Whither reform? *Towards a new agenda* for Latin America

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The article outlines a new agenda for reform that focuses on what Latin American countries can do given the current international regime, and identifies the failings of the earlier reform agenda: i) the reforms increased countries' exposure to risk without increasing their capacity to cope with it; ii) the macroeconomic reforms were unbalanced; iii) the reforms pushed privatization and measures for strengthening the private sector, but placed too little weight on improving the public sector. The article further argues in favour of formulating a set of economic policies that reflect a better balance between market and government, shifting the focus away from an overemphasis on inflation and towards job creation, away from privatizing existing enterprises and towards creating new ones, and away from a belief in trickle-down economics and towards poverty reduction, thereby reforming the economic agenda within the broader context of the transformation of society.

I
Introduction

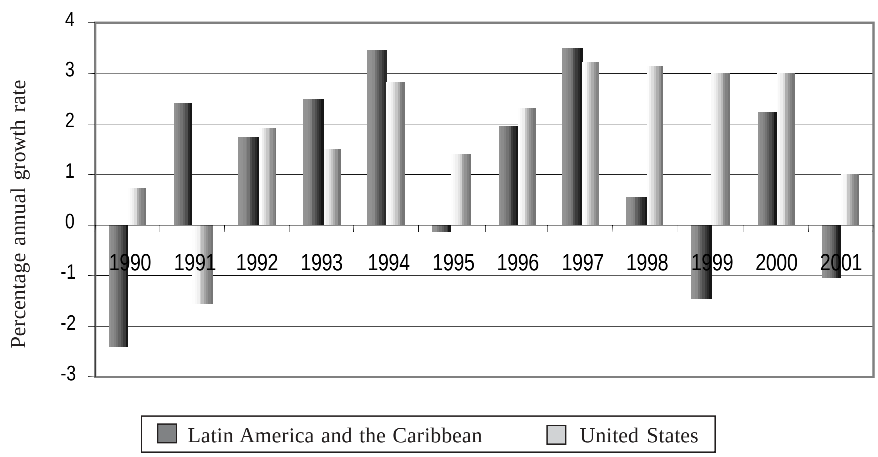
The experiment in so-called reform is failing in Latin America. After a brief spurt in growth in the early 1990s, growth has slowed (figure 1). Many of the countries of the region are facing recessions, depressions and crises; a few of them have been of an almost unprecedented level, reminiscent of the Great Depression.[1] Argentina, the A+ student of the first three quarters of the decade, has not only had a crisis but, at least in some quarters, it has become vilified beyond measure.[2] Brazil, too, a first-rate student of reform, faces a crisis at this very moment.[3] A reform strategy which promised to bring unprecedented prosperity has failed, in an almost unprecedented way. Its critics said that it *might* bring growth, but they worried, would that growth be widely shared? The outcomes have been worse than many of its critics feared: it has not brought growth to much of the region but, at least in some parts of the region, it has brought increased inequality and poverty (tables 1 and 2).

In this article, I want to explain and interpret these failures, and to lay out the framework for a new agenda of economic reform for Latin America. A few years ago, there was talk about the "second generation of reforms". It was assumed that the countries of the region were in the process of digesting the first generation of reforms, that these had provided the long-run

FIGURE 1

Latin America and the Caribbean and the United States: Per capita GDP growth, 1990-2001

(*Annual percentages*)



Source: World development indicators (World Bank, various years).

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[1] For instance, the following countries had negative GDP growth in 2001: Argentina, Uruguay, Mexico and Paraguay. The worst, of course, was Argentina, with a decline of 3.7%, but Uruguay had a decline of 3.1%.

[2] As this paper goes to press, in May 2003, even the International Monetary Fund (IMF) has, however, begun to change its tune. The dire predictions have turned out to be wrong; the country, while facing a severe depression, did not face hyperinflation, and even without IMF help –even with its constant criticism– it seems to have stabilized; and recovery has begun.

[3] The good news is that as this paper goes to press (May 2003), Brazil's prospects look far more positive.

TABLE 1

Population living below 1.08 dollars[a] a day
(*Percentages*)

	1987	1990	1993	1996	1998
Sub-Saharan Africa	46.6	47.7	49.7	48.5	46.3
South Asia	44.9	44.0	42.4	42.3	40.0
Latin America	15.3	16.8	15.3	15.6	15.6
East Asia	26.6	27.6	25.2	14.9	15.3
Middle East and North Africa	11.5	9.3	8.4	7.8	7.3
Eastern Europe and Central Asia	0.2	1.6	4.0	5.1	5.1
Total	*28.7*	*29.3*	*28.5*	*24.9*	*24.3*

Source: World Bank.
[a] At 1993 purchasing power parity.

TABLE 2

Latin America (13 countries): Income distribution
(Ratio of income share of richest 20% to poorest 20%)

	1990	1997	1999	Diagnostic
Argentina	13.5	16.4	16.5	Deterioration
Bolivia	21.4[a]	34.6	48.1	Deterioration
Brazil	35.0	38.0[b]	35.6	Similar
Chile	18.4	18.6[c]	19.0[d]	Deterioration
Colombia	35.2[e]	24.1	25.6	Improvement
Costa Rica	13.1	12.0	15.3	Deterioration
Ecuador	12.3	12.2	18.4	Deterioration
El Salvador	16.9[f]	15.9	19.6	Deterioration
Honduras	30.7	23.7	26.5	Improvement
Mexico	16.9[g]	17.4	18.5[h]	Deterioration
Panama	24.3[i]	23.8	21.6	Improvement
Uruguay	9.4	9.1	9.5	Deterioration
Venezuela	13.4	16.1	18.0	Deterioration

Source: ECLAC (2002c).

[a] 1989. [b] 1996. [c] 1996. [d] 2000. [e] 1994. [f] 1995. [g] 1989. [h] 2000. [i] 1991.

fundamentals for economic growth, and that it was time to move on to the task of "fine tuning" and addressing issues like competition policy which had been given short shrift in the first generation of reforms. I want to suggest that the first generation of reforms was fundamentally flawed. That it was not *complete* was clear. That it paid insufficient attention to issues of pacing and sequencing was also clear. But its failings were more basic: it failed to emphasize what should have been emphasized; it was based on a flawed concept of what makes a market economy work, and an inappropriate analysis of the role of government.

The failures of the so-called market-oriented reforms do not mean, of course, a return to the past, and for those committed to the objective of democratic, equitable and sustainable growth, this represents a challenge: what is the alternative? There is, of course, not a single alternative; each country must choose the alternative that is appropriate for its conditions and its people. Indeed, the attempt to promote a single agenda, untailored to the circumstances of each country, has been one of the main criticisms, rightly in my judgement, levelled against the Washington Consensus. But there are some overarching perspectives, some common themes, that are likely to be played out in many of the countries, and I want to try to articulate those common themes.

It is an especial privilege for me to deliver this lecture in the memory of Raúl Prebisch, the second such occasion on which I have been able to do so.[4] Prebisch too was concerned with the plight of Latin America, the difficulties that he saw it facing. He worried, for instance, about declining commodity prices. To the problems with which he was concerned we now must add several more.

[4] See Stiglitz (1998).

II
The failures

The dimensions of the failure are hard to fathom. The data for the first full decade of reform are now in. Growth has been slightly greater than half of what it was in the 1950s, 1960s and 1970s: for a set of reforms that began by criticizing the failed policies of the past, this is hardly an achievement to boast of (table 3). The numbers look even more dramatic when we compare the performance of Latin America relative to other countries.

TABLE 3

Latin America: Annual average growth
(*Percentages*)

	1960-1970	1970-1980	1980-1990	1990-2001
GDP	5.32	5.86	1.18	3.05
GDP per capita	2.54	3.36	-0.80	1.39

Source: World development indicators (World Bank, various years).

Standard neoclassical theory predicts convergence, that is, that less developed countries will grow faster (per worker) than developed countries. As table 4 illustrates, there was convergence during the pre-reform decades, but since 1980 there has been divergence. Figure 1 shows that even in the earlier part of the 1990s, in which success was claimed for the reforms, per capita income in the United States grew more rapidly than in Latin America. Of course, one might have said, "but it took time for the reforms to take effect". But here, the news is even worse. It was the first half of the decade in which growth occurred, as figure 1 makes clear. In the second half, especially since 1997, there has been stagnation, recession and depression. Indeed, income per capita has actually been declining over the past five years, in what ECLAC has begun to call "the lost half decade".[5]

TABLE 4

Latin America and the United States: Average annual rate of convergence
(*Excess of growth rate of Latin America over the United States*)

	1960-1970	1970-1980	1980-1990	1990-2001
GDP	1.42	2.58	-1.93	-0.46
GDP per capita	0.01	1.19	-2.95	-0.90

Source: Calculations based on data from *World development indicators* (World Bank, various years).

Advocates say: yes, growth in the 1950s, 1960s and 1970s was strong. But it was not sustainable. Yes, it was true that that growth was not sustained. But was it inner forces that led to the end, or a shock from the outside –the sudden, unexpected and unprecedented increase in interest rates in the United States– which made the Latin American debt unsustainable? That the increase in interest rates should have had such an impact in itself was as much a failing of international capital markets and the global financial regime as it was of Latin America. Well-functioning capital markets would have had the advanced industrial countries bear the risk of interest rate fluctuations. One would have expected, in any case, the sophisticated bankers of the advanced industrial countries would have done a risk analysis, showing that if interest rates increased, the debt would almost surely be unsustainable, and therefore they would have limited borrowing, and thereby the countries' exposure. One would have thought that the Federal Reserve Board, with all of its sophistication, would have taken into account the full ramifications of its raising interest rates to almost unprecedented levels. But no, none of this occurred: debt contracts forced the poor borrowing countries to bear the risk; Western banks did not perform the appropriate risk analysis, and not just because they were expecting a bailout. (Indeed, some of the Western bankers responsible for the irresponsible lending got promoted, not demoted: they had demonstrated their aggressiveness in lending, and that was what was rewarded.) The Fed was focused on inflation; when it raised interest rates, it paid scant attention to what it would do to America's financial system (it effectively bankrupted the S&Ls –savings and loan associations– which had long-term fixed-income assets with variable-rate liabilities; it would take almost a decade for the American taxpayers to pick up the multi-hundred billion dollar tab),[6] let alone what it

[5] See Ocampo (2002).

[6] For an account of the episode see, for example, Kane (1989).

would do to debtors abroad. Its claim was a simple one: it was not within its mandate to worry about impacts on the rest of the world!

But the economic leaders of the advanced industrial countries did not want to take full responsibility for these failures; it was easier, politically far more palatable, if they focused on the failings within Latin America, and unfortunately, there were easy prey. There were inefficient and corrupt State enterprises, high inflation, large fiscal deficits. Yet, for all of these problems, growth in the "pre-reform regime" was almost twice as fast as it was under the so-called reform regime.

There is, of course, no sure way of testing the alternative hypotheses: was it a shock from abroad or failings at home that brought on the lost decade? Indeed, both may play a role, and there is no simple way of "parsing" out blame precisely. But in the next section, I shall attempt to argue why I believe that *most* of the blame lies with the interest-rate shock imposed on the region from the United States. Latin America, like the rest of the world, was buffeted by the oil price shocks of the 1970s, and it weathered these shocks remarkably well, far better than other regions. But, arguably, it did so in an unsustainable way, relying on capital inflows (the recycling of petrodollars). It seems implausible that there was a sudden increase in corruption at the end of the 1970s and beginning of the 1980s that brought down the continent. The simpler and more persuasive explanation is that it was the sudden change in interest rates that brought a sudden end to growth. *Even if there had been no corruption, and State enterprises had been fully efficient, it is likely that most of the countries would have faced a crisis.*

Surely, no one wants to go back to the past. But the hard question is, what are the lessons to be learned from the *successes* of the past as well as its failures? But before turning to these issues, I want to describe more fully the nature of the failures of the past decade. While the Washington Consensus *promised* growth which it did not deliver, it said little about what the policies would do to instability. On poverty, it relied on the old trickle-down theories: economic policies were not specifically designed to address the problem of poverty; the presumption was that the promised benefits of growth would, somehow, trickle down to the poor—though by then there was ample evidence that "a rising tide need not lead to the rise of all boats".[7] There was, I would argue, not full disclosure: as we show in the next section, the policies led to both increased instability and poverty, and could have been expected to do so.

