

The Washington Consensus and (non-) development

Hansjörg Herr, Jan Prieue *

Introduction

In this paper we deal with some principal issues of strategies for development. First, we focus on the role of macroeconomic policies in what has been coined the ‘Washington Consensus’. The term was invented by John Williamson (1990) to express what he thought would be the lowest common denominator of policy advice to Latin American countries by Washington-based institutions. Here, we detect some shortcomings and lack of clarity which reflect that there perhaps never really has existed a more or less clear Washington Consensus, especially concerning macroeconomic strategies. We conclude that macroeconomic policies have to play a much more important and comprehensive role especially in the area of monetary and exchange rate policy, and the balance of payment equilibrium.

After interpreting the Washington Consensus in the first part, we discuss some of its macroeconomic key shortcomings in part two. Part three gives a short overview of a positive and a negative development scenario, the latter leading to repressed growth in a broadly liberalized market economy. In the final part an alternative policy package is sketched out briefly. The paper attempts to give a comprehensive and summarising critique and cannot go into details of the argumentation.

Interpreting the Washington Consensus

Whether it was or still is a consensus or not, there is probably a broad assent among many in the IMF and the World Bank that developing and transition countries need a mix of macroeconomic stabilization and structural adjustment. Williamson (1990) captured this idea in ten points.¹ Later it became a new consensus that especially institution building and poverty reduction had to be added to the original Washington Consensus. Rodrik summarized what he regards as the augmented Washington Consensus in another ten points.² These twenty points concern 'sound money' (= stabilization policy) and mainly improvements in the allocation of resources with the aim to increase productivity. Therefore privatisation, improving property rights, enhancing competition, getting the prices right, abandoning all barriers to domestic and international flows of goods and finance are in the focus. The aim is to implement what is conceived as a truly free and hence liberalized market economy. Whereas free capital movements were not part of the Consensus as Williamson explicitly pointed out, in the augmented version financial liberalisation which includes more or less all capital account transactions has become an important ingredient reflecting the de facto policies of the Bretton Woods institutions. The vision of the Consensus is that macroeconomic policies have to provide the stable framework which allows improvements in allocation to unfold positively. Thus, macro policies have to secure only the preconditions for economic growth which is triggered endogenously by improved allocation through structural adjustment policies.

The macro policies addressed in the Consensus can be summarized as follows: (a) absence of too high inflation, sometimes it is referred to one-digit inflation rates as

being tolerable (World Bank 2003), (b) balanced or close to balanced public budgets, (c) not too high current account deficits and (d) either flexible or fixed exchange rate regimes (corner solutions). The main instruments to achieve these goals are tight monetary policies in favour of the control of a broad money supply or to reach an inflation target, tight fiscal policies focusing on the retrenchment of government expenditures. The use of expansionary monetary and fiscal policies is excluded.

Furthermore if both stabilization and adjustment policies are agreed upon and implemented, preferential loans by the Washington institutions and other donators can be offered. This type of finance is regarded as predecessor for private capital flows, comprising all kinds of finance such as bank credits, portfolio investment or FDI which make up for the shortcomings of the domestic financial sector and of domestic savings. So, developing countries are seen as emerging markets which have to be enclosed into global finance. This will most probably lead to a net capital inflow reflected in a capital account surplus and a current account deficit for longer periods. Various theories underpin the necessity of net capital inflows: most prominently, the concept of a saving gap in the tradition of applied Harrod-Domar and Chenery/Strout (1966) growth theory and also the neoclassical growth theory which stipulates capital flows from the capital-rich to the capital-poor. Of course this requires removing barriers to capital mobility. This approach assumes a long phase of current account deficits and an accumulation of foreign debt in developing countries until the 'take-off' is reached. It should also be mentioned that the Washington Consensus is applied uniformly to all countries and only to a certain extent takes the specific local context of the countries into account (Rodrik 2003, Stiglitz 2002).

Recently Williamson (2004) has argued that the Washington Consensus of 1989 was a sensible though incomplete reform agenda. He had always rejected the widespread

notion that this agenda is `neoliberal` as it did not adhere to many typical convictions of market fundamentalists. However, the de facto interpretation and practice was in many (not all) cases close to such accusations. Williamson had conceded that the Consensus had evaporated in the late 1990s, especially in dissent with the Bush administration (namely the US Treasury) concerning fiscal policy, income redistribution and capital account liberalization, to some extent also in the field of exchange rate policy. Besides redistribution, institution building including a more active role of governments and countercyclical fiscal policies Williamson today adds prudent control of the capital account and sequencing of reforms as important supplementary issues of the old Washington agenda, without hope of regaining a consensus³. In the following we confine our analysis to the macroeconomic ingredients of what we conceive as the de facto Washington Consensus.

Some key shortcomings of the ‘Washington Consensus’

We focus on six shortcomings related to macroeconomic aspects of the Washington Consensus and the asserted relationship between allocation and economic growth which is questioned here.

Inflation analysis and stabilization policy

How much price stability do developing countries need? In the World Bank’s ‘PRSP Sourcebook’ less than 10 per cent is considered to be sufficient (World Bank 2003a). However under conditions of global currency competition with free capital mobility and the pending risk of capital flight and dollarization developing countries need a much

higher degree of price stability. Even if they are too ambitious, the benchmarks are set by the dominant strong currencies and their inflation rates. Strong deviations from these benchmarks result in permanent devaluation, higher dollarization, aggravated foreign debt burdens in case the nominal exchange rate is defended by stimulating capital inflows, weakening of the domestic financial sector including higher interest rates, to mention some of the economic costs of too high inflation. In other words low inflation, as hard as it may be to achieve and sustain, needs much more consideration⁴. With capital controls the currency competition might be dampened somewhat.

