Working Paper No. 533

The Discrete Charm of the Washington Consensus

by

Jan Kregel
Senior Scholar Levy Economics Institute of Bard College,
Center for Full Employment and Price Stability, Kansas City,
and Tallinn University of Technology

April 2008

The Levy Economics Institute
P.O. Box 5000
Annandale-on-Hudson, NY 12504-5000
http://www.levy.org

ABSTRACT

Over the last two centuries in Latin America a Washington Consensus development strategy based on integration in the global trading system has dominated both domestic demand management and industrialization "from within." This paper assesses the performance of each from the point of view of the impact of external conditions, and the validity of its underlying theory. It concludes by noting that replacing the Consensus will require not only reform of the international financial architecture but also a return to the integrated policy framework represented in the Havana Charter.

Keywords: Development Finance; Latin American Development Policy; Ragnar Nurkse; Development Economics; Employer of Last Resort

JEL Classifications: B31, O11, O14, O16, O23

ALTERNATING DEVELOPMENT STRATEGIES IN LATIN AMERICA

Latin America has experimented with two different development strategies over the last two centuries. During the first hundred years of its independence, Latin America pursued increasing integration into the international trading system via an "outward-oriented" development strategy based on exports of primary commodities, in conditions of open and volatile external capital inflows leading to periodic financial crises. The results were generally positive and, at the beginning of the First World War, per capita income in Argentina (the most advanced Latin American economy) exceeded that of France, Germany, Italy, and Spain; per capita GDP for the region as a whole exceeded that of Japan, and was around three times the average for the rest of East Asia.

However, the policy faltered as the U.S. economy replaced the UK as the motor of global demand and finally became unsustainable in the face of the collapse of primary commodity prices and developed-country trade restrictions during the 1930s depression. As a response to the collapse of external markets for its exports and the subsequent interruptions of transatlantic trade during the Second World War that cut off essential imports of industrial goods from Europe, domestic industrialization from within (*desde dentro*) was the natural response. This policy emphasized the importance of domestic demand in building domestic industry to replace European imports and eventually came to be called "import substitution industrialization," as protection of domestic industry from foreign competition was substituted for the natural protection of the war years. Similar to the experience of European reconstruction, Latin America also experienced "economic miracles" of extremely rapid growth under these policies. For the 21 years from 1950 to 1970, the eight major Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay, and Venezuela) grew at an annual average rate in excess of 5.25 percent with per capita incomes growing at over 2.36 percent. In Brazil, the increase in per capita income was over 3 percent.

However, this domestic development strategy in its turn proved to be ill-suited to the increased globalization of financial flows that occurred in the 1970s after the breakdown of the Bretton Woods system. The recycling of petrodollars produced a sharp increase in external borrowing that led to the debt crisis, hyperinflation, and the "lost decade" of the 1980s. The resolution of the crisis through the Brady Plan required the introduction of measures that would attract private international capital flows sufficient to repay the outstanding debts. This was achieved by a return to the 19th century strategy based on open trade via the elimination of internal development institutions to allow comparative advantage trade financed by external resources to act as an engine of growth. These policies, characterized as “neoliberal,” were codified in the Washington Consensus, enunciated by Williamson (1989) as the solution to the problems of the lost decade. However, the revival of the outward-oriented, export-led development strategy has not provided growth rates similar to the postwar period of domestic industrialization from within, because many economies in the region have been plagued by a return of financial crises similar to those of the 19th century.

ACADEMIC SUPPORT FOR THE ALTERNATING DEVELOPMENT STRATEGIES IN LATIN AMERICA

This shift in development strategy in response to the 1980s debt crisis has also been accompanied by a shift in academic opinion on the appropriate strategies to be followed by developing countries. This shift mirrored the change in academic opinion in developed countries away from the successful Keynesian policies that had provided high levels of growth and unemployment in the 1960s, to the counterrevolution that brought monetarism to the fore to fight inflation in the 1970s, and finally to a return of pre-Keynesian classical economics in the 1980s. Thus, in both development policy and economic theory the return to pre-Keynesian orthodox positions won out against what came to be considered as “deviations” from orthodoxy. The deviation of Keynesian demand management from the efficiency of markets and the deviation of managed trade to support domestic industrialization from the efficiency of international markets based on comparative advantage were both rejected in favor of a return to classical orthodoxy.

Although economists working within the UN system (such as Raul Prebisch, Celso Furtado, Hans Singer, and Arthur Lewis) building on the success of the autochthon Latin American policies in the 1950s and 1960s sought to formulate an alternative approach based on the specific problems facing the Latin American region, the dominance of this position was short lived. Almost a decade before the pronouncement of the Washington Consensus, Deepak Lal had attacked what was by then considered the "traditional" development economics of those seeking specific policy solutions for developing economies as mere "theoretical curiosities" based on a perversion of orthodox economic principles held to be applicable in developing economies only, and that they "falsely deny the universal applicability of rational economic behavior … on which standard economic theory relies for its results."[2] Even worse, in Lal's view, these economists had argued that the policies of domestic industrialization were based on the argument that the "case for free trade is invalid for developing economies."

