PPP $)	Ranking of technology level (out of 75)
East Asia	**13,200**	**28**
The Four Dragons	*20,778*	*16*
Hong Kong	25,153	33
Singapore	23,356	18
Korea	17,380	9
Taiwan	17,223	4
The ASEAN-4	*5,621*	*41*
Malaysia	9,068	22
Thailand	6,402	39
Philippines	3,971	40
Indonesia	3,043	61
Latin America	**8,925**	**46**
Argentina	12,311	48
Chile	9,417	42
Mexico	9,023	36
Brazil	7,625	49
Colombia	6,248	56
Latin America level as percentage of East Asian level	68%	62%
Argentina-Brazil-Mexico-Chile level as percentage of Malaysia-Thailand-Philippines level	148%	76%

Source: Ranking of Technology Level from *The Global Competitiveness Report 2001-2002* (GCR); PPP GDP data from *Human Development Report 2002*, except that for Taiwan which is from GCR.

new products, especially those that are based on the regional resource base. The universities in the poorest nations must, of course, give high priority to agricultural development by working collaboratively with the new regional agricultural research centres to effect technology transfers to farmers.

The truth is that the Washington Consensus (especially the Mark 1 version) is really an economic programme that is focused myopically on short and medium-term stabilisation of output, prices, and the balance of payments, and not on long-run sustained growth, particularly in the poorest countries. This accountant's approach to economic management means that little attention is given to national specificities because accounting statements are the same everywhere in the world (even though the same outcomes might have been generated by different sets of factors). Why is there this accountant's mentality toward economic management?

The answer to this question brings us to the final fundamental defect of Washington Consensus Mark 2. Washington Consensus Mark 2, despite its obsession with getting institutions right, misses a serious institutional defect in its own intellectual backyard. It ignores the institutional weaknesses in the international financial and development institutions, especially the World Bank and the International Monetary Fund, and the need for root-and-branch reforms there. The recent negative experiences with the EEFSU economic transition and the Asian financial crisis show that bureaucratic inertia, operational convenience, and governance problems within the international financial and development institutions coalesced to produce the "one-size-fits-all" type of policy packages. We have to change the incentives within existing international economic organisations (e.g. alter the voting structure in the IMF), and to create new international frameworks to deal with the increase in economic accidents created by greatly enhanced interactions from the accelerating pace of global economic integration (e.g. an international bankruptcy court), and to prevent the tragedy of the global commons caused by the trend of higher global economic growth (e.g. the Kyoto Protocol). Only by moving beyond the Washington Consensus, can we then move closer to achieving the dream of a richer, fairer, and greener world that the primogenitor of the Washington Consensus wished for us.

In conclusion, it needs to be re-emphasised that the causes of underdevelopment are many. The reality is that countries differ in structure and in the international economic constraints they face; many combinations of different shocks produce similar readings on a number of economic indicators; and country characteristics and the international situation could change abruptly. Thus development economics becomes a farce whenever the epigones of neo-classical economics apply the Washington Consensus uncritically or, worse, elevate it to the status of universal truths.

The frequent focus on the role of poor governance and inappropriate economic institutions (e.g. over-regulation, ignorance and corruption) is correct but not sufficient. Démurger, Sachs, Woo, Bao, Chang, and Mellinger (2002), for example, have found that geographical factors have been just as important quantitatively as deregulation policies in the growth of the coastal provinces of China, and Bloom and Sachs (1998) have found poor health conditions to be absolute barriers to African development. Physical capital formation for overcoming geographical and health barriers is, however, unlikely to be the final nail into the coffin in which poverty would be laid to rest. We believe that only human capital formation can come up with better solutions to the centuries-old problem of poverty and to the looming challenge of global ecological Armageddon because there is still a lot about the complexities of science-led growth that we have yet to understand. These two challenges will be easier to overcome if we can empower every mind in the world to be capable of thinking creatively about them, which is why the developed nations must redouble their efforts to help the developing nations meet the Millennium Development Goals of the United Nations. The common hope for a richer, fairer, and greener world will be realised if we can act collectively on this common agenda.

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Appendix

Figure 1 Seeing the Forest: Overall Trade Orientation
(exports in percent of GDP)

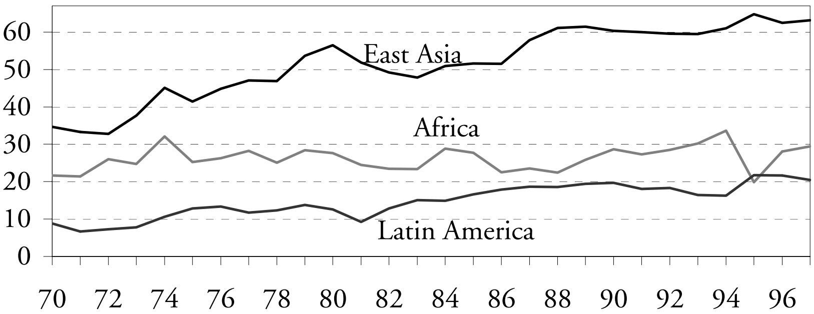


Figure 2 Export Orientation in Latin America
(exports in percent of GDP)

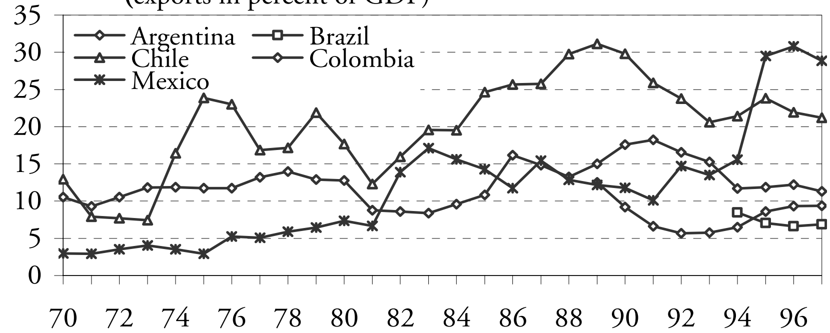
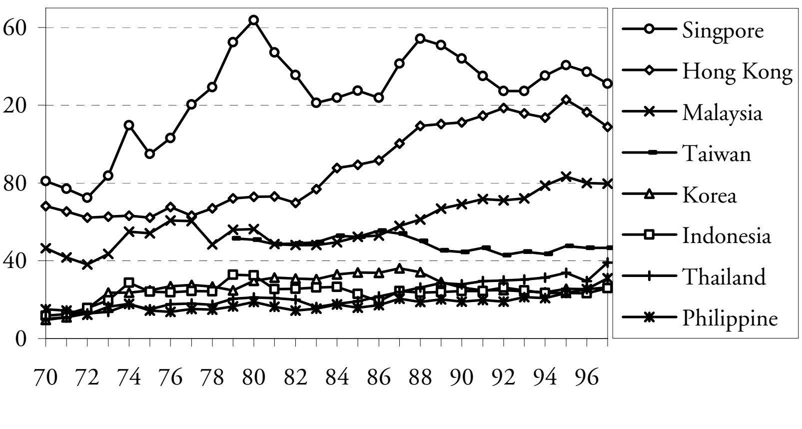


Figure 3 Export Orientation in East Asia
(exports in percent of GDP)



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In Figures 4 to 11, the notations are as follows:

—◇— Manu / Total	Manu = manufactured exports
—□— Manu A / Total	Total = total exports
—△— Manu B / Total	Manu A = low-tech manufactured exports
—✱— Mine / Total	Manu B = high-tech manufactured exports
—✕— Ag / Total	Mine = mineral exports
	Ag = agricultural exports

Figure 4 Export Composition in Argentina: Steady Manufactured Share

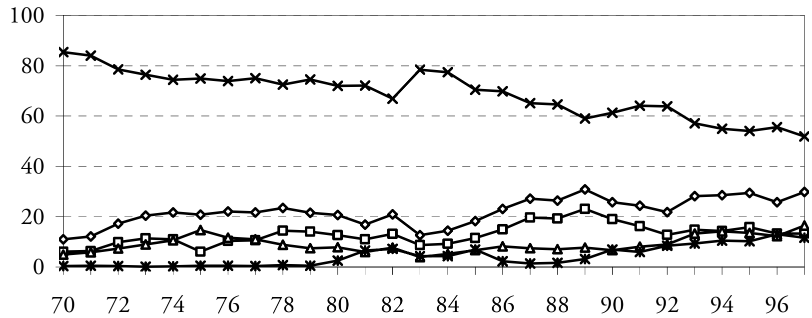


Figure 5 Export Composition in S. Korea: Steady Manufactured Share but Rising High Value-Added Component

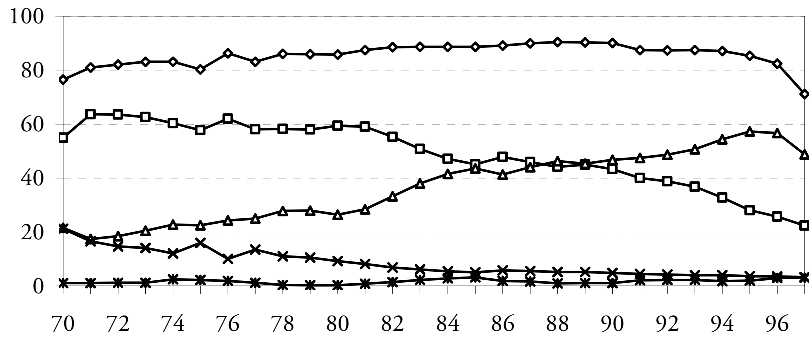


Figure 6 Export Composition in Taiwan: Steady Manufactured Share but Rising High Value-Added Component

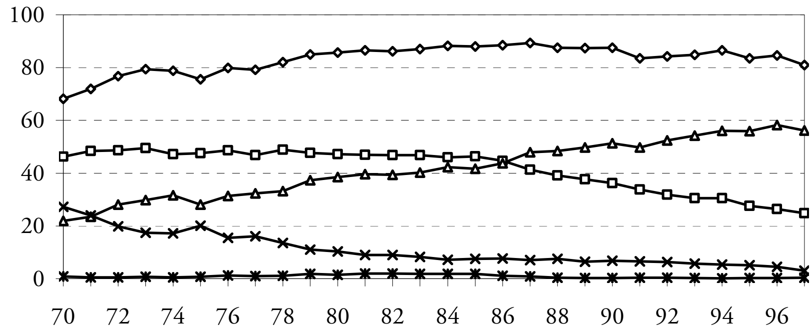


Figure 7 Export Composition in Brazil: Rising Manufactured Share

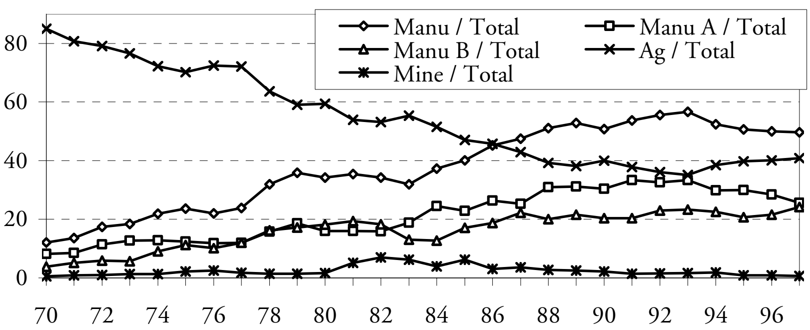


Figure 8 Export Composition in Malaysia: Rising Manufactured Share Driven by High Value Added Component

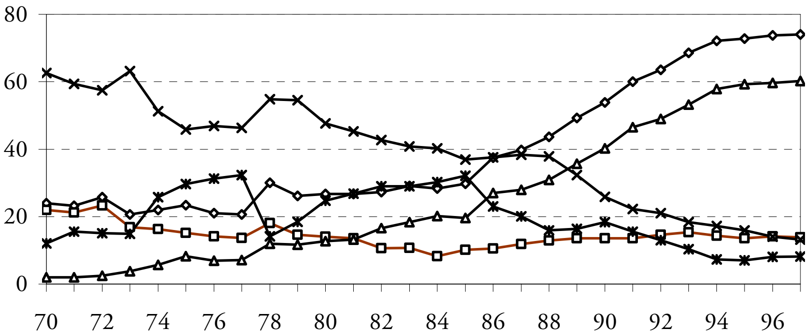


Figure 9 Export Composition in Thailand: Rising Manufactured Share Driven by High Value Added Component

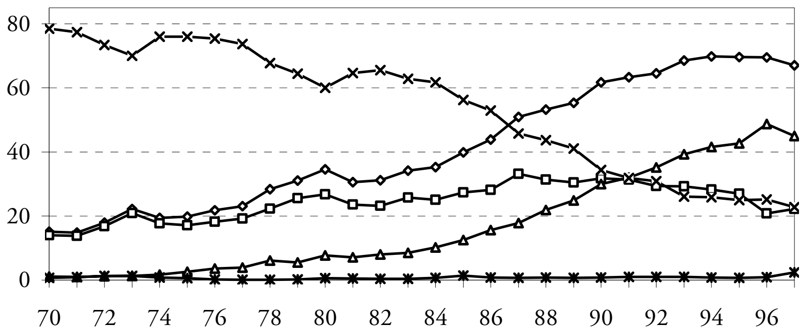


Figure 10 Export Composition in Colombia: Slightly Rising Manufactured Share

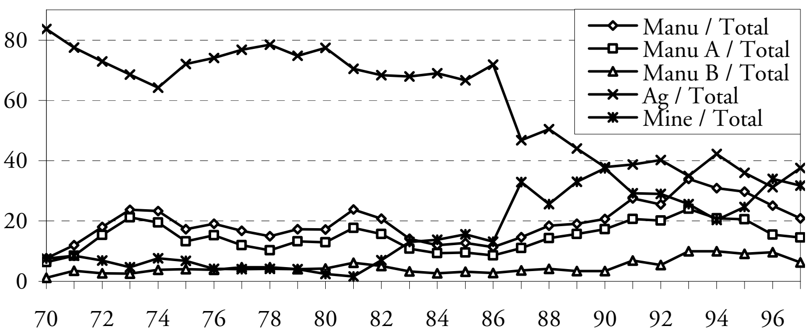
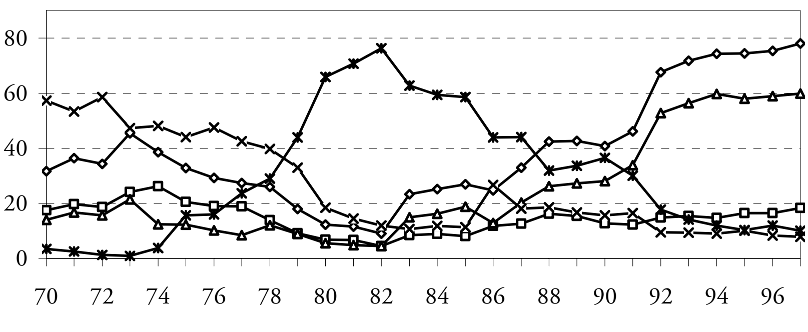


Figure 11 Mexico: South-East Asia-style Rise in Manufactured Export Share Driven by its High Value Component



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3

The Dogmatism of the Washington Consensus

Ariel Buira[1]

There is a quiet discontent in Latin America and the Caribbean today, after the lost decade of the 1980s and the policy reform efforts of the last 20 years. Growth rates are sluggish, unemployment is rising and poverty reduction is substantially lower than expected. Even though the reform efforts of the region in the 1980s were perhaps the basis of the now famous Washington Consensus, the region itself did not reap the rewards anticipated from this formula. Despite the articulation of the second-generation reforms of the Washington Consensus, various revisits to the 10 commandments and several attempts to fashion alternatives and additions, there is a need to re-think the vision of the future, to acquire one that is more realistic, effective and compelling.

The 10 commandments of the Washington Consensus, like the tablets given to Moses on Mount Sinai, were presented as a final product – not as the particular result of trial and error and deliberation. These 10 commandments were the decanted development wisdom of North-West Washington, between 15th and 20th Street and F Street and Massachusetts Avenue. In the Washington Consensus, the development policy establishment found a simple solution to the problem of development. The principles were to be adopted by developing countries – preferably by persuasion but when persuasion failed, through external pressures and IFI conditionality.

The ten commandments of the Washington Consensus can be briefly restated as: "You shall attain price stability" (note that the concern over stability does not extend to preventing falls in output and employment).

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[1] The views expressed are those of the author and do not necessarily represent those of the G-24.

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In order to achieve price stability it is argued, "You should maintain fiscal discipline and avoid fiscal deficits", with three corollaries: "You should forgo subsidies", "You should privatise public enterprises" and "You should broaden the tax base".

The next commandment, number 5, would be to liberalise interest rates and, in further evolutions, attain total financial liberalisation in a broad sense, including capital account liberalisation; (6) adopt an equilibrium exchange rate; (7) eliminate protection; (8) liberalise foreign direct investment; (9) deregulate the economy; and (10) protect property rights.

Some versions of the Washington Consensus reduced it to the simple slogan: "Free market forces to get prices right". This was perhaps a little too simple. It is as if there is no role for governments in the search for economic development, in promoting social equity, health, education, the development of technology and industrial policy.

The Washington Consensus was intended to produce growth and the efficient working of the economy. The Consensus agenda was loosely associated with the doctrine of supply-side economics, monetarism and minimalist government that characterised the thinking in Washington at the time of Reagan and Thatcher. Some of these ideas are now discredited. The results predicted by the Consensus did not materialise. Making markets work requires more than low inflation. It requires government to enact sound financial regulation, competition policy, policy to facilitate the transfer of technology and policy to encourage transparency – just to mention a few things the Consensus neglected.

In Adam Smith's conception, the invisible hand does not devise the institutions that harness the self-interest of individuals for the social good. The invisible hand requires the guidance of good institutions and laws to regulate the way in which individuals pursue their interests. Smith believed that, in the pursuit of their self-interest, merchants and manufacturers seek political influence since "to narrow competition, is always in the interest of the dealers" and this "must always be against the interest of the public".[2]

Thus, the invisible hand requires sound institutions and laws that regulate how individuals pursue their interests. These institutions and laws are the outcome of government policy: in the view of Lord Robbins, the invisible hand "is the hand of the lawgiver, the hand

[2] Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations*, Clarendon Press, Oxford, 1976, pp. 266-7, 459, 467.

which withdraws from the sphere of the pursuit of self-interest those possibilities which do not harmonise the public good".[3]

The contrast between the Asian dynamic experience in the 1980s and 1990s and the virtual stagnation of Latin America, where the Washington Consensus doctrine was faithfully applied, is rather striking and should give rise to a good deal of analysis and reflection.

To be sure, some of the policies Asia pursued fall within the Consensus: low inflation, fiscal prudence and so forth, while some others do not: the emphasis on industrial and technological policies, for example, fall outside and are contrary to the spirit of the Washington Consensus. It has been argued that governments should not intervene in the economy, but I would submit that the Asian experience suggests that governments in Latin America have not done too much but rather too little to promote the institutions that favour development.

Let me discuss some of the items of the Washington Consensus.

Inflation

High inflation is, of course, bad. It is costly, and it provokes distortions and so forth, but it is not true that once it starts to rise, inflation has a tendency to accelerate. As Stiglitz has noted, there is no evidence for this; it is just a hypothesis. And it is not true that high inflation is very costly to reverse. These premises have been tested empirically, and there is abundant evidence to the contrary. Bruno and Easterly, Barro, Fischer (the deputy managing director of the IMF at the time), Mohsin Khan (who was deputy head of research, now head of the Middle East Department at the IMF) all failed to find evidence that inflation is costly. If you have 15 or 20 percent inflation, it does not seem to have high costs in terms of growth. In fact, Akerlof, Dickens and Perry[4] and others claim that a moderate rate of inflation even improves economic performance.

Budget Deficits

Again, huge budget deficits are detrimental since they can lead to crowding out and unsustainable levels of debt, but there is no simple formula for determining what is the optimum budget deficit. The

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[3] L. Robbins, *The Theory of Economic Policy in English Classical Political Economy*, Macmillan, London, 1952, p. 52.

[4] George Akerlof, William Dickens and George Perry, "The Macroeconomics of Low Inflation", Brookings Papers on Economic Activity, No 1, 1996, pp. 1–59.

optimum deficit or a sustainable deficit depends very much on circumstances, including the cyclical state of the economy. What we have seen in Latin America is a dogmatic approach: countries with budget deficits of 0.5 or 1 percent have been reducing the deficit in the midst of a recession, just as countries with a 4 percent rate of inflation have been trying to tighten monetary policy to reduce inflation in the midst of a recession. This makes no sense. Stabilisation is certainly important, but it is a means and not an end in itself, and it should not be carried to the point where its effect is a net reduction of output over the long run.

Unemployment

Is the objective really stabilising prices or is it stabilising output? The social and economic cost of downturns can be devastating – the lives of people are disrupted, poverty increases, often giving rise to political turmoil and so forth. Moreover, all of these stops and starts have huge consequences for sustained growth. This has been completely neglected by the Washington Consensus.

Privatisation

Privatisation swept through Latin America and was presented as the solution to many problems. Latin America followed the UK with Chile and Mexico taking the lead. Most of the region's public enterprises were privatised, from banks to power plants, telecommunications, roads, and water transport systems. As a result of selling public enterprises, government revenues in Latin American countries reached 6 percent of GDP. Latin America's privatisation of infrastructure exceeded 360 billion dollars, more than twice of what Asia has done. While many privatisations can be considered successful, in that they freed governments from the provision of goods and services that could be provided more efficiently by the private sector, many others cannot. Privatisation has provoked a lot of political discontent, criticism, and demonstrations.

The private provision of public services has often led to conflicts over prices and over what is a reasonable return on investment. This is a difficult problem in periods of exchange rate instability and high inflation. If tariffs are indexed to exchange rates, and the exchange rate devalues 50 or 60 percent, tariffs cannot be adjusted by that amount because wages do not adjust. That is the real problem, and then government intervention is called in and often the government has to take back the privatised enterprise.

The approach has often been rather dogmatic. There is something to be said for increased competition, but what is the best way to increase efficiency and secure competition? Is it better to devote efforts at creating a regulatory framework and agencies to oversee the performance of the privatised enterprises or private sector, or should you make efforts to reform the state enterprises without necessarily changing ownership? China has done the latter. They appear to have established competition amongst public enterprises quite successfully.

Trade Liberalisation

The prescription is "Open up trade because this is good for you". This is presented as a prerequisite for development: only by dismantling the old policies of import substitution and by freeing imports will you allocate resources in an optimal manner. But historically, there is virtually no industrial country that has followed this path. Every country that I know of resorted to protectionism and subsidies for a long period. Even Britain, the pioneer of industrialisation, pursued protectionist policies between 1721 and 1846 during the period of the Corn Laws. They pursued a sort of infant industry policy with high tariffs, and they only accepted free trade when they had attained a large technological lead. The US had the highest tariffs in the world between 1860 and the Second World War, in addition to the high protection arising from transport costs and so on.

In fact, the history of these and many other industrial countries is rather different from the conventional wisdom of the Washington Consensus. It would seem that when you attain a certain level of industrial development, you rewrite the rules of the global system and call for the adoption of rules that fit your national interest. The concern over protection leading to poor resource allocation has to be balanced by the concern that you may reduce the policy space to the point where industrial development becomes difficult to achieve. The most successful experiences of development, countries that went from low income levels to high income levels in a generation, those of Korea, Taiwan and the current experiences of China, India, Vietnam and others, is not based on opening the economy to free trade and keeping government out of the economy. So often the opposite would seem a better prescription for achieving success.

The so-called level playing field is one where industrial countries and developing countries compete on equal terms, putting the latter at a disadvantage. In football, at least, you distinguish between amateurs and professionals, and you have different leagues and divisions.

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Technology

On technology, it is not simply catching-up. Japan and Korea have developed their own original technology, and any country that wants to develop technology should start by objectively analysing what successful countries have done to build research and industrial capabilities. However, the Washington Consensus denies that government has any role to play in assisting the growth of new industrial sectors, through any form of industrial policy.

A second point would be to create policy space for industrial policy. The move to wholesale liberalisation has great momentum, but it does impede the selection and support of special sectors. Despite all of the problems of growing poverty, marginalisation, Millennium Development Goals, and the like, the assumption on which international development policy is based today is that the industrial sector will develop best under Washington Consensus rules.

The next step would be to try and develop a capability to mount this industrial policy. There is a large body of material showing that selective interventions can and have worked. Government failure is avoidable when interventions are done very carefully. The experiences of South-East Asia and certainly of China bear this out.

The fourth step would be to develop strategies appropriate to the circumstances of each country. This does not mean returning to old-style import substitution. It means flexible, careful policymaking with clear targets aimed at a specific technology development. This is the most difficult step. Not only does it require skill, but it also requires industrial countries allowing it. Sanjaya Lall has written extensively on this issue.

Undervalued Exchange Rate and Unlimited Supply of Labour

Let me turn to Wing's chapter. Wing points out that export-led growth was perhaps the most conspicuous characteristic of the Asian development model. It seems that something of the Washington Consensus was lost in translation, so the Asians did not get it, and thus were very successful.

What are Wing's assumptions, what is his starting point? These are not made clear in his chapter. To what extent is he assuming that there is an unlimited supply of labour? To what extent is he saying that this exchange rate policy has to do with the objectives that you have? Some countries in Asia, Korea for example, went for large enterprises, tried to create export brands, went for the production of capital goods and so forth. Others, such as Taiwan, went for small and medium enterprises, gradually raising the local content. Then there was a push into high-tech industries, particularly in Singapore. So there are nuances. Surprisingly, Wing's chapter has, as far as I can see, no mention of high rates of investment, virtually no mention of savings rates, credit policy, and virtually no mention of problems of keeping currencies undervalued and the accumulation of capital. If you have an undervalued currency and are a successful exporter, you are bound to acquire large inflows of capital and you need capital controls, otherwise things will get out of hand. There is very little mentioning of sectoral industrial policies even though Asia has been rather selective.

Wing has a number of equations, and they all lead to the conclusion that you aim for an undervalued exchange rate. There is nothing else to the argument. And an undervalued exchange rate is perhaps the main reason that Asia has grown faster than Latin America; another part of the reason is the fact that it lacks natural resources and had to resort to export-based industrial growth.

Essentially, the Asian secret as interpreted by Wing is based on a combination of two things: the classical Arthur Lewis model of development with unlimited supplies of labour and the undervalued exchange rate. This is exactly what China has been doing. China has pegged the exchange rate to the dollar at a very competitive rate, perhaps undervalued, as several other Asian countries have, and they have been growing like mad. There is a rush to absorb around 40 percent of the labour force that is underemployed in agriculture and to bring them to the modern sector. The second element is the development of industrial technology and attempts to develop an educated manpower to attract foreign investors and to bring highly profitable operations into their countries. This again is the strategy followed by China and a number of other countries.

The real limit is absorbing the unlimited supply of labour. The next limit to this model is the catching-up. Japan's experience is that they have been able to develop scientific and technical innovation and develop a wide range of innovative products. Maybe Japan's problems have more to do with other issues of the economy; the weakness of the financial system.

The Global Implications of the Asian Development Model

One thing that is not considered in Wing's chapter is what the global implications of this Asian policy are. What is the global aspect of trying to base industrialisation on an undervalued exchange rate in order to maintain an export-led development strategy?

Asian countries have maintained high rates of export growth and large trade surpluses, and this has attracted large private investment flows. They have a combination of large trade surpluses and large capital account surpluses. Since they do not allow their currencies to appreciate, they accumulate very high levels of reserves. These have been heavily invested in US Treasury paper and have been financing the US twin deficits making them sustainable, at least for the time being. The perpetuation of global imbalances gives rise to a number of risks or problems related to this development strategy.

First, the depreciation of the US dollar has become an impediment to the recovery of the EU and other countries that float their exchange rate such as Canada, Australia, and many Latin American countries. Second, the depreciation of the US dollar vis-à-vis the pegged Asian currencies has given rise to trade tensions and calls for protectionism in Europe and a number of other countries whose currencies have appreciated in relative terms. Third, the rapid growth of Asian exports has also given rise to calls for protection inside the US. All of this talk about outsourcing and loss of jobs increases the risk of rising protectionism in response to the unemployment and political pressures in industries that are unable to compete. A fourth risk is that at some point when the demand for dollars as a reserve currency collapses, the loss of value of the dollar will no longer be offset in countries like China by the higher rates of growth, higher rates of employment and higher rates of the expansion of the industrial sector. What happens then? Fifth, a disorderly depreciation of the dollar could lead to a sharp rise in interest rates, and this will put the brakes on the recovery of the US economy and the growth in Asian and many other countries that are dependent on the US market. Sixth, although flexible exchange rates contribute to adjustment, the volatility of exchange rates among major currencies discourages trade and particularly investment flows that require a medium-term planning horizon since there are no hedging instruments for longer maturities. Simply recall that the rates between the euro and the dollar have fluctuated by more than 50 percent in the last 3 or 4 years since the introduction of the euro.

Wing's chapter does not address the domestic problems for the countries pursuing the undervalued exchange rate policy either. The risks of sustaining an undervalued exchange rate over a long period of time are: overheating of the economy, leading eventually to an appreciation of the real exchange rate as a result of inflation, and the decapitalisation of the central bank as a result of the accumulation of reserves in foreign exchange currencies. Just look at Korea. The domestic yield on government paper was 5 1/3, the return on US Treasury bills was 1 1/3, so if you accumulate reserves of 125 billion dollars – as they had in December 2003, this meant an interest rate differential loss of 5 billion dollars. Five billion dollars a year is a big loss to suffer for a central bank, it becomes a fiscal deficit. This affects the burden of external debt payments; it depresses domestic standards of living and income.

All of these imbalances should be corrected in an orderly fashion. IMF surveillance should be much more effective and even-handed. But surveillance bites the countries that have IMF programmes; it does not bite the big countries and those who do not have IMF programmes and do not need Fund resources.

4

The Need for a More Flexible Approach to Development

Barbara Stallings

In his chapter, "Serious Inadequacies of the Washington Consensus: Misunderstanding the Poor by the Brightest," Wing Thye Woo presents a hard-hitting critique of a set of economic policies that have been followed by many developing countries over the last two decades. Many of his points are well taken, and economic officials in Africa, Asia, and Latin America would benefit from a close reading of his analysis and his policy prescriptions. At the same time, I believe he misunderstands some of the material he is discussing, discards some important insights in his attempt to counter others' arguments, and is too narrow in parts of his analysis.

Although Woo's chapter touches on many topics, there are four main parts. First, he provides various types of criticism – both theoretical and empirical – of the original Washington Consensus on economic reforms (early 1990s). Second, he extends his critique to a second-generation version of the Washington Consensus, in particular its focus on institutions (late 1990s and early 2000s). Third, he discusses two important topics that he believes are missing from both: the impact of geographical location and the role of technology. Fourth, he finishes with the need for a greater and greatly revised international role in the development process.

My comments will roughly follow this same outline, although they will emphasise some points and leave others aside. They are based largely on a project on economic reforms in Latin America, carried out by the UN Economic Commission for Latin America and the Caribbean (ECLAC) in the late 1990s.[1] This project, which studied nine countries in the Latin

[1] Barbara Stallings and Wilson Peres, *Growth, Employment, and Equity: The Impact of Economic Reforms in Developing Countries*, Brookings Institution, Washington D.C., 2000.

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American region, was guided by a framework that viewed the reforms as determined by initial conditions in each country, but strongly influenced by various elements of the international environment. The reforms were accompanied by a package of economic and social policies, which might or might not be consistent with the reforms themselves. The reforms *cum* policies had their initial impact on investment and technological progress in each economy. These, in turn, determined the pattern of economic growth, employment creation, and the distribution of income. Drawing on this background, the rest of this brief comment will centre on "four I's," which are crucial in determining the impact of development policies: initial conditions; institutions; investment, technology, and dynamics; and the international context.

Initial Conditions

The characteristics of a country when a reform process begins are absolutely essential to the way such a process will play out and the impact it will have. Obviously, there is a long list of characteristics that could be included (economic, political, social, cultural, geographic, and so on), and the choice will lead to differing types of analysis. Here we concentrate on economic factors – although agreeing with Woo that geography is a force behind some of what we are defining as economic. Among the main economic factors are the structure of output, characteristics of the labour force, the state of macroeconomic variables (growth and investment trends, as well as inflation and deficits), the volume and pattern of international trade and capital flows, and the relative importance of the public and private sectors.

The difference in initial conditions is the reason that there is no single "solution" to development problems. Let's consider a few examples. If a country has a fairly low inflation rate (single digits), but also a low GDP growth rate, then focusing on polices to lower the former at the expense of the latter would be misguided. On the contrary, if the inflation rate is high (high double digits), then stabilisation should take precedent over stimulating growth in the short run. If a country has an extremely closed economy (high tariffs and a low export/GDP ratio), an emphasis on trade liberalisation is more justified than in a case where tariffs are fairly low and exports are high. If the state controls large parts of the economy, and especially if it does so in an inefficient way, there is more ground for focusing on privatisation and deregulation than if the private sector already has a strong role in the economy.

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Now, back to the Washington Consensus and Woo's critique. The original Washington Consensus, a term coined by John Williamson at a 1989 conference, focused exclusively on Latin America, where the high inflation-closed economy-state dominance syndrome was relatively common among the larger countries.[2] Contrary to Woo's assertion that Williamson "codified [a] litany of praise for East Asian economic management into ten commandments," the first version of the Washington Consensus had nothing to do with Asia. A search through my memory (I participated in the conference) and the index to Williamson's book reveals that Asia was mentioned only twice, by two of the commentators on the Williamson paper. Rather than "a wrong reading of the East Asian experience," as Woo puts it, the original Washington Consensus was a set of policies aimed specifically at the problems of Latin America in the 1980s. In another context, such as most of North-East and South-East Asia, such policies would have been inappropriate, but there was no indication that they were meant for such countries, which already had fairly stable economies and a heavy emphasis on exports. Of course, some of the East Asian group (Korea, Taiwan, Singapore) had high tariffs and a strong state role, although the latter tended to be more efficient than in Latin America. Others (South-East Asia, Hong Kong) were more open and less dominated by the state.

Even within the Latin American region, there were important distinctions. The ECLAC project, for example, distinguished between countries that had suffered negative growth and high or even hyperinflation in the years preceding the initiation of reforms (Argentina, Bolivia, Chile, and Peru) from those that had had high growth and lower inflation (Brazil, Colombia, Mexico, and Costa Rica). Not surprisingly, the former were much more eager to undertake reforms than the latter. One problem was that their eagerness led to a particularly ideological variant of reforms, such that they were unable to learn from mistakes and change course when that was called for. Countries that had performed better in the past were reluctant reformers, and their half-hearted changes sometimes left them with the worst of all possible worlds. Here, more attention to initial conditions would have been very helpful.

A second point in Woo's critique is "*the unambiguous promise*" (my emphasis) in the "extreme interpretation" of the Washington Consensus "that if a developing country were to implement conservative macro-

[2] John Williamson (ed.), *Latin American Adjustment: How Much Has Happened?*, Institute for International Economics, Washington D.C., 1990.

economic policies and liberal microeconomic policies…., then it would achieve high economic growth rates on its own". I think this extreme interpretation is a misreading of the Washington Consensus. While there was the implication that more exports and private-sector investment would have a positive impact, the ten policies of the Washington Consensus are better seen as prerequisites for growth – under the initial conditions of Latin America in the 1980s – than a growth strategy *per se*. Williamson himself says this in his conclusions: "It is not at all clear that the policy reforms currently sought by Washington adequately address all of the critical current problems of Latin America" (Williamson, 1990, p.18); he goes on to single out stabilisation, growth, and capital flight.

In summary, then, the initial conditions of an economy at a given point in time – the result of both historical and geographical factors – play a major role in determining what kind of policies are desirable as well as feasible. The Washington Consensus laid out a set of policies for a group of countries where the initial conditions were unpropitious for growth to take place. Indeed, the main elements are widely accepted in Latin America today: macroeconomic stability, the need to export, and the desirability of public-private partnerships. It is only when these policies are taken to the extreme that the Washington Consensus is unacceptable, but the term has been turned into something that Williamson never intended.

Institutions

Wing Thye Woo characterises what he calls the Washington Consensus Mark 2 as "institution mania" – a single factor whose absence is alleged to account for all of the problems in developing countries. Insofar as a single-factor answer is involved, I completely agree with him that such an approach is misguided in an area as complicated as economic development (to say nothing about other dimensions of development).

But there is another, equally important problem with the concept of institutions – it means something different to almost every policymaker, analyst, and observer. So institutions are not really a single factor; they are a panoply of factors at different levels of generality and with different relations to policy and outcomes. If we could successfully disaggregate the concept, we would have many factors that surely have important implications for growth and development. Framing the concept as a single factor, and thus delegitimising it as Woo tends to do, does not help to advance our understanding. It is interesting to note that Woo then proposes economic structure as a (single factor) alternative to institutions in explaining the different results of reforms in Russia and Poland as compared to China and Vietnam. Likewise, the Asian crisis is blamed on a single factor – financial contagion.

Let's see if it is possible to specify some of the meanings of the term "institutions" to see how they might be relevant to the development debate. At a fairly abstract level, the state itself and its relationships to the economy are an institution. The capacity of the state in its various dimensions – judicial, legislative, executive, bureaucratic – is certainly crucial to development, regardless of the relative importance of the public and private spheres. Without a state to provide public goods, however broadly or narrowly defined, development will not occur. One important example of a public good is the rule of law, as opposed to arbitrary decisionmaking by the governmental authorities of the day. Other types of public goods include infrastructure, environmental safeguards, and a social safety net.

It is also possible to define institutions in a more concrete way. The education and training systems of a country are important for development insofar as they determine the level and type of skills that are available. The financial system and its particular characteristics will determine the amounts of credit available for productive enterprises and who has access to these funds. The nature of the regulatory system – especially relevant for the financial system and newly privatised monopolies – has an enormous impact on how an economy with an important private component will function. And, of course, the innovation system is closely related to how technology will be incorporated and what kind of technology will be used.

All of these examples show that institutions are indeed important for development. They need to be better understood – both through a careful evaluation of the role they need to fulfil and the requirements for creating or strengthening them – rather than written off because some analysts unfortunately give the impression that they constitute a "silver bullet" for bringing about development.

Investment, Technology, and Dynamics

Woo puts strong emphasis on science and technology – and rightly so. Many experts argue that technology is the most important aspect of the development process. Even if developing countries generally cannot make contributions to basic science, it is important that they pay attention to the incorporation of technology into their products and to the teaching of scientific topics in their schools and universities. The fact that they trail behind the industrial countries in terms of science and technology enables them to make rapid improvements through "catch-up" activities – if they follow appropriate policies.

The question is the process by which technology is incorporated in developing countries. Woo gives some examples, pointing to the role of universities, incubation programmes, and incentives for high-tech foreign investment. In the ECLAC project, we gave major emphasis to technological progress, but it was viewed as intimately related to investment. In general, Woo gives little emphasis to investment in his chapter. Perhaps this is because savings and investment rates have been extremely high in the East Asian economies, especially in comparison with Latin America and Africa. Investment is important, of course, because it adds to production capacity and raises productivity as workers have more equipment with which to work. In addition, however, much if not most technology is "embodied" in investment goods, so investment is doubly important. One of the crucial decisions that entrepreneurs in developing countries, together with the relevant government ministries, must make is the extent to which technological advance should be made via the purchase of foreign equipment or through local innovation. Clear trade-offs are involved here.

The reforms have had both negative and positive implications for investment, according to the ECLAC research. On the one hand, import liberalisation and privatisation were very closely correlated with increases in investment; this came about partly through foreign companies coming into the countries to invest and partly through the ability of local firms to import foreign equipment that was not previously available. On the other hand, the reforms increased uncertainty in the short run, and uncertainty is a well known hindrance to investment as entrepreneurs – foreign and domestic – adopt a wait-and-see approach.

In addition to embodied technology, there is also the "disembodied" sort that involves more efficient organisation of the work place and new management skills. Disembodied technology can also be obtained externally or internally. One of the main reasons that developing countries seek foreign direct investment today is to obtain new management techniques, such as "just in time" methods of handling inventory or more flexible ways of using labour. Use of management consultants has also been prevalent. In either case, it is necessary to adapt international techniques to local circumstances and cultures.

Finally, investment in human capital is an essential part of improving production. (The need for governments to shift their expenditures to this area was an important component of the original Washington Consensus.)

New technologies need skilled workers to manage them, and herein lies one of the challenges of the increased use of technology. Those with better skills can take advantage of new opportunities, while those without are often worse off than before in relative terms. Governments must do what they can to ensure that high-quality education is available to all, so that social mobility is promoted rather than being cut off. Training programmes are complementary to the education system, both to assist those who have already finished formal schooling and to support businesses that need particular types of new skills in the workforce.

