Chapter 1
The Washington Consensus Proposals for Economic Restructuring: An Evaluation

This chapter attempts to set out and critically evaluate the near-hegemonic\(^1\) neoliberal\(^2\) consensus on development strategies to be used by developing countries faced with deep macroeconomic disequilibria and structural imbalances. Section I discusses the stylised facts which form the basis for the policy proposals developed by neoliberal consensus. Section II follows with an outline of these proposals. The following two sections take up a critical analysis of the models which underpin these proposals. Section III analyses the short-term model of stabilisation which is used. Section IV goes on to discuss the underlying explanation for growth which underpins the suggested supply side reforms. Section V offers a brief concluding note.

I. Stylisations of development experiences

Before the neoliberal consensus is discussed, it would, perhaps, be useful to set out the stylisation of the development experience of late industrialisers in the latter half of the twentieth century which forms the basis for this consensus.

From the neoliberal point of view, the major insights into the development experience of late industrialisers has provided by Krueger, Balassa and McKinnon among others. The benchmark for comparing the developmental failures are the success stories of the East Asian newly

---

\(^1\) How pervasive the hegemony is perceived to be can be gauged from an observation made by Fischer (1990). He noted that there were no longer two contending paradigms (the other he referred to was presumably the import-substituting-industrialisation or ISI model) to explain the dynamics of economic development and therefore both the levels and fields of discourse (among participating economists) were the same.

\(^2\) The term neoliberal has been advisedly used, as there is nothing like a similar consensus on such issues within mainstream neoclassical economics. The incorporation, into neoclassical economic theorising, of imperfect and non-competitive markets, technology, scale economies, asymmetric information, transaction costs and the role of institutions as a rational response to these, has meant a certain ambiguity if not scepticism about the two central tenets of the neoliberal position - the efficacy of market-led development strategies and (not quite the flip side), the inefficacy of state intervention in fostering development. For a representative sample of the neoliberal view of economic development see, for example, Lal (1983) and Michaely \textit{et al} (1991).
industrialising countries (or NICs, especially that of South Korea\(^3\) and Taiwan). Balassa and Krueger would stress the outward oriented nature of the Korean developmental experience with minimal state intervention\(^4\). Mckinnon would underline the role played by financial liberalisation in kick-starting and sustaining the process of growth. As noted above, there has been a steady accumulation of evidence suggesting that the state played a preeminent role in the developmental success of East Asian NICs. The response of economists of the neoliberal persuasion to this evidence has been, on the one hand,

\(^3\) The explanation of the South Korean experience closely resembles the story of the six blind men who were asked to describe an elephant. The cavalier disregard for other evidence (especially contending) has obviously meant that the stylisation has been somewhat removed from reality. A good example of this is Little's (1981) argument that the reason for the South Korean success was the government getting prices right. As evidence of this he suggests that high interest rates (as is right in a capital scarce economy) were used to mobilise savings thus permitting high levels of investment (labour intensive, again in keeping with the labour surplus nature of the economy). Little of course chose to ignore existing evidence [see Jones and Sakong (1980)] that on the demand side, the government both subsidised the price of credit and determined its use. It is another matter that high interest rates themselves prevailed for a relatively short period of time. If the heterodox explanation for South Korean economic growth was not reasonably current at the time when Little put forward his argument, it is certainly not the case today. Yet, in Krueger's (1995) contribution to the Handbook of Development Economics titled 'Policy Lessons from Development Experience since the Second World War', there is no reference to Amsden's (1989) seminal contribution on Korean economic development, which, warts and all, did help firmly establish the heterodox view on the issue. In Krueger's piece referred to above, she dismisses the role of the state in Korea's economic development on the grounds that it is "not yet completely understood"! [p 2543]

\(^4\) Whereas the outward-oriented nature (in the sense of the importance of exports as a source of demand) of South Korean or Taiwanese growth strategy is not being doubted (though in the process most neoliberal analysts tend to lose sight of the impressive import substitution achieved by both, especially Korea, in the early stages of industrialisation), the minimalist interpretation of the state's role is way off the mark. In fact, perhaps, the most remarkable feature about these development strategies has been the pervasive role of the state. The state intervened both at the macro level in the economy - through usual instruments such as subsidies and tariffs etc. - and at the micro or firm level - by coordinating both the build-up and later, the scrapping of capacity. In other words, the state prevailed upon firms to invest in industries and products in keeping with a certain dynamic trajectory which it (ie, the state) had in mind and, where that was not possible, entered into production itself. See Jones and Sakong (1980), Amsden (1989), Wade (1990) and Chang (1991) among others. As to the use of market forces to determine the dynamic trajectory of growth, a comment made by the Governor of the Korean Central Bank is revealing.

"Don't listen to "comparative advantage" advice. Whenever we wanted to do anything the advocates of comparative advantage said, "We don't have comparative advantage". In fact, we did every thing we wanted, but whatever we did, we did well." [cited in Alagh (1989)]
to assert the central role of the relatively free play of market forces and, on the other, to suggest that the role of the state was residual, stemming from efforts to correct earlier acts of intervention. The following quotations give a flavour of the kind of argument put forward.

"[g]overnments' main contribution ... was ... principally in removing the obstacles to growth which they themselves put there in the first place ... [a]nticipate and offset the market distortions which result from dirigiste strategies of industrialisation ... [n]eo-classical economic principles are alive and well ... [O]nce public goods are provided for and the most obvious distortions corrected, markets seem to do the job of allocating resources reasonably well" [Reidel (1988); pp 37-38]

"[O]ne question that arose ... whether in East Asia 'export-substitution' had replaced 'import-substitution' as a trade-development policy. Although researchers were able to identify some aspects of governmental policy which favoured exports, it was clear that there were other, residual, elements of the policy regime that were biased toward import substitution." [Krueger (1995); p 2519]

Establishing the role of the market in successful development is one side of the coin. On the other side, the neoliberals argue that state-led development episodes have inevitably ended in failure. In the context of the Latin American growth experience in particular, they suggest that things start going wrong from the second stage of import substitution. The first stage - typically involving what are called the light industries - is thought to have coincided broadly with the region's comparative advantage, in the sense that most were labour intensive in nature and scale requirements were met by the existing size of the domestic market. The second stage - the production of intermediate and capital goods - involved industries with substantial economies of scale and a high level of technological requirements. High capital costs and technological requirements within relatively small domestic markets meant high costs of production and therefore high levels of protection.