It is important to recognize that Lal was simply applying to traditional development theory that which was basically Keynesian, the "counter-revolution" against Keynesian economics proposed by Milton Friedman and Harry Johnson, supported by the political revolution led by Margaret Thatcher and Ronald Reagan.[3] Set off by Little, Scitovsky, and Scott's 1970 OECD study of trade and industry in developing countries that provided strong criticism of the impact of protection on growth, and extended by the work of Anne Krueger (1974) on perverse rent seeking incentives created by industrial protection, the counter-revolution called for a removal of the state from active participation in economic decision making, opening of domestic markets to external competition, and deregulation of domestic markets as the basis for eliminating the errors and inconsistencies in government regulations in support of development. Since "import substitution industrialization" was generally believed to be little more than extensive government protection of inefficient state monopolies, Latin America obviously was also ripe for counter-revolution.

Thus, when Williamson (2002) proposed the Consensus he was correct that it contained nothing novel, but was based on "ideas that had long been regarded as orthodox so far as OECD countries are concerned." The Consensus was also meant to counter what Williamson (2002) characterized, echoing Lal's earlier assessment of traditional development theory, as "a sort of global apartheid which claimed that developing countries came from a different universe." The implication was that the difficulties faced by Latin American economies in the 1980s were

[2] This attack was made not in an academic article, but in a political pamphlet (Lal 1983).
[3] Toye (1993) refers to a famous article by Harry Johnson heralding Friedman's theory as a "counter-revolution" against the Cambridge (UK) dominance of macroeconomic and monetary theory.

largely the result of the failed attempt by traditional development economists to formulate and apply policies that were specific to the context of the region. Following Lal, the further implication of the Consensus was not only that there was no need for a specific approach to the problems of development in Latin America, but that there was no need for a special theory of economic development—orthodox trade theory and policy were all that was required.[4]

THE LONG HISTORY OF THE WASHINGTON CONSENSUS

Indeed, reliance on orthodox policy from developed countries had been part of the Latin American experience in the 19th century and it was not uncommon in this period for business and financial circles to encourage their governments to employ experts from developed countries to formulate domestic policy.[5] Chile and Mexico are outstanding examples.

A similar approach can even be found in the early development policy of the United Nations. An economist working on development policy for the UN in its formative years has noted that "most of us …felt that economic problems are economic problems wherever they happen to be. You wanted to know the facts of a particular country and situation, of course, but detailed knowledge of a particular country wouldn't make much difference as to exchange rate policy or the investment situation or trade regulations and so on."[6]

Williamson also notes that the Washington Consensus was only a faithful rendition of the policy approach accepted by official circles in Washington. This was also correct, for almost a decade earlier the U.S. representative to the Asian Development Bank had declared that "the United States completely rejects the idea that there is such a thing as development economics."[7] Thus, not only did Latin America not require a special theory of development, there was no such thing as "development economics" that could provide a basis for policies to support

[4] Providing a perfect example of what Hirschman (1981) called "monoeconomics."
[5] In the mid-19th century, Courcelle-Seneuil was hired as a consultant to the Chilean Ministry of Finance to formulate European policy and made professor in the University of Santiago to train young economists to implement it. In Mexico, under Porfirio Diaz, the new economists also introduced liberal European policies. By the turn of the century the United States was sending economists such as Princeton Professor Edwin Kemmerer to formulate policies throughout Latin America as the United States wrested dominance in the region from Europe.
[6] John Coppock, a U.S. State Department economist from the UN Oral History Project, cited in Toye and Toye (2004, p. 26 and note 47).
[7]Cited in Toye (1993, p. 94).

development.

It is also important to note that it was not only in downtown Washington that these policies were commonly accepted; they had been proposed by influential Latin American business and commercial interests since the late 1960s. In Mexico, Coparmex[8] (representing the financial banking elite and Monterrey business interests) presented its own seven-point program for the new Eceverria government to adopt as early as 1971. Although the recommendations were not implemented, they provided the framework for the policies that were eventually introduced in the late 1980s by the Salinas government. The program included :

- reprivatization of the state controlled enterprises;
- an end to all state subsidies to state firms;
- an increase in direct foreign investment; and
- an end to all land reform programs and a "reorganization" of the countryside.

In Brazil in 1961, Jânio Quadros, successor to the populist Kubischek government, received a set of suggested economic policy measures (*Sugestões para uma politica nacional de desemvolvimento)* from Conclap that reaffirmed the primary role of the private sector and foreign investment in the development process, the reduction of the role of the state, the control of populist tendencies, the redefinition of the role of the state, control of inflation, and an improvement in the public administration (see Dreifuss 1981). When Quadros resigned, he was replaced by Joao Goulart who had defeated Quadros's running mate in the election. When he indicated his intention to return to the previous popularist policies, the military intervened, but did not proceed with the implementation of the suggestions from Conclap.

In 1976, the *Consejo Economico Argentino* produced a comprehensive economic program for the new military government, the *Proceso de Reorganización Nacional* (see Fuchs and Vélez 2002). It was based on three points:

[8]Coparmex had 15,000 affiliated members in 1986. The businesses controlled by members employed two million workers—that is, 24 percent of the full-time, private-sector jobs in Mexico, cf. Cypher (1990, p. 100).