International Context

Woo's emphasis in the international realm is on the need for greater foreign aid for Africa and the need to reform the international financial institutions to avoid "one-size-fits-all" policies and to address new problems in an appropriate way. While both are indeed necessary, the international role – both positive and negative – goes far beyond these particular aspects. I want to briefly mention four others: macroeconomic spill-over, financial policy, foreign direct investment, and market access.

Spill-over effects from world economic expansion are responsible for substantial amounts of volatility in developing countries, which is very problematic for the development process. One way this comes about is through changing demand for developing country exports, as growth rates in the industrial countries rise and fall. Another channel is interest rates. As international interest rates fall, developing countries become more attractive to foreign investors, but the opposite is also the case, which can produce very strong cyclical behaviour. Of course, developed countries do not purposely create business cycles, but neither do they pay much attention to the impact on developing economies.

Another aspect of the volatility problem, which derives from policy rather than spill-over, concerns capital flows. Capital flows can be very large with respect to the size of local economies, and they can reverse course very quickly. They also cause appreciation of the exchange rate and thus undermine export capacity, and in the worst cases, a crisis can result. Given these difficulties, some countries have introduced policies to limit capital inflows. While the IMF came to recognise the value of limited capital controls, developed countries – especially the United States – have been less willing to go along. In response to the problem of capital flow volatility following the Asian crisis, there was a good deal of discussion about the need for a "new international financial architecture". Proposals were made to better regulate international capital flows and to establish new rules for crisis management. As the Asian crisis was brought under control, however, the need for a new framework was moved onto a back burner, so the next crisis will again occur without policies in place to deal with it.

The capital flow volatility problem centres mainly on short-term portfolio flows. Foreign direct investment (FDI) has different characteristics and thus a different set of advantages and disadvantages. While other kinds of foreign capital became negative after the Asian crisis, FDI continued to record large inflows to developing countries. But there have been significant differences in the role that foreign capital has played. South-East Asian countries have been incorporated into production networks headed by firms from Japan, Korea and Taiwan, which substantially increased their manufactured exports. In South America, the main trade-FDI nexus involves natural resources. Less FDI has gone into the industrial sector, and a special lack has been investment in high-technology export industries. Mexico, with its important assembly plants, lies somewhere in between these two models. (For data, see Woo's Figures 1-11.)

One of the reasons that developing countries currently welcome FDI is that it helps with market access problems in developed countries. That is, foreign firms frequently sell their output in their own home country or in third markets. Otherwise, the structure of tariffs and subsidies in developed countries can undermine attempts by developing countries to raise the value added of their exports. Average tariffs are much lower in the former, but higher tariffs are frequently found on particular products and on more processed goods.

Developing countries would obviously be better off if the international system was a more equitable one, and if they had a way to make their voices heard. But rather than wait for this to happen, more emphasis needs to be put on improving the internal context. Sometimes this involves getting prices right, sometimes getting institutions right, and other times getting policies right. It may mean a bigger state role, or it may require more importance for the private sector. Just as we do not want single-factor models, neither do we want to exclude certain factors *ex ante*. It all depends on the particular circumstances of individual developing countries. Wing Thye Woo stresses this last point, but he does not always follow through in terms of allowing for diverse policy alternatives.

5

Globalisation and the Development Agenda

José Antonio Ocampo

Globalisation has been heralded over the past quarter century as the gateway to an era of unprecedented prosperity for all world citizens. Its major instrument, economic liberalisation, was presented to the developing world as an alternative to inefficient trade protection and state intervention. In the 1980s and 1990s, the liberalisation agenda gained support in mainstream policymaking circles worldwide, under the active promotion of the IMF and the World Bank through their "structural conditionality", and came to be referred to as the Washington Consensus. In recent years, however, this "consensus" has met with growing criticism, as the promised land of high growth is increasingly seen as a mirage, while the international divergence of income levels and high financial volatility in both the developed and the developing world are increasingly seen as inevitable outcomes of the neo-liberal global order.

As a result of widespread discontent, there is a general call to "civilise" the global economy (Helleiner, 2000) to generate a more inclusive form of globalisation or, in the words of the United Nations Millennium Declaration, "to ensure that globalisation becomes a positive force for all the world's people" (United Nations, 2000). Unfortunately, however, this has led to limited action so far. In many ways, the neo-liberal globalised order continues to deepen, as countervailing processes proceed at a slow pace.

Unfortunately too, the terminology used in the debate has become increasingly obscure. There is much talk about the need to consolidate the "first generation" of reforms (the liberalisation agenda), supplemented

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with a "second generation" or even a "third generation" of reforms aimed at strengthening institutions,[1] equity and social safety nets. In addition, while there is basic agreement on the need for strong macroeconomic frameworks, openness to the international economy, participation by the private sector in the development process, a more efficient state, stronger institutions and active social policies, profound differences of opinion remain as to the exact meanings of all these terms.

The reform fetishism implicit in the concept of generations of reforms is an essential part of the problem since it assumes that development processes are linear and universal in nature. Thus, according to the first of these assumptions, the steps that have been taken during the early stages of the reform process must constitute the foundations upon which the additional parts of the building should be erected. This is surely an inappropriate framework when macroeconomic policies have led to pro-cyclical management practices that increase the risks faced by all economic agents, or when the structural reforms have led to adverse distributive effects. In these cases, the first generation of reforms cannot be trusted to serve as the foundation upon which additional parts of the building can be erected. Rather, the system itself needs to be reformed. It is necessary, to "reform the reforms" (ECLAC, 2000; Ffrench-Davis, 2000).

Against the second implicit assumption, that of universality, it can be argued that there is no single model of economic management that would guarantee macroeconomic stability, nor is there only one way of integrating into the international economy or of designing economic and social institutions. There is no such a thing as a single "market economy". In the terminology of Albert (1991) and Rodrik (1999, 2001), there are different "varieties of capitalism", as the experience of developed and developing countries alike indicates.

This chapter presents an alternative view of the development agenda, with a focus on Latin America. It explores, in a parallel fashion, the need for new global arrangements. It is divided in four sections. The first two look at global and Latin American facts. The third presents the broad strokes of a global agenda, which assigns a critical role to regional institutions. The fourth looks at national development strategies.

[1] In this chapter, the concept of institutions is used in a more traditional and broader sense than it has had in the more recent literature, to include organisations (e.g. business firms, producer associations and government agencies) as well as policies, constitutional, legal and regulatory provisions, and intangible factors such as traditions and conventions.

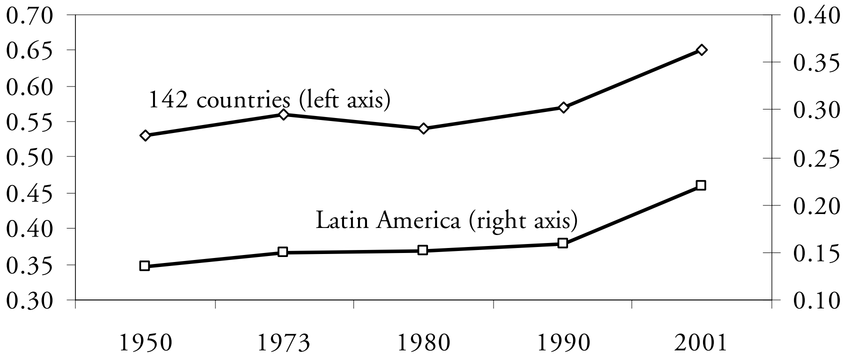
1 Global Historical Disparities

History demonstrates that international "convergence" in income levels, a typical prediction of many orthodox models of economic growth, has been the exception rather than the rule. The only strong case of convergence in per capita income levels occurred among developed countries during the "golden age" of the post-war period, 1950-1973 (Maddison, 1991). The process proceeded steadily until 1990, albeit at a slower pace, and came to a halt in the final decade of the twentieth century. The other historical period in which convergence occurred was the second half of the nineteenth century. O'Rourke and Williamson (1999) have demonstrated that during this period, the United States and Europe witnessed a convergence of wage levels, basically as a result of the mass migration of European labour to the New World. Within Western Europe, a process of wage equalisation also occurred, though it did not encompass countries of the European periphery. Hence, even within the group of now industrialised countries, there was a slight divergence in per capita GDP trends, and this divergence was even greater when a wider group of countries is included.

This subject has been examined thoroughly in the literature on economic growth in the last quarter century. In general, these analyses confirm that there has been a long-term *divergence* of per capita income levels over the past two centuries that was particularly rapid in the nineteenth and the first half of the twentieth centuries, slowed down in 1950-1973 and has renewed since then. Thus, using per capita GDP levels for the 141 countries included in Angus Maddison's historical series (Maddison, 2001), the mean log deviation increased from 0.56 in 1973 to 0.65 in 2001 (Figure 1). However, various studies also indicate that there is some, though not systematic, evidence of "conditional convergence" when other factors that influence the growth of countries are taken into account, including the educational level of the population, infrastructure, macroeconomic stability, and political, social and economic institutions. In light of the evidence of long-term divergence of per capita incomes, any conditional convergence may be read as implying that the factors which determine economic growth according to such analyses are distributed just as unequally as per capita GDP, or even more so. This casts significant doubts on the validity of the concept of "conditional convergence".

The trend towards an amplification of international inequalities in recent decades has been accompanied by a widespread increase in

Figure 1 Latin America: GDP and Aggregate Demand, 1950-2001
(annual growth rates, percentages)



Source: Author estimates based on Maddison (2001) and updates from that author.

inequalities within countries. According to a recent comprehensive analysis of this issue (Cornia, 2004, Part I), 48 out of 73 countries for which information is available experienced a deterioration of income distribution in the last decades of the twentieth century; this is concentrated in 87.5 percent of the population of the 73 countries.

On the contrary, only 9 countries, with 2.7 percent of the total population, lived in nations in which income distribution improved. The remainder lived in countries with stable levels of inequality or ones in which no clear trend could be identified (see Table 1). According to Cornia (2004), inequality tended to increase in most industrialised countries, in Central and Eastern Europe, and in Latin America. Several Asian countries, including China, have also shared in this trend. Only Africa has shown no clear trend of this type due to the opposite distributive trends experienced by different countries.

According to Cornia (2004), this widespread deterioration in income distribution contrasts with the experience of the 1950s and 1960s when several countries experienced the opposite pattern. The estimates by Bourguignon and Morrison (2002) indicate that the only previous period in which such a broad based deterioration in income distribution took place in the world was during the first phase of globalisation from the mid-nineteenth century to the First World War. During the reversal of globalisation that followed in the inter-war period, there was actually an important improvement in income distribution within countries, linked both to the emergence of the welfare state in Western Europe and the United States and to the socialist revolutions in Central and Eastern Europe.

Table 1 Changes in Income Inequality within Countries, 1960s to the 1990s

	Developed countries	Developing countries	Transition economies	Total
A. Number of countries				
Rising inequality	12	16	20	48
Constant	4	10	2	16
Falling inequality	2	7	0	9
Total	18	33	22	73
B. Percentage of population[a]				
Rising inequality	13.3%	66.7%	7.5%	87.5%
Constant	2.3%	7.3%	0.3%	9.8%
Falling inequality	1.8%	0.9%	0.0%	2.7%
Total	17.4%	74.8%	7.7%	100.0%

Note:
[a] Percentage of 73 countries population, that represent 78.5% of world population.
Source: Based on Cornia (2004), Table 2.8 and population data from the United Nations.

These two forces – the divergence of per capita income among countries and the deterioration of income distribution within countries – was counterbalanced at the global level in recent decades by the rapid growth of China and, to a lesser extent, India, the two largest low-income countries. Thus, estimates of the world distribution of income depend on the weight given to this factor and, thus, to the specific methodologies used to compare incomes across countries. Nonetheless, the majority of studies concludes that world income distribution tended to deteriorate in the last decades of the twentieth century,[2] though at a rate that was much slower than that which characterised the first phase of globalisation in the nineteenth and early twentieth centuries. In any case, it is hard to interpret the rapid growth of China and India as the result of the capacity of the global system to favourably redistribute world income.

Thus, convergence in income levels has occurred, but it has done so only among developed countries and only at specific stages in the

[2] Dikhanov and Ward (2001) come to this conclusion for the 1970-1999 period, Bourguignon and Morrisson (2002) for 1970-1992 when using a Theil index (the two other indexes calculated by these authors show no clear trend) and Milanovic (2002) for 1988-1993. The main study that comes to an opposite conclusion is Bhalla (2002).

evolution of the world economy. In Latin America, the stagnation at middle-income levels from 1870 to 1980 was followed by divergence in income levels vis-à-vis the United States in the last two decades of the twentieth century. Furthermore, within this pattern, there have been several experiences of "truncated convergence", such as Argentina after its period of rapid growth from 1880 to 1913, or Brazil and Mexico after their successful period of state-led industrialisation that went on for several decades until cut short by the debt crisis of the 1980s.

The strong renewal of the trend towards income divergence in recent decades also goes against the expectation that economic liberalisation would accelerate convergence by providing ample opportunities for developing countries. Thus, the attempt to draft simplistic links between economic liberalisation and growth has been misguided. The best stylised fact in this regard is that, although freer trade, capital market liberalisation and market incentives do matter, there are no single rules that can be applied to all countries at any point in time, nor to any single country in different time periods. This conclusion comes strongly from comparative analyses of development experiences (see, for example, Helleiner, 1994).

Mixed strategies, on the other hand, have proven optimal under many circumstances. Thus, successful growth of manufacturing exports in the developing world since the mid-1960s was, in general, preceded by periods of import-substitution industrialisation, and the very successful integration of the Asian newly industrialised countries into the world economy was matched by strong state intervention (see, for example, Chenery *et al.*, 1986). Interestingly, Bairoch (1993) came to similar views regarding the relations between protection and economic growth in the period prior to the First World War. He observed that the fastest periods of growth of world trade in those years were not those characterised by the most liberal trade regimes, which led him to conclude that the expansion of world trade resulted from economic growth, rather than the other way around.

The growth and persistence of large inequalities in the world economy make it useful to think of the latter as a system in which opportunities are unevenly distributed between the centre of the world economy and its periphery – or, perhaps more accurately, peripheries. Latin American structuralist thinkers suggested this centre–periphery analysis half a century ago (see, for example, the classic contributions by Prebisch, 1950), and their main thesis still remains valid. Indeed, the best simple manifestation of this fact is that, despite some changes, the world hierarchy of per capita GDP levels has been remarkably stable over the past century, as demonstrated by the fact that about 60 percent of current income disparities in the world can be simply explained by the same disparities existing in 1913. This is also reflected in other crucial features of the world economic order: the very high concentration of the generation of core technology in a few countries, and the equally high concentration there of world finance and the home headquarters of multinational firms.

The major implications of this finding are that while national economic, social and institutional factors obviously do matter, economic opportunities are largely determined by the position within the world hierarchy, indicating that climbing the international ladder is a rather difficult task. Essential international asymmetries help to explain why the international economy is an "unlevel playing field" (see section 3 below). Therefore, unless such asymmetries are systemically addressed, world inequalities would be maintained or may deepen through time.

This means, in turn, that economic development is not a question of going through "stages" within a uniform pattern associated to the rise in income per capita. Development is, rather, the result of structural transformations and the application of appropriate macroeconomic and financial strategies, within the constraints posed by a world hierarchical system and the domestic economic and socio-political institutions, which may be partly determined, in turn, by the particular modalities of insertion into the world economy. This is the essential insight of the Latin American structuralist school, as well as of the literature on "late industrialisation" since Gerschenkron (for a recent restatement, see Amsden, 2001).

2 Recent Latin American Frustrations[3]

In recent decades, Latin America has been a major – perhaps *the* major – showcase of economic liberalisation. The region undertook economic liberalisation with enthusiasm ("ownership") beginning in the mid-1980s (earlier in some countries) and pushed it further than other regions in the developing world. The frustrations with the results

[3] For an extended analysis of these issues, see ECLAC (2000, 2001a, 2001b and 2002), Ocampo and Martin (2003) and Ocampo (2004). For similar analysis relating to the developing countries as a whole, see UNCTAD (1997, 1999 and 2002).

should thus be taken as a serious demonstration of the weaknesses on which the liberalisation agenda was built.

On the positive side, substantial progress was made in controlling inflation. Also, on average (and contrary to widespread perceptions), budget deficits were brought under control in the second half of the 1980s and have remained moderate since then in most countries, though with a moderate slippage since the Asian crisis. Most importantly, the region clearly succeeded in boosting exports and becoming a magnet for FDI. Between 1990 and 2003, and even taking into account the strong slowdown of the early 2000s, the average annual increase in merchandise exports amounted to 7.8 percent in terms of volume, the fastest rate of growth in the region's history. Meanwhile, FDI flows to the region grew at an unprecedented rate too, increasing fivefold between 1990-1994 and 1997-2001; they have, however, experienced a sharp decline in 2002-2003.[4]

The region's success in increasing its share in world markets and attracting FDI has not been reflected, however, in rapid GDP growth. Indeed, the average growth rate in 1990-2003, of 2.6 percent a year, is less than half the record for the period of state-led industrialisation,[5] 1945-1980 (5.5 percent a year). Although there are many reasons – particularly the sweeping changes in the world economy – why it would be a major mistake to resume the policies typical of this earlier historical period, clearly the burden of proof is now on those who characterised state-led industrialisation as a major historical failure and liberalisation as the key to rapid growth. Even some supporters of economic liberalisation now regard the period of state-led industrialisation as a "golden age", and the growth rates achieved during that

[4] Integration into the world economy has followed three basic patterns. In the first, which has been exhibited primarily by Mexico but also by some countries of Central America and the Caribbean, countries joined in the vertical flows of trade in manufactures characteristic of internationally integrated production systems, concentrating their exports in the United States market. In the second, typical of South America, the countries belong to horizontal global production and marketing networks, chiefly for raw materials and natural-resource-based manufactures. This group is also characterised by highly diversified intra-regional trade and by a lower concentration of destination markets. The third pattern is based on the export of services, mainly for tourism, but also financial and transport services, and is the predominant pattern in some countries of the Caribbean and Panama.

[5] This term is preferred to the usual concept of import-substitution industrialisation, for reasons that are explained in Cárdenas, Ocampo and Thorp (2000).

period as a goal for future Latin American performance (Kuczynski and Williamson, 2003, pp. 305 and 29).

A major counterpart of this result is the structural deterioration in the growth/trade balance trade-off, which is equivalent to a weakening of the link between GDP growth and external resource transfers. Figure 2 indicates that this link had already weakened in the 1970s vis-à-vis the 1950s and 1960s (dynamic growth continued only on the basis of a higher trade deficit and increasing resource transfers). It further deteriorated in 1990-1997 with respect to the 1970s (much lower growth was obtained with similar trade deficits and resource transfers) and, once again, in 1998-2002. This reflects a series of adverse trends in the productive structure: (i) a decline in import-substituting industries that has not been counterbalanced by the acceleration of export growth; (ii) the high demand, in dynamic sectors, for imported capital and intermediate goods (a trait of internationally integrated production systems) which, together with the previous factor, has reduced production linkages; and (iii) the weakening of the national innovation systems inherited from the preceding stage of development, as engineering functions and research and development (R&D) that used to be performed by local firms are being transferred out of the region. An opposing trend has been the rapid growth of connectivity, though its counterpart has been the emergence of "domestic digital divides" reflecting the very uneven access of different firms and social sectors to the new technologies.

As a result of these factors, the multiplier effect and the technological externalities generated by the high-growth activities associated with exports and FDI have been weak. Also, the dualism (or structural heterogeneity) characteristic of productive structures in Latin America has become even more marked: there are now many more "world-class" firms, most of which are subsidiaries of transnational corporations. However, at the same time, a growing proportion of employment is being concentrated in low-productivity informal-sector activities, which account for seven out of every ten new jobs created in Latin American urban areas over the past decade. In a sense, the new dynamic activities are "enclaves" of globalised production networks, which have so far proved incapable of inducing rapid overall economic growth.

The structural deterioration in the growth/trade balance trade-off has generated a strong sensitivity to external financing, which has been enhanced by financial liberalisation, pro-cyclical domestic financial systems and equally pro-cyclical macroeconomic policies.

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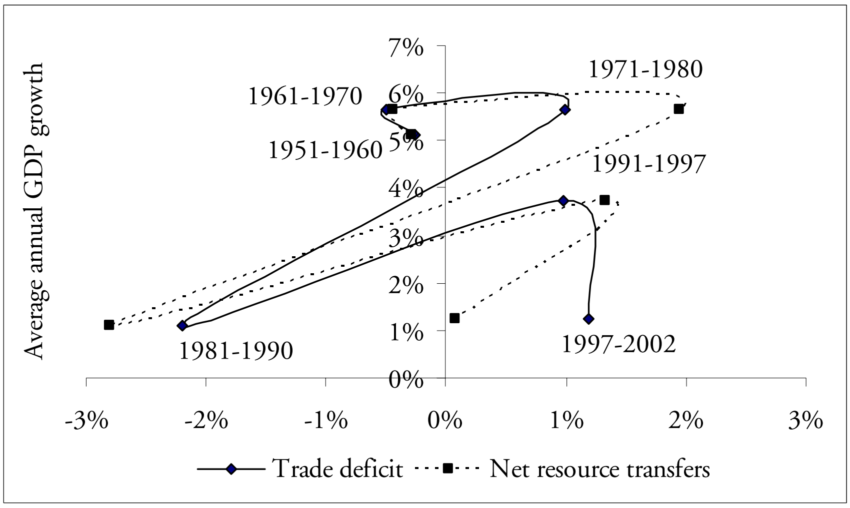
FONDAD, The Hague, December 2004, www.fondad.org

Figure 2 Growth, Trade Balance and Resource Transfers

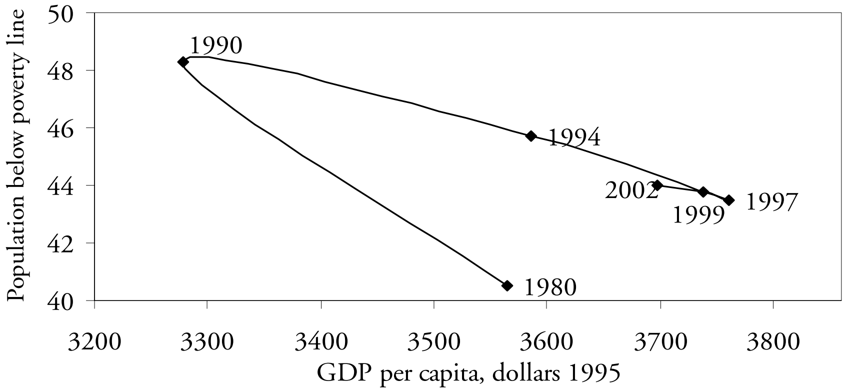


Source: Author estimates based on Maddison (2001) and updates from that author.

In the terms of Stiglitz (2003), the reform process replaced automatic stabilisers with automatic *de*stabilisers. As a result, economic growth has become increasingly sensitive to capital account volatility. Thus, the renewal of the net resource transfer in the early 1990s led to a recovery of economic growth, but capital account and other external shocks have interrupted growth three times in less than a decade (1995, 1998-1999 and 2001-2003). Overall, a period of fair economic growth in 1990-1997, of 3.7 percent a year (which was significantly below the record of 1945-1980, in any case), was followed by a "lost half-decade" – or, rather, a lost sexennial – in 1998-2003. During this recent period, per capita GDP has contracted for Latin America as a whole and for half the countries in the region. Furthermore, all patterns of rapid growth have been interrupted, including those of Chile and the Dominican Republic, the two most dynamic economies in Latin America in the 1990s.

Slow and volatile economic growth and adverse structural patterns have been reflected in weak labour markets. Employment generation has been particularly poor in South America. Rising informality, increasing income gaps between skilled and unskilled labour and, as already indicated, increasing dualism in productive structures are broader regional trends. A major reflection of this is the fact that the poverty/economic growth link experienced a structural deterioration in the 1990s, as Figure 3 indicates. Thus, poverty rates remained significantly higher in 1997 than they had been in 1980, even though the per

Figure 3 Poverty and Per Capita GDP



Source: ECLAC, Social Panorama of Latin America and Statistical Yearbook, various issues.

capita GDP decline that characterised the 1980s had already been reversed. With the further decline in average per capita incomes during the recent "lost half-decade", poverty rates have increased. In turn, this deterioration in the poverty/growth link reflects the fact that about half the countries in the region experienced a deterioration in income distribution during the 1990s, with only few of them experiencing the opposite pattern (ECLAC, 2001b; World Bank, 2004).[6]

These adverse trends defeated the positive effects of rising social spending, which rose from 10.1 percent of GDP in 1990-1991 to 13.8 percent in 2000-2001 – undoubtedly a major pay-off of the widespread return to democracy in the region. They also defeated some major innovations in social policy, particularly improved targeting. The continuous progress towards universal primary education has been accompanied by an increase in the coverage of secondary education (to an average of 70 percent in recent years). This progress notwithstanding, the education gap – in terms of both secondary and higher education coverage and educational attainment – separating Latin America from the developed economies and the emerging economies of Asia has widened. In an equally disturbing trend, the gap in secondary and higher education coverage separating high-income groups from low-income groups has tended to widen in many countries.

[6] Despite this general trend, the World Bank (2004) has argued that there has been an overall improvement in the regional income distribution due entirely to improvements in Brazil, a country that, according to ECLAC did not experience such positive trend.

Social security systems and social safety nets in the region have had to cope not only with the problems created by the segmented and insufficient coverage of the systems developed during state-led industrialisation, but also with the demands generated by population aging and the job and wage instability associated with recent development patterns. Increased levels of macro- and microeconomic risk have thus translated into greater social risks and greater demands for protection being made on underdeveloped social protection systems. Furthermore, in several cases, the principles of universality and solidarity that should characterise social protection systems have been put aside in social security reforms. This fact, together with adverse labour market trends, has been reflected in the frustratingly slow pace of progress in the coverage of these systems.

3 A More Balanced Global Order

3.1 The Basic Asymmetries of the International Economic Order

The strong divergence in the trends of per capita income across countries reflects basic asymmetries of the global order (Ocampo and Martin, 2003). These asymmetries fall into three basic categories. The first is associated with developing countries' greater macroeconomic vulnerability to external shocks, which also strain these countries' very limited means of coping with them. The net effect of this situation is that, whereas industrialised countries have greater manoeuvring room to adopt counter-cyclical policies and elicit a stabilising response from financial markets, the developing economies have almost no such room at all, since financial markets tend to accentuate cyclical variations, and market agents expect national authorities to behave pro-cyclically as well.

The second type of asymmetry is the extreme concentration of technical progress in developed countries. The spread of technical progress from the originating countries to the rest of the world has continued to be "slow and irregular", following Prebisch's half century-old verdict (Prebisch, 1950). This reflects prohibitive entry costs into technological dynamic activities, and even the constraints faced by developing countries in entering mature sectors, where opportunities for these countries are largely restricted to the attraction of multinationals that are already established in those sectors. In turn, the transfer of technology is subject to the payment of innovation rents, which are being afforded increasing protection by the international spread of intellectual property rights. The combined effect of all these factors explains why, at the world level, the production structure has continued to exhibit a high degree of concentration of technical progress in the industrialised countries, which thus maintain their predominant position in the fastest-growing branches of international trade and their hegemony in the formation of major transnational corporations.

A third asymmetry is associated with the contrast between the high degree of capital mobility and the limited international mobility of labour, especially among low-skilled workers. This asymmetry is a distinctive feature of the current stage of globalisation, since it was not observed in the nineteenth and early twentieth century (when all factors of production were highly mobile) or in the first quarter century following the Second World War (when all experienced limited mobility). This element is essential, as asymmetries in the mobility of production factors has a regressive impact, since it works to the benefit of the more mobile factors of production – capital and skilled labour – and to the detriment of the less mobile factors, such as unskilled labour (Rodrik, 1997).

Due to the strong trend towards inequality generated by global asymmetries, "levelling the playing field" through international rules is an inappropriate guide to reform. Attempts to apply the same measures to different situations may only serve to heighten existing inequalities. Thus, the principle of "common but differentiated responsibilities" enshrined in the Rio Declaration on Environment and Development, and the principle of "special and differential treatment" incorporated in the trade agenda, are more appropriate guidelines for building a more equitable global order than the "levelling of the playing field", which has guided efforts to revamp the international economic order in recent years.

This analysis establishes essential elements of international reform vis-à-vis developing countries (Ocampo and Martin, 2003). Correcting the first of these asymmetries implies that international financial institutions should adopt a comprehensive approach for reducing the segmentation and volatility of developing countries' access to international financial markets, and for providing them with more scope for actively using counter-cyclical macroeconomic policies. The latter include adequate surveillance during boom periods aimed at avoiding the accumulation of excessive macroeconomic and financial risks, as well as in adequate financing during crises, thus compensating for sudden stops in external financing. An additional, and equally essential, function is to counteract the concentration of credit at the global level through the provision of financing to those countries and agents that are subject to credit rationing in international private capital markets.

Correcting the second implies that the trading system should facilitate the smooth transfer of raw material production, technological mature industries and standardised services to developing countries, thus avoiding blocking of such transfer through protection or subsidies in the industrialised countries. It should also accelerate the access of developing countries to technology and guarantee developing countries' increasing participation in technology generation and in higher-technology branches of production.

To facilitate these processes, the trading system should give adequate room for the adoption of active domestic productive strategies in developing countries –"policy space", to use the terminology of the recent UNCTAD XI. In light of the problems that these countries currently face to guarantee a dynamic productive transformation, this implies "special and differential" treatment in several areas, but particularly in two critical ones: systems of protection of intellectual property rights that avoid increasing the costs of access to technology by developing countries or limiting the modalities through which the transfer is made, and the use of instruments to promote new export activities ("infant export industries"), which contribute both to the diversification of the export base and to the generation of additional value added in export activities. All of this requires the design of adequate instruments that avoid a sterile competition among countries for footloose industries.

Finally, overcoming the third asymmetry implies that labour migration should be fully included in the international agenda, both through a global agreement on migration policies as well as regional and subregional agreements. Such agreements should include, among others, mechanisms that facilitate migration (such as the recognition of educational achievements and labour market credentials, and the transferability of pension and other social security benefits), and promote the reduction in the costs of remittances.

3.2 Improved Governance Structures

There is now a broad consensus as to the decisive role played by national strategies and governance in determining how successful a country will be in forming strong links with the international community. However, without a suitable international framework, the inequality-generating forces spawned by international asymmetries will hinder national development.

The effort at building strong institutions for a better global order should be based on a network of world, regional and national institutions, rather than being limited to one or a few international institutions. Action at the regional and sub-regional levels plays a critical role as a midway point between the global and national orders for four main reasons: (i) the complementarities between global and regional institutions in a heterogeneous international community; (ii) the unequal size of the actors involved in global processes, which means that the countries' voices will be better heard if expressed as a regional voice; (iii) the greater sense of ownership of regional and sub-regional institutions; and (iv) the fact that the scope for effective economic policy autonomy has shifted in some areas (e.g. macroeconomic and regulatory policies) from the national arena to sub-regional or regional levels. Thus, a system that relies on networks of global and regional institutions is both more efficient and more balanced in terms of power relations.

In Latin America, regional institutions have played a stronger role than in other regions in the developing world. Nonetheless, Latin American integration has been subject to strong tensions in recent years, which can only be solved by a renewed political commitment to and a deepening of current integration processes. This means that beyond trade liberalisation and the design of common trade rules, there is a strong demand for macroeconomic and financial cooperation, harmonisation of regulatory regimes, complementary physical infrastructure, defence of regional commons, and a gradual advance in social and political integration.

Ultimately, however, international institutions would continue to rely on national responsibilities and policies, an essential characteristic of an international system where political processes continue to be built on nation-states. This is particularly valid in relation to the mechanism required to build social cohesion in the face of the strong domestic distributive tensions that characterise the working of the global economy. A basic corollary of this is that global institutions should be firmly respectful of national diversities. Furthermore, respect of diversity is the only principle that is consistent with the promotion of democracy at the world level. Indeed, promoting democracy as a universal value entails ensuring that national processes providing for representation and participation are allowed to influence the definition of economic and social development strategies and to mediate the tensions inherent in the globalisation process. This principle is embodied in the more recent thinking on cooperation for development, which emphasises that its effectiveness will depend on strong national policy "ownership" of the commitments made by developing countries.

It is convenient to recall, in this regard, that successful multilateralism under Bretton Woods was precisely based on a judicious mix of international rules and cooperation, which provided sufficient degrees of freedom for national authorities to pursue their growth and development goals. It was based on strong and effective national authorities, not on weak ones. In this light, the current mix of incomplete international arrangements and weakened national policy effectiveness must be seen as the most inappropriate of all possible mixes.

Lastly, steps taken to restructure the international order should also ensure the participation of developing countries on an equitable basis. Achieving this will require positive action in support of poor and small countries on the part of the international community, as well as requiring an effort on the part of those countries to organise themselves within the framework of regional and sub-regional institutions. Another implication of this principle is that preference should be given to institutional schemes having the largest possible number of active participants. Finally, the adoption of appropriate rules of governance is essential in ensuring the basic rights of developing countries – especially of the smaller ones – in the international order, institutionalising accountability and strengthening auditing functions carried out by institutions that enjoy credibility with all relevant actors. This approach involves placing limits on the power of the countries having the most influence over international institutions. However, this is not necessarily to their detriment, since it will also lead to a greater commitment by developing countries to the global institutional order.

4 National Strategies for Dealing with Globalisation

Any national development strategy in the global era must be founded upon solid social covenants that ensure political stability, non-discretionary legal systems and practices that provide security of contracts and an impartial, relatively efficient state bureaucracy. These broad institutional requirements, which have been correctly emphasised in the recent literature, are essential elements of an appropriate investment climate and, as such, may be regarded as necessary conditions for growth. However, neither of them accounts for the specific forces that drive economic growth, nor do they provide the means for dealing with old and new forms of vulnerability. Thus, the strategies adopted by the developing countries should incorporate at least four additional elements: (i) macroeconomic policies designed to reduce external vulnerability and facilitate productive investment; (ii) active productive development strategies aimed at building systemic competitiveness; (iii) highly active social policies, particularly in the fields of education, employment and social protection; and (iv) specific institutions that generate an appropriate balance between the public and the private interest. There are no universally valid models in any of these areas, and there is, consequently, a great deal of scope for institutional learning and, most importantly, for the exercise of democracy.

4.1 A Broad View of Macroeconomic Stability and the Role of Counter-Cyclical Policies

The consistency that ought to characterise macroeconomic policies should be based on a broad definition of stability that recognises that there is no single correlation between its alternative dimensions and, thus, that significant trade-offs may be involved. Two lessons are particularly important in this regard. The first is that real instability is costly – at least as costly as high inflation and external imbalances. Recessions entail a significant loss of resources that may have long-run effects: firms may sustain irreparable losses of both tangible and intangible assets, and the human capital of the unemployed and the underemployed may be permanently lost. In turn, the uncertainty associated with variability in growth rates encourages "defensive" microeconomic strategies rather than the "offensive" ones that lead to high investment rates and rapid technical change. Volatile growth leads to a high average rate of underutilisation of production capacity, reducing productivity and profits and adversely affecting investment and, thus, long-run growth (Ffrench-Davis, 2000).

The second lesson is that private sector deficits are just as costly as public sector deficits and that risky balance sheets may be as damaging as flow imbalances. When crises lead to a financial meltdown, the associated costs are extremely high. Asset losses may wipe out years of capital accumulation. The socialisation of losses may be the only way to avoid a systemic crisis, but this will affect future fiscal (or quasi-fiscal) performance. Restoring confidence in the financial system takes time, and the financial sector itself becomes risk-averse, a feature that undermines its ability to perform its primary economic functions.

These two lessons are interconnected, as financial boom-bust cycles have become the predominant source of business cycles in the developing world, particularly in emerging economies. The essential task of macroeconomic policy is thus to manage them with appropriate counter-cyclical tools. In particular, managing volatility requires a combination of three policy packages, whose relative importance will vary depending on the structural characteristics and the macroeconomic policy tradition of each country. The first is consistent and flexible macroeconomic policies aimed at preventing public or private agents from accumulating excessive levels of debt and at forestalling imbalances in key macroeconomic prices. The second is a system of strict prudential regulation and supervision, which should be tightened during periods of financial euphoria to counter the mounting risks incurred by financial intermediaries. The third element is liability policies aimed at ensuring that appropriate maturity profiles are maintained with respect to domestic and external public and private sector obligations (Ocampo, 2002b).

Managing counter-cyclical macroeconomic policies is no easy task, as financial markets generate strong incentives for developing countries to overspend during periods of financial euphoria and to overadjust during crises. Moreover, globalisation places objective limits on national autonomy and exacts a high cost for any loss of credibility when national policy instruments are poorly administered. For this reason, it may be necessary to rely on institutions and policy instruments that help to provide credibility, including fiscal stabilisation funds and a clear separation of fiscal and monetary policy management (which may take the form of, but does not necessarily imply central bank independence). The explicit renunciation of policy autonomy (e.g. by adopting a foreign currency) is hardly a solution to this dilemma. Recent events – the Argentine crisis, in particular – leave no doubt as to the fact that macroeconomic authorities' credibility can be strengthened more effectively through prudently managed flexibility than through the adoption of overly rigid rules.

In the long run, economic growth hinges on a combination of sound fiscal systems that provide the necessary resources for the public sector to do its job, a competitive exchange rate, moderate real interest rates and deep financial markets. Macroeconomic policy should be focused on ensuring the first three elements. The objective of financial deepening is to provide suitably priced investment finance with sufficiently long maturities. The liberalisation of financial systems in Latin America has not deepened financial markets or reduced the region's high intermediation costs as much as expected. Consequently, the public sector still has an important role to play in furnishing financial services and promoting the emergence of new agents and segments in capital markets. Meanwhile, efforts to increase public sector saving, the creation of corporate savings incentives and special mechanisms to foster household saving (for retirement, in particular) may be useful means of raising national savings rates.

4.2 Macroeconomic Policies Are Not Enough: The Role of Productive Development Strategies

The idea that the combination of open economies and stable macroeconomics – in the limited sense in which this term has come to be used, i.e. fiscal balances and low inflation – would be sufficient to spur rapid economic growth has not been borne out so far. This has sparked an unresolved debate concerning the underlying reasons for this result. The orthodox interpretation is that markets have not been sufficiently liberalised. This view is contradicted by the longest-lasting episodes of rapid growth in the developing world (i.e. the East Asian or, most recently, the Chinese and Indian "miracles" or, in the past, the periods of rapid growth in Brazil or Mexico), all of which involved a mix of "local heresies" with more orthodox policy prescriptions (Rodrik, 1999; Amsden, 2001). Alternative interpretations emphasise the role of market failures, particularly in the functioning of capital and technology markets, as the explanation for slow growth. Again, this line of reasoning must explain why rapid growth was possible in the past in many developing countries that faced constraints on this account.

A more promising line of reasoning draws upon the different historical variants of structuralism in economic thinking. This view emphasises the fact that economic growth involves a constant transformation of production structures. This process is not an automatic result of a strong macroeconomic performance, nor does it come about in an automatic, harmonious fashion, since the expansion of new sectors involves the accumulation of technological capabilities, and the creation of complementary set of activities and commercial networks, all of which involve learning process and coordination costs (Chang, 1994; Ocampo, 2002a). The transformation of production structures must therefore be an explicit priority of any development strategy. Its core objectives in an open environment such as that characterising the Latin American economies today should be building systemic competitiveness based on three fundamental pillars: (i) the creation of innovation systems to speed up the accumulation of technological capacities; (ii) support for new productive activities and the formation of production linkages; and (iii) the provision of quality infrastructure services. The role of deep financial markets has already been emphasised as an essential complement to an appropriate macroeconomic environment.

This interpretation brings forth a central feature of successful development experiences in the past: a strong industrialisation drive built on solid state/business sector partnerships. On the opposite side, the recent experience of Latin America and some other regions of the developing world indicates that opening markets with "neutral" incentives, arms-length government-business relations and multilateral (Uruguay Round) constraints on traditional development instruments do not provide an adequate substitute for active productive development strategies.

Because of the key role of knowledge, any such strategy must be based on increased public and private investment in education, vocational and business training, and science and technology. The strategy should be implemented through many different forms of collaboration between the state and the private sector, all of which should focus on creating dynamic innovation systems. In view of the intrinsic importance and crosscutting nature of new information and communication technologies, efforts to promote their active use are of vital importance in contemporary innovation systems.

