The Post-Washington Consensus

Development After the Crisis

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Article Summary and Author Biography

The last time a global depression originated in the United States, the impact was devastating not only for the world economy but for world politics as well. The Great Depression set the stage for a shift away from strict monetarism and laissez-faire policies toward Keynesian demand management. More important, for many it delegitimized the capitalist system itself, paving the way for the rise of radical and antiliberal movements around the world.

This time around, there has been no violent rejection of capitalism, even in the developing world. In early 2009, at the height of the global financial panic, China and Russia, two formerly noncapitalist states, made it clear to their domestic and foreign investors that they had no intention of abandoning the capitalist model. No leader of a major developing country has backed away from his or her commitment to free trade or the global capitalist system. Instead, the established Western democracies are the ones that have highlighted the risks of relying too much on market-led globalization and called for greater regulation of global finance.

Why has the reaction in developing countries been so much less extreme after this crisis than it was after the Great Depression? For one, they blame the United States for it. Many in the developing world agreed with Brazilian President Luiz Inácio Lula da Silva when he said, “This is a crisis caused by people, white with blue eyes.” If the global financial crisis put any development model on trial, it was the free-market or neoliberal model, which emphasizes a small state, deregulation, private ownership, and low taxes. Few developing countries consider themselves to have fully adopted that model.

Indeed, for years before the crisis, they had been distancing themselves from it. The financial crises of the late 1990s in East Asia and Latin America discredited many of the ideas associated with the so-called Washington consensus, particularly that of unalloyed reliance on foreign capital. By 2008, most emerging-market countries had reduced their exposure to the foreign financial markets by accumulating large foreign currency reserves and maintaining regulatory control of their banking systems. These policies provided insulation from global economic volatility and were vindicated by the impressive rebounds in the wake of the recent crisis: the emerging markets have posted much better economic growth numbers than their counterparts in the developed world.

The crisis underscored the instability inherent in capitalist systems—even ones as sophisticated as the United States. Thus, the American version of capitalism is, if not in full disrepute, then at least no longer dominant. In the next decade, emerging-market and low-income countries are likely to modify their approach to economic policy further, trading the flexibility and efficiency associated with the free-market model for domestic policies meant to ensure greater resilience in the face of competitive pressures and global economic trauma. They will become less focused on the free flow of capital, more concerned with minimizing social disruption through social safety net programs, and more active in supporting domestic industries. And they will be even less inclined than before to defer to the supposed expertise of the more developed countries, believing -- correctly -- that not only economic but also intellectual power are
becoming increasingly evenly distributed.

THE FOREIGN FINANCE FETISH

One of the central features of the old, pre-crisis economic consensus was the assumption that developing countries could benefit substantially from greater inflows of foreign capital -- what the economist Arvind Subramanian has labeled “the foreign finance fetish.” The idea that the unimpeded flow of capital around the globe, like the free flow of goods and services, makes markets more efficient was more or less taken for granted in policy circles. In the 1990s, the United States and international financial institutions such as the International Monetary Fund (IMF) pushed developing-country borrowers to open up their capital markets to foreign banks and dismantle exchange-rate controls.

Although the benefits of free trade have been well documented, the advantages of full capital mobility are much less clear. The reasons for this have to do with the fundamental differences between the financial sector and the "real" economy. Free capital markets can indeed allocate capital efficiently. But large interconnected financial institutions can also take risks that impose huge negative externalities on the rest of the economy in a way that large manufacturing firms cannot.

One of the paradoxical consequences of the 2008-9 financial crisis may thus be that Americans and Britons will finally learn what the East Asians figured out over a decade ago, namely, that open capital markets combined with unregulated financial sectors is a disaster in the waiting. At the conclusion of the Asian financial crisis, many U.S. policymakers and economists walked back their previous stress on quick liberalization and started promoting “sequencing,” that is, liberalization only after a strong regulatory system with adequate supervision of banks has been put in place. But they devoted little thought to whether certain developing countries were capable of enacting such regulation quickly or what an appropriate regulatory regime would look like. And they overlooked the relevance of their new message to their own case, failing to warn against the danger of the huge, unregulated, and overleveraged shadow financial sector that had emerged in the United States.

The first clear consequence of the crisis has thus been the end of the foreign finance fetish. The countries that pursued it the most enthusiastically, such as Iceland, Ireland, and those in eastern Europe, were the hardest hit and face the toughest recoveries. Just as for Wall Street, the strong growth records these countries amassed from 2002 to 2007 proved to be partly a mirage, reflecting the easy availability of credit and high leverage ratios rather than strong fundamentals.

