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Fads and fashion in economic reforms: Washington Consensus or Washington Confusion?

MOISES NAIM

What changes more often the fashion designs coming from Paris and Milan or the economic policy designs Washington and Wall Street prescribe for countries that are less developed or that are emerging from decades of communism? While this comparison may seem frivolous, a review of the ideas that have guided thinking and action about economic reforms in this decade shows that they are as faddish as skirt lengths and tie widths. The difference, of course, is that economic policy fashions affect the way millions of people live and define their children's chances of a better future.

Ideas about what makes a country prosperous have always been fickle. This decade has been no different in terms of the variety and volatility of the policy prescriptions that became dominant among academics, policy makers and the better-informed segments of the world's population. The 1990s, however, have been different in one significant respect: during this decade the world has been under the impression that there was a clear and robust consensus about what a poor country should do to become more prosperous. This misimpression clearly owes a lot to the surprising popularity of the term 'Washington consensus' the name that economist John Williamson gave in 1989 to a list of 10 policy recommendations for countries willing to reform their economies.[1]

The general ideas derived from the Washington Consensus had a huge influence on the economic reforms of many countries. Yet the way these countries interpreted such ideas varied substantially and their actual implementation even more so. Moreover, the original 10 policy prescriptions of the Washington Consensus reigned unchallenged for only a short time. Changes in the international economic and political environment and new domestic realities in the reforming countries created problems the Consensus did not envision or encompass, thus forcing the search for new answers. The newfound answers often complemented the recommendations originally offered by the Washington Consensus, but some also ran counter to them. The wildly gyrating ideas about controls on foreign capital or about exchange rate regimes that have been offered at different times are good examples of the lack of consensus or indeed the confusion that prevailed among the experts.

Moreover, throughout the decade, both the general media and expert commentators often characterised the reforms implemented in countries as different as

Moises Naim is the Editor-in-Chief of Foreign Policy, 1779 Massachusetts Avenue, Washington, DC 200 36, USA.

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Russia, Argentina, Rumania or South Korea as following the prescription of the Washington Consensus. In practice, however, the differences in the reforms of these countries often clearly exceeded their similarities and, in some cases, the only thing they had in common was their designation by proponents and detractors as 'Washington Consensus policies'.

When John Williamson summarised what he saw as the consensus that had emerged among the 'political' Washington of the US Congress, the Administration and the 'technocratic' Washington of the IMF, World Bank and the think-tanks, he did not suspect that he was fathering one of the brand names that would come to characterise the decade. Nor could he imagine that the popularity of the term would obscure profound disagreements among the experts in Washington and elsewhere behind the facade of 'the Consensus', or that the same label disguised what, in effect, were a multitude of very different reforms. The point is not that a Washington Consensus did not exist or did not embody an influential set of ideas. The point is that throughout the decade the core of the Consensus has experienced extraordinary mutations and shrinkage: *reforming governments everywhere saw how the policy goals that just a few years, or even months, earlier had been specified as the final frontier of the reform process became just a mere precondition for success. New, more complex, and more difficult goals were constantly added to the list of requirements for an acceptable performance.*

What Washington Consensus?

The impression that the Washington Consensus was, in fact, a set of rigid, almost unalterable, theoretical propositions about which the powerful and the knowledgeable had no doubt was widespread. Moreover, the often implicit corollary espoused by the more politically motivated of the Consensus' proponents was that most dissent with its policies was inspired by anti-market ideologies, nationalism, anti-Americanism and other forms of the modern-day equivalents of obscurantism. In 1993 Williamson explained that 'we can now develop far more consensus ... [because] we now know much more about what types of economic policy work'.[2]

Really? Perhaps that was the case a few years back or what the world needed to believe at the time. But an objective assessment of the situation shows that, while some convergence did emerge, confusion rather than consensus characterised then and now the intellectual climate among experts in the field of economic development and market reforms. In the past few years, this confusion among the leading lights of development thinking has even spilled over from scholarly seminars to television shows and from the pages of technical journals to those of daily newspapers. A few examples may serve to illustrate the intellectual texture of the debate.

Since the beginning, advocates of the Washington Consensus have been greatly divided about the pace and sequence of the reforms. Profound differences quickly emerged about the need for or desirability of what came to be known as the application of a 'shock therapy' (or alternatively 'the big bang') approach to policy reforms. This approach implied the implementation of as many reforms as quickly as possible.[3] Others argued for a slower, more sequenced pace. This

is not a debate just between experts in Washington and others elsewhere. It also rages among insiders. This is illustrated by Strobe Talbott's now famous remark during a 1993 trip to Moscow when he told an anxious Russian media that 'what Russia needs is less shock and more therapy'. The statement, warmly welcomed by many, was, however, clearly at odds with the line espoused by his colleagues at the US Treasury and by the IMF and World Bank with the active backing of the US government. That debate of course continues today and is far from resolved, with both sides declaring victory using the same facts to back their cases.[4]

A few years later, Joseph Stiglitz, the Chief Economist of the World Bank and former Chairman of President Clinton's Council of Economic Advisors, publicly denounced the IMF's handling of the financial crises in Asia and Russia. This led Anders Aslund, a Russian expert at the Carnegie Endowment in Washington to tell *The Economist* that 'without knowing anything [Stiglitz] mouths any stupidity that comes to his head'.[5] Ricardo Hausmann, the Chief Economist of the Interamerican Development Bank (IDB) enthusiastically recommends that countries shed their currencies in favour of the US dollar, a policy that would shield them from the ills brought about by international financial volatility. Harvard's Jeffrey Sachs thinks that this is a reckless recommendation and Enrique Iglesias, the President of the IDB, emphasises that Hausmann's opinions are his own and that the Bank does not endorse them.[6] The Asian crisis prompted MIT's Paul Krugman to call for the governments beset by the crisis to impose controls on capital flows, a solution that, at the time, was immediately rejected by then Secretary of the US Treasury Robert Rubin, the IMF's Michel Camdessus, his deputy Stanley Fisher, and Rubin's then deputy Lawrence Summers, among many others.

Nobel laureate James Tobin calls for a tax on currency transactions to 'put sand in the wheels of international finance' and tame volatility, while Nobel laureate Milton Friedman thinks that the problem is perhaps too much sand in the wheels of global finance and calls for, among other measures, the abolition of the IMF. Not so fast, say financier George Soros, Yale's Dean Jeffrey Garten as well as a blue ribbon commission sponsored by the New York-based Council on Foreign Relations. The world is in dire need of a new financial architecture, they claim. Some of them even urge the establishment of new multilateral institutions like an international debt insurance agency, a global central bank or an international bankruptcy court. Others, however, like Barry Eichengreen and Robert Rubin, insist that, while the international financial system does require some maintenance and modernisation, what is really needed is not a general overhaul or new institutions, but better 'plumbing', meaning the detailed re-examination and redesign of existing institutions and practices. James Wolfensohn, the President of the World Bank and Stiglitz, his Chief Economist, extol a new approach, the 'comprehensive development framework', that the Bank officially adopted in 1999 to guide its lending and advice to its client countries. This leads Columbia University's Jagdish Bhagwati to puzzle in the pages of the *Financial Times* about what could explain the mistaken assumptions and outright fallacies on which Wolfensohn and Stiglitz's framework is surely based. He generously concludes that perhaps it was just the result of 'plain ignorance'. A day later, in the same pages, T N Srinivasan, another prestigious

development economist at Yale, also fumed about Wolfensohn and Stiglitz's, arguments, dismissing them as 'cliché ridden and banal'.[7]

If this sample represents the Washington Consensus, then just imagine what a 'Washington Confusion' would be like. A point worth reiterating is that these are not debates between say, French deconstructionist sociologists and US mathematical economists. These are disagreements among some of the most respected and influential individuals in the field and ones who share favourable ideological predispositions towards markets, private capital and free trade and investment, while harbouring a deep distrust of socialist ideas, central planning and government intervention. The size of the rifts and the even bigger confusion that ensues when the opinions and policy prescriptions of less market-friendly experts are brought into the fray is hard to fathom.

