The Washington Consensus: Assessing a Damaged Brand

Nancy Birdsall, Augusto de la Torre, and Felipe Valencia Caicedo

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Abstract

In this paper we analyze the Washington Consensus, which at its original formulation reflected views not only from Washington but also from Latin America. We trace the life of the Consensus from a Latin American perspective in terms of evolving economic development paradigms. We document the extensive implementation of Consensus-style reforms in the region as well as the mismatch between reformers’ expectations and actual outcomes, in terms of growth, poverty reduction, and inequality. We then present an assessment of what went wrong with the Washington Consensus-style reform agenda, using a taxonomy of views that put the blame, alternatively, on (i) shortfalls in the implementation of reforms combined with impatience regarding their expected effects; (ii) fundamental flaws—in either the design, sequencing, or basic premises of the reform agenda; and (iii) incompleteness of the agenda that left out crucial reform needs, such as volatility, technological innovation, institutional change and inequality.

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1. Introduction

It is hard to overemphasize the practical and ideological importance of the Washington Consensus in Latin America. The Decalogue of Consensus policies laid out by John Williamson in his 1989 landmark paper became in the minds of advocates and pundits alike a manifesto for capitalist economic development. In the words of Moisés Naim (2000) the term “soon acquired a life of its own, becoming a brand name known worldwide and used independently of its original intent and even of its content.” For its advocates, the Consensus reflected a doctrine of economic freedom that was best suited for the political democracies to which many Latin countries had returned after a long spell of military dictatorships (Williamson, 1993). For its opponents, as Williamson (2002) himself noted later on, the Consensus was an unjust “set of neoliberal policies (...) imposed on hapless countries by the Washington-based international financial institutions.” Regardless of the political stance, there is no denying that overall the Consensus became, in Moisés Naim’s (2002) epigrammatic expression, a “damaged brand.”

The social and economic philosophy implicit in the Consensus was not created by Williamson. It was, so to speak, “in the air”—a robust intellectual and ideological current of the times which emphasized the virtuous combination of political democracy and free markets. Williamson’s article rode on a global wave that transformed the conventional wisdom in favor of free market economics, which included the rise of neoclassical economics and the rational expectations revolution among academic macroeconomists. It is not a coincidence then that the appearance in 1989 of the Washington Consensus coincided with fall of the Berlin Wall, which symbolically marked the burial of centrally planned economies.

This article analyzes the birth, evolution, implications, and controversy surrounding Williamson’s Decalogue from a Latin American standpoint. It is structured as follows. Section 2 provides the intellectual and economic context that preceded and gave rise to Washington Consensus. Section 3 examines the Consensus itself, as formulated in Williamson’s article, and distinguishes between its academic origins and subsequent incursion into the ideological sphere. Section 4 describes the extent of implementation of Consensus-style reforms during the 1990s and Section 5 analyzes their economic outcomes. Section 6 presents a typology views on what went wrong with the Washington Consensus and Section 7 concludes.

2. Economic and Intellectual Antecedents to the Consensus

Around the time when Williamson’s article was first published, the intellectual effervescence had been sufficient to move the dominant economic development policy paradigm away from state dirigisme—which had prevailed in Latin America and the Caribbean (LAC) during the 1960s and 70s—towards a greater reliance on markets. This mutation started in the 1970s, gained momentum during the 1980s—when a corrosive and generalized debt crisis sunk the region into a “lost-decade” of economic slump—and reached its heights during the 1990s—arguably the glorious years for the Washington Consensus.
The mutation of the economic development paradigm that led to the Washington Consensus was neither easy nor smooth, or completely linear. But the general outlines of this transition are clear enough and worth sketching. Prior to this change, the policy views in the region had drawn heavily from the early development literature’s emphasis on capital accumulation and the view that widespread market failures in developing countries would hinder accumulation. Markets were simply not expected to work properly in developing countries (Rosenstein-Rodin 1943, Gerschenkron, 1962; Hirschman, 1958; and Rostow, 1959). It was less important to gain an adequate understanding of why private markets failed than to verify that they did fail, and badly. Economic development—the argument went—was too important to be left at the mercy of flawed market forces and the state had to play a major role in accelerating capital accumulation. The state was to control, directly or indirectly, the “Commanding Heights” of the economy and mobilize and allocate resources purposefully (often via multiyear planning).

Interestingly and in contrast with the experience in East Asia, the pre-Washington Consensus LAC model of state dirigisme promoted inward-oriented economic development. There was of course no necessity in the internal logic of government activism for it to be associated with inward orientation, but in LAC it was and in a major way. This link was promoted by important intellectual strands prevalent in the region. It was consistent with the structuralist vision heralded by the Economic Commission for Latin America and the Caribbean (ECLAC) and underpinned by the writings of Raul Prebisch (1950) and Hans Singer (1950). For this vision, a virtuous circle between manufacturing growth and the expansion of domestic demand would enable LAC countries to break free from the terms-of-trade deterioration trap. Prebisch (1950) thus famously declared that “industrialization has become the most important means of expansion.” Inward orientation was also consistent with Hirschman’s notion—popular then in LAC—that the formation of strong backward linkages was crucial for sustained growth and hinged mainly on domestic economy dynamics. It was also in line with the Marxist inspired Dependency Theory (Gunder Frank, 1967; Furtado, 1963; and Cardoso and Faletto, 1979), which interpreted the relation of the “periphery” (developing countries) to the “center” (rich countries) as one of debilitating dependency—i.e., a structural subordination of the periphery’s economic activity to the interests of the center that stifled the former’s technological dynamism and economic diversification.

Dependency theory thus joined ECLAC-style structuralism and Hirschmanian views in emphasizing that the cure for underdevelopment was a proactive state pursuing industrial policies to secure the expansion of production for the domestic market. This underpinned the import substituting industrialization (ISI) model that dominated the region in the 1960s and 1970s. Promoting domestic manufacturing to replace imports implied an intense, hands-on involvement of the state through a large set of interconnected interventions, including, state

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1 These classic arguments have been formalized theoretically in terms of principal-agent problems, scale effects, and externalities (Hoff and Stiglitz, 2001; and Murphy, Shleifer, and Vishny, 1989).

2 For Prebisch and Singer, the decline of the terms of trade for primary commodities was secular. It emanated from the combination of a low income and price of global demand for commodities, on the one hand, and the excessive dependence of the periphery on primary goods exports, on the other. It thus led to systematic resource transfers from the commodity-intensive periphery to the capital-intensive center.
owned firms and banks, subsidization of infant industries, central planning, widespread price controls, high import tariffs and quotas, administered interest rates and directed credit.  

**Figure 1. Latin America and East Asia: Relative GDP per capita (1900-2008)**

(Ratio to US GDP per capita, in constant 1990 USD)

LAC did grow robustly during the height of the ISI period but so did the world; hence, its per capita income did not on average converge significantly towards that of the rich countries—a fact that often goes unnoticed (Figure 1). In any case, ISI showed signs of exhaustion around the late 1970s, as the initial growth dynamism of inward-looking industrialization subsided and associated macroeconomic imbalances mounted. While this was a heterogeneous process and with different timings across countries in the region, it was the Debt Crisis of the 1980s that intensified and synchronized LAC countries’ movement away from ISI to embrace the rising

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3 ISI was politically attractive and ideologically appealing for key interest groups that were increasingly entrenched. Overvalued exchange rates ensured cheap imports of capital goods for the rising industrial class, along with protection of their consumer products in the domestic market. Cheap borrowing on external markets and easy fiscal and monetary policies allowed for expanding job creation in urban areas, including in the public sector and state enterprises. By protecting activities oriented towards the domestic market and using an overvalued exchange rate to keep urban prices low, ISI policies acted as a tax on exporting agriculture. This dislodged the traditional power of large hacendado owners and contributed to increasing rural-urban migration, while creating a powerful new set of political constituencies in the rapidly growing urban areas (Lipton, 1977).

4 For example, Argentina and Brazil borrowed heavily to finance import-substitution while Mexico mainly to increase public spending. By contrast, public borrowing had little impact in Chile and Colombia.
global wave of pro-market policies. While triggered by an external shock—the sharp rise in dollar interest rates engineered by the U.S. Fed to fight inflation—the severity of the debt crisis reflected the magnification of that shock by the dangerous accumulation of domestic vulnerabilities, until then hidden under the mirage created of an unusually benign external environment (Kuczynski and Williamson, 2003). Global interest rates as well as high commodity prices had invited or at least allowed what in retrospect were unsustainable policies.

As the debt crisis deepened, the dark side of inward-looking industrialization and associated macro imbalances was manifested in a well-known catalog of maladies. These included internationally uncompetitive industries; severely distorted relative prices leading to inefficient allocation of resources; rent-seeking and corruption in the administered allocation or rationing of credit, fiscal, and foreign exchange resources; bottlenecks and economic overheating; large public deficits; excessive foreign borrowing by Latin sovereigns; rising and unstable inflation (and actual hyperinflation in several countries).