1. Increasing instability: contrasting experiences between the developed and less developed countries

Capitalism has always been marked by huge fluctuations. If anything, these fluctuations have become even more marked within the developing world.[8] The contrast between what has been happening in the developing countries and what has happened in the developed should draw our attention: in the latter, recessions have become shorter and expansions longer, and downturns arguably shallower. We now have the knowledge with which to manage the economy better, and evidently, in the more developed countries we are putting that knowledge to use. We know how to use countercyclical monetary and fiscal policies to bring an economy out of a recession, and we know how to design automatic stabilizers, to help buffer the economy against the inevitable shocks which it confronts. But somehow, the benefits of this improved knowledge have not been enjoyed by the developing countries—even though because of their weaker safety nets, one might have thought stability was of even greater importance.

Latin America did more than its share in contributing to this bleak picture. Table 5 shows that volatility, measured in several different ways, increased with reforms in Latin America, while volatility in the United States decreased. Of the countries in the region, in the period 1990-2001, 25 experienced at least one year of negative growth, 18 experienced at least two years of negative growth, and 12 experienced three or more years of negative growth.

2. Increasing poverty and inequality

The critics of reform not only point out, rightly, that growth was not sustainable (or at least it was not sustained), but that it exposed the countries to new sources of volatility (see below for a discussion of how the reforms increased instability). Volatility, in turn, is

[7] Indeed, data for the United States for the two decades beginning in 1973 showed that even as average incomes increased, those at the bottom were actually becoming worse off and, according to some studies, even the median family was becoming worse off. See Council of Economic Advisers (1997), Chapter 5.

[8] By some reckonings, 100 countries have faced crises in the past three decades. See Caprio and Klingebel (1999).

TABLE 5

Measures of instability

	1961-1980 (Pre-reform period)	1981-2000 (Reform period)
Variability (standard deviation of growth rate)		
United States	2.26	1.92
Latin America	1.80	2.36
Number of years of negative growth		
United States	3	2
Latin America	0	4
Number of years of growth below 90% of 1961-2000 average		
United States	8	3
Latin America	6	12

Source: Calculations based on data from *World development indicators* (World Bank, various years).

often associated with an increase in poverty—it is the poorest in society who typically bear the brunt of increases in unemployment; it is the unskilled workers who are thrown into unemployment, and have no savings to which they can turn.[9] The effects of even a temporary downturn can be long-lasting, as those that are thrown out of work cannot afford to send their children to school. Once their education is interrupted, there is a high probability that they will not return, even when things improve. Thus, poverty is passed on from one generation to the next.

In addition, some of the reforms themselves directly led to increased poverty—forcing poor farmers to compete with subsidized American agriculture lowered incomes of some of the poorest in the region, and the tight monetary regimes imposed made it difficult to create the new jobs that would provide alternative sources of employment. Moreover, the legacy of poor education for the disadvantaged made the task of reallocating labour all the more difficult, especially when liberalization was done rapidly.

For the region as a whole, the fraction of those in poverty rose from 15.3% in 1987 to 15.6% in 1998 (table 1). While more recent data are not yet available, almost surely, with the crises affecting so many countries, poverty since 1998 has increased significantly.

3. Inequality

Even in countries that have experienced growth, such as Mexico, a disproportionate part of the benefits have gone to the upper 30%, the upper 10%, with many of the poorest, those in the bottom 30%, worse off.[10] And again, we can understand why: it is partly the consequence of the fact that those at the bottom bear the cost of the economic fluctuations which are an inherent part of the market-oriented reform strategy.[11] It is partly the consequence of the overall structure of reform, with measures which had the effect of destroying jobs or lowering wages of unskilled workers preceding measures which might have led to job creation and increased their productivity, or even worse, with measures which had the effect of destroying jobs being accompanied by measures that inhibited job creation.

The result of the policies which were *supposed* to make markets work better is that, at least in some critical respects, markets worked more poorly. Unemployment increased by almost three percentage points,[12] and the numbers would have been even worse had it not been that more of the labour moved into the informal sector, a sector in which typically worker protections are weaker and access to capital –and thus future growth

[9] Agénor (2002) found that negative growth rates had a positive effect on poverty rates for a sample of less developed countries. This is true even in more advanced industrial countries. See Furman and Stiglitz (1998b).

[10] See, for example, Bouillon, Legovini and Lustig (2001).

[11] To be sure, some of the very poor –subsistence farmers isolated from the market economy– were the least affected by the reforms. If these are excluded from the analysis, the picture of the consequences may look even more bleak.

[12] ECLAC (2002a).

potential– is poorer.[13] Table 2 shows the increase in inequality over the decade for several of the countries in Latin America.

4. The many dimensions of poverty: human development indicators

The failures in the narrow dimensions of economic growth are paralleled by failures in the broader dimensions of human well-being, which include not only poverty, but education and health. Figure 2 shows the lacklustre performance of Latin America in the United Nations Development Programme (UNDP) human development index. Reforms have done nothing to close the gap between the level of the human development index for the region and that of the advanced industrial countries.

5. The many dimensions of poverty: insecurity

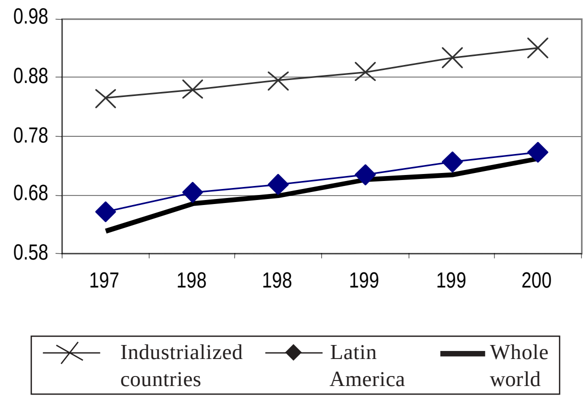
The World Bank's decennial report (World Bank, 2000) on poverty identified key dimensions of poverty as embracing not only lack of income, but insecurity and voicelessness, and the so-called reform strategies have exacerbated both problems. While the reform agenda did not produce robust growth, it did contribute to a heightened sense of insecurity. With the poor bearing the brunt of the increasing economic volatility, their sense of economic insecurity was increased. If that was not bad enough, the reforms almost deliberately worked to enhance insecurity further: one of the elements of the reform agenda went by the name of "increasing labour market flexibility", that is, weakening job protections, making it easier for firms to fire workers and lower wages; but remarkably, as we have noted, even though such reforms were *supposed* to lead labour markets to function better –that is, with less unemployment– the percentage unemployed actually increased. During the decade, an increasing fraction of the labour force moved into jobs in the informal sector—without any of the job protections provided by the formal sector.

There are, of course, other dimensions to insecurity. Personal security was affected by rising crime and violence in many countries (table 6), while the picture on health security is, by and large, positive (table 7).

[13] The magnitudes of the shift are startling. According to ECLAC (2002b), more than 70% of the jobs created in the 1990s in the region were in the informal sector.

FIGURE 2

World: Median of human development index



Source: *Human development report* (UNDP, various years).

6. The many dimensions of poverty: voicelessness

While most of my talk focuses on what are more narrowly construed as *economic* matters, I want to mention briefly the third dimension of poverty, voicelessness. One of the supposed great achievements of Latin American reform was the restoration of democracy. And that was an achievement. But meaningful democracy entails more than electoral democracy. Meaningful democracy entails participation in the country's decision-making, and among the decisions that are of most concern are those that affect the lives of the people most—the economic decisions. But under the so-called market-oriented reforms, many people in the developing world feel that they have been swindled. They may be able to vote, but in critical ways they are disenfranchised. After being sold on democracy, they are told that the key decisions, those involving macroeconomic (and especially monetary) policy are too important to be left to democratic political processes. The people, they are told, cannot be trusted, they are likely to be fooled by populist leaders. Central banks must be independent—and in most cases, they have been not only independent, but unrepresentative; only financial interests and perspectives have had a voice.

Worse still, they are told that they must open up their market to short-term speculative capital; doing so, it is contended, will provide discipline. Hardly hidden in such statements are a distrust of democratic processes: electoral processes themselves evidently do not provide the discipline required for good economic

TABLE 6

Latin America (15 countries): Homicide rate per 100,000 inhabitants

	Late 1970s	Late 1980s	Mid-1990s
Argentina	3.9	4.8	4.7
Brazil	11.5	19.7	23.0
Chile	2.6	3.0	3.0
Colombia	20.5	89.5	61.6
Costa Rica	5.7	5.6	5.4
Ecuador	6.4	10.3	15.3
El Salvador	…	138.2	55.6
Mexico	18.2	17.8	15.9
Nicaragua	…	18.3	8.4
Panama	2.1	10.9	10.9
Paraguay	5.1	4.0	12.3
Peru	2.4	11.5	…
Trinidad and Tobago	2.1	12.6	12.1
Uruguay	2.6	4.4	4.4
Venezuela	11.7	15.2	16.0

Source: For the first and second columns, PAHO (1996). For the third column, Krug, ed. (2002).

TABLE 7

Latin America and the Caribbean: Health indicators

	1970	1982	1993	1997	1998
Life expectancy at birth (years of life)	61	65	68	70	70
Infant mortality (per 1,000 live births)	84	41	38	32	31
Under-5 mortality (per 1,000)	123	78	49	41	38

Source: World Bank Statistical Information Management and Analysis (SIMA) database.

decision-making. The fact that the short-term speculators have perspectives and interests markedly different from those of the people of the country is hardly mentioned: the countries have subjected themselves to a disciplinarian that is not only fickle, but one whose focus is on the very short run, one which cares nothing about other social values like equity, or longer-run concerns, like the environment.[14] In some cases, the voices of those in Wall Street seem to be heard more clearly than the voices of those in the favelas and barrios.[15]

7. Some bright spots

I have, perhaps, drawn too dismal a picture. There are some bright spots, sometimes obscured by the aggregate statistics. In some countries, there are marked improvements in education: in Brazil, for instance, primary school enrolment has gone from 80% to 97%. In many, as we have already noted, there are marked improvements in health. In several countries, there are impressive institutional changes, from controlling State expenditures, to the creation of credible central banks, to the establishment of well-functioning capital markets, to the increase in efficiency and accountability in the public sector, to decentralizations which have enhanced the responsiveness of government to the concerns of the citizens.[16] These institutional reforms have, evidently, not yet led to the promised growth—but they may well lead to enhanced growth in the future. Interestingly, however, even those who believe in the reforms have begun to trim their optimism: they argue that the economies will move out of recession, that growth will be restored—but few are so bold as to even

[14] There is also reason to believe that, at least often, these speculators' understanding of basic economics is limited: they are more concerned with what drives short-run price dynamics than they are with what drives long-run growth dynamics.

[15] The consequences for democratic processes have been particularly evident in Brazil.

[16] Sometimes these reforms have been at odds with one another. In some countries, such as Colombia, decentralization has made the task of bringing control to overall budgets all the more difficult.

express a hope of a return to the kind of robust growth that marked the 1950s and 1960s. It promises to close the gap between Latin America and the advanced industrial countries, but at such a slow pace as to be barely perceptible, and in ways which leave open the question of whether in fact there is much hope for rapid progress either in enhancing stability or reducing poverty.

III
Interpreting the experiences

There can be little dispute: the performance of the past decade, in almost all of its dimensions, has not only been far less than was promised. It has been, by almost any standards, dismal.[17] Part of the problem in judging the Washington Consensus policies, however, is the familiar one of the counterfactual. What would have happened *but for* the Washington Consensus reforms? Would growth have been even more dismal?