The making of a global brand name

It would be a mistake, however, to assume that these differences emerged only recently. Early in the decade, Williamson acknowledged that not all the assertions he included in his original 'ten-best' policy recommendations enjoyed the same degree of consensus. According to his assessment at the time, in five of the 10 policy prescriptions 'consensus has been established'. Three of the prescriptions (financial and trade liberalisation and deregulation) were still controversial 'in a non ideological way' meaning that, in his judgement, the emergence of a consensus was just a matter of time and depended only on finding the technical solution that would reconcile the differences that still existed among the experts. The remaining two, changing public budget priorities and according the same treatment to foreign and domestic firms, were, in Williamson's view, always bound to be controversial because of their inherent political nature.[8] Six years later Williamson went even further and noted that in some of his assertions about the Consensus he 'was a bad reporter of the Washington scene'.[9]

In fairness to Williamson, it is important to emphasise that he was an innocent victim of the success of his very useful summary. Williamson went to great lengths to qualify carefully what he really meant when he framed the Washington Consensus. He often sought to correct those who misinterpreted the approach and made repeated attempts at clarifying the nuances of his conceptual framework. Williamson's efforts at clarifying the meaning and implication of the Washington Consensus were not enough to compensate for the distortions resulting from the term's global popularity and its frequent misuse.[10] Very soon, even the 10 prescriptions were not that well known and the term 'Washington Consensus' acquired a life of its own, becoming a brand name known worldwide and used quite independently of its original intent and even of its content.

How could such a wonkish moniker become so popular? Because, at the time, it filled an ideological vacuum and it was relatively simple for politicians to understand and use in speeches. It also gave ministers a practical action plan with specific goals; it had the endorsement of prestigious institutions and individuals; and, last but not least, it had the ring of money. The adoption of the Washington Consensus, it was promised (and expected), would bring tons of foreign money. The IMF and the World Bank would open their coffers. Foreign investors, eager to benefit from the prosperity that the new policies would bring to reforming countries would also contribute to the financial bonanza.

The timing of the formulation of the Washington Consensus in the late 1980s was also fortunate. It coincided with the sudden collapse of the Soviet system and its ideological apparatus. The disenchantment with socialist ideas and central planning, which had also pervaded many developing countries outside the Soviet bloc, created an urgent and widespread need for an alternative set of ideas about how to organise economic and political life.

An important function of any ideology is to serve as a thought – economising device that simplifies and organises what is often an overwhelmingly confusing reality. In a strange way, the Washington Consensus became an ill-suited and temporary substitute for the all – encompassing ideological frameworks on which millions of people had come to depend to guide their opinions about affairs at home and abroad, judge public policies and even to steer some aspects of their daily lives. Suddenly they had no rail to guide their thinking and the Washington Consensus was what everyone talked about. Its appeal was surely helped by its self-assured tone ('the Consensus'), its prescriptive orientation, its directional message, and its origin in Washington, the capital of the victorious empire. The need of newly elected, market-orientated administrations to downplay the costs and hype the virtues of the economic reforms they were implementing, as well as the lack of credible alternatives offered by an opposition that was often disreputable, also boosted the Washington Consensus' attractive *élan*. Had all this not been enough, what finally made the product really irresistible was the strong pressure from the IMF and the World Bank to make their loans conditional on the adoption of Consensus-inspired policy reforms.

Unfortunately, the relative simplicity and presumed reliability of the Washington Consensus was not reflected by the experience with market reforms in this decade. What was implemented was usually an incomplete version of the model and its results were quite different from what politicians promised, the people expected, and the IMF and the World Bank's econometric models had predicted.

The evolution of common wisdom in the 1990s of the Washington Consensus meets global surprises

Alfred Marshall once said that short words are usually bad economics. By that measure the decade of the 1990s was probably not one he would have admired: international financial contagion, sequencing, bailouts and bail-ins. The tequila effect. Moral hazard. Crony capitalism, Mafia capitalism, and voucher privatisation. Currency boards, dollarisation, crawling pegs, and capital controls. Savings rates, pension reform, and capital flight. Transparency and governance. Globalisation. Each of these terms became, at some point during the 1990s, the focus of sustained attention and heated debate among the experts, politicians and commentators interested in market reforms. None of these terms figured in the original formulation of the Washington Consensus.

These concepts and names, and the realities they tried to encapsulate, gained salience as a result of the many surprises that impaired and, in some countries, even derailed the implementation of market reforms. While this jargon-filled list of terms may sound like a cacophony of jumbled words, it can in fact be profitably used as a signpost marking the road through which common wisdom about market reforms evolved over the past 10 years.

This evolution had a pattern. It usually began with the increase in popularity of a general set of policy recommendations. For a while, these recommendations embodied, if not a consensus, at least the views of an influential majority of academics and high-level staff of the IMF, the World Bank and the US Treasury, think-tanks, and assorted editorialists. Very soon, sometimes just a few months after a certain degree of comfort was attained with respect to the new set of ideas, a surprising event would cast doubts on their adequacy and, with the benefit of hindsight, sometimes even make them look outright silly. The new data would usually show that the main 'lessons' derived from the previous crises missed some important element (usually summarised in one catchy term like 'weak institutions', 'corruption' etc) whose critical importance had now been clearly illuminated by the most recent crisis. It would also show that the policy goals that had become fashionable were necessary but insufficient to ensure policy stability and economic success. More reforms would be needed.

The Mexican crash of 1994 vividly illustrates this pattern. The almost universal lesson drawn from this crash was that a low domestic savings rate made Mexico overly vulnerable to the vagaries of foreign capital markets by making it too dependent on foreign funds. Therefore, a higher rate of domestic savings, complemented by 'sound macroeconomic fundamentals' would serve to inoculate a country from a crash induced by the volatility of short-term international capital flows.[11] The 'miracle economies' of East Asia, their enviably high savings rates and their robust macroeconomic equilibria were commonly paraded as an illustration of the validity of the conclusion and as the model for the low-saving Latin American countries. This 'lesson' lost a bit of its edge when, two years later, high-saving Thailand, Indonesia, Malaysia and even South Korea crashed. Soon thereafter, another wave of reports highlighting the new 'lessons' was issued by many of the same authors that had analysed the origins and implications of the Mexican crisis. This new wave of reports found a new culprit and a new word was thus introduced into the vocabulary of reform forensics: 'crony capitalism', meaning the reliance on a private sector highly distorted by the dominance of a few, large 'economic groups' closely associated with those in government. The moral of this example is not that sound macroeconomics and increasing the savings rate should not be worthy policy goals. It is that achieving such goals was now seen as insufficient and that a new and additional precondition for success was discovered thanks to the Asian crisis.

Throughout the decade, policy makers in reforming countries saw how the bar defining success kept being lifted and how the changes they were expected to make became increasingly complex and, sometimes, politically impossible. Presidents and finance ministers also saw how their apprehensions were denounced as evidence of their lack of 'political will', while the changing requirements coming from Washington and Wall Street were presented as reasonable changes resulting from the incorporation of 'the lessons of experience'. Common wisdom was simply 'evolving'.

This evolution of the common wisdom about market reforms can be divided into four general sets of discoveries that roughly followed a chronological sequence during the 1990s: the discovery of economic orthodoxy, the discovery

of institutions, the discovery of globalisation and the rediscovery of underdevelopment.

The discovery of economic orthodoxy

One of the undoubted historical contributions of the Washington Consensus is that it marked the end of the decoupling between development economics and mainstream economics that had gathered steam since the 1970s.