The economic and social pain involved in the adjustment process of the 1980s was immense, so much so that the period became known as the Lost Decade. As capital inflows abruptly stopped and terms of trade deteriorated sharply, the region was forced to shift from an aggregate external current account deficit of almost US$2 billion in 1981 to a surplus of more than US$39 billion in 1984. This was induced by major currency devaluations and severe restrictions on imports, including of vital capital and intermediate goods, which implied a dramatic erosion of real wages and living standards. To put the fiscal accounts in order, countries embarked on deep and highly disruptive expenditure cuts, which hit disproportionately social and infrastructure investment programs. Living standards collapsed—the regional average per capita income in 1985 barely exceeded that of 1975 and for some countries it fell to levels prevailing in the mid-1960s (Balassa et al., 1986). Unemployment rose to more than 15 percent in many countries while underemployment swelled. Inflation averaged 150 percent in the region, exploding into hyperinflation in Bolivia, Argentina and Brazil. Concerted debt rescheduling and roll-overs coupled with “new money” were engineered during the 1980s but they proved woefully insufficient as the problem was one of debt overhang. It was solved belatedly, as the internationally community reluctantly accepted the need for debt reduction and restructuring, implemented during 1989-1995 by a number of LAC countries (including Mexico, Costa Rica, Venezuela, Argentina, Brazil, Dominican Republic, Ecuador, Peru) under the Brady Initiative.

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5 The beginning of the Debt Crisis was marked by a fateful 1982 meeting in Washington D.C. when Mexican officials announced their payment difficulties to the US Secretary of Treasury. Mexican and Brazilian bond spreads skyrocketed 600 to 800 basis points. As the IMF offered Mexico US$5 billion in emergency lending, Mexico nationalized the banks and announced that principal payments on the foreign debt would be suspended until 1984.


7 In terms of net external transfer of resources, Latin America and the Caribbean swung from inward net transfers of US$11.3 billion in 1981 to net outward transfers US$18.7 billion in 1982 and to an average outward transfer of US$26.4 billion from 1982 to 1986.

8 The debt overhang is defined by debt levels that are high enough as to act as a 100 percent marginal tax on investment effort, thus undercutting growth. See Myers (1977), Krugman (1988) and Corden (1991).
Given the severity of the crisis, it is not surprising that by the end of the 1980s and the beginning of the 1990s the region was prepared for a major change. Economically, Sebastian Edwards (1995) summed up this paradigmatic change: “During the 1980s and early 1990s, there was a marked transformation in economic thinking in Latin America. The once-dominant view based on heavy state interventionism, inward orientation, and disregard for macroeconomic balance slowly gave way to a new paradigm based on competition, market orientation and openness.” Politically, the economic hardships tested the recently restored democracies (which followed the military dictatorships of the 1960s and 1970s in Argentina, Brazil, Bolivia, Ecuador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Paraguay and Uruguay). Against this background, by 1989 the shift away from “state-led industrialism” (as Ocampo and Ros, forthcoming 2010, aptly name it) or “import-substitution industrialization” (as it is more commonly known) towards a market-led model gained critical momentum.

3. The Washington Consensus

Williamson’s article was thus published when the region was already on the road of change. What Williamson did was to summarize in a Decalogue of 10 policies (Table 1) the converging views that had clearly emerged among the participants (including many prominent Latin American scholars and policy makers) in an 1989 Institute of International Economics Conference organized in Washington, D.C. by John Williamson himself entitled Latin American Adjustment: How Much Has Happened? While reflecting his own views, Williamson’s (1990) article constitutes a synthesis of policies already in vogue at the time—in Washington and the region as well. Indeed, Williamson is better portrayed as a recorder than a creator of the new paradigm, and the real actors in the drama of the decade that ensued were the technocrats and political leaders in the region itself.9

These winds of change were reflected not just in Williamson’s piece but in other visible—though less influential—writings of the time, who urged export-orientation, increased savings along with efficient investment, as well as a simplification and streamlining of a hitherto all too present role of government. Williamson would later make repeated reference to Toward Renewed Economic Growth in Latin America (Balassa et al., 1986) in his own formulation. Even ECLAC—still viewed as the intellectual home of a more state-led approach to development—supplemented the shift away from inward orientation. For example, Bianchi, Devlin and Ramos (1987) argued that “the debt problem requires a structural transformation of the economy in at least two senses: the growth strategy needs to be outward oriented and largely based on an effort to raise savings and productivity.” Similarly, Fajnzylber (1990), after examining the contrast with East Asia, saw the need for a major change in Latin America’s economic policy direction in order to combine market-oriented reforms with policies targeted towards the poor.

9 The role of the international financial institutions, which pushed for the reforms, often conditioning their loans on reform progress, remains a matter of debate. Reforms would not have been implemented only in response to outside pressure—but the pressure was probably not irrelevant to their timing and depth, and in some cases to the backlash that they created.
The Washington Consensus was a Latin version of what had in fact become a worldwide consensus by the 1990s. It had in common with the international version the conviction that economic prosperity could only be obtained by harnessing the power of markets. This was associated with a view of government interventionism as a fountainhead of distortions that represses creativity and causes resources to be misallocated. The new paradigm called for allowing the free play of market forces to coordinate through price signals myriads of decentralized decisions of firms and individuals, thus enabling efficient resource allocation and fostering creative entrepreneurship. In sharp contrast with the old paradigm, the new one proclaimed that economic development was too important to be left in the hands of government planners and bureaucrats. Development policy, therefore, had to focus on freeing and enabling markets to “get prices right.” Official World Bank and Inter-American Development Bank (IDB) documents that appeared during the 1980s heralded the coming of this new age for development thinking, clearly signaling that the view had left academic circles and was being mainstreamed into practical policy.\(^\text{10}\)

But there were two other defining features in the Latin version of the new paradigm that were duly captured in the Washington Consensus. The first was the quest for macroeconomic stabilization. The second entailed a marked shift towards an outward oriented growth strategy. Given that chronic macroeconomic maladies had become a Latin trademark, it is not at all surprising that the need to introduce macroeconomic policy rectitude would be high in LAC’s development agenda. The shift towards sound macro management was understood as a precondition for market-based development. The shift towards an outwardly orientated growth strategy was propelled by the exhaustion of import substitution and the success of East Asian export-led growth, which had put these economies on a frank path towards per capita income convergence with the industrialized countries.\(^\text{11}\)

A careful review of Table 1 shows clearly that Williamson’s actual formulation of the Consensus emphasized the technical dimensions of economic policy and is measured and balanced in its overall prescriptions. Its Latin American flavor comes through policy prescriptions geared to addressing Latin-specific maladies: macroeconomic stabilization (e.g., fiscal discipline to avoid high inflation, tax reform to broaden the tax base and positive real interest rates to overcome financial repression) and outward orientation (e.g., the elimination of import quotas and low and uniform import tariffs and a competitive exchange rate to induce non-traditional export growth and the removal of barriers to FDI). The pro-market agenda was embodied in policies aimed at: removing the entrepreneurial function of the state (e.g., privatization of state enterprises); freeing and enabling markets (via deregulation, the strengthening of property rights, moderate marginal tax rates, low and uniform import tariffs and

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\(^{11}\) During the 1970s and 1980s, the East Asian Tigers took off while LAC stagnated and lost ground. The ratio of per capita income (nominal dollars) of the East Asian Tigers to that of the United States rose from less than 20 percent in the late 1960s to around 40 percent by the late 1980s. By contrast, the same ratio for LAC hovered around 30 percent during the 1970s and fell to less than 25 percent by the late 1980s (see again, Figure 1).
a level playing field for foreign and domestic firms); and complementing markets (via the reorientation of public expenditures to primary education, health and infrastructure, both for growth and to improve the distribution of income).

Table 1. The Decalogue of Washington Consensus Policies (1989)

<table>
<thead>
<tr>
<th>1. Fiscal Discipline</th>
<th>Budget deficits—properly measured to include local governments, state enterprises, and the central bank—should be small enough to be financed without recourse to the inflation tax.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Public Expenditure Re-Prioritization</td>
<td>Public spending should move away from politically popular but economically unwarranted projects (bloated bureaucracies, indiscriminate subsidies, white elephants) and towards neglected fields with high economic returns and the potential to improve income distribution (primary health and education, infrastructure).</td>
</tr>
<tr>
<td>3. Tax Reform</td>
<td>To improve incentives and horizontal equity, the tax base should be broad and marginal tax rates moderate. Taxing interest on assets held abroad (“flight capital”) should become a priority in the medium term.</td>
</tr>
<tr>
<td>4. Positive Real Interest Rates</td>
<td>Ultimately, interest rates should be market determined. As this could be destabilizing in an environment of weak confidence, policy should have more modest objectives for the transition, mainly to abolish preferential interest rates for privileged borrowers and achieve a moderately positive real interest rate.</td>
</tr>
<tr>
<td>5. Competitive Exchange Rates</td>
<td>Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.</td>
</tr>
<tr>
<td>6. Trade Liberalization</td>
<td>Quantitative trade restrictions should be replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 percent is achieved.</td>
</tr>
<tr>
<td>7. Foreign Direct Investment</td>
<td>Barriers impeding foreign direct investment and the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.</td>
</tr>
<tr>
<td>8. Privatization</td>
<td>State enterprises should be privatized.</td>
</tr>
<tr>
<td>9. Deregulation</td>
<td>Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.</td>
</tr>
<tr>
<td>10. Property Rights</td>
<td>The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.</td>
</tr>
</tbody>
</table>


In contrast to the popular perception, Williamson’s Decalogue is a far cry from market fundamentalism. He does not even mention the liberalization of the (non-FDI) capital account—which became increasingly controversial in the policy debate as the 1990s unfolded. On the liberalization of domestic financial markets, Williamson is restrained calling only for gradually
allowing interest rates to be market determined. Similarly, he steers away from the polar choices in exchange rate policy—a hard peg or a fully free floating rate—which are arguably most consistent with the unfettered play of market forces.\footnote{A fixed peg (or a predetermined path for the nominal exchange rate) was used in several LAC countries during the 1990s to rein on inflation in an initially less contractionary manner. On the theory of exchange rate-based inflation stabilization see Dornbusch (1976); Calvo (1986); Kiguel and Liviatan (1992); and Rebelo and Vegh (1995).} Instead, he advocates keeping a “competitive exchange rate” which in practice requires discretionary intervention by the central bank. Paradoxically, as will be seen later, actual policy implementation in Latin America was much more aggressive precisely with respect to financial liberalization and exchange rate policy, the two areas where Williamson had been distinctively cautious.