CARING ABOUT CARING

The second consequence is a new respect among developing countries for the political and social benefits of a sensible social policy. Before the crisis, policymakers tended to downplay social insurance and safety net programs in favor of strategies that emphasized economic efficiency. U.S. President Ronald Reagan and British Prime Minister Margaret Thatcher had come to power in the late 1970s and 1980s attacking the modern welfare state, and many of their critiques were well taken: state bureaucracies had become bloated and inefficient in many countries, and an entitlement mentality had taken hold. The Washington consensus did not necessarily reject the use of social policy, but its focus on efficiency and fiscal discipline often led to cuts in social spending.

What the crisis did, however, was to underscore the instability inherent in capitalist systems -- even ones as developed and sophisticated as the United States. Capitalism is a dynamic process that regularly produces faultless victims who lose their jobs or see their livelihoods threatened. Throughout the crisis and its aftermath, citizens have expected their governments to provide some level of stability in the face of economic uncertainty. This is a lesson that politicians in developing-country democracies are not likely to forget; the consolidation and legitimacy of their fragile democratic systems will depend on their ability to deliver a greater measure of social protection.

Consider how continental Europe has reacted in comparison to the United States. Until now, with the eurozone crisis, western Europe experienced a far less painful recovery, thanks to its more developed system of automatic countercyclical social spending, including for unemployment insurance. In contrast, the jobless recovery in the United States makes the U.S. model even less attractive to policymakers in the developing world, particularly those who are increasingly subject to political pressure to attend to the needs of the middle class.
American-style capitalism has fallen from its pedestal. A good example of the new stress on social policy can be found in China. Reacting to the country's rapidly aging population, its leadership is struggling behind the scenes to build a modern pension system, something that represents a shift from the traditional tactic of concentrating solely on generating new jobs to maintain social and political stability. In Latin America, the same pressures are playing out differently. After experiencing fatigue in the wake of liberalizing reforms in the 1990s that did not seem to produce the growth that was expected, the region has moved to the left in this century, and the new governments have increased social spending to reduce poverty and inequality. Many countries have followed the successful example of Brazil and Mexico and instituted cash transfer schemes targeted to poor households (which require beneficiaries to keep their children in school or meet other conditions). In Brazil and Mexico, the approach has contributed to the first visible declines in income inequality in many years and helped shelter the poorest households from the recent crisis.

The question, of course, is whether programs like these that target the poor (and thus keep fiscal outlays surprisingly low) will have difficulty attracting long-term support from the region's growing middle class, and how these and other emerging economies, including China, will manage the fiscal costs of more universal health, pension, and other social insurance programs. Will they be better at handling the problems associated with these unfunded universal entitlement programs, the kinds of problems now facing Europe and the United States as their populations age?

THE VISIBLE HAND

The third consequence of the crisis has been the rise of a new round of discussions about industrial policy -- a country's strategy to develop specific industrial sectors, traditionally through such support as cheap credit or outright subsidies or through state management of development banks. Such policies were written off as dangerous failures in the 1980s and 1990s for sustaining inefficient insider industries at high fiscal cost. But the crisis and the effective response to it by some countries are likely to bolster the notion that competent technocrats in developing countries are capable of efficiently managing state involvement in the productive sectors. Brazil, for example, used its government-sponsored development bank to direct credit to certain sectors quickly as part of its initial crisis-driven stimulus program, and China did the same thing with its state-run banks.

However, this new industrial policy is not about picking winners or bringing about large sectoral shifts in production. It is about addressing coordination problems and other barriers that discourage private investment in new industries and technologies, difficulties that market forces alone are unlikely to overcome. To promote an innovative clothing industry in West Africa, for example, governments might ensure a constant supply of textiles or subsidize the construction of ports to avoid export bottlenecks. The idea is that by bearing some of the initial financial or other risks and more systematically targeting public infrastructure, governments can help private investors overcome the high costs of being the first movers and innovators in incipient sectors.

For the last three decades, Washington-based development institutions have taken the view that growth is threatened more by government incompetence and corruption than by market failures. Now that American-style capitalism has fallen from its pedestal, might this view begin to shift? Might the idea that the state can take a more active role get far more traction? The answer depends, for any single developing country, on an assessment of its state capacity and overall governance. This is because the most significant critique of industrial policy was never economic but political, contending that economic decision-making in developing countries could not be shielded from political pressure. Critics argued that policymakers would retain protectionist measures long after they had fulfilled their original purpose of jump-starting domestic industries. Industrial policies such as reducing dependency on imports and promoting infant industries, although later derided in Washington, did in fact produce impressive rates of economic growth in the 1950s and 1960s in East Asia and Latin America. The problem, however, was that governments in the latter region were politically unable to unwind that protection, and so their domestic industries failed to become globally competitive.

Therefore, technocrats in developing countries contemplating the use of industrial policies must consider the politics of doing so. Does a bureaucracy exist that is sufficiently capable and autonomous from political pressure? Is there enough money to sustain such an agenda? Will it be possible to make hard political decisions, such as eliminating the policies when they are no longer needed? Most of the successful uses of industrial policy have
been in East Asia, which has a long tradition of strong technocratic bureaucracies. Countries without such a legacy need to be more careful.