At the heart of the controversy over interpreting Latin America's history are three questions: how do we explain the lost decade, the seemingly rapid decline from robust growth; how do we explain the rise, in the early 1990s; and how do we explain the equally sudden decline, after such a short period? We are in the middle of a grand drama—will the next act bring robust growth once again? Will the next act bring still more crises? Or will the next act be more of the same, stagnation and limp growth? The problem, however, is that we are unlikely to see the next act played out as it was scripted. Most countries are so disturbed by the way the play seems to be moving that they are likely to rewrite the script. No matter what happens, then, we will enter another round of hard-to-resolve disputes: if the economies recover, will it have been because of the changes or in spite of them?

In interpreting the experiences, we need to look at what happened both from a microeconomic and a macroeconomic perspective. In the next section, I will try to show more specifically how *particular* policies of the Washington Consensus could be *causally linked* to the failures. Here, I want to take a broad-brush approach.

1. Interpreting the lost decade

Weak as it has been, growth has still been better in the 1990s as a whole than in the lost decade of the 1980s. But that was a decade in which the debt overhang squashed the economies of the region. That period of stagnation ended, but I would suggest the end of the lost decade had more to do with the resolution of the problem of the debt overhang than it did with the reform strategies, just as the stagnation in the region had begun with the overbearing weight of the debt. Looking at the 1990s through this lens puts an even more jaundiced perspective on the limited growth of that decade. For it is not uncommon when an economy goes through a period of recession or stagnation, that there is a period of "catch-up" as lost opportunities are taken advantage of, as investments embodying advances in technology are put into place. This interpretation becomes particularly plausible in light of the observation that the most robust growth did occur in the first half of the decade. In this perspective, then, we should look at the 1980s and 1990s together, in which case the growth under reform looks even more dismal—it is less than half of what it was in the pre-reform decades, and in per capita terms it was barely positive (table 8).

To be fair, there is another interpretation, one which sees the 1980s as the inevitable consequence of the failed policies of the earlier decades, in which case the stagnation of that decade should more accurately be attributed to the earlier period. But even in this scenario, pre-reform growth appears more robust than growth under reform.

There are several reasons that make me lean strongly towards the former interpretation. First, a

[17] Defenders of the "reforms" were quick to claim victory as they saw growth increase in the early 1990s. They assumed that the reforms were the explanation, and they paid little attention to the fact that even then, the performance was not particularly impressive historically. But now that the record looks more dismal, they claim it is too soon to tell, and it is an unfair comparison, because the last several years have been marked by a global slowdown. To be sure, one should be cautious in reaching judgements—as the early claims of success for the reforms amply demonstrate. Still, one of the criticisms of the reforms is that they have in fact both contributed to global economic instability *and* they have exposed developing countries to more risk (see below).

TABLE 8

A. Viewing reform period as catch-up from the fallout of unsustainable policies
(*Annual average growth rate*)

	GDP	GDP per capita
1961-1980	5.59%	1.96%
1981-2001	2.15%	0.34%

B: Viewing lost decade as part of failed import-substitution strategy
(*Annual average growth rate*)

	GDP	GDP per capita
1961-1990	4.10%	1.69%
1991-2001	3.05%	1.39%

Source: Calculations based on data from *World development indicators* (World Bank, various years).

macroeconomic disturbance of the magnitude of the increase in interest rates these highly indebted countries faced would, on its own, have been expected to have precipitated a crisis, even if the “microeconomics” had been working perfectly: a crisis which, in turn, would have led to a precipitous fall in GDP growth. Secondly, and relatedly, microeconomic weaknesses typically do not generate crises, but simply low levels of income. Of course, one might argue that the borrowing was caused by budget deficits brought about by inefficient government enterprises; on the other hand, most observers seem to believe that it was macroeconomic forces (the recycling of the petrodollars) which were largely responsible for the growing foreign indebtedness. Consider the following thought experiment: what would have happened if the enterprises had been fully efficient, but observing high (expected) returns to their investment activities –high at least relative to the interest rate being charged– had borrowed to finance investment, so that the gap between domestic savings and investment was identical to that observed? The countries would almost surely have entered into a crisis when the United States raised interest rates to unprecedented levels. In short, there would have been a crisis, whether the foreign indebtedness arose from low savings or high investment, whether the State-owned enterprises were fully efficient or not. In that sense, the inefficiency of the State enterprises, by itself, could not have been blamed.[18]

There is a counter thought experiment which goes something like this: assume the United States had not raised interest rates. Would the excessive borrowing of the inefficient State enterprises eventually have brought the system into collapse, even if the United States had not raised interest rates? If that were the case, one might claim that the interest rate increase only affected the timing of the crisis, not its occurrence. But if one believes that interpretation, one has to believe that the governments would not have seen “the writing on the wall”. The problems of the countries would, on this interpretation, have mounted slowly, so that the government would have been able to take action before the crisis came to a head.[19]

Part of the reason that it is so difficult to interpret the 1980s is that it is difficult to interpret the 1970s. That decade saw relatively strong growth, partly supported by huge capital flows which some would claim were not sustainable; but in any case, after the soaring United States interest rates, were not sustained. But that decade was also one which saw too massive oil price shocks which brought growth to a halt around much of the rest of the world. Thus, while Latin America’s total factor productivity (as conventionally measured) appears weak in that decade,[20] it was a decade which saw marked declines in total factor productivity growth around the world—even without corruption and the inefficiencies associated with State enterprises.[21]

[18] To be sure, there are scenarios in which Latin America might have been spared: if, somehow, institutions had developed (as they did in East Asia) to encourage private saving, so that there would have been little need for foreign investment. But these are not the “counterfactual” scenarios on which most policy discussion focuses.

[19] There are, of course, theories of political processes which claim that large changes often can only be brought about through crises.

[20] Not only was there convergence between Latin America and the United States in the 1970s, it appears that there was even convergence in terms of efficiency (total factor productivity). Though such measurements are notoriously sensitive to a host of measurement and methodology problems, one of the most respected studies for the United States showed total factor productivity in the 1970s declining (at an average annual rate of 0.25%) while another study showed significant increases in total factor productivity (at an average annual rate of 0.75%). For the United States see Dougherty and Jorgenson (1997) and for Latin America see De Gregorio and Lee (1999).

[21] In the United States, for instance, while labour productivity had increased at around 2.9% during the 1950s and 1960s, beginning in 1973 productivity increased at a rate of around 1.1%, with much of that decline associated with a decrease in the pace of total factor productivity. See Baily, Stiglitz and Tyson (1995).

2. Interpreting the slowdown of the late 1990s

The growth of the early part of the 1990s was not sustained. Critics might rightly say it was not sustainable. The early part of the decade was marked by huge capital inflows. The countries were, in a sense, living beyond their means. This might have been of little consequence if the capital inflows had gone to long-term greenfield investments that increased the productive capacity of the economy, with returns greater than the interest rates which the countries had to pay, and if so much of the capital flows had *not* been short-term.[22]

Indeed, at one point, the IMF, paying little heed to the risks posed by short-term capital flows, seemed to think that so long as foreign borrowing was not generated by public fiscal profligacy (government expenditures exceeding government revenues), current-account deficits would be sustainable. Even if the borrowing was to finance household consumption, lenders would not have made the loans unless households had the capacity to repay. International lending served an important function in helping smooth consumption over time.[23] In fact, however, capital flows are enormously volatile—capital markets are subject to excesses of irrational optimism and pessimism. And typically, for developing countries, large current-account deficits, whatever their source, are not sustainable, and the adjustments required to eliminate them involve large changes in exchange rates and/or large reductions in income (which will reduce imports). In many Latin American countries, there have been both.[24] When there have been large flows of short-term capital, changes in sentiment can be reflected quickly in a refusal to roll over loans or a withdrawal of portfolio capital. (With full capital market liberalization, even if there are not large amounts of short-term capital flows, there can be capital flight by domestic investors.)

But the influx of capital did not lead to a surge in real investment. In some accountings, much of the influx simply financed an increase in consumption.[25] Part of the flow of capital was the result of privatization, the selling off of the nation's assets to foreigners.[26]

3. How inappropriate accounting gave a false sense of success in the early days of reform

Accounting conventions contributed to a false sense of success. Countries should have been focusing on *net national income*, focusing on the potential future well-being of the citizens of the country, taking into account the depreciation of the country's physical resources and the depletion of its natural resources, the degradation of the environment, sales of a country's assets abroad, and an increased sense of economic insecurity and vulnerability.

There are several steps in going from GDP to net national income, and by focusing on the difference between the two measures, we can understand better why GDP provided a false sense of success in the early days of reform.

There are, first, a set of distinctions between *gross* domestic product and *net* domestic product. Any firm recognizes that it must take account of the depreciation of its capital. But if a country sells off its hardwood forests, it may treat the receipts as "income", but the wealth of the country is reduced.[27] Correct accounting frameworks would have differentiated between the sale of an asset, and true income. Net national or domestic product would, accordingly, have *deducted* the loss in the value of the forest.

By the same token, gross and net domestic product focus on the goods that are produced in the country,

[22] For a discussion of Latin America's macroeconomic instability from this perspective, see Ricardo Ffrench-Davis (2003a, b); for a discussion of Argentina see, for example, Damill and Frenkel (2003).

[23] For an articulation of this view see, for example, Prasad and others (2003).

[24] Recent work in macroeconomics, emphasizing the role of balance-sheet and cash-flow variables, has explained why large declines in exchange rates may, in the short run, be associated with a weakening of the macroeconomy. See, for example, Greenwald (1998), Greenwald and Stiglitz (1993) and Furman and Stiglitz (1998a).

[25] For instance, between 1990 and 1996, while investment increased by $166.4 billion, savings only increased by $132.4; if the savings rate had remained constant at the level of 1990 (as percentage of GDP), savings would have increased by almost the same amount that investment would have (the difference would have been only $0.3 billion), implying that Latin America would not have had to have borrow in that period. One can view almost all of $34 billion of the capital flows having accordingly gone into increased consumption.

[26] This did not enhance the productive capacity of the economy, except to the extent that foreign management improved the efficiency with which the assets were used.

[27] By the same token, the failure to take account of the depreciation of public capital goods can be very misleading. A country that cuts back its expenditures to maintain public assets may show a lower deficit, and short-sighted financial investors might accordingly think that the economy's future prospects are stronger; but the losses from the deterioration of the public infrastructure may more than offset –unrecognized in these accounting frameworks– may more than offset the seeming benefits of the deficit reduction.

not the welfare of the citizens of a country. It is a useful measure of the level of economic activity within a country, but it is not a good measure of the level of well-being of those within the country. What matters to citizens in a country is net national income. If a country is selling its assets abroad, and enjoying a consumption binge as a result, the citizens are becoming poorer. Their future prospects are worse. Thus, in the privatizations, the sale of State enterprises to foreigners should be treated as a diminution of the wealth of the citizens, to be subtracted from net national income; if the inflow of funds generated by the privatizations go to create new greenfield investments, the loss on one account is offset by the gain on the other; but if this does not happen –and to at least some extent it did not– the country is poorer. Hence, proper accounting would have shown a less rosy picture in the first part of the decade.

Beyond the privatizations to foreigners, much of the capital inflow was short-term, the kind of money that can come in and out overnight—not the kind of money with which one could build factories and create jobs. Proper accounting would have taken account of these liabilities, offset by the investment which they might have miraculously generated. Again, with an increase in liabilities unmatched by a corresponding increase in *productive* assets, the country is poorer. Good accounting would have shown this.

Of course, even if the short-term capital inflows did not contribute to an increase in *wealth*, they had a positive short-term effect on aggregate demand (which, depending on the circumstances of the country, may have been dampened by tight monetary and fiscal policies). To the extent that there were underutilized resources, the increase in aggregate demand fuelled growth. With output increasing faster than inputs, it *appeared* as if "reform" had let loose a new era of productivity increases; but to a large extent, the observed productivity increases were simply the normal productivity increases that are observed as an economy recovers from a recession—and Latin America in the early 1990s was recovering from a decade-long slowdown.