Williamson’s formulation is also a far cry from a radical view in favor of a minimalist state that is commonly attributed to the Consensus. There is no supply-side economics calling for a reduction in tax burdens or a major shrinking of the size of the state. To be sure, the privatization of state enterprises is a central policy in Williamson’s Decalogue, but it is not justified as a means to reduce the size of the state but to achieve economic efficiency and reorient government spending in favor of health, education and infrastructure, much of this in order for the state to play a greater redistributive role. In this respect, Williamson subsumed some of the equity considerations that had appeared, for instance, in UNICEF’s (1987) report on Adjustment with a Human Face.

Later on, Williamson (2000) characterized his ten policy items as summarizing the “lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989.” But this narrow characterization was a late and ultimately unsuccessful effort to keep it the Washington Consensus term from being dragged into an excessively ideological realm.\footnote{If pushed too far, a narrow and unduly technocratic view exposes the Decalogue to countless criticisms, starting with the obvious one that “consensus” is too strong a term, a point made by Richard Feinberg during the 1989 IIE Conference itself. Feinberg argued that, given the wide spectrum of views and personalities in Washington institutions, a better term would have been “convergence.” A similar criticism concerns the time horizon of the policies considered. Rodrigo Botero (Williamson, 1990) argued, that “there is a certain consensus on short-term policy issues, less on medium-term issues (…), and still less on the long-term issues.” Moreover, one would be hard pressed to argue that some of the specific policies in Williamson’s article—such as the recommendation to tax interest on assets held abroad—commanded strong consensus at that time. In a broader and deeper sense, this narrow, technocratic characterization falls short of the mark.} By then it was already seen as a synonym of market fundamentalism and neo-liberalism. The induction of the appealing “Washington Consensus” term into the ideological sphere is now a fact of history. And this helps explain why such renowned economists as Nobel Prize winner Joseph Stiglitz criticize the Consensus sharply even as they warn about the dangers of unrestrained financial liberalization and recommend measured trade liberalization, along the same lines of Williamson’s initial formulation. It is therefore more appropriate to characterize the Consensus—as done in this chapter—as an expression of a broader change in economic development policy, a paradigmatic shift in favor of macroeconomic stabilization and market-based development.

In the next sections, we keep this broad understanding of the Washington Consensus but focus on its economic dimensions, staying away from the heavy ideological connotations that
came to dominate the popular view. We start by inquiring how the Consensus, thus understood, fared in Latin America in terms of actual reform implementation and consequent outcomes.

4. **Consensus-Style Reforms: Implementation**

This section documents the intensity of reform implementation without assessing its effectiveness. The latter is a most relevant dimension of inquiry but lies outside of the scope of this chapter. The reader is referred to the numerous sources that assess implementation effectiveness more rigorously, often extensively, by type of reform.  

During the 1990s, most Latin American countries enthusiastically embraced Consensus-style reforms, with the strong support from international institutions, particularly in the context of IMF stabilization programs and policy-based lending programs of multilateral development banks. While the record is mixed and varied across countries, the vigor of reform implementation in the region was higher than at any time in memory. Eduardo Lora (2001) detects a “great wave” of Consensus-style structural reforms during the 1990s, with particular intensity and concentration in the first half of the 1990s (Figure 2). His structural reform index—which is measured on a scale from 0 to 1 and combines policy actions in the areas of trade, foreign exchange, taxation, financial liberalization, privatization, labor and pensions—rose steeply from about 0.4 in 1989 to almost 0.6 in 1995. As the structural reform process lost momentum around 2000, the 1990s can be considered as the “glorious years” of the Washington Consensus.

One key reform area concerned macroeconomic stabilization, where policy action was impressive. It was in the 1990s when Latin America finally conquered inflation—bringing it down from hyperinflation or chronically high levels to single digit rates in most countries (Figures 3a and 3b). Behind this achievement were important reforms to central banking that virtually eliminated the monetary financing of fiscal deficits. While progress on the fiscal front was less impressive than in the monetary area, things generally moved in the direction of greater viability, a process that, as noted, was aided in several countries by sovereign debt reduction agreements reached with external creditors under the Brady Initiative. The average public sector deficit in the region declined from minus 2.4 percent of GDP in 1980-1989 to almost zero during the mid-1990s, while public sector external debt fell on average from 60 percent to 40 percent of GDP during the 1990s, even if the total (external and internal) public debt did not decrease much (Figures 4a and 4b).

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15 This heterogeneity is in part captured by Lora’s (1997) classification of Latin American countries into four groups: early reformers (Argentina, Chile, and Jamaica); gradual reformers (Colombia and Uruguay); recent (or late) reformers (Bolivia, El Salvador, Nicaragua, Paraguay, Peru, and the Dominican Republic); and slow reformers (Brazil, Costa Rica, Ecuador, Honduras, Mexico and Venezuela). See also Morley et al. (1999).

16 The advance of the reforms is measured as the margin for reform existing in 1985 that was utilized in subsequent years—for trade, financial, tax and privatization policies (see Lora, 1997 and 2001).
Figure 2. Latin American Structural Reform Index Average (1985-2002)

Note: The advance of the reforms is measured as the margin for reform existing in 1985 that has been utilized in subsequent years. The index combines measures of trade, financial, tax and privatization policies.

Considering specific components of structural reform, action was concentrated in the area of liberalization, both in trade and finance. With respect to trade, the 1990s saw a confirmation of a liberalization trend that had started in the mid-1980s, involving mainly the removal of import quotas and the reduction of average import tariffs. The average tariff rate for the region, which had fallen from nearly 50 percent in the early 1980s to around 33 percent in 1990, declined further during the 1990s to around 10 percent by 1999 (Figure 5). The 1990s added to this trend a new feature—a significant reduction in the variance of import tariffs to only one fourth from 1990 to 1999.

But it was arguably in finance where—departing from Williamson’s cautious formulation—Latin America’s liberalization-oriented reforms were most aggressively implemented. While the region had lagged considerably behind the global wave of financial liberalization of the 1980s, it embraced it with vengeance during the 1990s. The financial liberalization index developed by Kaminsky and Schmukler (2003) shows that it took only the first half of the 1990s for the region to bring relatively closed and repressed financial systems to a level of liberalization comparable to that of developed countries (Figure 6). Financial liberalization was carried out on the domestic and external fronts. Direct credit controls were abandoned and interest rates deregulated. Restrictions on foreign investment were lifted, and other controls on foreign exchange and capital account transactions were dismantled. Foreign banks were allowed and encouraged to establish local presences.
Figure 3a. Latin American Inflation (1990-2000)

Note: Weighted regional averages.

Figure 3b. LAC Inflation, Selected Countries (1990-2000)
(In Percentage)


Figure 4a. LAC Budget Balance, Selected Countries (1990-2000)
(Percent of GDP)

Note: Central government budget.
Source: Economist Intelligence Unit (2010).

Figure 4b. LAC Public Debt, Selected Countries (1990-2000)
(Percent of GDP)

Note: Central government debt.
Source: Economist Intelligence Unit (2010).
Liberalization on the external front may have been attractive for many countries because of the region’s low domestic savings, despite its potential effects on exchange rates and financial systems. (Fukuyama and Birdsall, (eds.), forthcoming 2010). Private domestic savings were low while public savings were constrained by high public debt service (see Figure 7, comparing Latin American and East Asian savings). Perhaps this is why Williamson included taxing “flight capital” as a priority in the medium term. The reliance on foreign capital inflows was in turn associated with constant appreciation pressures on the exchange rates, which undermined competitiveness in non-commodity exports. Again the comparison with East Asia is apt. And while it is well known that the reform and modernization of the regulatory and supervisory arrangements for financial markets lagged their liberalization—which, as noted later on, constituted a source of systemic vulnerability—the 1990s did see important, if insufficient, improvements in legal, regulatory, trading and informational infrastructures that are germane to financial markets. These included the revamping or upgrading of banking and capital markets legislation (Figure 8).

