WHAT IS WRONG WITH THE WASHINGTON CONSENSUS AND WHAT SHOULD WE DO ABOUT IT?*

I. THE WASHINGTON CONSENSUS: CLASSICAL VS. POST KEYNESIAN VIEWS

John Williamson coined the term “Washington Consensus” in 1989. This Washington Consensus term, however, means different things to different people\(^1\) – and apparently even different things to John Williamson at different times. Williamson [2002] states that this consensus requires ten reforms:

“1. Fiscal Discipline. This was in the context of a region where almost all the 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.... from things like indiscriminate subsidies to basic health and education.

3. Tax reform. Constructing 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, and stressed that views differed on how fast it should be achieved\(^2\).

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 implies an intermediate regime; in fact Washington was already beginning to subscribe to the two-corner doctrine. [William has championed the establishment of FEER (a Fundamental Equilibrium Exchange Rate) target zone for the exchange rate, i.e., a zone based on a fixed competitive rate plus or minus ten percent. Williamson has argued that FEER would simultaneously achieve internal and external balance\(^3\)]

6. Trade Liberalization...
7. Liberalization of Inward Foreign Direct Investment...
8. Privatization...
9. Deregulation....
10. Property Rights....

The three big ideas” underlying these reforms are, according to Williamson, “macroeconomic discipline, a market economy, and openness to the world....The first three reforms are, so far as I am aware, widely accepted among economists.” (Williamson, 2002).

Developing from Keynes’s General Theory (1936) and Bretton Woods writings (Keynes, 1980) Post Keynesian analysis (e.g., Davidson, 2002) can demonstrate that what most orthodox economists mean by a policy of fiscal discipline will neither (1) avoid the possibility of current account crises, nor (2) produce a fully employed economic system. Trying to implement the reforms with their emphasis on fiscal discipline, the liberalization of financial markets, and the free market competitive exchange rate has created some severe problems for Latin America

This does not mean all ten reforms are bad. The importance of property rights for the productive operation of the operation of an entrepreneurial economy can not denied. Regarding privatization, however, “It is not the ownership of the instruments of production that is important for the State to assume. If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary”(Keynes, 1936, p. 378).

Why have intelligent economists such as John Williamson gone so wrong on their demand for fiscal discipline, financial liberalization, and actively pursuing a competitive exchange rate policy? The fundamental analytical framework underlying Williamson’s views is the same as the foundation of neoliberalist and market fundamentalists arguments (Davidson, 1992-3). For example, in an article co-authored with Marcus Miller (1989), Williamson accepts the classical belief that, in the long run, a free market economy will always revert to the optimum allocation
of resources at full employment. Williamson and Marcus (1989, p. 50), however, are impatient with the length of time it takes for the market to achieve this long-run equilibrium, and therefore they argue that the economy, prodded by intelligent authorities will show a greater “speed of adjustment” than the “automatic pilot” of a free market. In other words, the only analytical difference between Williamson and ideological Market Fundamentalists is the question of the length of time it requires for a free market to achieve a social optimum.

Those who profess a rational expectations approach can argue for immediate liberalization — shock therapy. The common sense of mainstream economists such as Williamson suggests that such “shock and awe” medicine might severely debilitate if not kill the patient. Thus Williamson tries to direct the discussion towards the speed at which governments liberalize markets and reduce the size of government. Nevertheless, all ten reforms of the Washington Consensus are founded on classical economic theory that supports the *laissez-faire* doctrine as necessary to solve all our economic problems.

The evidence of the last 10-20 years, however, has demonstrated that attempting to implement the ten reforms of the Washington Consensus has ultimately proven to be a disaster for developing nations. If the empirical evidence of the failure of the Washington Consensus under the existing rules of the game is so clear, why does the G-7, the World Bank and the IMF seek to tie aid for Latin American nations’ economic problems to a demand for the nation to move towards full adoption of the 10 consensus reforms? The answer to this question is nested in the classical theory belief in the beneficence of free markets. This beneficence, however, can only be “proved” if one invokes three very restrictive classical axioms. If these classical axioms are not applicable to the real world, then the characteristics of the Washington Consensus market vision of the economic system “happens not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience” (Keynes, 1934, p. 3).