Good accounting would even have gone further. It would have noted that short-term capital is highly volatile; when, given the vicissitudes of the market, it decides to withdraw or demand a higher interest rate, the country may be thrown into a crisis, and be forced to borrow from the IMF, or to cut back expenditures in ways which lower future income. A good accounting system would have required reserves to be set aside –a subtraction from the measure of net national income– to reflect these future expected costs. If an insurance company undertakes a risky action –like selling insurance– it must set aside money, a reserve, to reflect the expected cost of that action.[28]

Short-term capital presented another problem: the interest rate which was due was variable. The interest rates which the lenders might demand could increase dramatically—even if the countries did nothing wrong. This, as we have argued, was the primary reason for the crisis in the early 1980s: the Fed had suddenly increased enormously United States interest rates. What had been sustainable levels of debt suddenly became unsustainable. In the late 1990s, there was both an increase in market perceptions concerning emerging market debt (brought on, in part, by the global financial crisis) and an increase in market "risk aversion". As a result, the risk premium that investors required increased enormously, more than offsetting the slightly lower interest rates in the United States and Europe. Again, debt levels that might have been sustainable suddenly became unsustainable.[29]

Thus, the accounting framework –the focus on GDP– failed to provide an accurate picture of what was going on. While the cited numbers, gross domestic product, suggested that the Latin American economies' performance in the early 1990s was truly impressive, a better accounting framework would have provided a far more sombre picture.

4. If only the global financial crisis had not occurred

Defenders of the reform say, *if only the global financial crisis had not occurred, growth would have been sustained.* But that misses the point, in two respects. To a large extent, the global financial crisis was itself a

[28] Ironically, the IMF *thought* that the reforms it had pushed on Latin America had reduced its vulnerability to crisis, and in that sense, the true well-being of the countries was even better than the GDP numbers suggested. In *their* analysis, the major source of vulnerability was loose monetary policy, leading to inflation, and fiscal profligacy. In these dimensions, most of the countries' performance was vastly superior to what it had previously been. But capital market liberalization had introduced an even more important source of vulnerability. For a discussion of the sources of vulnerability, see Furman and Stiglitz (1998a) and Easterly and others (2001) and the references cited there.

[29] Damill and Frenkel (2003) estimate that most of the increase in Argentina's debt in the period prior to the final crisis of 2001 can be attributed to these increased interest rates.

product of the global reform movement, including capital market liberalization. What changed in East Asia, the region of the world which had, for three decades, not only had the most rapid growth, but also the most stability, with two of the crisis countries having had only a single year of downturn and two having had not even one year of downturn, a better performance than any of the OECD countries? The single factor, I would argue, was not the growth of corruption and lack of transparency, as the IMF might have one believe. On the contrary, in at least several of the affected countries corruption was being curtailed and transparency was increasing.[30] Rather, the problem was premature and excessively rapid financial and capital market liberalization, the failure to put into place adequate regulatory frameworks.[31] Rather than asking what the right regulatory framework was, there was a single-minded focus on deregulation, with disastrous consequences.

The reforms in Latin America had gone a long way in addressing some of the problems of the past. Budget deficits had been tamed, if not eliminated, and remarkable progress had been made in bringing down inflation. The advocates of reform looked at the data of the early 1990s as confirming the wisdom of these reforms. In retrospect, we see how misleading these conclusions were. Some of that seeming success was the expansion of aggregate demand, brought on by the fact that the debt overhang had finally been addressed, by the surge of capital inflows, and by an increase in exports, the result of the strong American economy—what came to be called the roaring nineties. This increase in aggregate demand put to use resources that had so long remained idle. It was more a conventional demand-side expansion than the supply-side growth that the reformers emphasized. There were some important supply-side elements, but even these were markedly different from those stressed by the reform advocates: some of that seeming success was the natural consequence of the catch-up from the lost decade of the 1980s. Some was the result of the unsustained, if not unsustainable, surge of capital from abroad.

It was within some of these very "successes" that the seed of the troubles of the latter part of the 1990s and the early years of the new millennium lay.[32] The reforms had exposed the countries of Latin America to new sources of risk. The accounting frameworks had not only failed to take account of those risks, they had, in so many other ways, provided exaggerated measures of success.

IV

Explaining the failures

In this section, I want to take a closer look at the failures. In the preceding section, I argued that *macroeconomic events* originating outside the region had much to do with its volatility, in particular the high interest rates in the early 1980s and the changing sentiment of short-term capital in the mid-1990s. Here, I want to show how the reforms of the Washington Consensus, however well-meaning they may have been, made the countries of the region more vulnerable to these outside shocks, and contributed in other ways to the failures of recent years. I focus on three critical failures of reform:

— The reforms, including various forms of liberalization, increased countries' exposure to risk, without increasing their capacity to cope with these risks.
— The macroeconomic reforms were unbalanced, putting too much weight on fighting inflation, not enough weight on fighting unemployment and promoting growth.
— The reforms pushed privatization and the strengthening of the private sector, and put too little weight on improving the public sector; they got the balance between the State and the market wrong.

[30] See, for example, Furman and Stiglitz (1998a).

[31] See, for example, Rodrik and Velasco (1999). More recent IMF studies have confirmed that in many developing countries capital market liberalization is associated with more volatility, but not necessarily more growth. See, for example, Prasad and others (2003).

[32] In Stiglitz (2003), I suggest that the economic downturn that began in the United States in March 2001 too can largely be explained as a consequence of policy failures in the 1990s.

1. Increased exposure to risk

The Washington Consensus reforms –trade, capital market and financial sector liberalization– all exposed countries to increased risk. Chile's experience with financial sector deregulation, as well as America's own experience in the early 1980s, should have provided ample warning of the risks.[33] But, seemingly almost unmindful of these risks, the liberalization agenda was pushed forward.

When I was in the White House in 1995, I watched closely as the value of the dollar fell with respect to the yen, from around 106 to 80. This 25% decline did not reflect a sudden worsening of America's economic prospects, or a sudden improvement in those of Japan, just as the equally marked subsequent strengthening of the dollar from 80 yen to the dollar to over 130 did not reflect a corresponding change in the two countries' economic prospects. As even that most ardent advocate of American capitalism, Alan Greenspan, has said, markets exhibit excessive and irrational exuberance, and as he could have said, they also exhibit at times excessive and irrational pessimism.[34] Strong economies like the United States can withstand these vicissitudes, but such volatility puts enormous strains on small, open, poor economies. Yet, the so-called reforms have exposed these countries to these vicissitudes of the market in an unprecedented way, both through trade and through capital flows—and before they have strengthened their safety nets.

2. Capital market liberalization

It was capital market liberalization which turned out to have the most adverse effects.[35] Simple models of the economy argued that developing countries were just like developed countries, except that they had few resources, and in particular less capital. This perspective on development led countries to the view that if only they could get more capital, they would grow more rapidly. If they could not generate savings at home (in the way that the East Asian countries were able to do so successfully—with the strong intervention of the government) then they should turn to foreigners. The argument was simple: so long as the return exceeded the interest rate paid, then the investment was good for the economy: the loan could easily be repaid, with the left-over profits enriching the country. And it didn't make much difference whether that capital was short-term or long.

The scarcity of capital meant that the return to capital should be higher in developing countries than in developed countries, and by liberalizing capital markets, there would be a steady flow of capital from the more developed to the less developed countries. Both would benefit: those in the developed countries by the higher returns to capital, those in the less developed countries by the increased influx of capital, which would lead to higher wages and productivity. Advocates of capital market liberalization even argued that it should lead to greater stability; in periods of downturn, the developing countries could borrow from abroad to strengthen their economies.

These arguments by the advocates of capital market liberalization were striking in the naivety of the underlying theory –which virtually ignored the growing literature emphasizing the consequences of information imperfections– and the degree to which they were out of touch with the realities of capital markets. Short-term capital flows are highly volatile—rather than dampening economic volatility, as their proponents claimed they would, they have been a great source of volatility, and even when not the source of the problem they have enhanced the magnitude of fluctuations. These capital flows are, in particular, highly procyclical. Capital flows into a country when things are going well, and flows out when things go badly. Bankers are fair-weather friends. They are willing to lend when countries do not need the money. And countries have foolishly been enticed to borrow. But when the going gets tough, the banks demand their money back.

Latin America had of course seen all this, with a vengeance, two decades earlier, when as it went into a recession, lenders not only refused to extend credit, they asked for their money back. And while multilateral creditors were supposed to help the countries out at these times of need, too often they simply exacerbated the problems. Typically in these times of crisis, when countries are in desperate need, all that is at issue is how much money they will send back to the United States and the other advanced industrial countries. The net flow is out of the country, not into the country. The

[33] There is, by now, a large literature analysing the risks of financial sector deregulation and the design of appropriate regulatory regimes. See, for instance, Honohan and Stiglitz (2001), Stiglitz (2001a) and Helmann, Murdoch and Stiglitz (2000).

[34] Greenspan was, of course, just making note of an important line of research by economists such as Robert Shiller (2000), whose work provides a convincing refutation of the efficient markets hypothesis.

[35] The risks associated with capital market liberalization are described more fully in Stiglitz (2000a and 2002a).

discussions between the IMF and Argentina were not about how much additional lending would be extended, but how much of what Argentina owed would have to be repaid within the next year.

The volatility and procyclicality of these funds has had further consequences. The borrowers do not take fully into account the *externalities*, especially those associated with such borrowing when things go badly, as they did in East Asia and elsewhere. It is not only the borrowers that bear the costs, especially under the responses to the crises designed by the IMF. High interest rates force even those who have borrowed moderately into bankruptcy; fiscal and monetary contraction force millions of workers into unemployment. To be sure, indirectly, the IMF recognizes the presence of a market failure—it talks about contagion. But remarkably, it has not responded the way economists normally do to the identification of externalities. We typically ask, is there an intervention in the market that can correct the externality, e.g., a tax on the externality generating activity? If short-term borrowing generates a risk of an externality, then short-term borrowing should be taxed. One does not deal with contagious diseases simply by building better hospitals for those who have the misfortunate to get the disease; one looks at how the disease is spread, one subsidizes vaccines, one even imposes regulations requiring vaccinations and prohibiting certain types of risky activities. And yet the Fund, in the policies that were so widely adopted within Latin America, actively promoting capital market liberalization, seemingly encouraged the very forces which were giving rise to the problem.

The willingness to borrow with short-term financing was particularly misguided. One can't build factories with money that can go in or out of a country overnight. And prudence today requires that countries maintain reserves equal to their short-term foreign-denominated debt. This means that if a country borrows 100 million dollars, it must set aside that amount in reserves—100 million dollars of public money that could have been used to build schools or highways. It gets a return on the reserves, but the country as a whole is worse off, for the reserves are typically held in the form of dollar Treasury bills, earning say today less than 2%, while it may pay the American bank 18% or more. The net cost to the country is $16 million, a net transfer from the poor developing country to the United States. It may be good for growth in the United States, but it is hard to see how it is good for growth in the poor developing countries. The story that I have just told shows that the full costs of borrowing are not borne by the borrower—there is, again, a market failure.

Of course, when the capital is flowing into the country, it is easy to see the benefits: they were evident in Latin America at the beginning of the 1990s. But the gains which countries get clearly do not compensate them for the losses which they experience in the event of a crisis, crises which happen with such frequency and regularity, and whose toll has been particularly high in Latin America. And the costs of bankruptcy have, over time, become larger, not only because of the increased number of creditors, making an orderly resolution more difficult, but also because the mix of domestic and foreign creditors, including domestic financial institutions, and the mix of dollar and domestically denominated debt, not only raises hard-to-resolve issues of equitable treatment, but also means that crises adversely affect the viability of domestic financial institutions, further undermining the economy.