The smallness of the sheltered domestic market meant monopolistic or oligopolistic market

5 For a representative statement of this viewpoint see Krueger (1990).

6 Commenting on the success of this early phase of import substitution, Krueger, in what must qualify as among the more breathtaking assertions in development economics, has the following to say:

"[A] most certainly there was also a significant backlog of worthwhile investments which had not been possible during the Second World War ... [T]hus it may be that in the late 1940s and the early 1950s, any economic policies which did not entirely thwart these investments would have generated rates of economic growth significantly above long-term trends." [Krueger (1995); p 2508; emphasis in the text].
structures and with high profits provided by substantial tariff and non-tariff barriers, there was little
incentive to get into manufactured exports. High levels of protection, overvalued exchange rates (to
cheapen industrial imports) and export taxes meant that terms of trade moved against primary
activities. With little incentive to export manufactured goods and primary exports pricing themselves
out of the market, the lack of foreign exchange became the binding constraint. Therefore, it is argued,
import substituting industrialisation which among other things was advocated as a response to a
foreign exchange constrained economy, ended up reinforcing the very same constraint. Borrowing
abroad was then seen as way out of this impasse. But distorted economic structures, inefficient
production and the lack of export orientedness meant that the day of reckoning was merely delayed
rather than avoided.

Outside of problems inherent to the strategy of import substitution, it is also asserted that, the
pitch in Latin America was queered by the financial repression which accompanied the import
substituting phase. Financial repression meant negative real rates of interest to savers, credit rationing
by the government on a preferential basis and segmented credit markets. As a result of these features,
there was little incentive to keep savings in the official financial system, and uneconomic projects
were financed because the interest rate did not reflect the opportunity cost of funds. Additionally,
preferential allocation of credit for some borrowers meant that many economically viable projects
were crowded out of the market. As a result, efficient financial intermediation which is necessary to
bring together savers and investors as also to oil any successful growth effort was not allowed to
develop. Shallow and rudimentary financial markets, in turn, stunted the process of growth.

The last major, distinct though inter-related, strand of criticism has to do with the role of the
state and hence its relationship with the private sector. In Latin America, as in much of the newly
independent developing economies across the world, the state took on the role of the 'engine of
growth' and adopted ISI as its growth strategy. The widespread use of an activist state in both
developed and developing economies in the immediate post-second-World-War period was made
possible because of, among other reasons, an enabling external conjuncture. The consensus on the
use of the state was fashioned by the Great Depression of the 1930s, the perceived success of Soviet
planning and the deleterious impact on domestic economies of relatively open trade regimes during
the colonial period. It should also be noted that an activist role for the state was broadly endorsed by mainstream economic theory. Be that as it may, neoliberals argue that, the state's chosen role, not only had little or no economic rationale but went well beyond its managerial capabilities. The state entered not only infrastructural activities but also the production of goods across use categories. Besides, it was saddled with, for political reasons, inviable private sector units which not only became a drain on the state exchequer, but created an additional moral hazard problem in that inefficiency was encouraged in the private sector with the removal (at least for some private sector agents) of the threat of bankruptcy. All this meant large public sector borrowing requirements which not only crowded out private investment, but being typically deficit financed, led to inflationary pressures on the economy. The state in an effort to move the economy onto a desired growth path introduced a mass of

---

7 This issue is touched upon in somewhat greater detail in Section III below and Section I, Chapter 3.

8 To touch upon a theme which will get discussed in somewhat greater detail later, the state, in neoliberal discourse, is conceived of as an autonomous entity, almost divorced from the society within which it operates. It is suggested that state-led import substituting industrialisation was the result of distrust of markets and private producers and was in some sense imposed from above [see Krueger (1995)]. That economists of the neoliberal persuasion have this caricature notion of the state is hardly surprising, given that their somewhat meagre analytical toolkit helps them elide such issues as the class nature of society and its impact on development strategies. On the other hand, as any discerning social scientist would know, in non-socialist economies the choice of development strategies rarely comes about without the consent and the cooperation of the bourgeoisie. In the immediate context of post Second World War, state-led development strategies were endorsed by national bourgeoisies of the newly independent developing economies, a reflection perhaps of the critical and fragile state of post-colonial economies. Perhaps the most cogent articulation of this viewpoint is the celebrated 'Bombay Plan', drafted on the eve of India's achieving independence, by a group of leading industrialists whose industrial empires even today are among the most dominant in the country. They argued for state intervention on the grounds that

"[u]nrestricted private enterprise under the capitalistic system of production has not served the interests of the consumers and the community generally as satisfactorily as it should have."

and went on to note

"[S]tate control of this character is, however, bound to put important limitations on the freedom of private enterprise ... [L]egal ownership would lose some of the essential attributes which are attached to it ... [T]he rights attaching to private property would naturally be greatly circumscribed." [Thakurdas, Tata, Birla, Dalal, Shriram, Lalbhai, Shroff and Matthai (1944); pp 94-95]
regulation to guide the economic behavior of all agents. This resulted in an over-regulated economy which not only stunted 'animal spirits' and reduced flexibility, but spawned a bureaucracy which then had a vested interest in maintaining regulation (the regulatory mechanism being the source of its power and payoffs). State regulation not only meant that the state opened itself up to 'regulatory capture', thereby negating the very essence of state intervention, but also that private sector agents indulged in rent-seeking activities all of which are directly unproductive and hence constituted another source of waste of scarce resources. The state then became the fountainhead of all waste in the economy, not only on its own account but also in inducing socially wasteful private sector behaviour.