Concerning the sources of inflation, the analyses should focus on the causes of cost-push inflation accommodated by the monetary authorities in almost all developing countries; especially in an economic crisis there is by definition no excess real aggregate demand.⁵ Non-accommodation of cost-push inflation leads to an extreme degree of tightness of monetary policy which prevents development and endangers the functions of the domestic financial system. Contrary to the traditional viewpoint, devaluations and wage-price spirals are the most prevalent sources of inflation in developing countries. The stronger the integrated international goods markets and the higher the import-GDP share, the stronger the pass-through from devaluation to inflation (see Rojas-Suarez 2003, pp. 146 ff.). The higher the degree of dollarization – for example in case of indexation of domestic prices and wages in foreign currencies – the more direct is the pass-through (Ize/Parrado 2002, IMF 2003, Fischer/Sahay/Végh 2002). In many developing countries with low growth rates, a devaluation-wage-price spiral in combination with restrictive monetary policy to fight inflation leads to low domestic demand and/or even stagflation. The muddling-through between the fight against inflation with restrictive macro policies and the need to reduce aggregate demand typically leads to a situation of repressed growth and continuing inflationary problems (stagflation). Hence inflation control obviously requires stable exchange rates.

Exchange rate regimes

The inflationary process can be stopped by stable nominal exchange rates as nominal anchor and a complementary nominal wage anchor. If these two anchors hold, monetary policy can be less restrictive or even expansionary. Adjustments of exchange rates should be possible; arrangements like currency boards or absolutely fixed nominal exchange rates are too rigid and can become too costly in certain economic constellations.

Orthodox monetarist theory is in favour of flexible (i.e. floating) exchange rates, whereas the Washington Consensus admitted that absolute tight exchange rates, for example currency boards, might also be feasible. The macroeconomic guideline is not very clear in this point, especially as it remains unresolved how to maintain fixed exchange rates once this regime is chosen (Baliño/Bennett/Borensztein 1999). Foreign reserves will only suffice in the short run, and even very high interest rates can hardly defend exchange rates once the confidence in the domestic currency has vanished as experienced in many countries. The traditional bi-polar view on either fixed or flexible regimes seems somewhat beyond reality and practice, since almost all countries avoid (and must avoid) too high fluctuations of the exchange rates. There is much evidence for open economies that devaluations are closely linked to inflation (see above). Therefore permanent and/or strong devaluations have to be avoided. So the floating option with high volatility contradicts the emphasis on price stability and 'sound money' as stipulated in the Consensus.

Capital account liberalisation or control?

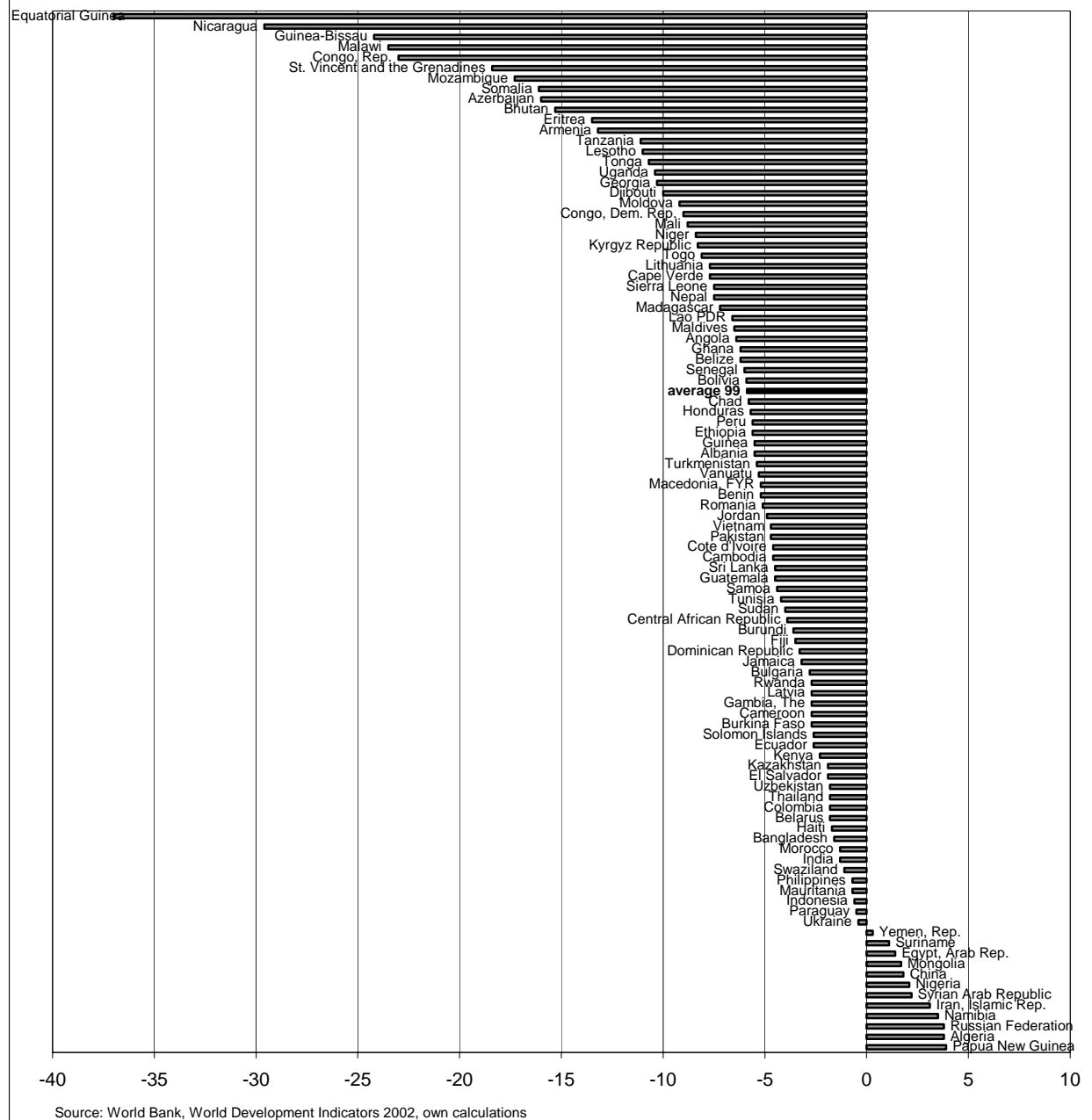
International capital movements between the developed and underdeveloped world have been unstable.⁶ Very often, capital flows into developing countries and builds up a fragile macroeconomic constellation, then follows the sudden return of the capital to the developed world and a subsequent currency crisis. The strength of such capital flows is intensified by contagion after a crisis in one country started. The capital in- and outflow waves can roll over one part of the developing world after the other. This happened, for example, when in the early 1990s capital moved to Central America; in 1994 during the Mexican crisis, the wave left Central America and hit some transition countries like the Czech Republic and Asian countries like Thailand or Indonesia. In spring 1997 the Czech model collapsed in a currency crisis and in autumn of the same year the Asian crisis shocked the world when the capital came back into the developed world. Such types of capital movements make it extremely difficult even for developing countries following sound economic policies to avoid large exchange rate changes. In developing countries supportive capital controls to stabilize the exchange rates seem to be necessary to avoid destabilising capital inflows and outflows.