- redefining the role of the state and reducing its role in the economy;
- the liberalization, opening, and modernization of the economy; and
- monetary stability.

As in Brazil and Mexico, the program was not instantly accepted by the new military government, but became the background for policy discussion and eventually became the basis for government policy when democratic governments returned (see FIEL 1988).

ASSESSING THE SUCCESS AND FAILURES OF THE POLICY ALTERNATIVES

There are two possible ways of assessing the relative success and failures of the Washington Consensus policies and those of domestic industrialization in the Latin American experience. One view would emphasize the importance of changing external conditions in the global economy, in particular the interrelation of Latin America with industrialized countries, on the results of the two strategies. The other would be to assess the academic argument that there is only one correct policy approach for all conditions and countries, and that the preordained failures of heterodox policy alternatives eventually required a return to orthodox policies.

Alternative Explanations of the Failure of Domestic Development Strategies

While Prebisch and his associates in Economic Commission for Latin America (Prebisch 1950) and the United Nations Conference on Trade and Development (UNCTAD 1964) were very critical of import substitution policies as they were practiced in Latin America, the positive performance of over a quarter century appears more than a mere deviation and thus raises the question of why performance deteriorated in the 1970s and 1980s?

Two important events changed the conditions facing developing countries in the last half of the twentieth century. The first was the breakdown of the Bretton Woods stable exchange rate system based on the premise that private international capital flows would be minimal. The move to more open international capital markets and floating exchange rates that occurred in the early 1970s was accompanied by official encouragement of increased private international capital flows to provide investment outlets for the large surpluses of petroleum producers, as well as by domestic policies that encouraged capital imports. During and immediately after the war, Latin American countries reduced their defaults on U.S. dollar bond issues from over $1.5 billion to $127 million and new inflows remained modest and were primarily from official sources or direct investments of U.S. companies in petroleum, mineral extraction, and public utilities (some of which were nationalized in the 1960s). Between 1947 and 1952, U.S. direct investment increased by around $400 million per annum, although well over half of this amount was reinvestment of earnings. After the liberalization and deregulation of international capital markets in the mid-1970s, Latin American economies accumulated much larger amounts of private debt in the form of private bank lending and portfolio flows. When economies pursuing domestic industrialization strategies based on external protection borrow from private international capital markets to finance their domestic industrialization programs these funds are used to support investment in domestic industries that supplant imports, usually of consumption goods. The inflows thus have little immediate, in any, impact on exports, while they increase imports, causing an initial deterioration in the trade balance. However the capital inflows also create external payment commitments in the form of debt service that can only be paid by increasing exports. External financing of import-substituting investment, if successful, may improve a country's net trade balance in the long run, but it initially does not generate any additional foreign exchange earnings to meet debt service. In addition, increased domestic investment in consumption goods production will increase imports of foreign capital goods and the resulting increase in activity may stress domestic supply, also increasing imports of consumption goods and putting pressure on prices.

A rapid increase in external financing (much of which was not used for import substitution at all), such as the one that occurred in the 1970s, places a heavy burden on a country's balance of payments that can only be financed by increased foreign borrowing. This appears to have been the case in Latin America in the 1970s as increased borrowing was used to meet increasing debt service in a sort of Ponzi scheme. The process remained sustainable until the October 1979 Volcker surprise in U.S. monetary policy that increased the interest payments on foreign borrowing and caused an appreciation of the dollar that increased the domestic burden of dollar denominated loans and, at a stroke, drove most countries to insolvency. The problems that were faced by import substitution industrialization were caused as much by the inappropriate and potentially incendiary mix of financing domestic import substitution industrialization through private external financial flows as in the inherent difficulties in building sufficiently large domestic markets to support competitive domestic industry and avoid rent-seeking behavior.

In any event, the policy became untenable in the face of the insolvency created by the large external claims and the failure to recognize this insolvency through default. The reforms that were introduced in a number of highly indebted economies in Latin America at the end of the 1980s were thus promoted by the industrial countries to avoid default that would have rendered the developed country lending banks insolvent given that their exposure to Latin America was a multiple of their capital. After attempts to generate external surpluses sufficient to meet external obligations and avoid default led to a sharp decline in growth and placed political stability in jeopardy, the Brady Plan sought a combination of debt relief and the creation of conditions that would allow the indebted countries to return to international capital markets to borrow the funds needed to meet the remaining debt service.

The new policy had two main objectives. The first, driven by the counter-revolution against heterodox policies, was to introduce increased efficiency and profitability into the previous state-dominated systems by expanding the role of the market in economic decision making. This required eliminating inflation and other sources of distortion of market prices, such as protection of domestic producers and subsidies to state enterprises. This was achieved by introducing policies that restricted the growth of the money supply, opened domestic markets to foreign competition, privatized state-owned industries, and government spending reductions to reduce or eliminate government budget deficits.

The second objective was to create conditions to allow countries to return to international capital markets in order to refinance the remaining external debt and provide additional savings to finance growth. This was achieved by liberalizing capital inflows, allowing the sale of privatized government activities to foreigners, deregulation of domestic financial systems, and the creation and support of domestic financial markets. It was assumed that if these objectives were satisfied, the high expected rates of return offered by investments in the region would be sufficient to generate higher investment, employment, and growth.