When put in the context of an open economy, Keynes’s *General Theory* analytical
framework demonstrates that the theoretical foundation for some of the reforms advocated by the Washington Consensus are not applicable to the economy in which we live. In a passage that is particularly a propos to the Washington Consensus, Keynes noted that "in a society where there is no question of direct investment under the aegis of public authority [due to the need for fiscal discipline per se], the economic objects, with which it is reasonable for the government to be preoccupied, are the domestic interest rate and the balance of foreign trade" [Keynes, 1936, p. 335].

If, however, the government institutes reform #4 of the Washington Consensus and permits capital funds to freely move across national boundaries, then "the authorities had no direct control over the domestic rate of interest or the other inducements to home investment, [and] measures to increase the favorable balance of trade [are]...the only direct means at their disposal for increasing foreign investment" [Keynes, 1936, p. 336] and domestic employment.

The orthodox policy for improving a nation’s trade balance is to make the domestic industries more competitive either (1) by forcing down nominal wages including fringe benefits (i.e., liberalizing or “freeing up” the nation’s labor market) to reduce labor production costs and/or (2) by encouraging a decline in the nation’s exchange rate to a more competitive level. Keynes (1936, p. 338) warned that the domestic employment advantage gained by pursuing a competitive exchange rate policy (reform #5) to encourage export-led economic growth "is liable to involve an equal disadvantage to some other country". Whenever countries pursue an "immoderate policy" [Keynes, 1936, p. 338] of export-led growth by making domestic industries more competitive, this aggravates the unemployment problem for the competitor nations and may even create unemployment problems for the trading partners of the successful export-led growth country. Consequently these other nations are then forced to engage in some policy to make their industries more competitive and in so doing they engage in a "senseless international competition for a favorable balance which injures all alike" [Keynes, 1936, pp. 338-9].

Williamson’s reform #5, requiring the establishment of a competitive exchange rate for
each Latin American country, can only exacerbate the problem of exchange rate changes adversely affecting Latin American nations, as the recent experience of yo-yo exchange rates between Argentina and Brazil indicates. More importantly, attempts by many nations to obtain competitive gains by policies that will reduce the domestic monetary costs of labor and/or the exchange rate can only foster further global stagnation and recession as each nation attempts to regain a competitive edge induces similar depressionary policies in others.

Unlike the classical theorists of his day (and our day as well) Keynes (1936, p. 345) recognized that "the mercantilists were aware of the fallacy of cheapness and the danger that excessive competition may turn the terms of trade against a country" thereby reducing domestic living standards in the country searching for a competitive exchange rate in a global economy. If each nation does not actively undertake a program for public domestic investment to generate domestic full employment, then the resulting laissez-faire system of prudent fiscal discipline in tandem with liberalized international financial markets that encourage speculative free international monetary flows creates a global environment where each nation independently sees significant national advantages in a policy of export-led growth even though pursuit of these policies simultaneously by many nations "injures all alike" (Keynes, pp. 338-9).

This warning of Keynes has gone virtually unnoticed as mainstream economists waxed enthusiastically about liberalized international financial markets and the export-led economic miracles of Japan, Germany in the 1980s and the economic miracles of the Pacific Rim Newly Industrialized Countries (NICS) in the early 1990s. These miracles, it was claimed, proved the validity of the Washington Consensus and was often used to justify the Washington Consensus reforms for Latin America.

As markets are liberalized and governments shrink, international finance and IMF loans flow into the nation. Normally this brings about a momentary improvement in economic growth and a feeling of euphoria. Only later does it become apparent that this inflow of funds ultimately saddles the nation with large, and difficult to sustain international debt service out-flows that
often can only be met by a Ponzi-type financing via more loans from the IMF and international bankers.

To prevent indebted Latin American nations from defaulting on their international debts, the IMF makes additional loans — contingent on Latin American nations pursuing the ten reforms of the “one-size-fits-all” Washington Consensus. Latin American nations should not let the "inadequacy of the theoretical foundations of the laissez-faire doctrine" (Keynes, 1936, p. 339) and the oratory of Williamson and other "orthodox economists whose common sense has been insufficient to check their faulty logic" [Keynes, 1936, p.349] to convince them to swallow the bitter medicine of the consensus reforms to obtain additional international loans in the false hope that this new influx in funds will improve their economic position.