It may now seem obvious, for example, that large public deficits and loose monetary policies fuel inflation. However, for a long time in many developing countries, especially in Latin America, South Asia and Africa, these ideas were dismissed as a rather myopic form of 'monetarism'. Inflation, it was widely believed, was the result of 'structural' conditions such as the highly concentrated nature of the private sector, the unequal pattern of distribution of income and wealth, or the country's structure of imports and exports.[12] These views informed many of the failed attempts at economic stabilisation, notably in Argentina and Brazil, that were usually characterised as 'heterodox plans'.[13]

Similarly, it is also worth remembering that the belief that a less developed country could not really benefit from freer international trade and investment was, and to a certain extent continues to be, widely held in these countries. Therefore, the Washington Consensus' prescription that government-imposed barriers to imports and exports, to foreign investment and to foreign currency transactions had to be lifted was sharply at odds with the long-held conviction that developing countries had to protect their economies from an unfair and exploitative international system rigged against them. This belief, of course, flowed from the core proposition of 'dependency theory', a set of ideas that gained much currency in the developing word and which had few if any conceptual points of contact with the economic profession as it was practiced in most industrialised, capitalist countries.[14]

Along the way, several different variations of the dependency theory framework became fleetingly fashionable and had their 15 minutes of fame among development specialists. In the late 1950s Nobel laureate Gunnar Myrdal waxed eloquent about the consensus he saw among development experts that the adoption of centralised planning, which naturally accompanied these kinds of policies, was the only option a country had to overcome poverty. Myrdal wrote that 'what amounts to super-planning has to be staged by underdeveloped countries ... and grand-scale national planning [is] the policy line unanimously endorsed by governments and experts in the advanced countries [...] central planning [is] the first condition of progress'.[15]

Variations on these themes were Tanzania's Julius Nyerere's 'autonomous development', Samir Amin's 'de-linking', the 'basic-needs' approach, François Perroux's 'development poles', United Nations' Economic Commission on Latin America's 'comprehensive social development', the UN's 'new international economic order' and a myriad of nuanced variants of dependency theory. All these proposals had a modicum of success in attracting the attention of academics, politicians, and policy makers, mostly in developing countries.

Yet the reliance on a large and fiscally expensive public sector and the disdain for foreign investment and macroeconomic orthodoxy implicit in most of these

frameworks soon became an unaffordable luxury. The debt crisis and the end of the Cold War made it impossible for governments to sustain economic policies that were not anchored in sound macroeconomic principles or that were based on an adversarial posture towards foreign investment.

This convergence of factors left many developing countries with no other choice but to fall into the welcoming but stern arms of the Washington Consensus. This, in turn, meant the discovery of orthodox macroeconomic policies and the dismantling of the protectionist structures that had been put in place. This was especially true of highly indebted countries desperate to seek some form of respite from the weight of their massive foreign financial obligation—a respite that was offered in exchange for the adoption of economic reforms.

National economic debates thus had to shift their foci. In many countries, politicians and media leaders had to focus with a new urgency on how to reduce fiscal deficits or current account deficits rather than discussing which new industrial sector was going to become 'a national priority' (and therefore subsidised and protected). The debates also had to shift their attention away from the expansion plans of state-owned enterprises, which the newfound fiscal restraint made impossible to fund, to the debate about which of them would be privatised. The links between a recently acquired and floating exchange rate and an interest rate that had been deregulated only recently were also themes that began to occupy more space in the media and in the minds of policy makers than ever before. Policy makers who had hitherto never heard of the long bond suddenly had to scramble to understand the impact of debt–equity swaps on their country's fiscal account and their link to foreign portfolio flows. In bookstores from Caracas to Warsaw, books on government planning were replaced by textbooks authored by the likes of Paul Samuelson, Stanley Fisher and Rudiger Dornbush.

The Washington Consensus also nurtured an implicit but important change in attitudes about the extent to which a country's economic destiny could be shaped by national policy makers. For years external factors, foreign conspiracies, foreign aid, the externally determined price of the main export commodity (cotton, copper, coffee, oil, etc) or an impenetrable international economy were seen as the main drivers of a developing country's poor economic performance. Naturally, this view fed the attitude that domestic policies had far less impact than decisions taken abroad. In contrast, the message of the Washington Consensus was that good domestic policies could make a difference even if international economic conditions were not favorable—ironically, a message of national economic self-determination that was often imposed from abroad.

By then, several countries, especially in Latin America and Africa, had experienced prolonged bouts of hyperinflation, their economic growth had been stunted throughout the 'lost decade' of the 1980s, and poverty levels had increased dramatically. Newly elected governments were eager to take advantage of the promises and opportunities offered first by the Baker Plan and then even more concretely by the Brady Plan. These US-led debt-reduction initiatives offered significant incentives to indebted countries on the condition that they reform their economies according to the principles embodied in the Washington Consensus. Similarly, the countries in Central and Eastern Europe which were just emerging

from communism also saw in the Washington Consensus a hopeful recipe to inject the best of Western economic thought into their national policies.

Thus, at the beginning of the decade an inordinate number of countries in different continents, each with a different development experience and with wildly varying economic structures and political systems, embarked on experiments with market reforms, all guided by their also wildly varying interpretations of the Washington Consensus.

Most countries advanced quite rapidly in the implementation of the 'easy' prescriptions of the Consensus. Typically, these were the ones that were hard to decide but comparatively easy to implement. These reforms often required just a change in the macroeconomic rules of the game that could be accomplished by issuing a decree or some form of executive order. Dismantling currency controls and adopting a single exchange rate, eliminating price controls, lowering import tariffs, easing restrictions on foreign investment, or deregulating the financial sector are decisions with formidable consequences that many governments found relatively easy to implement in the early 1990s. This was especially true in the first stages of newly elected administrations which had to deal with disastrous legacies left by their predecessors in government. It became quite common under such circumstances for administrations to secure some form of extraordinary legal authority that enabled them to enact measures that, under normal circumstances, would have required congressional approval.[16]

But the first stage of reforms not only benefited from an exceptional political climate or from relatively simpler administrative requirements. Its implementation also coincided with an extraordinarily auspicious international financial environment. The debt crisis had been defused. With the advent of new, non-traditional financial instruments, unprecedented volumes of private capital in the developed countries had become available for investment in the developing world and in the economies in transition from communism. Thanks to the Thatcher and Reagan deregulation of financial markets and the technological and institutional innovations that took place almost at the same time, global financial markets were also undergoing dramatic changes. Commercial banks were being supplemented by investment banks, international portfolio capital was complementing bank loans, individuals and families in the USA and Europe were increasingly taking their money away from their traditional savings accounts in banks and investing it instead in mutual funds that offered the lure of higher returns and diversification, often internationally. The new category of 'emerging markets' was thus born as an attractive investment possibility for investors wanting to benefit from the opportunities opened by countries that were dismantling their protectionist past, freeing their economies and privatising government-owned companies. The fact that in the early 1990s investment returns in the industrialised countries were not as high as they became later in the decade pushed a wave of money overseas, some of it towards the countries that had enacted reforms to pull private foreign capital in. Not surprisingly, private financial flows to the newly renamed 'emerging markets' boomed. In 1990 private capital flows to these countries accounted for a meager 0.75% of their GDP. By 1993 it had reached almost 4% of GDP.[17]

In many countries the market reforms paid off rapidly and handsomely,

especially when measured in terms of the restoration of macroeconomic equilibrium, the lowering of inflation and, in some, even the reappearance of economic growth after almost a decade of stagnation and decline. Soon, however, it became apparent that the magic of macroeconomic orthodoxy had limits in terms of how far it could take reforming countries on the path toward sustainable and equitable growth.

The discovery of institutions

1 January 1994 marked the day that the North American Free Trade Agreement (NAFTA), signed the year before by Canada, Mexico and the USA officially entered into effect. It also marked the day in which the Zapatista National Liberation Army (EZLN) staged an uprising in Chiapas against the Mexican government, catching both the Administration of President Carlos Salinas de Gortari and an admiring world that had been marvelling at Mexico's market reforms by surprise.