Given existing Latin American conditions, the strategy for diversifying production has three clear-cut priorities: export diversification; broadening the linkages between domestic production and activities catering to the international market; and the integration of small and medium enterprises into production for the international market. Given the strong processes of "creative destruction" characteristic of modern economies, these actions should be matched by explicit policies aimed at restructuring non-competitive activities.

The other core element of systemic competitiveness is the provision of quality infrastructure services. In a number of countries, various public-private partnerships have succeeded in making significant progress in this regard, particularly in telecommunications, port services and maritime transport, and – to a lesser extent and with wider differences across countries – in energy services (electricity and gas). More difficulties have been encountered in bringing about substantial improvements in overland transport infrastructure, filling regulatory gaps in the provision of the corresponding services and increasing the efficiency of state enterprises in areas where the state continues to furnish services directly.

The effective incorporation of the sustainable development agenda places additional demands on production strategies today and, in particular, for the mobilisation of investment in dynamic production sectors that use clean production methods and technologies and achieve competitiveness through the accumulation of capital in the broad sense of the term (i.e. human, social, physical and natural capital). The creation of markets for environmental services is the most promising idea in this realm, as it simultaneously generates the economic incentives and the financing required for adopting new technologies.

Progress on all these fronts requires innovative public-private partnerships based on shared strategic visions. An active learning process would necessarily generate different mixes of private and public sector involvement and of horizontal and selective instruments. In any case, these instruments should include a clear link between incentives and results.

4.3 Improved Social Linkages

Social progress may be thought of as the result of three basic factors: a long-term social policy aimed at improving equity and guaranteeing inclusion; economic growth that generates adequate quantities of quality employment and opportunities for small firms; and the reduction of the productivity gaps (dualism) between different economic activities and economic agents. Globalisation has increased tensions in all of these realms, as it has biased the demand for labour towards high skills, generated new tensions between competitiveness and employment, increased dualism in productive structures and created new social risks. Given these tensions, social strategies should focus on three critical areas: education, employment and promotion of small business, and social protection.

Advances in these areas build upon one another. Education is the primary means of halting the inter-generational reproduction of poverty and inequality. It has become all the more important because globalisation has increased the need for human resources capable of engaging in new modes of production, competition and harmonious coexistence. Employment is a key factor in social integration by virtue of its importance in terms of social fulfilment and as a determinant of individuals' opportunities for consumption. As small firms are generating most employment, the environment in which those firms operate has become a major determinant of the quality of employment. The risks faced by the population include those associated with macroeconomic volatility, the adaptation to new technologies and ways of organising work, and reduced employment in many sectors.

In the area of education, efforts should focus on achieving universal coverage, preferably up to the end of secondary school, and on reducing differences in the quality of the education provided to different socio-economic groups. New approaches to learning are also required, involving access to knowledge, networking and the use of information and communications technologies. The modernisation of educational tools is not enough, however. In conjunction with these new tools, it is even more important to develop higher cognitive functions by orienting the learning process towards problem-identification and problem solving, an increased capacity for reflection, creativity, the ability to distinguish between what is relevant and what is not, and planning and research skills, since these functions are vital in an information-saturated world.

Job creation by proactive labour policies is only sustainable when the economic activities concerned are competitive in the long term. The retooling of production activities and increased labour mobility make it necessary to implement aggressive labour training policies that will give workers opportunities to learn how to adapt to new conditions. On the other hand, the central role of small firms (including micro enterprises) and the increasing dualism that characterise productive structures emphasise the need for special policies aimed at guaranteeing the access of these firms to technology, capital and managerial abilities and, as noted in the previous section, at clustering their activities and encouraging their links with larger firms. In addition, labour ministries should adopt policies that help foster self-regulation by social actors (social dialogue) and that devote special attention to the workers who have not gained entry to modern sectors (unemployed and informal-sector workers). To these ends, these ministries' role as policy-setting bodies should be restored.

The development of social protection systems should be guided by the principles of universality, solidarity, efficiency and integrality. Progress cannot be made towards universality unless the sharp inequities in access to services and in their quality are corrected. Solidarity should be ensured through a combination of compulsory contributions, public transfers, and cross-subsidies between different income strata and risk groups. Latin American countries faced enormous demands in this area, as the chronic shortcomings in the coverage of traditional risks are now mixed with the additional burden generated by the new risks associated to the vulnerability in employment and income. Furthermore, the extent of unemployment and, particularly, informal-sector employment limit the feasibility of attaining universal coverage by means of the traditional forms of social protection. Accordingly, emphasis should be placed on complementary insurance mechanisms that are in keeping with the wide range of employment arrangements in use today. These types of arrangements should be designed to promote labour mobility and provide protection against both external and domestic shocks.

The huge disparities in income distribution that characterise the Latin American countries generate considerable demands on social policies. Cross-country evidence indicates that such disparities may have become an essential obstacle to economic growth. This indicates that active social policies are, in a very direct sense, a productive investment. Nonetheless, these policies face the constraints posed by low tax revenues in most countries of the region, as well as traditional high demand on social spending by middle-income groups. Considerable political effort must thus be focused on guaranteeing a fiscal covenant that satisfies the multiple demands that social policy faces in the region, but it is hard to think of any solution that does not involve high tax revenues with a progressive component.

4.4 An Appropriate Balance Between the Public and the Private Interest

Given the tensions that characterise the contemporary world, a new balance between the market and the public interest is an essential component of institution building. This should not be viewed as running counter to the operation of the market. Actions that ensure an adequate supply of public and merit goods, exploit positive and avoid negative externalities among agents, and ensure an equitable distribution of the benefits of development, can serve as market enhancers.

The concept of "public policy" should be understood in a broad sense, as any organised form of action aimed at achieving objectives of collective interest, rather than as a synonym for government actions. This definition of "public" is in keeping with an awareness of the need to open up opportunities for participation by civil society. It is also consistent with the need to overcome a crisis of the state that characterises many countries, and to correct both "market failures" as much as "government failures". This approach emphasises the importance of attaining a high "institutional density" in which a wide range of social actors participate actively, and are accountable to the citizenry – i.e. a high "democratic density".

Institution building, in this sense, recognises that development comprises broad goals, an idea that is implicit in the concepts of sustainable human development or the more recent concept of "development as freedom" (Sen, 1999). These concepts are obviously expressions of long-standing and deeply rooted notions in development thinking. Its major implication is that the economic system must be subordinated to broader social objectives (Polanyi, 1957). This is the only way to confront the strong centrifugal forces that characterise private affairs today. Indeed, in many parts of the developing (and industrialised) world, people are losing their sense of belonging to society, their identification with collective goals and their awareness of the need to develop ties of solidarity. This fact drives home how important it is to foster those bonds in order to "create society". In other words, it means that all sectors of society need to participate more actively in democratic political institutions and that a wide range of mechanisms need to be developed within civil society itself to strengthen relationships of social solidarity and responsibility and, above all, to consolidate a culture based on the sense of a collective identity and a tolerance for diversity.

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6

Improving Rather than Abandoning Reforms

Anthony Boote

José Antonio Ocampo's chapter covers a lot of ground and therefore inevitably I have to be somewhat selective in my comments. I agree that a key task of the international community is to ensure that everyone benefits from globalisation rather than some groups being left out. I think, however, that the chapter is a little pessimistic on the impact of globalisation: following Sala-i-Martin,[1] and reflecting growth in China and India, over the last 30 years there has probably been an overall decrease in inequality. Similarly, there is some evidence that overall inequality fell in the most rapid periods of globalisation, i.e. late nineteenth and early twentieth century and post-second world war. There is strong evidence that trade liberalisation has helped growth and has not worsened inequality so it is unambiguously positive for poverty reduction.

This said, I accept the challenges outlined in the chapter. I agree that a better global order with promotion of global public goods is an important part of the appropriate response. The Fund has taken steps to improve global financial stability and to help countries limit the impact of financial volatility. In common with our colleagues in the World Bank, we have urged developed countries to remove trade barriers, to open their markets to exports and to eliminate agricultural subsidies. We have also taken steps to improve the financial architecture such as the work on standards and codes. A second area that is important in this context is governance, although this remains an ongoing

[1] Xavier Sala-i-Martin, "The Disturbing 'Rise' of World Income Inequality", NBER Working Paper 8904, April 2002.

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challenge. We certainly have stressed the importance of improvements in the rule of law, accountability and efficiency of the public sector and of tackling corruption and we are prepared to offer advice, and technical assistance in that area.

Turning to what the chapter describes as three asymmetries, I would acknowledge that macroeconomic stability is an area where there is more discretion for developed countries to act than for developing countries in relation to international capital markets. We are working hard to help developing countries to have more scope for counter-cyclical macroeconomic policies. We are continuing to work on how we can help countries, including low-income countries, best respond to shocks. On technological transfers, there is considerable scope for both domestic policies and also for trade policies and foreign direct investment. Labour mobility is also a very important issue as the chapter acknowledges given the size of remittances to developing countries. However, the benefits from these remittances need to be weighed against costs in loss of educated and trained labour from the countries concerned: this is an area where the Bank has done considerable work.

On the challenges facing Latin America, I would suggest that there might be a consensus in the region that there is a need to improve and strengthen rather than abandon the current approach. There needs to be more emphasis on policies that reduce vulnerability, including an overall approach to try and reduce relatively high levels of debt in the region. In the fiscal area, the focus should be on broadening and making more uniform the tax base, with achievement of income distribution goals through the expenditure rather than the revenue side of the budget. Further trade liberalisation should be a priority: one diagnosis of the Latin American situation is that you have had relatively free financial markets without enough trade integration into the world economy. Policies are needed which promote both public and private investment in the region. Clearly there is some role here for public private partnerships but consistent with overall macroeconomic stability and the aim of reducing debt levels. There is also a need for legal and public administration reform. A particular challenge is to strengthen financial systems so that they can play a greater role in the financing of investment; this will involve steps that should reduce the large spreads in the banking system. I agree with the emphasis placed in the chapter on the need for improved prudential regulation particularly in the counter-cyclical context. Further progress on inflation-targeting regimes plus central banking independence remains important. Equally, there is a continued agenda of labour market reform and in particular removing disincentives – both regulatory and taxation – to employment in the formal sector.

Finally, I agree with José Antonio Ocampo's emphasis on the importance of domestic ownership of policy choices. We have adopted a whole new approach to lending to low-income countries by the Bretton Woods institutions, based on ownership of poverty reduction strategies produced within countries. I think there is widespread recognition throughout our activities that there are no single solutions coming from Washington and that what matters is that countries adopt programmes and policies which deal with the problems they face in a way that they believe in.

7

The Widening and Deepening of Democratic Development

Osvaldo Sunkel

In an elegant, convincing and comprehensive manner, José Antonio Ocampo's chapter covers the dual task of justifying the need for a new development agenda to overcome the serious deficiencies of the policies of the so-called Washington Consensus, and presenting a well-structured alternative agenda at the global, regional and national levels. Since I concur with most of Ocampo's analysis, I will limit myself to three comments. My first comment refers to my single substantial disagreement with Ocampo, and my other two comments will emphasise aspects of Ocampo's agenda that I believe must be given priority.

Economic Liberalisation and Democratic Development

In his second section, Ocampo states, "the region undertook with enthusiasm ('ownership') economic liberalisation in the mid-1980s (or earlier in some countries)". I have a rather different view of what took place, and it is important to clarify this matter because it has some serious implications for the economics profession, international financial institutions and the socio-political situation of many Latin American countries.

It is important to recall that after the Great Depression and the Second World War, all regions of the world adopted wide-ranging modernisation and growth policies, inspired by the state-led Keynesian and socialist paradigms. In the non-industrialised countries, these policies consisted of the development of infrastructure (energy, communications and transportation), industrialisation, agricultural reform and social services (public

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education, health, housing and social security). In the case of Latin America, this gave rise to the so-called "import-substituting industrialisation" model, a completely misleading label, which singles out one problematic aspect of a much more complex, wide ranging and rather successful modernisation process: GDP grew faster than at any other time before or since, poverty declined, standards of living increased, and social conditions improved.

Although serious economic imbalances were developing, what brought this state-led modernisation process down were not so much the pitfalls of the import-substituting industrialisation policies, which in any case were being widely recognised and in the process of being revised, but two other unrelated events.

The first type of events were the internal socio-political upheavals leaning towards socialism that – in the context of the Cuban Revolution and the Cold War – ended in some countries in harsh dictatorships and the adoption of neo-liberal market-led policy reforms.

The second event was the oil crisis, with the consequent huge accumulation of petrodollars in the international banking system and the large increase in foreign debt that followed. This brought about the debt crisis of the early 1980s, after the sharp shift in monetary policy in the United States with the second oil shock. The imminent threat of default on these foreign debts rallied the governments of the industrialised countries and the international financial organisations to impose drastic macroeconomic adjustments on the debtor countries, policed by the IMF, followed later by market-oriented structural reform programmes.

These policies found local support in a new generation of US-trained economists, largely in the Chicago School tradition, which were gaining a strong academic presence mostly in some private universities, where they were seen as a healthy antidote to the structuralist and socialist learning tradition of the public universities, but which did not have any substantial support in the private business community nor in the population more generally.

The negotiating weakness of the debt-ridden countries afforded the international financial community and the community of orthodox economists a golden opportunity to dismantle the state-led development policies of the previous decades and to impose a simplistic technocratic and normative textbook version of neo-classical economics, strongly biased ideologically against almost any kind of government activism in the economy. In fact, a black legend was invented to characterise the earlier policies as if they had been total failures and as if there had existed centrally planned socialist economies.

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The dramatic shift from a mixed-economy, state-led development process to an extreme neo-liberal market economy was not simply a shift in economic policies, it was nothing less than a socio-political and cultural revolution, which has brought about fundamental changes in social structure and behaviour and has entailed enormous costs, both economic, social and moral (meaning corruption). This in turn has produced serious destabilising political effects in Latin America on the newly inaugurated phase of democratically elected governments of the 1980s. Over the last eleven years, seven presidents have had to abandon office before ending their terms due to corruption and popular upheavals!

In a new era of democratic governments, a growing contradiction is emerging between the majority of the population and the kind of economic policy favoured by the technocratic elites of governments and international financial institutions, or at least with the way in which these policies are implemented. This contradiction surely has much to do with the recurrent phenomenon of presidents that are elected on progressive platforms only to turn, when taking office, to a team of conservative technocrats – or directly to former high banking or financial executives – in order to implement policies aimed at financial stability and investor confidence.

There is an urgent task for the economics profession and the international economic organisations to critically review the prevalent conventional economic policy prescriptions in the light of the economic and socio-political experience of the last two decades. They should make the prescriptions more flexible and adjustable to the particularities of different countries via creative economic, social and political proposals with respect to such major intractable problems as persistent low investment and growth, large foreign debt burden and economic instability, state reform, unemployment, inequality, poverty, innovation and creativity, and so on.

Financial stability cannot constitute a rigid and dogmatic framework, but financial globalisation imposes certain limits on policy, depending on the efficiency, creativity and responsibility with which the political and technical teams (including those belonging to the international financial institutions) promote the process of political and economic reform. The challenge is a formidable one, but it also represents an opportunity to reorganise our economies and societies to move towards a new era of democratic sustainable development.

If development and democracy are to be mutually sustainable, it is vital that economic policy and public institutions become impregnated with the need for solidarity with the majority of the population, through greater social participation, decentralisation, the strengthening of social movements and of the weakest social actors, as well as non-governmental organisations. This constitutes a wide and complex field of action that is part and parcel of what could be called the "widening and deepening" of democratic development. The science of economics, the economics profession and international economic organisations cannot continue to ignore the social, political and cultural effects of globalisation and neo-liberal policies.

Old and New Development Strategies

In the first section of his chapter, Ocampo offers strong evidence against the orthodox prediction that neo-liberal policies would lead to international convergence. Indeed, such convergence only seems to have occurred in periods and countries when deliberate state-led industrialisation policies were adopted. Therefore, "levelling the playing field" (i.e. applying Washington Consensus policies) worsens asymmetries since it favours the stronger against the weaker actors in the international and national systems, as shown by the strong renewal of the trend towards income divergence in recent decades. When the players are unequal, "levelling the playing" field benefits the stronger players. This is why in sports, for instance, players have different handicaps as in golf, and there are different categories and levels in boxing, football and other games. Therefore, as Ocampo correctly states, international systemic asymmetries must be addressed and corrected, and he makes several important proposals in this regard. But meanwhile, the levelling of the playing field in such matters as trade and capital market liberalisation continues to take place. This must be compensated urgently and strongly with national public policies aimed at strengthening the weaker local players. The development of competitive, innovative and high value added productive activities must be a top priority.

The success achieved in international markets in recent years by many Latin American countries was based principally on the move from an inward-looking to an export-based development strategy. This required the establishment of the appropriate framework of macro and microeconomic conditions, an extension of the role of the market and support for private economic agents. A greater innovative and entrepreneurial effort was likewise required on the part of the business community. The implementation of these urgently needed changes have been the most important tasks after the debt crisis.

It is only fair to point out that in order to achieve the objectives just mentioned, Latin American countries have been able to count on a considerable patrimony or "stock" of pre-existing productive potential, which is the positive inheritance of the state-led development of previous decades. This includes the accumulation of social capital and knowledge about the availability of natural resources; transport, communications, and energy infrastructure; the increased capacity for industrial production and the availability of experienced and well-qualified human capital. In other words, initial conditions were far more favourable than in the earlier phase.

Indisputably, the most positive aspect in this process of transformation has been the great qualitative and quantitative leap in terms of international integration through dynamic export expansion. But there is no guarantee that this newly found dynamism is lasting, because it contains contradictory trends. On the one hand, to continue to conquer foreign markets and develop deeper international linkages, the learning process will have to be strengthened. On the other hand, to the extent that the impulse derived from the favourable initial conditions gradually becomes exhausted, one can expect a deceleration in this process. After the first stage, which was to some extent based on an expansion of previously "repressed" exports, we could enter into a phase of decreasing returns.

To a large degree, the principal institutional changes and shifts in the orientation of the economic policy that were required have already been undertaken. The exceptional profit rates at the beginning of the period are tending to level out because of the pressures for a lower real exchange rate and the increase in national and foreign competition. The most accessible foreign markets are showing signs of saturation and it is increasingly difficult to gain access to these markets. New competitors are appearing from countries that are in the process of adopting similar export strategies. The existing infrastructure and productive capacity are reaching their limits. Renewable natural resources are being deteriorated by overexploitation, and the non-renewable resources are running out or are entering a phase of increasing costs. The entrepreneurial dynamism and innovative capacity, linked above all (although not exclusively) to large enterprises, has to confront the challenge of interacting with medium, small and even micro-firms.

Within the context of the new export-based model that has been adopted, the potential for economic and social development in our countries depends to a large extent on the successful promotion of export growth and the strengthening of its internal productive and social linkages, which has been disappointing. We cannot continue on the same path as before – a dynamic structural transformation is required with respect to markets, products, processes, organisation, technology and resources. Export growth in excess of the current expansion of productive capacity is a necessary condition for the success of economies that depend on the highly dynamic importation of capital, technology, critical inputs and sophisticated consumer goods.

This implies a whole new set of objectives and policies: an intensification of the process of capital accumulation, innovation and adaptation of scientific and technological knowledge; the penetration of new markets; the revitalisation and modernisation of domestic production; the promotion of linkages between the export sector and international and internal markets; the incorporation of the informal productive sector into the modern sector; the exploitation, in a sustainable manner, of renewable natural resources; the replacement of non-renewable resources through new investment and technologies; and a shift towards the export of goods with higher value-added, singling out products in the most dynamic segments of international trade in goods and services.

To sum up, the challenge is to promote an "industrialising" export-led developmental model, in the sense of increasingly incorporating technology and knowledge, and making better use of economies of scale through the deepening of the process of domestic integration between productive sectors, both horizontally and vertically. All this should be directed towards improving competitiveness and raising the share of technologically advanced, high value-added exports.

This set of structural and institutional policies should be specified in detail in an explicit development strategy over the medium and long-term for each country. It represents the way of the future with regard to industrial, science and technology, human resource and educational policies.

Some important initiatives already exist and have been put into practice, in both the private and public sectors. But a lack of a general national and regional awareness in the countries of Latin America about the need for a renewed collective effort of sufficient scope, tenacity and coherence, especially with respect to regional integration, is worrying. All social and economic actors should be involved in an informed and systematic process of discussion regarding possible and probable scenarios. Debates should be encouraged with respect to policy guidelines and the identification of priority actions over the long and medium term. It is necessary to pool limited resources and to take maximum advantage of the available opportunities against an admittedly sombre situation of competitive international markets, sluggish economic growth, persistent protectionism, and growing uncertainty and instability.

It is also necessary to acknowledge the fact that it is impossible to respond simultaneously and instantaneously to all social demands. We need to define medium and long-term priorities and search for compromise solutions that distinguish between what is feasible immediately and what can only be achieved gradually. This requires the elaboration of a clear vision of the future in which all members of society will find a decent place, including the most marginalised members. We have learned that it is not possible to supplant the market. It constitutes an irreplaceable system of signals by which economic transactions are ordered. Nevertheless, at the same time, it is also necessary to recognise that the market is incapable of resolving the kind of questions raised before, all of which require important strategic decisions and public policies. These should be elaborated collectively by means of a medium and long-term strategy, articulated through all the actors involved (private, public and foreign). The strategy should stimulate and bring forth proposals and initiatives that are complementary to those that emerge from the market process.

No organisation, institution or modern enterprise can dispense with a strategic vision. In the past, exemplary planning and developmental organisations were created in Latin America; institutions that played an extraordinarily important role in their heyday: Corporación de Fomento de la Producción in Chile, Nacional Financiera in Mexico, Banco Nacional do Desenvolvimento Económico in Brazil, the Planeación Nacional in Colombia and so on. Perhaps it is worth remembering that many of the most successful privatised enterprises of today, and a considerable number of their owners and managers, owe their apprenticeship and development to these institutions. For the era in which we now live, we need to invent new institutions designed to deal with the medium and long term according to the realities and necessities of the present and with the objective of anticipating those of the future. In collaboration with the state, all the different social actors have a fundamental contribution to make in this respect.

The Social Challenge

Latin America is facing an era of sharp social polarisation. Even during its most stable and successful periods, Latin America has been characterised by the persistence of enormous disequilibria between its different economic and social sectors and geographical areas. These imbalances are profoundly rooted in history. As a consequence, islands of modernity, progress and richness comparable to those in the developed world, coexist with oceans of backwardness and poverty, similar to those of the most underdeveloped regions in the world.

There are violent social and demographic contrasts between the levels of income and the quality of life in the midst of the large urban metropolis, as well as between these urban centres and the rural areas, and within the urban and rural areas. There are huge areas where large marginalised populations of pre-Hispanic and Afro origin and culture persist side by side with privileged sectors in an advanced process of integration with the global economic and cultural system. These small modern areas are like an archipelago in an ocean where the basic economic, political, cultural and environmental conditions are more akin to the underdevelopment of the nineteenth century, or even earlier.

The principal and immutable social, economic, political and cultural characteristic of Latin America is this heterogeneity, diversity, contrast, and fragmentation. Will these characteristics be accentuated or weakened by the profound national and international processes of economic reorganisation, socio-political restructuring, institutional reform and cultural transformation in which they are immersed? As can be gathered from some of the observations that follow, I believe that the future panorama is fairly grim.

The widespread and prolonged reduction in investment, employment, income and consumption over the last decades has led to an overwhelming expansion in the numbers of "new poor", in addition to those who already lived in poverty. One of the most significant elements of this phenomenon in most countries has been the lack of adequate public social expenditures, even through these expenditures increased in several countries. This has manifested itself in numerous ways; a serious deterioration in the public educational and health institutions and infrastructure; a large increase in unemployment and underemployment, a striking reduction in the salaries of professionals and other people who work in these sectors; a sharp decline in the middle and organised working classes; a serious shortage, and sometimes complete lack, of essential supplies and equipment; the overcrowding of classrooms and hospital wards; an alarming school drop-out rate; a lack of urgent attention and the existence of prolonged waiting lists at hospitals; a precipitous decline in morale and a partial or total exodus of the most able staff. In general, there has been a serious deterioration in public services. One especially shocking example is the neglect of preventive health care facilities.

Bearing in mind the experience of the majority of members of the lower and lower-middle classes in Latin America with respect to social service provision, we cannot help but conclude that a new form of polarisation is occurring that represents a kind of social apartheid. Whereas a select minority enjoys social services of a quality similar to those in the industrialised countries (even to the extent of having access to the most reputable hospitals of the United States), the great majority are deprived of adequate social services. Another aspect intimately linked to the subject of poverty and social inequality is the widespread and profound change that has occurred in the employment structure during the past decade in Latin America. It is the key to understanding the gravity of the current social problem. The current process of economic liberalisation and transnational integration further aggravates the pre-existing conditions of social segregation. This is particularly relevant in those sectors of the economy where large and medium enterprises with the greatest innovative capacity are continuously restructured in order to compete on the domestic and international markets. This process results in the creation of highly productive and well-paid employment for some, but also considerable job losses for others in the newly privatised, restructured enterprises and in the firms that do not resist the intensification of competition.

Thus, there are divergent tendencies between the workers who form part of the modern sector, characterised by high productivity and a considerable and growing degree of internationalisation, and the rest, who either join the ranks of the unemployed or are forced into low-productivity activities, self-employment and unemployment. Unfortunately, left to the spontaneous interaction of market forces, the latter group is usually far more numerous than the former, and together they make up what we could term "the new poor".

The social challenge that Latin America faces is staggering in scope. There is a pressing need to tackle both the "old poverty" inherited from previous socio-economic models and the "new poverty" generated by the present transition, crisis, adjustment and restructuring. Social policies must be placed within this context; however efficient they may be, they can represent no more than palliatives since they constitute merely an attempt to struggle against the current thrust of economic policy. To make social policy truly efficient, substantial modifications are required in economic policy, as well as changes in social policy itself.

To achieve this objective, there is a need to distinguish between the primary income distribution and the degree of redistribution achieved after state intervention. Redistribution as a policy is very much constrained due to the reduction in the role of the state and the preference for low and regressive taxation. While this situation needs to be corrected urgently, it is also necessary to think of ways to alter the primary distribution of income through structural reforms which promote better access to productive assets such as land, capital, education and knowledge, and institutional changes to facilitate the creation of new small and medium-sized business ventures.

8

Reforming the Reforms of the Washington Consensus

Ricardo Ffrench-Davis[1]

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

Reforms were conducted under pressures from international financial institutions, some governments (particularly that of the US) and economists following the recipe, in strong fashion, of a neo-liberal approach. It was the time of the supposed "end of history", with a naive interpretation that there was a *unique* road to a market economy in a globalising world that drastically limited the room for choice. Broadly speaking, Latin American countries were the more active implementers of neo-liberal reforms.

Nearly one and a half decade of intensive and profound reforms has left a mix of successes and failures, with a "disappointing" net outcome, using an expression summarising an evaluation by John Williamson (2003), the economist who coined the expression *Washington Consensus* in his well-known 1990 publication. The net balance, in terms of growth and equity, has been notoriously poor. Of course, there are clearly positive results in several areas: the eradication of hyperinflation,

[1] Principal Regional Adviser of ECLAC and Professor of Economics at University of Chile. All opinions expressed in this chapter are the sole responsibility of the author.

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more balanced public budgets, a rise in the share of exports, less bureaucratism, and less microeconomic decisions taken centrally. Actually, Latin American countries achieved an average one-digit inflation in 1999 to 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 percent of GDP, quite positive compared to that of developed nations; the volume of exports grew vigorously, 8 to 9 percent per year in the 1990s, close to 50 percent faster than world trade in that decade.

However, 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 by only 2.4 percent during the fourteen years between 1990 and 2003, and 1.3 percent in the past six years, which ECLAC has called the "over one-half decade lost". Since population rose 1.6 percent per year, per capita growth has been negative. Additionally, active population (the labour force comprising all workers and entrepreneurs) increased 2.6 percent annually since 1990; consequently, the mediocre growth implies a declining output per worker in the long period 1990 to 2003. This contributes to explaining the poor performance of wages: they stagnated since 1990 (see Table 2). But, wages refer only to the formal segment of labour markets. Actually, labour markets expelled workers from the formal to the informal segments, with more instability of jobs and falling average income of non-waged workers (ECLAC, 2003, based on ILO data for Latin American countries).

In terms of poverty, after the sharp rise recorded in the 1980s (see Table 2), an additional worsening took place during the neo-liberal reforms; now there are 21 million more poor people than there were in 1990, and income distribution remains highly regressive (World Bank, 2003). This is partly associated with the slackness of labour markets, higher open unemployment, the low physical investment ratio (that is, productive investment or gross capital formation), and the underrated role granted to reducing the equity gaps in education, labour training and access to capital markets. The distribution of opportunities and of productivity has become even more skewed than before reforms.[2]

[2] This was clearly the case of Chile during the 1970s and 1980s, when most neo-liberal reforms were implemented. Some correction, *with reforms to the reforms*, took place with the return to democratic rule in the 1990s (Ffrench-Davis, 2002, Chapter 9).

Table 1 Latin America: Gross Domestic Product, 1971-2003
(percentages of annual growth rates[a])

	1971–1980	1981–1989	1990	1991–1994	1995	1996 – 1997	1998–2003[b]	1990–2003[b]
Argentina	2.8	-0.7	-2.0	8.0	-2.9	6.7	-1.4	2.2
Brazil	8.6	2.3	-4.6	2.8	4.2	2.8	1.3	1.7
Chile	2.5	3.0	3.3	7.5	9.0	6.8	2.7	5.1
Colombia	5.4	3.7	4.1	4.2	4.9	2.6	1.0	2.6
Mexico	6.7	1.5	5.1	3.5	-6.1	6.1	2.8	3.0
Peru	3.9	-0.7	-5.4	4.9	8.6	4.7	2.0	3.1
Uruguay	3.0	0.0	0.5	5.7	-2.4	5.3	-2.5	1.1
Latin America[c]								
Total	5.6	1.3	-0.5	4.1	1.0	4.5	1.3	2.4
Per capita	3.1	-0.8	-2.4	2.2	-0.7	2.8	-0.3	0.7
Per worker	1.8	-1.6	-3.3	1.3	-1.6	1.9	-1.2	-0.2

Notes:
[a] Expressed in dollars at 1980 prices for 1971-80, at 1990 prices for 1980-89, and at 1995 prices for 1989-2003.
[b] Preliminary data for 2003.
[c] 19 Latin American countries.
Source: ECLAC.

Table 2 Latin America: Selected Social Indicators, 1980-2002

	Poverty[a]		Real wages[b] (average annual change)	Urban unemployment[a] (percentage of labour force)
	Population (percentage)	Population (million)		
1980	38.7	135.9		
1990	48.3	200.2		5.8
1994	45.7	203.2	0.7 (1990-94)	6.3
1998	43.5[c]	203.8[c]	0.6 (1995-98)	8.0
2002	44.0	221.4	-0.4 (1999-02)	8.9

Notes:
[a] 19 Latin American countries.
[b] Rates of change of 14 countries (94 percent of Latin American labour force), weighted by labour force.
[c] 1997.
Source: Author's calculations and official ECLAC data.

Such a "disappointing" outcome can be associated with many analytical and empirical flaws. These take several interrelated issues into account, associated to the nature of the specific economic model being implemented: One, just one, of the many alternative models of market economies.

Here we will refer to: (i) the analytical model; (ii) productive investment and missing factors; (iii) real macroeconomic balances (that is, a macroeconomics for growth) and imbalances of voices; (iv) upgrading of fast rising exports (non-traditional exports intensive in "value-added"); and (v) conclusions, including policy proposals for improving performance. Naturally, the international economic architecture, with its pro-cyclicality and biases toward richer countries has been part of the problem (Ocampo, 2001; Stiglitz, 2002), but here we will mainly focus on domestic policies.

1 Theoretical Outlierness

Latin American countries have chosen a wide variety of paths in designing their structural reforms and economic policies. However, there are some distinctive features that reflect common external influences or common domestic approaches, which imply significant shortcomings of the first generation of reforms across Latin America. The prevailing style has involved the repetition of costly mistakes, particularly in macroeconomic management, the design of financial and trade reforms and in the weakness of efforts to complete markets.

In fact, neo-liberal reforms were, generally, conducted under the belief that there is a *unique* good policy recipe: liberalising markets across-the-board, and until the extreme (more of the same is always good). There was no significant consideration of the fact that the selection of policies should depend on: (i) the objectives of society; (ii) the degree of development of markets; (iii) the degree of homogeneity of domestic markets; and (iv) the nature of international institutions and markets.

The approach in fashion assumes that market signals flow transparently and fluidly among markets and among generations. In doing so, structural imbalances are assumed away, except those generated by state intervention; it is also assumed that, under free markets, intertemporal adjustments are efficiently stabilising. These assumptions lead to an underestimation of the negative effects on capital formation, the utilisation rate of potential GDP, and the distribution of productivity and opportunities among people. These are some of the outstanding problems that neo-liberal reforms and adjustment processes tend to generate in the face of external shocks and of anti-inflationary programmes. The outcome is associated to the specific features of the set of structural reforms that have been implemented.

The approach in fashion, which is built on microeconomic theory and *optimisation*, paradoxically, jumps to policy recommendations based on the *maximisation* of liberalisation. It disregards intermediate positions between the extremes of indiscriminate liberalisation and arbitrary interventionism. It also underrates the deep implications of the absence of complementary reforms; two most evident cases, with respect to financial reforms, are the absence of effective prudential regulations of financial institutions and public services, parallel to their liberalisation or privatisation, and the absence of institutions or incompleteness of a long-term segment of domestic capital markets. In the end, reforms became the target rather than a means, with a lack of accountability with respect to the true goal, that is, growth with equity.

There is no doubt that Latin America needed tough reforms, but it also needed a pragmatic approach. Most economies were over-intervened, with a restricted private sector, and rules were not transparent. The spirit of the Washington Consensus sought reforms that would generate "right" prices and would be "market friendly", two principles we fully share. However, the reforms failed dramatically in achieving both targets. Actually, reforms are means and intermediate targets that led to missed growth and equity by failing.

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

What are the main analytical flaws? They are related to the actual working of markets and to the response capacity of different economic agents.

Several dimensions of structural heterogeneity play a crucial role: among others, heterogeneity in the openness and stability of various external markets; heterogeneity between stages (expansive and contractionary) of the business cycle; variety in the elasticity of response to incentives among domestic regions and among market segments (big and small businesses, rural and urban enterprises, infant and mature firms, consumers and producers, productive and speculative investors);

and the effects of the adjustment path on the feasibility of attaining different combinations of objectives (hysteresis), which implies that there is no single equilibrium but rather multiple ones. In short, the adequate management of a series of variables is quite relevant: the degree of resource mobility and price flexibility, the eventually destabilising dynamics of "automatic" or neutral macroeconomic adjustment policies, depending on the response capacity of diverse sectors and markets, the perceptions or expectations of economic agents, and the sequencing and gradualism of changes.

Hence, the recommendation of public policies contributing to improve the working of markets, enhancing the role of longer-term horizons and productive factors arises. The target is an endogenous development process guided from within (Sunkel, 1993). A crucial space corresponds to two lines of action. On the one hand, regulating actively capital flows, exchange rates, monetary and fiscal policies. On the other, the application of a productive development policy, including systematically developing and completing factor markets, which guides the allocation of resources towards investment in physical and human capital, deliberately improving the distribution of productivity and opportunities across society, and promoting the acquisition of comparative advantages. This is the constructive option, in contrast to inward-looking development in the more naïve import-substitution industrialisation (ISI) approaches, or outward-looking ones in the approaches based on the integration into world markets via abrupt and indiscriminate import liberalisation and capital account opening, and the fading-out of the sense of nation.

Our approach requires a dynamic and modern private sector, together with active linkages with the global markets and an efficient state. Given the framework of structural heterogeneity, achieving an efficient state – central and local governments, regulatory agencies, and public enterprises – is not easy. Furthermore, it is also necessary to be selective in the sense of dealing only with that quantity and quality of actions that the state is capable of designing and implementing with social efficiency, and focusing efforts where they will have the greatest impact. These principles help to minimise "state failures".

Factor heterogeneity or markets segmentation is one of the most typical features of developing countries. This naturally affects the transparency and flow of information. Factor markets are usually incomplete or underdeveloped. Reforms and policies should strive to actively contribute to complete and integrate markets rather than increase segmentation, as it has often tended to occur with naive liberalisation.

Pragmatic gradualism, explicit efforts to achieve more complete markets, macroeconomic-cum-macrosocial balances, should all be geared to strengthening integration of typically segmented markets. Mezzo-policies, such as labour training, dissemination of technical knowledge, and space for small and medium-firms are at the core of spreading productivity through society. This is the most sustainable road to endogenous dynamic growth with equity.

2 Real Macroeconomic Imbalances and a Macro-For-Growth

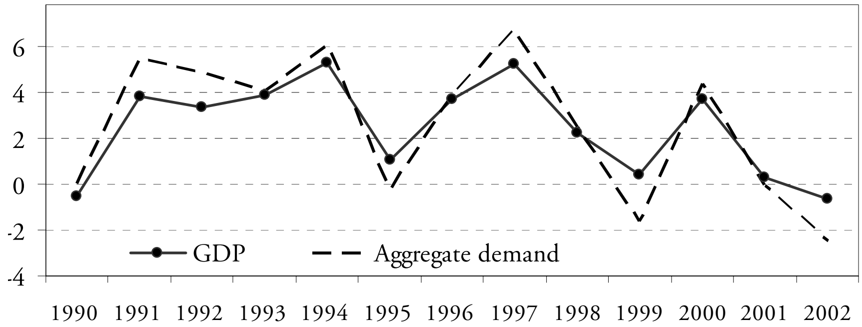
There is a broad consensus that macroeconomic "fundamentals" are a most relevant variable. However, there is wide misunderstanding about what constitutes "sound fundamentals", and how to achieve and sustain them. The fashionable approach emphasises the macroeconomic balances of two pillars: low inflation and fiscal balances, together with full opening of the capital account. We call it financial macroeconomic balances. This approach assumes either that financial macroeconomic balances are enough for achieving productive development in a liberalised economy, or that it becomes enough with the addition of microeconomic reforms.

As shown, Latin American countries were successful in the 1990s in reducing inflation to one-digit figures, and balancing their fiscal budgets (fiscal deficits averaged less than 0.5 percent of GDP in 1995-97). In fact, Latin American countries fulfilled the neo-liberal requirements of macroeconomic balances. However, economic activity was notably unstable; in the period covered, overall changes in GDP were led by ups and downs in aggregate demand, and these responded to shifts in net capital flows. In the 1990s, East Asia continued to fulfil the two conventional pillars – low inflation and fiscal surpluses – but lost the third pillar, of sustainable macrobalances for the real economy. Therefore, most emerging economies were implementing financial or two-pillar macroeconomics at the outset of the Asian crises, with the euphoric support of specialists in microfinance. A financierist approach had become binding.

Latin American firms and workers have been subject to great instability in domestic demand, exchange rates, and interest rates. It has become a roller coaster ride, discouraging productive investment, employment and equity. Figure 1 dramatically depicts this perverse fact.

Actual experiences of frequent macroeconomic crises, now not only in Latin American countries but also in East Asia, reflect that the wide-

Figure 1 Latin America: GDP and Aggregate Demand, 1990-2002
(annual growth rates, percentages)



Source: ECLAC data, includes 19 countries.

spread recognition of the importance of macroeconomic equilibrium is not matched by a better understanding of how to achieve it or capability to implement it.

In general, the neo-liberal approach assumes, sometimes explicitly and frequently implicitly, that full opening of the capital account would contribute to balance the external sector and automatically generate an aggregate demand consistent with productive capacity: a frequent assertion in the conventional literature is that an open capital account imposes macroeconomic balances to emerging economies. It is well documented that this is not the usual experience in the frequent cases of external, positive and negative, financial shocks experienced by emerging economies (Ffrench-Davis and Ocampo, 2001).

It can be true that full opening of the capital account deters domestic macroeconomic mismanagement and encourages good macroeconomic "fundamentals" in cases of *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 (Frenkel, 2003; Stiglitz, 2002). Contrary to what is usually argued, this is not associated solely with inappropriate information. Indeed, even well informed market actors, such as credit rating agencies or investment banks, usually operate in a pro-cyclical fashion because of the nature of their rewards and time horizon intrinsic of their job description.

The opening of the capital account may lead emerging economies to import external financial instability, with capital inflows leading to a worsening of macroeconomic fundamentals. The market may induce deviations of macroeconomic variables from sustainable levels: it is the market itself, which, during financial booms, generates incentives for emerging economies to enter the *vulnerability zones* of appreciated outlier real exchange rates, 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, have come to play a role that has significant macroeconomic implications. With their herd-prone expectations, they have contributed to intensifying 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). However, in reality bubbles are being generated with outlier macroprices, which sooner or later, will tend to bust. Moreover, the typical situation, during the boom period, has been that the cost of external financing has gradually fallen (and risk rating grades improved), which implies that the market actually operates with a sort of a downward sloping mid-run supply of funds.