Keynes once said “If a man owes his banker 5 pounds it’s the man’s problem but if he owes 500 pounds it’s the banker’s problem”. This same moral is applicable to the outstanding debts of the Latin American nations. The problem is not Brazil’s or Argentina’s etc. and they should not let the pressure of their international bankers force them to adopt those reforms that will further depress their economies. They will be doing themselves and their international bankers a favor if they avoid the constraints imposed by the international bankers and the IMF and pursue an independent full employment policy while negotiating the restarting of debt service payments after the domestic economy is showing significant signs of improvement.

To break out of a global slow-growth or stagnating economic environment in which the global economy has become immersed, requires each nation to adopt a "policy of an autonomous rate of interest, unimpeded by international preoccupations, and a national investment programme directed to an optimum level of employment” (Keynes, 1936, p.349) If a nation adopts such an independent policy then it “is twice blessed in the sense that it helps ... [the nation and its] neighbors at the same time. And it is the simultaneous pursuit of these policies by all countries together which is capable of restoring economic health and strength internationally, whether we measure it by the level of domestic employment or by the volume of international
The liberalization of the market doctrine solution embedded in the Washington Consensus is analytically based on the aforementioned three classical postulates. These presumptions logically assure a global full employment result. In the real world, however, a globally full employment environment can be achieved only when each nation pursues expansionary fiscal and monetary policies that are shielded from international interference. Only after these independent nations approach full employment will free trade increase the global wealth of nations by reducing each nation's aggregate supply constraints through the law of comparative advantage. By assuming liberalized markets reforms per se assure global full employment, as, Keynes (1936, p. 339) pointed out, "the [orthodox] faculty of economists prove to have been guilty of presumptuous error". We live in a world where global unemployment and income inequality problems has been exacerbated by the mindless imposition of the Washington Consensus reforms by Washington Institutions.

Today powerful players are attempting to force all debtor nations (except perhaps the United States) to operate under the laissez-faire mentality that is the foundation of the Washington Consensus. In a passage that is amazingly prescient, Keynes warns that if these nations play by the rules of this game, then if any "country were to neglect the struggle for markets its prosperity would droop and fail. But if [all] nations can learn to provide themselves with full employment by their domestic policy...there need be no important economic forces calculated to set the interest of one country against that of its neighbors. There would still be room for the international division of labour and for international lending in appropriate conditions. But there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbor, not because this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting equilibrium in the balance of payment so as to develop a balance of trade in its own favor [i.e., export-led
growth policy]. International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage" [Keynes, 1936, pp. 382-3 emphasis added].

II. The Washington Consensus and Income Inequality

Before presenting my suggestions for a Post Keynesian alternative to the Washington Consensus, let me indicate why I believe that even if the search for a competitive exchange rate (reform #5) was successful in allowing a Latin American nation to avoid persistent adverse trade balance problems, the result would tend to increase the global inequality of income.

Williamson is for a flexible “competitive” exchange rate system rather than a fixed exchange rate system. Under this policy approach if a Latin American country is suffering from a persistent trade payments deficit, then this is prima facie evidence that its domestic industries are not competitive. Williamson would argue that it would be necessary and desirable for the nation to experience a decline in the exchange rate target to make the nation’s industries competitive. Of course, for a decline in the exchange rate to reduce (eliminate) the trade payments deficit, the Marshall-Lerner conditions would have to be applicable.

Typically, however, a Latin American nation has a comparative advantage in exports whose income elasticity of demand for these exports exhibited by the rest of the world is lower than the nation’s income elasticity of demand for imports from the rest of the world. Under these income elasticity conditions, even if there is no persistent trade payments imbalance, the demand for the LA nation’s exports will tend to grow at a slower rate than the domestic market’s demand for imports from the rest of the world. Thus, even if trade payments equilibrium could be maintained over time solely by globally pursuing Williamson’s “competitive” exchange rate target system, the rich developed nations would experience a higher rate of growth of income
earnings from sales to the Latin American nation than the growth in income earned by the Latin American nation from sales to the rest of the world. The result is a growing inequality of income. If, at the same time, population growth in the Latin American nation is greater than in the developed world, the income per capita in Latin America falls significantly relative to the income per capita of the developed nations.