The 1990s also registered a wave of privatizations (of public banks and enterprises) and significant, albeit one-dimensional, pension reforms. More than 800 public enterprises were privatized between 1988 and 1997 (Birdsall, de la Torre and Menezes, 2001) and the cumulative amount of funds raised through privatizations during the 1990s was on the order of US$200 billion (Figure 9). In pensions, Chile’s pioneering reform of 1981 had a major demonstration effect throughout the region. Similar systems were adopted during the 1990s by Argentina, Bolivia, Colombia, Costa Rica, El Salvador, Mexico, Peru and Uruguay. These reforms consisted basically of a shift away from government-administered, pay-as-you-go, defined-benefit pension systems for private sector employees to systems that rely mainly on a so-called “second pillar” of mandatory, defined and privately-administered pension funds. The market orientation herein is clear, as these pension reforms shifted from the state to the capital markets the dominant role in administering retirement-related savings.

Lastly, structural reform intensity was more modest in tax reform and virtually non-existent in labor markets (Figure 10). Lora’s index of labor market reforms barely rose during the 1990s (progress was actually negative by 1994 and only slightly positive by 1999). Williamson’s inclusion of “public expenditure reprioritization” has usually not been viewed by students of the Consensus as a structural reform and is not even included in the reform indices—which is itself a commentary on the tendency even in scholarly work to overlook aspects of the Consensus that are not associated with market liberalization.

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17 The actual motives for privatization ranged from the search for efficiency gains to the need for fiscal revenues or pure rent-seeking.
18 Brazil did not carry out a Chilean-style pension reform but pension funds account for a significant portion of Brazil’s institutional investor base. At the end of 2004, Brazilian pension funds assets represented about 19 percent of GDP.
19 There were also other important reforms implemented during the 1990s which lie outside the scope of the Consensus but are of importance in assessing subsequent economic performance in the region. Several countries, for instance, adopted new constitutions and moved decidedly towards fiscal decentralization.
Figure 5. Latin American Import Tariff Liberalization (1985-1999)  
(Average and Deviations in Percentages)

Note: The solid line represents the simple average tariff rate for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Mexico, Peru, Uruguay and Venezuela. The area represents the average deviation of the tariff rate across countries. Costa Rica and Guatemala are excluded from the deviation calculations.  

Figure 6. International Financial Liberalization Index (1973-2002)

Note: The liberalization index is calculated as the simple average of three indices (liberalization of the capital account, domestic financial sector and stock market) that range between 1 and 3, where 1 means no liberalization and 3 means full liberalization. The regional averages are simple country averages.  
Source: De la Torre and Schmukler (2007).
Figure 7. Latin America and East Asia: Gross Domestic Savings (1970-2008)  
(Percent of GDP)  

Note: East Asia is the un-weighted average of Hong Kong, Singapore, South Korea, Taiwan, Indonesia, Thailand and Malaysia, while LAC covers the whole Latin American and Caribbean region.  

Figure 8. Latin American Capital Markets Reform Implementation (1990-2002)  

Note: Percentage of Latin American countries having implemented reforms.  
Source: De la Torre and Schmukler (2007).
Figure 9. Latin American Cumulative Amount Raised by Privatizations (1988-2003)  
(In billion USD)

Source: De la Torre and Schmukler (2007).

Figure 10. Latin American Advance of Reforms (1989-1999)

Note: The advance of the reforms is measured as the margin for reform existing in 1985 that has been utilized by 1989, 1995 and 1999.  
5. Consensus-Style Reforms: Outcomes

While Latin America championed the Washington Consensus in the 1990s, the observed outcomes were disheartening and puzzling. Disheartening because of what was arguably too meager a payoff relative to the intensity of the reform effort. Puzzling because of the lack of clarity on what went wrong. This section discusses the disheartening side of the equation. The next addresses the puzzles.

As noted before, inflation reduction and macroeconomic stabilization were an undeniable achievement of the 1990s. In addition, the optimism inspired by the convergence of views around Consensus-style reforms contributed to a major surge in net private capital inflows to the region. These inflows rose from US$14 billion in 1990 to $86 billion in 1997, before declining to US$47 billion in 1999 in the wake of the Asian financial crisis (Birdsall, de la Torre and Menezes, 2001). Whether these inflows led to higher investment is a different question, and it seems that in general might have not (Ffrench-Davis and Reisen, 1998).

But when the attention is focused on the outcome variables that really matter for economic development—per capita income, poverty and income distribution—it appears that the Washington Consensus yielded little progress during the 1990s relative to expectations in most of Latin America with the notable exception of Chile (and even there excluding income distribution).20

5.1. Factual Overview

Consider first GDP growth and per capita income. Regional growth did recover modestly—from 1.1 percent per year in 1980-1990 to 3.6 percent in 1990-1997 and 3 percent average for the 1990s as a whole. But this hardly involved productivity growth and was not sufficient to reduce the convergence gap in per capita income between the region and the rich economies.21 Instead, the ratio of per capita income in Latin America relative to the United States, which had already fallen precipitously during the “lost decade” of the 1980s, continued to decline, albeit marginally, throughout the 1990s (see again, Figure 1). This stands in sharp contrast with the experience of the East Asian Tigers, whose per capita income gap with the U.S. narrowed significantly, while countries pursued policies that were not framed in the Washington Consensus spirit of liberalization, privatization and macroeconomic stabilization. The exception in the disappointing growth picture for Latin America was Chile, which became the poster child of the Washington Consensus policy agenda. Real GDP growth in this country rose to an average of 6.4 percent per annum during the 1990s from 4.5 percent in the 1980s, so that the ratio of Chilean to U.S. per capita income increased significantly over the decade (Figure 1).

20 The Dominican Republic was another notable exception during the 1990s, especially in terms of robust growth performance.

21 On the generally low total factor productivity growth in Latin America during the 1990s, see Loayza, Fajnzylber and Calderón (2005). While overall productivity in the region was relatively low, except in the case of Chile, major productivity gains were realized in many countries at the sector level, especially in agriculture.
Outcomes in the social arena were even more disappointing. Consider first poverty. The expectation was that the pickup of growth in the 1990s, modest though it was, would lead to a proportional reduction in poverty.\textsuperscript{22} That expectation was not realized. While the region’s per capita GDP increased by a cumulative 12 percent from 1990 to 2000, poverty rate (measured at 4 dollars a day in PPP terms) did not decrease (Figure 11). Moreover, the absolute number of poor in the region (calculated on the basis of countries’ own definitions of the poverty line) remained roughly constant, at around 200 million people throughout the 1990s (World Bank, 2009). Similar figures from ECLAC (2010) give a 1.5 percent yearly growth from 1990 to 2000 rate for Latin America and the Caribbean along with a slight decrease in poverty from 48.3 percent to 43.9 percent. Only in Chile did the poverty rate fall sharply, from 38.6 percent in 1990 to 20.2 percent in 2000.

The distributional outcomes were equally frustrating as income inequality remained stubbornly high throughout the 1990s (Figure 12). The non-weighted average Gini coefficient for income distribution in the region increased somewhat, from 50.5 in the early 1990s to 51.4 in 2000, while the weighted average remained virtually unchanged (World Bank, 2004).\textsuperscript{23} Even Chile’s Gini coefficient was stuck at around 55 during the 1990s. The fact is that income inequality is stickier than poverty everywhere and has remained stubbornly high in the region for decades (declining later on for the first time, and only modestly, in Brazil and Mexico during the 2002-2007 period of faster growth).\textsuperscript{24}

From a strictly technical point of view, the limited progress on social outcomes might have been foreseen. The Washington Consensus reforms, as will be seen later, were mainly meant to liberalize and stabilize the economies and allow for growth, not reduce inequality. But to the extent that the 1990s became in the public consciousness the decade of the Washington Consensus reforms, and those reforms became synonymous with expectations of social and economic growth outcomes, expectations were disappointed.

5.2. Counter-Factual Overview

There is little doubt that outcomes during the 1990s in terms of growth, poverty and inequality were disheartening relative to expectations. But would the assessment change if the focus is placed on reform impacts not relative to expectations but compared to the counterfactual—i.e., to what would have happened in the absence of Consensus-style policies? This line of inquiry—evidently of greater interest to academics than to the average citizen—has given rise to copious empirical research. When all is said and done, the preponderance of the econometric evidence arising from this research suggests that Latin America would have been worse off without the reforms. Per capita income and output in the 1990s would have been lower and poverty deeper. Moreover, the relatively strong performance of Latin America during

\textsuperscript{22} In a well-known article, Dollar and Kraay (2001) find a robust empirical regularity that the per capita income of the poor increases proportionately to average per capita income.

\textsuperscript{23} To the extent that public goods provision is not incorporated into the income-based Gini measures, inequality may be overstated.

\textsuperscript{24} The situation in the unemployment front was varied but job creation was generally weak during the 1990s and informality tended to increase (Stallings and Peres, 2000; and World Bank, 2007).
Figure 11. Latin American Poverty and GDP per capita (1980-2006)


Figure 12. International Gini Coefficients (1970-1999)
(Household per capita income)

the global crisis of 2008-2009 can be attributed to a significant extent to improvements in macroeconomic and financial fundamentals resulting in part from the reforms of the 1990s and early 2000s (more on this later).