To conclude, the neoliberals argue that, an ill-designed development strategy meant an inefficient production structure; financial repression meant lack of growth in domestic savings and misallocation of resources both across and within sectors; and pervasive state intervention meant a distorted incentive structure. In short, a recipe for an economic mess. For a while disaster was averted by deficit financing at home and borrowing abroad. But this only delayed the inevitable and made the landing harder⁹.

II. The Washington Consensus policy proposals

Based on this stylisation of success and failure¹⁰ the Washington Consensus emerged as a set

---

⁹ If in the build up to the debt crisis, the international economic conjuncture is strangely missing the reason is fairly simple. The neoliberal explanation suggests that while external factor may have exacerbated the crisis, inefficient production structures and policy mismanagement caused it in the first place. For an alternative view that the debt crisis was caused by factors external to the economies of the region see, among others, Diaz-Alejandro (1984); Taylor (1985); and Mohanty (1992).

¹⁰ As noted above (see fins. 3 and 4), the stylisation of the developmental success stories is way off the mark. Not only that, but the stylisation of why Latin American economies failed also leaves much to be desired. That is not to say that some of the lacunae pointed out - e.g., excessive export pessimism; the policy-induced bias against agriculture; the deleterious effects of sustained over-valuation of currencies; over-regulation of economic activity - were incorrect, but that an insufficient understanding of key markets (e.g., finance and labour) and sectors (both agriculture and industry) meant that the causal mechanisms were wrongly specified. Put differently there was little understanding of the institutional structure through which prices and quantities work themselves out and equally importantly, the focus was entirely on price responses [see section III below]. As a result policies suggested (and followed) tended to aggravate disequilibria. For a catholic analysis of how markets and sectors with differing institutional specifications may interact and complicate the
of policies to meet the requirements of growth with adjustment. Fischer (1990) summarises the policy objectives as being the following: (a) a sound macroeconomic framework - read elimination of budget deficits; (b) an efficient and smaller government - read deregulation (both internal and external) and privatisation; (c) an efficient and expanding private sector (d) policies for poverty reduction - read temporary targeted assistance (either through subsidies or employment guarantees) to help cope with transitional stress.

Aimed at achieving these objectives, the Washington Consensus, as set out in Williamson (1990), suggests a set of ten policy instruments and the manner of their use. They are as follows:

(a) As noted in the stylisation above, according to neoliberal economists, the end result of the import substituting strategy was the government's attempt to deficit finance its way to growth. Hence large budget deficits are considered to be the locus of all macroeconomic instability. Budget deficits, therefore, are to be drastically curtailed. An operational deficit greater than 1-2 per cent of GNP is deemed to be evidence of policy failure. Given Lafferian incentive problems with raising taxes, the public sector borrowing requirement is to be lowered by reducing expenditure.

(b) Expenditure reduction should emphasise elimination of subsidies. Governments should switch expenditures to education and health and public sector investment should be confined purely to stabilisation and adjustment process see Taylor (1988). On this subject also see Frenkel, Fanelli and Rozenwurcel (1993).

11 The growth-with-adjustment strategy was itself a delayed response. To start with, the response of the international creditor community as well as that of most economists to the Latin American debt crisis was that it reflected a short term liquidity crisis arising out of overabsorption. Hence, standard IMF-style demand management policies were sufficient to rectify the situation. It was much later (Diaz-Alejandro's celebrated 1984 paper which was aptly sub-titled We are not in Kansas any more) that mainstream economists accepted the worsening external circumstances for what they were - a long term tightening of international credit markets reflecting profound structural changes in developed market economies. It was only then that growth with adjustment started getting talked about. The classic analytical exposition of this growth-with-adjustment strategy which was done by Khan and Knight appears only in 1985. For a discussion of the various strategies used to resolve the debt-crisis and the economic implications of each see Mohanty (1992).

12 An operational deficit is a technical concept which factors out the impact of inflation on the overall budget deficit. For a discussion see section V, Chapter 13.
infrastructural areas.

(c) Most Latin American economies were considered to be highly taxed. Hence tax reform was suggested, aimed at lowering average tax rates coupled with moderate marginal rates and broadening the taxation base.

(d) As was noted above, financial repression is said to have played a key role in misallocation of resources and lack of investible funds. Thus, financial markets are to be liberalised. Market determined interest rates are presumed to offer savers a positive but moderate rate of return on deposits and reflect the true opportunity cost of funds, hence allowing for a correct allocation of resources.

(e) A realistic exchange rate policy is to be pursued. Overvaluation is to be strictly avoided and the policy objective should be to maintain competitive rates (competitive presumably means that which would keep exports competitive). The exchange rate is a key variable in effecting changes to the relative price structure facing the economy. A competitive exchange rate along with a lowering of tariff and non-tariff barriers is supposed to shift production from non-tradeables to tradeables and within tradeables from importables to exportables. Growth, then, hinges crucially on this relative price change and the consequent reallocation of resources in keeping with existing comparative advantages. Although ideally the exchange rate should also be market-determined the emphasis is on competitive rates, that is to say policy determined undervaluation is allowed. Additionally, even though policy determined undervaluation is allowed, taxes and subsidies in foreign trade are to be eliminated so that real effective exchange rate is not distorted.

(f) Trade policy is to be neutral as between earning and saving a unit of foreign exchange. To that end economies are supposed to have a low average tariff rate (not only the mean but the variance around the mean is also supposed to be low) and all non tariff barriers are to be dismantled. Non-tariff barriers are in the first instance to be converted to their tariff equivalent and then phased out. Exports taxes are to be removed. Infant industry protection is permitted but is to be strictly time bound. If an economy uses tariff protection then it must ensure that all imported intermediate inputs be available at internationally competitive prices.

(g) Foreign direct investment is to be subject to minimal regulation so that economies could
access to much needed capital and technology. Not only that, but their presence in the domestic market would weed out inefficient domestic firms and thus raise the resource use efficiency of the economy.

(h) Outside of investment in infrastructure, the public sector should not undertake production of goods and services. Public sector units are seen to be inefficient because of a host of factors - they operate under soft budget constraints; are immune to the discipline of the market (no fear of bankruptcy, takeovers, mergers); are prone to principal-agent problems; and create vested interests. The state should therefore privatise existing public sector units. In fact debt-equity swaps are seen to be useful in this context.