Risks of current account deficits and external debt

In most developing countries there is simply no domestic saving gap. In spite of the weak empirical and theoretical background of the saving-gap models it is still widely used in international institutions and ministries (Easterly 1999). In principle import goods can be financed by export proceeds; external debt⁷ does not augment necessarily investment, and even if it does so temporarily, debt has to be repaid (and portfolio and FDI can be withdrawn). When depreciations cannot restore international competitiveness, if the Marshall-Lerner-conditions do not apply, a market failure exists

that requires special remedies as exceptional cases. A balance of payment regime with long lasting current account deficits has fundamental disadvantages. In the 1990s the average (unweighted) current account deficits in low and lower middle income countries were 5.9 per cent of GDP. Among these 99 countries with data available (out of 117 in these groups) there were only 12 surplus economies (Herr/Priewe 2004, p. 77; see Diagram 1). That such deficits can hardly be regarded as sustainable is ignored or repressed by the proponents of the Washington Consensus. In other words, there is no coherent balance of payment concept within this Consensus⁸.

Diagram 1: Current account balance in % of GDP, 99 low and lower middle income countries 1990-2000



With the current account deficits, external debt is built up, denominated in hard currency. This 'original sin' (Eichengreen/Hausmann 1999, Eichengreen/Hausmann/Panizza 2002) which cannot be overcome by developing countries, leads to a high

vulnerability of the indebted country. The higher the (gross) indebtedness, the higher the danger that indebtedness will lead to financial crises. There are two patterns:

- 1) A country with high foreign debt is confronted with an abrupt refusal of creditors to roll-over credits and/or a sudden outflow of capital. The resulting devaluation then leads to an epidemic domestic liquidity and solvency crisis (Jeanne/Zettelmeyer 2002). Kaminsky/Reinhart (1999) have found out that particularly in developing countries exchange rate crises typically lead to systemic banking crises as firms and banks in countries with high foreign debt in cases of devaluation break down.⁹ It should be emphasized that current account deficits (even high ones) combined with high growth may sometimes prevail for quite long periods, especially if the deficits are used to import investment goods. However the seeming link between growth and current account deficits is deceptive; the longer the imbalance sustains the more risks will emerge that ultimately trigger off strong and often sudden devaluations¹⁰.
- 2) Most low income countries let alone highly indebted poor countries (e.g. HIPC-countries) have little access to commercial capital markets and rely more or less on credits from international institutions and foreign governments, apart from the low level of FDI. These capital flows are relatively stable as donors normally do not stop to issue credits. The problem of these countries is that their current account situation is not sustainable and that they grow slowly in a situation of over-indebtedness. Debt relief in HIPC-countries improves the situation until after some time over-indebtedness returns (Easterly 2002).

As rational economic agents know the disastrous consequences of over-indebtedness and devaluations, high current account deficits and high gross foreign debt will weaken the reputation of the domestic currency. This leads to a risk premium with substantially

higher real interest rates¹¹ in developing countries. The result is low growth and a less equal income distribution as compared to the developed world.

Countries with high foreign debt in foreign currency fear to devalue and thus tend to delay devaluations even if they have huge current account deficits and the situation will become unsustainable. Such a policy is detrimental to exports and the reputation of the local currency. Capital flight has to be reduced or necessary capital imports have to be stimulated by high interest rates. Countries in such a situation are caught in a difficult dilemma. Devaluation will destroy the domestic financial system because of high foreign debt and not to devalue will lead to even higher foreign debt and low growth. Since the current account deficits in such countries are typically partly paid by policy loans or donations, soft budget constraints can delay necessary adjustments.

Debates about poverty reduction and debt relief remain at the surface of the problems, insofar as new foreign debt is created even in the case that international institutions give credits. The discussions have focused too much on so-called good or bad foreign debts, for example private foreign debt is conceived as 'good' compared to budget deficits in foreign currency. It has been overlooked that high foreign debt makes a country vulnerable against shocks which in developing countries cannot be avoided, independent of the individual debtor. Prudence in financial liberalization is mentioned in the Washington Consensus, but actual policy by international institutions and Western governments much too often press developing countries to open up the capital account too early. The avoidance of a current account deficit and of a substantial gross foreign debt is the best basis to develop in a world with volatile international capital movements and an unstable world economy. It also has to be recognized that countries with high foreign debt in foreign currency lose the exchange rate as an adjustment instrument. Especially if the exchange rate in developing countries cannot be kept stable

and frequent economic shocks need exchange rate adjustments to (re)establish international competitiveness, foreign debt should be low. To avoid vulnerability and to keep a certain degree of economic policy autonomy are convincing arguments to prevent substantial net and gross foreign debt in developing countries. The best constellation for development is to prevent a current account deficit, limit foreign gross debt and strive for a stable nominal exchange rate (see below). If it is not possible for a country to combine a stable exchange rate with a balanced current account, the second best option is to realign the exchange rate by a once-off devaluation and thus re-balance the current account. To maintain the option to devalue, a high level of foreign and domestic debt in foreign currency has to be avoided.