The results from econometric studies have to be taken with a large grain of salt considering the numerous and thorny technical complications with the associated empirical tests. These include: small sample sizes; the potential presence of global trends that may affect both reforms and outcomes; difficulties in quantitatively isolating impacts; complications in establishing a causal relationships; problems with adequately measuring reforms, their degree of implementation and, even more, their quality; and the dependency of results on time periods under investigation. In any case, while studies differ in terms of evidence and methodology and their results are difficult to compare, a general pattern emerges: earlier research that focuses on the first half of the 1990s tends to produce results that are more favorable to Consensus-style reforms than later research focusing on the second half of the 1990s.

An important paper that sets the tone in the earlier wave of research is Lora and Barrera (1997). These authors compare 1987-1989 with 1993-1995 and find that structural reforms and their accompanying macro stabilization spurred growth by 2.2 percentage points relative to the growth rate that would have been obtained in the absence of reforms, of which 1.9 points are due to structural reforms and the remainder to stabilization policies. Other studies in this group went further to argue that actual growth performance in the region during the first part of the 1990s was better than that predicted by econometric models. In this sense, growth outcomes are considered to have exceeded expectations—if expectations are defined as those arising from econometric predictions. For example, Easterly, Loayza and Montiel (1997), using a panel from 1960 to 1993 with 70 countries, 16 of them Latin American, find that reforms allowed the region to return to a 2 percent per capita growth rate from 1991 to 1993, a rate that—given country characteristics and the relative depth of the reforms implemented—was higher than predicted by their model. Similarly, Fernández-Arias and Montiel (1997), using a panel from 1961 to 1995 with 69 countries, 18 of which were Latin American, find that the aggregate contribution of stabilization and structural reforms to long-run growth was 1.84 percentage points and argue that, despite a negative external environment, Latin American growth during the 1990s was greater than otherwise predicted.

While the generation of early research converges on the view that reforms boosted growth in the first half of the 1990s by about 2 percentage points, later studies have a much less favorable assessment. For example, Lora and Panizza (2002) compare 1985-1987 with 1997-1999 and find that the reforms lifted growth in the latter period by only 0.6 percentage points. They conclude that the beneficial impact of reforms decreased as the 1990s unfolded and that their effects were largely transitory, raising the level of income but not the rate of growth. A series of studies spearheaded by ECLAC also yielded very modest results and Ffrench-Davis (2000) calls for the reforming of the reforms. Escaith and Morley (2001) find a minimal and non-

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25 This result was confirmed later on by Loayza, Fajnzylber and Calderón (2005) who, comparing 1986-1990 with 1996-1999, estimated that structural reforms and accompanying macro stabilization policies had a 1.9 percentage point average impact on growth for Latin America for the decade as a whole. Loayza, Fajnzylber and Calderón (2005) is, however, an exception among the studies that appeared after 1997.
robust effect of the reforms taken as a whole. Stallings and Peres (2000) conclude that a 10 percent increase in the overall reform index boosted growth by a meager 0.2 of a percentage point and that the effects of individual reforms were ambiguous. While import liberalization, privatization and capital account opening had a positive effect, the same is not true for the tax or the financial reforms. In a review article, Ocampo (2004) notes that the positive post-reform performance in the first part of the 1990s stands in contrast with the low growth of the “lost-half decade” of 1998-2002, stressing that growth during the decade was sluggish and volatile.

Studies on the effects of Consensus-style reforms on poverty and inequality, independent of their growth effects, are rarer, with the notable exceptions of Székely and Londoño (1998) Morley (2000), and Behrman, Birdsall and Székely (2007). Most studies conclude that financial sector liberalization was associated with an increase in income inequality, though with diminishing effects over time. Other reforms, including privatization, seem to have reduced inequality. The privatization of water and other services actually improved access for the poor and reduced the prices they paid (see studies in Nellis and Birdsall, 2005). But the overall effect of the reforms was at best neutral and at worst harmful in terms of income inequality outcomes.

5.3. Bottom Line

The conclusion is inescapable that, with the exception of Chile, outcomes during the 1990s generally fell significantly short of the reformers’ expectations. Even if inequality is not considered, growth and poverty reduction outcomes were disheartening when compared to the intensity of the reform effort. There is reasonable support for the technical counterfactual argument that growth in the first part of the 1990s would have been lower and poverty higher in the absence of Consensus-type reforms. But even this view loses force when: the years beyond 1997 are taken into account, individual reforms are examined separately and growth volatility (not just the growth rate) is also considered. Moreover, the counterfactual reasoning—that without reforms things would have been worse—provides little consolation to the region’s many poor and unemployed citizens.

The sense of disenchantment with the Washington Consensus deepened dramatically in the late-1990s and early-2000s when the region was hit by a wave of financial turbulence that pushed several countries into crippling twin (banking and currency) crises, including Ecuador (1999–2000), Argentina (2001–2002), Uruguay (2002) and the Dominican Republic (2003). Not surprisingly, during 2001–2003 per capita income growth in the region was negative even as other regions in the world enjoyed positive growth.

As the region entered the new millennium not only did the Washington Consensus lose support but it also generated vibrant opposition in many quarters. With societies disappointed by the outcomes, policy makers found little or no ground to mobilize the political coalitions needed for additional doses of Consensus-style reforms. Not surprisingly, the region entered into a period of structural reform fatigue, as economic reforms stalled in most Latin American countries around 1997 (Lora 2001 and Lora et al. 2004).

Public opinion polls (Latinobarómetro) of the early 2000 found Latin Americans resentful of market-oriented reforms, especially privatization and tired of high unemployment and stagnant wages.
The puzzle then is what went wrong with the Washington Consensus? To this issue we turn next.

6. What Went Wrong?

Setting ideological differences aside, there is a wide range of economic views on what went wrong with the Consensus-style reform program. This variety of views should of course come as no surprise, for the same evidence examined from different perspectives can lead to different diagnoses. This section provides a flavor of the range of perspectives on the subject by classifying them into three typological views, each of which provides a distinct and non-reducible answer to the question of what went wrong, namely:

i. There was nothing wrong with the Consensus reform program itself. The problem was the faulty implementation of the reforms (including due to political economy constraints) combined with impatience regarding their effects.

ii. The Consensus reform program was fundamentally flawed. This view has two very different variants. Variant one: the Consensus failed to consider sequencing issues and threshold effects. Variant two: the Consensus was based on a simplistic and ultimately wrong understanding of the linkages between policy reform and economic outcomes.

iii. The Consensus reform program was not wrong in what it included but it did not include all that was needed. The Consensus was thus patently incomplete. It was based on too narrow a view of what matters for economic development and, as a result, left out essential areas for reform action.

Each of these contrasting views captures a relevant aspect of the debate, bringing out points that are mostly complementary but sometimes fundamentally at odds with each other. The reader should not make too much of this taxonomy of views, as there is no presumption that it represents a complete set nor that it is necessarily superior to potential alternative taxonomies. It should be seen essentially as a framework constructed from hindsight to help organize and discuss in an orderly fashion the salient aspects of, and discrepancies in, the assessment of the Washington Consensus.

6.1. Faulty Implementation and Impatience

According to this view, the Washington Consensus was fundamentally right in its principles, content and overall design. The set of Consensus-inspired reforms was fairly complete and reflects international “best practices” that are, by and large, of general applicability across developing countries and for a broad range of development stages. Moreover, in line with the econometric evidence presented, Consensus-style reforms were part of the solution and not the problem. Consistent with this view, Fernández-Arias and Montiel (1997) argue that “most of the enormous growth gap with East Asia (…) is explained by incomplete reform” and could be
closed by “pushing further in the direction of the reforms that have already been implemented.” A more recent study by the IMF (2005) blames the poor post-reform outcomes on uneven and incomplete reform implementation.  

Hence, supporters of this view argue that the shortfall in the outcomes relative to expectations was not due to flaws with the Consensus reform package itself but to the deficient manner in which it was executed. Reforms were unevenly implemented, hence the uneven outcomes. Where reforms were implemented more deeply and consistently (i.e., Chile) they were associated with impressive growth and poverty reduction outcomes. In the majority of countries, however, reforms, even when initiated, were insufficiently implemented or suffered reversals. In many cases, when laws were passed they were not adequately enforced or regulatory changes, institutional adaptations and capacity building did not follow. In other cases, key reforms were not even initiated (as in the labor field).

Moreover—this view contends—reformers were too impatient, unreasonably expecting results to materialize sooner than warranted. While the expectation of a rapid payoff was justified with respect to some types of first-generation reforms—especially in the macroeconomic stabilization arena—it was unrealistic for the more complex structural reforms that typically require long implementation and gestation periods. Looking back from 2010, a case can be made that the payoff of sustained reform did come for Latin America, when the global crisis of 2008-2009 hit. Countries such as Brazil, Chile, Colombia, Mexico, and Peru that persevered in implementing sound macroeconomic policies over the past fifteen years and that reacted with appropriate reforms to the crises of the late-1990s—by introducing greater exchange rate flexibility, developing local-currency debt markets, reducing currency mismatches and modernizing financial regulation and supervision—came out of the recent global crisis bruised to be sure, but without systemic damage. Those reforms helped reduce systemic vulnerability, prepared the countries to better face financial globalization, and enabled them to undertake countercyclical policies to cushion the effects of the external shock and avoid a systemic crises at home (Porzecanski, 2009; Rojas-Suarez, ed., 2009, and World Bank 2010a). This illustrates that patience and sustained implementation of Consensus-style reforms pays off in the long run.