Moreover, if initially the Latin American nation had been receiving an influx of direct foreign investment and/or an international financial flow of funds, then the decline to find a “competitive” target exchange rate would make the servicing of international out-payments on the already existing stock of international capital inflows more onerous in real terms. Almost inevitably this is will result in greater impoverishment of Latin America.

III. Conclusions Regarding The Washington Consensus

The Washington Consensus has created perverse incentives that set nation against nation in a process that perpetuates a world of slow growth (if not stagnation). Because the global economy is on a de facto dollar standard, the United States is the only nation that can benefit from the existing international payments system—at least as long as it ignores its own deficit balance of payments position and continues to run the horrendous annual trade deficits that it has experienced since 1981. This continuing US trade deficit has been, in recent decades the primary (sole?) engine of growth for the rest of the global economy as the other nation’s of the world focus on policies that promote export-led growth as a solution to each nation’s unemployment rates and stagnating rates of growth.

Since 1982 the United States has been obtaining an annual "free lunch" from the rest of the world as the US consumes more than it earns internationally. Although residents of most other nations may resent the ability of the United States to use the present system to obtain this "free lunch", they are hesitant to change a system (1) that is heralded as the only mechanism that permits every one the freedom to choose, and (2) that provides, in the form of the U.S. economy’s willingness to import more than it exports, the only visible engine of growth.. To be
against the Washington consensus is considered to be anti-free market. To advocate governmental financial regulations (controls) of international capital flows and a larger government input into the domestic economy is a particularly unpopular position in these days when State planning has failed so spectacularly in Eastern Europe. In the absence of a complete collapse of the international monetary payments system, however, unless an attractive feasible alternative to the current system is put on the public agenda for discussion and development, the status quo will remain. It is an old adage in political science that "you can't beat somebody with nobody!"

Generalizing Keynes's General Theory to an open economy provides a rationale for designing an international payment system that rejects reforms 1, 4, 5, and 7 as more likely to cause problems than provide solutions. Any alternative must create incentives for each nation to pursue domestic demand policies that ensure full employment without the fear of a balance of payments constraint or unbearable international debt service payments. Only under such an alternative to the Washington consensus will the gains from the law of comparative advantage become possible.

Nowhere is the difference between the Keynes view and the view of those Consensus advocates who believe that free capital markets efficiently allocate capital more evident than in regards to these questions of international capital movements and payments mechanisms and the desirability of using the exchange rate to make one’s industries more competitive. Moreover, Keynes's General Theory analysis suggests that government monitoring and, when necessary, control of international capital flows is in all nations’s interests. Capital controls are not an infringement on the freedom of economic agents right to move their wealth between countries whenever the spirit moves them any more than the making it illegal to shout "fire" in a crowded theater is an infringement of the individual's right of free speech.

Any suggestions for reforming the international payments mechanism should build on whatever advantages the current flawed system possesses, while providing rules to prevent any
one nation from enjoying a free lunch -- unless a free lunch is available to all. If a new international system has a built-in expansionary bias that encourages all nations to operate closer to full employment than the existing system does, then it provide all nations with a free lunch by increasing the rates of global economic growth and global full employment with the same quantity of available resources.

In what follows I wish to focus primarily on the Washington Consensus fallacy of demanding reforms (1) that liberalize international capital markets and (2) urge changes in the exchange rate to make industries more competitive. It is, in my view, these two “reforms” that have been a primary cause of the failure of Latin American nations — and the global economy generally — to grow at a rate equal to their resource potential where such growth which would provide a greater economic prosperity for all the inhabitants of this planet.

IV. A Post Keynesian Proposal As An Alternative to the Washington Consensus

The following proposal for an international payments system builds on Keynes's Bretton Woods proposals that, during the 1947-73 period, proved successful for producing a global expansionist pressure on world trade and development. Economic development expert Irma Adelman has declared this 1947-73 period “The Golden Age of Economic Development”.

Our suggestion is aimed at obtaining an international agreement that does not require surrendering either monetary policy and national control of domestic banking systems, nor surrender of a nation’s fiscal policies. Keynes provided a clear outline of what was needed when he wrote:

"We need an instrument of international currency having general acceptability between nations .... We need an orderly and agreed upon method of determining the relative exchange values of national currency units.... We need a quantum of international currency... [which] is governed by the actual current [liquidity] requirements of world commerce, and is capable of deliberate expansion.... We need a method by which the surplus credit balances arising from international
trade, which the recipient does not wish to employ can be set to work... without
detriment to the liquidity of these balances” (Keynes, 1980, p. 168).