However if external debt is regarded as necessary or unavoidable it should be confined to beneficial or less risky flows. FDI are preferable and should be advised (mainly because of the lack of a currency risk for the recipient country and the desired technology transfer); roll-over risks in case of loans should be minimized through long-term contracts or political guarantees. Again in such cases appropriate capital controls can help avoid the unfavourable sources of inflows and destabilising exchange rate volatility due to volatile capital flows.

The neglect of dollarization

Dollarization is the unofficial or official use of hard currency within a country for holding wealth, giving credit or expressing the price for wages and goods. Here we focus on unofficial dollarization. It is a sign that agents do not trust the national currency as they expect high inflation and/or high devaluation. Dollarization is a double-edged sword as it makes the domestic banking system inherently fragile:

- 1) Dollarization produces dangerous currency mismatch, as banks, firms, households and the government may have debts in dollars and revenues in domestic currency.
- 2) For countries with high dollarization a lender of last resort (for example the central bank providing always sufficient liquidity for the banking system) does exist only for the part of the financial system working with domestic currency.
- 3) Because of currency mismatch there is a high incentive for banks to invest collected foreign currency deposits abroad. In addition the typically high stock of cash hoarding in foreign currencies disrupts bank intermediation and is lost for domestic credit supply.
- 4) The higher the dollarization the smaller the room to manoeuvre for monetary policy. In a state of high dollarization financial wealth in domestic currency can only increase in line with the increase in wealth in foreign currency. If there is an increase in domestic monetary wealth (due to credit creation in domestic currency) according to the degree of dollarization, domestic wealth will be exchanged in foreign currency. Particularly in developing countries nominal devaluations are risky and will further increase dollarization. Thus the volume of money creation and credit expansion in the domestic economy may become so small that credits for investment are almost not available. If they are available, then they are extremely costly or their volume may be even too small to prevent a permanent lack of liquidity. Increasing dollarization is identical with portfolio shifts from domestic to foreign currency. If there are no sufficient capital imports, which lead to the negative effect of higher indebtedness in foreign currency or sufficient current account surpluses, any domestic credit expansion and/or an increasing degree of dollarization will lead to devaluation, inflation and finally to higher domestic interest rates. Overall, dollarization reduces the availability of domestic credit and

increases interest rates for credits in foreign and local currency, as compared with a situation where dollarization is lower (Honohan/Shi 2003).¹²

Obviously the issue of dollarization has been neglected in development macroeconomics and is regarded as an intricate issue of minor impact. There are plenty of publications stressing the disadvantages of dollarization (for example World Bank 2002, IMF 2003), but there seems to be no clear commitment in the Washington Consensus to seriously fight dollarization as a precondition for a stable financial system and for sustainable development.

A country that cannot provide a domestic currency with sufficient trust will hardly be able to establish coherent economic mechanisms. Instead the economy will be divided into a domestic currency segment, a foreign currency segment and – due to a restrictive monetary bias of the regime and a lack of credit – barter and subsistence segments. In case the domestic currency segment is inflationary, the erosion of the monetary system continues and dollarization increases. If the domestic currency sector in respect to inflation is stable, credit expansion in this sector is likely to be so much restricted that growth is repressed and in extreme cases the shortage of liquidity stimulates barter and subsistence segments in the economy.

The underestimated domestic financial system

Although the domestic financial sector using domestic currency is one of the main strategic sectors in developing countries to stimulate investment, there are severe theoretical shortcomings which are not yet seriously addressed in mainstream development strategies. In traditional theories finance automatically follows the real economy. The question of finance was often simply ignored. Much of the discussion about structural adjustment in the financial sector is focused on the debates on repressed

versus liberalized finance. The bi-polar view is not very conducive as both alternatives involve shortcomings. We call for more attention to the macroeconomic framework of the financial sector and appropriate institution building including adequate regulations. Prior to facilitating cross-border opening of financial flows, a stable domestic financial system has to be shaped. As dollarization makes a financial system inherently vulnerable, the degree of dollarization has to be reduced to low levels as a precondition for a sound financial system.

Table 1: Domestic credit provided by the banking sector and the trade balance in the year 2002 in % of GDP*

	Domestic credit in per cent of GDP	External balance of goods and services in per cent of GDP
Low income countries	48.6	0.4
Middle income countries	82.9	3.4
High income countries	168.5	0.0
Latin America & Caribbean	42.7	2.8
China	166.4	3.0
Belarus	17.5	-4.4
Uganda	15.4	-15.4
Vietnam	44.8	-4.0
Mozambique	13.2	-14.7
Nigeria	25.3	-5.9
Russian Federation	26.6	10.8

* Domestic credit includes domestic credit in foreign currency.

Source: World Development Indicators 2004, World Bank, Washington, D.C.

We agree with Chenery and Strout (1966) (and many others) that investment is the key for growth and development¹³. In line with investment, human capital formation must and can take place. But we disagree that investment should be financed by foreign sources (except FDI). Basically a domestic financial system has always the potential to finance investment with domestic credit. Among others it was Schumpeter (1934) who argued that development is only possible if innovative entrepreneurs get credits from banks to invest. What is necessary is new credit created first of all by the banking system with the help of the central bank. Saving in such an approach will be created out of the new income stimulated by investment.¹⁴ From a macroeconomic point of view, prior saving (say in period t_0 , without respective investment in the same period) as a precondition for investment (say in t_1) is logically impossible. The paramount role of finance-led growth is also stressed by the World Bank (2001). Indeed there is an impressive correlation between domestic bank credits to GDP and the development of countries. Low-income countries have a low percentage of domestic bank credits to GDP, whereas in developed countries the ratio is three times higher. There is no clear relation between the trade balance and this ratio (cp. table 1). Russia, for example, has a high trade (and current account) surplus and a poorly developed financial system.¹⁵ Uganda, often regarded as a model economy in Africa, relies heavily on foreign finance and reforms have not improved the outreach of the domestic financial systems. China as a developing country is an exception. Bank credits to GDP is nearly as high as in developed countries¹⁶; China had the highest growth rates of all the countries listed in the table mainly because of the domestic investment dynamics fuelled by state-owned banks and state-owned enterprises (cp. Herr/Priewe 1999), despite severe shortcomings in the allocation of resources.