The two main objectives were rapidly attained in most countries in the region that embarked on these policies. While there was widespread agreement that the new policies were more efficient than expected in eliminating inflation, even Williamson (2002) admits that the results "have been disappointing ... particularly in terms of growth, employment, and poverty reduction." Ironically, these are the same failings of import substitution that the new policies were supposed to resolve.

There is, however, less agreement on the reasons for these disappointing results. Williamson (2002) has repeatedly noted that his original codification of the Washington Consensus reforms did not include using "the exchange rate as a nominal anchor" nor "opening the capital account prematurely," which would "let money flood in" and cause overvaluation of the currency, in contradiction to the Consensus' recommendation of keeping a competitive exchange rate.[9] His conclusion is that the series of financial crises that led to lackluster growth in emerging markets in the 1990s were caused by the inappropriate use of nominal exchange rate anchors, premature capital account opening, the neglect of some of the "first generation" reforms—in particular, more rapid labor market liberalization and more active countercyclical fiscal policy—and the failure to introduce "second generation" reforms to strengthen market institutions. In short, the governments were at fault for not applying the Consensus policies appropriately, even though these policies had generally found approval within the multilateral financial institutions and had become the basis of the conditions attached to official lending programs. Indeed, during this period the IMF had considered modifying the Article of Agreement to make capital account convertibility a member-country commitment on a par with current account convertibility.

But this explanation of the disappointing performance begs the question of whether hyperinflation in countries such as Brazil and Argentina, economies with long histories of failed stabilization plans, would have been eliminated if these factors that Williamson identifies as the cause for the failure of the Consensus on the growth and employment front had not been present. In assessing the performance of Latin American economies in the 1990s, debate has been centered on the so-called "two-corner" solution to the question of the appropriate exchange

[9] Although it did allow for liberalization of direct investment inflows which now constitute nearly all of the capital inflows for some Latin American countries, such as Brazil and Mexico, and met around 80 percent of Argentina's external financing needs in the period 1992–2000.

rate regime—fixed or floating—with official opinion supporting the latter, while the original Consensus had side-stepped this choice by advocating "competitive" exchange rates without specifying how this might be achieved.[10]

THE ROLE OF EXCHANGE RATE ANCHORS, CAPITAL FLOWS, AND THE CONSENSUS DISAPPOINTMENT

The question of the appropriate exchange rate regime has bedeviled postwar economic policy from the discussions at Bretton Woods to the failure to find a solution to the large international imbalances that have been built up both before and after the collapse of its exchange rate system.[11] While the so-called corner solution presents a false dichotomy in the context of the specific objective of halting inflation, the intermediate case of managed competitive exchange rates does not appear to offer a solution either. In developing economies, and in particular for economies with histories of hyperinflation, there is in the mind of the public a clear and visible linkage based on past experience between exchange depreciation and inflation. Thus, whatever the particular exchange rate arrangement adopted in support of price stabilization policy—currency board, fluctuation bands, crawling pegs—a credible price stabilization policy must start out with a more or less formal commitment to a nominal exchange rate that is expected to be maintained for a sustained period of time if economic agents are to use it with confidence as a reference for expectation formation concerning the future path of prices. Further, if capital inflows and foreign direct investment are to be encouraged, foreign investors must also be assured of some degree of commitment to maintaining the initial nominal exchange rate in order to ensure their expected rates of return. The same considerations that led the architects of the Bretton Woods system to limit the distortions to international relative prices of traded goods

---

[10] The obvious reference is to Williamson's fundamental equilibrium exchange rate (FEER) proposal (Williamson 1983; Williamson and Miller 1987) to solve the instability of the dollar in the 1980s. This would imply a wide adjustable band around a "sustainable" rate including some estimate of long-term capital flows. The alternative of fixed rates would have required domestic wage and price flexibility, which the Consensus believed to be desirable, but not capable of sufficient control to keep exchange rates competitive. After the Asian Crisis this preference for an intermediate solution is made explicit (Williamson 2000).

[11] The move to flexible exchange rates was supported at the same time and by the same economies who sought the counter-revolution in economic theory and a return to economic orthodoxy. However, the support for flexible rates

caused by excessive exchange rate volatility (and, in some cases, conscious beggar-my-neighbor manipulation) recommended an exchange rate anchor as part of domestic price stabilization policy.

Indeed, the experience of countries experimenting with stabilization policy in the 1990s suggests just how difficult it is, once a stable nominal exchange rate has become embedded in market expectations, to keep exchange rates competitive given the substantial external and domestic forces in favor of nominal stabilization and the accompanying real appreciation. In Argentina there was public opposition to the various proposals to adjust the exchange rate within the currency board, and the government that replaced Menem ran its election campaign on maintenance of the policy. In Brazil in the period before the 1998 election it was clear that any hint of depreciation would quickly rekindle middle-class fears of inflation and reduce the support for any candidate that supported it, while in Mexico the announcement that what was already an adjustable scheme was to become slightly more flexible with the entry of a new government in 1994 was enough to trigger a wholesale collapse of the foreign exchange market.[12] Even after Mexico and Brazil moved to floating exchange rates, they have suffered from periods of sustained overvaluation that have not been corrected by automatic market forces. It is certainly not encouraging that today, with exchange rate flexibility the rule in most countries, the same generalized overvaluation that characterized the early successes of the structural adjustment stabilization policies has returned in all of the regions with the exception of Argentina.