"Financierism" tends to lead, unsurprisingly, to unsustainable macroeconomic imbalances, with an effective demand that deviates sharply from the production frontier and with "wrong" or outlier macroprices and ratios. In Figure 1, we observe a notorious instability of GDP growth for the total of Latin America; obviously, that of individual countries tends to be even more unstable. The data shows that changes in GDP have been led by up-and-downs in aggregate demand. Given that fiscal balances have characterised East Asia, and that Latin American countries reduced their deficits along the 1990s, during the capital surges, it is evident that increases in aggregate demand were intensive in private expenditure, an outcome strongly associated to the evolution of net capital inflows (Marfán, 2004). Actually, capital tended to flow from private sources to private users.

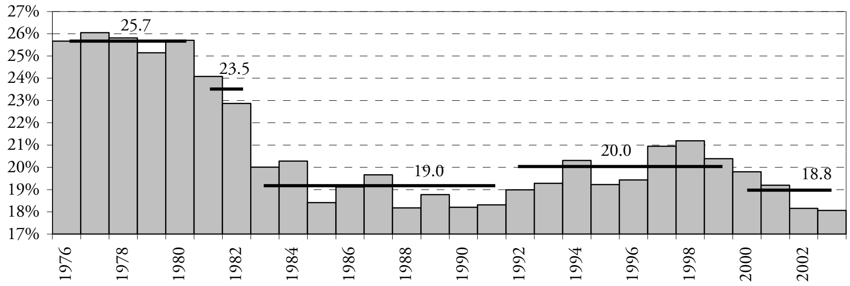
There is a growing duality, worrisome for democracy, in the constituencies taken into account by authorities in emerging economies. An outcome of the specific road taken by globalisation has been that experts in financial intermediation – a microeconomic training – have become determinant for the evolution of the domestic macroeconomic balances and their volatility. The integration of capital markets has remarkable implications on governance, room for domestic policies, and on the constituencies to which national governments respond. On the one hand, political authorities are elected by their countries' voters, and promise to implement a platform designed before their election, but on the other hand they also seek, after being democratically elected, the support of those who "vote" for their financial investments (not necessarily productive investments or may be at their expense). Recent cycles in financial markets have revealed a significant contradiction between the two, in a negative-sum game.

It is "irrational", and evidently inefficient from the perspective of resource allocation and total factor productivity, that the decisions of authorities, which should obviously be taken with a long-term horizon, seeking sustainable growth with equity, become entrapped with the lobbying and policy recipes of microfinance experts, which leads to "irrational exuberance". Economic authorities should make macro-fundamentals prevail (sustainable external deficit; moderate stock of external liabilities, with a low liquid share; reasonable matching of terms and currencies; crowding-in of domestic savings; limited real exchange rate appreciation; effective demand consistent with the production frontier), in order to achieve macroeconomic balances that are both sustainable and functional for long-term growth.

In brief, there appears to be widespread 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, for Korea and Thailand in 1996, and for Mexico and Argentina in 1994, and for all emerging economies in Latin America in 1996-97. Something "fundamental" was thus missing in markets evaluation of "market fundamentals"! Obviously, the sharp crises of those emerging economies 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.

Figure 2 Latin America: Gross Fixed Investment, 1976-2003
(percentages of GDP)



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

3 Insufficient Productive Investment and Missing Factors

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 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 2). In the 2000s, productive investment has fallen further.

Real macroeconomic instability in emerging economies is one strong force behind the poor achievement of investment ratios in the 1990s. A significant, well-documented, variable underlining the drop in productive investment is the output gap between actual and potential GDP (Agosin, 1998). The gap reflects the underutilised installed capacity in firms and other components of the stock of physical capital, unemployment of labour, and reduced actual total factor productivity (Ffrench-Davis, 2000, Chapter 6). Profits tend to decrease while the mood of lenders becomes sombre. A notorious effect of these recessive situations, usually, has been a sharp reduction in investment ratios; for instance, a drop of fixed capital formation in 1995, of 13 percent in Argentina and 30 percent in Mexico; in 1999 it fell 18 percent in Chile, and between 1998 and 2002, 56 percent in Argentina, and 11 percent in all Latin America.

That source of discouragement for domestic private investment has been reinforced by a change in the relative composition of FDI, from greenfield investment to acquisitions, stimulated by depressed prices of domestic assets and depreciated currencies. As documented by Easterly and Servén (2003), most Latin American countries also "witnessed a retrenchment of the public sector from infrastructure provision and an opening up to private participation".

The other relevant explanatory variable is the scarcity of the ingredients required by a productive investor. There is a need for long-term financing, access to technology and capacity to absorb it, availability of well-trained labour, and infrastructure complementary to productive investment. It is what we call *completing* factors markets, since incomplete, underdeveloped or inexistent markets cannot work well: they are missing factors in the aggregate production function. This is a feature intrinsic of underdevelopment and lack of enhanced systemic productive capacity.

4 Export Upgrading and Productive Linkages

A fixed ingredient of development strategies is export promotion. The modal policy tool has been, interestingly, import liberalisation; that is, an indirect incentive. The contrast with the direct export incentives in the East Asian approach is sharp (see Ffrench-Davis, 2000, Chapter 3; Rodrik, 2001b).

The indirect road, to some degree, did work, since protectionism of ISI was limiting the expansion of exports dependent from imported inputs. In all, exports of Latin American countries were dynamic in the 1980s and 1990s, growing much faster than world trade. However, GDP growth has been low and external sector imbalances frequent.[3] The explanation is in the heart of the neo-liberal approach. 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 (Ocampo and Parra, 2003). This is the result of not being concerned about the level and stability of the exchange rate and the disregard of the need for completing markets of the set of factors behind productive development or systemic competitively.

[3] 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.

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, (ii) a sustainable macroeconomic policy for growth, and (iii) for factor market completion in enhancing productive linkages. We know that real exchange rate 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, though very useful for tackling short-term risks, are not of much help in face of processes of capital surges.

There are lessons from the East Asian success in export dynamism-cum-growth of non X-GDP. Current 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. The reforms introduced by the Uruguay Round should be reformed in order to provide room for export policies that are effective in diversifying trade toward quality and deeper linkages with the domestic economy (Rodrik, 2001b).

Another relevant factor has been, again, real macroeconomic instability. Recoveries of economic activity have been associated to capital inflows and exchange rate appreciation. This, evidently, discourages increases in the share of domestic value-added in exports.

There is a role for regional trade agreements in increasing the quality of exports. The composition of intra-regional trade is notably different from that of the rest of exports of Latin American countries. A lot of research from ECLAC and IDB suggests that regional trade agreements 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 Latin American countries remains low (as said, about one-seventh of value-added or regional GDP). Hence, notwithstanding that reciprocal trade was rising fast, it was just a quarter of the total exports (now reduced to one-fifth). So, in all, we are talking of about 3 or 4 percent of GDP. As a consequence, for overall economic growth, what happens with the rest of the economy is very crucial. The actual effectiveness of productive linkages of exports is much related with systemic competitively of non-tradables and importables, and with the macroeconomic environment.

5 Closing Remarks

Reforms to the economic reforms, that preserve achievements but correct systematically the most severe failures, are crucial. In brief, the changes required, in the areas covered here, include:

- Macroeconomic reforms to achieve more sustainable equilibria, functional for productive development, discourage excessive borrowing, control the external deficit, and avoid exchange rate appreciation during next capital surges. Some crucial ingredients are: (i) improving counter-cyclical regulation and supervision of the financial system; (ii) establishing strongly counter-cyclical fiscal policy; (iii) returning to intermediate managed flexibility of exchange rates; (iv) establishing selective prudential regulations of capital flows; and (v) giving the predominant voice in public affairs to producers – capital and labour – and society, rather than the financieristic lobbying.
- Systematic efforts to complete factor markets (labour training, technology, long-term financing, and infrastructure); all are policy variables related to systemic competitivity. Two strategic ingredients are: (i) making effective efforts to develop long-term segments of the capital markets, improving notoriously the access of small and medium-sized firms; and (ii) implementing comprehensive national programmes of labour and entrepreneurial training and technological spreading.
- Upgrading the quality of exports and their linkages with the domestic economy, for which real macroeconomic sustainable balances (including, notably, a rather stable real exchange rate) and completing factor markets are crucial ingredients. The consistency and proper sequencing of reforms and policies have shown to be severe flaws in the actual design and implementation of the Washington Consensus.

Latin America is capable of encountering the elusive road of growth with a pragmatic approach away from ideological neo-liberalism.

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9

"Right" Prices for Interest and Exchange Rates

Roberto Frenkel

Ricardo Ffrench-Davis presents a critical appraisal of the reforms of the Washington Consensus. He criticises the reforms from two perspectives. On the one hand, he shows the results of their actual implementation. The outcome is not only much poorer than expected and announced by their promoters, but in important aspects, such as employment and income distribution, the reforms led to a deterioration. On the other hand, the author points to the lack of realism of the theoretical foundations of the reforms, in particular the assumption of a complete and well-behaved market system, both at the domestic and international levels.

The author links the two critical perspectives and argues that the actual results are a consequence of the design of the reforms because they were erroneously founded and consequently miss-conceived. This is an important point. A mere acknowledgement of the negative results is not enough to know what has happened and what should be done next. After all, facts are facts and cannot be denied. The important point lies in determining the causes of those results. As the title "Reforming the Reforms" indicates, the author intends to differentiate his criticism from the line of reasoning that calls for another sequence of reforms, in which new generations of reforms should follow the first generation. According to this line of reasoning, the reforms were only incomplete and should be completed by other reforms in a sequential linear way. Opposing this view, the author tells us that the reforms were erroneously founded and, therefore, he calls for a reform of the first-generation reforms.

I agree with the main points of the author and will focus my comments on the macroeconomic policy regimes. As Ricardo correctly

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points out, while the Washington Consensus reforms intended to generate the "right" prices, they failed dramatically to do so with regard to two crucial prices: the real exchange rate and the real interest rate.

Misalignment of the Real Interest Rate

The misalignment of the real interest rate has been an unexpected result of the financial globalisation. The liberalisation and opening of the domestic financial market was supposed to lead the developing economies to integration with the international financial markets. The idea was that local real interest rates of the newly integrated domestic financial markets would converge to the developed countries' real interest rates. This has not happened. Actually, the process has developed into a segmented integration in which the real interest rate in the emerging markets is systematically higher than in the developed countries. Country risk premiums have not shown a declining trend. Behind this fact lies not only the imperfection of the international financial market – every financial market is imperfect – but the lack, at the international level, of most of the institutions that improve the working of the financial systems at the national levels. Institutions that the international financial market is missing are, for instance, a lender of last resort, bankruptcy laws and prudential regulations. Some steps towards the development of international institutions were taken in the last quarter of the nineties, but this process was turned back more recently. The existence of widely diverging views about the functioning of international financial markets seems to inhibit initiatives in this crucial area.

The worst distortions in real interest rates in developing countries have usually been related to the misalignment of the real exchange rate. Appreciated real exchange rates led to unsustainable balance of payments and external debt trends. Very high interest rates resulted from those trends pushed by high country risk premiums or induced by monetary policies that aimed to attract capital flows.

Revitalise the Competitive and Stable Exchange Rate Regime

The reforms disregarded any concern about the real exchange rate. This is a curious point, in some sense, because "achieving a competitive exchange rate" was one of the ten principles presented by John Williamson in his famous baptism of the Washington Consensus.

In the mid-seventies, when the process of financial globalisation was beginning, the idea that the real exchange rate should be competitive and stable was broadly shared. This consensus tended to dilute afterwards, eroded by the emergence of high inflation processes in Latin America and by the growing influence of the "monetary approach to the balance of payments". The idea that financial globalisation would remove the balance of payments constraints on growth gained momentum. Consequently, the exchange rate policy could neglect real and balance of payments targets and be oriented to the control of inflation. The macroeconomic policies of the so-called Southern Cone experiments in liberalisation and opening – then supported by the IMF – were the first implementation of those ideas.

The competitive exchange rate regained a priority place in the macroeconomic policy agenda in the mid-eighties, helped by the failures and consequent crises of the Southern Cone experiments and by the resurgence of the external constraint in Latin America. But when capital flows boomed again in the early nineties, the notion of competitive exchange rates vanished.

The IMF supported the full opening of the capital account and the fixed exchange rate regimes adopted by the biggest countries in the Latin American region. Without capital account regulations, monetary policy can hardly play any significant preventive role when capital inflows are booming. In spite of this, the orthodox view showed no concern about the possibility of crises in the first booming phase of the nineties. The Mexican crisis showed that the lack of concern was unjustified.

From then on, the orthodox view and the IMF adopted a preference for floating exchange rate regimes. However, the IMF continued its intellectual and financial support to Brazil and Argentina, which continued operating with full capital account opening and fixed exchange rate regimes. The concern about the possibility of a crisis increased in these cases, but the preventive role was ascribed to the monetary policy: contractive policies in the case of Brazil, and the "currency board" rules in the case of Argentina.

The adoption of pure floating exchange rate regimes was the main change in the orthodox view in the nineties. The change pointed exclusively to the prevention of crisis of the kind experienced under fixed exchange rate regimes. But the change was minimal with respect to the full capital account opening and the fixed exchange rate regimes previously supported. There was no evaluation of the policy regimes that allowed some countries to participate in the financial globalisation process without exposing themselves to high vulnerability and without suffering crises. It was diagnosed that the fixed exchange rate was incompatible with capital flow volatility, and the minimal changes congruent with the orthodox perspective were adopted. The newly adopted regime has been conceived with a defensive attitude in order to preserve the full financial opening when the volatility of capital flows became apparent.

In a pure floating exchange rate regime, there is no exchange rate policy. Monetary policy is isolated from the balance of payments and focused on internal targets. According to the orthodox and IMF perspectives, monetary policy should focus exclusively on inflation and should be implemented with quantitative monetary targets.

The pure free floating and monetary rules regime performs some crisis prevention functions that are inexistent in a fixed exchange rate regime, but it does not exclude the possibility of a crisis in a situation of full financial opening. For instance, in a situation of balance of payments deficit, if an important portion of the demand for international currency is inelastic, because it is mainly originated in interest and amortisation debt commitments – private or public – as is the case of highly indebted countries, the equilibrium exchange rate could be unattainable. In this case, there will be a crisis in spite of the isolation of central bank reserves, because the debtors cannot fulfil their external obligations.

In exchange for performing some crisis prevention functions, the pure free floating exchange rate regime has an important negative attribute: the volatility of capital flows is transmitted through the volatility of nominal and real exchange rates and relative prices, with adverse effects on growth and investment. Under this regime, macroeconomic policies completely neglect real objectives, such as employment, activity level and the real exchange rate, as an intermediate target of real and balance of payments objectives.

The parallel histories of financial globalisation – allowed and induced by the liberalisation reforms – and orthodox macroeconomic regimes led to a paradoxical situation. On the one hand, the integration into the international financial markets has become an important source of volatility. On the other hand, the macroeconomic policy regimes became mainly focused on inflation control and on the prevention of balance of payments crises, in a defensive attitude towards external volatility but giving priority to the preservation of free capital mobility while other objectives were lost in the way.

It is time to revitalise the competitive and stable exchange rate as an intermediate target of macroeconomic policies that focus on growth, employment and stability. This does not mean that we should turn back to crawling pegs. The short-run flexibility of the exchange rate performs some preventive roles that should not be lost. But central bank interventions in the exchange market should be oriented to signalling the long-run stability of a competitive real exchange rate in order to give proper incentives to tradable industries, reduce the uncertainty of investment and employment decisions, and prevent unsustainable balance of payments and debt trends.

Nobody criticises the competitive and stable exchange rate intermediate target on behalf of its objectives. On the contrary, it is not easy to find arguments against the role it can play in development and employment creation. Besides, it is difficult to find any critical argument against the importance of relative prices stability. Sometimes it is argued that the real exchange rate should be determined by "the markets" since the public sector has no informational advantage over the private sector. But this theoretical argument is not very appealing because, in practice, the volatility of capital flows is evident and the floating exchange markets show intrinsic instability – also in the developed countries.

The orthodox arguments against macroeconomic policy regimes with a competitive real exchange rate as an intermediate target are more complex. They point, on the one hand, to the incompatibility of the regime with free capital flows or, on the other hand, to the impossibility of controlling inflation under this regime. In the orthodox view, it is not possible to sustain an exchange rate level – or to limit its fluctuations to a relatively narrow band – in a context of free capital mobility, while the central bank simultaneously implements a monetary policy focused on inflation – on inflation exclusively, we add.

The orthodox criticism points to actual difficulties for the implementation of a competitive real exchange rate regime in the context of financial globalisation. But that judgment is derived from confronting the regime with extreme situations of capital outflows or inflows. In addition, the orthodox perspective brings in, implicitly or explicitly, the disbelief about the ability of the government to commit itself to monetary discipline.

However, in the competitive real exchange rate regime, monetary policy cannot – and should not – focus exclusively on inflation. The monetary policy has to be broader and should simultaneously pursue exchange rate, inflation and economic activity level objectives. These objectives can sometimes be in conflict, as is emphasised by the orthodox criticism. But this is not a particular characteristic of the regime. Monetary policy in the US also pursues conflicting objectives.

In the suggested regime, the central bank should have an ample mandate. Monetary programming should be jointly formulated with the rest of the macroeconomic programming, and implementation should be frequently coordinated. In any case, the central bank independence should help to enhance the credibility of exchange and monetary policies.

It is true that free capital mobility complicates the management of monetary policy when the central bank intervenes in the exchange market. But, as was already mentioned, the conclusion that it is impossible to manage monetary policy derives from supposing huge capital flows. In other contexts, monetary policy can be managed by implementing sterilisation policies, by managing the banking system liquidity and also by prudential regulation and supervision of banks and other financial institutions. In cases where the volume of capital flows makes it impossible to manage monetary policy, regulations on capital mobility should be implemented. In case of a balance of payments surplus, there is a menu of experienced restrictive measures, such as those implemented by Chile and Colombia in the nineties. In case of a balance of payments deficit, if there are no reasons to expect an exchange rate depreciation, the monetary and fiscal policies are consistent with the exchange rate target and inflation is controlled, the policy regime and the exchange rate target should be preserved. Under these circumstances, exchange controls and restrictions on capital outflows should be imposed, as did Argentina in mid-2002. If there are no fundamental reasons for the excess demand for international currency, the controls can be temporary.

Macroeconomic Policies with Growth and Employment Objectives

To end, let me highlight three circumstances that currently facilitate the adoption of competitive exchange rate macroeconomic regimes.

First, fixed exchange rate regimes and overvalued currencies are generally left behind. Consequently, in many cases the adoption of the regime does not require an initial discrete exchange rate adjustment.

Second, the regime would generally be adopted in a low inflation context. This makes it possible to give inflation control the same priority that is given to the other objectives of macroeconomic policy.

Third, we are not living in a period of a capital inflows boom and there are no prospects of such a boom in the foreseeable future. In a rather paradoxically way, this circumstance facilitates getting macroeconomic policies on their feet and conducting them with growth and employment objectives.

Part 2

Financial Stability at the National, Regional and Global Level: Governance, Markets and Institutions

10

Financial Instability in Emerging Market Countries: Causes and Remedies

Charles Wyplosz

1 Introduction

In the new era of worldwide financial integration, currency and financial crises seem to be circumscribed to the emerging market countries. While this is not surprising, less expected, perhaps, is that the crises seem to hit primarily those countries that have played by the rules of what used to be called the Washington Consensus. Developed countries can still be rocked by serious financial disturbances, as has been the case with the Nasdaq technology crash of 2000, but the consequences are mild. In the developed part of the world, the Washington Consensus has delivered; the financial markets are resilient, and so are the economies. In addition, governments and central banks in the developed countries have many tools available to cushion any blow.

The developing countries have not yet developed a similar degree of resilience. Minor disturbances can have massive effects. Chile is a good example. It has long adhered to disciplined macroeconomic policies. It has gone very far in liberalising not only its financial markets, but also much of its economic system. And yet, it has repeatedly suffered severe blows, be it contagion from the Tequila crisis or the NASDAQ crash. Argentina is another point in case. By the end of the 1990s, its currency regime was commonly described as unassailable and its banking system one of the safest in the world. Move forward to 2002 and you only see debris floating in troubled waters. Many other countries, from Korea to Brazil, have also painfully felt the extent of their vulnerabilities.

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This chapter reviews the causes of emerging market instabilities. A number of explanations have been put forward. They invariably point to the financial markets. A serious question, therefore, is: What is wrong? Are we facing market failures or is it simply that financial markets play their role of monitoring country performance? A main theme of this chapter is that both factors are at work. This conclusion brings about the second theme, which concerns the possible policy responses. Adequate national policies, both microeconomic and macroeconomic, are necessary but not sufficient conditions for rotting out vulnerabilities. Instability –more precisely multiple equilibria – is in the nature of financial markets and will keep hitting forever. This requires a great dose of resilience and policy instruments, which are not always available, and take years to achieve after full internal and external liberalisation.

This, in turn, explains why the experience with financial liberalisation has not been as happy as promised by the Washington Consensus. Arteta *et al.* (2003) find that liberalisation may lead to higher growth in the long run but, in the shorter run, tends be associated with crises that foster deep recessions. Edwards (2000) finds that capital account openness spurs growth only for countries that have reached a certain degree of development. Kaminsky and Reinhart (1999) find that financial liberalisation is the most reliable predictor of twin (currency and banking) crises. This impressive evidence explains much of the debate between those who argue that financial liberalisation is good for developing countries (e.g. Levine, 1997, or Guiso, Sapienza and Zingales, 2002) and those who take a more sceptical view (e.g. Rodrik, 1998, Stiglitz, 2002).[1]

Fortunately, the debate is shifting. It is increasingly being recognised that what matters for growth and development is the quality of domestic institutions. Weak institutions lead to bad policies or to fragile financial systems, and most likely to both. The interaction of bad policies and fragile financial systems is a sure recipe for disaster. Financial repression, domestic and external, acts a fig leaf: it prevents markets from revealing existing weaknesses. At the same time, financial repression stunts growth, so it is not a long-term solution. Liberalisation is necessary, but it must first be recognised that there is a proper order, as recalled in Wyplosz (1998). It is also crucially important to recognise that financial repression is just one aspect of poor quality institutions. One of the lessons from the Asian crisis is that financial liberalisation alone, without a serious overhaul of other institutions, is bound to result in highly disappointing outcomes (for a recent contribution see Prasad *et al.*, 2003).

[1] An excellent review of this literature is Eichengreen (2001).

2 Causes of Financial Instability: the Institutional Connection

2.1 Policy Mistakes

Up until a decade ago, the standard presumption was that the blame for any episode of acute financial instability had to be laid to misguided macroeconomic policies.[2] Unsustainable fiscal policies led to the accumulation of public and external debts, or high inflation was inconsistent with a fixed exchange rate. This interpretation lies at the root of the IMF's classic conditionality approach.

While this remains a key reason for many financial crises, the simple view that governments should promptly adopt commonly agreed standards of good macroeconomic behaviour has been challenged both by economic theory and by the facts. Recent theoretical research (e.g. Persson and Tabellini, 2000, Drazen, 2000) has shown that the ability of governments to make wise economic decisions is constrained by the quality of the political and social institutions, and that these institutions are shaped by history and the make-up of society. These ideas are backed by an increasing amount of empirical evidence, drawn from both developed and developing countries. They imply that adequate policies will not just be possible, even if requested by the IMF or G-7 pronouncements. Indeed, it is quite naïve to expect most of the developing countries to adopt the same policies as the US or Switzerland, even if "it works" there.

Adopting sound policies is not always a matter of good judgment or good will. A central banker may know what is appropriate but may be unable to do so because he is not independent, having to take instructions from the finance minister. The finance minister may be unable to control public spending because other ministers or the parliament (when it exists and has any power) can overrule him. Ministries and members of parliament may have to cater to special interests if they want to stay in power. These special interests may be segments of the business community, or of ethnic groups, not to mention the military establishment or widespread corruption.

The IMF has now explicitly recognised the importance of this observation. Its response, however, has not always been satisfactory. A good example is the Asian crisis, when the Fund effectively asked for changes in political personnel or sought to reshape ownership structures of firms and banks. The logic of such conditions is compelling, of

[2] This is the central insight of first-generation crisis theory. See Krugman (1979).

course, but deep interventions of this kind challenge national sovereignty and often provoke a backlash in the affected countries as well as among observers.[3]

2.2 Public Indebtedness

The quality of institutions also affects how governments view their own indebtedness. In a process called debt intolerance by Reinhart *et al.* (2003), some governments may be tempted to accumulate a large debt and then expropriate its creditors, whether they are domestic or foreign. Expropriating domestic creditors may carry large political costs but can be made "legal" in many ways, from taxation to hyperinflation. Expropriating foreign creditors may earn points with residents but it carries significant costs. Since it cannot be made legal, it leads to pariah status on financial markets until some agreement is found.

A sovereign default typically triggers a multifaceted crisis. The exchange rate usually crashes and the interest rate jumps. Private borrowers face much increased debts, either because of the depreciation effect on foreign currency loans or because index-linked domestic currency borrowings are affected by the interest rate. Private sector bankruptcies soon follow sovereign default, ripping through the financial sector.

Why should any government contemplate such an action? Obviously, when the debt is being accumulated, defaulting requires a very short horizon, poor political control and public opinion oversight. Yet, once indebtedness has been allowed to reach a high level, defaulting may well be the best option. This well-known time-inconsistency problem means that any sovereign borrower faces the temptation to default. Knowing that, lenders are cautious and, if they lend at all, they typically organise themselves in such a way that they can liquidate their exposure as soon as – sometimes well before – they perceive the threat of a default. The result is considerable potential financial instability, which has been characterised by a number of colourful expressions including capital flow reversals, sudden stops, twin crises, etc.

2.3 Market Volatility

An inherent characteristic of financial markets is their volatility. Because they deal with an uncertain future, market operators are prone to frequently changing their views and to adopting herding behaviour.

[3] See, e.g. Feldstein (1998).

Technically, these markets are subject to sell-fulfilling prophecies. Market sentiment can shift abruptly and without any advance notice. All it takes is that market expectations converge to a view that was previously considered unlikely or even misguided. Brazil offers two examples of such events. At short intervals, its currency was hit in the wake of the Russian crisis in 1998 and then again in 2002. In the former case, the markets thought that they had identified some macroeconomic similarities between Russia and Brazil. In the latter case, the cause was the then-likely election of Lula, widely interpreted as signalling the end of policy discipline. In both cases, subsequent events disproved the analysis that underpinned market expectations, but harm had been done.

Deep financial markets tend to be less unstable than shallow markets. They can handle large swings in order flows with smaller price variations. One reason is that large asset stocks are mobilised when a swing is perceived to be excessive or unjustified. In addition, a more widely spread ownership translates into more heterogeneity of opinions, which works to reduce herding behaviour. The availability of more instruments also allows individual market participants to reduce their exposure to risk and steady their reactions. On the other side, the same advanced instruments allow speculators to take very large positions and may thus destabilise the markets.

Financial volatility has long been recognised as a serious problem. A first approach has been to ban or severely repress financial markets. For a long time, this has been the solution chosen by most countries, including many European countries until the 1980s,[4] and virtually all developing countries until the 1990s. The second approach is to regulate the financial markets with two main aims in mind: (i) to make financial institutions more resilient in case of serious disturbances; (ii) to provide financial actors with incentives to act in responsible and prudent ways. Regulation in turn calls for supervision.

Once again, we face a trade-off. Financial repression reduces an important source of economic instability but it carries serious effectiveness costs that may inhibit growth. From the experience of the developed countries, the lesson is that financial markets must be very gradually freed, starting domestically and then opening up, to allow for the establishment and honing of adequate regulation and supervision. Regulation and supervision, on the other hand, are fairly delicate to design and enforce in many emerging countries. Not only does it require skills

[4] Wyplosz (2001) describes financial repression in post-war Europe.

often in short supply, but the regulator and supervision agencies must be independent from interference by political and special interest groups while being transparent and accountable. This, in turn, requires adequate political institutions. Indeed, recent research on financial instability increasingly provides support for the view that the quality of domestic governance – proxied by indices measuring the rule of law, corruption, political polarisation, etc. – play a crucial role in allowing financial liberalisation to boost growth rather than holding it back.[5]

2.4 Original Sin

Eichengreen *et al.* (2002) have called original sin the fact that most countries cannot borrow internationally in their own currencies. Table 1 documents this fact: by end 2003, just five currencies (US dollar, yen, euro, sterling and Swiss franc) accounted for 97 percent of all international bond and note issues, two of which (the US dollar and the euro) account for 84 percent of the total. Table 1 also shows that over the last ten years the situation has changed little; in fact, the concentration has increased.

While it is not clear who the sinner is, the fact is that borrowing in foreign currency creates an exposure to exchange risk that has proven to be the source of many recent currency crises of the self-fulfilling variety. Thus, the main benefit from financial openness, the ability to access the world pool of saving to finance development, is associated with an unlucky probability that adverse shocks, most of which do not originate locally, will result in a serious dislocation of domestic financial markets accompanied by a deep recession.

The emerging evidence is that the source of original sin lies with financial market failures. One suspect is the existence of increasing returns to scale in international financial markets.[6] International investors, in this view, can diversify most of the currency risk by holding assets denominated in a small number of currencies. Fixed costs of developing additional markets limit the range of currencies actually in use, in effect imposing the original sin to most other currencies. Another suspect is adverse selection based on established country misbehaviour. In this view, international investors will not lend to a country in its own currency if they believe that the country will then inflate away its debt. Only the most trustworthy currencies can be used.

[5] For a recent review, see Prasad *et al.* (2003).
[6] This is the explanation advanced by Eichengreen *et al.* (2002).

Table 1 Currency of Issuance for International Bonds and Notes
(percentage of total)

	September 1993	December 2003
US dollar	38.2	40.4
Yen	14.4	4.4
Euro	26.1	43.5
Pound sterling	7.7	7.0
Swiss franc	8.0	1.8
Others	5.7	2.8
Total	100.0	100.0

Source: Bank for International Settlements.

The first view receives support from the evidence presented by Eichengreen *et al.* (2003), that country size is the single most significant explanatory variable for original sin. The second view is unable to explain why many developed countries with a solid policy and governance record, for example Denmark and Sweden, do not borrow much in their own currencies, nor does Chile after a long period of highly disciplined policies.

The original sin creates a very serious difficulty for affected countries. If they wish to tap the world financial markets, they have to accept a currency mismatch which, in turn, becomes the potential source of severe difficulties. Exchange rate fluctuations affect the debt level and its service: depreciation requires either raising taxes and cutting spending to contain the debt, or allowing the debt to grow, which is bound to raise concern among investors and to result in a full-blown crisis when capital inflows abruptly stop. The same pressure develops when interest rates in the major currency countries rise; indeed, it is well known that most crises in the emerging market countries have followed a period of rising interest rates in the US. Currency mismatch is widely recognised as a major source of economic vulnerability.

Many countries affected by the original sin have responded by pegging their exchange rates to the currency they most use to borrow internationally. This strategy reduces short-term volatility in debt levels and service but, as happened in South-East Asia in 1997-98, it can backfire and transform mundane currency depreciation into an unmanageable currency crisis. Another strategy, adopted by Korea and Taiwan for instance, is to cut the link between original sin and currency mismatch. To that effect, the monetary authorities accumulate a volume of foreign exchange reserves commensurate with external borrowing. It remains to be seen whether this approach will be able to deter speculative attacks and currency crises.[7] At any rate, this strategy implies that net external borrowing is strictly limited. What, then, is left of the key benefit from financial openness, that of tapping the international financial markets to supplement domestic saving in the financing of productive investments?

3 Remedies and Policy Implications

The revised Washington Consensus now recognises that capital liberalisation is not working as smoothly and efficiently as once argued. The official view is that liberalisation is to be approached cautiously and should follow the development of adequate institutions that deliver prudent macroeconomic policies and sophisticated regulation and supervision of the financial markets. This is a welcome step, but not quite enough yet. This section first asks whether liberalisation is, in fact, desirable, and if so, what must be done to make it deliver its promises.

3.1 Should All Countries Eventually Liberalise?

Conventional wisdom holds that financial liberalisation is on the agenda for all countries. As noted above, the evidence that it is growth-enhancing remains muddled. The Washington Consensus interpretation is that the benefits from liberalisation are theoretically unassailable and that the evidence is concealed by ill-designed experiments. Once all the necessary preventive steps are taken, it is argued, liberalisation will deliver.[8]

It is not clear at all that the theoretical case for financial liberalisation is as robust as claimed. True, financial liberalisation opens up important possibilities to draw upon the world pool of saving and to diversify investments. Equally true is that financial markets play an important role in monitoring national policies and thus provide incentives for governments to follow best practice in carrying out macroeconomic and structural policies.

All this assumes, however, that financial markets are adequately functioning and that market failures can be corrected through appropriate regulation. In that respect, the record of the last decade among the developed countries is impressive. The financial markets

[7] The arguments presented in Jeanne *et al.* (2003) cast serious doubts on the robustness of this strategy.

[8] For an excellent presentation of this view, see Prasad *et al.* (2003).

have weathered many storms, including the LTCM failure, the bursting of the IT bubble, and the attack on the World Trade Center in New York. A combination of deft policy actions and well-crafted regulation has made financial markets remarkably resilient. In previous times, any of these shocks would have precipitated a serious world crisis. It is fair to conclude that the developed countries have passed the stage where financial instability is potentially lethal. Financial markets remain volatile, but they are able to cope with this volatility by themselves, and the real economy is largely immune. Hence, the belief that all that is left for the developing countries is to draw on this accumulated knowledge and prepare their own liberalisation. This is the road followed by Chile, for instance, and success there is impressive.

The assumption behind this view is that every country can adopt the set of policies that have proven to work elsewhere. Governments are seen as both benevolent and able to implement welfare-enhancing policies. Unfortunately, there is no evidence that these conditions are met in practice. Few students of public affairs are willing to accept the hypothesis that governments are benevolent, and even fewer take it for granted that good policies are easy to implement. Interestingly enough, many of those who argue that market failures are small enough to be ignored, and who therefore strongly support financial liberalisation, also consider governments as captured by a host of private interests. They see economic and financial liberalisation as a way of lessening the grip of ill-intended governments and malfunctioning political systems.

They have a point, but they need to recognise that successful liberalisation requires first adopting good policies, which requires good government. Put differently, the countries that stand to benefit most from being subject to market-based discipline are precisely those less able to liberalise. Implicitly, the Washington Consensus was that the benefits from market-based discipline and market access were worth the early liberalisation costs, including possible currency crises which were seen as a cleansing influence. The revised view recognises that the costs, economic and political, may well exceed the benefits.

Is financial liberalisation still on the agenda, then? A positive answer requires a more subtle argument. It rests first and foremost on the need for every country to have good governance, a government less captured by private interests and subject to rigorous accountability. Such a requirement is based both on political and economic grounds: good governance is a desirable objective in and by itself, and it delivers better economic policies, which in turn promote growth. Financial liberalisation becomes the by-product of a wider agenda.

3.2 What to Do with the Exchange Rate?

Even assuming good governance and a reasonably benevolent government, financial liberalisation does not come easily. A particularly difficult question concerns the choice of an exchange rate regime. The Washington Consensus view, for a while, seemed to adopt the two-corner solution.[9] According to this view, with full capital mobility, the only sustainable exchange regimes are either fully floating rates or hard pegs such as currency boards, dollarisation or currency unions. This view is now undermined by recent events.

First comes the demise of Argentina's convertibility law. A currency board was presumed unassailable, at least if supported by adequate financial sector regulation and supervision and by reasonably disciplined macroeconomic policies. Argentina's financial sector was considered as a model to follow, and no one seems willing to argue that it was not so. There is much debate about fiscal discipline. Mussa (2002) argues that provincial authorities failed in that respect, raising the spectre of a federal bailout incompatible with the sustainability of the currency board. Yet, the combined deficit of state and provincial governments remained subdued, barely exceeding 3 percent in 2001, for the first time since the adoption in 1991 of the currency board. This is why an alternative interpretation emphasises instead an overvaluation of the peso and the rigidity of wages.[10]

Second, studies that attempt to identify the de facto exchange regime[11] show that the migration to either of the two corners has not happened. Many countries declare that they let their exchange rates float but they intervene more or less heavily, as several Asian countries currently do. Fear of floating is widespread and reveals deep-seated preferences for nominal exchange rate stability. Fear of fixing too is widespread, especially concerning hard pegs, reflecting a general reluctance to fully sacrifice the monetary policy instrument. What seemed once to be a new fashion, spearheaded by Argentina and Ecuador, has now come to a full stop.

There are good reasons for developing countries to be reluctant to adopt either of the extreme exchange rate regimes. Free floating never

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[9] See Fischer (2001).

[10] This alternative is sometimes criticised on the ground that exports doubled in volume since the adoption of the currency board. On the other side, as a percentage of GDP, exports remained essentially flat at a very low level and the current account deficit fluctuated around 4 percent of GDP.

[11] Levy-Yeyati *et al.* (2002) and Reinhart *et al.* (2004).

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resembled Friedman's classic description. Freely floating exchange rates move quite a lot; for reasons now well understood, exchange rates behave like asset prices. As they do, they become an autonomous source of uncertainty, in effect discouraging international trade. Hard pegs, of either variety, require quite a large degree of price and wage flexibility. What is possible in Hong Kong is not easily achieved elsewhere. Hard pegs without an exit strategy amount to a huge bet, with considerable costs if the bet is lost. So far, no one has been able to design a credible hard peg with an exit strategy. The challenge is plain to see. Not only does an explicit exit strategy mean that the peg is only temporarily hard, but the activation of the strategy is likely to require some advance preparation, which is bound to precipitate a full-blown crisis.[12]

Well-designed limits on capital mobility make the middle ground – soft pegs, managed exchange rates – possible. That does not mean that intermediate arrangements are easy to operate; in fact, the evidence is that they are prone to misalignments and to speculative attacks. Misalignments require realignments and realignments remain difficult to implement. Not only is there much evidence that many countries wait far too long to correct misalignments, but realignments can often be foreseen, which invariably triggers speculative attacks. The only virtue of limits to full capital mobility is to make speculative attacks manageable, at least if the authorities are well-prepared and ready to act fast. When this is the case, soft pegs equipped with an explicit realignment escape clause offer a very attractive way out of the two-corner strategy. Financial liberalisation all but closes down the escape clause option and limits the choice of an exchange regime to the two corners. Advocates of full capital mobility must also take into account this important aspect. This is the object of the next two sections. In both cases, the challenge is to establish domestic institutions that deliver outcomes compatible with the exchange rate regime.

3.3 Institutions for the Two-Corner Exchange Rate Regimes

Freely Floating Exchange Rates

Freely floating exchange rates are a source of uncertainty that may trigger the various forms of financial instability identified previously.

[12] Interestingly, the currency boards in Europe (Bulgaria, Estonia, and Lithuania) have as explicit strategy the adoption of the euro. Activation of this strategy is only going to strengthen the arrangements.