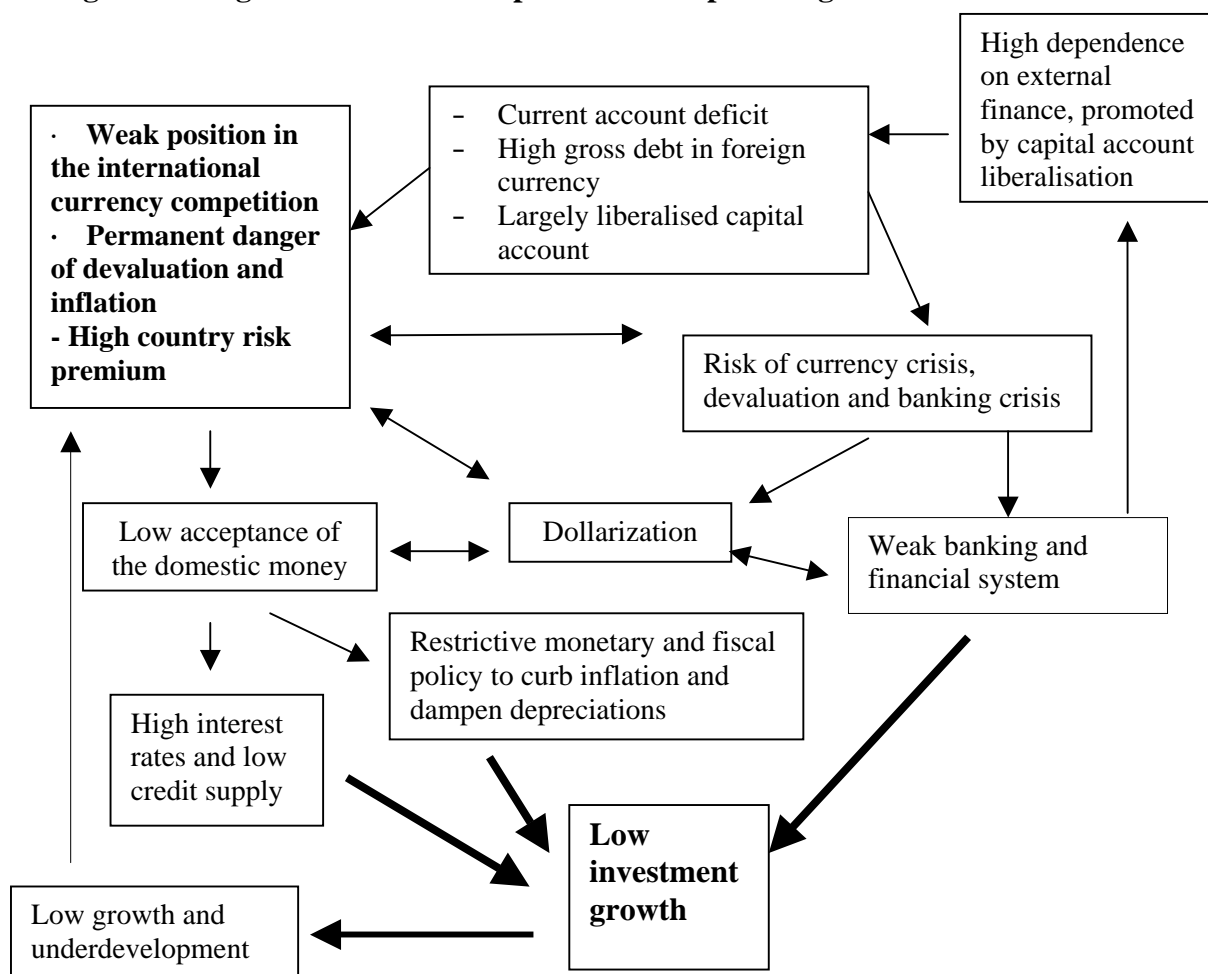
Scenario of underdevelopment and ‘repressed growth’ versus growth scenario

The most important single macroeconomic factor contributing to development is a stable domestic currency, which is broadly accepted by domestic households, banks and firms.¹⁷ This is a necessary precondition for a workable financial sector which can offer sufficient credit and low interest rates. It is evident that especially currencies issued in developing countries have problems to compete with the worlds’ leading currencies even if they are stable.