While it certainly would have been possible for governments to unilaterally devalue or adjust fluctuation bands, such a move in the presence of a rapidly declining inflation rate usually generates expectations of future nominal appreciation so that an attempt at devaluation against market sentiment would simply reinforce market expectations of future appreciation and lead to increased speculative capital inflows that would confirm them. If domestic monetary policy objectives are to be maintained, the inflows will have to be sterilized through issue of domestic

---

was on the prior condition of a strict monetary growth rule that would provide price stability. In such conditions flexible exchange rates would provide both automatic international adjustment and stability in exchange rates.

[12] In addition to citizens and politicians, central bankers also have a strong preference for an exchange rate that is stable and under their control, so overvaluation of a stable exchange rate is easy to overlook. If the market evaluates

securities, driving domestic interest rates higher and making domestic securities even more attractive for foreign investors by increasing interest differentials. Thus, foreign investors attracted by rising interest rate differentials and rising domestic profitability have an even greater reason to expect future appreciation of the currency that will further increase their expected returns on investment in the country.

Thus, most all of the heterodox and orthodox stabilization plans experimented with in Latin America in the 1980s and 1990s were grounded in an exchange rate anchor. The real question then is not whether the anchor was necessary, but why the plans introduced in the 1990s were successful when earlier plans had failed. It was characteristic of stabilization plans that the immediate fall in the inflation rate produced an increase in real incomes and an increase in consumption expenditure as consumers sought to benefit from price stability before the expected return of inflation. This, in turn, produced a rise in imports relative to exports and the eventual rise in the external deficit eventually led to a drain on reserves, a collapse of the exchange rate, and a return of inflation. However, in both the case of Brazil and Argentina, the 1990s stabilizations occurred after the economies had taken the Brady Plan measures to attract foreign capital inflows. Foreign capital inflows, in particular direct investment flows attracted by the opportunities of privatized state-owned industry and deregulation, were more than sufficient to cover the rising trade deficits, leading to nominal and real appreciation of exchange rates. The size of external flows thus made it possible to pursue stabilization even in the presence of rising external and internal deficits that previously had defeated the attempts to halt inflation. (see Kregel 1999, 2003).

The return to price stability and the tendency to overvaluation was thus the result of the strong capital inflows that were initiated by the initial success of the Brady process, reinforced by the announcement of Washington Consensus-style reforms, including privatization and trade liberalization. Given the series of failed stabilization attempts and new currencies introduced in the 1980s, it seems clear that the success in eliminating inflation was the result of a reflexive,[13]

---

a government's policy by the faith it puts in a currency, devaluation can only send the market the signal that the government thinks its policies are not adequate, leading to an overshooting that may get out of control.

[13] George Soros (1987) has identified this process as supporting the overvaluation of the dollar in the first half of the 1980s, and the experience of countries such as Brazil and Argentina seem very similar to the process he describes. Just as the U.S. overvaluation was justified by the increased returns available in the United States due to

self-reinforcing, cumulative process driven by direct investment and speculative capital inflows. It is well known that such processes are not sustainable.

As noted above, the new policy was meant to replace the monopoly inefficiencies and rent-seeking of external protection import substitution with market forces to transform microeconomic incentives to create an internationally competitive production structure. However, the rapid reduction in inflation that occurs with successful stabilization policies initially produces an increase in incomes and wealth; in the presence of more open trade this leads to increased imports and a rising current account deficit which can be easily financed by foreign investors who interpret the increased growth as the result of the impact of the reforms in raising domestic productivity and profitability. However, the technological innovation and restructuring associated with the creative aspect of destruction remains stymied by the macroeconomic environment of high interest rates, overvalued exchange rates, and volatile capital flows. Thus, the failure of the Consensus reform policies lies in the fact that they provided support for the "destruction" of inefficient domestic industry, but failed to provide support for the "creative" phase of "creative destruction" of a real transformation of the productive structure through higher investment and technological innovation. The adjustment was to be one patterned after the Schumpeterian process of "creative destruction." Or, as the 2003 UNCTAD *Trade and Development Report* described it, the sound macroeconomic fundamentals required for fighting inflation were not the same as the strong microeconomic fundamentals necessary to transform domestic industry to meet foreign competition and increase exports.

The problem with the Washington Consensus was that its success in eliminating inflation relied on high levels of capital inflows that produced byproducts that were crucial to its success—overvalued exchange rates, open capital markets, high levels of capital inflows—but were not part of the original Consensus and created domestic incentives that impeded the domestic restructuring required to provide improved growth and employment. Further, the disappointing performance of Latin American countries after the initial success in taming inflation has been due to the failure to provide a transition from inflation-fighting adjustment

---

the introduction of supply-side policies, in Latin America it was suggested that overvaluation was, in reality, only a reflection of the higher rates of return resulting from the market-based policy reforms.

policies to employment and growth-creating adjustment policies because of the difficulty in producing competitive exchange rates.