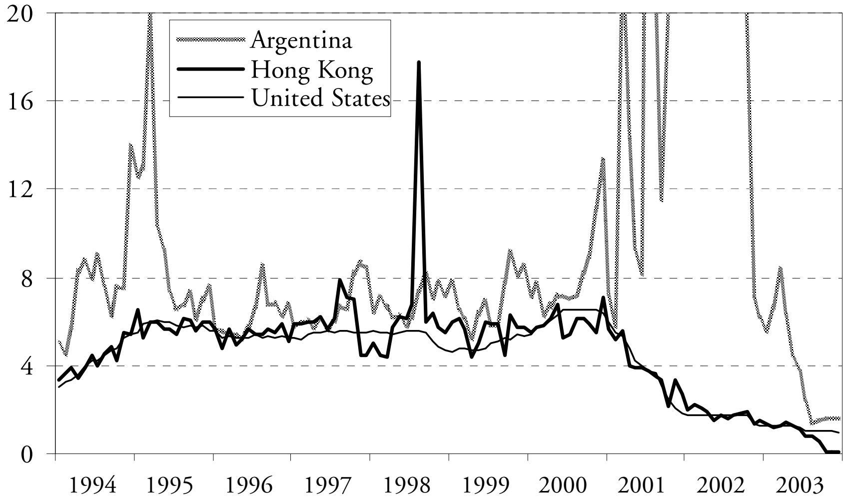
On the other side, freely floating exchange rates may exert a strong disciplinary effect on governments, thus reducing the odds of policy mistakes and providing strong incentives to contain, and possibly reduce public debts. The following is a list of requirements that must be met when adopting freely floating exchange rates:

- The financial markets must be able to cope with sizeable exchange rate volatility. This calls for the implementation of international norms in terms of accounting standards, financial market regulation and supervision. Accountants, regulators and supervisors must not only be competent, they must also be free from political and special interest influence.
- Macroeconomic policies must be shielded from political interferences. For monetary policy, this means a clear framework and strong central bank independence. A number of emerging market countries has adopted the inflation targeting strategy, very successfully so far. The strategy offers a clear objective and a high level of transparency, which helps upholding the central bank's independence.
- In the area of fiscal policy, the original sin implies that public debts denominated in foreign currency are a major source of vulnerability. Reducing this vulnerability constitutes therefore an overriding objective. One obvious step is to issue the debt domestically in domestic currency, but experience shows that, in this case, most governments cannot place bonds beyond a short maturity or they must accept indexation; in both cases, via the interest rate parity condition, the difference with foreign currency debt is symbolic.
- In such a situation, it becomes essential to provide a hard commitment to long-term debt sustainability. Chile has taken a step in this direction with the adoption of a fiscal rule. Countries with less accumulated credibility should consider more constraining arrangements, yet allowing for the shorter-run counter-cyclical use of the fiscal policy instrument. Wyplosz (2002b) suggests setting up independent fiscal policy committees that monitor or mandate annual budget balances designed to achieve a long-run debt target, much like inflation-targeting central banks use the interest rate to achieve a long-run inflation target (see also Teunissen and Teunissen, 2003).

Hard Pegs

A hard peg provides some credibility to monetary policy, although not always a perfect one, nor is it guaranteed forever. This is exemplified in Figure 1a, which displays short-term interest rates in Argentina and

Figure 1a Money Market Interest Rates in Argentina, Hong Kong and the United States
(percentages)



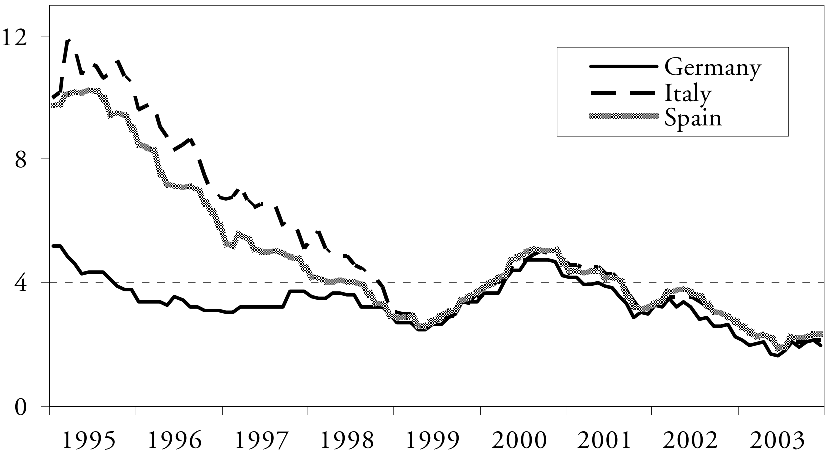
Source: IMF 2004.

Hong Kong, comparing them with those in the US since Argentina and Hong Kong had currency board arrangements vis-à-vis the dollar. The figure shows that the Argentine interest rate never came down to the US level, reflecting a limited credibility. Interestingly, much the same applies to Hong Kong until it repealed powerful speculative attacks during the Asian crisis. On the other side, Figure 1b shows that the adoption of a hard peg in Europe, a common currency, has delivered immediate and full credibility.

A hard peg needs to be supported by a number of specific features:

- The loss of the exchange rate instrument means that external competitivity must be maintained through other means. This is why prices and wages must be flexible, a difficult task in many countries. The solution may be two-part wages or indexation schemes.
- The loss of monetary policy implies that the monetary authorities will not be able to carry out large-scale lender of last resort operations. For this reason, banks in particular but also other financial institutions have to be strengthened. As with freely floating rates, this calls for the adoption of international norms in terms of accounting standards, financial market regulation and supervision, in the full knowledge that crises will occur and financial institutions will fail.

Figure 1b Money Market Interest Rates in Germany, Italy and Spain
(percentages)



Source: IMF 2004.

One lesson from Argentina is that undisciplined fiscal policy can undermine a hard peg. On the other side, fiscal policy becomes the only counter-cyclical macroeconomic instrument available, which rules out strict rules like balanced budget laws or the European Monetary Union's Stability and Growth Pact (Box 1 explains why the pact failed).

- As in the case of free floating, the solution is the establishment of solid institutions that credibly aim at a long-run debt target while allowing for shorter-term flexibility.
- A hard peg provides an implicit guarantee for borrowers in foreign currency. This has the effect of eliminating the original sin and is therefore highly beneficial. If, however, the peg arrangement needs to be reconsidered, or is unexpectedly dissolved, the resulting currency mismatch can be destructive, as was the case in Argentina. One approach is to accumulate a large volume of foreign exchange reserves, which is costly *ex ante* and insufficient *ex post*.[13] Another approach is to have an exit strategy regarding the treatment of all assets and liabilities.

[13] A currency board requires that the reserves be equal to the money base. In Argentina, the coverage was higher, at some 130%. However, the currency mismatch extends potentially to all financial institution liabilities, representing a multiple of the money base.

Box 1 Why Europe's Stability and Growth Pact Failed

The Stability and Growth Pact stipulates that the budget deficit can never exceed 3 percent of GDP. It allows for "exceptional circumstances" but these are so exceptional that the cause is irrelevant. The Pact includes a procedure, which starts with an advance warning when the first excessive deficit is happening, and gradually raises the surveillance until a fine is imposed if the deficit is still above 3 percent of GDP after three years. The European Commission is mandated to exercise surveillance and make recommendations to the Council of Finance Ministers. The Council decides on a qualified majority.

In November 2003, the Commission asked the Council to trigger the procedure that should have eventually imposed a fine on France and Germany. After intense lobbying by the euro zone's two largest countries, the Council decided to put the Pact in abeyance, arguing that the long slowdown did not allow these two countries to fulfil their commitments. The Commission took the Council to the European Court of Justice. In June 2004, the Court ruled that the Pact could not be put in abeyance, that the Council was free to not follow the Commission's recommendations, and therefore set the stage for a new vote, to be formulated differently.

This episode has confirmed what many analysts had argued: the Stability and Growth Pact is badly flawed. The Pact suffers from two key weaknesses:

- Economic flaw. The aim of the Pact is to enforce fiscal discipline. The correct definition of fiscal discipline is that the intertemporal budget constraint be met at all times. In practical terms, this means that the public debt must remain sustainable. A particular year's annual deficit is largely irrelevant. By focusing on annual deficits, the Pact has chosen the wrong indicator. This is precisely the argument used by the Council in its November 2003 decision.
- Political flaw. Fiscal policy is explicitly recognised as a sovereign competence. In each country, the budget is drawn up by the government and voted upon by the parliament. The Pact requires that fiscal policy be subjected to international constraint. While, formally, this is the implication of a national commitment – enshrined in a Treaty – the procedure is politically unacceptable.

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3.4 Building Institutions for Soft Pegs

Traditional Unilateral Pegs

A number of countries will want to continue to operate some form of soft peg vis-à-vis a major currency or a basket of major currencies.[14]
Any peg must include the escape clause of realignments. Realignments, in turn, are unlikely to be possible in the presence of full capital mobility. An obvious possibility is to restrict capital mobility. This is, by far, not a guarantee of success, and offers only a limited ability to deal with speculative pressure. Unless financial repression is severe, the risk of financial instability remains, as does the original sin problem. Here again, the main requirement is the adoption of well-designed macroeconomic policies. A brief list of desirable features is as follows:

- As always, strengthening the financial sector is highly desirable.
- Great care must be paid to dismiss the belief that the peg will be indefinitely maintained; this concerns current exchange rate level and the fixed exchange rate regime itself. This is especially important to limit the extent of currency mismatch. Borrowers in foreign currencies, including the authorities, must remain aware at all time that the existing peg can be unhooked.
- The choice of a monetary policy strategy is delicate. Adopting a peg implies subordinating monetary policy to the exchange rate target. Limits to capital mobility can create the misguided impression that there is a sizeable room for manoeuvre. This is illusory. Herein lies the main drawback of soft pegs: they do not provide much more flexibility than hard pegs – except for the realignment option – but the perceived commitment is weaker, opening up the way to policy miscalculations. Central bank independence is a guarantee that monetary policy will not be misused for political advantage.
- Fiscal policy discipline remains a necessary condition for the long-run survival of soft pegs.

Multilateral Pegs

Nearly all countries that adopt soft pegs do so unilaterally vis-à-vis a major currency. The successful European experience has been different

[14] This is likely to be optimal under most conditions. Indeed, the term “two-corner” is borrowed from the optimisation literature. Unconstrained optima are typically “interior solutions”, meaning that the extreme cases are not generally optimal.

since 1979, however. The choice of an exchange rate regime has been collective and based on multilateral pegs among the members of the European Monetary System (EMS). Undoubtedly motivated by the existence of a common market, this arrangement has proven to be superior to the traditional unilateral peg to an outside currency. Although the EMS has been buffeted by a number of speculative crises, it has served as a training ground for the eventual adoption of a hard peg in the form of a common currency. The crucial element has been the setting up of common institutions.

Since the pegs were unilateral, holding large amounts of dollar reserves was not essential; indeed, mutual foreign market assistance in European currencies allowed for major savings regarding foreign exchange reserves. Yet, the European experience includes a number of very specific features:

- The emergence of an anchor currency, the Deutsche Mark, provided increasingly clear guidance for the conduct of national monetary policies. Most of the crises occurred when this evolution was ignored or resisted, as was the case during the 1992-1993 crisis.
- The European countries were largely spared the original sin challenge.

Developing countries that might also adopt multilateral pegs will not be in a similar solution. If one member country's currency is free from the original sin (for example Japan in South-East Asia), it can be used for international borrowing, under the assumption that the arrangement will be upheld. However, failure to uphold the arrangement, or simply realignments, will always remain a possibility. In such instances, intensified cooperation among all member countries may cushion the impact of currency mismatch by limiting the size of exchange rate changes.

If no member country is free from the original sin (as would be the case in Latin America), the proper approach is to adopt the institutional arrangement described previously in the case of freely floating exchange rates.

4 Conclusion

The emerging market countries are going through a phase that is perilous from the financial point of view. To maintain fast growth, do they need to integrate themselves economically and financially into the world economy? Trade is everywhere an engine of growth; in fact, the most successful emerging market countries from Asia have all adopted the Japanese export-led growth strategy. Financial integration is also in their interest. Not only do they need to access the pool of foreign savings, but their own corporations will not become world players unless they can rely on wider ownership and get involved in the process of mergers and acquisitions that support their expansion and guarantees a timely transfer of technologies.

Nearly every emerging market country already had had at least one, and usually many more, encounter with currency and financial crises. Crises are parts and parcels of financial markets. The objective, therefore, should not be to aim at no crisis, but to make crises manageable, as innocuous as possible. This, in turn, raises two deeply inter-related issues: the exchange rate regime and the capital mobility regime.

The Washington Consensus had easy answers: exchange rates should be of the two-corner variety and capital should be freely mobile. These recommendations have not been followed – very few countries have moved to the corners – or have provoked severe currency and financial crises where capital has been fully liberalised. A better approach is possible, at the cost of eschewing the simplicity of the Washington Consensus. Three lessons must be kept in mind.

First, adopting “good policies” is easier said than done. Most countries have not yet developed well-performing political institutions. Weak institutions make it impossible for the best-intentioned government to carry out good policies. Bemoaning policy mistakes, as is often the case, missed that point, as do many of the conditions requested by the IMF and recommendations from the developed countries. Building up good institutions is the first step, one that takes a very long time and that cannot be imposed from outside. This may be a frustrating conclusion.

Second, most countries seem to prefer soft pegs to either corner. There are good theoretical and practical reasons for that. Soft pegs come in many forms and shapes, but they all require a number of accompanying measures. In particular, they must be flexible enough to accommodate policy mistakes. This means that the currency will have to be realigned now and then. This, in turn, argues for limiting capital mobility. The line of reasoning here is the exact opposite of that followed by the Washington Consensus, which starts with the assumption that capital movements should be fully liberalised and, therefore, would imply the choice of either one of the two corner regimes.

Finally, unilateral peg to a major currency is not the only option. A multilateral peg organised at the regional level is another option. That such a peg have worked well in Europe, however, does not mean that it will work in other regions. Here again, the building up of institutions is a prerequisite.

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11

Competent Institutions and Selective Globalisation

Yunjong Wang

A key message from Charles Wyplosz' insightful chapter is that developing countries are different from developed countries in financial matters. While the developed countries may be rocked by serious financial disturbances, their financial markets remain resilient and their governments and central banks have many tools available to cushion any blow. In contrast, in the developing countries, minor disturbances can have massive effects. Charles Wyplosz reviews the causes of emerging market's financial instability: i.e. policy mistakes, public indebtedness, market volatility and original sin. I would like to express a few thoughts about his explanations.

First, misguided macroeconomic policies are often likely to generate financial instability. For instance, unsustainable fiscal policies lead to the accumulation of public and external debts, or high inflation is inconsistent with a fixed exchange rate. If so, why do many emerging market governments make such policy mistakes? The answer may be that the ability of governments to make wise economic decisions is constrained by the quality of the political and social institutions, and that these institutions are shaped by history. Political pressures for maintaining high rates of economic growth may lead to inflationary monetary policy and undisciplined fiscal spending. Many developing countries fail to build a democratic governance system in making economic policy decisions. However, in the case of Japan, misguided macroeconomic policies were responsible for a decade of economic stagnation during the 1990s. Also, even under the authoritarian regime, East Asia's economic rise could be attributed, in large part, to responsible and disciplined fiscal and monetary policies.

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Second, as pointed out by Charles Wyplosz, governments with weak quality may be tempted to accumulate a large debt and then expropriate its creditors, whether they are domestic or foreign. This notion implies that creditors and investors should evaluate risks more carefully as they seek higher yields. In other words, international lenders have as much responsibility for the debt accumulation as emerging market borrowers: for every questionable borrower there is a questionable lender.

Third, financial markets are inherently volatile. Skittish behaviour of international investors and creditors may have been a major triggering factor in the outbreak of the Asian crisis. Some observers argue that the crisis was no more than a liquidity crisis. In other words, the crisis was mainly caused by the illiquidity of the financial sector where their potential short-term obligations in foreign currency exceeded the amount of foreign currency it could access at short notice. The illiquidity of the financial system was almost entirely rooted in the previous bout of financial liberalisation, which accentuated the maturity mismatch between international assets and liabilities. In addition, capital flows from abroad, caused by an opening of the capital account and a fall in world interest rates, magnified the problem by making available huge amounts of resources that could be intermediated by domestic banks. When this mismatch met the panicking international creditors and their refusal to roll over short-term loans head on, the stage was set for an immediate illiquidity crisis and the resultant bank-runs. As clearly pointed out by Charles Wyplosz, financial repression reduces an important source of economic instability but it is accompanied by serious effectiveness costs that may inhibit growth. This view emphasises the danger of financial liberalisation that is not matched by the necessary regulatory supervision.

Fourth, the original sin hypothesis asserts that currency mismatch reflects structural defect of financial markets of emerging market economies. This is a situation where the countries cannot borrow internationally in their own currencies. In the presence of this incompleteness, financial fragility is unavoidable because all domestic investments will have a currency mismatch. This mismatch exists not because banks and firms lack the prudence to hedge their exposures, but rather because a country whose external liabilities are necessarily denominated in foreign currency is by definition unable to hedge. According to the original sin hypothesis, the solution is not the choice of exchange rate regime, but no exchange rate – dollarisation or its euro equivalent. Once the dollar is adopted for all domestic payments, currency mismatches dissolve, since income streams are denominated in the same unit liabilities. However, dollarisation eliminates all scope for an independent national monetary policy and is likely to limit the capacity of the domestic authorities to provide lender of last resort services. In addition, seigniorage accrues to the anchor currency countries. Therefore, dollarisation is most likely unacceptable politically unless a stabilisation device is well prepared.

Given these discussions of the causes of financial instability in emerging market economies, I would like to add a few supporting evidence to his point.

In the 1990s, there were three region-wide crises: the exchange rate mechanism (ERM) crisis of the European monetary system in 1992-93, the Mexican peso crisis of 1994-95, and the East Asian crisis of 1997-98. These three region-wide crises shared a common characteristic in that they gave rise to exchange rate collapse. However, the two emerging market crises have been widely characterised as financial crises of the twenty-first century, clearly distinguished from previous balance of payments crises. The ERM crisis was primarily a currency crisis, and the industrial countries affected by the crisis did not experience a serious banking crisis that disrupted the real economy, except for Sweden and Finland. Great Britain and Italy – countries that were the first to abandon the peg of the sterling and lira to the German market – did not suffer a serious deterioration of macroeconomic indicators. The associated output losses of the ERM crisis were more limited than in the Tequila and Asian crises.

These three region-wide crises have systemic implications for the globally integrated financial markets. In the context of a crisis dominated by capital account fluctuations, capital account liberalisation tends to heighten financial risks and instability. Capital surges and abrupt reversals of capital flows were conspicuous in the three cases of crises. Most of the EMS countries removed capital controls in the years leading up to the crisis. In Mexico, an ambitious structural reform programme and the opening of capital markets invited the ensuing surge in private capital inflows, which allowed Mexico to finance current account deficits of around 7 percent of GDP in 1992-94. In East Asia, even partial capital account liberalisation led to a surge in private sector borrowing with unwarranted exuberance until the bubble burst in 1997.

The core of the East Asian crisis was the failure to appreciate the fatal risks of financial liberalisation and globalisation in the context of weak domestic institutions. Unfortunately, financial liberalisation (both internal and external) has often been synonymous with the accelerated development of short-term instruments. Domestic financial liberalisation, with its removal of limits on bank interest rates, credit expansion, and required reserves, has often resulted in the fast acceleration of bank credit and, conversely, of money aggregates. External liberalisation, in turn, has prompted a large upswing in short-term inter-bank funding from more developed to developing countries. The recent East Asian experience made the case that market freedom requires regulatory vigilance.

Having said this, traditional macroeconomic fundamentals were of secondary significance. If countries had put in place sound institutions to prevent investor herding, contagion, and speculative attacks, they would have been able to thwart the crisis even while going through cyclically unfavourable macroeconomic conditions. Taiwan and Singapore managed the contagion by floating their currencies and insulating their financial markets through a gradual and orderly sequence of capital account opening. China, another one of the less affected economies, was saved by a very restricted capital account during the financial turmoil of its neighbours.

Contrarily, the four crisis-hit countries in East Asia – Indonesia, Korea, Malaysia and Thailand – had structural deficiencies exposed to the vagaries of international capital. Again, market freedom requires vigilance. However, pressured by Western governments and international financial institutions, these four East Asian countries rather involuntarily followed the Washington consensus and liberalised their financial markets prematurely. As a result, they did not consider the possibility that pell-mell liberalisation could invite speculative attacks and financial crises. Singapore and Hong Kong had financially sound and economically healthy fundamentals as well as mature institutions vis-à-vis the above four crisis-affected East Asian countries. However, Hong Kong also became a victim of the crisis because of its firm commitment to the pegged exchange rate system that invited speculative attacks. Hong Kong weathered a series of attacks at the expense of its overall macroeconomic performance.

That the structural frailties of financial systems increased the susceptibility of the East Asian countries to financial crisis is not disputed. However, it is not altogether clear whether those frailties directly caused the crisis. Moreover, the crisis does not provide any evidence suggesting that the Anglo-American market-based system works better than the bank-based system. The East Asian financial weaknesses were by no means inherent in the intermediary-based financial system; they were the consequences of its general lack of transparency and the repressive financial policies which resulted in the inefficient allocation of resources and collusion between large businesses on the one hand and politicians and government policymakers on the other. The moral hazard syndrome stemming from the implicit government guarantee that banks would never fail further compounded the balance sheet problems at the financial institutions.

Since the crisis, East Asian countries have introduced and enforced new rules for accounting and auditing that conform to international standards. Along with these institutional reforms, most East Asian countries have made impressive progress in deregulating and opening financial markets. As a result, financial institutions, markets, and government policies have been evolving to a competitive and market-oriented financial system. These developments are expected to overcome the inflexibility of the existing bank-based financial systems. However, the market-led strategy does not mean that East Asian governments have no important role to play and must blindly move toward becoming minimalist states. The challenge facing East Asia is rather to develop strong governments able both to resist political pressures from domestic financial establishments and to push forward market-led financial development along with necessary institutional reforms. Within such a framework, the East Asian countries have a better chance of converging with advanced financial systems in the future.

As developing countries take time to build up competent institutions, selective globalisation would be preferable. This entails an approach that steers an economy away from excessive short-term capital movements, but maintains trust in free trade and the virtues of foreign direct investment. Given that the road to free markets through financial liberalisation and opening is bumpy enough to deter countries from taking the trip, the safest route seems to be to wait until the necessary institutions are in place. Thus, public policy should be directed at improving institutional infrastructure, legal systems and bureaucracy.

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In Search of a New East Asian Development Paradigm: Governance, Markets and Institutions

Yung Chul Park, Choong Yong Ahn, and Yunjong Wang[1]

1 Introduction

Viewing the 20th century as a competition of economic models, many observers claim that capitalism proved its superiority in the semi-finals of the 1980s. Frankel and Roubini (2003) describe how some claim that the "American brand of capitalism beat the Japanese brand of capitalism in the finals of the 1990s". In an opposing view, Stiglitz (1998), in his Prebisch lecture, argues that despite the financial crisis that devastated East Asia, many of the alleged institutional weaknesses blamed for the collapse may well have played a minute role. In his assessments, East Asia was no more vulnerable to the crisis than other parts of the world, and in fact, East Asia may be the best model of development the world has seen to date. Stiglitz adds that the East Asian miracle was real and was based on a set of sound fundamentals and public policies.[2]

Between these two opposing views, there is a third – that increasing demands for economic governance reform and unwavering commitment to open trade and financial regimes, together with strong fundamentals under more transparent and democratic auspices provide the basis for

[1] This chapter heavily draws upon Park (2003a, 2003b).

[2] Stiglitz (2001) remarks that the Asian crisis has only slightly tarnished the economic record East Asia had achieved and, if anything, together with the strong recovery in several of the countries, may have reinforced the conclusion that there is something very special about these countries.

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substantial optimism for the future of the East Asian development paradigm (Haggard 2000, pp. 236-37). In fact, Stiglitz and his supporters acknowledge that East Asian countries now face a new set of challenges as their economies become increasingly open and as they are further exposed to the vagaries of international markets as a consequence. At the same time, most of the countries are well poised to take advantage of many of the opportunities that are afforded by globalisation and the new economy (Stiglitz, 2001).

Six years after the crisis, East Asia is at the crossroads. If Frankel and Roubini (2003) are correct in their description, East Asian countries should not hesitate to entirely replace the pre-crisis model of economic development with an Anglo-American system of capitalism. On the other hand, if the problems are associated with imperfections in international financial markets, in particular panic and herding of market participants, Asia would be better off maintaining the traditional East Asian model and at most reforming it to be compatible with changes in the domestic and global economic environment.

In this chapter, we search for a new development paradigm that could help East Asian countries adapt to societal and political changes taking place in the region while retaining their persistent vitality and competitiveness for sustainable growth in integrating into the global economy. Is the East Asian development model, described by a World Bank study (1993) as *The East Asian Miracle*, so outdated and out of touch with the realities of a new global economy that it should be repudiated in favour of an alternative model, such as Anglo-American capitalism? If not, can the model be reformed in a way that will make it as viable for post-crisis development as it was in the past in East Asia?

At the outset, it should be emphasised that East Asia covers a huge area, is home to almost 2 billion people, and in 2000, accounted for 23 percent of the total world gross domestic product. It indeed would be presumptuous to talk about a new development paradigm for all East Asian countries. Our focus is placed mainly on crisis-hit countries in East Asia.

This chapter is organised as follows. Section 2 analyses some of the structural strengths and weaknesses of the pre-crisis East Asian model and asks whether the general features of the model can survive the global economy of the 21st century, driven by innovation in information and communication technology. Section 3 discusses some key reforms for the financial, corporate and public sectors, necessary for rejuvenating the model as a new paradigm for post-crisis development in East Asia. Section 4 concludes.

2 Strengths and Weaknesses of the East Asian Model

Strengths of the Model

East Asia is often referred to as a sub-region of Asia that includes the 10 ASEAN member states and China, Japan, South Korea, Taiwan, and Hong Kong. It should be noted that while a single set of broad characteristics of the East Asian development model could be identified, in reality, there may be as many East Asian models as there are East Asian countries, each with different cultural and historical backgrounds and at different stages of development. However, the East Asian countries share some economic characteristics that distinguish them from many countries in other regions of the world.

Among the economic successes of East Asia before the crisis, rapid growth stands out. From 1960 onward to the early 1990s, the East Asian countries grew three times as fast as Latin America and South Asia. Between 1960 and 1985, real income per capital more than quadrupled in Japan, Taiwan, Hong Kong, Singapore, and South Korea. Another accomplishment was declining inequality: the rewards of the rapid growth were evenly spread throughout the populations. A third notable achievement was the quick reduction of the technology gap via massive investment in human capital, importation of foreign technology, export orientation, and the opening of markets for foreign direct investment as a means of introducing advanced technology.

Voluminous literature exists on economic and social factors that contributed to East Asia's rapid growth-with-equity, which led to a dramatic reduction in poverty rates. Of these contributions, the World Bank miracle study (1993) was the most rigorous and comprehensive analysis of East Asia's development experience. It described the East Asian development model as a functional framework of growth in which macroeconomic stability, superior accumulation of physical and human capital, efficient allocation, and catching-up with advanced foreign technology were important elements supporting rapid growth with equity.

The World Bank study concluded that East Asia's rise could be attributed, in large part, to getting the basics right. Some of the basics or fundamentals included responsible and disciplined fiscal and monetary policies that helped maintain moderate rates of inflation. Relative price stability, in turn, contributed to providing a stable economic environment conducive to private investment and financial savings. Large investments in education, i.e. improving and expanding primary and secondary education, promoted rapid growth in human capital. This emphasis together with post-secondary education that focused on vocational and technical skill training, nurtured a better educated labour force, suited for rapid economic development.

In line with the market friendly approach, East Asia's strategy of social protection also focused on promoting an expansion of employment and enhanced real wages through rapid growth. The European model of social welfare with various entitlements to government transfers, including publicly funded retirement programmes, was considered inconsistent with East Asia's outward-looking development strategy. It was bound to undermine the competitiveness of their exports. As a result, the East Asian policymakers resisted organised labour's demand to legislate a minimum wage and unemployment insurance and suppressed the formation of industry and economy-wide unions. They avoided intervention in the labour markets to the greatest extent possible, so that wages and employment were determined largely by demand and supply factors.

Rapid growth could not have been sustained had it not been backed by high rates of investment and domestic saving. To secure a foundation for high and rising saving rates, the East Asian governments managed its spending programmes within the revenues available so that they could be net savers. This spending discipline restrained large increases in social expenditure and gave the East Asian policymakers moral latitude to extol virtues of saving and to introduce various voluntary and involuntary saving schemes.

Finally, East Asia's model also included actively seeking foreign technology through foreign licensing, capital good imports, and liberalisation of foreign direct investment. One might question whether this policy indeed constitutes market friendly policies. Most East Asian countries did not take any significant steps to liberalise their trade regimes until the late 1990s, and when they did open, they did so under foreign pressure. They needed foreign technology to remain competitive in global markets. Liberalisation of foreign capital imports and foreign investment was therefore dictated by the export promotion strategy; it was not part of trade liberalisation.

East Asia's development model is fundamentally a traditional model of a mixed economy in which the government plays an important role. Within the confines of the mixed economy model, there is little that is unique about the development strategies of the East Asian countries. According to Stiglitz (1996) and the World Bank (1993), East Asian policymakers realised the severity of the numerous market failures associated with the inefficiency of existing markets, non-existence of several markets, technological and marketing spill-overs, coordination problems, and increasing returns to scale. They could therefore easily justify their intervention in various markets. What set East Asian policymakers apart from their counterparts elsewhere, however, was that unlike communist state planners, they were intent on complementing markets rather than replacing them.

An interesting question is: Why did the market complementation or the "fundamentals plus interventions" strategy work well in sustaining rapid growth with equity before breaking up with the onset of the 1997 crisis?

While espousing a market friendly strategy, in reality the East Asian policymakers did not hesitate to intervene in various markets in a systemic fashion and through multiple channels to encourage savings, promote exports, and to achieve the desired allocation of resources. Interventions were not confined to traditional areas in which significant externalities were present, such as developing technological capabilities by building research and development centres and industrial parks and supporting all levels of education. Instead, interventions included import substitution of a wide range of intermediate products, the promotion of heavy and chemical industries as in Korea, government ownership and subsidisation of many financial institutions, mechanisms for mandatory saving, and even setting export targets at the firm and industry levels. Financial policies were repressive in that they kept bank deposit and other interest rates below a market clearing level and maintained ceilings on lending rates.

Contrary to conventional wisdom, both the World Bank (1993) and Stiglitz (1996) argue that these market interventions were not inefficient; in fact, they were associated with high rates of investment and productivity growth in many cases. One explanation for this success is the high level of institutional capacity in East Asian countries, backed by strong bureaucracies capable of administering and implementing interventionist policies. Many East Asian countries, some of which were authoritarian, were "strong" in that they had the ability to seriously commit themselves to long-term development goals and choose those policies that would enable them to attain those goals. The export push, which has been the most conspicuous feature of the East Asian development model, did not allow unnecessary or costly interventions, largely because to be successful it required meeting the efficiency standards of global markets.

Weaknesses of the Model

Notwithstanding its strengths, even before the outbreak of the crisis in 1997, the East Asian model had also been showing various structural weaknesses. The three decades of rapid growth imbedded institutional weaknesses and rigidities in the East Asian system which in turn bred resistance to changes that were necessary to facilitate societal and economic adjustments to political democratisation, economic liberalisation and globalisation of the world economy. More specifically, the East Asian countries failed to restructure their systems in line with democratisation and market liberalisation and to be credible in their interfaces with global markets. We identify four critical failures.

The first failure was the inherent conflict between East Asia's governance mechanism on the one hand and democratic polity and market liberalisation on the other. East Asian countries were slow in developing a democratic governance mechanism at various levels of the economy to replace the system of "consultative polities" that, as described by Campos and Root (1996), characterised these authoritarian regimes. By the early 1990s, it was clear, at least in some East Asian countries, that the consultative mechanisms of coordination and cooperation between the government and private sector – and between the different groups within the private sector – were crumbling and degenerating into collusion, political cronyism and corruption.[3]

The collapse of consultative polities revealed serious coordination problems at the national, industrial and enterprise levels. Large family-owned firms and industrial groups were growing more politically powerful – to the point of dictating national economic policy. Their predatory pursuit of large shares in many markets, including financial ones, brought on further concentration of both economic power and industrial structure. Yet many of the East Asian governments literally did not want to know what the large, family-owned enterprises and their main banks were doing. Governments acted as if they should not be involved in monitoring the behaviour of banks and corporations, lest it should be misunderstood as unnecessary intervention in a market economy. In addition, banks did not seem to know what their client firms were doing. Furthermore, in the case of Korea, labour movements became more militant, disrupting not only workplaces but also

[3] Under authoritarian rule up to 1987, the "hard state" nature of Korean developmental state dominated the governance mechanism. The government could order large firms to exit when their performance was not proved.

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at times entire national economies. Yet the government could no longer mediate disputes between labour and management.

The transition process to liberal democracy and deregulated market capitalism needed a new governance mechanism to fill the vacuum resulting from the disappearance of the old governance mechanism. In particular, financial institutions could have played a role as a disciplining mechanism, but they did not do so. The East Asian model's second failure arose from the delay in developing a proper financial infrastructure as well as legal and regulatory systems that could support a market-oriented and open financial system. In the relationship banking that characterised the East Asian financial system, banks were supposed to play an important role in governing corporations, but it was unclear who was to monitor the banks. In the end, it was the government's responsibility.

Toward the latter part of the 1980s, East Asian policymakers embarked on financial market deregulation and opening. Financial deregulation sought to diversify financial instruments and markets. Due in part to this effort, banks, non-bank financial institutions and capital markets all grew quickly and became more active in the 1990s. However, the financial deregulation was not accompanied by institutional reform for strengthening regulatory, governance, legal and judiciary systems that would improve accounting, auditing and disclosure requirements of financial institutions and firms. Consequently, without proper institutional reforms in place, such a transition led to difficulties in preventing moral hazard and the eventual financial crisis when banks and regulators lacked adequate human capital and resources.[4]

Advanced market infrastructures, such as competent accounting and securities law firms, investment banks, credit rating agencies, corporate restructuring specialists and fund managers were understandably slow to develop. In the absence of these market-supporting institutions, it is questionable whether incipient capital markets could have been buffered against speculation and served as stable sources of investment financing. As far as the financial system is concerned, the failure of the East Asian development model did not lie in bank domination but was instead rooted in poor management and regulation of the banking

[4] Under the old governance mechanism, direct government control over the management and credit allocation at banks and other financial institutions left little room and few incentives for the regulatory authorities to develop and improve their capacity for prudential supervision and regulation. It also meant that the banks and other financial institutions did not develop their own risk management capacities.

sector. There is no theory or empirical evidence suggesting that bank-based financial systems *per se* are more vulnerable to financial crisis than market-based ones. Without due consideration of the level of financial market development, identifying a simple dichotomy between banks and markets may not help much in assessing financial vulnerability to crises. The problem was that East Asian policymakers abused their financial systems as a means of industrial policy before the crisis. That abuse rather than any structural characteristics of East Asian financial systems may have been responsible for the 1997 crisis.

A third failure of the system can be found in the closed and non-transparent corporate sector, which did not fare well with market liberalisation and opening. In the early 1990s, major corporations from East Asia were beginning to borrow heavily from international financial markets and expand their direct investment throughout East Asia, and even in Europe and North America, as part of their globalisation strategy. Although these corporations were becoming more active on the global scene, they were slow in reforming themselves to accept global norms and practices in accounting, disclosure and corporate governance. Western investors were attracted to the growing economies of East Asia and to owning a stake in these large corporations that looked invincible with a global reach. Up close, however, these corporations were riddled with poor accounting and auditing irregularities, non-transparent management and little protection for minority shareholders. Once again, East Asian economies failed to build a modern corporate sector that was transparent and accessible to foreign investors.

The seriousness of crony capitalism, or widespread corruption in East Asia, was well known to foreign investors. However, there is corruption in every society. When campaign contributions lead to corporate welfare, rent-seeking activities are the optimal responses from the corporate sector. Stiglitz (2001) says: "It is easy enough to say that the government should do everything it can to reduce corruption, and that government intervention should be designed in such a way as to mitigate the risk of corruption. It is also easy enough to explain why corruption has adverse effects on economic growth. But it is harder to design and implement corruption-resistant strategies. It is even harder to assess with any precision the impact of the particular level and forms of corruption on the growth of the economy. Many rankings show China at the high end of the corruption scale. Does this suggest that but for the corruption, the economy would have grown significantly faster?"

It has been shown that export-led development strategy was the most conspicuous, as well as successful, feature of the East Asian development model. However, it was predisposed to a number of serious domestic risks, which were overlooked or improperly addressed, resulting in market distortions, concentrated industrial organisation and private economic power, an inflexible exchange rate system, and in some cases, perpetuation of government control of markets and the financial system. This is the fourth failure of the East Asian model.

Policy Implications

The rapid industrial development experiences of the East Asian countries under their export-oriented regimes suggest four sets of policy implications. First, they point to the importance of an export-oriented industrialisation strategy, which in turn requires price stability, high savings and a realistic exchange rate in macroeconomic management. Second, industrial policy for manufactured exports should not only be flexible to meet the changing environment, but it should also be accompanied by development in finance, human resources and infrastructure. Third, both technology acquisition and indigenous research and development promotion should be consistently emphasised to ensure rapid industrial growth. Last, latecomers' industrial policies in the form of sector specific incentives, if applied to the permissible degree in today's increasingly globalising environment, should be disciplined using strict performance criteria.

Ahn (2001) provides an overview of the three East Asian countries' industrial policy regimes and resulting competitiveness in an increasingly globalising world economic order. In his study, he finds that despite their common emphasis on export-led industrialisation, the three countries – Korea, Malaysia and Taiwan – have been differentiated according to industrial strategies. These primarily include a big business approach for Korea, FDI-triggered industrial development for Malaysia and SME-based industrialisation for Taiwan. However, except for Taiwan, financial sector development has not been parallel with industrial development. During their respective high growth periods, in both Korea and Malaysia a crony partnership developed between business and political elite. This granted nearly unlimited expansion for big businesses through "administered credit" from the financial sector in the case of Korea and "connected lending" in the case of Malaysia.[5]

[5] See Ahn (2001) for more detailed description of the three cases of Korea, Malaysia and Taiwan.

Immediately after the 1997-98 crisis, exports provided the only way out of the crisis and sustaining recovery for the crisis-hit countries, since they were not able to implement expansionary monetary and fiscal policy to expand domestic demand. Since the crisis, interest rates have come down to a historically low level, leaving little room for additional monetary expansion. East Asia has traditionally valued fiscal prudence, and with the IMF on the watch, these countries have never seriously considered fiscal expansion as a means of expanding domestic demand regardless of its effectiveness. Given these macroeconomic policy constraints and their traditional orientation toward export-led growth strategy, most East Asian countries have naturally turned to exports as the major source of growth. More importantly, most East Asian countries had to generate current surpluses to replenish their foreign reserves. In recent years, with domestic demand remaining sluggish, they have continued to rely on exports to sustain recovery.

As Stiglitz (2001) points out, the export-led strategy may encounter difficulties as such policies become widely imitated and the world becomes saturated with the goods that represented the traditional comparative advantage of East Asian economies, and more broadly, as they become larger relative to the rest of the world. This can be a problem, especially for China. In this regard, East Asia will have to seek new sources of dynamic comparative advantage rather than relying on price competitiveness. Clearly, the export-led growth strategy also has an undesirable side effect in that it is prone to creating a boom-bust cycle. An export boom that is accompanied by a current account surplus brings in large capital inflows, thereby magnifying a cyclical upswing while an export slowdown deepens a cyclical downturn. Without imposing capital controls, conventional monetary and fiscal policy may not be enough to moderate cyclical swings.

3 The Reform Agenda

Although the 1997-98 crisis exposed a number of structural problems and damaged the universal applicability of the model, East Asia's experience with the crisis by no means proves that the Anglo-American model surpassed the East Asian system, as Frankel and Roubini (2003) claim. A review of the characteristics and evolution of the East Asian model suggests that despite its structural weaknesses and failures in fending off financial crises, some of the main features of the system remain intact. These main features could serve well for the post-crisis development of East Asia, although as a whole, the model is in need of a major structural repair (Park 2003b). However, one must hasten to add that this conclusion does not mean that East Asia can remain content with its vintage 1960-70s model, placing the blame for the 1997 crisis on foreign speculators. In fact, except for the basic building blocks of economic fundamentals, all aspects of the model, in particular institutions governing the financial system, the corporate sector and the labour market will have to be reformed. This need for reform is not surprising in view of the fact that an old development paradigm designed to serve the interests of authoritarian regimes during an era characterised by tightly controlled and closed markets, as well as protectionist trade practices, would be no longer viable. What, then, are the necessary reforms and how could they be implemented to make the model as effective in a new East Asian and global environment as it was before?

Although the liberal policies of the Washington consensus still find many proponents, the virtues of the mixed economy are now better appreciated than before. As Rodrik (2000) points out, "the idea of a mixed economy is possibly the most valuable heritage the twentieth century bequeaths to the twenty-first century in the realm of economic policy". Reflecting on this heritage, a new paradigm is most likely to be one of a large variety of mixed economy models that combine the state and market (*laissez faire* and intervention), as was the case in the old East Asian development model. The major challenge facing East Asian economies in the coming decades, therefore, is to nurture the evolution of their own specific models of a mixed economy. In this evolutionary process, East Asian policymakers will come to realise that democratisation has imposed a different participatory mechanism for consensus building. Economic liberalisation has reduced the scope of industrial policies and other types of market intervention. It has also required the creation of a new set of institutions for financial regulation and supervision, corporate governance and the management of industrial relations for the efficiency and stability of the market.