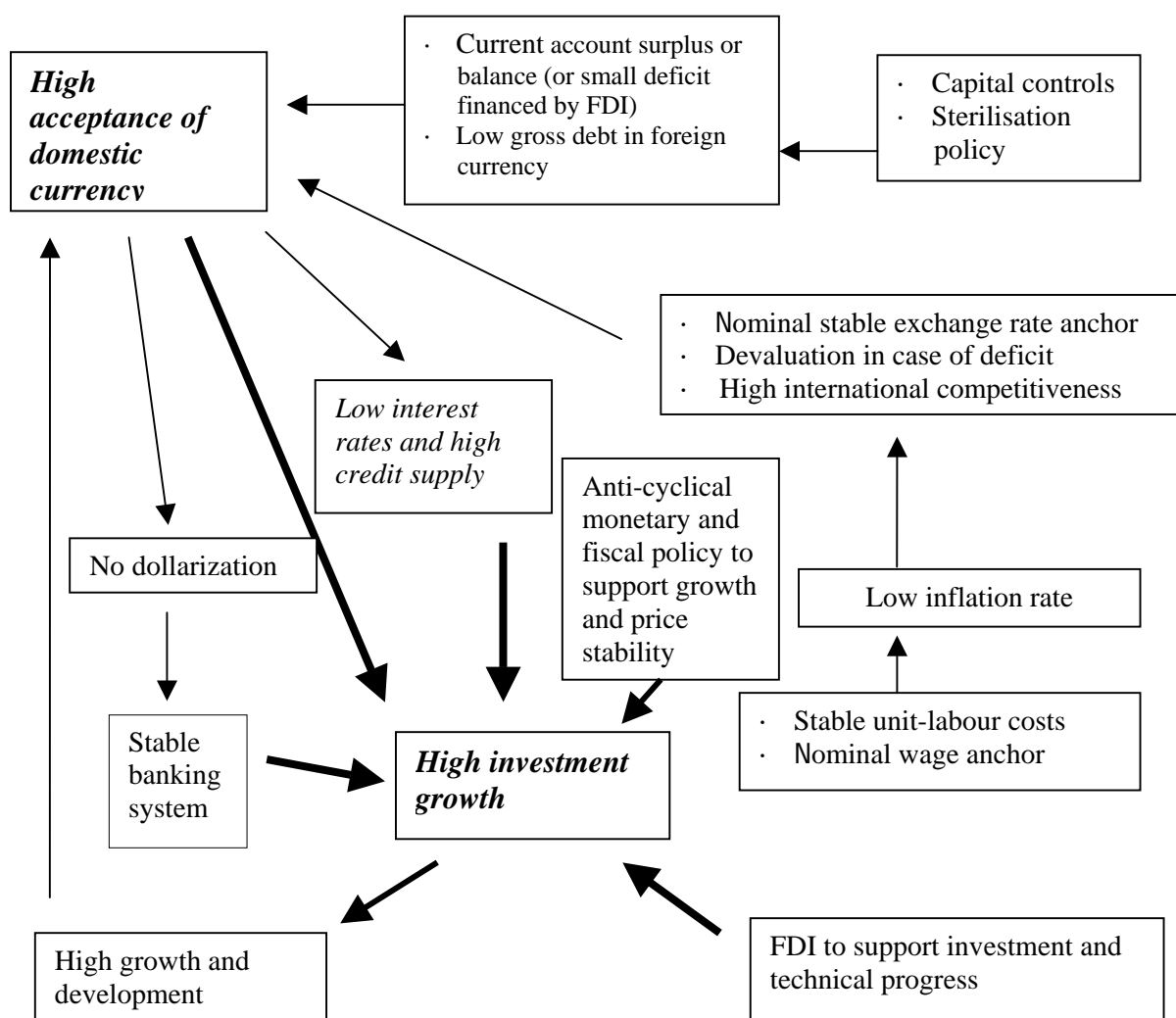
Diagram 2 shows a typical regime of underdevelopment and ‘repressed growth’.¹⁸ The country has a current account deficit and thus an increasing debt in foreign currency. Such a constellation can be stable for a long time – theoretically even the sustainable correlation between the current account deficit in per cent of GDP, the growth rate of GDP, the interest rate and foreign debt to GDP can be calculated. But the point is that the fragility of the economy increases with increasing gross foreign debt. Rational economic agents expect that any external shock from the world economy or from inside the country – and shocks are especially likely in developing countries with their often fragile economic, social and political system – may lead to devaluation and inflation and the weakening (in some cases destruction) of the domestic banking system indebted in foreign currency. In such a situation economic agents will prefer to keep financial wealth in foreign currencies. If it is kept abroad there is capital flight; if it is kept inside the country there is dollarization. The results are high interest rates and an unstable domestic banking system. To put it differently, the country is not able to issue a domestic currency which is sufficiently accepted by economic agents with the result of high interest rates due to a high country risk premium, high dollarization and a lack of credit supply. The overall effect is low investment and low growth. The bad

economic performance of the country gives no scope to improve the acceptance of the domestic currency. Even a stable price level and a stable exchange rate may not be able to improve the quality of the domestic currency, reduce dollarization and give the central bank the option to cut interest rates and stimulate credit supply. The ‘wait-and-see’-attitude, stressed by Dornbusch (1990), prevents the (re)vitalisation of the acceptance of the domestic money and the country is stuck in an underdevelopment path. It should be emphasized that this constellation of ‘repressed growth’ likely occurs with floating exchange rates, liberalized capital account and deregulation of the domestic financial sector. It is one of the typical Washington Consensus regimes (cp. Herr/Priewe 2004, chapter 2)¹⁹; maybe even the most typical one.

Diagram 2: Regime of underdevelopment and ‘repressed growth’



A positive macroeconomic scenario is the reverse of the repressed growth regime (see diagram 3). Policies are geared towards the most vital point for development – the creation of an accepted national currency. A high quality of the domestic currency can only be reached if price-level stability, exchange-rate stability and sufficient growth can be realized over a longer period. Price-level stability and the accumulation of trust in the domestic currency in developing countries are directly related to nominal exchange-rate stability as the exchange rate is the best indicator for a currency to survive in the international currency competition. Nominal exchange-rate stability and high international competitiveness – the latter also a precondition for development – can only be achieved simultaneously if domestic unit-labour costs are stable, what is identical with the notion that nominal wage increases follow an average productivity growth (plus target inflation rate). Ideal for a single country is a constellation of surplus in the current account and appreciation expectations, which keep the domestic interest rate low. The higher the acceptance of the domestic currency the lower the domestic interest rate and the higher domestic investment as the reputation of the domestic currency is built up and fears for devaluation and systemic domestic failures in the banking systems vanish.

Diagram 3: Regime of development and growth

In our positive scenario we did not stress improvements in the allocation of productive factors which are so much in the centre of policy recommendations of international institutions. In contrast to neoclassical thinking, improvements in allocation do not automatically trigger growth. In some areas there might even exist a trade-off between improved allocation and macroeconomic stability. This does not mean that we do not want a better allocation or the improvement of institutions. But we believe that only a stable macroeconomic development and integration into the world economy, which makes the country not dependant on instable international capital movements are capable to pave the way to deepen allocation improvements. Allocation

reforms – what are coined structural adjustments – without a stable macroeconomic constellation are doomed to fail and can even lead to disastrous economic crises (as for example in Russia in the early 1990s).