This view does not ignore the costs of reforms, including those arising from transitory instability. But it notes that this is as it should be, since teething pains and even crises are part and parcel of the market-oriented development process.  

The opening and competition that result from liberalization may increase instability in the short run but also help expose weaknesses and foster a cleansing process that ultimately strengthens defenses and stimulates further reform. Over time, through pain and success, learning takes place and incentives are eventually set right, yielding durable results. Chile’s strengths owe in no small part to a constructive reaction to the painful crises of the late 1970s and early 1980s. The message that

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27 Additional renditions of this sort of message can be found in Krueger (2004) and World Bank (1997).
28 Aghion, Bacchetta, and Banerjee (2004) show theoretically that countries undergoing intermediate stages of financial development are likely to experience greater instability that countries in either advanced or early stages of financial development.
29 Consistent with this hypothesis, Kaminsky and Schmukler (2003) find that financial liberalization is associated with more pronounced boom-bust cycles in the short run but leads to more stable financial markets in the long run.
naturally arises from this view is the need to persevere. Reforms must be sustained and consistent. And along the path to economic development a premium should be placed on letting market discipline work, recognizing that it sets in motion a process of “creative destruction” that involves short-term pain and long-term gain.

The emphasis going forward, this view would stress, should be on overcoming political resistance to reform implementation, as it is now well known that politics mattered much more than reformers anticipated. Much of the political economy constraints revolve around the collective action problem. That is, the difficulty of mobilizing broad support for reform given the status quo bias that emerges from self-reinforcing factors, including the fact that losses from reform have to be absorbed upfront while the (greater) gains accrue overtime, and the fact that losers are easy to identify and typically well-informed and well-organized (which boosts their capacity to lobby against reform) while winners (including future generations) are dispersed, unorganized and prefer to free ride. Taking into account the political economy of reform implementation is essential to complement the technical soundness of reforms.

6.2. Fundamental Flaws

This view, in sharp contrast with the previous one, finds the Washington Consensus agenda to be seriously flawed in some fundamental sense. It involves two variants that are very different in nature.

The first variant is the sequencing critique. The original formulation of the Consensus was mostly silent on sequencing. It left open the question whether the outcomes would be similar, independently of whether reforms were implemented simultaneously or separately and, in the latter case, regardless of the order of implementation. A key focus of this critique, though by no means not the only one, is on premature financial market liberalization—the de-regulation of the domestic financial system and opening of the external capital account ahead of adequate regulatory strengthening. A wrong sequencing of reforms in this field can turn the normal pains of growing up into unnecessary suffering, as financial crises can rapidly wipe out gains achieved over several decades (Bhagwati, 1998 and Stiglitz, 2002).

Earlier versions of the sequencing critique to financial liberalization applied mainly to the domestic banking system. Weak banking systems are ill-prepared to operate prudently in freer financial markets and properly intermediate surges in capital inflows. As a result, they become prone to credit bubbles followed by credit busts (Gavin and Hausmann, 1996). Therefore, a minimum threshold of institutional strength—in terms of the legal framework, regulatory system, supervisory capacity, and accounting and disclosure standards—should be in place before

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30 Fernandez and Rodrik (1991) argue that there can also be a status quo bias in the presence of uncertainty with regards to the distribution of gains and losses. Alesina and Drazen (1991), focusing on fiscal adjustment, conclude that any efficient policy change with significant distributional consequences can be delayed by a “war of attrition.” Lora (2000) finds that crises are significant predictors of reform while Lora and Olivera (2005) show that reformers can pay a significant price in the ballots.
liberalizing the financial system.31

In the second half of the 1990s, the critique was first applied to the domestic banking system.32 Weak banking systems are ill-prepared to operate prudently in freer financial markets and properly intermediate surges in capital inflows, becoming prone to credit bubbles followed by credit busts (Gavin and Hausmann, 1996). A minimum threshold of institutional strength should be in place before liberalizing the financial system. This sort of sequence is of course easier to implement in countries where financial systems are repressed by administrative controls and the capital account is relatively closed. But what to do with respect to countries whose financial system is already liberalized? Some would counsel emerging economies to roll back capital market opening and “throw sand in the wheels,” including through the use of Chilean-style disincentives on short-term “hot money” inflows. Some would even suggest that liberalization of capital flows should be managed on a permanent basis (Fukuyama and Birdsall (eds.), forthcoming 2010), as full financial integration might never be desirable (Ocampo, 2003; Stiglitz, 1999 and 2000; and Tobin, 2000). Others would advocate delaying further liberalization while attention is reoriented towards re-prioritizing reforms, in favor of strengthening in earnest the regulatory and institutional preconditions.

A later version of the financial sequencing critique—stemming from the so-called ‘original sin’ literature—focuses on currency and maturity mismatches in the balance sheets of borrowers. The “original sin” consists of the inability of emerging economy sovereigns and corporates to issue long-term domestic currency denominated debt, which begets the currency mismatches that, in turn, raise systemic vulnerability. In a first incarnation, this literature recommended the adoption of formal dollarization to bypass the “original sin” (Calvo and Reinhart, 2000; Hausmann et al., 1999). In light of the disastrous collapse of the Argentine currency board,33 a second incarnation of this literature focused, instead, on sequencing—the need to develop the market for domestic currency denominated debt before completely opening the capital account (Eichengreen, Hausmann and Panizza, 2005). Proponents point to Australia as an example of a country that got this sequence right, one that is arguably also being adopted by the two largest emerging economies—India and China (Lane and Schmukler, 2006).

In general, sequencing arguments can also involve a reference to threshold effects—i.e., the notion that positive outcomes cannot be attained unless a minimum degree of implementation

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31 A number of theoretical papers show that financial liberalization may be associated with crises (see, for example, Allen and Gale, 2000; Bachetta and van Wincoop, 2000; Calvo and Mendoza, 2000; and McKinnon and Pill, 1997). Empirically, several papers have found links between financial deregulation, boom-bust cycles, and banking and balance of payments crises (see, for example, Corsetti, Pesenti, and Roubini, 1999; Demirguc-Kunt and Detragiache, 1999; Kaminsky and Reinhart, 1999; and Tornell and Westermann, 2005).

32 A brilliant, pre-Consensus rendition of the sequencing critique can be found in Díaz-Alejandro (1984).

33 On the rise and fall of the Argentine convertibility system see Cavallo and Cottani (1997), De la Torre, Levy Yeyati and Schmukler (2003), Perry and Serven (2003), and Galiani, Heymann and Tommasi (2003). For assessments of the conceptual and empirical basis in support of exchange rate flexibility see, for instance, Goldstein (2002), Larrain and Velasco (2001), and Mishkin and Suvastano (2002). Prior to the early 2000s, hard-pegs or dollarization, on the one hand, and exchange rate flexibility, on the other, were seen as competing, albeit equally respectable, alternatives for emerging economies seeking a safe integration into international capital markets (Calvo and Reinhart, 2002; Eichengreen and Hausmann, 1999; Fischer, 2001; and Frankel, 1999).
of an appropriate combination of complementary reforms is achieved. This perspective leads to the recommendation that reforms should be ordered so as to ensure that certain preconditions are put in place first to enhance the likelihood of success of subsequent reforms. Thus, the best designed fiscal rules would not work well in the absence of institutional preconditions that prevent, say, populist governments from arbitrarily breaking rules and contracts. This perspective also leads to the warning that there may be little or no gain (and maybe even significant losses) if a critical mass of complementary reforms is not implemented in a coordinated fashion (Rojas-Suarez, ed., 2009).

There are many more aspects to the debate on sequencing and threshold effects. Trade liberalization in the absence of a safety net can undermine poverty reduction, and privatization short of an adequate regulatory framework may lead to monopoly pricing. In some cases, the resulting political backlash can also short-circuit the reform process itself. Initial uncorrected flaws may compromise implementation. In all, the “right” sequence is easier to define on paper than in the real world where reformers usually had to make do with second-best approaches in the face of political constraints. As such, sequencing remains largely an academic consideration.

Consider now the second variant of the view that the Washington Consensus incurred fundamental flaws. It contends that the main error was the Consensus’ apparent assumption that a one-to-one mapping exists always and everywhere between reforms and economic outcomes. The reality is, however, much more complex and elusive. Even perfect sequencing could lead to faulty outcomes depending on their mapping to reforms. As noted by Hausmann, Rodrik and Velasco (2008), reforms that “work wonders in some places may have weak, unintended, or negative effects in others.” The empirical evidence that specific reform packages have predictable, robust, and systematic effects on national growth rates is weak (Rodrik, 2005a). Much of the variance that explains the difference in countries’ growth rates is random, which implies that imitating successful reform experiences of other countries may not be wise (Easterly et al., 1993). In sum, contrary to the implicit understanding of the Washington Consensus as generally applicable, effective reform agendas have to be carefully tailored to individual country circumstances, both in their design and implementation sequence. The expectation that reforms would promise certain good outcomes almost automatically was simply wrong.