The rapid improvement in the external accounts of many countries in the region, due to expanding markets and rising prices for primary products, has not made the process of providing a transition in policy any easier, for current account surpluses now join capital inflows in putting pressure towards appreciation. The Consensus calls on countries to maintain competitive currencies, but in the absence of exchange controls on capital inflows, this has proven to be extremely difficult to achieve in practice and if achieved risks creating a flight from the currency that would jeopardize the stability that has been achieved. Indeed, Williamson himself has now suggested that control of capital flows might be required, without realizing that had they been applied initially they would have diminished the success in stabilizing inflation.

An additional difficulty that has been created by the failure to achieve a transition to employment and growth-creating policies is the impact that it has had on domestic investment and financial systems. The continued existence of large external debt stocks and the use of interest rate policies in the context of inflation targeting have led to conditions in which the return on the increasing supply of safe government assets far exceeds the return on investment in transforming the domestic production structure. As an example, fixed interest rates on five-year government securities (NTNF 2010) earned holders 17% per annum in 2005, while large companies such as the Pão de Açúcar group and AmBev reported a return on equity of 6.3% and 9.1%, respectively, for the year. Others such as Braskem (operating in petrochemicals) or Klabin (one of the largest paper producers) had returns of 14.9% and 14.7%, respectively; in telecommunications, Embratel showed a return of 3.9% (d'Amorim 2006). The same interest differentials that produce large capital inflows and currency overvaluation create interest differentials in favor of financial assets rather than domestic corporate restructuring to increase productivity to offset the decline in competitiveness caused by the overvaluation of the exchange rate.

The same is true of banks who find it more profitable to hold indexed government bonds than to make commercial loans to the productive sector. This has produced banking systems that are solid, but whose asset portfolio is dominated by loans to the government rather than loans to the private industrial sector in support of domestic restructuring. What additional lending that is done tends to be for consumer credit or for house mortgages.

Finally, the impact of the highly overvalued exchange rate simply aggravates these problems. A study of 110 stock exchange listed firms in Brazil shows that industries most exposed to exchange rate variation (such as paper, cellulose, chemicals, and transport) have suffered earnings declines due to the overvaluation of the real (Mandl 2006).

These results also suggest that one of the major reasons for the failure of the Consensus to provide the basis for industrial transformation and recovery has been its success in reducing inflation, creating the paradox of providing stability to the financial system, while at the same time reducing its contribution to financing the industrial system.

Thus, just as the sharp increase in external capital inflows provided financing for the continuation of rapid growth under import substitution, but eventually led to unsustainable external imbalances, the return of capital inflows after the lost decade provided the needed support to eliminate hyperinflation, but eventually led to domestic conditions that impeded domestic investment to provide restructuring to increase productivity and competitiveness, as well as to provide support for a return to growth and employment. It is ironic that the recent return of external surpluses in most countries in the region has been due to the rapid increase in global demand and prices for their primary commodities reinforcing the domestic deindustrialization that was produced by the "right" macroeconomic policies, rather than microeconomic industrial restructuring.

The experience of the 20th century thus leads to the conclusion that opening to external capital inflows has been one of the major causes of the demise of both import substitution and the Washington Consensus policies—with the difference that had the latter employed policies to manage capital inflows it would not have been able to achieve success in eliminating inflation, much less increase growth and employment.

THE ACADEMIC CASE FOR FREE CAPITAL FLOWS

It is interesting that the support in orthodox theory for free international capital flows that has caused so much difficulty for both approaches to development is based on an unsupported assumption and a recognized theoretical error. It is a generally accepted assumption that there is an unequal distribution of resources across countries, so that welfare could be improved by a more equitable distribution of global resources. This position is an axiom of development theory—developing countries lack financial resources, such as domestic savings, and thus require foreign capital inflows in order to further their development.[14] This means that developing countries are characterized by excess labor resources and deficient capital resources—thus, the relative return to capital is high relative to the return to labor compared to developed countries, where the opposite is true. The theoretical argument put forward to justify free capital flows was thus made in these terms by Viner (1947, p. 98):

> "The basic argument for international investment of capital is that under normal conditions it results in the movement of capital from countries in which its marginal value productivity is low to countries in which its marginal value productivity is high and that it thus tends toward an equalization of marginal value productivity of capital throughout the world and consequently toward a maximum contribution of the world's capital resources to world production and income."

Viner's argument is predicated on the assumption that the free flow of capital to developing countries would move them down their declining marginal productivity of capital curve. Although the criticisms of the marginal theory of distribution were not yet common, Viner's explanation did not go unchallenged by early development economists. Counterarguments were provided by both Singer (1964, pp. 19–22) and Nurkse (1953), among others. Both suggest that increasing returns, rather than decreasing returns, reign in manufacturing and thus, in opposition to Viner and most neoclassical theorists, that the return on investment is higher in developed countries.

While this is a question of fact, there is a stronger theoretical argument that challenges Viner's position that relies on a negative, monotonic relation between capital intensity and rate of return, and that capital intensity can be measured independently of the rate of return on capital. However, after the Cambridge controversies in capital theory, we now know (Harcourt

[14] Paradoxically, this position is not reflected in "traditional" development theory, which emphasized the lack of ability to employ resources to increase real wages and per capita incomes through improved technology. Most were skeptical of the role that foreign resources could play in the development process.