Perhaps this date should also come to symbolise the day when the message that macroeconomic reforms, while necessary, are not enough to propel countries along the road to prosperity began to be taken seriously by politicians, policy makers, reform experts and journalists around the world. After all, Mexico had been the example used by proponents of the Washington Consensus everywhere to support their case. NAFTA was just final confirmation that market reforms work and had enabled a poor country to be well on its way to joining the richest countries on earth. The armed revolt of the peasants in Chiapas undermined that assumption.

That same message had been sent two years before in Venezuela by then Colonel Hugo Chavez, who also staged a military uprising against the government of Carlos Andres Perez, at the time implementing market reforms that were much admired around the world. While Chavez's 1992 coup failed, its initiative was so popular that it unleashed a process that led to the ousting of President Perez a year later and the inauguration of Chavez as Venezuela's democratically elected President in 1999. Just before Chavez's 1992 coup and thanks to its reforms, Venezuela had been the fastest growing economy in the world.[18] Venezuela's travails should have served as an early wake up call about the fact that record macroeconomic performance does not buy political stability if it is not accompanied by many other conditions. Two years later the events in Chiapas and Mexico's financial crash at the end of 1994 made that message impossible to ignore.

Reforming countries were discovering that economic growth did not matter much to people if hospitals did not have medicines, and that a booming stock market could be highly dangerous if the domestic equivalent of the Securities and Exchange Commission was ineffectual. A competitive exchange rate could not do much to bolster exports if inefficiency and corruption paralysed the ports, and fiscal reform did not matter much if taxes could not be collected. The elimination of restrictions on foreign investment, while indispensable to attract foreign capital, was far from sufficient to make a country internationally competitive in the race to attract long-term foreign investment. A reliable justice system, a well educated workforce and an efficient telecommunications infrastructure were some of the additional factors, among many others, that would

give a country an edge in its effort to attract foreign investors. In short, it became apparent that stronger, more effective institutions were urgently needed to complement macroeconomic policy changes.

While the role of institutions in economic life has long been acknowledged, it was not until recently that mainstream economists systematically and significantly incorporated it into the analysis.[19] In the late 1980s and early 1990s, the justified preoccupation with restoring macroeconomic balances, crushing inflation and restoring growth in developing countries, as well as the need to stabilise the transition economies, created an almost obsessive interest in macroeconomic analysis, almost to the exclusion of everything else. Crucial insights about the importance of institutional factors in economic development that had been at the centre of thinking and research about the obstacles to development were forgotten, or at least temporarily ignored.[20]

But not for long. In most reforming countries around the world progress in the implementation of what I dubbed in 1993 'the second stage of reforms' had slowed down considerably or stopped altogether.[21] A combination of reform fatigue, the exhaustion of the 'sneak attack' approach to reforms based on quick actions taken by the executive acting alone, the growing role of parliaments, the courts, and NGOs in resisting the reform initiatives made progress more difficult and slower than that of the initial macroeconomic reforms. What in many instances brought progress to a complete halt was the combination of the political difficulties with the formidable bureaucratic complexity of the second stage reforms. Politically, second-stage reforms are more demanding because their impact is less immediate and visible while their costs tend to be borne by specific groups which therefore have more incentives to organise in order to resist the reforms. The effects of a currency devaluation or a wholesale tariff reduction are immediate and their costs are relatively widespread throughout society. In contrast, reforming the health care sector takes longer and its costs are permanent and borne by the specific groups that will lose the benefits of working in public hospitals, supplying to them or having them as an inefficient competitor (see Table 1).

Administratively, second stage reforms are more complex because the involvement of a larger number of government agencies and social actors is required, and therefore the informational and co-ordination demands are more intense. Also, the steps required for their implementation tend to be more numerous and more geographically dispersed. Again, liberalising the financial sector is a reform that can be implemented with a few administrative steps concentrated in one or two government agencies. But reforming the educational system takes a myriad of additional steps and entails modifying the basic operations of a widely dispersed system of educators and administrators.

Finally, institutional reform or institutional strengthening is a field with much action and little theory. As Carol Graham and I demonstrated elsewhere, what passes for knowledge about institutional reforms is often nothing more than a series of partial findings with little capacity to provide universal prescriptions to guide efforts aimed at improving institutional performance in reforming countries.[22] In fact, institutional weakness is not one specific illness but, like cancer, include variety of maladies, each requiring different treatment (Table 2 offers a taxonomy of different institutional illnesses).

TABLE 1
Two stages of economic liberalisation

	Stage I	*Stage II*
Priorities	• Reduce inflation • Restore growth	• Improve social conditions • Increase international competitiveness • Maintain macroeconomic stability
Reform strategy	• Change macroeconomic rules • Reduce size and scope of the state • Dismantle institutions of protectionism and statism	• Create and rehabilitate institutions • Boost competitiveness of the private sector • Reform production, financing, and delivery of health care, education and other public services • Create 'economic institutions of capitalism' • Build new 'international economic insertion'
Typical instruments	• Drastic budget cuts and tax reform • Price liberalisation • Trade and foreign investment liberalisation • Private sector deregulation • Creation of social 'emergency funds' bypassing social ministries • Easier privatisations	• Reform of labour legislation and practices • Civil service reform • Restructuring of government, especially social ministries • Overhaul of administration of justice • Upgrade of regulatory capacities • Improvement of tax collection capabilities • Sectoral conversion and restructuring • 'Complex' privatisations • Building of export promotion capacities • Restructuring relations between states and federal government
Principal actors	• Presidency • Economic cabinet • Central Banks • World Bank and IMF • Private financial groups and foreign portfolio investment	• Presidency and cabinet • Congress • Public bureaucracy • Judiciary • Unions • Political parties • Media • State and local governments • Private sector
Public impact of reforms	• Immediate • High visibility	• Medium and long term • Low public visibility
Administrative complexity of reforms	• Moderate to low	• Very high
Nature of political costs	• 'Temporary corrections' widely distributed among population	• Permanent elimination of special advantages for specific groups
Main governmental challenge	• Macroeconomic management by insulated technocratic elites	• Institutional development highly dependent on mid-level public sector management

Source: Moises Naim, *Latin America's Road to the Market: From Macroeconomic Shocks to Institutional Therapy*, San Francisco, CA: ICEG, 1994.

Strengthening the rule of law entails a different approach than ensuring that telecommunications are well regulated, children are properly immunised, or bankers adequately supervised. Unfortunately, the knowledge available to guide efforts to improve the institutions in charge of performing such tasks is ratherpoor. Advice on these issues is often based on limited experience or specific case studies that are not easily transferred across countries and cultures.[23]

TABLE 2
Sources of institutional malfunction

Type of malfunction	*Source of malfunction*	*Characteristics*
	Chronic congestion (overdemand and underfunding)	Typical for new initiatives. Erodes quality, equity, tax/resource base. May limit access to those who wield sufficient influence, Private alternatives flourish
Resource-related	Inadequate input	Insufficiently educated workforce. Lack of thorough, competent legal and regulatory standards, outdated hardware resources
	Concentration of funding on personnel costs	Insufficient resources for resolving key organisational issues/ objectives. Precludes flexibility and innovation
	Capture by special interests	An external, related group exercises influence over directives and ideology
Politically driven	Corruption	Distorts objectives of the institution. Affects all levels of functions, from personnel to executive decision making
	Politicisation	Recruitment, appointments and remunerations heavily influenced by political patronage
	Volatility	Institutional priorities fluctuate thanks to shift in internalised priorities or political turnover
	Coal ambiguity	Lack of clarity manifested in overambitious objectives (eg overregulation)
Organisational	Monopoly/monopsony control	Only one body provides service and only one body supplies workers
	Degree of government involvement	A 'hands-on approach' by government (especially in terms of the economy or monetary policy)

Ignorance, however, has never stopped an issue from becoming a priority to which ample attention and resources are allocated, even though clear ideas about how to use them are scarce. Once the economic reform establishment discovered 'institutions', no speech or policy paper could be written about market reforms without including a fashionable reference to the need to strengthen institutions. In particular, it has now become obligatory to refer to the need to develop the institutions that are relevant for the establishment of the rule of law, for effective regulatory frameworks and, of course, for the provision of health and education to the poor. Unfortunately, far fewer of these speeches and papers include useful ideas of how to implement these needed institutional reforms.