3. Macro stability

The economies of the region have experienced enormously macro instability. As already noted, the IMF and the neo-liberals had a particular interpretation of those events, one which saw government profligacy and intervention in markets and loose monetary policy as the primary cause of macroeconomic disturbances. Such an interpretation of macroeconomic instability ignored two hundred years of the history of capitalism: well before government assumed the roles that it does today, market economies were plagued by volatility, by booms and busts. At least in the more advanced industrialized countries, the record is clear: government intervention has helped stabilize the economy. More recently, the East Asia crises showed that there could be other sources of disturbances. Prior to the crises, these countries had low inflation and budget surpluses; if there was a failure of government, it was that they had not regulated the financial sector enough, that they had done too little to tame the surges of capital flows that capital market liberalization had unleashed, and done too little to limit the scope for destabilizing speculation.

There is, in this, a remarkable resemblance between the crises in Latin America and those in East Asia: the macro instability was brought on largely by problems associated with foreign borrowing and capital market liberalization. The Latin American countries were once again forced to bear the brunt of interest rate increases that were initiated by forces elsewhere in the world, and to face the consequences of the instability of capital flows.

While the reforms (including the trade reforms, to be discussed below) thus confronted them with new sources of enormous risk, they also affected the way the economy responded to these shocks. The reforms have replaced automatic stabilizers with automatic destabilizers. For Latin America as a whole, fiscal policy, rather than being countercyclical, has been procyclical. It is not because the economists in Latin America have failed to read the macroeconomic textbooks of the last 70 years, in which the importance of countercyclical fiscal policy has been stressed. Rather, it is partly because the IMF, on which so many of the Latin American countries have become dependent for advice and money, has encouraged and in some cases insisted on these procyclical policies. With thin domestic capital markets, with procyclical private capital flows, with strong memories of the rampant inflation of the past, with the IMF insisting on budget cutbacks, with the multilateral institutions, and especially the IMF, often engaging in procyclical lending, countries have *seemingly* had no choice but to engage in procyclical fiscal policy. But, as I shall suggest later this article, there *is* an alternative.

While the automatic fiscal stabilizers associated with fiscal policy have been replaced by an automatic destabilizer, monetary policy too has become a source of instability, and this is likely only to get worse in the future. Countries have been encouraged to rely more extensively on capital adequacy requirements and not to give in to forbearance which, it is contended, only postpones the day of reckoning, making matters worse when the problems finally surface. But in East Asia, we saw dramatically the consequences of this policy stance: as an economy goes into a downturn, defaults rise, banks' balance sheets worsen, and they are forced quickly as a result to contract lending. (The alternative, a fresh injection of capital, is typically not feasible in the midst of an economic downturn.)[36] But as they contract their lending, more firms are forced into default, or at least obliged to contract investment and production, and thus the downturn is exacerbated. In some cases, even banks' balance sheets, in the end, do not improve, or improve much; they may even worsen.[37]

[36] Or the cost to current owners –in terms of the dilution of their ownership claims– is sufficiently great that they find this course unattractive.

[37] This is another example of what is taught in the first weeks of elementary economics courses, the "fallacy of composition". What would make sense if there is a single bank facing a problem does not make sense when the problem is systemic.

While the reforms thus both exposed the countries of the region to more shocks, and worsened its capacity for automatically coping with those shocks, the policy stances advocated by the Washington Consensus made matters still worse: an almost-single minded focus on the problems of the past, on budget deficits and inflation, meant that as countries saw tax revenues decline as their incomes declined or as they saw expenditures increase as the interest rates they faced rose, they were encouraged to cut expenditures and raise taxes, and these procyclical discretionary fiscal policies exacerbated the downturns still further in country after country.

In some cases, countries' hands were tied, as they faced difficulties raising funds. But even countries which had access to funds –a country like Chile which had created a stabilization fund, or resource-rich countries like Ecuador or Bolivia that could borrow against future sales– were discouraged from engaging in countercyclical fiscal policies. In some cases, the misleading accounting frameworks used by the IMF and other financial analysts contributed to the problems.

We are increasingly becoming aware of the limitations of our accounting frameworks, both in the public and the private sphere. Bad information leads to bad decisions. The bad accounting frameworks employed by American companies contributed to the overinflated prices, which in turn contributed to the excess investment in areas like telecommunications. The deficiencies in the public accounting frameworks are even more notorious, the conflation, for instance, of capital expenditures and current expenditures, the failure to take account of the depletion of natural resources or the worsening of the environment, as we noted in our earlier discussion. But good macroeconomists should understand the limitations of the accounting frameworks. If, for instance, the social security system is privatized, and funds that formerly flowed into government accounts suddenly start flowing into private investment accounts, the increased government deficit does not necessarily lead to increased macroeconomic imbalances, and may not even present problems for the government financing those deficits.[38]

[38] Whether it does or not depends in part on the rationality of the market; if it took the unfunded liabilities as true government commitments, a reform that led to an increased fraction of those liabilities being funded should improve the market's view of the government's financial position. Note that if the government borrows the money from the private funds, then in terms of the flow of funds, the situation is identical to that prior to the privatization.

The misleading accounting frameworks not only contributed to excessive austerity, excessively contractionary fiscal policy in an economic downturn, they also contributed to an underinvestment in infrastructure (the expenditures added to the deficits, while the benefits were simply not recognized) and increased economic instability. Countries would be encouraged to borrow in dollars, because the dollar interest rate was lower than the interest rate in local currency.[39] The budget *looked* better. But of course, to the extent that markets work well, the difference between the dollar interest rate and the interest rate in local currency reflects expectations about changes in exchange rates. But governments (and the private sector, both lenders and borrowers) systematically underestimated the risk of exchange-rate fluctuations, and the consequences. In country after country, what began as moderate levels of foreign indebtedness wound up being unbearable levels as a result of depreciations.

4. Trade liberalization

While capital market liberalization and the procyclical macro policies were central to the region's economic travails, trade liberalization also played a role. Markets were opened up, with jobs destroyed, in the naïve belief that Say's Law still held: supply creates its own demand.[40]

When, not surprisingly, this did not happen, the countries were blamed again: it was excessive labour market rigidity. Wages should fall even more, impoverishing the poor even more. At low enough wages, firms would find it profitable to hire workers. This ignored both theory and evidence: one of the major advances in economic theory of the last thirty years has been the efficiency wage theory, which argues that lower wages may lower productivity, so much so that the demand for labour increases little, and possibly even decreases. Empirical work in the United States has shown that the minimum wage has had little if any adverse effect on employment (Card and Krueger, 1995). In most of the countries in the region, the informal sector, in which conventional rigidities play no role, is huge. If IMF economics were correct, then this sector by itself would be able to absorb all the labour; the rigid wage sector would shrink; there would be wage differentials and some inefficiency due to the wage differentials, but the economy would still be at full employment. The evidence is overwhelming against this hypothesis. In fact, in Argentina, as the informal sector grew to embrace perhaps 50% of the economy, unemployment continued to grow: it has been at double-digit levels since 1995.

It is not wage rigidities[41] so much as IMF policies that are to blame: for those policies have often undermined the ability of the economy to create new jobs by, among other things, forcing high interest rates. As a result, trade liberalization has resulted in workers moving not from low-productivity jobs to high-productivity jobs, but from low-productivity jobs to unemployment.

Matters have been made even worse, of course, as a result of the unfair international trade regime. How could the poor farmers in Chiapas compete with the heavily subsidized corn from the United States? As corn prices fell with trade liberalization, so too did the incomes of the poor farmers in Mexico who depended on sales of corn. Mexico's industrial workers in the north were better off, as the demand for exports to North America increased, but those at the bottom of the income distribution were among those who paid the price.

5. A balanced role for the State

There was almost a single thrust to the Washington Consensus policies: reducing the role of the State. Even macro stability focused not on a more active role for government in stabilizing the economy, but restricting its role by cutting back on expenditures. The focus on value-added tax (VAT) –without exceptions for food, or even medicine– as a source of tax revenue too limited the role of the government in redistribution.

Private markets did not play the stabilizing role that the market fundamentalists claimed they would. Why should we be surprised: market forces have never by themselves automatically ensured economic stability. The only surprise is how unexpected these outcomes seem to have been to the advocates of the Washington Consensus.

But even the advocates of private markets never believed that they could solve all problems. They did not, for instance, ensure an equitable distribution of

[39] In some countries, the IMF actively encouraged countries to borrow in dollars.

[40] Other reforms also may have contributed to instability: replacing quotas with tariffs, whatever its virtues in transparency, can expose a country to greater volatility. See Dasgupta and Stiglitz (1988).

[41] In fact, the work of Easterly, Islam and Stiglitz (2000) shows that greater wage flexibility is not associated with greater economic stability.

income. One of the central problems of the Washington Consensus policies was their narrowness of view: they focused on economic efficiency, hoping that, somehow, other societal concerns would be addressed in some other context. They failed in their narrow economic objectives. But even as they failed in their narrowly defined mission, they exacerbated broader societal problems. Even if the Washington Consensus policies had been successful in promoting growth and stability, there might have been demands for reforming the reforms. But the combined failures make the task of reforming reform an absolute imperative.

V

The principles of reform

In this section, I want to formulate some general principles that should lie behind any reform agenda—any agenda for reforming reform.

1. Objectives

The *objectives* of reform should be clear—and they should go well beyond simply increasing some measure of GDP. There is now an increasing recognition that the Washington Consensus was too narrow in its objectives—or more accurately, misguided in its priorities. The focus should have been on democratic, equitable and sustainable development.

2. Ends versus means

One should never confuse means with ends. All too often, the Washington Consensus treated privatization, liberalization and stabilization as ends in themselves, rather than means to achieve broader objectives. They are supposed to achieve higher incomes, faster growth. Capital market liberalization clearly has not done that: it has instead only brought more instability. Financial sector liberalization too has often brought instability —followed by costly government bail-outs. Privatization of monopolies, without regulation, can bring higher prices, as the private owners are better able to exploit market power. The region is marked by failed privatizations and privatizations that have failed to live up to their promises—of banks, roads, water, telecom, social security. Perhaps if the privatizations had been done differently, more carefully, outcomes would have been better.[42] But that is part of the point: these reforms were taken almost as ends in themselves. At times, there seemed to be the belief that it didn't matter how the reforms were done: all that mattered was that they be done.

The focus on inflation reflects both a narrowness of vision –there is more to macro stability, as we have seen, than just bringing down the rate of inflation– and a confusion of ends with means. The reason we *should* be concerned with inflation is that it can impede economic growth,[43] and there is some evidence that very high rates of inflation do that.[44] But the actions taken to limit inflation may themselves have adverse effects on growth, in which case we have to balance off the two.[45] We have seen how, in practice, the

[42] The issue of privatization and liberalization is discussed at somewhat greater length below.

[43] There is also a concern that inflation has adverse effects on the poor; but the adverse effects of unemployment are even greater. Many of the empirical studies suggesting that "inflation is the cruellest tax on the poor" confound the effects of inflation itself with the underlying disturbance which gives rise to it; the oil price shock of the 70s, for instance, both gave rise to inflation and had adverse impacts on the poor.

[44] The evidence has to be interpreted with caution, because typically when there are very high rates of inflation, there are some underlying disturbances which give rise to the macro imbalance, and a failure of government to deal with those problems. Hence there is often an identification problem: is the low growth the result of the high inflation, or the factors which give rise to it?

[45] There are, to be sure, models which suggest that there is no trade-off, that there is a vertical augmented Phillips curve, but there are also those who claim that there is no Phillips curve at all. In any case, the recent experience, in the United States and elsewhere, is consistent with the hypothesis of a non-vertical Phillips curve in the short run—even if eventually the economy will pay the price for the very low levels of unemployment. In any case, I would argue that the evidence for a vertical Phillips curve is sufficiently weak that countries should not base policies on the assumption that it is vertical, in a relevant time span. More generally, if there is a non-accelerating inflation rate of unemployment (NAIRU), but there is uncertainty about its level, the policy conclusions are much the same.

excessive focus on inflation has stifled growth.[46] Indeed, Akerlof, Dickens and Perry (1996) have argued that the optimal level of inflation is strictly greater than zero—and in Japan and elsewhere we have seen the adverse effects of deflation.[47] Those with a single-minded focus on inflation have argued that once inflation starts, it cannot be stopped, and that the costs of reversing inflation are large, but both of these contentions do not withstand empirical scrutiny.[48]

But the excessive focus on fiscal austerity that follows from an excessive focus on inflation has further consequences. It means that resources are not being fully utilized, and the waste of resources has not only a welfare cost today, but also in the future. Investments, both in physical and human capital, that could have been made are not undertaken.

