

Reading 5

The Washington Consensus and Its Critics

I. The Conservative Answer to Marxism

We have seen that Marxism (or a command economy system) has become unpopular around the world since the fall of the Soviet Union and the market reforms of China and Vietnam. Even so, there has been a renewed interest in socialist solutions to macroeconomic problems. This is because of the stupendous fallout from the Great Recession. Many people have claimed that free-wheeling markets were responsible for the Great Recession. Even MIT economist Paul Samuelson (Nobel Prize 1970) took the view that the Great Recession had completely vitiated Milton Friedman's (Nobel Prize 1976) view that the private laissez-faire economic system could be self-regulating.

A big government man from way back—in an edition of his best-selling college textbook *Economics*, (Paul Samuelson) argued that “the remarkable fact is not how much government does to control economic activity, but how much it does not do”—Samuelson, now 93, gave an interview not long ago. The current crisis, he claimed, validates his own economic views—and invalidates those of his longtime rival, the late free-market economist Milton Friedman.

“Today we see how utterly mistaken was the Milton Friedman notion that a market system can regulate itself,” Samuelson said. ” ...

Everyone understands now, on the contrary, that there can be no solution without government. The Keynesian idea is once again accepted that fiscal policy and deficit spending has a major role to play in guiding a market economy. **I wish Friedman were still alive so he could witness how his extremism led to the defeat of his own ideas.”**

These were pretty harsh words from Samuelson, even though he was 93 years old and had fought Friedman his whole life. I doubt Friedman would have accepted Samuelson's observation, though.

The real issue concerns the extent to which government should be part of the economy. This is a policy question and a now-famous prescription was offered in 1989 by English economist John Williamson. A list of 10 policy directives were grouped together and called the Washington Consensus, since the US Treasury, the IMF, and the World Bank (all located in DC) ostensibly endorsed them. These were to form a set of recommendations for countries around the world to follow in establishing a growth oriented economy. In addition, they were believed to be a major part of all developed countries' economic philosophies. These were the rules to success. Here are the 10 policy prescriptions called the Washington Consensus:

- (1) Fiscal policy discipline, with avoidance of large fiscal deficits relative to GDP;
- (2) Redirection of public spending from subsidies ("especially indiscriminate subsidies") toward broad-based provision of key pro-growth, pro-poor services like primary education, primary health care and infrastructure investment;
- (3) Tax reform, broadening the tax base and adopting moderate marginal tax rates;
- (4) Interest rates that are market determined and positive (but moderate) in real terms;
- (5) Competitive exchange rates;
- (6) Trade liberalization: liberalization of imports, with particular emphasis on elimination of quantitative restrictions (licensing, etc.); any trade protection to be provided by low and relatively uniform tariffs;
- (7) Liberalization of inward foreign direct investment;
- (8) Privatization of state enterprises;
- (9) Deregulation: abolition of regulations that impede market entry or restrict competition, except for those justified on safety, environmental and consumer protection grounds, and prudential oversight of financial institutions;
- (10) Legal security for property rights.

Williamson's original publishing of these ten principles was intended as a depiction of what policymakers at the World Bank, IMF, and US Treasury agreed were solid recommendations for strong and stable economic development and growth. Note that it is weak on the idea of developing inclusive institutions within the economy; apparently these would arise naturally with the freeing of markets. It should be clear that the Washington Consensus (whether intended as such) became associated with conservative "market fundamentalism". As such, it was soundly attacked from the Left as being a one-size-fits-all assault on progressive economic ideas, especially Keynesian thought. Joseph Stiglitz (Nobel Prize, 2001) has been prominent in criticizing the Washington Consensus in many settings and forums, not to mention his books.