The discovery of globalisation

In what surely is a great irony, the Washington Consensus missed globalisation. It is indeed ironic because the elimination of obstacles to international trade and investment that fuelled much of the economic integration the world has witnessed in this decade certainly owes a lot to the influence of the Washington Consensus on many liberalising countries.

What the Washington Consensus did not provide was a set of policies that would enable reforming countries to cope better with the consequences of globalisation, especially in the financial sphere. While the 1990s will be remembered for the large number of countries that experimented with market reforms, they will surely also be remembered for the periodic financial crashes that rocked these countries and spread across borders in quick and unpredictable

ways. In just five years, between 1994 and 1999, 10 middle-income developing countries had a major financial crisis.[24] These 'accidents' wrought havoc in these countries' financial systems, bankrupted their banks, set back some of the economic gains they had accumulated through years of painstaking reforms and, in some cases, unleashed a severe political turmoil. They also created the demand for reform in the rules and institutions that govern the international financial system.

What these crashes mostly created, however, was confusion. Was financial opening a good idea? Trade liberalisation? Should currencies float freely or are countries better off with a currency board or some sort of pegged rate? Is the combination of hiking interest rates and tightening the fiscal belt as the IMF often prescribes in these situations good medicine or a poison that debilitates the patient and makes the illness more acute and harder to cure? Should the IMF be abolished or strengthened? Are the bailouts of countries in financial crisis a source of global stability or instability? These dilemmas are just a few examples from a long list of disagreements among the experts about how to approach and cement economic reforms in a global economy. These disagreements can be grouped into four general categories. The fix or float debate, the capital account liberalisation debate, the inflate versus deflate debate, and the global financial architecture debate.

The fix or float debate is about the nature of the exchange rate regime a country should have and it is a testament to the still primitive nature of economics as a science. After all, the fact that at the end of the century economists are still unable to agree about exchange rate regimes would be akin to engineers disagreeing about the principles of how to design the structure of a building. Yet, while a certain convergence has emerged in favour of floating exchange rates (or, perhaps more accurately, against fixing the rate too rigidly), the debate is still far from reaching the kind of expert consensus that would make policy makers in emerging markets cross this one off their long list of difficult policy dilemmas. After their respective crises, leaders in Mexico, Asia, Brazil and Russia received a barrage of contradictory advice.[25] For at least a few years into the next decade, leaders of countries facing financial difficulties should expect to get highly conflicting advice on what to do with their exchange rate regimes. Even the experts who favour floating rate regimes will offer different prescriptions as to what specific kind of floating regime is the most desirable.

The debate about exchange rate regimes is closely related to the debate on the liberalisation of a country's capital account. In the words of Alan Binder, a former Vice Chairman of the US Federal Reserve Board, 'the hard-core Washington Consensus which holds that international capital mobility is a blessing, full stop needs to be tempered by a little common sense'.[26] Proponents of capital controls, however, do not share the same common sense about what kind of measures are the best. Some of the most radical proponents, like Paul Krugman, recognise that 'there is virtually unanimous consensus among economists that exchange controls work badly'.[27] Yet, in Krugman's judgment, the kind of impending disaster facing Asia at the time was of such magnitude that the only way out was to impose currency controls. For him, the costs of a

system that made most foreign currency transactions not directly handled by the government illegal were tolerable given the alternatives facing the region. We now know, of course, that Asian countries are recovering and that, fortunately, the debacle envisioned by Krugman and others did not happen.

More moderate proponents, like Blinder or the Council on Foreign Relations' Task Force on the Global Financial System, qualify their recommendations, emphasising that they are not recommending the imposition of heavy-handed controls to protect the local financial sector from foreign competition. Rather, the suggestion is to find mechanisms that just 'slow down the flow of hot money'.[28] The country most commonly used as the model to emulate is Chile. While open to foreign banks and allowing capital outflows, Chile in effect taxed the inflows of short-term capital.

But this is not a good idea, according to Sebastian Edwards, himself a Chilean, who is the former chief economist for Latin America at the World Bank. He writes: 'Supporters of capital restrictions have misread Chile's history, and have heavily oversold the effectiveness of this policy. In fact, there are good reasons to believe that capital controls in Chile have not worked as expected and that they have largely failed to reduce macroeconomic instability.'[29] In fact, Chile eliminated its controls roughly at the same time that concerns about the volatility of the flows of portfolio capital led many commentators to recommend 'Chile-type' controls.

Research by Barry Eichengreen and Michael Mussa confirms that countries with freer regimes on foreign capital had higher rates of economic growth. They also found that financial crises have more to do with inadequate banking supervision than with the opening of the country's capital account.[30]

For many emerging markets the idea of imposing limits on how much foreign capital is flowing in must have the ring of past battles rather than those of the present, or even those of the future. Not many emerging markets ended the 1990s with foreign money, hot, warm, or cold, overflowing into their economies. On the contrary, the decade ended with a boom in Wall Street that makes investors wary of sending their hot money abroad. Internet stocks are providing the high risk and high rewards once supplied by the allure of emerging markets, only they do it with a higher credit rating. Moreover, investors' appetites for emerging markets have, at least temporarily, abated as a result of the many crashes that have affected these countries. Many are still mired in the recessions induced by the stringent fiscal and monetary policies they had to adopt in response to their financial crises. Why a financial crash has to be cured with a recession is the crux of the deflate versus reflate debate.

Essentially, some economists argue that the unequivocal priority after a country suffers a financial crash is to stabilise its exchange rate, even at the cost of plunging the economy into a recession. Protecting the currency from spinning out of control requires cutting public budgets, raising taxes and hiking interest rates. Naturally, this combination of measures slows down the economy and boosts unemployment. Moreover, in countries where banks have not been competently supervised and are not adequately capitalised, the recession may also create a costly banking crisis. This is, no doubt, bitter medicine, but to many experts there is no other solution. Stanley Fisher, the IMF's second-in-command,

noted in the context of discussing the IMF's reliance on this approach in Asia, 'I can't believe that serious people believe that with temporarily increasing interest rates, we could have contained the problems.'[31]

It turns out that there are plenty of 'serious people' who believe that hiking interest rates is the wrong medicine. Some of them even sit across the street from Fisher's offices at the IMF: Joseph Stiglitz writes that 'research by the World Bank has identified pivotal factors contributing to financial crises, including sharp rises in interest rates' and that 'a standard "one-size-fits-all" response to a financial crisis such as East Asia's clearly did not work and imposed a heavy cost for many in the region'.[32] Harvard's Jeffrey Sachs is somewhat less diplomatic: 'The IMF worked mightily and wrong-headedly to make the world safe for ... short-term money managers. [It] bought into the investment-bankers' mantra: exchange rate stability above all else ... [and] encouraged central banks from Jakarta to Moscow to Brasilia to raise interest rates to stratospheric levels to protect their currencies.'[33]

MIT's Krugman shares this view and notes that 'instead of trying to prevent or even alleviate the looming slumps in th economies [Asian countries] were told to follow policies that would actually dampen those slumps'. He is also perplexed: 'why did the high-powered economists near the top of the IMF and the Treasury, as soon as they encountered a crisis, throw away the textbooks indeed, do almost the opposite of what the textbooks would have suggested?'[34] Across the corridor at MIT his colleague, Rudiger Dornbusch, who is also the author of one such textbook, sharply disagrees: 'Many, including World Bank chief economist Joe Stiglitz, have been preaching liberation theology. The IMF is wrong they say ... [but] it is not quite clear what stabilization is all about if not tighter money and sounder public finances ... A successful stabilization without a hike in rates is like Hamlet without the Prince or Denmark ... The World Bank's liberation theology is a very bad idea which only makes stabilization even harder. If one institution is guilty of malpractice it would be the World Bank'.[35]

Disagreements between the IMF and the World Bank are not new. Never before, however, have they been this profound and this public. These differences are also reflected in the debate about the global financial architecture.