IMF has argued that countries have to feel the pain, and by doing so, presumably, growth will be more robust in the future. But pain is not a virtue in its own right. Some forms of pain actually can impede not only growth today but growth in the future. Macroeconomic studies broadly support a near-unit-root hypothesis, so that policies which lead to lower income today lead to lower income tomorrow, and well into the future.

Let me be clear: I am not advocating unbridled inflation.[49] What I am claiming is that when a country currently has large underutilized resources, when there is currently deflation, one should not make a fetish in worrying about the fact that some degree of fiscal expansion *might* lead to slightly higher prices.

3. Developmental orientation, with a sensitivity to social consequences of economic policies

Similarly, reform must be based on a broad conception of development, what I called in my first Prebisch lecture, *development as transformation*. Because development is the transformation of society, the social consequences of reform not only cannot be ignored, but must be front and centre.

4. A recognition of the limits of markets and a balanced view of the role of government

It is perhaps obvious that reform must be based on a sound understanding of the economy. But just as the Washington Consensus was criticized for its focus on too narrow objectives, so too can it be criticized for being wrong, or overly simplistic, in its "model" of the economy. It ignored the limitations presented by limited and asymmetric information, incomplete markets and imperfect competition—limitations which are important in any economy but especially in developing ones. The view that markets, by themselves, lead to economic efficiency –or more broadly, that markets by themselves can solve society's basic problems– is sometimes referred to as market fundamentalism.

It should have been recognized that, while markets may be at the centre of a successful economy, government had to play an important role. One of the great problems in Latin America is the persistence of a high level of inequality. Markets, by themselves, will not deal with this problem, and the trickle-down economics of market fundamentalists simply does not work; and even when it works, it works too slowly. Markets, by themselves, do not ensure macro stability; and even if eventually the economy would recover from an adverse shock which leads to high unemployment, markets by themselves work too slowly.

As part of a sound understanding of the economy there must be an understanding of the *role of government*. The view of the role of government in the Washington Consensus was, too often, unbalanced. It saw the government as part of the *problem* of development; it often seemed to argue for a minimalist State. The scandals facing corporate America today have shown the dangers of unregulated markets: they have shown that incentives work, but not necessarily in the interests either of the economy as a whole or even the ordinary shareholder. They are the consequence of the same deregulation mantra that was pushed in Latin America. America should have learned its lesson: excessive deregulation of the financial system under Reagan (combined with the excessively high interest rates referred to earlier) led to the S&L debacle, costing not only the American taxpayer billions, but the American economy even more, through misallocated investment.

Underlying market fundamentalism is the belief in the invisible hand, in the efficiency of unfettered markets. But we now recognize that with imperfect information and incomplete markets –problems which

[46] And indeed, in the case of Russia, may have been one of the factors contributing to the growth of barter, which itself leads to inefficiencies in market allocation every bit as serious as those associated with high inflation.

[47] A point which Fisher (1933) and Greenwald and Stiglitz (1993) have also emphasized. More recently, concerns about deflation have been raised in Europe as well.

[48] See, for example, Council of Economic Advisers (1996 and 1997) and also Stiglitz (1997).

[49] As some IMF critics have claimed.

are particularly relevant in developing countries– the invisible hand may be invisible simply because it is not there (see, in particular, Greenwald and Stiglitz, 1986). Market failures are rife. Even when there are several firms in a market, limited information may give each a certain degree of monopoly power. This is, for instance, often the case in lending markets, especially to small and medium-sized enterprises, and in marketing in agriculture, especially in very underdeveloped countries. This is one of the reasons, for instance, that even in the United States we do not rely on *private* firms for marketing of many agricultural products, from raisins to oranges, but instead resort to *cooperatives*; and it is also one of the reasons that lending cooperatives have traditionally played such an important role. As the international economic institutions have demanded the abandonment of marketing boards in several west African countries, there is, at least in some cases, the worry that farmers have benefited little; money that used to go to help pay for general government services –and in some cases went to corruption– now goes to support local monopolies and mafia and more local corruption.

There are no general theorems that say that liberalization and privatization in the kind of imperfect world in which we live will lead to improvements in overall societal welfare. There are theorems which have shown that trade liberalization in the presence of imperfect risk markets may actually make *everyone* worse off (Newbery and Stiglitz, 1984), and that show that the only conditions under which one can be sure that privatization will be welfare-enhancing are the same highly restrictive conditions under which Adam Smith's invisible hand theorem was valid (Sappington and Stiglitz, 1987).[50] Empirical research is supportive of this sceptical approach.[51] While I believe that it does make sense for government to get out of areas, like steel, for which there is no obvious role for government, in areas like water, electricity, transport and gas, in which government will, in one form or another, have to play a major role, the problems of regulation, and deregulation, that have come to light in California and the United Kingdom, and in a myriad of concessions in Latin America, demonstrate that privatization is no panacea, and may actually make matters worse. And the process of privatization, especially when pushed excessively rapidly, itself is fraught with problems.

Market fundamentalism fares no better at the macroeconomic level than at the micro: and partly because of its failure to appreciate the links between the two. Of course, few market fundamentalists today believe that markets are so self-adjusting that there is no need for government to play a role in macroeconomic policy. But, as I noted earlier, it used to be argued that, especially in developing countries, government was the source of macro instability: with fiscal prudence and sound monetary policy, countries would not face crises. The East Asia crisis laid that particular myth to rest. These countries had been running fiscal surpluses and inflation was low. It was weak financial institutions—caused in part by *underregulation*.

It is not just that the Washington Consensus policies have not succeeded in achieving macro stability: they have, partly for the reasons cited earlier in this paper, actually contributed to macro instability, through policies of capital and financial market liberalization.

The irony is that the countries that have been most successful –both the advanced industrial countries of Europe and North America and the rapidly growing economies of East Asia– have intuitively recognized the need for a balance between markets and the State. The version of market economy that is being foisted on developing countries does not correspond, for instance, to that of the United States. In the United States, the central bank (the Federal Reserve) focuses not only on inflation, but on employment and growth; there is an acceptance of deficits –even large deficits– when there is an economic slowdown.[52] In the United States there is strong opposition to the privatization of social security, and the government is a major provider of electricity, with even mild attempts to privatize being strongly resisted.[53]

[50] See also Simon (1991).

[51] See, for instance, Rodrik and Rodríguez (2001) in the area of trade; in the case of capital flows, Rodrik (1998) shows that capital market liberalization, using IMF measures, does not lead either to increased growth or more investment. The fact is that Korea's State-owned steel mills were far more efficient than America's private ones, that France's State energy sector is more efficient than America's private one, that China's Township and Village Enterprises have been among the most entrepreneurial in the world.

[52] In 1992, the United States deficit was close to 5% of GDP. If the United States had privatized social security (or if social security revenues are excluded), the deficit rises to 8% of GDP. These numbers are far larger than those in Argentina, or most of the other countries in Latin America which have been criticized for budget profligacy.

[53] How, with the dominant role of the United States, one might ask, could the IMF push policies which are so different from those of the United States, especially during an Administration, such as Clinton, seemingly committed to a concern for equality and the poor? The answer is partly that concepts of social justice often

5. No single "best" system or "right" policy

One of the greatest failings of the Washington Consensus policies was the seeming belief that reforms could be left to technocrats. This was presumably based on the premise that there was a single best economic policy—and it was best to leave it to the experts to find that policy. But there is no single Pareto dominant set of policies, a set of policies which makes all individuals better off than any other policy.

The problem is that financial markets,[54] and the IMF which often represents their interests and ideology, often act as if there was a single Pareto dominant set of policies. This is contrary to one of the first lessons we teach in economics, the existence of trade-offs. The role of the economic adviser is to lay out those trade-offs. Economic science, of course, emphasizes the limits of our knowledge, the uncertainties associated not only with the future, but the consequences of alternative actions. Incidence analysis identifies not only who gains and loses from each policy, but also who bears the risks associated with each. The role of the political process is to make the choices, aware of the trade-offs, aware that some gain from some policy, some lose, some policies involve more risks, some less, some policies involve certain groups bearing those risks. There are trade-offs in the short run and the long. When outside advisers try to sell a particular policy as *the* right policy –implying that there are no trade-offs, no risks, no alternatives– governments and the citizens should rightly be suspect.

So too, advocates of capitalism American style have acted as if there is a single dominant form of economic organization, and they felt so especially after the collapse of Communism. Though recent events have taken some of the sheen off of capitalism American style, these crusaders have never really understood either the American economic system and what has made it work, nor that of other countries; they have underappreciated the role that the government has played –for instance, the industrial policies, from agriculture to high tech, from the creation of the telecommunications industry, in 1842, with the laying down of the first telegraph line, to the modern Internet, or the regulatory policies that are so important for the functioning of our securities markets and banking systems– and even underestimated the role of non-governmental not-for-profit institutions, whether credit and agricultural cooperatives or universities, hospitals and foundations.

And they have similarly underestimated the success of alternative versions of capitalism, such as that presented by Sweden. They have misrepresented the reforms of the early 1990s in that country as an abandonment of their traditional welfare model. That is wrong: they have been fine-tuning their system. The level of social protection remains much higher than in the United States, the role of government remains much larger than that in the United States, yet they have been every bit as successful in the New Economy—and they have evidenced greater stability in the current economic downturn. I would argue that their success is, at least in part, due to their strong social protections: an essential part of success is the willingness to take risks, and the strong safety nets provided by Sweden enhance individuals' ability and willingness to do so.

6. Political economy

If, as we have argued, there are alternative economic policies, and if these alternatives affect different groups differently, then it matters a great deal who makes decisions, and how those decisions are made. If there is an unemployment/inflation trade-off, and if workers care more about unemployment, while financial markets care more about the erosion of the value of their nominal assets with inflation, then workers and financial markets will see the trade-off in different lights; entrusting the decision about monetary policy to an independent central bank controlled by financial interests, or mandating that the central bank focus only on inflation, makes it more likely that the outcomes will accord with financial interests, rather than the interests of workers.

One of the major reforms of Latin America has been its democratization. It is increasingly being recognized that electoral democracy –where elections are bought, where the media are controlled by certain special interests, or even when citizens do not have the knowledge required to be informed voters– may itself not be enough. What are those in Venezuela, the two thirds of the population who remain in poverty in an oil-rich country where the fruits of their rich endowment

seem to stop at borders; and partly that the United States is represented by its Treasury Department, which often pushes views that are markedly different from those of others even within the Administration.

[54] I oversimplify in referring to the "financial markets", because there are of course many players in the financial markets, with different interests. Long-term investors, as I have already noted, have markedly different interests than short-term speculators. While speculators make money off of variance, off of instability, long-term investors gain from stability.

have flowed to particular groups, to think about an electoral democracy which, at least before the advent of Chávez, simply perpetuated this state of affairs? Today, throughout the region, those who have been disenfranchised in the past are demanding a voice. The electoral democracies of the past, whatever their merits, have not improved their plight. That is what they know.

There are, of course, many connections between the political regime and economic success:[55] countries facing social and political turmoil do not create an environment which is good for business. The policies of the past have set in motion a vicious circle: failed macro policies which have led to high unemployment have in turn led, or at least contributed, to urban violence and guerrilla wars which, in turn, have discouraged investment and impeded growth. Stabilization –or more precisely, misguided stabilization, with an excessive focus on eliminating inflation through excessively contractionary monetary and fiscal policies– not only does not lead by itself to growth, but fuels this downward spiral. A sense of disenfranchisement, of economic policies dictated by special interests either within their countries or, even worse, within the advanced industrial countries, only worsens the dissatisfaction.