(i) It is argued by neoliberal economists that the best way to foster efficient growth is to approximate competitive market structures. Therefore markets should function under minimal (certain amount of prudential regulation is acceptable) regulation. Regulation introduces rigidities and hence makes markets inflexible and slow to respond to changing economic environments. Regulation also distorts incentives which in turn make price as a signalling device ineffective or inefficient. In this context, two important areas emphasised are removal of barriers to entry and exit of firms and deregulation of the labour market.

(j) One of the key institutions which underpin a smoothly functioning market economy is secure property rights. Property rights are seen to be particularly insecure in most of Latin America, leading to a dampening of the incentive to invest. Governments should therefore undertake necessary institutional change to ensure that property rights are made secure.

As Guitan (1987) suggests, an assumption underlying the Washington Consensus is that growth and adjustment are complementary. Growth is supposed to be induced by a change in relative prices (now market determined), leading to a more efficient allocation of resources and a better utilisation of existing capacity. Selowsky (1990) suggests that structural reforms and

13 The complementarity between adjustment and growth comes about because of the neoclassical penchant for assuming a cleavage between the real and the monetary segments of the economy. Inflation which is an indicator of, as well as caused by, macroeconomic imbalances is treated as essentially a monetary phenomenon. Therefore, reduced emission of money in the economy (curtailment of the budget deficit or restrictions on credit creation or both) is sufficient to tackle
macroeconomic prudence would induce agents to invest at home rather than abroad, which would then sustain long run economic growth.

But the package above lacks a truly short run stabilisation model with which to correct short run disequilibria like high rates of inflation [Frenkel, Fanelli and Rozenwurcel (1993)]. Reducing fiscal deficits clearly may not be enough. Therefore, it is married on to the standard IMF stabilisation package which centres around the management of aggregate demand. In the IMF view, rules of sound economic management would require that aggregate demand keep pace with the growth of productive capacity in the economy. As Guitan (1987) points out, reining in aggregate demand means not only achieving fiscal balance but keeping credit creation in line with the prospective path of desired money holdings in the economy. The short run stabilisation model of the Fund along with the supply side reforms outlined above would characterise the full set of measures which would both get rid of macroeconomic imbalances and put the economy on to a sustainable growth path.

The adjustment-with-growth model also stipulates a certain sequencing of this reform process. It is suggested that the process be broken up into two phases. The policy objective of the first phase would be to restore macroeconomic equilibrium in the economy and would therefore see the implementation of the Fund stabilisation package along with public sector reforms suggested in the Washington Consensus package. Once macroeconomic stability has been restored the second phase

inflation. The working of the real economy is governed by the relative price structure it faces. Given that inflation distorts key relative prices including the real exchange rate, control of inflation (along with removal of artificial barriers to price movements) along with supply side reform brings the economy in line with its 'true' (reflecting current scarcities) relative price structure. The real economy passively adjusts to this new set of prices which being 'true' leads to an efficient reallocation of resources and thereby growth. Notice that there are no feedback mechanisms in this model, the existence of which would unfortunately (as in the real world) complicate the story of adjustment considerably. Structuralists have pointed out that inflation may not be a monetary phenomenon, arising due to structural or institutional rigidities. Marxists have stressed the redistributive nature of inflation, where it is actually the actions of agents in the real economy (to increase or protect existing shares) which may result in an inflationary situation.

Though why the policy proposals do not explicitly address stabilisation is unclear. It may be the case that IMF-style stabilisation programmes are seen as both necessary and sufficient to stabilise the economy. The Consensus proposals can then be seen as addressing specifically the issue of growth which is essentially seen as a matter of supply side reform.
would commence - the policy objective being the use of supply side reforms to bring private incentives more in line with existing economic scarcities.

This phase would see the implementation of the core of the Washington Consensus proposals - that is, those relating to trade policy, financial deregulation, privatisation, deregulation of labour markets etc. It is also suggested that as far as liberalisation of the external sector is concerned, the freeing of capital account transactions should be the last item on the agenda, after all other supply side reforms, including those on the trade account have been accomplished and the economy has adjusted to the new regime [see e.g., Edwards (1984); Rodrik (1987)]. The underlying logic of this gradual sequencing path is to try and minimise the spillover effects stemming from sectoral liberalisation episodes.

If, for example, trade liberalisation is embarked upon before macroeconomic stability has been achieved (say, before inflation has been brought under control) then the real exchange rate would soon get overvalued, turning relative prices against exports and cheapening imports. The resultant pressure on the balance of payments could result either in a further tightening of monetary policy and/or a devaluation. The former could dampen the recovery of investment and the latter could exacerbate inflationary pressures. The two policies in conjunction could well push the economy into stagflation, as happened in Mexico in the mid-1980s.

Similarly, if, financial deregulation and both current and capital account liberalisation take place simultaneously, then the increase in interest rates consequent upon deregulation could induce an inflow of foreign portfolio capital into the economy, leading to an appreciation in the exchange rate. This appreciation would not only be contrary to the other objective of the reform process - namely, to use a competitive exchange rate as a tool for export promotion - but also by cheapening imports within a liberalised trade regime, lead to balance of payments difficulties. Balance of payments difficulties, in turn, could put a downward pressure on the currency, giving rise to expectations of a devaluation. This expectation could be self-fulfilling, if as a consequence private sector agents move capital out of the economy. The consequent devaluation could then threaten, both, macroeconomic stability and the reform process, as happened in Chile in the late 1970s and the early 1980s and in Mexico in the early 1990s.

20
Even though in theory, the nature of the sequencing process is one of the less contentious
issues among those who subscribe to the Washington Consensus, it does not follow that in practice,
the implementation of the package follows a pattern which the Consensus might consider optimal\textsuperscript{15}. That is, governments may decide to undertake a host of sectoral liberalisations simultaneously (the 'big bang' approach) rather than opt for gradualism.