This debate was heightened by the Asian crisis that began in Thailand in 1997. To many observers, the fact that the countries crashing were among some of the world's stellar economic performers meant that the problem lay less with the countries themselves than with the international financial system in which they operated. Thus, proposals to create a less accident-prone global financial system proliferated. In general, the proposals ranged from the sweeping, radical and politically naive to the minimalist, technocratic and practical. At one point the UK government proposed the merger of the IMF, the World Bank and the Bank for International Settlements, while George Shultz, the former US Secretary of Treasury and State, demanded the abolition of the IMF. At the other extreme, the IMF recently centred its efforts on understanding the workings of private credit rating agencies, with an eye to identifying ways to reduce the role that they may have in exacerbating international financial volatility.[36]

In between these two extremes many complementary and contradictory

proposals to increase the stability of the global financial system have been made. In general, these proposals fall into five general categories: 1) proposals that seek to increase the efficiency of international capital markets (improve transparency, prudential regulation, reduce moral hazard, improve IMF surveillance, improve risk management; 2) initiatives to slow down the flows of short-term international capital; 3) proposals to reform existing multilateral financial institutions and or create new ones; 4) proposals to use exchange rate regimes to minimise currency fluctuations; and 5) initiatives aimed at improving international macroeconomic policy coordination.[37]

Each of these categories includes proposals that complement others in the same categories and in the other four, as well as some that are mutually exclusive. In any case, the only consensus that seems apparent is that no sweeping redesigns of the global financial architecture are imminent and that the system today is only marginally better prepared to deal with large-scale, highly contagious financial crashes. This means that in the next crisis we should expect that, again, policy responses will be largely improvised and the institutional arrangements to deal with it will essentially be *ad hoc*. This be especially true if the financial crisis is not in an emerging market but in a large industrial country deeply integrated into the global economy.

The rediscovery of underdevelopment

Early in the 1990s the fashionable code words commonly used by politicians, experts and journalists commenting on economic reforms were 'macroeconomic stabilisation' and 'structural reforms'. 'Governance', 'transparency' and 'institutions' have now replaced these terms. Concerns about states that were too strong has now given way to concerns about states that are too weak. The obsession with crushing inflation, common in the late 1980s and early 1990s, has been substituted by the obsession with the need to curb corruption. Leaders of multilateral institutions today spend as much time highlighting the importance of strengthening the rule of law in some of the problem countries as their predecessors did 10 years ago about the need for their client governments to 'get the prices right'. Investing in physical infrastructure used to be the focus of the efforts of most multilateral development institutions. Today, investing in 'social capital' and developing the organisational infrastructure of civil society is seen as an obvious, albeit formidably difficult, goal.

For much of this last decade the sustainability of market reforms was a main concern. Now the concern is about the sustainability of democracy in many reforming countries, from Russia to Peru and from Indonesia to Venezuela. During the golden years of the 'stage one' reforms, attention to international constraints was mostly concentrated on the protectionism of the richer countries that could slow down the export-led growth of the reforming countries. The century ended with a heightened awareness of the dangers of an international economic environment that periodically unleashes financial shocks which obliterate almost overnight the results of years of reform efforts. Poverty alleviation continues to be a paramount goal, but it now has to share the limelight with mounting concerns about the increase in inequality and its consequences. Inequality is now seen not only as a threat to political stability but also as a major drag on international competitiveness.[38]

The reform agenda has become broader and infinitely more complex. World Bank President James Wolfensohn has become a vocal proponent of a broader agenda: 'The Comprehensive Development Framework I am proposing highlights a more inclusive picture of development. We cannot adopt a system in which the macroeconomic and financial is considered apart from the structural, social and human aspects, and vice versa ... What is new [in this proposal] is an attempt to view our efforts within a long-term, holistic and strategic approach where all the component parts are brought together ... [through] a participatory process, as transparent and as accountable as possible within the political climate prevailing in each country.'[39]

Some of the issues that seem to inform Wolfensohn's concerns are similar to those first advanced in the 1940s and 1950s in what was then called 'development economics'.[40] Underdevelopment could not be tackled, it was argued, without a broad-based, all-inclusive approach that emphasising the importance of institutions, inequality, 'structural factors', cultural specificities, and the constraints imposed by the international economic environment. These earlier approaches also paid great attention to power relations, both inside the poor countries and within the international system, as well as the way these shaped development prospects.

An important difference in the current revival of these classic ideas of development economics is that, nowadays, almost all statements about reform priorities, economic agendas, or 'new development frameworks' seem to require a strong preface clarifying that sound macroeconomic fundamentals are indispensable. After that clarification, however, the lists offered then proceed to outline an overwhelming set of societal transformations. For example: 'The end of the Cold War ... [offers] an unprecedented opportunity to make development work. To do this we need a consolidated package of specific requirements that include honest governments, open legislative and transparent regulatory systems, properly trained and remunerated officials and a vigorous commitment by leaders to fight corruption at all levels. We also need an effective and impartial legal justice system ...' and the list goes on.[41] This quote is useful because it not only illustrates how far the current agenda has drifted from the orthodox economics of the early 1990s, but also how what used to be goals are now seen as 'specific requirements'.

The difficult paradox, of course, is that any country that is capable of meeting such stringent requirements is already a developed country. The means to attain utopia are themselves utopian goals for most countries.[42] This does not imply, of course, that these are not valid aspirations. They are valid but, mostly, they are overwhelming. The challenge, therefore, is to use the many lessons accumulated throughout decades of development efforts to create agendas that include intermediate stepping stones and more manageable goals.

While the 1989 Washington Consensus might have been too reductionist, it had the virtue of being concrete and action-orientated. Also, politicians adopted it because its goals looked achievable within the time horizon that most elected officials use to decide what their real priorities will be. Development prescriptions for the next decade ought to incorporate the many useful lessons in political

marketing that can be derived from studying the reasons for the popularity of the Washington Consensus early in the decade.

The 'Five I's' of economic reforms

The 1990s began with the widespread expectation that achieving sound, market-oriented, macroeconomic fundamentals was the ticket for the prosperity that had long eluded poor countries. The decade is ending with the more frustrating but also more realistic understanding that sound macroeconomics is not a goal but just a precondition. It is also clearer now that the recipe for prosperity has many ingredients and that their exact quantities, mix, and sequencing are not well known. We have also rediscovered that prosperity is harder to achieve and takes much longer than what was easy to believe possible in the triumphal few years following the fall of the Berlin Wall, 'The End of History,' and the worldwide movement toward freer market economies.

The search to find widely acceptable syntheses of the public policies that should be used to move countries forward on the path toward prosperity will continue. Consensus on this subject is still elusive when the discussion moves from general goals to the means to achieve them. However, this decade has left a rich legacy in terms of the areas where action is needed. They can be grouped in five general categories: international economic instability, investment, inequality, institutions, and ideology (the 'Five I's'). No matter what shape the future of economic reform takes, any new consensus that may emerge will need to offer sound responses to these challenges.

International economic instability

As long as the evolution of the reforming economies is periodically derailed by powerful international shocks, it will be difficult to cement whatever gains are produced by the policies now in place. The solution is not to wait for a new 'global financial architecture' that would eliminate the effects of the international economic cycle. Nor is it to impose a set of quasi-protectionist obstacles to trade and investment flows that would isolate the economy from external shocks. Rather, countries will have to develop a set of institutions and policies that mitigate the impact of the shocks when they come—and come they will. Examples of such measures are the commitment to strong and well-supervised banking systems, the establishment of a network of contingent international lines of credit, the creation of public budgeting processes and institutions that counter the effects of external shocks instead of amplifying them, and last but not least, the establishment of an exchange rate regime that diffuses the impact of external shocks. Many countries have already begun to move in this direction, and some have made significant progress in accepting that international financial volatility is here to stay and thus that they must prepare for it before the next shock hits their shores. Yet, no generally accepted blueprint is now available to insure a country's peaceful coexistence with a volatile global economy. Also most of these measures need effective institutions, which is in itself one of the 'Five I's' for which there are no clear answers.