There are other links between economic success and politics. Concentrations of economic wealth can, even in democracies, result in concentrations of political power, limiting the scope for regulation or redistributive taxation or the ability to raise taxes, hindering the capacity of the State to perform its vital functions. At the same time, the extremes of instability have led to the erosion of the middle class, the groups which have been most supportive of the establishment of the rule of law, so necessary for the effective functioning of a market economy.

The Washington Consensus policies paid scant attention to issues of distribution. But politics and economics are intricately intertwined. Even if one cared little about poverty or inequality, the distribution of income, both directly and indirectly through the political processes, is important for the performance of the economy.[56] These concerns must be central to any agenda for reforming reform.

7. Beyond economic principles

I have devoted most of my discussion in this section to issues of *principles of economics*, but I should mention briefly four broader philosophical issues. First, there has been an important shift in notions of equality, with greater emphasis on *equality of opportunity*, rather than equality of outcome. Second, there is a recognition of the importance of *community*, of the need for collective action, of the need to go beyond individualism to a sense of social solidarity. But collective action, community, can be expressed not only through government, at its various levels, but also through civil society and non-governmental organizations, which can be important vehicles not only for action, but for expressing voices. Third, there has been, in recent decades, a broadening of the concept of basic human *rights*—not just the civil rights and liberties, the freedom of speech and press, the right to assemble, the freedom of religion, but economic rights, access to basic health care, the right to earn a living. There may be conflicts among these rights, and between the rights of some and those of others, and there have to be ways by which such conflicts are resolved: this is one of the areas of collective responsibility. And finally, with rights come responsibilities, responsibilities at the individual and communal level. What those responsibilities are, and what the consequences of not living up to those responsibilities should be, pose some of the hardest questions of public policy, going well beyond the limited scope of this article.

[55] This list is not meant to be comprehensive. Recent development literature has emphasized the importance of ownership and participation to development success. See, for example Stiglitz (2001b). Meaningful participation in the electoral process requires, of course, that citizens be informed of what their government is doing, and of what it proposes to do. This implies that transparency of government and the citizens' *right to know*, implemented by effective freedom of information acts, are essential. While Sweden has had such legislation for more than two hundred years, in recent years more and more countries have adopted such reforms.

[56] It is widely recognized, for instance, that part of the success of East Asia was the result of the active pursuit of egalitarian policies. See, for example, Stiglitz (1996) and the references cited there.

VI
Elements of a reform agenda

The principles of the previous section provide guidance in thinking about how to reform reform. I have criticized the Washington Consensus not only for what was on the agenda, but also for what was not, and by looking at what was on and not on the agenda, one gets a better view not only of the role of ideology, but also of interests. In some countries, sharecropping is a prevalent form of agriculture. Under sharecropping, 50% (in some cases even more) of the output is turned over to the landlord. The attenuation of incentives is obvious. Normally, the IMF speaks out forcefully in criticism of high taxes: they reduce incentives. But the adverse effects of sharecropping on the very poor are no less important. Yet never has land reform made it onto the IMF agenda, or at least made it in a way which has any prominence, and for obvious reasons.

To emphasize the fundamental difference between the Washington Consensus approach to development and that which I am advocating here, I want to begin with those parts of the agenda that deal with issues that previously have been given short shrift. Each of the items listed below could be the subject of a paper on its own, and there are many other reforms –e.g. to political institutions– that I do not have time to discuss today. I have criticized the Washington Consensus for being excessively narrow in its focus; the reform agenda below could equally well be criticized for being excessively broad, for lacking focus. Yet, I believe the World Bank has been correct in stressing the need for a comprehensive approach;[57] and while no government can pay equal attention to all the items at the same time, it would be a mistake to ignore any of these dimensions.

1. Social mobilization

The most important element of social mobilization is, perhaps, education. While *increasing expenditures* on education has become part of the mantra of both the left and the right, there has been less attention to issues of the *allocation* of educational expenditures and *content*. The educational disadvantages of the poor begin *before* they enter school, and that is why Project Headstart has played such an important role in educational policy in the United States.

Education is so important because it affects the mindset of the next generation: it affects, for instance, their attitudes towards change and tradition. It enhances their understanding of their rights and responsibilities, the role of the individual and the State. In the nineteenth century, one of the functions of the early development of public education was to provide a disciplined labour force, with just the amount of education required. Today, we want a citizenry that stands up for their rights, and that is prepared for the process of lifelong learning, that has the skills required to function in a modern society (e.g., computing skills) and the mastery of the requisite languages. In many of the poorer countries, for at least the next quarter century, large fractions of the population will remain on the farms, and for these, education needs not only to be a way out but a way up: not just training for urban jobs, but skills which can increase productivity within the rural sector. Knowledge about health and the environment can have an immense effect on the quality of everyday life, and affect the sustainability of the environment and even long-run living standards.

Entrepreneurship will be the key to the future, and entrepreneurship, as well as the other skills and knowledge for success in business, too can be taught.

In some developing countries, *microcredit* schemes have proved to be an important instrument for social mobilization. Much of the discussion of microcredit has emphasized the *economic aspects*, the provision of credit to poor households, especially poor women, who otherwise would not have access. But the original promoters of microcredit believed that more was at stake. They wanted to overturn power structures in local villages by giving more economic power to poor women, who had previously been effectively disenfranchised. And that is why in Bangladesh, one of the main provides of microcredit, the Bangladesh Rural Advancement Committee (BRAC), has supplemented the microcredit programmes with education programmes, including those focusing on female education, with a stress on the environment, health and legal rights.

The *media* can play an important role—but not if the media is controlled by a few wealthy individuals,

[57] See, for example, Wolfensohn (1998) and Stiglitz (1998).

and is heavily concentrated, as is the case in many countries. Government has to pass, and enforce, legislation ensuring media diversification, but it also has to ensure that there are more voices heard over the media, e.g., through the support of community radio stations and radio stations controlled by NGOs.

In recent years, increasing attention has been paid to the environment. But in some circles, it seems that a good environment has been viewed as a luxury of the rich: the poor cannot afford to pay attention to such matters. But I would argue[58] that, at least in many instances, growth, poverty reduction and the protection of the environment are complements: the erosion of the commons or the failure to control population will mean that, in the future, there will both be a worse environment *and* more poverty.

In many parts of the world, communities have traditionally found ways of managing the environment for the common good. The *tragedy of the commons*,[59] which is sometimes portrayed as the failure to establish well defined property rights over common resources is, too often, the result of the intrusion of (imperfect) market forces into traditional cultures. More broadly, recent work at the World Bank[60] has emphasized the importance of culture, enhancing the sense of identity and community, so important for long-run well-being.

The process of development has, almost everywhere, been accompanied by urbanization, and today one of the main challenges facing many developing countries is how to make cities liveable. One aspect of liveable cities is the environment: the creation of urban public transport systems that avoid the air pollution that chokes so many cities, and the establishment of public parks, which can not only provide places where individuals can relax, but can also help create a sense of community.

Another aspect of development associated with urbanization is the weakening of traditional social safety nets that communities and families had previously provided. As I noted earlier, an important dimension of poverty is insecurity, and while I have argued that economic reforms have to be designed to enhance economic stability and reduce risk, in fact, no matter how successful such reforms are, developing countries will be buffeted by shocks. The government needs to help create a social safety net, working with non-governmental organizations which can often provide effective delivery mechanisms. In some countries, there has been concern at the excesses of parts of the social safety net, in particular, pension programmes. Undoubtedly, these will need to be reformed. In many cases, the programmes were badly designed; perverse incentives were put into play, e.g., to give large pay raises shortly before retirement; and these perverse incentives have had perverse effects, with retirement benefits well beyond the levels originally intended. But as the reforms proceed, they must be sensitive to the underlying concerns that gave rise to these programmes.

2. Enhancing equity and fighting poverty

Poverty was given short shrift in the Washington Consensus, perhaps because they believed that the benefits of growth would eventually trickle down. But there is little reason to believe that that is the case. And, for reasons highlighted in earlier sections of this paper, the Washington Consensus policies almost surely made problems of poverty worse.

The first item in an anti-poverty agenda should be the commitment by the government to the creation of jobs, of *decent work*, in the words of the ILO, for everyone: it should be the fundamental right of everyone in society who is willing to work to have a job, and it is the fundamental responsibility of government to ensure that those rights are fulfilled. Any government that fails, fails miserably, as is so often the case, should lose its mandate.

Thus, there needs to be a shift from the single-minded focus on fighting inflation, to promoting growth and job creation. We understand some of the impediments to job creation, including lack of credit and overvalued exchange rates.[61] That is why macroeconomic management is so important: if it leads to overvalued exchange rates and high interest rates, there will not be job creation. But we also have to understand that capital markets are not like ordinary markets, in which efficiency requires a "single price", and which can be well described *as if* there were an auction. In all countries, government has played an important role in providing credit—to students, for home finance, for farmers, for small and medium-sized businesses, for exports. To be sure, these programmes

[58] See also Dasgupta (1995).

[59] See Hardin (1968).

[60] Rao and Walton (2003).

[61] There are others, such as *excessive* job protections that increase the costs of hiring a worker, but for reasons explained earlier, I do not believe that these have been pivotal, in at least many of the countries in the region.

have *sometimes* been abused, but we now know better how to provide protections against these abuses.

Promoting equity and fighting poverty has to begin with education and health programmes for children, but it has to be lifelong. We now know the enervating effects that disease can have, and we have the tools to reduce disease and its consequences. But there is more to health than just health care: we need to promote healthy living styles, including fighting cigarettes and substance abuse, and promoting the consumption of vegetables and a balanced diet.

Success in the fight for equity and against poverty requires economic empowerment as well as political empowerment. In the rural sector, that will entail land reform—meaningful land reform that accompanies land redistribution with the provision of credit and access to technology. Land registration is important, but it has to be seen as only one component of a broader programme. Land registration enhances the use of land as collateral, but it will be effective only where there are well functioning land markets.

In both the rural and the urban sectors, there have to be programmes to promote saving. Recent collapses of banking systems may have eroded confidence in the financial sector. We need to look for ways of providing credible government guarantees for small savers, and an awareness of this issue of confidence should affect strategies for bank restructuring in countries in crisis. One possibility to encourage the use of domestic financial institutions is to have some government matching of savings for small savings accounts (a form of cashable "earned income tax credit" for savings for low-income individuals).

Taxation has to be made more equitable. The VAT is not an equitable tax; and in most developing countries it is a tax that is neither consistent with economic efficiency nor promotes growth, for it is a tax on the formal sector—the sector which should be promoted in the process of development. And since the very wealthy often spend substantial sums of income abroad, it does not even represent a proportional tax on consumption.

Tax policy should be aimed at promoting equity, stability and sustainable growth; and we should be looking for corruption-resistant tax structures. Thus, we should rely more heavily on *indirect taxes*, like those imposed on large cars and luxury consumption goods, consumed largely by the rich (and largely imported). We should tax commodities like oil and coal which are bad for the environment, impose higher taxes on *rents*, such as those associated with natural resources or monopolies or near monopolies, as in the telecom or cement sectors in some Latin American countries. We should impose highly progressive taxes on large houses, on large holdings of land—and think about ways in which we can induce landholders to hire more labour, e.g., give them a tax deduction or credit for the hiring of workers. We should even consider taxing flows of short-term capital into and out of a country—adjusting the tax rate to the economic circumstances (and we should use other measures to stabilize capital flows and reduce exposure, like provisions affecting the tax deductibility of short-term foreign-denominated debt, and bank regulations to discourage short-term foreign-denominated liabilities, which seem to generate such large externalities, as we have noted).

3. Creating an environment that is good for business

I finally come to the part of the agenda that has come to be standard fare: creating a good business environment, one which not only attracts foreign investors, but also provides a hospitable environment for domestic investors.