In part, the reason may lie in political expediency. Most countries which undertake Fund/Bank
stabilisation and adjustment packages do so at points in time when they are not only faced with
economic chaos but also attendant political and social stresses. Paradoxically, this may increase the
political manoeuvreability of the state (what political scientists call 'relative autonomy'). It can be, as
normally is, argued that there is little option to implementing reforms, as all aid is contingent upon
the reform package's implementation. Hence a part of the blame is shifted on to actors external to the
economy.

It may also be the case that forces opposed to reforms, because of the economically chaotic
situation at that point in time, are relatively weak, making comprehensive packages more feasible to
push through. Simultaneity (as opposed to gradualism) can also be seen as an attempt to "front load"
incentives in favour of investors, both foreign and domestic, in the hope that private investment picks
up concurrent with the stabilisation package. If this comes about, not only would it ameliorate some
of the economic cost of stabilisation, which is now widely accepted as being non-trivial, but also
create a political constituency which would have benefitted from the reform package, and thereby
improve the chances of its sustainability\textsuperscript{16}.

\textsuperscript{15} There is now a huge amount of literature on optimal sequencing paths which essentially posits
the problems in terms of adjustment speeds of various markets and stabilising and destabilising
influences therein. For a review of this kind of literature see Edwards (1989).

\textsuperscript{16} The gradualism versus 'big bang' debate is applicable to the speed of liberalisation within
particular sectors as well. For example, should an economy move gradually towards free trade or is
it better to see an abrupt change in regimes? Mussa (1986), for example, argues that if economic
agents are rational and markets undistorted, the big bang approach is optimal. In the matter of timing
and sequencing of reforms, there is also, what the literature calls, the credibility issue. That is reforms
may not succeed because private agents are unconvinced about the government's seriousness and
therefore believe that it will soon backtrack. It is argued that if this belief is widespread then it
introduces distortions in the behaviour of private agents, making the belief self-fulfilling. For example,
III. The macroeconomics of stabilisation

As has been noted earlier, IMF stabilisation packages are centered around the view that inflation is the result of excess of aggregate demand over aggregate supply. On the additional assumption that demand and supply in the private sector of the economy is essentially in balance, it follows that this excess aggregate demand is the result of excess of government consumption over revenue, i.e., budget deficits. IMF stabilisation policies, therefore, are centered around a reduction in aggregate demand, through a balancing of the government's budget and a restrictive monetary policy. They also suggest a devaluation of the currency to correct for the overvaluation of the real exchange rate consequent upon the inflationary episode. The reduction in the real wage, consequent upon a reduction in the budget deficit and devaluation, is then supposed to lead to a substitution of labour for capital, make domestic goods competitive in export markets and therefore lead to output growth and a reduction in unemployment. Unemployment is clearly seen as a result of labour pricing itself out of the market.

consequent upon an `incredible' trade liberalisation, agents may import much more than they would done otherwise, leading to the undermining of trade liberalisation due to balance-of-payments problems [see e.g., Calvo (1989)]. In this context it has been suggested that a big bang approach may be useful in signalling the government's seriousness about reforms [see Rodrik (1989)]. In the context of signalling, governments may choose to undertake external commitments to signal the irreversibility of a reform process (e.g., Mexico's accession first to GATT and then to NAFTA may be read as such a signal). In the context of open capital market and volatile agent expectation, the issue of credibility does take on an added edge. But in my judgement, in the final analysis, the timing and sequencing of reforms are far more influenced by political economy factors, rather than technical issues of speeds of adjustment of markets and so on. Be that as it may, even if the 'big bang' approach is undertaken either to overcome credibility problems or because of reasons of politically expediency, it nonetheless, as indicated above, may complicate the stabilisation process, making it a fairly long drawn out affair.

17 The reduction in the budget deficit would be achieved both by a reduction in expenditures and an increase in revenue. Given that subsidies are typically political 'hot potatoes', the first item of expenditure to get axed is public investment. On the revenue side, public sector tariffs are increased. This would affect the overall price level, and therefore the real wage, if the public sector produces intermediate inputs (electricity, steel, coal etc). In addition, if the public sector produces basic consumer necessities (bread, housing, transportation) then an increase in these prices would affect the real wage directly. Public sector tariffs, if they are below the cost of production, are of course indirect subsidies. But if along with raising public sector prices, direct subsidies are also reduced, that could either directly or indirectly impact on the real wage. The government's recourse to these measures to balance its books is reinforced if there are 'fixed cost' elements in the budget, e.g., defence expenditure and debt-servicing.
But as Taylor (1988) suggests, this simple and therefore perhaps appealing story has far too many pitfalls. Despite the contrary economic world view of the IMF, ever since Keynes it has generally been accepted that demand and supply in an economy are equilibrated by both output and price changes (or what is the same thing, changes in income distribution). In the IMF's world view, couched in the more anodyne technicality of microeconomics, the dominant equilibrating mechanism is shifts in relative price induced substitution effects. To put it differently, even though the IMF would never look at it in these terms, changes in income distribution. But moving away from the rarified world of homogenous economic agents with similar savings propensities, to a world characterised by class differentiation and dissimilar savings behaviour, price changes must necessarily work themselves out through changes in income distribution. This is what makes stabilisation policies so intensely political.

But returning to the IMF model, on the assumption that an economy is capacity constrained or at full employment, prices would be the dominant adjusting variable. In such a situation, if one assumes, that the national income is broken up into two broad flows - wages and profits - then any increase in prices, either because of a demand injection or a supply contraction, would mean a redistribution of incomes in favour of profits, on the assumption that the mark-up pricing rule is followed and wages are not indexed. If savings propensities differ as between wages and profits in favour of the latter, then national savings increase and excess demand gets inflated away, or what in macroeconomics is called the phenomena of 'forced saving'. Economies such as these are called 'exhilarationist' because a redistribution of incomes towards profits stimulates production.