Investment

Without investment there is no economic growth, and without economic growth there is no sustainable economic policy. Economic growth is not always sufficient to alleviate poverty and certainly is not equivalent to development. Nonetheless, we know that without growth, all other poverty alleviation efforts fall short.

From this perspective, both savings rates and foreign investment become critical variables. Most recent research shows that higher savings rates are better approached as an outcome resulting from the successful implementation of a variety of other policies rather than as a target.

Even if, as the Asian crisis has shown, a high rate of savings does not protect a country's economy from crashing, a higher savings rate is needed to develop a stronger financial system that can help buffer the economy from external shocks. Mostly, however, higher domestic savings and foreign capital are needed to fund the huge investments that most reforming countries require to catch up with their high demand for infrastructure and social services.

Therefore, given the magnitude of the demand for investment in most countries and the need for new technologies, dependence on foreign capital will remain significant for many years to come. Countries with the combination of conditions and policies that are attractive to private investors in general (and foreign investors in particular) are going to find that it is easier to fund their social programs and build public support for the policies they are pursuing. The capacity to attract and retain private investment will be a crucial defining factor in the economic stability of a country and the sustainability of policies that can, over time, improve the living conditions of the poor.

In this sense, it is also worth remembering that many episodes of massive capital flight tend to transform most domestic investors into international investors. Therefore, the conditions needed to attract them and motivate some degree of capital repatriation are not that different from the set of incentives that all other foreign investors usually require to put their money in a given country.

Inequality

Although poverty continues to be a focus of political attention, it now has to share the stage with inequality. Inequality is not a new phenomenon, but in recent years, it has become the focal point of political debates worldwide. Moreover, public debate over inequality has further intensified with the spread of democracy and the concomitant increase in scrutiny by the mass media.

This heightened awareness of a problem that is becoming more acute is bound to pressure governments to take swift actions against inequality and show tangible results in reducing income gaps. In some countries, these efforts will amount to nothing more than populist rantings and the adoption of policies that sound good but in practice increase inequality and retard development. Examples of these are the adoption of protectionist trade and investment policies, taxes that scare investors away while not really distributing wealth, social protection

policies that cannot be funded without generating inflationary deficits, labour laws that overly benefit those already employed while reducing opportunities and income for unemployed workers that need it the most, or the support for demands of public sector unions that cripple the capacity of the state to deliver social services. Often these policies are likely to delay growth, increase poverty, and retard any significant progress toward a more just distribution of income. In other countries, the search for ways to minimise the inequities may lead to a healthy focus on the urgent need to improve the performance of public institutions, especially those in charge of providing education and healthcare to the poor.

Institutions

Public sector institutions are the black holes of economic reforms. In most countries they absorb efforts and investment that yield obscenely low returns to society, distort labour markets, reduce countries' overall productivity, impair international competitiveness, and are easy prey for vested interests. Public institutions are often at the center of the corruption that corrodes the political system.

Since time immemorial, malfunctioning institutions have been at the core of most developing countries' incapacity to achieve higher living standards. The elimination of government controls and the deregulation of many sectors of economic activity, together with more prudent public spending, have done wonders to alleviate some of the problems that plague these countries' institutional landscape.

Yet, in most poor countries public sector institutions do not function properly or simply do not work at all. Many, such as schools, hospitals, or police departments, which are overwhelmed by a booming demand for services, do not have, and have never had, the adequate personnel or equipment to respond. Others are paralysed by labour laws and various regulations that stifle any attempts at efficiency. And still others, such as tax and customs agencies, jails, or agricultural subsidies' boards, are often corrupt to their core.

Revamping institutions requires a long-term effort and the capacity to tackle difficult political and technical challenges that have no preordained solutions. Moreover, institution building is vulnerable to political discontinuities and economic volatility. A change of minister or a sudden budget cut can do away with years of efforts aimed at building competent teams or modernising the organisational culture of a public agency.

Sound macroeconomics and a competitive private sector are necessary. But stability and market reforms are bound to be periodically derailed without a strong and efficient public sector. Yet, the real challenge will be ensuring that the urgent need to strengthen institutions (and therefore the political will to allocate massive resources to these initiatives) does not get too much ahead of the limited existing knowledge about how to do this right. Again, whatever progress may be achieved in expanding and consolidating market reforms will depend on the identification of the reliable approaches to institution building that are now sorely lacking.

Ideology

The deeply troubled transitions toward market-based economies in the former Soviet Union, Central Europe, and Latin America, as well as the Asian financial crisis, are frequently paraded as examples of the bankruptcy of the neoliberal approaches in vogue during the 1990s. However, market reforms have exhibited a surprising resilience in most countries. Based on the magnitude of the rhetorical assault against globalisation and market reforms, by now all sorts of protectionist measures should have crippled the world's trade and investment system. Similarly, the economic reforms adopted around the world in the last 10 years should have been subject to a wholesale reversal. But none of that has happened. Some reversals in economic reforms have taken place and the speed of reform has certainly slowed down. In reality, however, the backlash against market reforms has manifested itself more in speeches than in actual policies.

Nonetheless, a general uneasiness about the policy direction of the last 10 years has prompted a search for a free-market model that recognises an important role for the state and pays more attention to social policies. In some countries, this search may lead to experiments that diverge drastically from some of the basic ideas of the 1990s that we now know are necessary but not sufficient. These departures are likely to end in major economic and political catastrophes and in an eventual return to the basic features of the approach now in vogue. In others, the search may lead to innovations and refinements that, while respecting the need for macroeconomic balances and avoiding the over-reliance on the state, may in fact accelerate economic and social development.

But accelerated development does not mean instant results. Developing countries will need considerable time to reap the benefits of these policies. In decades past, many of these countries were run by authoritarian regimes that relied on ideological fervour and the repressive mechanism of the state to sustain policies that yielded poor results. Lacking a deeper ideological grounding, the reforms implemented today are more vulnerable to the impatience of more open democratic societies.

If developing countries are to buy time to make these reforms work, then they must rely on a shared ideological commitment that emerges from within, not one that is imposed from without. Absent a wide social base of support, the acceptance (and stability) of these reforms will depend on a sustained level of high performance that, in most cases, is unrealistic. Ideology breeds patience—people are willing to give change a chance if they believe that the underlying principles are sound and that it ultimately will benefit them. But if ideology is forced upon a nation, then it is only a matter of time before people become suspicious of its intentions and impatient with its results.

The central challenge for economic reformers is to foster a widely shared commitment to a set of policies that may take years to reach fruition. Their task, however, would be much easier if they were not compelled to conform to a new economic fad every few years. The patience of developing countries will not only be taxed by the volatility of the global economy, but by the volatility of the fickle demands and prescriptions emanating from Washington and Wall Street.

Notes

This article is based on a paper prepared for the IMF Conference on Second Generation Reforms, Washington, DC, October 1999. A shorter version appeared in *Foreign Policy*.

[1] Williamson's 10 prescriptions reflecting his interpretation of the Washington consensus in the early 1990s were: 1) fiscal discipline; 2] redirection of public expenditure; 3) Tax reform; 4) Financial liberalisation, 5) Adopting a single, competitive exchange rate; 6) Trade liberalisation 7) Eliminating barriers to foreign direct investment; 8) Privatising state-owned enterprises; 9) Deregulating market entry and competition; 10) Ensuring secure property rights. See John Williamson (ed), *Latin American Adjustment: How much has Happened* Washington DC: Institute for international Economics, 1990.