It does not necessarily follow from this variant that anything goes when it comes to growth determinants and the design of reform packages. A constructive and nuanced way forward is feasible under this view, as illustrated in Dani Rodrik’s (2005b) “Growth Strategies” chapter in the Handbook of Economic Growth. While specific reform packages must be tailor-made, good economics highlights the crucial relevance of growth “foundations” or “first principles,” notably the role of technological innovation and institutions such as property rights,

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34 Graham and Nafım (1998), for instance, see macroeconomic stability as a precondition for more extensive and gradual institutional reform. Rodrik (1990) argues for undertaking a few, deep reforms with narrow scope. Martinelli and Tommasi (1997), by contrast, note that radical or so-called bitter pill reform strategies can be optimal due to credibility problems and political sustainability considerations.

35 The lack of robustness is highlighted by, for example, Levine and Renelt (1992), Rodriguez and Rodrik (2000), and Ciccone and Jarocinski (2007), who show that the empirical results of regressions on growth determinants are sensitive to changes in country samples, control variables and econometric specifications.
sound money, fiscal viability and contestable markets (Growth Commission 2008 and Rojas-Suarez, ed., 2009). Although the mapping of first principles to specific reform packages is elusive and country-specific, it can be adequately served by diverse policy packages.

Moreover, growth strategies must be informed by the critical distinction between igniting and sustaining growth (Hausmann, Pritchett and Rodrik, 2005). Igniting growth in a particular country typically requires a few (often unconventional) reforms that need not unduly tax the country’s limited institutional capacity. But the exact composition of these few reforms and how they can successfully be combined with “first principles” cannot be predicted easily—it varies from country to country. Sustaining growth is a different matter—it requires the cumulative building of functional institutions to maintain productive dynamism and endow the economy with resilience to shocks over the long term. A sensible growth strategy would search for the tailor-made agenda of few reforms that can ignite a growth process. Once ignited, growth itself can help align incentives in the political economy in favor of reforms that strengthen the growth foundations, thus setting in motion a virtuous circle that sustains growth over the long haul.

Putting together growth-oriented reform programs that are adequately adapted to a given country is then a much more difficult and complex task than the Washington Consensus led people to believe. But it is not an impossible task. To avoid getting things wrong, there is no substitute for deep country knowledge and experience. To use an analogy often mentioned by the late Rudy Dornbusch, good reformers are like good “country doctors” than can develop good diagnoses and suitable cures for individual patients whom they know well. Adequately designed and appropriately implemented reforms are more likely to be developed by well-trained, practically-minded, and experienced economists that collectively have not only a good grasp of international reform practices but also experience in and strong knowledge of the circumstances of the country in question. These packages will, by definition, stay away from the mechanical application of ‘best practices’ and from un-prioritized laundry list-type reform agendas. They will also stay away from the pessimistic belief that nothing can be done where institutions are weak. Much help can be obtained in this process from a finer “growth diagnostics” method, one that focuses on the binding constraints to growth, rather than on the distance to “best practices,” along the lines of the method proposed by Hausmann, Rodrik and Velasco (2008). While not a silver bullet, this method can greatly complement the task of reform prioritization and design.

6.3. Incomplete Agenda

This third view agrees with the first one in stating that the Consensus reform program was not wrong in what it included. But it differs from it in claiming that the Consensus was patently incomplete, that it did not include all the relevant reforms needed to achieve sustainable

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36 The authors couch their argument in a second-best framework. They focus not only on the direct (negative) effect of the specific distortion, but on the additional interactions of this distortion with the other inefficiencies in the economy. Given the impossibility of reaching the first best, the authors suggest focusing on the country’s most binding constraints, as this increases the chances that the benefits of relaxing a binging constraint will not offset by indirect adverse effects. For a discussion of the growth diagnostics method along with applications to a number of Latin American countries see IDB (2009). On the limitations of the method see De la Torre (2007).
and equitable growth. The Consensus simply had too narrow an understanding of what matters for economic growth and development.

Trying to assemble a comprehensive list of important reform areas left out by the Consensus is a rather futile exercise—for the components chosen for inclusion are not independent of the perspective adopted and the preferences of the researcher—and one that in any case lies beyond the scope of this chapter. In what follows, therefore, we illustrate this view using as guidance key flagship reports published by multilateral development agencies (World Bank, IDB, ECLAC and CAF) since the second half of the 1990s. Using headline publications from some of the institutions that supported (and at times actively championed) the Consensus during the 1990s helps to highlight the growing acceptance of this third view.

Among the many reform areas left out by the Washington Consensus are: (a) volatility; (b) institutions; (c) knowledge and technological innovation; and (d) equity. What these areas have in common is the presence of significant market failures (due to externalities, coordination problems and imperfect information) which markets themselves cannot repair and that thus require active policy. They were not seen as part of Consensus-style reform agenda basically because the Consensus relied on well-functioning markets to solve the relevant development challenges and viewed any state interference in the economy with suspicion. Successful reformers, like Chile, also implemented important reforms in these other areas, thus supplementing the Washington Consensus.

Consider first volatility. By focusing on the first moment—the average or expected value of reform effects—Washington Consensus-style policies ignored the crucial relevance of the second moment—the variance of such effects. The fact is that volatility has an independent, first-order impact on economic development. This argument was forcibly put forward in the 1995 annual report of the IDB *Overcoming Volatility*. It discussed Latin America’s proneness to volatility, driven by a high incidence of external shocks whose effects are magnified by shallow financial markets and inconsistent macro policies. Volatility is estimated to have reduced the region’s historical growth rate by one percentage point, with particularly strong negative impacts on investment in infrastructure and human capital, and especially detrimental impacts on poverty and inequality. To overcome volatility, reforms need to put a premium on export diversification, financial market deepening and stable macroeconomic, particularly fiscal, policy.

A key area that was completely ignored by the Washington Consensus and yet is not in this list is environmental sustainability, particularly climate change. This topic is not developed here because it is as much about global as well as domestic policy. The topic was until recently relegated to sector experts but Nicholas Stern (2008) decidedly brought climate change to the core of development policy thinking, arguing that greenhouse gas emissions represent the biggest market failure the world has seen. That climate change has been finally mainstreamed into Latin American development policy thinking is illustrated by the 2009 flagship report of the Latin American Region of the World Bank entitled *Low Carbon, High Growth: Latin American Responses to Climate Change*. For a global perspective, see the 2010 World Development Report *Development and Climate Change*.

Follow-up articles to this report, which expand on the analysis and conclusions, include Gavin and Hausman (1996) and Gavin et al. (1996). They highlight the interplay of volatility with the region’s precarious access to international financial markets and fiscal pro-cyclicality and propose as additional solutions regional integration and collective risk hedging. In a similar vein, Caballero (2001) proposes a simple organizing framework to study shocks, volatility, and crises in the context of weak international financial integration and underdeveloped domestic
Subsequent reports of the World Bank and ECLAC drove home similar arguments and worries. The 2000 flagship publication of the Latin America region of the World Bank, *Securing our Future in the Global Economy*, raised policy issues from the macroeconomic, social, financial, labor and poverty dimensions. At ECLAC, Ffrench-Davis and Ocampo (2001) argued that financial liberalization brought with it the globalization of volatility and a new variety of crises linked to shocks to the newly deregulated emerging capital markets. Indiscriminate opening of the capital account led to macroeconomic and financial disequilibria, placing countries in a “financierist trap” of high vulnerability. To escape the trap, a relatively flexible exchange rate and comprehensive macroeconomic regulation is recommended.

Consider next institutions. The Consensus overlooked the institutional underpinnings of its proposed policies, with one key exception: establishing secure property rights which, in the spirit of De Soto (1989), should also be available to the informal sector. However, quoting Rodrik (2006), property rights “was the last item on the list and came almost as an afterthought.” Williamson himself shared the view (see Birdsall and de la Torre, 2001) that property rights were added “mostly to get to a total of 10 items.” In general, the Consensus was largely blind to institutions. It came at the end of the 1980s before what amounted to an institutional revolution in the development economics literature in the 1990s.