A new world order for economic development

Above it has been argued that a current account surplus is an important part of a positive development strategy; many of the most successful countries after World War II were in such a constellation. Many of them – for example Japan, Germany, Taiwan, Peoples Republic of China – followed or still follow an aggressive neo-mercantilist strategy. Obviously not all countries in the world can have a surplus in the current account and can follow the ideal development strategy of a single country. If all countries in the world strive for current account surpluses the world economy attains a restrictive and destabilising bias (Robinson 1937, Vandenbroucke 1985, Herr 1997). There are several ways how this problem can be solved.

1) Global competition for achieving surplus, unfavourable for the majority of developing countries: In the present world economy there is a tough economic competition between surplus and deficit countries. Deficit countries try to improve through real depreciations (nominal devaluations, if possible, and/or reduction of unit-labour costs and/or low domestic growth), but in many cases fell involuntarily into deficits; surplus economies try to maintain or increase their surpluses. It is almost only the US that has accepted deficits to a certain degree since the early 1980s as its external debt is in domestic currency and even strong exchange rate fluctuations do little harm to the US economy and the reputation of the US-dollar. Unfortunately the current account deficit of the US is not (fully) reflected in surpluses of countries in the developing world

(e.g. China) as to a large extent it reflects surpluses of other developed countries (e.g. Japan). Most developing countries are caught in the regime of underdevelopment and have to fight against current account deficits, over-indebtedness, dollarization, capital flight and stagnation.

2) Global balance of payment clearing mechanism: The world economy would create less destabilising shocks for developing countries if there were more exchange rate stability between US-dollar, euro and yen,²⁰ and if at the same time there were a mechanism which could keep current account balances of developing and developed countries in check. A worldwide regime with an equilibrium mechanism is only possible if there is a supranational institution which organizes cooperation between countries and is able to stimulate adjustment mechanisms in case current account deficits occur. Such a supranational institution could follow ideas of the international 'Clearing Union' proposed by Keynes after World War II (Keynes 1969, cp. Davidson 1999)²¹. This would require a new world currency system, something like a Post Keynesian Bretton Woods II.

3) Surplus for developing and deficits for developed countries: The most favourable constellation for developing countries is current account deficits of the bloc of developed countries – especially the United States, European Union and Japan – and current account surpluses of the bloc of developing countries. In such a constellation developing countries could stimulate their economies by dynamic export performance and at the same time strengthen the reputation of their currencies. This requires undervaluation policies in the developing countries vis-à-vis hard currencies and overvaluation policies in the bloc of developed countries vis-à-vis developing countries; furthermore goods markets would have to be fully opened in developed countries for imports from poorer countries.

There may be a group of some fifty very poor countries which completely depend on foreign aid to survive. Clearly such countries are on the drip and have to be further financed by rich countries. They can only develop as transfer economies in dependence from their donors. A sharp increase in foreign aid for this country group as proposed vigorously by Jeffrey Sachs and others can be of strong direct help but corroborates many macroeconomic distortions and will probably result in long-term economic and political dependence. Instead a new orientation in development strategy including a policy to stimulate exports from developing countries and lower current account deficits is gradually needed to overcome the existing development blockade of many over-indebted countries in the South. Such alternatives – for example grants instead of loans, or loans to be repaid in local currency, exchange rate stabilization aid – cannot be discussed here.

Conclusions

Theoretically, even the best allocation (or perfect performance in structural adjustment) does not induce enduring aggregate demand, and hence growth and capital accumulation. Allocation improvements can even go along with low growth or recession; long-run positive effects may never be realized if short-run problems cannot be overcome and a ‘bad’ development path is followed. Vice versa there can be high growth due to favourable macroeconomic conditions despite sub-optimal allocation (Herr/Priewe 1999 for the case of China). Furthermore to find out what ‘optimal’ allocation really is will take a long period of time and depends on the specific circumstances of countries (the simple model of perfect competition can be misleading); structural adjustments including institution building is time consuming, as can be

studied through the economic history of developed countries. Therefore an increased attention has to address the macroeconomic forces of growth separately from adjustment issues at a micro level. Of course improvements at the micro level also have to take place continuously to remain on a path of high growth (Rodrik 2003).

In the field of development it is very often not possible to realize quickly the first best solution. Typically there are trade-offs. For example in case of a conflict between stabilization and growth on the one hand and optimal structural adjustment on the other, there is no doubt that growth is more important in the short-run and high growth improves the economic, social and political conditions for structural reforms which require a long period of time.

Capital controls are a good example. They are commonly regarded as an awkward and old-fashioned instrument from the age preceding the globalisation of finance. If stable exchange rates, a current account surplus or at least a balanced current account and low foreign debt are regarded as a necessary - although not sufficient - precondition for growth and development, there is a conflict of goals. Capital import controls (rather than capital export controls) can help to keep the balance of payment in equilibrium. Furthermore the liberalization of the capital account should progress gradually as it did over many decades in the now developed countries. Premature liberalization of cross-border capital flows can smash or suffocate the domestic financial sector which, however, is crucial for development. Premature liberalisation of the capital account prevents the development of – in most countries – an immature and distorted local financial sector, thus inducing high opportunity costs. Highly developed global finance without any restriction for mobility may conflict the need to secure macro stability in less developed economies (Eichengreen 1999, Stiglitz 1999). In the augmented Washington Consensus, prudent capital account opening is mentioned but international

institutions much too often recommended and pressed for quick capital account liberalisation rather than to consider that developed countries, even after World War II, needed decades and not years.

To sum up, an alternative macroeconomic policy package to the old or augmented Washington Consensus should comprise the following objectives and policies as long as there exist no new global currency and balance of payment clearing system:

1. low inflation near to the inflation rate in hard currency countries in case of an open capital account with unfettered currency competition
2. current account surplus via stimulating exports (first best) or balance or small deficit financed only by FDI inflows (second best) or moving gradually towards these goals (third best); avoiding forced current account balance through low growth and austerity policies
3. low gross external debt
4. stable nominal – though adjustable – exchange rates backed by stable unit-labour costs as two interlinked nominal anchors for the price level; real under-valuation of the currency (first best)
5. low real interest rates, through reduced currency risk premium
6. repressed dollarization
7. sustainable budget deficits in local currency
8. capital account controls (temporary or permanent) to (a) curb current account imbalances, (b) stabilize exchange rates, (c) dampen dollarization, (d) extend leeway for domestic monetary policy, (e) shelter the domestic financial sector
9. foreign aid: grants instead of preferential loans, debt relief with new conditionality according to the above mentioned policies.

