Reconsidering the "Washington Consensus" in the 21st Century

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The "Washington consensus" has become a hissing and a buzzword over time.

The usual implication is that free-market zealots in Washington, DC, told developing countries around the world that they would thrive if they followed free-market policies, but when developing countries tried out these policies, they were proven not to work. William Easterly, who has been a critic of the "Washington consensus" in the past, offers an update and some new thinking in "In Search of Reforms for Growth New Stylized Facts on Policy and Growth Outcomes" (Cato Institute, Research Briefs #215, May 20, 2020). He summarizes some ideas from his NBER working paper of the same title (NBER Working Paper 26318, September 2019)/

Before discussing what Easterly has to say, it's perhaps useful to review how the "Washington consensus" terminology emerged. The name traces back to a 1989 seminar in which John Williamson tried to write down what he saw as the main steps that policy-makers in Washington, DC, thought were appropriate for countries in Latin America facing a debt crisis. As Williamson wrote in the resulting essay published in 1990:

No statement about how to deal with the debt crisis in Latin America would be complete without a call for the debtors to fulfill their part of the proposed bargain by "setting their houses in order," "undertaking policy reforms," or "submitting to strong conditionality."

The question posed in this paper is what such phrases mean, and especially what they are generally interpreted as meaning in Washington. Thus the paper aims to set out what would be regarded in Washington as constituting a desirable set of economic policy reforms. ... The Washington of this paper is both the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve Board, and the think tanks. ... Washington does not, of course, always practice what it preaches to foreigners.

Here's how Williamson summed up the 10 reforms he listed in a follow-up essay in 2004:

1. **Fiscal Discipline.** This was in the context of a region where almost all countries had run large deficits that led to balance of payments crises and high inflation that hit mainly the poor because the rich could park their money abroad.

2. **Reordering Public Expenditure Priorities.** This suggested switching expenditure in a progrowth and propoor way, from things like nonmerit subsidies to basic health and education and infrastructure. It did *not* call for all the burden of achieving fiscal

discipline to be placed on expenditure cuts; on the contrary, the intention was to be strictly neutral about the desirable size of the public sector, an issue on which even a hopeless consensus-seeker like me did not imagine that the battle had been resolved with the end of history that was being promulgated at the time.

3. **Tax Reform.** The aim was a tax system that would combine a broad tax base with moderate marginal tax rates.

4. **Liberalizing Interest Rates.** In retrospect I wish I had formulated this in a broader way as financial liberalization, stressed that views differed on how fast it should be achieved, and—especially—recognized the importance of accompanying financial liberalization with prudential supervision.

5. **A Competitive Exchange Rate.** I fear I indulged in wishful thinking in asserting that there was a consensus in favor of ensuring that the exchange rate would be competitive, which pretty much implies an intermediate regime; in fact Washington was already beginning to edge toward the two-corner doctrine which holds that a country must either fix firmly or else it must float "cleanly".

6. **Trade Liberalization.** I acknowledged that there was a difference of view about how fast trade should be liberalized, but everyone agreed that was the appropriate direction in which to move.

7. **Liberalization of Inward Foreign Direct Investment.** I specifically did not include comprehensive capital account liberalization, because I did not believe that did or should command a consensus in Washington.

8. **Privatization.** As noted already, this was the one area in which what originated as a neoliberal idea had won broad acceptance. We have since been made very conscious that it matters a lot how privatization is done: it can be a highly corrupt process that transfers assets to a privileged elite for a fraction of their true value, but the evidence is that it brings benefits (especially in terms of improved service coverage) when done properly, and the privatized enterprise either sells into a competitive market or is properly regulated.

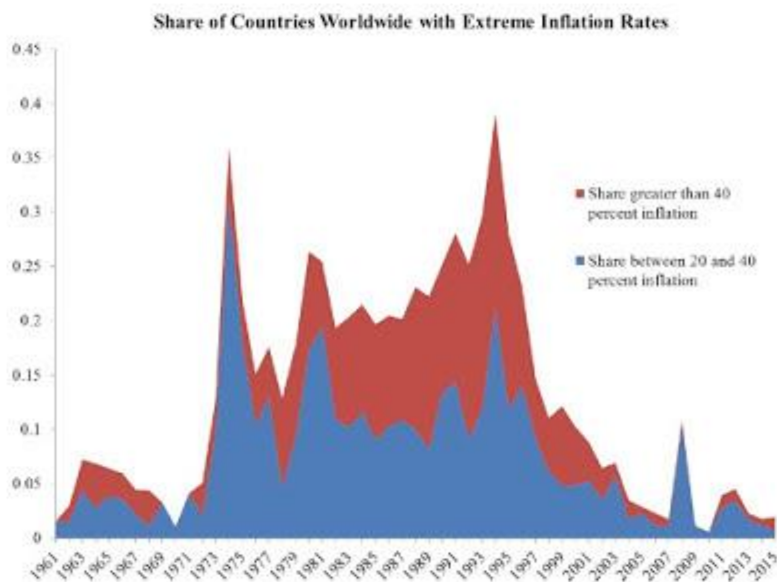
9. **Deregulation.** This focused specifically on easing barriers to entry and exit, not on abolishing regulations designed for safety or environmental reasons, or to govern prices in a non-competitive industry.