While East Asia may not have to embrace Anglo-American capitalism, the global realities leave the region with no choice but to conform to international standards of transparency, disclosure, corporate governance and banking – all established by the advanced countries in Europe and North America. Cultivating compatibility between the new East Asian system on the one hand, and global standards and codes on the other will be important because most of the East Asian Countries will continue to rely on North America and European markets for their exports and will integrate themselves into a new global economy, which is likely to be dominated by the United States and European Union.

These two economies will dictate the rules governing international trade, foreign direct investment and international financial transactions. At the same time, viability of the new East Asian model would require consistency with the rules of the World Trade Organization and the capacity to accommodate the global activities of multinational companies. It would also require the flexibility needed to adjust to the ongoing revolution in information technology. The scope and speed of the overall economic reform will have to be adjusted to the quality of government, institutional capacity to reform, and the other political and societal constraints to which East Asian emerging and developing economies are subject.

What type of a new model could satisfy all of these old and new conditions and specifications? There would be little disagreement that the fundamentally sound development policies of the earlier periods will survive political and economic liberalisation in East Asia. Indeed, East Asian countries would be better off if they continued to adhere to the sound policies from which they benefited during the rapid growth period. These policies include: (i) continuing incentive schemes for promoting high rates of saving and investment; (ii) ensuring large investments in education in general, and research and development in particular; (iii) sustaining macroeconomic stability; (iv) maintaining market openness to acquire foreign technology and exposure to foreign competition; and (v) complementing social welfare policies with the growth-with-equity strategy.

As for the restructuring of the pre-crisis model, the discussion of the failures of the system in the preceding section leads one to identify the following areas where fundamental reform is required.

Governance

One of the priorities of reform falls on building a new governance system by embracing a set of new democratic institutions, rules and norms, and complementing it with a host of new institutions for conflict management, social insurance and regulations so that the market system can function better. In particular, regulatory and judicial mechanisms for enforcing investor and creditor rights need to be improved by reforming securities, commercial and bankruptcy law. Many of these institutions are Western concepts and will have to be transplanted on an inhospitable East Asian cultural terrain. However, blind and wholesale borrowing will not work. Unless this transplantation is carefully managed with due consideration of the capacity and constraints of the reforming economies, the reform may not succeed. Specifically, legal and judiciary reform will be met by strong political obstacles set up by bureaucracies and large family-owned enterprises, the two principal groups of architects of the East Asian paradigm of development. Instead of blindly introducing an ideal set of institutions and rules borrowed from the West, East Asian countries would be better advised to enact rules that they can enforce within existing legal and judicial frameworks.

East Asian countries will also be struggling with the question of why democracies have not been effective in moderating social conflict and political instability, improving government effectiveness and establishing the rule of law. The following agenda includes East Asia's priorities for institutional reform for more effective governance: (i) establishing and enforcing procedural and constitutional rules for the democratic system and market-supporting institutions; (ii) improving the quality, effectiveness and efficiency of the delivery of public services; (iii) enhancing the effectiveness of the judiciary and regulatory system; (iv) reducing the incidence of corruption.

The Role of Government

While accelerating their plan for building democratic and market institutions is critical, most East Asian governments cannot ignore the fact that their role has been undergoing a fundamental change from leading economic development to leading social development. However, less-developed East Asian countries may have a better chance of making a smooth transition to a democratic and market-oriented regime if they first succeeded in developing a strong but limited government. And within this framework of governance, these economies may be able to design industrial policies consistent with the World Trade Organization to facilitate technology transfers and manage limited intervention in the market when market failures dictate stronger actions. To these countries, the priorities of public sector reform are likely to be directed to establishing rules and norms that could provide government officials with incentives to act in the collective interest while controlling corruption and arbitrary actions.

Social Protection

There is widespread consensus that East Asian countries, even after recovering from the crisis, may not be able to return to the high growth path of the pre-crisis period. This deceleration of economic growth has undermined the viability of the growth-with-equity strategy for social welfare. However, this does not necessarily mean that the European welfare system would be an alternative mechanism for social protection for East Asia. To the extent that targeting the poor is the objective of social welfare policy, one can make a strong case for East Asia's social contract that places emphasis on investment in people and communities.

Individual countries in East Asia will find it increasingly difficult to produce public goods for social welfare on their own as a result of economic globalisation. This difficulty suggests the need for collective social security and harmonisation of the tax system through economic integration at the regional level.

Industrial Relations

The region will be searching for ways to accommodate labour's growing demand for political participation. In managing industrial relations, East Asia's task would be to weigh the relative advantages of the Anglo-American system favouring labour market flexibility to the European "corporatist" approach, which places more emphasis on labour's participation in economic and social choices. After many years of suppressive labour policies, East Asian countries will benefit from making room for labour's political participation without compromising labour market flexibility. As far as labour participation is concerned, unlike other areas of economic management, there cannot be a single approach acceptable for all of East Asia. Each country is expected to fashion its own mechanism of participation and bargaining with labour compatible with its political system.

Financial Reform

Despite the structural problems that crippled the functioning of the financial system when it fell victim to speculative attacks, East Asia may have to depend on a bank-oriented financial system for an extended period of time in the future. This system would remain until a legal and regulatory structure is established that provides adequate protection to outside investors as a foundation for efficient securities markets.

Theory and experience do not prove that a capital market-oriented financial system is more effective in promoting economic development and financial market stability in emerging market economies. In fact, in many East Asian countries, particularly those at earlier stages of development, the sequencing of financial reform would begin with improving efficiency and stability of the banking system before setting out to develop money and capital markets because they have not established an efficient and stable payment system and a legal and regulatory system capable of supporting securities markets.

If there is one lesson to be learned from the crisis, it is that East Asian corporations will not be able to maintain robust growth unless they reduce their leverage by going directly to capital markets rather than to banks for their investment financing. In this regard, the backwardness of capital markets could serve as one of the major constraints on future growth in East Asia. Therefore, more developed East Asian countries may attempt to simultaneously develop both market-based and bank-based financial systems. Both require prudential regulation, supervision and administrative rules, although the development of capital markets requires a more elaborate system of regulations and legal infrastructure. Development of the regulatory and legal infrastructure may in turn require a medium-term strategy in which reforms involving capital adequacy, loan classification, loan-loss provisioning, risk management and corporate governance introduce and enforce international codes and standards.

Reform of Industrial Organisation

East Asian countries will gain little by dismantling large, family-owned businesses. What is needed at this stage of development is the strengthening of bank-based corporate governance and other legal and judiciary reform that will improve the transparency and accountability of these enterprises and provide better protection of minority stockholders.

Despite their problems of inefficiency, non-transparency and inadequate governance, the break-up of East Asian family-owned industrial groups may cause more harm than good. The experiences of Western economies also suggest that the building of market institutions, better governance, transparency and the protection of minority stockholders over time will strengthen market discipline to which the East Asian industrial groups will be subjected and which will weed out the inefficient groups. Increased competition from domestic market liberalisation and integration into the global system will also weaken the traditional advantages of a large, family-owned group. In particular, the growth of knowledge-based industries could accelerate the break-up of these groups (World Bank, 2000). It is also worth noting that East Asian industrial groups are not so much products of Asian values as they are of a certain stage of economic development. Some of today's industrial icons, such as Ford, Thyssens and Siemens, started out as family businesses. Over time, they have become modern, transparent and shareholder-friendly corporations (The Economist, 2000).

The Exchange Rate System

In the aftermath of the East Asian crisis, emerging market economies have been given two alternatives choices for their exchange rate regimes: a free-floating or a currency-board system. The experiences of East Asian and other emerging market economies do not support viability of the two corner solutions. Instead, they suggest that the policymakers of the East Asian countries may be justified in operating a managed floating system that allows intervention in the foreign exchange market to smooth high-frequency movements in nominal exchange rates (Dooley, Dornbusch, and Park, 2002; Goldstein, 2002).

Regional Integration and Cooperation

During the last decade, more advanced East Asian economies have gone so far into Western reform based on the Anglo-American capitalism that they cannot, and in fact should not, turn back the clock to return to the old East Asian development model. However, in a Washington Consensus milieu, other less-developed countries in the region could be thrown into a disorderly and confusing process of market deregulation and opening without adequate preparations. East Asian countries may desire to determine an appropriate scope and control the speed of economic reform that will facilitate their gradual and smooth integration into the global economy. However, unless they are prepared to coordinate their policies and pool resources to guard against future crises through forming regional cooperative arrangements, there is the concern that their institution-building reforms and future policies regarding market opening are likely to be dictated by international financial institutions and advanced economies in Europe and North America.

Small East Asian countries have found it increasingly difficult to provide many of the important public goods such as social protection, combating corruption, securing financial stability, and resolving the conflict between domestic politics and global economics. These public goods may be more efficiently produced at a regional level. Recognising this reality, combined with the need for solidifying regional defences against future crises, they have initiated serious discussions on the need and modality for regional integration in East Asia through trade liberalisation and financial cooperation at various intergovernmental forums. These efforts have resulted in a number of regional agreements for integration, including the Chiang Mai Initiative in 2000. In this initiative, the 10 members of the Association of South-East Asian Nations (ASEAN), along with China, Japan and South Korea (known as ASEAN+3), agreed to establish a system of bilateral swaps, which is a facility for liquidity support for those participating countries suffering from short-run balance of payments problems. However, receding fear of another crisis has combined with Japan's deepening recession to considerably dampen the initial enthusiasm for regional cooperation and integration. The China-Japan rivalry over political and economic leadership in East Asia and other regional disputes on trade, territory and historical issues have also been formidable barriers to advancing the regional movement for integration.

4 Conclusion

With the growing acceptance of the liberal ideology of the Washington Consensus throughout East Asia since the early 1990s, many countries in the region embarked on liberal reform, deregulating and opening their markets for goods and services as well as financial assets. Democratic transition and economic globalisation accelerated the reform process even before the crisis. Unable to manage the speculative attack on their own, the three crisis-hit East Asian countries – Indonesia, Korea, and Thailand – sought IMF rescue financing and accepted a structural reform programme aimed at transplanting Anglo-American free market capitalism in place of a development system that had served them well for the three decades preceding the crisis. Many detractors of the IMF were critical about the reform programmes, arguing that these programmes were so misguided and out of touch with the realities of these countries that they could not work. Although the jury is still out, growing evidence suggests that the IMF-directed reforms covering the financial, corporate and public sectors have not been as successful as initially expected, and in many instances, they resulted in little more than cosmetic changes.[6]

Over the last three years, the rapid recovery has renewed a re-evaluation of the East Asian miracle and a search for the kinds of institutional reforms East Asia cannot avoid or delay in order to regain its pre-crisis dynamism and strength. The rethinking centres on the question of whether the East Asian model in the old structure still provides a better framework for development than an American free capitalism model for emerging markets and developing economies in the region. This question arises because many of the structural problems in East Asia may not have been any worse than those faced by other countries (including advanced countries) and may not have been directly responsible for the crisis (Stiglitz, 1998; 2001). Nevertheless, the crisis itself, and the subsequent revelation of the weaknesses in the crisis-hit countries, provide good reasons to think about whether East Asian countries can stay with the old regime, reform it while keeping major elements intact, or eschew it altogether in favour of an Anglo-American model of free capitalism.

The discussion of the failures of the pre-crisis East Asian model leaves little doubt that it will have to undergo an extensive overhaul to be credible as a development paradigm, not because it was susceptible to crises, but because it may have become too outdated to cope with the changes taking place in both domestic and global economies. For example, many of the policies, such as the export push that worked well at early stages of development, may no longer be relied on, and the old governance system that befits authoritarian governments has become irrelevant to democratic regimes. The East Asian development model is not a static concept, but rather path dependent in the sense that its formation has been greatly influenced by cultural, historic and political factors. A new system will also evolve over time with societal, political, and economic changes taking place in East Asia and throughout the global economy. But without proper reform, it may not be viable.

Although the pre-crisis East Asian development model is outdated in many respects, neither the crisis itself nor the structural failures have necessarily rendered the model dysfunctional. Certainly, the structural

[6] Six years after the crisis, many banks and other non-bank financial institutions have yet to restore soundness of their balance sheets as they are still burdened by large amount of non-performing loans (NPLs). As far as NPLs are concerned, China and Japan have not of course fared any better.

weaknesses of the model do not support the view that East Asian countries will find it in their interest to emulate Anglo-American free capitalism. Institutions and policies should be likewise reformed to support the indigenisation of such a paradigm for post-crisis development rather than grafting the Anglo-American model on East Asia. Reforming the existing system would make it better suited for, and more flexible to adjust to, the new realities of East Asia and the rest of the world.

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13

Path-Dependent Reforms of the East Asian Development Model

Joseph Ramos

Professor Park and associates' chapter shows that the recent Asian crisis has led to profound rethinking about the merits and demerits of the so-called East Asian development paradigm. The authors delineate three differing perspectives. The first claims that the American model of capitalism has proven superior to the Japanese one, so that (implicitly) the sooner the East Asians Americanise (more fully liberalise) their economies the better. On the contrary, the second view argues that the rapid rebound of the East Asian economies in the aftermath of the Asian crisis suggests that the model that served East Asia so well for 30 years is fundamentally solid, and that at most minor reforms are required for the coming future. The third position, that is espoused rather convincingly by Professor Park and his associates, is that the pre-crisis model must evolve significantly, not because it was unsuitable in the past but because it could become outdated in the future, given the many changes taking place both domestically (the democratisation of their societies) and internationally (globalisation).

Since Professor Park presented this chapter in Latin America, I would like to complement what to me seems a persuasive presentation with what, from a Latin American perspective, seems to be the sources of East Asia's past success and what weaknesses or reforms it might seem in need of for the future.

To begin with, though there are many features in common, there are also important differences between many of the countries, especially as we shift the focus from Japan, to China or to the Tigers. Moreover,

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there are also important differences within the "Tigers". Just to cite a few:

- Korea, as Japan, has grown largely on the basis of domestic firms and entrepreneurs financed locally, as compared to Malaysia and Singapore whose development has relied heavily on direct foreign investment by transnational corporations.
- Conglomerates and large firms have dominated in Korea, whereas small and medium-sized firms have been the rule in Taiwan.
- Hong Kong has the most open and least interventionist economy, not of Asia, but of the world; this contrasts with the protection afforded most sectors elsewhere in the region.
- Unlike the United States, but more like Japan, there are very close, long-term relations between firms and banks in much of East Asia, especially in Korea.

The implication for me is that the diversity of these experiences suggests that none of the above features were essential to their success.

Viewed from Latin America, what indeed seems central in explaining East Asia's success from 1955-1997 and beyond are the following five features:

Undoubtedly, the first feature which stands out is their *ultra* export promotion bias (vs. import substitution alone and no more, as in Latin America until the 1980s) thus forcing their firms to learn to either compete with the world's most efficient firms in third markets or, eventually, go under. And since these economies are, for the most part, scarce in natural resources, if they were to promote exports these would necessarily have had to focus on manufactures. Their instruments of choice for export promotion were for the most part different forms of export subsidies. Since export subsidies are no longer feasible, given the WTO rules, I would like to know what other export-promotion policies, if any, were used – or was it principally export subsidies? If so, Latin America and East Asia in the future would have to consider WTO-compatible export-promotion policies, such as credits to exporters of non-traditional exports at international interest rates – given the normally much higher domestic interest rates, this is a tacit credit subsidy, but is WTO friendly.

Moreover, while East Asian countries are heavily export-oriented, many of these countries still maintain important restrictions on imports. Might import liberalisations and FTAs not be one of the liberalisations needed in the future or are these countries to continue to shelter domestic agriculture and import competing manufactures? These are reforms that Professor Park and his colleagues do not emphasise but which, from my perspective, would be important within the spirit of a strong export orientation.

The second feature which stands out is East Asia's high savings and investment ratios. In part these are the result of investment opportunities; in part, it seems, these are also due to an active policy of savings promotion (for example, Singapore's social security surpluses). I would certainly like to know (and so would the rest of the world) what the secret was. For savings rates of near 30 percent (not to mention close to 40 percent in China) are the order there (vs. 22 percent in Latin America).

Third, I was under the understanding that insofar as labour markets were concerned there was far more flexibility in East Asia than met the eye. In effect, Japan certainly and Korea also, pay participatory wages (that is, where an important component of income is made up of a wage which varies with the firm's output, sales, profits, etc.) – thereby enabling firms to lower wages and thus prices in the face of economic downturns to maintain sales (output and employment) rather than having to lay-off as in the US and Latin America. This provides important labour market flexibility, though it is not of the type typically argued for in this region (to wit, lower minimum wages, lower severance pay, lower indirect taxes on wages). If my impression is correct, this feature of East Asian labour markets warrants greater emphasis.

Fourth, we must not forget that all of these East Asian countries were late starters. The ultimate basis of their spectacular performance would seem to derive from the fact that they actively sought out to identify and incorporate best practices and modern technology. Some did so attracting transnational corporations with modern technology and market access (Malaysia and Singapore); others – Japan and Korea – pursued an active policy of intelligent imitation, be it "learning by visiting", "learning by photographing", learning by taking things apart or reverse engineering and "learning by paying for it" (licensing).

Incidentally, while Korea's strong investment in R&D is much heralded (today close to 3 percent of GNP), in fact, in the hey day of its growth in 1955-1980, this percentage was less than 1, just as in Latin America today, while its strong purchases of licenses – something it long did and still does – tends to be overlooked. For as late as the mid-1980s Korea paid 0,5 percent of GNP in royalties for licenses, five times what Latin America currently spends. Moreover, as was pointed out in a seminar on technology policy in CEPAL several years back, Korean firms came to Canada – knowing what technology they wanted and what other technologies were available in their stead in the rest of the world. Hence, they bargained from a show of strength or knowledge. Latin American firms, by contrast, were passive and laid back and often were sold licenses by Canadian firms without knowing clearly what the alternatives were.

I would like to have more details on all of these forms of "catch up". For East Asia, as Latin America, has only half caught up, so it still has a long way to go before it will have used up this source of growth.

Last, but not least, though the East Asian economies are all market economies, it is noteworthy that, except for Hong Kong, few are in the forefront of economic liberalisations. A ranking by the Fraser Institute by the degree of economic liberalisation shows that while Singapore is even more liberal than the US, the same is not true of Korea and Taiwan (who have the same amount as Sweden – *not* the hallmark of free markets). And what are we to say of continental China – the fastest growing economy of the last 20 years? Even Argentina and Brazil are well ahead of China in terms of economic liberalisation. Yet their growth rates are but a fraction of China's rates. Hence, it would seem that while a fair amount of economic liberalisation is necessary to have good growth, beyond a certain threshold, economic growth and degree of economic liberalisation are not closely related. Which is not to say that it might well be that in coming years greater liberalisation will be needed.

Which brings me back to Professor Park and associates' conclusion. While East Asia was in the catch-up phase, and so long as it continue to be so, it is quite understandable that active and interventionist policies have been successful, for the trajectory of the economy was reasonably predictable. Yet as East Asia approaches the technological frontier and international best practices, it will no doubt have to adapt its model to acquire an institutional frame more suited to such a condition. As the authors so correctly emphasise, these adaptations need to be consistent with East Asia's past model. In this sense, they must necessarily be path-dependent and should not be imposed or imported from outside. Given the forces of democratisation, political and economic governance will no longer be able to be handled by a limited technocratic elite, no matter how professionally competent. Similarly, while globalisation and freer financial markets are part of the present not to mention the future, the international financial architecture is not yet in place that can spare developing countries from severely disruptive speculative attacks. And until such an architecture is found and established it would be folly for East Asia to liberalise financially without limit or restraint.

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East Asian Cooperation, Social Policies and the WTO

Zdeněk Drábek

I like the discourse of Yung Chul Park and his colleagues very much for a number of reasons: it is provocative, intellectually challenging and ambitious. The chapter is an attempt to redefine the "East Asian model" of economic development. I have considered this model to be probably one of the most successful development experiments in recent economic history with spectacular achievements in a very short period of time. This model is now being put in doubt. The second reason is that the chapter is written by economists who come from the region and not from Columbia University – with all due respect to Professor Ramos. This shows that there is a lot of thinking among East Asians about the idea of "what next". The third reason why I liked the chapter is that it asks extremely important questions.

Let me give you two examples of why I think the chapter is important. The authors emphasise the importance of the political changes that are taking place, including primarily the process of democratisation. These changes must surely have important implications for how governments manage their economies. The democratisation will undoubtedly affect the way labour markets operate. This has something to do with how labour is organised and with how labour is trained and mobile. Democratisation is also likely to affect the claims on budgetary resources of states and provinces. It may also affect claims on social spending, and so forth. In brief, the question asked by the authors is extremely important: "Is the current system capable of coping with all these political and economic changes in an economically efficient and effective way, and in a manner that will not be politically destabilising?"

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A second example of the usefulness of the chapter is only implicit in the text. What are the broad implications of economic liberalisation on the society and on the operation of markets? For example, what will the effects of liberalisation of financial markets in the region be and how will the goods and services markets be affected by further opening? Again, these are important questions and even though they are not fully spelled out in the chapter it is clear that they must be on the minds of the authors as well as politicians and the business community.

I find it somewhat curious that the authors seek to reform their development paradigm for another reason. As economists we typically point to failures of policies that can be measured. For example, we assess economic performance in terms of a slowdown of economic growth, the rate of unemployment or the persistence of unemployment, inflation, the ability to cope with inflation pressures, the flexibility of the system to adjust to external shocks etc. None of this is brought out in the chapter.

I would argue that East Asia did remarkably well before the financial crisis of 1997 as well as after the crisis. When we look at the numbers on trade flows in recent years, East Asia has not only recovered from the crisis but it has also been one of the engines of global economic growth. If we did not have East Asian growth, the global economy would have been in a dramatic stagnation in the beginning of this decade. It has been East Asian intra-regional trade that has driven the global growth of world trade as the adjustments of individual countries after the crisis – such as Korea (the authors' own country) Indonesia, and Thailand – have been remarkable.

In brief, I am somewhat puzzled as to why the authors are so hard pressed to seek a new paradigm if the main economic indicators are not all that disturbing. This is how the East Asian picture appears to an outsider. On the other hand, strong undercurrents of fears and concerns may exist in the society and the markets that are only known to those who are part of those societies. Notwithstanding the questions that I have just mentioned on the role of democratisation and economic liberalisation, these fears and concerns could have been more strongly articulated.

The authors mention essentially four reasons for the need to reform the economic and political system: (i) they are concerned about a weak financial sector; (ii) the system of the "consultative polities" is breaking down; (iii) corporate governance is plagued by problems of non-transparency and corruption. Finally, (iv) the authors are also concerned about the countries' strategy that is heavily dependent on export-led growth.

Let me pause briefly and make a brief comment on the last of their worries – the issue of export-led growth. Once again, I am somewhat puzzled that this is raised as an issue. On the one hand, there can hardly be any doubt that the success of the East Asian "miracle" was brought about by the countries' openness to markets and by their willingness to expose domestic firms to competition in global markets. The authors recognise the importance and positive features of the export-led growth but their concerns are less clear. It would help the reader to know the reasons for their scepticism. It would also be helpful to better understand the origins of their concerns.

These are small points that can be handled by a minor editing work. Let me now turn to what are relatively more substantive issues. I shall focus in the rest of my comments on the second group of issues that Professor Ramos mentioned. While he discusses the main features of the East Asian model, I shall look at the future of the paradigm and "dream" essentially with the authors. Our comments are, therefore, complementary because of the way we have divided them.

I would like to suggest two issues that might be of interest, and which, in my view, need to be addressed in any future reform of government policies. The first issue is the question of regional cooperation. Unfortunately, the question receives relatively minor attention. The authors only make passing comment at the end of their presentation even though regional cooperation is already raising hot debates in the region. The second issue concerns the implementation of government policies. Following the IMF interventions in the area during the 1997-98 crisis, interventions that were deeply resented, the authors criticise the influence of outside bodies on the domestic process of policymaking. This raises an interesting question about the role of multilateral institutions in domestic policymaking. What I would like to do is to briefly discuss the importance of the WTO agreements and rules on how future economic reform might have to be conceived and implemented.

Let me start with the first issue – the issue of regional cooperation. The authors say something very interesting on page 165:

> Unless they [the countries] are prepared to coordinate their policies and pool resources to guard against future crises through forming regional cooperative arrangements, there is the concern that their institution-building reforms and future policies regarding market opening are likely to be dictated by international financial institutions and advanced economies in Europe and North America.

This is clearly a heavy stuff, which permeates with the authors' dislike of IMF interventions. It shows their desire to maintain "indigenous" East Asian policies. Moreover, the authors raise the limits of regional cooperation to highly ambitious levels.

What kind of regional cooperation would be required to ensure that the cooperation is effective? My answer is that such a new regional cooperation would have to go far beyond what has been contemplated in the ASEAN until now. What the ASEAN has done so far is very modest in terms of both the scope of measures and depth of integration, a process that has been very slow, and certainly not adequate to address the authors' concerns. In other words, the present shape of trade policies, which are the single target of ASEAN cooperation policies, will not be enough to make the cooperation work. Being focused on border measures, the present structure of ASEAN is far too limited. In brief, what needs to be done is to extend the scope well beyond the border measures to inside-the-border measures to make the cooperation effective.

Moreover, trade policy measures are the wrong policies for targeting financial instability, which is one of the major concerns of the authors. The theory of balance of payment adjustment is quite clear on this point. The origin of balance of payments crises or of financial crises does not typically lie in distortions of trade flows. More likely, the crises originate in poor macroeconomic management or in distortions of financial markets. In either case, the cure for instability lies in domestic macroeconomic management; trade policy measures can only serve as temporary instruments.[1]

Given the theory of macroeconomic management, let me make three snap suggestions from the empirical literature, which might give us some further guidance on the kind of regional cooperation required to reduce to mitigate financial instability.

Notwithstanding my comment on border measures above, one would have to start with further coordination of border measures. This means the completion of the process of removing the barriers to the internal (intra-regional) trade flows. This will further call for a coordination of trade policy measures toward third countries. These are no minor tasks. They would require a considerable degree of fine-tuning of trade policies without introducing further distortions.

[1] For more details see Zdeněk Drábek, "Trade and Macroeconomic Policy", Working Paper, World Trade Organization, Geneva, 2004 (forthcoming).

In addition, one would need to adopt measures for deeper integration, which nobody is contemplating as far as I know. Empirical literature provides strong support for the claim that a necessary condition for effective cooperative arrangements, defined in terms of efficient trade dynamics, must involve arrangements for deep integration. I am referring to the literature on currency arrangements, currency unions, and their effects on trade flows and welfare.[2]

We have recently done a study using a few case studies of countries that apply different models of regional arrangements. We have asked which arrangements have been more successful in targeting the question of financial stability and crisis prevention. The study shows that the conditions for a successful prevention for financial crises must include a set of at least three important measures: first, cooperation on standards, including standards such as technical standards, sanitary standards, prudential laws in the financial sector etc. Second, one also needs to think in terms of further liberalisation of capital and labour markets. Third, and certainly not in the order of importance, is the argument that countries aiming at avoiding or, at least, at minimising the risk of financial crisis it would have to consider cooperation on the level of macroeconomic policy as well.[3]

This has been my comment on regional cooperation. My second comment is about the degree to which government policies are constrained by WTO rules. WTO rules could affect government policies in two areas. It is clear that the area in which WTO rules are extremely influential is the area of industrial policies. However, that is such a big issue that it would require separate treatment. What I shall do instead is to refer another area – the area of social policies.

How are social policies of countries affected by WTO agreements and rules? Social policies can be affected directly and indirectly. The direct effect comes from the commitments of countries in the WTO in social sectors such as education, culture and health. Indirect effects affect countries through the operational rules on subsidies and on market access.

The third important area is the intellectual property agreement (TRIPs), which would obviously affect countries through their access to medicine, for example, as a result the provision of health services.

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[2] See, for example, Andrew K. Rose "One Money, One Market: The Effect of Common Currencies on Trade", In: *Economic Policy*, April 2000, pp. 9-45.

[3] The conclusions are based on a project that I have recently completed. See Zdeněk Drábek, *Are Regional Integration Arrangements Able to Enforce Trade Discipline?*, Palgrave Press, London, 2005 (forthcoming).

In order to understand how these agreements affect countries it may be useful to recall the modalities under which these agreements are made in the WTO. There are three important features of those modalities that should be singled out. The first is the concept of what is known as the positive list. This is a *request-offer* kind of a deal, whereby countries make commitments on access and non-discrimination only if they schedule those particular sectors in their offer. This also means that if a country does not want to make any offer outside its list, it does not need to do so – unless of course it will negotiate concessions from their partners.

The second important issue on modalities concerns the agreement on services (GATS). There are four different kinds of *modes of deliveries*: cross-border delivery; consumption abroad; commercial presence, and movement of national persons. The degree to which domestic policies will be affected by the WTO will again depend on the kind of commitments countries make in the negotiations. However, it is evident that each of these four modes of delivery will affect the country in question differently.

Finally, the third element of WTO modalities concerns the question of *bindings*. *In strictu sensu,* the only commitment that fully constraints countries' policies from their undertakings in the WTO are bound commitments. The governments may have to agree to bind only some of their commitments. In contrast, unbound commitments can be changed. If a country schedules a commitment in the WTO and the commitment is not bound, such a commitment is not firm.

Why am I making this elementary introduction to the WTO? When one looks at commitments made by East Asian countries in services negotiations in the WTO, one discovers that there are very few sectors that have been scheduled in GATS by these countries. Furthermore, there are very limited commitments made on the individual modes of delivery and whatever was scheduled, the commitment were made in such a way that they did not restrict in my view domestic policies. Finally, while I do not have the precise numbers, it is very likely that the majority of these countries' commitments have been unbound. In brief, it is not very likely that the domestic policymaking has been significantly constrained by the WTO agreements.

Let me conclude with a minor comment. The East Asian model has been criticised by Krugman[4] and others on the grounds that it is an

[4] Krugman was probably the first to note this feature of East Asian economic model. This would make the model similar to the one practiced by the communist countries until their collapse in 1989. See, Paul Krugman, "What Happened to Asia?", mimeo, 16 January 1998 (in P. Krugman's website).

input-intensive model and, therefore, a highly inefficient one. The empirical evidence is far from conclusive but the issue needs to be emphasised in discussing the strategy. The authors, too, acknowledge that economic growth has been generated by massive capital accumulation, by a rapid growth of labour input, by an extraordinary expansion of intermediate inputs rather than by greater efficiencies. If I understand well the sentiment of the authors' position, they seem to dismiss these arguments on the grounds of statistical shortcomings and other methodological problems. Nevertheless, the argument should not be dismissed out of hand. Take the example of Japan in the 1990s. With savings and investment rates of around 40 percent – historically high levels – economic growth was during the same period about zero and even declining. Surely, this is not a particularly efficient way of using countries' resources. *Pari passu,* this also has important implications for policymaking. Once the criticism is taken seriously, the process economic liberalisation, which brings more competition to markets, and democratisation, which changes the structure of markets, can become key factors in stimulating more competitive and efficient responses of economic agents. Such responses are critical to create conditions for faster economic growth as well as for a greater financial stability.

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The Search for a Stable and Equitable Global Financial System

Amar Bhattacharya[1] *and Stephany Griffith-Jones*

The financial crises of the late 1990s generated a broad consensus that fundamental reforms in the international financial system are needed to appropriately address the challenges of the 21st century: how to prevent financial crises and better manage them when they occur, and how to provide adequate net private and public capital flows to developing countries, in support of poverty eradication and sustainable development (Stiglitz and Bhattacharya, 1999; Griffith-Jones and Ocampo, 2003).

Efforts to improve the framework for crisis prevention and crisis resolution have encompassed both international and national actions. In this chapter, we focus on the global agenda for international financial reforms and particularly the global agenda for private capital flows.

We start with a broad overview of progress on international financial reforms. In the second section, we develop a conceptual framework to evaluate progress on the main challenge of international financial reform: crisis prevention. We use this framework to examine key features of the financial sector and its macroeconomic interactions, leading to a number of policy proposals. This framework will also be applied to an analysis of proposals on a new Basel Accord (Basel II). In the third section, we look at issues of post-crisis recovery, focusing

[1] The views expressed are those of the author and do not necessarily represent those of the World Bank.

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especially on encouraging private flows in times of drought, and trying to ensure that resulting flows are more stable. As in the previous section, this includes a review of counter-cyclical mechanisms, incentives and policies. In the fourth and final section, we examine issues of representation of developing countries in global economic and financial governance, including proposals under discussion for increasing their representation.

1 Progress on International Financial Reforms

1.1 Reduction of Vulnerability to Shocks

When the crisis erupted in East Asia, many observers argued that the primary cause of the crisis were weaknesses in macroeconomic and financial sector policies and institutions including the lack of transparency and disclosure. Even though we do not agree with this one-sided proposition, the East Asian crisis did point to the need for improvement in transparency and disclosure at all levels. Indeed, one of working groups established under the aegis of the G-22 focused on transparency and disclosure, and this gave a big impetus to what we now call the three standards of disclosure, notably the Special Data Dissemination Standard (SDDS) on data, the code on fiscal transparency, and the code on monetary and financial transparency.

The global community has accepted these codes as important standards and assessments of two-thirds of the membership of the Fund and the Bank with respect to these standards have been undertaken. Although there is a push towards greater transparency at the national level, the impact on country practices is unclear. Second, as we have seen from LTCM, from Enron and from many other debacles in industrial countries, failures in accounting and accountability are not just an issue of emerging market economies. An area where there has been considerable progress is greater transparency about the deliberations and assessments undertaken by the IMF and the World Bank. There is now a presumption that IMF papers on Article IV consultations are published with the concurrence of the authorities, and key Board discussions and decisions are posted on the website.

A second way to reduce vulnerability to shocks is through improved surveillance. IMF surveillance, which has been the most important in this regard, has been strengthened at the global, regional and national levels (IMF 2004b). In addition to the *World Economic Outlook,* the *Global Financial Stability Review,* which analyses developments and risks in global capital markets and the transmission of shocks to emerging markets, is now a central vehicle of the IMF's global surveillance. Regional surveillance efforts of the IMF have also been expanded, including surveillance of currency unions such as the euro area. Country-level surveillance is now more intensive and more frequent especially for systemically significant economies. The analytical foundations have also been strengthened, including the framework for vulnerability assessments and use of a balance sheet approach, which entails examining sectoral balance sheets and inter-linkages in order to detect currency mismatches and other balance sheet weaknesses. IMF surveillance has also been broadened to cover structural sources of macroeconomic vulnerability.

The two key inputs to this broader coverage of vulnerabilities have been the joint IMF-World Bank *Financial Sector Assessment Programme* (FSAP) and the *Reports on Observance of Standards and Codes* (ROSCs). To date 96 financial sector assessments have been completed or underway and more than 550 ROSCs prepared, with two-thirds of all countries now covered in full or partially by both programmes. At the global level, the Financial Stability Forum has also focused on the monitoring of global financial market vulnerabilities as well as examining specific issues of concern in more depth. The Forum brings together the international financial institutions and the standard setters, but country participation is limited to the G-7 and selective countries of systemic importance. In addition to the multilateral surveillance, there is now increasing regional surveillance. For example, in East Asia surveillance discussions are now taking place in ASEAN, ASEAN+3, the Manila Framework Group, the Meeting of East Asia-Pacific Central Banks (EMEAP), in various other sub-regional groups, and in APEC.

A third way to reduce vulnerability to shocks is the strengthening of financial systems. This was one of the three topics taken up by the working groups established by the G-22 in the aftermath of the East Asian crisis. It was also one of the areas of early attention by the Financial Stability Forum and has remained on the agenda of international discussion since including in the G-20. The more careful scrutiny of the role of the financial sector has led to four important conclusions: first, that there are clear perils to speedy and poorly sequenced liberalisation; second, that weaknesses in the financial sector can amplify vulnerabilities through the domestic credit channel; third, that a weak financial sector is less able to withstand macroeconomic shocks and external financial instability; and, fourth, conversely that deep domestic financial markets can lead to more prudent risk taking and avoid currency mismatches through excessive reliance on foreign intermediation. These discussions led to a renewed emphasis on adequate supervision and regulation and the enunciation of good practices embodied in the internationally agreed standards for banking, insurance and securities market supervision. But it is now also recognised that supervision and regulation need to be complemented by adequate incentives for prudent risk taking including the need to avoid excessive insurance and by robust institutional underpinnings. The institutional agenda encompasses many elements, but building strong and efficient payments systems, an incentive-compatible institutional framework for financial supervision, sound accounting and auditing practices and a well functioning legal system including for collateral and for bank and corporate insolvency are key priorities. Strengthening financial systems is a long-term and complex institutional building task which must be anchored in the local context and led by national authorities. The international community can however play an important supportive role given the scarcity of expertise in many key areas. The international financial institutions working in collaboration with standard setters and bilateral agencies are the main conduit for providing such support. The recommendations for reforms contained in FSAP and ROSC reports are now providing additional, more systematic, ways to identify technical assistance needs.

Another issue that has come to the fore since the East Asian crisis is appropriate exchange rate management. The early debate on exchange rate regimes was based on the effects of different shocks, monetary or real and domestic or external, and on fixed or floating exchange rate regimes. In the 1980s and early 1990s, with a preoccupation on price stability, the use of exchange rates as a nominal anchor gained increasing support. In the aftermath of the East Asian crisis, the dangers of pegged exchange rates in a world of large and volatile capital flows led to the two-corner view that countries should either adopt a floating or fixed exchange rate system. This view has progressively evolved. Although the norm that there is no right currency regime for all countries for all times still stands, most economists now agree that financial integration places a premium on exchange rate flexibility and that fixed exchange rate regimes are much more demanding in terms of required fundamentals. In a recent work, Morris Goldstein (2002) argues that the best regime for countries that rely heavily on private capital markets would be a managed floating plus regime, where "plus" refers to a supportive framework that includes inflation targeting and aggressive measures to discourage currency mismatching. There is also broad consensus that credible exchange rates must be based on credible institutional arrangements for macroeconomic policy such as central bank independence and fiscal discipline in the long-run based on automatic fiscal stabilisers and fiscal responsibility arrangements.

On debt and contingent liability management, a lot of new work has been undertaken at the international level. There is now an agreed set of principles and guidelines on sovereign debt management, and these guidelines focus much more on contingent liability management than previous practices emphasised.

An area where the views of the international community has changed most markedly since the East Asian crisis relates to capital account liberalisation. There is now wide agreement that capital account liberalisation needs to be sequenced carefully and with due regard to financial sector vulnerabilities. Conversely countries need to take steps to avoid boom-bust cycles associated with pro-cyclical capital flows and to minimise currency and maturity mismatches. In this regard, prudential regulation of financial systems can be as important as capital controls (Stiglitz and Bhattacharya, 1999).

1.2 Response to Shocks and its Aftermath

In assessing progress in the international financial architecture with respect to crisis response and crisis resolution, it is important to distinguish between two elements: how to prevent small shocks from becoming bigger ones, and how to facilitate restructuring when it becomes inevitable.

In addition to a renewed emphasis on investor-country relations, the main initiative taken to deal with the problem of fading investor confidence was the establishment of the Contingent Credit Line (CCL) by the IMF in 1999. To access the facility a country had to meet several tests and it could only tap the funds after an activation review by the IMF. Many countries were also concerned about the adverse signaling if they were to apply for the CCL. In the end the facility was never utilised and the IMF Board decided not to extend it when it relapsed in November 2003. In East Asia, partly in response to some of these concerns, the proposal to set up regional financial cooperative arrangements have gained some momentum. The so-called Chiang Mai Initiative which was set up initially as modest bilateral swap agreements between countries in the region is gradually evolving into a more multilateral arrangement and its scope expanded. Nevertheless the magnitude of this facility is likely to remain small in relation to the IMF and the size of potential shocks.

So the main instrument of response remains traditional IMF lending. Views on the scale and conditions associated with IMF lending however remains sharply divided. Some have argued with good basis that since the IMF is not a true lender of last resort, either in its ability to provide unlimited resources or to impose and monitor the necessary conditions, large scale IMF lending only adds to the problem by increasing moral hazard. Others have argued that neither IMF quotas nor the magnitude of Fund resources have kept pace with the growth of the world economy, and that the IMF can only deal with the problem of volatile capital and financial contagion with much larger and less conditional IMF support. Actual practice has fallen in between these two alternative visions of the role of the IMF. The Fund did provide large scale support in some cases, notably for Turkey and Brazil, but it has been less willing to do so in other cases. The debate on limits on IMF lending, and the criteria on which it should be based, is far from settled.

Views on how to deal with eventual debt restructuring in the event of a crisis also remain sharply divided. The reluctance to rely on the provision of large amounts of official finance to resolve debt service difficulties, coupled with potential problems in coordinating bond creditors, have led to increased interest in improving the framework for the restructuring of bonded debt. Bonds have become the preferred instrument of borrowing, and now account for 25 percent of the debt of emerging market economies, compared to 11 percent in 1990. Three proposals have been the focus of recent debates: a sovereign debt restructuring mechanism (SDRM), the greater use of collective action clauses (CACs) to facilitate coordination, and the development of a voluntary code of conduct that would help improve the environment for the resolution of debt difficulties.