On the other hand, in an economy which is not facing a capacity constraint and their exists unemployed labour, output changes may be the dominant equilibrating mechanism. In such an economy a demand injection feeds through to a higher level of economic activity and therefore higher

---

18 Taylor (1988) has a lucid and exhaustive analysis of the stabilisation process in developing economies. Nayyar (1996) provides a concise and lucid critique of IMF orthodoxy. There is of course a huge literature which analyses both the theoretical framework of the IMF stabilisation and adjustment policies and the experience of economies which have implemented these policies. Outside of references mentioned above, also see Killick (1984); Pastor (1992); Cooper (1992); Taylor (1993) and Bhaduri and Nayyar (1996).
incomes. Higher incomes lead to higher consumption levels which then feeds through the multiplier process to a new equilibrium output level. In the literature these are called 'stagnationist' economies, because an increase in the real wage by activating demand and leading to a higher capacity utilisation, would result in higher investment and growth. In an economy such as this, an austerity induced contraction in demand could result in lower levels of output and employment.

The key question then is what is the dominant equilibrating mechanism in an economy. If prices are the dominant mechanism then one would expect the IMF kind of story to go through. On the other hand, if output equilibrates demand and supply then IMF style policies could well end up exacerbating the disequilibria. As Taylor (1988) details, in a large number of countries which have undertaken IMF stabilisation policies, wage cutting and other measures which have pushed the distribution of income against labour have elicited a 'stagnationist' response - Mexico, before the heterodox stabilisation programme was adopted, perhaps being a classic case.

Not only is it the case that IMF stabilisation models assume a particular equilibrating mechanism, in these models, the causes of inflation are also eclectic. In the IMF world view, inflation is essentially a monetary phenomena, caused by excessive monetary emission. Based on the famous 'equation of exchange', which in the ex post sense is an accounting identity, but on the assumption that output and the velocity of circulation of money are constant, tells an ex ante causal story in a world of price-clearing markets, where increases in money supply lead to an increase in the price level. On the other hand, Structuralists and Marxists have long pointed out that inflation may be the result of institutional rigidities and distributional conflict. Again, if inflation in economies reflects Structuralist or Marxist concerns then, reductions in money supply are not only unlikely to give a handle on it, but what is more, perhaps deepen the disequilibria. For example, if inflation is the result of distributional conflict and there exist indexation mechanisms, then the decline in real wages as a result of policies to reduce excess demand may well spark off an inflationary spiral.

In the real world of course, economies exhibit both price and output clearing markets and sectors which could well run up against capacity constraints. Which not only means that economies use both price and output as equilibrating mechanisms, but also that the response of an economy to a macroeconomic shock is the result of a complex interplay between markets with different
equilibrating mechanisms and institutional specifications. The fact of complexity does not mean that
generalisations should not be attempted or that sensible stabilisation policies are not possible. It
simply means that the simple and neat IMF economic world view which underpins its stabilisation
model is too much of a straitjacket within which to bind policy formulation. Equally importantly,
following IMF policy prescriptions on stabilisation could well end up complicating the process.

For example, it is suggested that a shift in terms of trade in favour of agriculture, by increasing
the purchasing power of farmers, may have an expansionary effect on the economy. On the other
hand, if agriculture is characterised by flex-price markets and is capacity constrained and industry is
characterised by mark-up pricing then, an increase in the price of basic foodstuffs (by increasing the
price of wage-goods) could well retard industrial growth [see e.g., Mitra (1977)]. Additionally, an
increase in agricultural prices, could in the presence of indexation and mark-up pricing spark off an
inflationary spiral. Similarly it is suggested that public investment crowds out private investment. On
the other hand, if public and private investment are complementary, then the negative effect on
demand because of a cut back in public investment could well get reinforced by a sympathetic fall in
private investment, exacerbating recessionary pressures [see e.g., Taylor (1988)]. Similarly,
devaluations are supposed to be expansionary by stimulating export growth. But a devaluation could
well be contractionary through its negative impact on real wage movements [see Diaz-Alejandro
(1965); Krugman and Taylor (1978); and Lizondo and Montiel (1989)]. Additionally, devaluation,
through cost-push effects on the price level, could end up pushing the economy towards stagflation.

The above examples are merely illustrative of the kinds of complications that could arise. It
is also important to remember that should stabilisation go hand in hand with structural reform (as a
way out of perceived 'credibility' problems or because of reasons of political expediency) then, as
noted in the earlier section, the stabilisation story could get additionally complicated. To reiterate,
the essence of the above is that the IMF stabilisation model overlooks both structural and institutional
features of developing economies and could therefore end up exacerbating disequilibria rather than
correcting them.

Unfortunately, that is not all. Even if the myriad complications that could arise on the path
to stabilisation are for the moment overlooked, and it is assumed that stabilisation is achieved, it does
not mean that growth would necessarily follow. It could well founder on issues of income redistribution and recession. If the private sector is not willing to invest (and supply side changes in themselves do not guarantee this)\(^9\) and if the government is constrained from using expansionary policies then the economy is trapped. As Dornbusch (1991) notes, the basic problem is that the stabilisation with growth model is inadequate:

"[a]ll the crowding-in problems...are solved by assumptions: investment is assumed to rise spontaneously to structural adjustment; real depreciation drives growth immediately; and whenever the economy deviates from full employment the growth rate responds positively to the gap by an unexplained mechanism. In practice, of course, none of these assumptions hold. Unless the export sector rapidly becomes a strong, driving force, growth will not come. If domestic demand is the source of growth, external constraints soon become binding." [p 42]

**IV. The underlying growth model of the proposals**

Ultimately the differences of those of a non-neoliberal persuasion with the Washington Consensus set of reforms is less to do with the specifics of the package (even though there are important differences there as well) and more to do with the underlying explanation of the dynamics of growth and the process of industrialisation\(^20\). Or to put it differently, a non-neoliberal reform

\(^9\) Recessions are not particularly conducive to the revival of sagging 'animal spirits'. Private sector agents may choose to wait because individual actions are characterised by 'herd behaviour' [see e.g., Banerjee (1992); Bikchandani, Hirshleifer and Welch (1992)] or because there are pure informational externalities to be gained from observing the actions of other agents [see Chamley and Gale (1994)]. Or it may be the case that private sector agents invest in liquid financial assets rather than physical capital, because there is some uncertainty about either stabilisation and/or the structural reforms [see e.g., Dornbusch (1991)]. Notice that in the last example, unless something happens to nudge investor expectations, not investing in physical capital may well turn out to be a self-fulfilling expectation.