Notes

* Professors of Economics at FHW Berlin (Berlin School of Economics) and FHTW Berlin (University of Applied Sciences) respectively. A longer version of this paper with country case studies was presented at the ABCDE conference of the World Bank in Paris 2003.

¹ Williamson mentioned: fiscal discipline, redirection of priorities in public expenditures, tax reforms to lower marginal rates and a broader tax base, interest rate liberalisation, competitive exchange rates, trade liberalisation, liberalisation of foreign direct investment (FDI) inflows, privatisation, deregulation, secure property rights (cp. Williamson 1990, 2000, Kuczynski/Williamson 2003).

² Rodrik (2003) proposed the ‘augmented’ Washington consensus as the previous 10 items plus the following ten: corporate governance, anti-corruption, flexible labour markets, adherence to WTO disciplines, adherence to international financial codes and standards, ‘prudent’ capital account opening, non-intermediate exchange rate regimes, independent central bank/inflation targeting, social safety nets, targeting poverty reduction.

³ See Williamson 2004 and his further explanations at the conference in Berlin “Searching for Alternatives – Beyond the Washington Consensus”, 22-23 September 2004.

⁴ In a cross-country analysis Bruno/Easterly (1995) found out that below an inflation rate of 40 percent there is no clear link between inflation and per capita growth. Dornbusch/Fischer (1993) found that inflation rates over 30 percent would become unstable. We believe inflation rates of 30 or 40 percent are too high for stable development. Firstly, cross-country regressions are based on weak methodological grounds. They do not take into consideration individual country circumstances like the existence of capital controls, the political situation, the effectiveness of government policies and the whole institutional structure of a country (Arestis/Demetriades 1997). Secondly, during the last decade the degree of dollarisation in developing countries increased, capital controls were reduced and liberalisation was pushed. In such an environment the currency competition between the currencies of developing countries and the leading world currencies (US-dollar and euro) becomes more intensive. Substantially higher inflation rates in developing countries than in industrial countries would certainly induce more capital flight, higher dollarisation, devaluation and higher real interest rates in developing countries. Such a constellation would not foster a stable sustainable growth process.

⁵ The idea of cost inflation goes back to Keynes (1930). Keynes distinguishes between cost inflation and demand inflation. For him cost inflation is in the centre of inflationary processes (see also Herr/Priewe (2003) and Herr (2002a)).

⁶ There is no economic model available that can explain the volatile exchange rate movements between the leading world countries since the early 1970s. The purchasing-power-parity theory in all its forms is certainly not helpful to explain these exchange rate swings (Isard 1997). Instead, foreign exchange markets should be regarded as asset markets without a stable equilibrium determined by fundamentals, but governed by unstable short-term expectations and jumping from one short-term equilibrium to another.

⁷ External debt is interpreted here in a broader sense, including portfolio and foreign direct investments. Portfolio investment includes shares and debt securities. In the case of the latter foreign debt in foreign currency is built up. In principle, FDI and portfolio investment in the form of shares can be regarded as external debt, too (liabilities vis-à-vis foreign wealth owners), however the exchange rate risk is born by the foreign investor.

⁸ As a rule of thumb in many instances practitioners regard deficits up to 5 per cent of GDP as tolerable, in particular if they root in non-budget deficits. There is not one glimmer of theory backing such rules. If deficits are considered too high, mostly restrictive macro policies are advised to dampen GDP and imports.

⁹ The Asian crisis in 1997 and the Russian crisis in 1998 are good examples among many for the effects pointed out. In both cases the central bank could not help and the financial systems broke down. For an overview of such twin crises cp. Kaminsky/Reinhart (1999).

¹⁰ Such strong devaluations are predominantly real devaluations which increase the real burden of external debt as well as domestic debt in foreign currency in the case of debt dollarisation.

¹¹ Even worse is the predominant fact that long term credit is often not available.

¹² High market determined interest rates in liberalised credit markets lead to a distorted credit allocation as good debtors drop out and risk prone debtors are selected (Stiglitz 1992). This effect is usually not discussed when the liberalisation of financial systems is recommended.

¹³ Hence we disagree with Easterly and others that physical investment is irrelevant for long-run growth because they assert that only technical progress drives growth. This assumes the notion of disembodied technical progress which is a rare phenomenon in reality.

¹⁴ Keynes (1937) developed similar arguments and the modern circuit models drawing on Schumpeter and Keynes see banks as necessary 'circuit starters' for investment and production (Bossone/Abdourahmane 2002).

¹⁵ In Russia, the highly in foreign currency indebted banking system was nearly wiped out in the currency crisis in 1998.

¹⁶ Even if the estimated amount of non-performing loans is deducted, the ratio is outstanding in the developing world.

¹⁷ We certainly do not claim that a stable and accepted currency is the only factor for development. Human capital, innovative entrepreneurs, rule of law etc. are also of eminent importance. But without stable domestic money these factors cannot unfold their positive effects.

¹⁸ Here the term development is used in the sense of sustained growth. We are, of course, well aware that development is more than just growth.

¹⁹ GDP per capita grew in the 1990s in low income countries (unweighted average) by – 0.5 per cent and by 1.4 per cent in lower middle income countries (Herr/Priewe 2004, p. 84; the figures refer to 100 out of 117 countries in these categories because of data availability. The data are based on the World Bank Indicators.)

²⁰ For a long time Paul Davidson has been arguing for more stable exchange rates (1982).

²¹ Keynes proposed three obligatory options for severe surplus countries: a) increasing imports from clearing union member countries, b) additional FDI and c) unilateral capital transfers to deficit countries.

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