At end-2001, the IMF proposed a formal bankruptcy procedure to enable an insolvent government to seek legal protection from external creditors, while negotiating a restructuring of its debt. The SDRM would enable creditors and debtors to negotiate a restructuring, aggregating across instruments, and ratifying an agreement binding on all by a specified super-majority. However, the requisite level of support among the Fund's membership to establish the SDRM through an amendment of the Fund's Articles of Agreement was not reached, in part reflecting opposition from the private sector as well as key emerging markets. The International Monetary and Financial Committee (IMFC) agreed on April 12, 2003 that while "it is not feasible now to move forward to establish the SDRM", work "should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises *(including)* inter-creditor equity considerations, enhancing transparency and disclosure, and aggregation issues".

In contrast, the international community has made considerable progress on collective action clauses, or CACs. There is now a broad consensus that greater use of CACs – that provide for the modification of terms on bonds by a substantial majority – can help impose debt-restructuring agreements on minority creditors, thus reducing the probability of a disorderly default. Although the inclusion of CACs has been a long-standing market practice in some jurisdictions, including bonds governed by English law, bonds issued under US law do not automatically have such provisions. After emerging market countries such as Mexico, Brazil, Korea and South Africa started in 2003 to include CACs in their bond issues governed by New York law, many other investment-grade countries have followed suit and such clauses are rapidly becoming the standard practice in the New York market, with no apparent effect on pricing. Sovereign issues containing CACs have grown to represent more than 90 percent of the total value of bonds issued since April 2004, and 40 percent of the value of the outstanding stock of bonds from emerging market countries as of end-July 2004.

The international community has also made encouraging progress on a voluntary Code of Conduct. Recent experience suggests that debtor-creditor dialogue is critical to the success of the debt restructuring process. Discussions within private and official sectors have taken place recently on the potential benefits of a voluntary Code of Conduct for creditors and debtors. Such a Code could, in principle, facilitate dialogue between creditors and debtors, promote corrective policy action to reduce the frequency and severity of crises, and improve the prospects for an orderly and expeditious resolution of crises. A draft code has been prepared on the basis of extensive consultations between several emerging market countries of the G-20 and private sector representatives. The draft principles provide a market-based, voluntary and flexible framework for cooperation between debtors and creditors that could potentially complement CACs in helping to contain crises at an early stage and facilitate restructurings when they become inevitable.

1.3 Assessing the Progress

The progress to date has been the greatest with respect to reducing vulnerability to crisis as a result of efforts of countries and complementary international actions. Developing countries have significantly improved their macroeconomic policies and financial systems, and international efforts have distilled, disseminated and supported the adoption of good practices. The steps taken to reduce vulnerability have also had a development payoff since much of the agenda aimed at reducing vulnerability is also key to accelerating and sustaining growth. Although it is difficult to assess the counterfactual if these steps had not been taken, the improved growth performance of developing countries and resilience to recent shocks suggests that developing countries are less vulnerable to potential instability. The ability of emerging markets to withstand turbulence in individual countries including the major crisis in Argentina also suggests that these steps have reduced the impact of financial contagion.

On the other hand, the impact of measures on crisis response is mixed, because of limited progress at the international and regional levels. The existing arrangements have not been able to deal speedily with the fading of investor confidence, that can last for a relatively long period and can give rise to adverse and self-fulfilling debt dynamics. Emerging markets that have private debt levels that make them susceptible to high and volatile risk premia, such as Brazil or Turkey, need to maintain large primary surpluses to maintain confidence and meet the high interest costs of rolling over the debt. Recent empirical findings show that emerging markets are susceptible to debt distress at far lower levels of debt to GDP than is the case for industrial countries. Partly in response to the experience of indebted emerging markets, developing countries that are able to are building up large pools of reserves in order to insure against potential instability. As a result of such excessive and inefficient insurance, and the reluctance of emerging markets to rely on private debt finance, developing countries have become net capital exporters which is developmentally perverse. Given more rapidly aging populations in the North and the higher marginal returns in the South, there are mutual benefits from net capital flows to developing countries.

The mechanisms to resolve financial crises when they occur are also unlikely to produce efficient outcomes. Differences of views on whether to provide large scale official support or to sanction a tough approach including standstills means that a voluntary approach must be the primary means to resolve a crisis and any eventual restructuring.

Although the adoption of CACs will facilitate debtor-creditor dialogue, it is unclear whether CACs by themselves can deal with the complex incentive and collective action problems that arise at a time of restructuring.

Finally, reforms to date have been characterised by insufficient developing country representation in key fora and institutions. This lack of participation by developing countries slows down progress in reform of the international financial architecture, and undermines the legitimacy and effectiveness of measures adopted.

2 The Limitations of Crisis Prevention Measures

Since 1997, much effort has focused on crisis prevention in response to the large number of crises in developing countries, which came with very high macroeconomic costs and damage to development and potential and real costs to the international financial system.

These efforts have been centred on the development of international codes and standards for financial sector regulation, and their implementation in developing economies. Two aspects have received less attention. The first is that there has been far less emphasis on improvements in global capital markets, especially in possible weaknesses in source countries.

The second, and perhaps least explored limitation of prudential efforts undertaken so far, is that they do not avoid unwelcome macroeconomic costs resulting from inherent imperfections of financial systems. This second limitation arises partly from insufficient (though growing) understanding of the relationship between imperfections in financial systems, their macroeconomic impact and the new regulatory needs. It has also been attributed to the insufficient application of the rapidly evolving insights to the practice of regulation and of macroeconomic policy, due to implementation difficulties, bureaucratic inertia, or power of vested interests.

The new insights (which draw on a tradition that starts with Pigou and Fischer, and was developed more by Keynes, Minsky and Kindleberger) stress the inherently pro-cyclical nature of financial markets and their interaction with the real economy. Indicators of risk perception decline sharply in good times – when in fact risk may be greatest – and increase sharply in bad times, overshooting both ways. Asset prices, risk spreads and provisions fluctuate sharply following risk perceptions. This partly reflects the fact that financial agents are far better at measuring the cross-sectional (in a moment of time) rather than the time dimension of risk, being on the whole rather bad at measuring and allocating risk over time (Borio and Crockett, 2000; Persaud, 2003; Borio and White, 2004). At the same time, there is a tension between individual rationality and desirable collective outcomes, reflected in phenomena such as herding. This implies that recent slowdowns (both in developing and developed economies) may not mainly result from a tightening of monetary policy, but from reversals of asset prices and levels of exchange rates, often accompanied by sharp reversals of capital flows in the case of developing economies. An alternative explanation is that the fear of financial distress or capital flow reversal may force economic authorities to follow “excessively” tight macroeconomic policies, which also discourage growth.

These new realities imply that in the prevention phase, far closer cooperation is needed between financial regulators and macroeconomic authorities. Even a well regulated financial system is unable to withstand major macroeconomic shocks, as illustrated clearly by the Argentinean experience in 2002. At the same time, imbalances or instability in the financial system often undermines macroeconomic performance. Furthermore, financial regulation needs to have a far stronger prudential dimension (Crockett, 2000; Ocampo and Chiappe, 2003; Borio and White, 2004). This is due to the fact that the evolution of risk is partly the result of the collective behaviour of financial players, and that risk perceptions are influenced by overall liquidity. By stressing pro-cyclicality of financial markets, this approach emphasises the need for countervailing or counter-cyclical measures in regulation (Ffrench-Davis and Griffith-Jones, 2003).

Instruments such as forward-looking loan-loss provisions for banks, or at least cyclically neutral provisions, have not only been amply discussed in the literature, but have begun to be implemented to a limited extent in countries such as Spain and Portugal. More generally, regulators could require prudential provisions when the growth of credit and key asset prices, such as stocks, accelerates sharply or exceeds some long-term average. These types of measures raise a number of fairly difficult questions about implementation. More broadly, they raise the issue of potential trade-offs between counter-cyclical regulation of the financial sector for crisis prevention and measures to warrant enough credit to support economic growth (Stallings and Studart, 2003). Many measures being discussed (e.g. proposals for Basel II, see below, or the SDRM proposal) discourage private flows to developing economies and thus reduce growth.

An important under-researched issue is how pro-cyclical and herding behaviour of financial actors can lead to complex and problematic interactions between different actors and flows (Griffith-Jones, 2003). Regulators also need to look at the interaction of risks between different actors as they affect one type of borrower or country, as well as the possibility of risk spreading across borrowers and countries. Increased coordination – or even better, integration, where feasible – between regulators in different financial sectors is required, both domestically and internationally.

Additionally, the close interaction between the financial sector and the economic system also seems to require changes in how macroeconomic policy is formulated, i.e. making it more counter-cyclical and taking account of longer horizons so as to allow for lack of predictability on the possible unwinding of financial imbalances.

Finally, to the extent that responsibility for preventing crises is not clearly allocated between national financial regulators and monetary authorities (and even more so internationally), there is a risk that problems can "fall through the gaps" with no economic authority taking appropriate responsibility. International institutional developments such as a sharper focus on systemic issues by the International Monetary and Financial Committee of the IMF and the creation of the Financial Stability Forum are valuable steps forward, but need to be built upon.

The tasks and aims of policymakers and regulators in developing countries have become more numerous and more complex, whilst the instruments have not been sufficiently adapted to the new realities. The aims include maintaining high and sustainable growth, avoiding financial imbalances that could result in financial crisis and maintaining relatively low inflation. Therefore, it is important to develop new instruments, for example of counter-cyclical regulation of the financial sector, to meet the challenges.

It is essential to evaluate progress on crisis prevention against the challenges posed by the above framework on a continuing basis. To what extent, for example, do codes and standards reflect the interactions and complexities outlined above? Are they "best practice" given the evolving state of knowledge? To what extent are the international measures sufficiently robust and consistent with the main problems being faced? Why, for example, is the new proposed Basel Capital Accord likely to increase procyclicality, when so much research argues to the contrary, i.e. that regulation should be counter-cyclical? How should the objectives of the new Basel Capital Accord of better risk management be balanced with the goals of promoting sustained and stable capital flows to developing countries?

3 A New Basel Accord

As noted earlier, it is important to encourage more private capital flows to developing countries. But it is equally important to avoid an international regulatory framework that may have an unintended negative impact on these flows.

Basel II is intended to increase the sophistication of risk management practices globally in view of changing market developments and to address some of the inadequacies in the existing Basel capital accord such as the excessive reliance on a single capital ratio and mechanical application of rules and the narrow focus on credit risk. Improved risk management should strengthen the soundness of the international banking system, thus contributing to the avoidance of crises. Basel II implementation will be especially challenging for developing countries. Many developed countries have already been upgrading their risk management practices consistent with Basel II. Developing countries need to consider when and how to implement Basel II consistent with the stage of their banking sector development, market infrastructure including accounting, auditing and the legal framework, and the quality of banking supervision. Regulators and bank managers will have to upgrade skills and adopt a risk-based culture. As a result of the more explicit recognition of risks, capital requirements may change and flows of credit may be affected. In transition there is likely to be a mismatch between the regulatory regime of G-10-based bank and the regime appropriate for a developing country. All of these issues will require careful attention in the implementation of Basel II in developing and developed countries.

Another aspect of concern to developing countries is how the adoption of the new accord will affect the willingness and costs of bank lending to developing countries. Although Basel II has positive features with respect to better recognition of risk and the removal of the OECD/non-OECD distinction), in its present form it is likely to overestimate the risk of lending to developing countries. In particular it does not take into account the considerable benefits of international portfolio diversification. This may imply a significant increase in regulatory capital requirements for lending to developing countries, which in turn could result both in less lending to these countries and an increase in the costs of the lending that does take place.

The lack of inclusion of the benefits of international diversification has been highlighted as an important concern by both analysts and market participants. For example, Stanley Fischer, Vice Chairman of

Citigroup, argues that by not taking into account the risk mitigation effects of international diversification, "Basel II in its current form runs the risk of materially reducing the incentive for larger internationally active banks to maintain and expand their operations in emerging market economies." Given the economic and other benefits of such operations, says Fischer, this must be considered "a significant shortcoming".[2] A variety of financial institutions, including representative industry bodies such as the Institute of International Finance (which represents all major international banks) and The New York Clearing House Association (that represents several of the major banks), have argued strongly for the incorporation of the benefits of international diversification into the Accord.

Griffith-Jones *et al.* (2002) presented empirical work confirming that the degree of correlation between the real and financial sectors of developed economies is greater than that which exists between developed and developing economies. These results offer substantial support for the proposition that excluding the benefits of diversification introduces a significant bias against lending to developing countries.

An internationally diversified loan portfolio, with a range of developed and developing country borrowers would have a lower level of risk – in terms of the overall portfolio – than one that focused primarily on developed country lending. In order to test this hypothesis in the specific context of a bank's loan portfolio, Griffith-Jones *et al.* (2002) conducted a simulation exercise to assess the potential unexpected loss resulting from a portfolio diversified within developed countries, and one diversified across developed and developing regions.

The unexpected losses simulated for the portfolio focused on developed country borrowers were, on average, almost twenty-three percent higher than for the portfolio diversified across developed and developing countries. This offers more direct evidence that the benefits of international diversification produce a more efficient risk/return trade-off for banks at the portfolio level. In order to accurately reflect the actual risks that banks may face – Basel II should take account of this effect.

Further evidence using real data has been provided by the major Spanish bank, BBVA, in its document: "A practical proposal for improving diversification treatment in Basel II" (2003).

This analysis uses a "correction factor" which measures the error made when using a single factor model – such as that envisaged in Basel II –

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[2] Presented as the William Taylor Memorial Lecture at the International Conference of Banking Supervisors, Cape Town, September 19, 2002.

when in fact there are two (or three) factors affecting diversification of the portfolio. These factors could be geographical areas (emerging vs. non-emerging economies), industrial activities or a combination. The correction factor is defined as the ratio between the capital calculated with the two- or three-factor model and the capital obtained with the single factor model.

Given this and other evidence, as well as the widespread acceptance of the risk-reducing benefits of international diversification, it is important to consider how such benefits could be incorporated into the Basel II proposals. The new Chairman of the Basel Committee, Jaime Caruana, has noted that an obvious step to further enhance the risk-sensitivity of the capital framework would be "to incorporate calculations of diversification benefits into the framework".[3]

The intention of moving Basel to full credit risk models is highly welcome. However, we think it is important that in a transition phase – whilst they are developed – benefits of diversification are already incorporated in simpler ways. If this is not done, international banks may be inappropriately discouraged in the short term from lending to developing countries, a trend which may then take some time to reverse. Such a reduction of international bank lending could have negative impacts on output and poverty reduction.

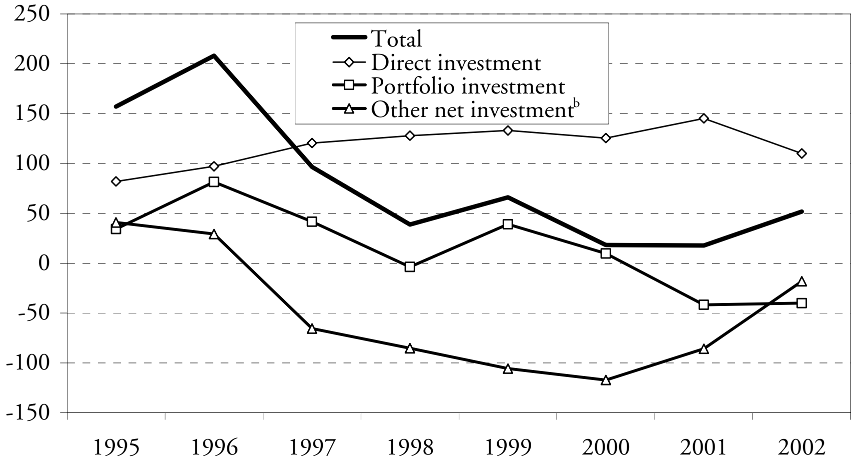
Very recent research (Griffith-Jones *et al.*, 2004) shows that incorporating these benefits of diversification also increases the stability of the risk/return relationship through time. This latter effect would imply that the appropriate inclusion of diversification benefits should, for example, smooth regulatory and economic capital requirements for banks; this would lead to more stable bank lending which could reduce excessive economic cycles, so harmful for long-term growth (in both developed and especially in emerging countries) and strengthen the stability of large international banks. The latter is a key economic objective, and an absolutely central one for G-10 bank regulators.

4 Capital Flows to Developing Countries

Private capital flows can be a vital source to support sustainable growth and poverty reduction in developing countries. However, they declined dramatically in net terms from 1996 to 2001, linked to the Asian and

[3] Speech to the British Bankers Association (BBA) on 9 October 2003 by Jaime Caruana, Chairman of the Basel Committee on Banking Supervision.

Figure 1 Net Private Capital Flows to Developing Countries, 1995-2002[a] (in billions of dollars)



Notes:
[a] Excludes transition economies.
[b] Includes commercial bank lending (short- and long-term).
Source: UN, *World Economic and Social Survey, 2003.*

other crises, with a slight recovery in 2002 (see Figure 1). During this half decade, there was a virtual drought of private flows going to developing countries. Net transfers, that include all forms of financial payments, became increasingly negative since 1998, reaching minus $193 billion in 2002, according to the UN World Economic Survey (2003).

For the group of emerging market economies, net private capital flows has also declined since 1996, a decline which continued in 2002, reaching a 10-year low of $124 billion (see IIF, 2004). The partial recovery in 2003 is projected to continue in 2004, and has been associated with the current world economic recovery and low international interest rates, and to some extent to improvements in macroeconomic fundamentals and policies in emerging countries.

The recent increase in capital flows should be viewed with caution. First, the recovery reflects primarily cyclical factors, and is based mainly on increases in portfolio equity and bond flows, and to a lesser extent on bank lending, which tends to be the more volatile component of total flows. Foreign direct investment fell in 2003, reinforcing a moderately declining trend initiated in 2001. Second, the flows are concentrated mainly in Asia, which accounts for nearly 60 percent of the total flows to emerging markets, and for over 70 percent of their growth in 2003. This contrasts with the current share in total flows for Latin American and African/Middle East regions – currently at 14 percent and 2.6 percent respectively – and with the year 2001, when shares for Asia, Latin America and Africa/Middle East corresponded to 40 percent, 39 percent and 7 percent, respectively.

Given the role that cyclical factors have played in this recent recovery, and the fact that there seem to be structural factors (such as the fact that banks have "crossed the border" and established branches and subsidiaries in developing countries, from which they lend in local currency) that may be inhibiting international private flows, the level of private flows may remain relatively modest (Griffith-Jones, 2003). Furthermore, a large part of recent flows may be easily reversible.

Thus, two problems identified in the past regarding capital flows are still present in the recent upward trend: their potential reversibility and their geographical concentration, the latter implying that whilst some countries are facing surges of flows, others are still receiving insufficient flows. Moreover, a large group of developing countries, which includes the poorer ones, continue to be outside the radar of private capital flows, therefore remaining heavily dependent on aid flows. To meet the Millennium Development Goals, these countries need to receive much higher levels of concessional finance (see UN, 2003).

5 Public-Private Links for Increasing Capital Flows

To encourage increased stable capital flows, new public-private mechanisms could be created. In the case of private flows, in the following section, we discuss proposals for partial counter-cyclical guarantees, and public incentives for encouraging socially responsible investment (SRI) in developing countries. In the case of official flows, we discuss the International Finance Facility (IFF) proposed by the United Kingdom Treasury as a means to augment official development assistance in the near term.

5.1 Guarantees for Private Investment, Especially in Infrastructure

Encouraged by privatisation, investment in private infrastructure in developing countries surged from 1990 to 1997, with an associated increase in private investment flows. However, this investment was particularly badly hit by recent crises (see Griffith-Jones and Fuzzo de Lima, 2004).

Existing public guarantee mechanisms (granted by the multilateral development banks and export credit agencies) play a positive role in mitigating risks of long-tern investment and loans to fund important activities, such as infrastructure investment.

Existing guarantees have positive features in that they increase flows and extend maturities of debt instruments in developing countries. According to the World Bank (2001), this is up to twelve times what would have been without guarantees. Nonetheless, this does not imply that the guarantees can lengthen the duration of private credits not covered by the guarantee.

Another positive feature of guarantees is its ability to reduce spreads, not only for guaranteed loans, but also for non-guaranteed private credits.

In spite of all the advantages of existing loan guarantee mechanisms, they deal more with overall risks, rather than with the cyclicality of risks. It is widely accepted that international financial and banking markets tend to overestimate risk in difficult times and underestimate it in good times. As a result, private lenders are prone to boom-bust patterns that are often determined more by global factors, and not so much by country fundamentals. This provides a strong case for public institutions to play an explicit counter-cyclical role, for example in long-term trade credit.

There could be two paths for increasing the counter-cyclical role of national or international bodies. One would be for public international bodies like the multilateral development banks to provide more counter-cyclical lending than already occurs. Another path, that could provide more leverage of public resources, would be for multilateral development banks and export credit agencies (ECAs) to introduce an explicit counter-cyclical element in all the risk evaluations they make for issuing guarantees for lending to developing countries. This would imply that when banks or other lenders lowered their exposure to a country, multilateral and regional development banks or ECAs would increase their level of guarantees, if they believed that the country's long-term fundamentals were basically sound. When matters were seen by private banks to improve, and their willingness to lend increased, multilateral development banks or ECAs could decrease their exposure, for example by selling such guarantees in the secondary market.

Another alternative could be special stand-alone guarantee mechanisms for long-term trade credit, for example within multilateral or regional development banks, or even bilaterally, that had a strong explicit counter-cyclical element to be activated in periods of pre-crisis, during crises or for countries facing a sharp decline or dramatic increase in cost of capital inflows when they emerge from crises. Its aim would be to catalyse long-term trade credit, in particular for infrastructure in a broad sense.

Although a range of technical and operational issues would need to be sorted out, if properly designed and implemented, counter-cyclical guarantees could provide an important policy instrument to help deal with a genuine market failure, the boom-bust pattern of private lending. The desired policy outcome would be to help smooth private lending.

5.2 Social Responsible Investing in Developing Countries

Social Responsible Investing (SRI) assets have grown dramatically in recent years, reaching \$2.7 trillion in 2001. In the US, they grew from just \$1.0 trillion to over \$2.0 trillion between 1997 and 2003. In the UK, SRI growth has been even more dramatic – with asset values quadrupling from just about £50 billion in 1999 to over £200 billion in 2001.

Changes in the UK legislation on pension funds have been pointed out as a key factor behind this increase. In 2000, the UK government modified the 1995 Pensions Act to require that pension funds report to what extent their investment decisions take into consideration social and environment issues. As a consequence, institutional investors hold over 80 percent of total UK SRI assets today.

However, the strong growth SRI has exhibited in the recent past has been a phenomenon limited mainly to the acquisition of developed country assets. Of the \$2.7 trillion of total SRI assets in 2001, only 0.1 percent was emerging market assets (IFC, 2003). This is much lower than the share of emerging market assets held by mainstream investors, around 2 or 3 percent. There is therefore an enormous potential for SRI growth in emerging markets.

An acquisition of emerging markets' assets can be justified both on moral and economic grounds. On the moral side, SRI investors, could help developing countries grow faster, create jobs and reduce poverty by investing in these countries, especially if the flows are long term and fairly stable. This would lead to overall prosperity in developing countries and would therefore be coherent with SRI global sustainability concerns. On the economic side, investing in emerging markets can be justified by the fact that, historically, returns on emerging markets' bonds, equities and bank loans have been higher than developed country returns on each of these assets (Gottschalk, 2004). Furthermore, investing in emerging markets' assets may bring clear portfolio diversification benefits.

Despite these potential benefits, the SRI investor community points to a number of barriers for acquiring emerging markets' assets in a major way. Most of these barriers are related to pure lack of knowledge about the opportunities emerging markets can offer, and to informational gaps on environmental and social standards in emerging markets. The latter can only be overcome if demand for emerging markets increases to justify the establishment of research organisations that can provide systematic information on these standards (IFC, 2003).

The official sector in industrialised countries could provide incentives to encourage SRI investor community based in their countries to invest in emerging markets assets. For example, they could follow the UK example by modifying pension funds' legislation. They could even set a minimum developing countries' asset holding target to be reached over a certain time frame. Moreover, they could facilitate the establishment by the SRI industry of a set of principles to guide their investment decisions towards emerging markets, in the same way the IFC has done with major internationally active banks, in establishing the Equator Principles on social and environmental issues. The Millennium Development Goals could serve as a basis for the establishment of these principles. They could include supporting economic growth and poverty reduction, by generating jobs and paying at least minimum wages of the country and at the micro level encouraging a company to engage in the provision of health facilities and primary educational programmes, and training to the working force (Gottschalk, 2004; Williamson, Griffith-Jones and Gottschalk, 2003).

5.3 The International Finance Facility

While private capital flows are key to supporting growth in developing countries, there is now an increasingly shared view that substantially larger amounts of aid resources and more effective use of such resources will be needed to scale up efforts to meet the millennium development goals (MDGs) for two reasons. For many of the poorest countries that do not have access to external private capital, aid resources are the primary available means in the medium-term to support the expansion in public investment and social spending needed to meet the MDGs. Even for some middle-income countries aid can play a catalytic and supportive role in enhancing focus and increasing spending targeted to the poorest communities and the attainment of the MDGs.

The best approach to ensure that the needed aid resources to meet the MDGs are available is for donor countries to increase their aid budgets. Many countries have indeed done so in the lead up to and since Monterrey. Five additional countries – Belgium, Finland, France, Ireland and the United Kingdom – have laid out a clear timetable for achieving the 0.7 percent of official development assistance to gross national income target. Given that these and other sources of additional aid flows will take time to materialise, the UK has proposed the establishment of an International Financial Facility (IFF) to frontload the delivery of aid.

Under the scheme, the disbursements of resources raised would be concentrated in the years up to 2015, while the streams of donor's income to the IFF would be distributed over a 30-year period. Not all donors would have to agree to the facility for this to be implemented. And those donors agreeing to the facility would be able to allocate the resources raised linked to their contributions using the existing channels of aid disbursement. Moreover, they would be able to decide to which countries they would allocate such resources.

The IFF is based on four essential components: (i) government backing based on legally binding pledges of future increases in future aid commitments, but with a "high level" condition that would permit donors to suspend payments if recipient countries violated an agreed fundamental condition such as being in good standing with the IMF; (ii) a treasury platform for bond issuance; (iii) governance arrangements for channelling bond proceeds through existing multilateral and bilateral aid programmes; and (iv) repayments of bonds. According to the World Bank (2004a), although subject to the accounting, legislative and other circumstances of individual donors, the IFF appears to be technically feasible. Work is now underway in setting a pilot facility targeted to supporting MDG goals on immunisation. If this effort succeeds, it can provide the basis for a much larger IFF that can bring forward and improve the predictability of aid resources needed to meet the MDGs. Other innovative financing mechanisms are also under consideration. One important array of options are global taxes and voluntary contributions. Some of these options are technically feasible and efficient, but will take time to implement as they are likely to face political opposition. Another innovative approach is to blend aid flows with other forms of financing such as MDB lending to augment resources for targeted MDG spending in both low- and middle-income countries where governments do not have the revenue or borrowing capacity to finance such investments themselves. Together with the delivery of aid flows that have already been pledged, these innovative mechanisms can give much needed impetus to scaling up efforts in all developing countries to meet the MDGs.

6 Increasing the Voice of Developing Countries

An essential ingredient for improving global economic governance is strengthening the voice and participation of developing countries in the decisions of key international institutions and fora. Without adequate representation and voice, decisions reached will be less informed, less legitimate and less effective. The international community has focused increasing attention on the issue in recent years. The Monterrey Consensus adopted in 2002 encouraged the Bretton Woods Institutions (BWIs) to find pragmatic ways to "continue to enhance participation of all developing countries and countries with economies in transition in their decision making". Since then the Development Committee has urged both the Bank and the Fund to step up efforts already taken and to consider and elaborate upon all options with potential for broad support.

Efforts to date and ongoing discussions have spanned three important facets for enhancing voice of developing countries in the decisions of the BWIs: (i) enhancing country-ownership and perspectives in Bank and Fund supported programmes; (ii) greater support for Executive Directors of large multi-country constituencies; and (iii) dealing with structural issues related mainly to voting and capital structure (World Bank 2004b).

For low income countries, the adoption of the Poverty Reduction Strategy (PRS) Initiative represents a major shift in programme formulation and implementation by the BWIs. By providing a sharper focus on country-driven and country-owned poverty reduction strategies, the PRS has started the process of putting developing countries more firmly in charge of the formulation and implementation of their development programmes. While a number of challenges remain to enhance the effectiveness of the approach including further strengthening of the country-driven process, the PRS marks an important and welcome shift towards greater country ownership. The PRS has been supported by increasing decentralisation of staff at the World Bank and by steps that are underway to harmonise donor policies and practices and better align them to country-driven strategies.

A number of steps have also been taken to enhance the capacity of Executive Directors of large multi-country constituencies: (i) the two sub-Saharan African offices, which each have more than 20 countries, have been authorised three additional senior positions; (ii) communications with capitals have been improved; (iii) a secondment programme to the Bank is underway to develop capacity to engage in discussions at the BWIs; (iv) an Analytical Trust Fund has been established with the aim of providing the two sub-Saharan African Directors with independent technical and research support; and (v) a learning programme has been established for staff in Executive Directors' offices. The Bank and Fund have also supported the G-24 as a means to enhance the voice of developing countries in the deliberations and decision making of the BWIs.

The area where shareholder views remain most divided and where there has been least progress relates to the so-called structural issues. The primary focus of these discussions have been on voting structure in the IMF and the World Bank, and the composition of the Board of Executive Directors. Three proposals in particular have been central to this debate:: (i) an increase in the share of basic votes to allow greater representation of smaller economies; (ii) amending of the quota formula to reflect the more rapid growth of some developing economies; and (iii) to add at least one seat for African countries in the IMF and World Bank Boards.

Basic votes currently represent just under 3 percent of total votes compared with around 11 percent at the founding of the BWIs. If it were agreed to return Basic Votes to their original proportion, the developing country share of total votes in the Bank would increase from 40 percent to 43 percent. IMF quotas and the voting structure in the Bank also do not reflect changes that have taken place in relative roles in the world economy over the past 60 years. As Table 1 and Buira (2003) point out, large countries like Brazil, China, Korea and Mexico have a share of quotas that are far below their share of gross domestic product (GDP), whilst countries like Belgium and Switzerland have quotas far larger than their share of GDP. This is true for both GDP measured at market exchange rates and at purchasing power parity, particularly the latter. The third change that would redress a major imbalance is to add at least one additional seat for sub-Saharan Africa to enhance voice and reduce the workload on the two African constituencies that jointly represent 45 countries.

Kelkar *et al.* (2003) have made a proposal for quota and voting power of the Board of the IMF that increases the overall voting share of

Table 1 IMF Quotas and GDPs for Selected Countries
(billions of SDRs and percentages)

	Quota as of December 31, 2002		Share of world aggregate GDP in purchasing power parity, 2002	GDP, 2002 (billions of dollars converted at market exchange rates)
	billions of Special Drawing Rights	As a proportion of total quotas		
Canada	6,369	2.99	2.01	728
People's Republic of China	6,369	2.99	12.67	1,237
Russian Federation	5,945	2.79	2.68	346
Netherlands	5,162	2.43	0.88	449
Belgium	4,607	2.16	0.59	247
Switzerland	3,458	1.63	0.45	268
Brazil	3,036	1.43	2.63	448
Mexico	2,586	1.22	1.90	642
Denmark	1,643	0.77	0.33	172
Republic of Korea	1,634	0.77	1.78	462

Source: Buira (2003), based on IMF World Economic Outlook Database.

developing countries while preserving the dominant weight of industrial countries in quotas. A similar proposal could be applied for the World Bank. In the Kelkar *et al.* proposal, voting power would be determined by weighted averages for PPP-GDP (88.7 percent) and basic votes at the historic ratio (11.3 percent).

As can be seen in Table 2, this would mean that the voting share of developing countries would go up in the IMF from 30.5 percent to 42 percent, thus clearly increasing their voice, whilst developed countries would reduce their voting share from 62 percent to 51 percent, but maintain their majority. Both the US and the EU would retain their veto power. If united, Asian developing countries would also have veto power.

Discussions are continuing between shareholders on how to make progress on this set of interlinked issues. Although there are difficult political tradeoffs entailed, progress on enhancing voice and representation is key to securing the legitimacy and effectiveness of the international financial institutions.

While much of the discussions have been centred on the BWIs, there is a need for a broader approach to enhancing voice of developing countries

Table 2 Present and Proposed Quota and Voting Power[a]
(billions of SDR and percentages)

Country category[b]	GDP-PPP 1997-99 Average in billions of SDR	Present Quota Share	Proposed Quota Share on basis of GDP-PPP	Present Voting Share	Proposed Voting Share on basis of GDP-PPP (87.7%) and BV (11.3%)[c]
Advanced economies	16,303	62.763	55.492	61.768	50.950
Major advanced	13,375	46.030	45.523	45.146	40.811
Other advanced	2,929	16.732	9.969	16.622	10.139
USA	6,315	17.383	21.494	17.030	19.127
Japan	2,282	6.229	7.767	6.110	6.951
EU	5,900	30.106	20.083	29.647	18.740
Developing countries	11,320	29.697	38.530	30.529	42.019
Africa	1,086	5.493	3.695	5.962	6.427
Of which sub-Saharan Africa	873	4.496	2.970	4.952	5.599
Asia	6,181	9.120	21.038	9.250	20.390
Western Hemisphere	2,504	7.456	8.523	7.666	9.536

Notes:
[a] BV stands for Basic Votes; PPP refers to GDP valued at purchasing power parity.
[b] Country categories based upon IMF World Economic Outlook.
[c] Does not add up to 100 percent, as transition economies are not included.
Source: Kelkar *et al.* (2003).

in global economic governance. The representation of developing countries in other fora and informal groupings that have an important role has been quite limited in the past. The extent of participation though has varied significantly from universal or almost full participation in standard setting bodies such as UNCITRAL and IOSCO to virtually none in the case of the BIS, the G-10 and the Financial Stability Forum.

Since the East Asian crisis, a range of steps have been taken to include developing countries in global discussions by giving them representation in existing or new fora or by undertaking more systematic outreach to them when they are not represented. An important example of the former is the establishment of the G-20, which in the five years since it has been established, has become an important forum for policy dialogue and agenda setting on global economic and financial issues between the larger developed and developing countries. Examples of greater efforts at outreach include the OECD, the BIS, the Basel Committee and the Financial Stability Forum. Such efforts are useful, but if standards are to be truly global, it is important to go beyond consultation to full representation of developing countries in bodies that deliberate and set international norms and action plans on the global economic, financial and development agendas.

One such important grouping is the Basel Banking Committee whose members are from the G-10 plus Switzerland. Each of these countries is represented by their central bank and by the authority responsible for banking supervision in that country where this is not the central bank. The composition reflects the world political order in the middle of the twentieth century. There is no representation of emerging market economies and developing countries on the Basel Banking Committee.

Given that the Basel Capital Accord is a global standard that is likely to have a very large impact on emerging economies, and that emerging markets are critical to the global economy, the composition of the Basel Committee needs to be changed. One alternative would be to chose countries in terms of their weight in global GDP. The ten largest economies would bring in China, India, Brazil and either Mexico or Russia to the Committee to join the US, Japan, Germany, UK, France and Italy. The new countries are critical to the global economy and to cross-border bank lending.

Another possibility is that current membership could remain and India, China and Brazil could be added. Alternatively or in addition, one or two representatives per each developing country regions (Asia, Latin America and Africa) could be added for a four-year period. There could then be rotation for different countries to be represented (from each of the three regions). The principle would be similar to the one under which the Executive Boards of the IMF and World Bank operate.

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16

Global Crisis Prevention and Liquidity Provision

Esteban Jadresic

The original Washington Consensus was about a set of policies that most people in Washington, and probably most policymakers in our region, believed Latin America ought to be undertaking as of the late 1980s. The chapter by Amar Bhattacharya and Stephany Griffith-Jones makes it clear that the search for "stability, growth and a new development agenda" for the region must involve not only thinking about national policies, but also about the challenges for the international financial institutions and the advanced economies. I very much agree with this key message.

Bhattacharya and Griffith-Jones provide a very useful presentation of a number of issues in this area, many of which have been analysed and discussed by the same authors elsewhere. In the remainder of this comment I will address some of the specific topics they raise.

Progress in International Reform

The authors start by assessing the progress that has been made in international financial reforms. Their evaluation is that, while there appears to be consensus that fundamental reforms are needed to improve crisis prevention and management and to provide adequate capital flows to developing countries, there clearly has been insufficient progress. They relate this outcome to a number of problems, including:

- a lack of an agreed agenda for crisis prevention and management;
- uneven and asymmetric progress, with an unbalanced focus on national policies and on standards and codes, and much less emphasis on global regulations, especially in source countries;

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- reversals in important steps such as the Contingent Credit Line (CCL) and Sovereign Debt Restructuring Mechanism (SDRM);[1]
- insufficient developing country representation in key fora, such as the IMF, BIS and the Financial Stability Forum.

I agree with all the elements of this diagnosis. However, I would add that in recent years the agenda on the international financial architecture has also been characterised by too much emphasis on crisis resolution relative to crisis prevention. While substantial time and effort were devoted to discussing the SDRM and collective action clauses (CACs), the CCL, the main tool designed to provide liquidity to solvent countries to avoid the effects of contagion and provide incentives for good policies, was never used and expired almost unnoticed in November 2003.

The focus on crisis resolution has been unfortunate, for it has absorbed time and effort of the international financial community on discussing solvency crises, rather than liquidity crises. The latter are, by far, the most typical crises faced by emerging market economies. Moreover, the focus on crisis resolution has diverted attention from the fact that globalisation and integration of financial markets requires more, rather than less, resources to deal with liquidity shocks.

Of course, the focus of the international financial architecture agenda can at least partly be attributed to the dominant role played by actors in advanced economies who are concerned about the moral hazard created by the international financial institutions (IFIs). They seem to have seen the development of the SDRM and CACs as means to reduce lending by the IFIs.

Crisis Prevention and Liquidity Provision

On the crisis prevention agenda, a top priority issue should be the development of improved liquidity instruments to confront capital flow reversals and other shocks. This points to the need for putting back into centre stage the IMF's purpose of giving confidence to members by making resources available to them in order to correct

[1] Incidentally, the authors claim that the widespread use of collective action clauses (CACs) is an important step forward. It may be too early, however, to assess how important it has been. Unlike the SDRM, CACs do not solve the problem of aggregating the interests of creditors across jurisdictions and debt issues. It would not be surprising if, following the first debt restructuring process of bonds with CACs, the SDRM proposal resuscitates.

maladjustment in the balance of payments without resorting to measures destructive of national or international prosperity.

In practice, the above implies giving priority to initiatives such as the search for alternatives to the CCL, which did not work for design reasons, either by enhancing current instruments, or creating new ones. Similarly, the examination of the role that the IFIs can play in fostering the development by private financial markets of financial securities to provide hedging and insurance against capital flow reversals should be high on the agenda. Another priority issue is to develop initiatives for increasing the amount of resources that can be made available in times of liquidity crises, in order to deal properly with such crises in the context of increasingly more globalised and integrated financial markets.

The importance of reviewing the provision of liquidity by the IFIs, as well as its conditions and amounts, is also borne out by the point emphasised by the chapter that financial markets are inherently pro-cyclical and that progress on crisis prevention should be evaluated taking this into account. Historical experience shows that financial markets tend to be pro-cyclical, due to factors such as herding and contagion. Capital flows to emerging markets, in particular, are volatile and pro-cyclical. This reality stands in sharp contrast with the theoretical role of financing in order to smooth consumption through the economic cycle.

Basel II

Turning to the issue of Basel II, which is more extensively discussed in the chapter, the authors argue that it may inappropriately discourage international lending and make it more pro-cyclical. They note that there has been improvement, but that there are still problems in the internal ratings based approach.

One particular aspect they discuss in the chapter is that Basel II does not take into account the benefits of international diversification. This is well substantiated by the authors. They provide, for instance, evidence that the correlation between real and financial sectors of developed economies is greater than that between developed and developing economies. This point persuades me. Most important, as the Institute of International Finance (IIF), major banks and the chairman of the Basel Committee also agree, we should not lose hope that positive changes will eventually be made.

The authors also argue that Basel II is likely to accentuate the pro-cyclicality of bank lending, which would be especially adverse for the most vulnerable developing countries, and thus, that there is a need for counter-cyclical measures, such as forward-looking loan-loss provisions. My feeling is that this point is right, but I missed a fuller discussion in the chapter substantiating it.