1971) that there is no specific relation between capital intensity and rate of return that is fully general because it is impossible to define an unambiguous measure of capital intensity that is independent of the rate of return on that capital. Indeed, there is little empirical evidence that foreign financial inflows increase domestic investment. There is some evidence, however, that foreign capital inflows in Latin America bring about an increase consumption, rather than investment, as noted in the early periods of successful price stabilization policies. If there is no relation between the complement of capital resources and the rate of return on capital, the justification for free capital movements to ensure a more equal distribution of capital across countries and a high rate of global growth has no theoretical basis. It must be sought elsewhere.

BACK TO THE BRETTON WOODS DRAWING BOARD OR BACK TO HAVANA?

As noted above, traditional development economists have always considered that the basic problems facing developing countries have been in their inability to mobilize their abundant labor and natural resources (Kregel 2004) effectively due to domestic deficiencies such as the absence of organizational or entrepreneurial ability (e.g., Hirschman 1958) or due to systemic problems caused by the organization of the international trade and financial system (e.g., Prebisch), rather than to a lack of resources. The primary systemic difficulties were in the area of trade and the first UNCTAD conference produced a plea to provide preferential treatment to developing countries to allow them to break out of the unequal exchange represented by the declining terms of trade between developed and developing countries. Other development economists less convinced by this thesis argued that comparative advantage was an inappropriate theoretical basis for development policy (Nurkse 1953) or that the orthodox explanation of the operation of market stabilization should be replaced by a process of cumulative causation (e.g., Myrdal, Kaldor). All these positions led to the fact that developing countries should engage in policies to move from reliance on the exports of primary products to managing trade so as to build up domestic industrial sectors. Erik Reinert (2007) convincingly argues that this is not, in fact, a deviation from orthodoxy, but is the policy that has been followed by every successful developing country since the Henry VII in England![15]

Thus, while the specification of the international financial system is an important part of the development process, it should be remembered that the aim of the Bretton Woods system was to insure that exchange rate movements did not interfere with the operation of the free movement of goods and services based on relative international prices. The international financial system was thus to be the handmaiden of the system of free trade in goods and services that many development economists saw as the basis for the systemic impediments to development. Keynes himself recognized the importance of combining measures in the area of international trade with the purely financial aspects of the international system, as shown by his support for an international commercial union to accompany his proposal for a clearing union, and the importance of commodity stabilization funds because they could be used to support global demand. It was impossible to separate measures on the trade front from measures on the international financial system. However, the important point is not so much the imbedded liberalism or the promotion of the diversity of national policies implicit in Keynes's proposals for a new global order, but rather their different objective.

The results at Bretton Woods were in support of the U.S. decision to establish an open, multilateral trading system based on most-favored-nation principles—a decision accepted by Churchill in Article 21 of the Atlantic Charter in exchange for U.S. support of the UK in the war with Germany. Given this constraint, Keynes's objective was to ensure that the international trade and financial system would not constitute an impediment to global demand sufficient to allow full employment.

However, from the point of view of developing countries, neither position was appropriate to their circumstances. When the third pillar of the Bretton Woods system—an international trade organization to deal with commercial policy to accompany the IMF and the IBRD—was being debated at the UN Conference on Trade and Employment in Havana, developing countries made a plea for exemption from the same requirements as developed countries in regards to opening their domestic markets to developed country manufactured goods (WTO 2002). This was basically because they wanted to use protection, not as a means to

[15] Reinert's research on the history of development policy also suggests that it is the orthodox theory and policy that is the deviation from tradition.

support domestic employment, but as a means of creating a domestic manufacturing sector. At the same time, the UK, Canada, and Australia—countries that had been part of the Ottawa preferential trading systems in support of full employment—argued that policies to ensure full employment were a prerequisite to ensuring gains from trade for all countries.[16] Both of these exigencies were reflected in the Havana Charter. However, by the time it came to approval by the U.S. Congress, opinion had moved beyond the 1944 Employment Act and there was strong opposition to any exemptions for developing countries or further strengthening the commitments to government guarantees of full employment. The Havana Charter that blended the aims of full employment and domestic industrialization for developing countries was sacrificed on the altar of the universal application of free trade to all countries. It is thus to this more comprehensive representation of Keynes's views and the exigencies of development that the response to the Washington Consensus is to be found.

Finally, the importance of the clearing union proposal is not only in its elimination of the negative impact of asymmetric adjustment on employment policy, but in the fact that it would have made real the intentions of both the U.S. and the UK to limit the private international flows of capital. It would also have eliminated the debt problems that are faced by many developing countries by limiting the size of the surpluses that could be run by developed countries in their trade with developing countries. Thus, the negative impact of free capital flows on the development process, as well as the buildup of large international indebtedness, would have been eliminated.

[16] It is interesting that James Meade was largely responsible for the UK proposal for a Commercial Union and its representation in Havana where the UK tried to reintroduce the importance of Keynes's position at Bretton Woods by arguing that all countries could benefit from opening to trade if they were on their production possibilities curve (i.e., were at full employment). Thus, the name of the Havana Conference.

