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The Need for a More Flexible Approach to Development

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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.

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 hyper-inflation 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-

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[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.