[2] John Williamson, 'Democracy and the Washington Consensus', *World Development*, 21(8), 1993, p 1331.

[3] See David Lipton & Jeffrey Sachs, 'Creating a market economy: the case of Poland', *Brookings Papers on Economic Activity*, 1, 1990, pp 75–147; Abel Istvan & John Bonin, 'The "Big Bang" versus "slow but steady", a comparison of the Hungarian and Polish transformations', CEPR Discussion Paper No 626, London, 1992; and Richard Portes, 'Transformation traps', *Economic Journal*, 104 (426) pp 1178–1189.

[4] Recent examples of the two contrasting arguments are Charles Wyplosz, 'Ten years of transformation: macroeconomic lessons' and Joseph Stiglitz 'Whither reform: ten years of transition', both papers presented at the Annual World Bank Conference on Development Economics, Washington, DC, April 28–30 1999. For a journalistic interpretation of the debate, see John Lloyd, 'Who lost Russia?', *The New York Times Magazine*, 15 August 1999.

[5] 18 September 1999, p 81.

[6] *Foreign Policy Magazine*, Fall 1999

[7] *Financial Times*, 22, 27, 28 September, 1999.

[8] Williamson 'Democracy and the Washington Consensus', pp 1332–1333.

[9] John Williamson, 'What should the Bank think about the Washington Consensus', paper presented at the World Bank's PREM meetings, July 1999 (mimeo), p 3.

[10] Ibid.

[11] In 1995 President Ernesto Zedillo said in a press conference; 'What we say is very simple: Mexico's economic crisis is a product of our country's domestic savings crisis' (FBIS-LAT-95-158, 16 August 1995). This was a conclusion echoed by the post-mortem reports on the crisis issued by the IMF, The World Bank, the IDB and most academic writers and journalists who reported on the issue. See Sebastian Edwards & Moises Naim (eds), *Mexico 1994: Anatomy of an Emerging-Market Crash*, Washington, DC: The Carnegie Endowment, 1997.

[12] A classic statement of this view is Celso Furtado, *Development and Stagnation in Latin America: A Structural Approach*, New Haven, CT: Yale University Press, 1963. For one of the early summaries of 'structuralist' analysis, see Osvaldo Sunkel, 'El transfondo estructural de los problemas del subdesarrollo Latinoamericano', *El Trimestre Economico*, 34, 1967, pp 11–58. See also Raul Prebish, 'Five stages in my thinking on development', in G Meier & D, Seers (eds), *Pioneers in Development*, Washington, DC: World Bank, 1984.

[13] See Miles Kahler, 'Orthodoxy and its alternatives: explaining approaches to stabilization and adjustment', in Joan M, Nelson (ed), *Economic Crisis and Policy Choice*, Princeton, NJ: Princeton University Press, 1990, pp 33–61.

[14] 'Dependencia', which originated in Latin America, held that rich countries at the 'centre' of the international system became and stayed rich thanks to the unequal trade and investment relations they imposed on the poorer countries of the 'periphery'. The most extreme formulations of dependency theory saw almost no room for manoeuvre for any developing country's government. Effective government action required both a drastic 'restructuring' of international power relations and of the domestic politics of the country. A less paralysing policy stance was taken by those who, while subscribing to the idea that the impact of domestic policies was curtailed by an international economic system that put poorer countries at a disadvantage, still saw a role for domestic economic policy. This approach led to the widespread adoption of import-substituting industrialisation policies that sought to create an indigenous industrial infrastructure which could produce locally the equivalent of the imported goods. This resulted in high import barriers, restrictions on the entry of foreign firms and the selection of specific industrial sectors as 'national champions' to which massive subsidies and trade protection was accorded. The establishment of state-owned enterprises that, in theory, would have the size and resources to compete successfully with the large multinational corporations that boomed during the post-world war period was also a common feature of this approach, as were government controls on prices, interest rates, credit allocation and exchange rates.

[15] Cited in P T Bauer, *Reality and Rhetoric: Studies in the Economics of Development* Cambridge, MA. Harvard University Press, 1984, pp 19–20.

[16] See Moises Naim, 'Latin America: the second stage of reform', *Journal of Democracy*, 5(4), 1994 pp 32–48.

[17] World Bank, *Global Economic Prospects 1988–1999*, Washington, DC: World Bank, 1999.

[18] Moises Naim, *Paper Tigers and Minotaurs: The Politics of Venezuela's Economic Reforms*, Washington, DC: The Carnegie Endowment, 1993, p 119.

[19] Douglass C North, *Institutions, Institutional Change and Economic Performance*, Cambridge: Cambridge University Press, 1990; Oliver Williamson, *Markets and Hierarchies*, New York: The Free Press, 1975; and Williamson, *The Economic Institutions of Capitalism*, New York: The Free Press, 1985.

[20] Albert O Hirschman, *Essays in Trespassing*, Cambridge: Cambridge University Press, 1981; and Peter Evans, 'The state as problem and solution: predation, embedded autonomy and structural change', in S Haggard & R Kaufmann (eds), *The Politics of Economic Adjustment*, Princeton, NJ: Princeton University Press, 1992.

[21] I first called attention to these two stages of market reforms in my 1993 book *Paper Tigers and Minotaurs*, p 142ff and then extended the analysis in a 1994 article in the *Journal of Democracy*, 5(4), pp 32–48 and in *Latin America's Journey to the Market: From Economic Shocks to Institutional Therapy*, San Francisco, CA: International Center for Economic Growth, 1995. See Table 1 for charts comparing the content, characteristics and the politics of the two stages. Reforms in the second stage are also often referred to as 'second generation reforms'.

[22] Carol Graham & Moises Naim, 'The political economy of institutional reform in Latin America', in Nancy Birdsall, Carol Graham & Richard Sabot (eds), *Beyond Trade-Offs: Market Reforms and Equitable Growth in Latin America*, Washington, DC: The Brookings Institution, 1998.

[23] In some instances the advice about institutional reform may have even been counterproductive. During the early and mid-1990s it became fashionable to prescribe the decentralisation of public services as a remedy for poor performance. Some of the experiences with this approach show that decentralisation has lowered even more the quality and availability of public services while also creating grave fiscal distortions. In some countries, raising the admittedly low public salaries as a means to increase the quality of the public sector has backfired, as the higher salaries made it harder and more costly to dismiss poorly performing employees, while not being high enough to attract the needed talent or curb corruption. See Carlos Acuna & Mariano Tomassi, 'Some reflections on the institutional reforms required from Latin America', mimeo, CEDI, Buenos Aires, 1999.

[24] Turkey, Venezuela, Argentina, Mexico, Indonesia, South Korea, Malaysia, Philippines, Thailand, Russia and Brazil. See Jeffrey Sachs 'Creditor panics: causes and remedies', *Cato Journal*, 18(3), 1999, pp 377–390.

[25] For a typical example of the strikingly different advice leading experts offered Asian countries, see 'Asia and the dollar', *The International Economy*, January–February 1999, pp 18–23. Ricardo Hausmann offers an overview of the different positions of a group of respected academic economists in 'Should there be five currencies or one hundred and five?, *Foreign Policy*, Fall 1999, 116, pp 65–79.

[26] Alan Blinder, 'Eight steps to a new financial order', *Foreign Affairs*, September–October 1999, p 57.

[27] See Paul Krugman, 'Saving Asia: it's time to get RADICAL', *Fortune*, 7 September 1998; and Krugman, *The Return of Depression Economics*, New York: W W Norton, 1999, pp 145–146.

[28] Council on Foreign Relations, *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture*, New York: CFR, 1999.

[29] Sebastian Edwards, 'Barking up the wrong tree', *Financial Times*, 7 October 1998.

[30] Barry Eichengreen & Michael Mussa *Capital Account Liberalization* Washington, DC: IMF, 1998.

[31] Quoted in Krugman Saving Asia, p 79.

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[42] I owe this idea to Ramon Pinango.