What is required is a **closed**, double-entry bookkeeping, clearing union institution to keep
the payments score among the various trading regions plus some mutually agreed upon rules to
create and reflux liquidity while maintaining the international purchasing power of the
international currency. The eight provisions of the following Post Keynesian clearing system
proposal meet the criteria laid down by Keynes. The rules of our proposed system are designed
[1] to prevent a lack of global effective demand\textsuperscript{11} due to any nation(s) either holding excessive
idle reserves or draining reserves from the system, [2] to provide an automatic mechanism for
placing a major burden of payments adjustments on the surplus nations, [3] to provide each
nation with the ability to monitor and, if desired, to control movements of flight capital\textsuperscript{12}, and
finally [4] to expand the quantity of the liquid asset of ultimate international redemption as
global capacity warrants.

[The rest of this section repeats the argument presented in Section VII of chapter 1 supra.]

Some think that this clearing union plan, like Keynes’s bancor plan, a half century
earlier, is Utopian. But if we start with the defeatist attitude that it is too difficult to change the
awkward system in which we are trapped, then no progress will be made. Global depression does
not have to happen again if our policy makers have sufficient vision to develop this Post Keynesian
approach. The health of the world's economic system will simply not permit us to muddle through.

REFERENCES

Economics, 15, reprinted in Uncertainty, International Money, Employment and Theory, edited


To Do The Job When Boulders Are Often Required?”, The Economic Journal, 107, pp. 671-
Williamson, J. (2002) Remarks to the Center for Strategic and International Studies, on November 6, 2002

NOTES


1. Williamson [1999] claimed that the term Washington Consensus has developed into something different from that which he intended. The Washington Consensus concept had become what is often called “neoliberalism” or “market fundamentalism”. Williamson points out that Bresser Perriera patiently explained to him that just because he invented the term he did not have intellectual property rights to control its meaning. [One could suggest to Williamson that just because Keynes invented The General Theory did not limit the perverse meaning that neoclassical synthesis Keynesians and New Keynesians gave to the meaning of Keynesian macroeconomics.]

2. Williamson (1999) indicated that he “long ago changed my description of the fourth element of the Washington Consensus to ‘financial liberalization’”. In other words Williamson believes that all regulations controlling international capital flows should be abolished.

3. The internal balance implied an unspecified low rate of inflation that would be associated with NAIRU, while external balance was associated defined as maintaining a current account balance that is “sustainable and appropriate” in the medium term.

4. An axiom is defined as a statement accepted as true and not necessary to be proved. The three restrictive classical axioms are (1) the ergodic axiom in stochastic models or the equivalent ordering axiom in deterministic models, (2) the ubiquitous gross substitution axiom, and the neutral money axiom (See Davidson [2002, chapter 3]).

5. For example, in 1977 the Carter Administration's attempted to "talk down the dollar". In the Spring of 1993, Secretary of Treasury Bentsen tried to talk up the yen. In January 1994, the New York Times quoted Secretary Bentsen as saying that "allowing the yen to decline would not be an acceptable way for Japan to try to escape from its recession".
6. Currently, given the jump in the unemployment rate and the loss of jobs since George W. Bush became President in 2001, many economists are applauding the fall in the dollar exchange rate as a means of making American industry more competitive and therefore increasing jobs by increasing exports.

7. Most mainstream economists were appalled by President Reagan's boasts of superiority regarding the higher dollar that was achieved in the early years of his Administration.

8. Under a Keynes-Post Keynesian view, the imbalance may be due to the oversaving of the nation's trading partners.

9. And does not allow proponents of fiscal discipline to shrink the size of government.

10. Though modified by Harry Dexter White's views on the role of the IMF and the World Bank, these proposals plus the Marshall Plan (which unintentionally followed one of Keynes's proposals) were the basis of the Post World War II global prosperity (see Davidson, 2002).

11. Williamson recognizes that when balance of payments "disequilibrium is due purely to excess or deficient demand", flexible exchange rates per se can not facilitate international payments adjustments. [Williamson, May 1987, pp. 200-204]

12. This provides as an added bonus by making tax-avoidance and profits from illegal trade more difficult to conceal.