\(^20\) Even though there is a reasonable consensus among most participants in this debate about the importance of industrialisation in any growth process, there are notable exceptions as well. Krueger (1995) argues that the emphasis on industrialisation in the growth strategy of developing countries was misplaced, leading to the neglect of agriculture. This is of course another example of Krueger's masterly generalisations, but I do not think that there is necessarily a contradiction between rapid industrialisation and expansion in agriculture output (it is another matter that trade policy associated with import substituting industrialisation may have worked as a disincentive against agricultural exports). Indeed, for economies facing a wage-goods constraint, expansion of agricultural output is a prerequisite for rapid industrial growth [see Kalecki (1971)]. On the other hand, if there exist supply rigidities, then a movement of relative prices in favour of agriculture could well result in a retardation of industrial growth [see Mitra (1977)].
package would differ from the proposals outlined above because of a fundamentally different understanding of the process of industrialisation and growth.

In the 1950s and the 1960s theorising about economic growth was dominated by the Solow-Swan type of growth models which explained growth in per capita incomes to be driven by capital accumulation and labour augmenting technical change (the latter increasing labour productivity and thereby allowing a pari passu increase in real wages). The central developmental problem was thus seen to be one of resource mobilisation\(^{21}\) which constrained investment in developing economies. Around the same time, theorising in welfare economics suggested that state intervention was necessitated in the presence of widespread market failure [see e.g., Baumol (1967)]. Stemming from this was also a discussion about the nature of state intervention, in terms of 'first-best' and 'second-best' options\(^{22}\) [see e.g., Bhagwati (1971); Corden (1974)].

The recognition of resource mobilisation as the central development problem within a context of widespread market failure therefore formed, in mainstream development economics, the raison d'être of arguments in favour of an interventionist state. This consensus on the need for state intervention was not confined to the cloisters of academia but was also endorsed by multilateral lending institutions such as the IMF and the World Bank. In sum then, theorising in growth economics and welfare economics underpinned a widely held consensus about the necessity of state intervention both to maximise investment (as a proportion of GDP) through domestic resource

\(^{21}\) As opposed to this, the neo-Keynesian view is that even in the long run investment determines savings. For example, Marglin (1987) and Marglin and Bhaduri (1990) argue that investment is dependent upon Keynesian 'animal spirits', i.e. the expectation of profit, a matter which is entirely subjective. The interesting thing about these expectations are that, under certain conditions, they are self-fulfilling. Of course, the notion of savings in neoclassical and neo-Keynesian models are radically different and explains in part the self-fulfilling nature of expectations. In the context of this discussion, one simply notes that an alternative explanation for the desire to rein in the state and deregulate is an attempt at affecting the subjective probabilities mentioned above.

\(^{22}\) Typically, this kind of literature would suggest that state intervention ought to be targeted specifically at the sector or market in which the distortion exists (the 'first-best' option). But if the first-best was not available as a policy option, then the theorem of the second-best justified indirect sectoral intervention to counteract the distortion (say the use of trade policy to protect infant industries rather than a direct production subsidy).
mobilisation and foreign aid and correct for market failure.

The 1970s saw the demise of, what Marglin and Schor (1990) call, the 'golden age of capitalism', partly due to structural changes that had been wrought as a result of the success of the accumulation model and in part due to conjunctural factors. The consequent rise of the free market ideology (Thatcherism in the UK and Reaganism in the USA) and, hanging onto its coat-tails, *laissez-faire* economics, meant that multilateral aid agencies did an about turn in the developmental advice proffered to developing countries. The focus shifted to getting prices right (read letting the free play of market forces determine all prices). That is, far more important than resource mobilisation was efficiency in resource allocation and use. Growth then was seen to stem from efficient allocation of resources across sectors and efficient use within sectors.

This was buttressed by growth decomposition exercises using TFP models which suggested that by far the most important contributor to growth were increases in total factor productivity (TFP) which was taken as an indicator of efficiency in resource use. Empirical research also pointed to the fact that economies with lower price distortion indices had higher TFP levels. Add to this the advantages of backwardness a la Gerschenkron, or to use a more neutral term, advantages of latecomers to development, and the story is complete, in that convergence to industrialised country per capita income growth rates is predicted. The underlying theory of growth would be some kind

---

The development of two-gap models [see e.g., Chenery and Strout (1966)] is to be seen in this context. Economies were seen to be constrained either by a lack of domestic resources (the savings gap) or foreign resources necessary to finance complementary imports (it was world characterised by export pessimism and hence the foreign exchange gap). If an economy was foreign exchange constrained then the ability to finance a higher level of imports (say by foreign aid) would result in a more than proportional increase in income and investment. Two-gap models were extremely influential in theoretically underpinning the importance of resource transfers to developing countries via foreign aid.

Gerschenkron had pointed out that an advantage of being a backward economy (or a latecomer in the development process) is that it need not expend resources on developing technology as there already exists a range of technology which has been tried and tested by those who are ahead in the developmental race. Therefore if technology is exogenous, and one assumes as the neoclassicals do, that all countries have access to the same technology, then economies comfortably converge to the same growth rate. Additionally, because developing economies start from a lower level of per capita capital than what would obtain in the steady state, in the transition period they would achieve higher rates of growth. This transitory high rate of growth can be thought of as the
of an augmented Solow-Swan model where growth would come about not only because of increased capital accumulation and labour augmenting technical change but primarily due to increases in TFP stemming from getting prices right. Getting prices right would not only mean that economies would be able to export on the lines of existing comparative advantage and thereby expand their markets, but the free flow of goods and capital would make available the technology necessary for a sustained increase in growth rates.