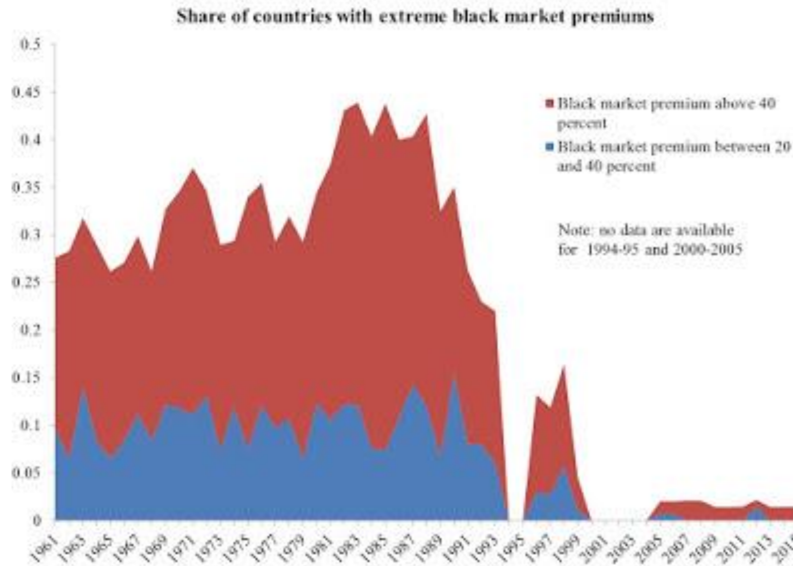
10. **Property Rights.** This was primarily about providing the informal sector with the ability to gain property rights at acceptable cost (inspired by Hernando de Soto's analysis).

There are really two main sets of complaints about the "Washington consensus" recommendations. One set of complaints is that a united DC-centered policy establishment was telling countries around the world what to do. The other complaint was that the recommendations weren't showing meaningful results for improved economic growth in countries of Latin America, Africa, or elsewhere. As Easterly points out, these complaints were being voiced by the mid-1990s.

Conversely, standard responses were that many of these countries had not actually adopted the list of 10 policy reforms. Moreover, the responses went, there is no instant-fix set of policies for raising economic growth, and these policies need to be maintained in place for years (or decades?) before their effects will be meaningful. And there the controversy (mostly) rested.

Easterly is (wisely) not seeking to refight the specific proposals of the Washington consensus. Instead, he is just pointing out some basic facts. The share of countries with extremely negative macroeconomic outcomes--like very high inflation, or very high black market premiums on the exchange rate for currency--diminished sharply in the 21st century, as compared to the 1980s and 1990s. Here are a couple of figures from Easterly's NBER working paper:





These kinds of figures provide a context for the 1990 Washington consensus: for example, in the late 1980s and early 1990s when between 25-40% of all countries in the world had inflation rates greater than 40%, getting that wildfire under control had a high level of importance.

Easterly also points out that when these extremely undesirable outcomes diminished in the 1990s, growth across countries of Latin America and Africa has done better in the 21st century. Easterly thus offers this gentle reconsideration of the Washington consensus policies:

The new stylized facts seem most consistent with a position between complete dismissal and vindication of the Washington Consensus. ... Even critics of the Washington Consensus might agree that extreme ranges of inflation, black market premiums, overvaluation, negative real interest rates, and repression of trade were undesirable. ...

Despite these caveats, the new stylized facts are consistent with a more positive view of reform, compared to the previous consensus on doubting reform. The reform critics (including me) failed to emphasize the dangers of extreme policies in the previous reform literature or to note how common extreme policies were. Even if the reform movement was far from a complete shift to "free market policies," it at least seems to have accomplished the elimination of the most extreme policy distortions of markets, which is associated with the revival of growth in African, Latin American, and other countries that had extreme policies.