Our understanding of how the government can do this represents one of the most important shifts in development thinking in recent years. In the decades immediately after World War II, the focus was on the construction of infrastructure. In the decades of the dominance of the Washington Consensus, the focus was on getting the government out of the way, e.g., by minimizing regulations and privatizing infrastructure. We now know that there is an important role for government, a role which goes beyond projects and even beyond policies (such as those promoting macro stability), though both remain important—the market often does not undertake needed infrastructure projects, like rural roads, and as we have noted, privatization of infrastructure has been beset with problems, and the market by itself has not produced macro stability. Today's development mantras focus on the importance of institutions, though even here the discussion is often unbalanced, with more attention to the problems posed by corruption in the public sector than on weaknesses in corporate governance in the private; on the creation of an *independent* central bank focusing on fighting inflation, than either on one which is representative of the concerns of the citizens, with a balanced perspective in fighting inflation and promoting growth and employment, or on the creation of financial institutions which ensure a flow of credit throughout society.

Unfortunately, we can say more about what is needed than we can about how to create what needs to be created.

I have already outlined two of the central ingredients: education and credit. The countries that have fared best in Europe recently, such as Ireland and Portugal, have had strong, well regulated, *local* banking systems and good educational systems. In the development of the United States in the nineteenth and twentieth century, a great deal of emphasis was placed on local banks, because the importance of local information for lending was recognized; there was the legitimate worry that a concentrated banking system, centred in New York, would drain resources away from the rest of the country and impede broad development. It was not until the 1990s that national banking was allowed. Yet internationally, we have insisted that small countries open themselves up to international banks, with little attention paid to whether these banks will provide credit for small and medium-sized firms. Argentina has shown that having international banks does not ensure the stability of the banking system. Some thought that the "mother banks" would come to the rescue of their subsidiaries; certainly many depositors seemed to have been led to that belief. But that has not occurred. To level the playing field and to promote growth, there needs to be imposed something analogous to the Community Reinvestment Act: banks which garner resources in a country must relend the money within that country, and significant portions to small and medium-sized domestic enterprises.

Other actions to promote small businesses, like incubators, should be tried. There have been, around the world, some notable successes.

The hallmark of the earlier period of success in Latin America were *industrial policies.* Such policies have, in the course of the past quarter century, unjustifiably obtained a bad reputation. Earlier, I described the important role that they played in the development of the United States, and I also believe that they were important in the success of East Asia. But policies that worked in one era may be less effective in another, and the global trading regime has imposed limitations on the extent to which governments can make use of some of the standard techniques, even if they would have liked to have done so. I do not want to rehearse the problems with import substitution strategies in Latin America, or the abuses of industrial policy. Like many such policies, it can be an effective instrument for growth, but it can also be abused. We do know now some of the ways in which we can increase the likelihood that such policies will be effective, and by which we can reduce the likelihood of abuse. The Clinton Administration, in which I served, believed strongly that such policies could play an important role in the advancement of the American economy, and there is an even more compelling case for developing countries. The fact that the United States Treasury was more sympathetic to large bail-outs for Wall Street or certain other items of corporate welfare than for forms of market intervention that promote technology, either at home or abroad, says more about the role of interests and the impurity of ideology than it does about the wisdom of certain economic policies. Government has in the past, and can in the future, play a catalytic role: it can not only make markets work better, it can help shape the economy, most importantly through the physical, institutional and educational infrastructure, e.g., ensuring that there is an educated labour force. Part of that catalytic role in *today's* economy is to help promote the recognition of the changes in structure that have been occurring through the world: the reduction in the manufacturing sector, the growth of the service sector, the ability of services to move across borders as well as goods. The countries that have had the most rapid growth in the last decade –and the most employment creation– have been those that have accommodated themselves to, and even supported, these changes.

Obviously, regulations can stifle business; regulations have to be re-examined, recognizing that the objective should not be deregulation, but finding the right regulatory framework, one which makes the market economy work and which minimizes unnecessary regulatory burdens, e.g., by providing one-stop centres. Regulatory uncertainty –and corruption, which is often associated with regulatory discretion– has been shown to be an important impediment to business. There are ways by which corruption can be monitored, and we now have strategies for reducing it. Corruption, of course, as we are learning, can occur in the private sector as well as in the public, and transparency can be at least a partially effective antidote against corruption. Legal frameworks that ensure good corporate governance –a system of checks and balances that protect shareholders against the unbridled greed of management, minority shareholders against major shareholders, bondholders against shareholders, junior bondholders against more senior bondholders– are necessary, but hard to design, and even harder to implement.

Macro stability is critical for maintaining a good business environment—real stability, not what has gone by the name of stability in the last decade. Recessions, depressions, are bad for business, and policies –like capital market liberalization and poorly designed bank regulations, bank regulations that have automatic destabilizers built into them– that lead to instability should be avoided. To be sure, governments must avoid excessive inflation, just as they must avoid deflation. But there is more to stability than that.

Maintaining stability in the face of a highly unstable environment, with huge fluctuations in exchange rates and commodity prices, will not be easy. Countries will need to learn how to manage these risks, including through commodity diversification, the creation of stabilization funds, the use of countercyclical tax and credit (not just monetary) policies, and modulating short-term capital flows.

There are, obviously, many other issues that I have not touched upon: transportation systems, especially in rural areas, may have to be improved if individuals in the rural sector are to have access to markets. In some cases, there are "missing markets" or competition is so limited that small producers and consumers are exploited or entry is impeded. It is important that there be effective competition and regulatory policies: again, failure can come from government playing too small a role, as it can from it being too intrusive. In some instances, government should consider promoting cooperatives, which have played such an important role in many market economies, including those in the United States and Scandinavia.

I have emphasized the important role of government, but government can only play these roles if it is not captured by special interests, if it is relatively free from corruption. There needs to be a rule of law, effectively and fairly enforced. There may be the same concern for efficiency and effectiveness in the public sector that there is in well functioning market economies. These are challenges for all countries, not just developing countries. These are battles that are never over: there are always special interests who would like to use the power of the State to advance their interests, rather than to promote equitable and sustainable growth. The good news is that we have seen countries, in both the developing and developed world, in which there have been great strides forward in creating responsive, effective, transparent and democratically accountable governments.

I have had less to say here about the standard issues, how privatization and liberalization need to be reformed. The failings of the past are by now well documented. Nor have I had much to say about labour market reform—except the words of warning issued earlier against the simplistic mantra calling for labour market flexibility: such flexibility may not lead to increased employment and may lead to increased poverty and instability. I have commented on many of these topics elsewhere;[62] and a fuller exposition of the reform agenda must await another occasion.

VII

Concluding remarks

I have outlined here a new agenda for reform. I hesitated to use that term, given the negative overtones which the word Reform has attained in recent years. But Reform simply means change, and Reform itself has had to be Reformed. I have focused my remarks on what the countries of the region can do, *given the current international regime.* Elsewhere, I have argued that that regime has fundamental problems: there are by now well documented inequities in the global trading regimes, and the global financial regime is not only inequitable, but it is *inherently* unstable. Given that the sum of the deficits in the world have to equal the sum of the surpluses, if some countries, like Japan and China, insist on having surpluses, the others –in total– must have deficits. And if countries with deficits are likely to be plagued with crises, then crises are indeed inevitable. As one country addresses its problem by changing its exchange rate, as it moves from deficit to surplus (as Korea did after its crisis), then some other country will have to move into deficit, or its deficits worsen. This is the simple arithmetic of global finance.[63]

[62] See, for instance, Stiglitz (2002b) or Stiglitz (1999a).

[63] I am currently working on a book with my colleague Bruce Greenwald detailing these weaknesses and setting forth a set of proposed reforms. See also Soros (2002).

The countries of the region have learned –at great pain to themselves– about the instability of global capital markets, as well as their inefficiencies: while standard economic principles would suggest that it is the rich countries of the world which are better able to bear the risks of interest-rate and exchange-rate fluctuations, and therefore they ought, in a well functioning market, to bear these risks, in practice it is the poor countries which are forced to do so.

The countries of the region should take advantage of globalization, but should seek to shape globalization on their own terms. A Free Trade Area of the Americas could be of enormous benefit to the countries of the region, but only if the United States truly opens up its markets, all of its markets, to the goods of the region—which means not only opening up its agricultural and textile markets, but eliminating agricultural subsidies and foregoing the myriad of non-tariff barriers which the United States has employed even against its neighbours Canada and Mexico. And a free trade agreement cannot be used to promote policies, under the rubric of "investment protections", that would be otherwise unacceptable (as may be the case under NAFTA) or an unbalanced intellectual property regime (as was arguably the case under the Uruguay Round). Capital market liberalization has been one of the major sources of instability in the region, and even the IMF has come to recognize that it brings risk without reward. Yet the United States, in its bilateral trade agreements (with Singapore and Chile), has insisted on it.

In this article, I have not only tried to identify the failings of the earlier reform agenda, but also to link the failures with the policies: it is more than just a matter of bad luck or, as the defenders of the Washington Consensus would like to put it, inadequate implementation. At the very least, well designed policies have to be designed to be implemented by mortals, in the volatile environment in which we live. The failures, however, were even more fundamental: they go to what was on the agenda and what was not, what was stressed and what was not. Many of the "reforms" on which attention was focused have contributed to the region's problems. I have spent a considerable amount of time talking about some items that have received less attention than they should.

I have argued here that we need to formulate a set of economic policies that reflects a better balance between markets and government, that recognizes the critical role that both must play if the economy is to function, that recognizes that that role will change over time, depending on the strengths of institutions in both the public and private sector, that recognizes that development strategies must focus on *simultaneously* strengthening both.[64] We need too to shift our focus away from an excessive focus on inflation to focusing on job creation; from restructuring and privatizing existing enterprises to creating new ones. We need to move away from a belief in trickle-down economics (or even from modern renditions, which I have referred to as trickle-down plus, which add to the simplistic Washington Consensus a concern for primary education, especially for girls) to an explicit focus on poverty –in all of its dimensions– and a recognition that one cannot separate out economic policies from their social and political context. As I emphasized in my UNCTAD Prebisch lecture, development is more than a matter just of accumulating capital and improving the efficiency with which resources are allocated, though these are important. Development represents a transformation of society. The Washington Consensus simply ignored these dimensions. Somehow, it believed that if we could let markets work, by themselves, countries would develop. That has not happened, and it has never happened. But by encouraging, forcing, countries to focus on a narrow economic agenda –one which was misguided at that– it took attention away from the broader goals of societal reform, in which land reform, education, political and economics rights, would have featured more prominently.

Today, we recognize the intertwining of economic, social and political processes. There is open discussion of the problems posed by one political regime or another. But there has been insufficient attention to the role that policies –including economic policies– play in shaping the political regime; or the impact that the way reforms have been pushed has had on the political process. In Russia, some pushed the idea of rapid privatization, no matter how done, in the naïve belief (which I referred to as the Political Coase theorem) that once control over property was given out, a rule of law would emerge. That did not happen, and predictably so. It was not Rockefeller that pushed for antitrust laws at the end of the nineteenth century, nor has it been

[64] For instance, the observation that there are problems with the public pension system does *not* imply that we should privatize. We should not compare an idealized private system with an actual public system. In practices, transactions costs even in advanced industrial countries have turned out to be enormous. It may be easier to improve the public system than to create a private system, with the necessarily regulatory apparatus. See, for example Orszag and Stiglitz (2001) and Murthi, Orszag and Orszag (1999).

Gates that has pushed for the effective enforcement of such laws today. Indeed, there have been attempts even to cut off funds for the effective enforcement of antitrust laws, by those who might be affected. It has been, and continues to be, the middle class which has been the most important source of support for the rule of law,[65] and it has been the middle class which has been devastated by some of the Washington Consensus policies.

If development is in fact the transformation of society, we need to think carefully about what that entails, and how that transformation can be most effectively promoted. The neoliberal reform agenda failed even in its more narrow objectives of promoting growth. As we think about what should succeed it, we should not be trapped into the narrow vision that that agenda supported. As we reform the *economic agenda*, we must place that agenda within the broader context in which it must reside.

[65] See Birdsall, Graham, and Pettinato (2000).

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