Supply side reforms which allow prices to reflect existing scarcities; outward orientation of the economy; and minimal state intervention would, therefore, allow economies to maximise their rates of growth in a sustainable fashion. The implicit role of technology in the above growth model and therefore the necessity or otherwise of an industrial policy, the nature of distortions in the behaviour of private economic agents arising from state intervention induced rent-seeking and the role of finance in economic growth will be studied in greater detail in subsequent chapters. But here one would simply like to note that the importance of both, improved resource allocation as well as outward orientation in overall growth performance are by no means settled issues.

Ever since the famous Harberger triangles [see Harberger (1954)], it has been recognised that the magnitude of welfare costs arising due to distortions in relative prices is not very large. More recent works using the general equilibrium framework reach similar results [see e.g., Dervis, de Melo and Robinson (1982), and Srinivasan and Whalley (1986)]. Equally importantly, neither in theory nor in empirical research is the link between outward orientation and growth clearly established. As one would expect, there is a veritable cottage industry trying to empirically establish a positive relationship between some measure of outward orientation and growth [see e.g., Balassa (1978); Feder (1983); Michaely (1977); Alam (1987); Syrquin and Chenery (1989); and Dollar (1992)]. But as pointed out by a host of studies [see e.g., Jung and Marshall (1985); Dornbusch (1991); Esfahani (1991); Taylor (1991); Levine and Renelt (1992); and Rodrik (1995)], empirical research seeking to establish a positive relationship between outward orientation and growth suffers from both statistical advantage of backwardness. The nature of technology and how it may affect, both the microeconomic behaviour of firms as well as the overall growth process will be discussed in greater detail in Chapter 2.
and interpretational problems.

First, there is no consensus on what is the correct measure for outward orientation and there is no statistically significant positive correlation among the various measures used. Sometimes, the trade-regime indicator may actually be an endogenous variable. Second, in a large number of instances, the cross-country regressions used are very sensitive to the particular configuration of dependent variables used. Third, even in instances where statistically robust results are achieved, there remains the problem of causality. There are also studies which have sought to demonstrate that there is no relationship between distortions in the exchange rate and the interest rate on the one hand and any measure of outward or inward orientation on the other [see e.g., Bradford (1984)] or that the level of per capita income is a much better predictor, than some measure of outward orientation, of economic performance across a large cross-section of countries [see Singer (1988)]. What the above suggests is that the impact of distortions in the trade regime, one way or another, on economic growth is far from being conclusively established.

If the older static models, using the 'small country' assumption and homogenous goods, of comparative-advantage based gains from trade fail to conclusively link the benefits of openness with economic growth, new trade theory, incorporating imperfect market structure, heterogeneity in goods and increasing returns to scale has been far more successful in doing so.

Here the heterogeneity assumption is of particular importance. With heterogenous goods, the stock-in-trade 'small country' assumption becomes a gross mis-specification. Perhaps equally importantly, if heterogenous goods are inputs into the production process then trade, both by increasing the variety available and allowing for cheaper inputs (countries can reap increasing returns to scale by accessing larger markets), can positively affect growth. And as Grossman and Helpman (1991) and Rivera-Batiz and Romer (1991) have argued, if these inputs also incorporate improved technology then the effect noted above gets reinforced.

But unfortunately for those of the neoliberal persuasion, new trade theory reaches unsettling conclusions as well. The size and nature of the home market is important to the pattern of
specialisation; there are benefits to be achieved from strategic interventions, technological leads and lags may get reinforced through the mechanism of international trade [see e.g., Krugman (1987)]. What is more, if imperfect market structures and technological spillovers are incorporated within endogenous growth models of the kind suggested by Romer (1986) and Lucas (1988), then the impact of international trade on domestic economies could also be deleterious [see Aghion and Howitt (1992); Krugman (1990); Rivera-Batiz and Romer (1991); and Grossman and Helpman (1991)].

In sum, neither theory nor empirical research seems to justify the centrality accorded to an undistorted price structure and an 'outward oriented' economy (however defined) as explanations for successful economic growth. It may be useful to close this section with a quote from the conclusions which Rodrik (1995) reaches at the end of a survey on trade and industrial policy reform:

"[t]he benefits of price reform remain small in relation to developmental objectives, and tend to be linked with economic growth through uncertain and unreliable channels ... [I]t bears repeating that the South Korean and Taiwanese economies have prospered in policy environments characterized by quantitative trade restrictions, selective subsidies, and discretionary incentives bearing more than a passing superficial resemblance to those in other developing countries ... [I]t also bears repeating that countries like Mexico, Argentina, Chile and Bolivia have travelled recently much faster and further on the road to price reform and trade liberalisation than South Korea, Taiwan and Japan before them ever did." [p 2972]

V. Conclusion

Notwithstanding the current neoliberal fashion of laying the blame for all macroeconomic ills and microeconomic distortions at the door of 'government failure', there was, even as late as the 1970s, a reasonable consensus among mainstream development economics and multilateral lending agencies about the necessity of state intervention. The erosion of this consensus has as much to do

25 It should be noted that the original Brander and Spencer (1985) paper which suggested that, in an imperfect market set up, there may be benefits from strategic intervention in favour of domestic firms which compete internationally, has been shown to be a much less robust result than originally thought. Specifically, the Brander-Spencer results get overturned if firms, rather than competing in quantities as in Brander-Spencer, instead use prices [see Eaton and Grossman (1986)]. But as Levy and Nolan (1992) suggest, strategic intervention in favour of firms in the domestic market, either against foreign goods or foreign firms which compete domestically may still have a theoretical rationale.
with structural economic change seen in developed market economies after the end of the 'golden age', as with perceived failures and successes among late industrialisers in the second half of the twentieth century. Indeed, the stylisation about the developmental experiences of late industrialisers is ranges from the seriously inadequate (experiences in Latin America) to simply incorrect (the role of the state in East Asian economies). Additionally, the stabilisation model used, which views the world essentially through monetarist glasses, is inadequate if not inappropriate. Incorrect stylisation in combination with an excessively monetarist macroeconomic stance has meant a set of policy proposals flawed in conception, and not surprisingly inappropriate in practice.