REFERENCES

Cypher, James. 1990. *State and Capital in Mexico—Development Policy since 1940*. Boulder, San Francisco, and Oxford: Westview Press.

d'Amorim, Sheila. 2006. “Juro rende mais a empresas do que produção.” *Folha de S. Paulo,* March 12.

Dreifuss, Rene Armand. 1981. *1964: A Conquista do Estado—Ação, Poder e Golpe de Classe*. Petropolis: Editora Voces.

FIEL. 1988. *Los Costos del Estado Regulador*. Buenos Aires: Ediciones Manantial.

Fuchs, Jaime, and José Carlos Vélez. 2002. *Argentina de rodillas.* Buenos Aires: Tribuna Latina Americana.

Harcourt, Geoffrey C. 1971. *Some Cambridge Controversies in the Theory of Capital*. Cambridge: Cambridge University Press.

Hirschman, Albert. 1958. *The Strategy of Economic Development*. New Haven, CT: Yale University Press.

————. 1981. *Essays in Trespassing*. Cambridge: Cambridge University Press.

Kregel, Jan. 1999. “Alternative to the Brazilian Crisis.” *Revista de Economia Política—Brazilian Journal of Political Economy* 19(3): 23–38.

————. 2003 “An Alternative View of the Argentine Crisis: Structural Flaws in Structural Adjustment Policy.” *Investigacion Economica* January–March(243): 15–49.

————. 2004. “Two Views on the Obstacles to Development.” *Social Research* 71(2): 279–292.

Krueger, Anne. 1974. “The Political Economy of the Rent-Seeking Society.” *American Economic Review* 64(June): 291–303.

Kuczynski, P.-P. 2003. *After the Washington Consensus: Restarting Growth and Reform in Latin America*. Washington, D.C.: Institute for International Economics.

Lal, Deepak. 1983. *The Poverty of Development Economics.* London: Institute of Economic Affairs, Hobart Paper # 16.

Little, Ian, Tibor Scitovsky, and Maurice Scott. 1970. *Industry and Trade in Some Developing Countries: A Comparative Study*. Published for the Development Centre of the Organization for Economic Co-operation and Development. Oxford: Oxford University Press.

Mandl, Carolina. 2006. "Balanços revelam queda de lucros por efeito do câmbio." *Valor*, March 28.

Nurkse, Ragnar. 1953. *Problems of Capital Formation in Underdeveloped Countries.* New York: Oxford University Press.

Prebisch, Raul. 1950. *The Economic Development of Latin America and its Principal Problems*. New York and Geneva: UNECLA.

Reinert, Erik. 2007. *How Rich Countries Got Rich...and Why Poor Countries Stay Poor*. London: Constable and Robinson.

Singer, Hans. 1964. "An Example of the New Pragmatism: Towards a Theory of Pre-investment." in *International Development: Growth and Change*. New York: McGraw-Hill.

Soros, George. 1987. *The Alchemy of Finance.* New York: Simon and Schuster.

Summers, Lawrence. 1998. "Deputy Secretary Summers Remarks before the International Monetary Fund." U.S. Government Press Release, 2286. March 9.

Toye, John. 1993. *Dilemmas of Development,* 2nd edition. Oxford: Blackwell.

Toye, John, and Richard Toye. 2004. "The UN and Global Political Economy." *United Nations Intellectual History Project*. Bloomington, IN: Indiana University Press.

United Nations Conference on Trade and Development (UNCTAD). 1964 "Report of the Secretary General." New York and Geneva: United Nations

————. 1998. "Anatomy of the Crises in the Post-Bretton Woods Period." *Trade and Development Report, 1998*. New York and Geneva: UN.

————. 2003. *Trade and Development Report, 2003, Part II: Capital Accumulation, Growth and Structural Change*. 57-149.New York and Geneva: UN

Viner, Jacob. 1947. "International Finance in the Postwar World." *Journal of Political Economy* 55(April): 98.

Williamson, John. 1983. "The Exchange Rate System." *Policy Analyses in International Economics* 5. Washington, DC: Institute for International Economics.

————. 1989. "What Washington Means by Policy Reform." in J. Williamson (ed.), *Latin American Adjustment: How Much Has Happened?* Washington, D.C.: Institute for International Economics.

————. 2000. "Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option." *Policy Analyses in International Economics* 60(September). Washington, DC: Institute for International Economics.

————. 2002. "Did the Washington Consensus Fail?" Outline of remarks at the Center for Strategic & International Studies, November 6. Available at: http://www.iie.com/publications/papers/paper.cfm?ResearchID=48.

Williamson, John, and Marcus H. Miller. 1987. "Targets and Indicators: A Blueprint for the International Coordination of Economic Policy." *Policy Analyses in International Economics* 22(September). Washington, DC: Institute for International Economics.

World Trade Organization, Working Group on Trade, Debt, and Finance (WTO). 2002. "The Effects of Financial Instability and Commodity Price Volatility on Trade, Finance, and Development." WT/WGTDF/W/5/Rev.1 31 July 2002 (02-4229). Communication from UNCTAD.