While institutions became firmly established among academic economists since the 1980s, 39 multilateral agencies jumped onto the institutional bandwagon starting in the late 1990s, as the realization grew stronger that the efficiency of markets and durability of reform effects needs appropriate institutional frameworks to avoid such problems as rent-seeking and policy reversals. In Latin America, this was illustrated in the IDB’s 1997 report *Latin America after a Decade of Reforms* as well as the 1998 World Bank’s regional flagship entitled *Beyond the Washington Consensus: Institutions Matter*. The former summarizes the evidence on the role of institutions in long run economic development, makes a case in favor of the feasibility of institutional reform, and offers a policy-oriented analysis of institutional reform issues in the financial sector, education, judicial systems and public administration. The latter develops an analytical framework and uses case studies to explain why policy reform processes that work in

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39 The seminal work was that of Nobel laureate Douglas North (1990), who defines institutions as a “set of rules, compliance procedures and moral and ethical behavioral norms designed to constrain the behavior of individuals.” A pioneering application of the institutional approach to development was Engerman and Sokoloff (1997), who trace differences in economic development throughout the Americas to the nature of colonial institutions interacting with initial resource endowments. Hall and Jones (1999) present evidence to support the thesis that “the primary, fundamental determinant of a country’s long-run economic performance is its social infrastructure.” It was perhaps the contributions of Acemoglu, Johnson and Robinson (2001 and 2002) that gave institutions a definitive push in the development profession. To address the endogeneity of institutions and income, they used the now famous colonial settler mortality instrument and conclude not only that institutions are key drivers of growth, but also that they are responsible for the reversal of fortunes of once rich nations. In a similar vein, the empirical study by Rodrik et al. (2004) finds that institutional variables, rather than integration or geographical variables, matter the most for economic development.
certain institutional environments may not work in others. The institutional literature also influenced the 2008 Growth Commission Report chaired by Michael Spence, which concludes that there can be no simple recipe for growth and sustainable development, implying that too much is country-specific to define any general policy consensus.

Consider now knowledge and technological innovation. If the Washington Consensus touched on this area, it did so indirectly—when it advocated the reorientation of public expenditure towards education and emphasized the need to remove barriers to FDI. The latter was intended not just to enhance competition but also to facilitate technological transfer. That the Consensus did not delve more deeply into policies related to technological innovation is somewhat surprising. After all, technological progress is at the heart of market-based growth and has been regarded as the main driver of productivity growth in economic theory since the times of Robert Solow’s publications in the 1950s. The implicit assumption in Consensus-style reform agendas seems to have been that policies to promote export orientation and the opening to FDI would be sufficient to achieve the adoption and adaptation of new technologies as well as to eventually foster the capacity to innovate.

While the theme of knowledge and innovation was never absent from the academic literature, multilateral agencies sought to bring it squarely into Latin American development policy thinking during the early 2000s. An important precursor was ECLAC’s 1990 report on Productive Transformation with Equity. Later on, the Latin American region of the World Bank devoted its 2002 flagship publication to the need to shift From Natural Resources to the Knowledge Economy. This publication was subsequently complemented by the 2003 regional flagship on Closing the Gap in Education and Technology and the work of Lederman and Maloney (2007). This body of research argues that the region’s growth has not lagged behind due to a natural-resource curse but due to a major shortfall in technological adoption and innovation. The regional deficiency in “national learning capacity” is not independent of its gap in the quality of its education (Figure 13 shows LAC’s backwardness in this regard), which along with entrepreneurship constitutes a key ingredient for innovation. A premium should then be placed on policies to diversify international trade and foreign direct investment flows, improve education (particularly secondary and tertiary), deepen the links between universities and the private sector, and foster the development of innovation networks.

Around that time, the IDB and the Andean Development Corporation (CAF) focused on the role of knowledge and technology in growth from the perspective of competitiveness. They did so through their annual reports entitled, respectively, Competitiveness: the Business of Growth (IDB, 2001) and Competitiveness and Growth (Sachs and Vial, 2002). ECLAC also launched a 2008 Report on Structural Change and Productivity Growth. To correct the low levels of factor accumulation and productivity in Latin America, policies should aim at alleviating credit constraints, modernizing labor markets, boosting human capital investment, easing infrastructure bottlenecks, and fostering the development of clusters and supply chains.

Consider finally equity. As noted, it was in the social arena where the disenchantment with the Washington Consensus was greatest. Williamson himself later declared (see Birdsell and De la Torre, 2001) that the Consensus policies he compiled were oriented towards achieving
efficiency, not equity, and that he “deliberately excluded from the list anything which was primarily redistributive [because he] felt that the Washington of the 1980s (…) was essentially contemptuous of equity concerns”

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When it comes to economic development, equity considerations are not simply a helpful corollary, but an essential ingredient, especially in unequal Latin America. For one thing, equity is in itself as important a developmental objective as growth—not least considering that excessive inequality of outcomes and high inequality of opportunity constitute an insult to our basic sense of justice. To the extent that reforms’ uneven outcomes reflect unequal opportunities—across racial or ethnic groups and between those born poor as those born rich—their sense of unfairness also undermines the legitimacy of those reforms. Moreover, by failing to more explicitly deal with equity, the Washington Consensus neglected what is in effect a key impediment to growth. High income inequality not only hinders the impact of growth on poverty reduction but can itself contribute to low growth which, in turn, makes it difficult to reduce
inequality. Institutions and policies in contexts with high poverty rates and heavy concentrations of income may themselves be a source of growth-impairing inefficiency (Aghion et al., 1999; World Bank, 2006; Levy and Walton, 2009; Demirguc-Kunt and Levine, 2009). Under those conditions, the interplay among political parties, business organizations and powerful large labor unions can result in rent-seeking and monopoly behavior that undermines the growth gains the reforms were meant to capture. Similarly, imperfect credit markets combined with unequal endowments of financial and human capital—typical of Latin America—are widely acknowledged as a constraint on growth, implying that inequality itself is worth addressing explicitly to minimize that perverse combination.

It was precisely in the failure to include an explicit concern with equity that Birdsall, De la Torre and Menezes (2008) find the most notable shortcoming of Washington Consensus-inspired reform packages. The omission undermined the benefits of and enthusiasm for market oriented reforms. In a booklet first published in 2001 under the title Washington Contentious and subsequently expanded into a 2008 book entitled Fair Growth, these authors discuss win-win policies that would serve the interests of greater equity while enhancing growth directly and indirectly. They reaffirm the relevance of fiscal discipline and counter-cyclical macroeconomic and financial policies. But they also emphasize new areas for policy action, including the establishment of automatic social safety nets; improving schooling for the poor; making income taxes progressive in practice; building a more supportive environment for small businesses; protecting worker rights and labor mobility; launching a head-on attack on corruption and discrimination; repairing land markets and establishing consumer-driven public services.

The equity theme was also bought to the center stage of the development policy debate through official publications by multilateral agencies. In its 1998 annual report Facing Up to Inequality in Latin America the IDB studied the resilience of the region’s high inequality, attributing the gap mainly to wage differentials in a segmented labor market and underlying educational disparity. ECLAC focused on this issue in its 2001 Equity, Development and Citizenship, where redistributive fiscal policies were highlighted. Inequality was also tackled in the World Bank’s 2004 regional flagship Inequality in Latin America and the Caribbean: Breaking with History? The report emphasizes the deep historical roots of inequality and its multidimensionality, affecting not just income but also the distribution of education, health, water, sanitation, electricity and telecommunication provision. It recommends using the redistributive power of the state through progressive taxation, basic service provision and transfers. It also advocates policies aimed at broadening asset ownership by democratizing education, improving land distribution, investing in public infrastructure and making labor markets truly inclusive.

7. Concluding Remarks

For all of its faults, the policies set out in Williamson’s original Washington Consensus hold enduring messages. Countries that ignore them do so at their peril. If there is any consensus about the Consensus, it is especially with respect to sound macroeconomic policy, including not only fiscal discipline (still a challenge in most of the region) and transparent and steady monetary policy, but arguably also the logic of flexible exchange rates with a small dose
of management. On these the Consensus aptly reflected the direction taken by most Latin policymakers since the late 1980s, by then already deeply allergic to the region’s periodic and destructive bouts of inflation. This allergy was shared by citizens and voters virtually everywhere making it politically possible for small technically adept cadre to implement the appropriate stabilization policies in line with the Consensus (Naím, 2000). On these macroeconomic policies the controversy has focused not on the merits of the policies themselves, but on the role of the IMF and the World Bank in conditioning their lending not only on reasonable fixes to macro problems but also on privatization, trade and capital market liberalization and other structural policies, leaving aside the supportive institutional matrix to an extent that in many countries turned out to be politically toxic.

While the Consensus is typically criticized for its dogmatic adherence to market fundamentalism, the view that development must be market based has in fact endured—not only in Latin America, the original home of the Consensus, but throughout the developing world (Birdsall, forthcoming 2010). The reliance on markets to foster development is in effect a New Consensus among emerging markets and other developing countries, and it has survived well the crises of the second half of the 1990s and early-2000s as well as the global crisis of 2008-2009, including in Africa (Radelet, forthcoming 2010). To be sure, warring parties have engaged over the past quarter century in heated debates about the merits and shortcomings of the Consensus (defined variously as the original ten points, market fundamentalism, neo-liberalism or multiple variations of those). Yet beyond the differences, the great majority of developing countries—across the ideological spectrum from China to Chile—in fact adhere to a market orientation and indeed to a quest for safe integration into global markets.

So, on the one hand, the love-and-hate affair with the 1989 Washington Consensus might be over. On the other, for developing countries including across Latin America, the marriage of the state to markets is firmly in place. But a complex challenge that will test any new consensus going forward will be on how to manage and adapt that marriage in a shock-prone global economy. Global shocks widen the gap between private and social interests and increase the premium on global public goods and global collective action—as was brutally highlighted by the subprime crisis turned global. For Latin America, the limits and benefits of the role of the state in a global economy will once again be on the agenda, and arguably with a greater sense of urgency.
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