There are numerous problems with the Consensus above – not the least of which is that many at the World Bank, IMF, and US Treasury have claimed they do not agree on these principles. For example, many would argue that low deficits to GDP are impossible during recessionary times and that trying to maintain austerity during a downturn will only make the downturn worse. Also, there is no guidance on how the international flow of goods and services and capital market flows should be liberalized. In some cases, a liberalization of capital flows without sufficient legal and institutional preparation can result in turmoil in the foreign exchange markets, not to mention speculative attacks on currencies by hedge funds and insiders. ¹

II. Trouble Implementing the Washington Consensus

Obviously, it is not true that all countries everywhere agree to implement and follow the principles listed in the Washington Consensus. Many of the principles involve considerable pain.

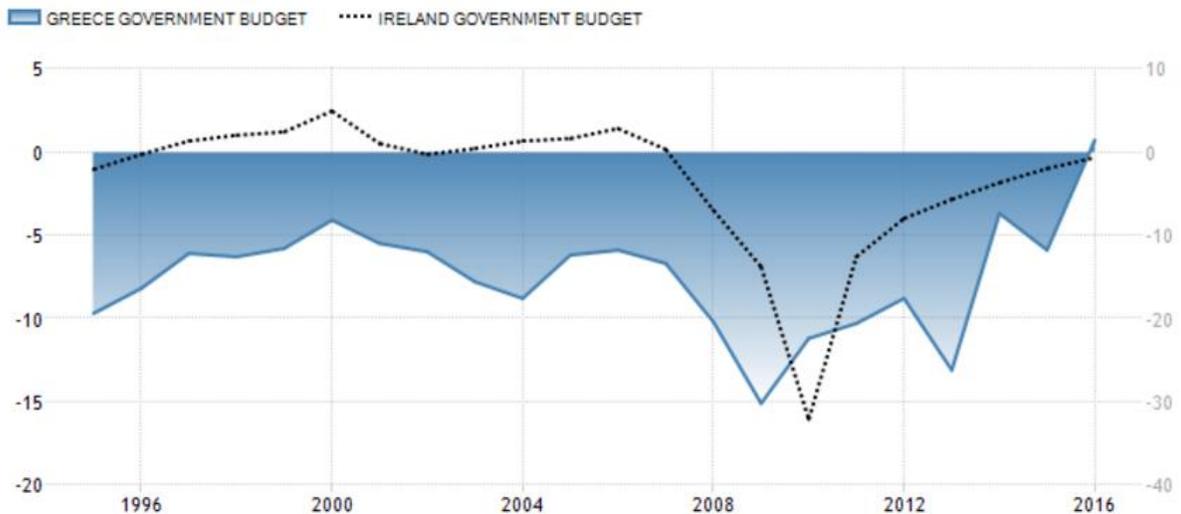
¹ A very [good article](#) (somewhat long) on the confusion surrounding the so-called Washington Consensus is given by the then editor of Foreign Policy magazine, Moise Naim (1999).

The IMF has been vilified many times for harshly instituting austerity programs as part of the loan packages made to developing countries seeking to stabilize their economies and exchange rates. This was true of some Latin American countries that borrowed heavily in the 70s and 80s and some Asian countries that borrowed heavily in the late 1990s. More recently, austerity associated with loans to Greece and other problematic Euro Area countries have caused the IMF to be roundly despised.

How does the Washington Consensus force difficult changes on countries?

First, the Consensus requires that budget deficits be reduced. This is painful since it then requires governments to make choices among vested interest groups, especially those enjoying the very broad social safety net and generous public pensions. These people protest and vote, making it political suicide to cut benefits, even when such cuts are necessary. Cutting deficits means that deficit stimulus is no longer possible, meaning that the private sector must pick up the slack, if there is to be continued strong demand. Figure 1 shows that both Greece and Ireland are making good progress at controlling their budget deficits.

Figure 1 Comparing Greece to Ireland – Both are Making Good Progress



Note how that Ireland's government budget was in surplus for the period prior to the Great Recession, whereas Greece consistently had deficits in the 5-10% range. These Greek debts were relatively large deficits, but not extreme. Ireland's deficit expanded to nearly 30% of GDP in the wake of the Great Recession. Greece had deficits in the range of 15% after the Great Recession. Both countries have moved to near balance in their budgets, after tremendous changes. Ireland has reduced its public investment in half during this time.