One general caveat on this issue is that the pro-cyclicality of bank lending does not necessarily mean that their internal risk management is inadequate. In principle, proper risk management would take this fact into account. If there is an externality in their decisions, however, so that they do not take into account how individually they contribute to exacerbating pro-cyclicality, this observation could lead to a different type of regulation.

Increasing Capital Flows to Developing Countries in Times of Drought

The authors also discuss a number of ideas about what industrial countries could do to encourage increased and more stable capital flows. One is the establishment of guarantees for private flows, especially for investment in infrastructure. The idea is to introduce a counter-cyclical element in guarantees for lending to developing countries. In this regard, just as loans and credit guarantees offered by the World Bank are instruments to promote development rather than to deal with pro-cyclicality, the proposal would seem to put the World Bank and others in the business of the IMF. On this matter, I am not convinced. In principle, if one could change IMF governance in order to make it a more effective institution, I would not go that route. The whole idea of international initiatives for liquidity provision is to pool the resources, since that is cheaper and more effective.

Representation

The authors make, in their own words, a "modest proposal for increasing the voice of developing countries" in the Governance of IFIs, which would build on the agreement reached in Monterrey. The changes would include an increase in basic votes in both the IMF and the World Bank, amending the quota formula to reflect the rapid growth of some developing economies, and add at least one seat for African countries, while the voting share of developing countries would be maintained at below 50 percent, with veto power for the US and Europe. Also, the changes would include enhancing developing country representation in other international fora such as the BIS, the Basle Committee, and the Financial Stability Forum.

Given the agreement reached in Monterrey, this is a theme worth working on, and, while there may be similar or better variants, this proposal seems a reasonable starting point to me. On this matter, one point that I would like to emphasise is that proposals should not focus exclusively on representation at the IMF and World Bank, but also on the other above mentioned international fora. The fact is that the representation problem today is indeed much larger in the latter than in the former.

More broadly, I certainly agree that "the search for a stable and equitable global financial system" must involve finding ways to increase developing countries representation in international fora. This would give greater democracy and legitimacy to the IFIs, and through improved ownership and better-informed discussions, contribute to improving financial stability and fairness. Moreover, in my view, it would also contribute to making the global financial system more efficient.

Part 3

Towards a New Development Agenda

17

Africa and the Washington Consensus

Brian Kahn[1]

Introduction

Although Africa remains marginal to the globalisation process, the continent's future development prospects are nevertheless profoundly influenced by the global environment. Washington Consensus-type reforms have been implemented in many instances, although as John Williamson,[2] in his review of the Washington Consensus argued, sub-Saharan Africa moved "spottily and grudgingly, too often under foreign pressure rather than out of conviction". However, South Africa's Minister of Finance, Trevor Manuel, has argued in a recent *Finance and Development*[3] article, that few African countries have applied all the reforms because of the difficulties of pursuing them, and it is not clear that some of the proposals contained in the Washington Consensus are appropriate to Africa's needs. In particular, there are difficulties with the emphasis on privatisation and fiscal reform and trade liberalisation. The New Partnership for Africa's Development (NEPAD) initiative is an attempt to overcome some of these shortcomings, although at this stage the jury is still out as to the efficacy of NEPAD.

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[1] The views expressed are those of the author and do not necessarily represent those of the South African Reserve Bank.

[2] John Williamson (2004) "The Washington Consensus as Policy Prescription for Development", A lecture in the series "Practitioners of Development" delivered at the World Bank, January 13, 2004.

[3] Trevor Manuel (2003) "Africa and the Washington Consensus: Finding the Right Path", *Finance and Development*, September.

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The nature of globalisation has made it difficult for African countries to apply the Washington Consensus reforms and at the same time benefit from globalisation. In particular, I would argue that the dependence of many African economies on a narrow range of commodities has made it difficult for them to undertake the proposed reforms. In turn, some of the reforms that have been undertaken, particularly with respect to the role of the state, have made it difficult for African countries to deal with the more open trade environment. While recognising that the problems of African development have an important domestic dimension, my brief remarks will focus on some of the external constraints to growth.

Africa and the Washington Consensus

Although Africa's economic performance has improved in recent years, the 7 percent growth rate required to meet the Millennium Development Goals (MDGs) in the timeframe set, is still a long way off. There are major structural problems that the Washington Consensus cannot deal with, and inequalities continue to abound. These inequalities do not only manifest themselves internally, but internationally as well, with Africa falling further behind in the global distribution of income.

Very few economists argue against the importance of macroeconomic balance, but the emphasis placed on this in the Washington Consensus too often resulted in a focus on stabilisation rather than on growth and development, and ignored the equity dimensions of growth. Although stabilisation is important, it invariably has been seen as the end product rather than a precondition for sustainable development. As Manuel has argued, one of the most important drawbacks of the Washington Consensus was that although it provided a good mixture of reforms to both stabilise the economy and encourage private sector activity, it has done very little to help resolve the structural constraints on growth. An important constraint is Africa's interaction with the international trade regime and the international financial system.

Africa and the International Trade Regime

Much emerging market literature focuses on the problems caused by the volatility of capital flows and problems of access to international capital markets. Because most African countries are marginal or negligible borrowers, these problems are of secondary importance. Most

African countries, particularly those in sub-Saharan Africa, rely on foreign aid flows for financing. As with most of the developing world, African countries depend on exports for growth, but most African countries are dependent on commodities whose share in world trade is declining, and subject to high price volatility and declining terms of trade. Real exchange rate volatility is associated not with capital surges but with commodity price volatility. These issues are highlighted in a recent UNCTAD study.[4]

The UNCTAD study shows that although trade relative to GDP for sub-Saharan Africa (excluding South Africa and Nigeria) increased from 45 percent to 50 percent between 1980 and 2000, Africa's share of world exports declined from 6 percent to 2 percent, and imports from 4,6 percent to 2,1 percent over the same period. Even though Africa has remained commodity dependent, Africa has been losing market share in commodity exports to other developing countries and has been unable to diversify into manufacturing exports. It is argued that Africa's primary commodity dependence is unlikely to decrease in the short to medium term, which accentuates the need to reduce the problems associated with this dependence.

Primary commodities have tended to exhibit short-term instability and long periods of slumps resulting in uncertainties relating to export revenues, external debt and fiscal solvency. According to UNCTAD, between 1997-2001, the UNCTAD combined price index of all commodities in US dollars declined by 53 percent in real terms. Had the terms of trade of sub-Saharan Africa remained at 1980 levels, Africa's share in world exports would be twice its current level. This has clear implications for employment and the possibilities for poverty alleviation.

Price volatility has resulted not only from weather conditions and other supply shocks, but also from the secular decline in real prices caused by structural oversupply in commodity markets as a result of EU and US policies that have stimulated output in the advanced economies. Other causal factors include increased productivity in other emerging market regions and the unwillingness of the international community to support price stabilisation through commodity agreements.

The price volatility and declining terms of trade have created problems for macroeconomic management in African countries as they have resulted in uncertainties regarding exchange rates, return on investment

[4] UNCTAD (2003) "Economic Development in Africa: Trade Performance and Commodity Dependence", Geneva.

and import capacity, and debt overhang. It has also been argued that despite macroeconomic reforms, sub-Saharan Africa is not in a position to manage fluctuations any better than in 1970. Indeed, it is argued that some aspects of these reforms have undermined the capacity of governments to mediate these shocks.

The reason for Africa's continued commodity dependence is related to (i) domestic policies and (ii) market access issues and agricultural policies in industrial countries.

Domestic Issues

With respect to domestic issues, it is argued that African agriculture has not been modernised because of the inability to overcome structural constraints against a high cost of trading background. Low agricultural productivity has resulted from land tenure policies and the lack of state institutions in innovation and investment. This lack of state institutions is exacerbated by the emphasis in the Washington Consensus on a decreasing role of the state.

The UNCTAD report further argues that Africa's trade performance reflects its inability to tap into cheaper finance, efficient logistics, capital resources and skills. Africa has also been unable to cope with the new demands linked to production technology and changing consumption habits, while at the same time EU disciplines for food exports as well as WTO requirements are causing additional problems.

The nature of international trade has changed significantly and many African countries have been unable to adapt to these changes. At the distribution and marketing levels, trade is increasingly dominated by supermarkets and there is greater importance attached to quality, packaging and timely delivery. The report points to weak private sectors, unreliable communications and transport links, cumbersome customs formalities and the lack the institutional capacity to provide support services to producers and exporters.

Market Access

The UNCTAD report argues that market access is an important constraint on African development, as most tariff peaks are in agriculture. A further constraining factor is that in the oligopolistic marketing structures primary producers have been accruing smaller shares of the final product prices. Finally, subsidies in the US and EU have also distorted world prices. The 2002 cotton subsidies for US and EU producers caused a loss of revenue to Africa greater than the total debt relief under the HIPC Initiative.

Access to Capital

The nature of capital flows has also affected Africa's ability to insert itself into the global economy. As I mentioned earlier, much of the focus on capital flows is on the problems caused by volatility and reversals. In the case of Africa, the problem is generally one of access. Since the Asian crisis, flows to developing countries in general have declined and there has also been a change in the composition of capital flows with the collapse of net bank lending. This has made aid flows even more important, and these have dropped sharply during the 1990s. By 2000, for example, aid flows were 10 percent lower in real terms than in 1990. Increasing private capital flows to sub-Saharan Africa failed to offset this decline in official flows, and the increase in FDI explains more than 100 percent of the increase in private capital flows. Much of the increase in FDI in turn was focused on a narrow range of countries, mainly oil producers and South Africa. Africa's total share of global FDI nevertheless remains extremely low.

According to the World Bank, the aid flows to sub-Saharan Africa declined due to delays in reform implementation. But there have been numerous criticisms of the nature of ODA flows to Africa. According to Trevor Manuel, "the Washington Consensus implicitly assumed that there was nothing wrong with the development assistance relationship, but certainly, from an African perspective, development assistance has tended to undermine growth prospects, even if it has helped fill the investment-savings gap". He has argued for a move away from the donor-recipient relationship of tied, politically driven and welfare based aid.

The Monterrey Consensus gave some recognition to this, with increased aid being pledged and a recognition of a need for aid through partnerships. (At Monterrey donors underlined the difficulties facing Africa, and at the subsequent G-8 summit it was concluded that up to 50 percent of additional funds announced at Monterrey would be targeted to Africa.) This theme was extended to the Johannesburg World Summit on Sustainable Development and is one of the cornerstones of the NEPAD initiative. However, it is not clear that these aid flows have been forthcoming on the scale envisaged, with Manuel describing it as no more than "a slight reversal of the trend of declining aid levels".

What Can Be Done?

The solutions are not straightforward and it is clear that the reforms proposed by the Washington Consensus in themselves are insufficient to tackle the structural problems faced by African countries. Reliance on a fluctuating single commodity complicates fiscal policies, as there is a reliance on a very narrow tax base, and a reliance on trade taxes as the main source of revenue which explains in part why trade liberalisation is opposed in many cases. The narrow tax base in many countries precludes significant direct government support to farmers while compensatory financing mechanisms are premised on temporary declines rather than on secular declines. Monetary and exchange rate policies are complicated by fluctuating commodity prices which result in real exchange rate instability.

Furthermore, as noted above, access to international capital markets is limited and pro-cyclical, i.e. access is available when commodity prices are high. In addition, there is opposition by developed countries to intervention in international commodity markets, despite significant intervention by these countries in their own domestic agriculture.

Much of the focus on the solution relates to the possible role of the state, not in the old-style protectionist form, but rather as a means of overcoming market failure and filling institutional voids. It is essential not only to adapt macroeconomic policies to deal with structural constraints, but also to build up and reinforce institutional capacities, rather than stick to an excessive focus on reducing the role of the state. Manuel, for example, has argued that most African states need to expand their public sectors and improve their efficiency in delivering quality public services, particularly in the areas of regulation, service delivery and social spending.

Finally, UNCTAD has argued that action is needed at the international level to mitigate adverse effects of market failure. Increased international economic cooperation and integration is seen as essential to stimulating intra-regional trade. The UNCTAD report calls for renewed efforts to deal with subsidies and protection in the agricultural sector, and provide a mechanism to compensate African countries for increased losses from subsidies. In addition, increased ODA, debt relief and a solution to the debt overhang are seen as essential components of the solution. Although an international policy package aimed at the structural transformation of African commodity-dependent economies is seen as essential, it is stressed that better market access and lower subsidies in developed countries are not sufficient, and that there have to be domestic reforms as well. This is a theme taken up strongly in the NEPAD initiative.

NEPAD

NEPAD is to some extent a reaction to the Washington Consensus, taking some of the positive aspects and attempting to promote greater integration of Africa into the international economy from which it has been marginalised. It emphasises the collective responsibility of Africa to meet its developmental challenges and recognises the external constraints discussed above. Although NEPAD is clear about the problems Africa faces, it is less clear about the development path required.

Although NEPAD has been successful in getting Africa back into the international discussion and debate, the tangible results are still to be seen and the initiative is not without its critics within Africa. Some see the main focus being on the African Peer Review Mechanism as a means to show the rest of the world that there is a commitment to democracy and human rights in Africa. If this is the case it suggests a fairly narrow focus for NEPAD as an institution. Others argue that NEPAD is limited to grandiose wish-lists and schemes which have little chance of success. Ravi Kanbur argues that both proponents and opponents are arguing on too grand a scale – proponents are in danger of taking on too much, whereas opponents risk losing an opportunity to do some small things right.

Conclusion

The global economic environment reduces the prospects for internal reforms being undertaken and sustained. Many of the solutions to Africa's problems are contained in the NEPAD initiative. There is a recognition that Africans must be part of the solution, and that there is not one simple development path. Many African countries have improved significantly on the macroeconomic policy front, but this on its own will not guarantee future growth and development. There are numerous external constraints, particularly relating to the trade-related external environment that will continue to make it difficult for Africa to overcome the challenges to meet the Millennium Development Goals, particularly in the light of developments at Doha and Cancún.[5]

[5] See the next chapter in this volume.

Increased regional integration is part of the solution, but international and multilateral agreements are needed on substantially increasing partnership-based and focused ODA, debt relief and funding mechanisms for dealing with commodity price shocks. Finally, internal public sector institutional reforms and increased efficiency of state structures are also vital.

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The Potential of the Doha Development Agenda

Zdeněk Drábek[1]

This book is a highly laudable attempt to contribute to the ongoing debate and the search for a "new development agenda". The time is ripe to enhance international financial stability and promote faster and more equitable economic growth. The financial turmoil of 1997, its aftermath and what is perceived by critics of the existing Bretton Woods system as a "marginalisation" of many developing countries have started a debate about the current system and about how it could be changed or improved. Admittedly, there is a great deal of concern about our repeated inability to prevent the emergence of financial crises, and there is equally a concern about how financial crises have been managed. Hence, many experts and governments are looking for new ways of preventing financial crises and for more efficient instruments to deal with financial instability. To paraphrase a more colloquial expression, many observers are beginning to look for a "post-Washington Consensus" as a new approach to these challenges.

Without much fanfare or a prior announcement, a major contribution both to the debate and to the actual practical way in which we will address problems of global markets was made on the platform of the World Trade Organization at the fairly recent Ministerial meeting in Doha. The meeting resulted in an agreement on the new agenda for negotiations of WTO Members in the next multilateral round. The agenda known as *Doha Development Agenda* can potentially make an enormous difference to how international trade is regulated and disciplined. I say

[1] The views expressed are those of the author and do not necessarily represent those of the WTO Members or the WTO Secretariat.

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"potentially" because the Agenda is still only an agenda, and it remains to be seen whether the negotiations will be taken to a successful conclusion. Nevertheless, the potential is there, and it makes, a great deal of sense to analyse the contribution of Doha to the debate about a "new development agenda".

The purpose of my contribution to this debate is focused on a brief assessment of Doha. I shall also briefly comment on the post-Doha developments in the WTO in order to see how the contribution of Doha is put to actual work by negotiators. In order to understand what has actually happened in Doha and what has been happening since then, it is important to go back somewhat in history to the previous meetings in Singapore and, mainly, in Seattle.

I structure my note along four lines. First, I identify issues that tarnished multilateral negotiations prior to Doha. Second, I outline what I consider to be the main achievements at Doha. What happened thereafter has not been all "smooth sailing". As it is well known, Doha was followed by a fiasco at Cancún, which has dramatically changed the perspectives on multilateral negotiations. I summarise my views of the reasons for the failure in Cancún, and, finally, I outline few ideas on the lessons that we can learn from the collapse in Cancún.

Reasons for Tensions in Multilateral Negotiations

The multilateral negotiations in the WTO have been under a great strain in recent years, and there were various origins to this strain. The critics have criticised the WTO on several grounds. The Uruguay Round agreements have been seen as promoting interests of developed countries since some of the agreements brought no tangible benefits to developing countries. Examples of those agreements are the Agreement on Services (GATS) and, in particular, the Agreement on Trade Related Intellectual Property (TRIPs). Issues of critical importance to developing countries have been either addressed in an unsatisfactory fashion or not at all. Again, examples include the Agreement on Agriculture, which is seen by defenders of *status* quo as feeble in terms of poor concessions given by highly protected developed countries. The Agreement on Textiles and Clothing (ATC) was also initially seen as an instrument of protecting markets of rich countries but the criticism is now much more muted in view of concerns of many developing countries to lose out in competition with China and India. The Uruguay Round agreements have also not addressed satisfactorily the interests of developing countries in markets for sensitive industrial products and in the area of public health and emergencies.

In addition to problems with Uruguay Round Agreements, developing countries had also criticised before Doha the new agenda proposed for the new Round. First of all, they vehemently opposed the introduction of the so-called Singapore issues for negotiations. They also opposed the attempt by some countries to introduce trade and labour as additional element to be negotiated. They complained about the excessive burdens put on their administration by the implementation of the Uruguay Rounds Agreements, and they complained about the WTO rules that they find biased.

Let us pause briefly and review the problems related to the Singapore issues as an example of the criticism. The Singapore issues have four components: (i) foreign investment, (ii) trade facilitation, (iii) competition policy, and (iv) government procurement. They are called Singapore issues because they were first brought on the agenda at the Ministerial Conference in Singapore.

Arguably one of the most difficult, controversial and, to some extent, paradoxical proposals was the suggestion to negotiate an agreement on foreign investment. I say paradoxical because a large number of developing countries have rejected these negotiations despite the fact that they have already taken a great deal of commitments in the WTO on FDI. It should be recalled that the WTO already has a number of agreements and disciplines that cover foreign investments. These include agreements on services – GATS, TRIMS (Trade-Related Investment Measures), TRIPS, and a number of other core WTO agreements such as Agreements on Subsidies and on Countervailing Measures, on Safeguards and others.

Developing countries have resented the incorporation of FDI on the agenda for a variety of reasons. When the proposal was originally made, they saw it as an attempt to move the negotiations to the WTO from OECD where an agreement had been negotiated for years without success. But the opposition soon turned to more substantive arguments. Some countries saw the agreement as an instrument of rich countries to dominate foreign markets, other countries worried about foreign control over manufacturing and service industries while other countries conditioned the negotiations on the premise that the negotiations must be not only about the rights and obligations of host countries but also those of home countries.

Similar "turmoil" surrounded the debate about the fourth Singapore issue: government procurement. The main aim of attempts to discipline procurement of government services and contracts was based on the idea that we needed rules governing the procedures and mechanism for awarding government contracts. Governments' contracts represent a significant commercial opportunity in virtually all countries. Yet, they can be highly discriminatory and thus inefficient, they may be poorly administered and they may also be the origin of corruption. Developing countries have nevertheless been resisting negotiations on the grounds that government contracts must provide an opportunity for local businesses to develop.

Turning to the second component of the Singapore issues, the idea of trade facilitation is essentially to help developing countries to establish disciplines to accelerate and facilitate the process of trade administration. There are many developing countries in which trade does not move primarily because of enormous bureaucratic and administrative constraints that exist between producers and the final consumers or users. These may relate to problems of customs administration, trade information, or to problems of licensing, government administration and, once again, they may also be the result of corruption. For reasons that are not entirely clear, developing countries were once again reluctant to accept the topic of trade facilitation as a negotiating issue.

Finally, developing countries have also been highly reluctant to the third Singapore issue: rules of competition. The idea of those who were supporting the inclusion of competition was to mitigate the market imperfections arising from excessive market power of companies and to ensure that this power does not translate into cross-border distortions in trade and investment. However, developing countries saw this attempt as a tool that would considerably weaken their abilities to promote national "champions" and to protect domestic industry.

Considerable tension arose about a separate issue of agriculture. As it is well known, agriculture has been out of GATT until the successful conclusion of the Uruguay Round. As a result, agriculture remains a highly protected sector in the developed countries, and the protection comes from three different types of measures: border measures, i.e. tariffs and quotas; domestic support in the form of various transfer payments; and, export subsidies. When one attempts to measure protection to include the effects all three "pillars" it is, of course, necessary to consider the impact of all three types of measures – tariffs and quotas, domestic support in the form of subsidies and transfer payments and export subsidies.

I am noting this simple fact only because it is not always evident that the point is well understood and accepted. In one of his interesting speeches on the status of negotiations, our Director General referred in good faith to the fairly high rate of protection in many developed countries and in the European Union in particular. He used a sophisticated methodology that attempts to capture the effects of all those three types of measures. The methodology, which was worked out and the estimates provided by the OECD Secretariat, became very controversial. The figures showed, for example, that the EU was protecting agriculture to the tune of some 300 billion dollars per year as opposed to 40 billion that would come out of the calculations based on tariff incidence. The speech was strongly criticised by the EU, which found the figures misleading. Whatever the right estimate of agricultural protection might be, the important point is that agricultural negotiations must incorporate far broader issues than tariffs or quotas (which are still permitted under the existing WTO Agreement on agriculture). It is necessary to include negotiations about all three "pillars" of protection – border measures, domestic support and export subsidies.

The last point that deserves mention concerns cotton. Cotton got on the agenda in Cancún very late in the day and this happened primarily because cotton subsidies became a very big political issue before Cancún. The "battle" sparred four West African countries (and their supporters) against the United States (even though the EU has been also implicated). The political and economic issue is that the four African countries are almost exclusively dependent on production and exports of cotton. But cotton also happens to be produced – and heavily subsidised – in the United States. There are some 25,000 farmers engaged in cotton production in the United States and they received a total subsidy of about 3.5 billion dollars in 2002. While the subsidy was lower in 2003 (about $1.7 billion), the amounts are so large that they significantly distort prices at which cotton is traded in world markets. Given the dependence of these African countries on cotton, the issue naturally raised a great deal of sympathy and support among many WTO Members.

The cotton issue ultimately became the most visible, controversial and sensitive topic in the Cancún negotiations. The four African countries that put cotton on the agenda (with considerable help from the Director General and other countries) increased their stakes by demanding that all cotton subsidies be completely eliminated and that the four African countries receive a financial assistance for three years as compensation for their losses due to adjustment. These proposals turned out to be excessively ambitious. For a variety of reasons, the United States was obviously not prepared to move immediately and

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offer significant concessions. In addition, the African countries' request for financial assistance was not accompanied with a proposal for a modus operandi for disbursements of the assistance. In brief, the debate about cotton broke down quickly because the African bets were placed far too high and there was very little to negotiate about.

Agriculture is undoubtedly the biggest negotiating issue – these tussles over cotton notwithstanding. With regard to agriculture, there is strong and in many respects justifiable pressure on developed countries to substantially reduce protection of their agriculture and particularly the export subsidies that seriously distort agricultural markets. But at the end nobody touched agriculture in Cancún because the meeting collapsed on cotton, and on the Singapore issues. In particular, developing countries were extremely hostile to the idea of negotiating foreign investment, a reaction that was actively shaped and pushed mainly by India, Malaysia, Brazil and South Africa.

Post-Cancún Rays of Optimism

While the negotiating mood immediately following Cancún was extremely sombre, to put it mildly, hopes for a successful conclusion of the Doha Development Round have been raised by more recent events. These culminated when the General Council of the WTO adopted the decision on the future conduct of negotiations on July 31, 2004. The decision consists of a general text and four specific annexes. The first of those annexes establishes a framework for negotiating modalities in agriculture. The second annex does basically the same regarding non-agricultural market access. The third annex contains recommendations for service negotiations. The fourth annex establishes modalities for negotiations of trade facilitation.

The decision was a pleasant surprise since it effectively restarted the negotiations. The "success" was possible because of concessions made by both developed and developing countries but it were the latter that clearly took far greater steps. The Round has already included an earlier agreement to tackle the problem of access of developing countries to cheaper medicine at times of emergency and medical crises. In the July 2004 decision, developing countries succeed in virtually "killing" the Singapore issues from the agenda, at least for the time being. The only component left in the package is trade facilitation. Cotton, which the United States insisted had to be treated as a part of the package on agriculture, received at the end a special attention in the text by asking

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Members to address the issue "ambitiously, expeditiously and specifically, within the agricultural negotiations".

But the biggest achievement was the decision concerning agriculture. The text includes a decision to completely eliminate export subsidies. The biggest related issue will only be the date by which the subsidisers will agree to terminate such subsidies. The decision also calls for a "substantive reduction" in the combined support provided through Final Total Bound Aggregate Measure of Support (AMS) – known as Amber Box. Members with higher total AMS are called to make the greatest reductions. The so-called *de minimis* support should be cut and the coverage of Blue Box (allowing exemptions from subsidy reductions for production-limiting schemes) will be expanded. Members also agreed to revise the criteria for Green Box payments (Green Box is perceived as having no or at most minimal trade-distorting effects).

The text also contains other measures to address the interests of developing countries in more specific terms. For example, even though the text decrees a "single approach" for tariff negotiations in non-agricultural market access, tariff reductions will be made through a "tiered formula that takes into account the countries' different tariff structure". This should help in addressing the issue of protection of "sensitive products". Additional flexibility has been also introduced. Members will be able to designate "an appropriate number" (to be negotiated) of sensitive products. In addition to special and differential treatment (S&D treatment), developing countries will be able to designate "an appropriate number" of Special Products based on criteria of food security, livelihood security and rural development needs. Developing countries will be also allowed to establish a Special Safeguard Mechanism.

Lessons

What lessons can we learn from the collapse of Cancún? There are four that should be singled out. The first lesson is that the politics of the WTO is changing quite dramatically. In contrast to what is happening in the IMF and the World Bank, developing countries have a considerably stronger voice in the WTO.

This is not only due to different systems of governance in the WTO relative to, say, the World Bank and the IMF, but also due to increased negotiating activity of developing countries. Clearly, the latter countries have become much more assertive than in the past. After all, the current Director General comes from a developing country.

The second lesson, which is closely related to the first, is the increased polarisation in the WTO. We have seen a greater polarisation of interests between developed and developing countries, between Quad and non-Quad developed countries, and the emergence of several powerful groups of developing countries.

The third lesson is that developing countries have made significant inroads in the negotiations. They have achieved considerable success in securing concessions under the TRIPS Agreement with regard to the exceptions on compulsory licensing for medicine. In short, developing countries have been more *effective* in the WTO than in the past in pushing their interests. Even though the details of this provision will still have to be negotiated, the hopes are high that developing countries will obtain access to cheap medicine.

The list of "successes" is longer. The Singapore issues have been all but dropped from the current Round; additional flexibility has been introduced to facilitate the developing countries' implementation of WTO commitments. Most importantly, the issue of agriculture has been successfully brought into the picture even though we still have to wait for the final outcome from detailed negotiations. As we know, the difficulty and the crux of the matter often lie in the detail.

The fourth lesson concerns the reasons for the increased assertiveness of developing countries. The reasons are probably several. However, one of the most interesting factors was the fact that developing countries have become much better *organised* in the WTO than in the past. They have spoken with a greater force; they have acted with greater vigour and on several substantive issues they have increasingly spoken with one voice.

Whether these changes will lead to a significant improvement of conditions for developing countries remains to be seen. Obviously, we still have to wait for details of negotiated outcomes. However, there are questions whether all these changes will benefit all developing countries as a group or whether some of them may not again fall by the wayside. For example, agricultural liberalisation will undoubtedly favour the existing agricultural exporters. But will other developing countries equally benefit? After all, most of them are net food importers. In 2000, 105 out of 149 developing countries were net food importers. Many of these countries have been able to meet food requirements only through subsidised agricultural exports from developed countries. Similar worries of developing countries exist in the case of liberalised trade with textiles, which is likely to be dominated by more efficient producers from China and India.

The resistance of developing countries to negotiate an agreement on foreign investment is also intellectually dubious and hard to understand. Around 80 percent of FDI flows today is directed to developed countries. The remaining 20 percent goes to ten developing countries at most. If most developing countries get no FDI to speak of, should they not strive for such an international agreement to attract FDI?

These are some of the remaining questions about substantive issues in the current negotiations. I am sure I have left many others[2] but they suggest that the benefits from the Doha Development Round will not be as significant and widespread as we would all wish.

[2] Stiglitz recently developed a comprehensive list of development-related issues for the agenda of multilateral trade negotiations. The list goes far beyond the current proposals under the Doha development agenda as well as the content of the July 2004 decision of the General Council. Stiglitz is also highly critical of the Doha's development record so far, taking a fundamentally different view than the one presented in this note. It goes without saying that his criticism far exceeds my own reasons for scepticism. See J. Stiglitz and A. Charlton: "*The Doha Round of Trade Negotiations: An Agenda to promote Development and Facilitate Adjustment*", The Commonwealth Secretariat, London, 2004.

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A Development and Research Agenda for the Poorest Countries

Roy Culpeper

The title of the conference from which this volume emerges is about a search – a search for a new development agenda in the post-Washington Consensus period. My principal contention is that there are not many people who are engaging in such a search, and it is also my contention that Doha, Monterrey, Johannesburg, Cancún did not do much to advance the search. My colleague at the North-South Institute, John Foster, referring to the paucity of new thinking embodied in the Monterrey Consensus, called it "the Washington Consensus wearing a sombrero". And as Brian Kahn observes in this volume, Monterrey has not really generated too much in the way of additional ODA flows to date either. The UN Millennium Summit of 2000 with its Millennium Declaration and the Millennium Development Goals is perhaps the most singular contribution that has been made towards a new development agenda among the whole list of meetings and activities that we have seen. I will return to this point shortly.

In these brief remarks I will argue that the absence of a search for a new development agenda is most evident when it comes to the poorest countries and the poorest people. What this suggests to me is the need for research: we don't really know enough in order to generate the solutions or the policy frameworks that we need to address the problems of the poorest countries. So I think that the place to start is with more, and more focused research on the particular problems of the poorest countries. This is not particularly surprising because, as has been pointed out, the Washington Consensus was born in the specifically Latin American context. Therefore, we should not be surprised that the

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Washington Consensus was not really appropriate to be applied to the problems of the poorest people and the poorest countries.

Add to this the fact that the poorest people and the poorest countries have tended to be the least positively or the most negatively impacted by globalisation: Brian Kahn is referring in Chapter 17 in this volume to commodity shocks and these could cumulatively add up to some 20 percent of GDP in poor countries. Even though middle-income countries are also subject to such shocks, they are much smaller in relative terms.

What we are faced with particularly in the poorest countries is what Bill Easterley has called the "elusive quest for growth". The reason that the quest is so elusive, it seems to me, is growth's location specificity as well as its path dependency. Thus, if as some argue there are "poverty traps" inhibiting growth, these tend to be very specific to the geography and to the history of the people and the regions in question.

Furthermore, there is a need for more interdisciplinary approaches and research on growth and poverty beyond economics. Some economists seem to feel growth and poverty are primarily economic problems, but the fact is that economists really need the cooperation of political scientists, sociologists, geographers, historians, and anthropologists, if we are going to get anywhere in understanding and resolving the problems of the poorest countries.

What I would like to do next is to focus on a particular policy vehicle that has emerged in the context of the poorest countries, which offers both opportunities and challenges. What I am referring to is the Poverty Reduction Strategy Paper (PRSP), which was born as part of the HIPC Initiative of the late 1990s and early years of this century. Subsequently I will address the issue of policy coherence, and end by looking at the need for further research on some key issues.

The Challenges of PRSPs

It is important, first of all, to acknowledge the PRSP, which is now required of all low-income countries, as a significant innovation in the development policy dialogue. Here we have a vehicle in which government, civil society and the private sector are being challenged to engage in a process of planning. Now this is very interesting: planning is suddenly back on the agenda. It is not the command-and-control planning that got such a bad name, but it is planning all the same – an experiment in strategic planning for the poorest countries.

But is it an experiment that is likely to work?

If we look at the first generation of PRSPs, I think the probabilities are fairly low that they will get anywhere close to achieving their objectives. The first generation of PRSPs suffered, as have many middle-income countries, from the application of Washington Consensus types of conditions, based on the assumption that macroeconomic stability and an enabling business environment will lead somehow to spontaneous growth, particularly growth led by private sector investments. This approach has not worked well in the middle-income countries in Latin America; it has not worked at all or at least to a much lesser extent in the poorest countries.

In this respect, unfortunately, one is led to the conclusion that the PRSP is not that distinct from its immediate predecessor, structural adjustment lending, of the 1990s and 1980s. Additionally, the ambitiousness of the PRSPs is indicated by their target growth rates in the order of 6 to 8 percent, in comparison with actual recent growth rates ranging from 3 to 4 percent, which themselves are a huge improvement in Africa over growth rates of a decade ago. So we have gone from negative or zero percent growth rates to 3 or 4 percent, and suddenly we are aiming for something twice that order of magnitude.

It is difficult to see how these kind of targets could be met given the paucity of new ODA forthcoming from Monterrey, the continuing constraints on other kinds of official financing, and a huge shortfall of domestic savings and investment.

As mentioned, the economic core of PRSPs remains based on the objectives of stability and fiscal consolidation, which tend to militate against growth. Even though, as has been pointed out, inflation is still quite high in a couple of countries, in many African countries inflation has not been too bad. So a continual emphasis on monetary and fiscal stringency in the PRSP is not contributing to these very ambitious growth targets.

Add to that the fact that terms of trade and natural shocks present a huge challenge to the growth of most poor countries. Altogether the quest for growth in poor countries is not only "elusive," it is forbidding.

I would like to point out in passing that there are nonetheless some very important divergences from strict orthodoxy, in the first generation of PRSPs. For example, in the case of Uganda and Zambia, the possibility of some fiscal deficits has been allowed for. If you look at the PRSP in Mozambique and Tanzania, you have the planning for social safety nets. This is something new in the least-developed country context. And in the case of Mauritania there is the objective of "fiscal balance in the long term".

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I think it is fair to say that both the IMF and the World Bank have recognised that there is a crying need for more research and more creative approaches when it comes to the macroeconomic core of the PRSP – if indeed the objective is pro-poor growth, with the particularly ambitious target range 6 to 8 percent.

A final and obvious comment is that PRSPs and the Millennium Declaration and the MDGs are on different institutional tracks. It is not hard to understand why. The PRSPs are a product of the HIPC debt relief initiative led by the Bretton Woods institutions. The MDGs are a product of the many international conferences of the 1990s, led by the UN. Yet there is the potential for great complementarity: the MDGs articulate the objectives, or "the what", while the PRSPs articulate the means, or "the how". Clearly, these two initiatives must be brought together, so that in each country, the PRSP is seen as the specific set of policies and action plans that will help to realise the Millennium Development Goals.

Policy Coherence, But Around the Right Objectives

Next, I would like to emphasise the need for greater policy coherence, both within individual donors at the bilateral level, and among multilateral agencies. The eighth MDGs call specifically on donors, to do their part in creating an international environment conducive for propoor growth, looking across the whole spectrum of their policies, not only their aid policy, but their trade policies, their investment policies, and so forth. We just could read from Zdeněk Drábeks chapter about the most egregious example of the lack of policy coherence, agricultural subsidies amounting to at least 360 billion dollars a year, juxtaposed with the relatively puny amount of ODA totalling 50 billion dollars. Policy is not coherent when the impact of the agricultural subsidies is to undermine the economic viability of the world's poorest people and countries – which, in the meantime, ODA from the same countries is trying to bolster. At Monterrey it was estimated that in order to achieve the MDGs at least double that amount of ODA is required; it is unlikely that this is going to happen. A perfectly rational but highly unlikely solution would be for donor countries to reallocate resources from agricultural subsidies to ODA. In our discussion on Asia I suggested that given the huge pool of reserves in East Asian countries of 1.8 trillion dollars, perhaps we should put on our thinking caps and reconsider recycling of the order that the world undertook in the 1970s, the last time we had such huge international disequilibria.

Back to the point of policy coherence, the challenge for donor countries is to ensure that their aid, trade and export credit insurance agencies, along with their investment promotion agencies, all sing from the same song sheet with respect to their policies toward developing countries, since they do not, as a rule. A very imaginative index has been created at the Centre for Global Development. Under the rubric of "Ranking the Rich" this index measures each industrial country's commitment to development by conflating into a single index all of their policies toward developing countries, including aid, export credits, immigration and so forth. But the fundamental issue here is that while it is good to have policy coherence, it is imperative to have policy coherence around the right set of objectives. Because if you do not have policy coherence around the right set of objectives, you might have a worse situation than policy incoherence.

One suggestion is that the Millennium Declaration and the MDGs provide just the kind of objective framework for donors around which to cohere their separate and individual policies towards developing countries. Let me say it bluntly: the big danger facing us at this historical conjuncture is that if we do not succeed in focusing policy coherence around a very clearly articulated development agenda, the default option is clear: we will have policy coherence around the war on terrorism, or around the security agenda.

I do not have to look beyond Canada to find an example of this. Just over the past year – despite the fact that Canada was not part of the coalition against Iraq – CIDA, the Canadian aid agency managed to find 650 million Canadian dollars for reconstruction in Afghanistan and Iraq in the wake of the wars in those countries. Contrast that to the amount of money allocated to Africa – CIDA's core bilateral partners in Africa are getting perhaps 20 million dollars per year. Debt forgiveness for Iraq will amount to 90 billion dollars. Do we see that kind of debt forgiveness being considered for Africa? No. My point is simply that the default option for policy coherence is going to be the security agenda, unless a compelling case is made instead for development.

I would argue that the question of coherence arises in the case of the multilateral organisations as well, the classic case in point being coherence across 19th street, between the World Bank and the IMF. But, one looks at the Poverty Reduction and Growth Facility (PRGF) and has to ask, what does this facility really contribute to poverty reduction? More generally, what in fact is the IMF's role in this area? My view is that it is better to have the IMF as part of the solution in the fight against poverty than part of the problem. I am not one of those who believe that the IMF should simply get out and leave it all to the World Bank.

Then there is the issue of coherence between the WTO, the Bretton Woods Institutions and the UN agencies. Zdeněk Drábek addressed the issue of TRIMs and TRIPs in the previous chapter. I find it very interesting that in the case of the agreement on trade-related investment measures, Brazil and India are presently looking to open it up. They have good reason to do so, because if you look at what Canada did in the 1960s, as part of its industrial policy, it resorted to measures that are now impossible for developing countries because of TRIMS. Other industrialised countries also engaged in activities to build up their industrial sector – activities that are not permitted for developing countries today by the WTO.

A Research Agenda for the Poorest Countries

Finally, let me move quickly to the key elements of a research agenda for the poorest countries, bearing in mind the importance of diversity among developing country needs and ownership. First, how to stimulate investment in productive sectors and particularly agriculture? Here I would point to the need to open up issues such as land reform. The issue of land reform, having been avoided for decades because of its political sensitivity, is back on the agenda; that is a good thing. Second, how to increase investment in human capital and the social sectors, including the centrality of dealing with the scourges of HIV/AIDS and malaria in the poorest countries? It is hard to conceive of making any inroads for development in Africa without progress on this front. Third, how to deal with shocks in a very systematic way? Fourth and finally, we talked about good governance; in the case of much of Africa it is not just a question of *good* governance, it is more fundamentally a question of governance. That means helping to build from the bottom up a functioning state, the bureaucracies, the police, judiciary, the legal system etc. This is a capacity-building process that takes generations, not something that can be done to a Northern textbook or conjured up overnight; it takes long-term commitment going beyond 2015, which is currently the target date for the MDGs.

More research on capacity-building in the poorest countries is critically needed, and, as I suggested, such research ought to involve, in an interdisciplinary effort, political scientists, sociologists, geographers, anthropologists *and* economists.

A development agenda for the poorest countries critically depends on progress in two fronts: at the national level, on policies that promote economic growth and social equity; and at the international level, on policies that democratise international rules and institutions. Development economists involved in both types of endeavours should keep in mind that diversity comes before consensus since each developing country faces a specific set of opportunities and challenges.

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Edited by Jan Joost Teunissen and Age Akkerman

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