The record in GDP growth is very different between the two countries. Greece has not been able to turn its austerity into high growth and recovery. Figure 2 shows a comparison of the two Euro

Area countries. Growth in Greece has been in the 1-2% range, which is very respectable. It has not seen such growth for nearly a decade. By contrast, Ireland has had consistent positive growth since 2013, and reach very high double-digit growth for a short time in 2015. It is easily growing

Figure 2 Ireland is Having Much Better Growth than Greece



at 5-10 % on average now. Both Ireland and Greece took on loans from the IMF. But, Ireland has convinced [the IMF that it is strong and capable of repaying](#).

Second, the Consensus is against the use of subsidies and high taxes. Both of these tools are used to discriminate, particularly against possible foreign competition. One of the most important functions of government is to generate and maintain a strong competitive environment. For example, if the domestic economy has only one airline, it may be necessary to ensure foreign airlines do not collude with the domestic airline to keep airfares high. The domestic airline may be subtly subsidized by saying that all government travel must be on a domestic carrier. Low priced fuel, heavily subsidized by government, may give the local carrier a special privilege. Also, it may be essential for the government to abstain from using tariffs to keep foreign competitors from the domestic market. Often the use of such taxes is justified by noting that a fledgling domestic industry can keep from being destroyed by initially keeping foreign competitors out. However, it is often the case that the industry becomes used to such protection and never matures into a strongly competitive force.

Third, both privatization and deregulation are very controversial policies to undertake. Privatization is especially difficult for existing laborers and management to accept since state run enterprises typically are overstaffed at nearly every level. Pay is normally above equilibrium, as well.

III. Critics of the Washington Consensus

Many critics of the Washington Consensus are people who do not agree with conservative economic theories or market fundamentalism. John Williamson early on wished to distance himself from that interpretation of the Consensus. As he [expressed in his own words in 2002](#)

Some of the most vociferous of today's critics of what they call the Washington Consensus, most prominently Joe Stiglitz (whose recent book, for example, specifically endorses gradual trade liberalization and carefully done privatization), do not object so much to the agenda laid out above as to **the neoliberalism that they interpret the term as implying. I of course never intended my term to imply policies like capital account liberalization (as stated above, I quite consciously excluded that), monetarism, supply-side economics, or a minimal state (getting the state out of welfare provision and income redistribution), which I think of as the quintessentially neoliberal ideas.** If that is how the term is interpreted, then we can all enjoy its wake, although let us at least have the decency to recognize that these ideas have rarely dominated thought in Washington and certainly never commanded a consensus there or anywhere much else except perhaps at meetings of the Mont Pelerin Society. (my emphasis, not Williamson's)

It is possible to take each of the 10 points of the Washington Consensus and criticize that particular point alone. However, much of the criticism can be traced to problems in the actual application of that point to a specific case. The appropriateness of the policy is determined by the stage of development and maturity of the economy. It is not a one-size-fits-all. However, the overwhelming view we can take is that extensive planning by government usually involves tight controls on the economy that ultimately stunt growth and reduce innovation. The Washington Consensus, although perhaps flawed in many ways, is therefore useful in reminding us that to err on the side of liberalization may not be all that bad for the economy.

Questions:

- #1. Why do people call Williamson's list the "Washington Consensus"?
- #2. The Consensus is opposite to Marxism – explain.
- #3. What is meant by broadening the tax base? What are marginal tax rates?
- #4. What is privatization and why is it difficult to accomplish?
- #5. What is a reasonable level for the Deficit/GDP ratio? What about the Debt/GDP ratio?
- #6. Why do most people support free trade? Why is Trump opposed to greater free trade?
- #7. Greece and Ireland have tried austerity. What is austerity and is it always successful?
- #8. Which of the 10 principles in the Consensus do you find hard to accept?