**MAKING BUREAUCRACY WORK**

If countries are to promote industrial development and provide a social safety net, they will need to reform their public sectors; indeed, the fourth consequence of the crisis has been a painful reminder of the costs of not doing so. In the United States, regulatory agencies were underfunded, had difficulty attracting high-quality personnel, and faced political opposition. This was not surprising: implicit in the Reagan-Thatcher doctrine was the belief that markets were an acceptable substitute for efficient government. The crisis demonstrated that unregulated or poorly regulated markets can produce extraordinary costs.

Leaders in both the developing world and the developed world have marveled at China’s remarkable ability to bounce back after the crisis, a result of a tightly managed, top-down policymaking machine that could avoid the delays of a messy democratic process. In response, political leaders in the developing world now associate efficiency and capability with autocratic political systems. But there are plenty of incompetent autocratic regimes. What sets China apart is a bureaucracy that, at its upper levels at least, is capable of managing and coordinating sophisticated policies. Among low-income countries, that makes China an exception.

Promoting effective public sectors is one of the most daunting development challenges that the world faces. Development institutions such as the World Bank and the United Kingdom’s Department for International Development have supported programs that strengthen public sectors, promote good governance, and combat corruption for the last 15 years with little to show for it. The fact that even financial regulators in the United States and the United Kingdom failed to use their existing powers or to keep pace with rapidly evolving markets is a humbling reminder that effective public sectors are a challenge to maintain in even the most developed countries.

Why has so little progress been made in improving developing countries’ public sectors? The first problem is that their bureaucracies often serve governments that are rent-seeking coalitions acting according to self-interest, instead of an ideal of impersonal public service. Outside donors typically do not have the leverage to force them to change, with the partial exception of mechanisms such as the European Union’s accession process. Second, effective institutions have to evolve indigenously, reflecting a country’s own political, social, and cultural realities. The development of impersonal bureaucracies in the West was the product of a long and painful process, with factors exogenous to the economy (such as the need to mobilize for war) playing a large part in creating strong state institutions (such as Prussia’s famously efficient bureaucracy). Institutions such as the rule of law will rarely work if they are simply copied from abroad; societies must buy into their content. Finally, public-sector reform requires a parallel process of nation building. Unless a society has a clear sense of national identity and a shared public interest, individuals will show less loyalty to it than to their ethnic group, tribe, or patronage network.

**MOVING TO Multipolarity**

Years from now, historians may well point to the financial crisis as the end of American economic dominance in global affairs. But the trend toward a multipolar world began much earlier, and the implosion of Western financial markets and their weak recoveries have merely accelerated the process. Even before the crisis, the international institutions created after World War II to manage economic and security challenges were under strain and in need of reform. The IMF and the World Bank suffered from governance structures that reflected outdated economic realities. Starting in the 1990s and continuing into the new century, the Bretton Woods institutions have come under increasing pressure to grant more voting power to emerging-market countries such as Brazil and China. Meanwhile, the G-7, the elite group of the six most economically important Western democracies plus Japan, remained the world’s informal steering committee when it came to issues of global economic coordination, even as other power centers emerged.

The financial crisis finally led to the demise of the G-7 as the primary locus of global economic policy coordination and its replacement by the G-20. In November 2008, heads of state from the G-20 gathered in Washington, D.C., to coordinate a global stimulus program -- a meeting that has since grown into an established
international institution. Since the G-20, unlike the G-7, includes emerging countries such as Brazil, China, and India, the expansion of economic coordination represents an overdue recognition of a new group of global economic players.

The crisis also breathed new life and legitimacy into the IMF and the World Bank. Beforehand, the IMF had looked like it was rapidly becoming obsolete. Private capital markets provided countries with financing on favorable terms without the conditions often attached to IMF loans. The organization was having trouble funding its own activities and was in the process of reducing its staff.

But the outlook changed in 2009, when the G-20 leaders agreed to ensure that the Bretton Woods institutions would have as much as $1 trillion in additional resources to help countries better weather future financing shortfalls. Countries such as Brazil and China were among the contributors to the special funds, which have ended up supporting Greece, Hungary, Iceland, Ireland, Latvia, Pakistan, and Ukraine.

By requesting that emerging markets take on a bigger leadership role in global affairs, the Western democracies are implicitly admitting that they are no longer able to manage global economic affairs on their own. But what has been called “the rise of the rest” is not just about economic and political power; it also has to do with the global competition of ideas and models. The West, and in particular the United States, is no longer seen as the only center for innovative thinking about social policy. Conditional cash transfer schemes, for example, were first developed and implemented in Latin America. As for industrial policy, the West has contributed little innovative thinking in that realm in the last 30 years. One has to turn to emerging-market countries, rather than the developed world, to see successful models in practice. And when it comes to international organizations, the voices and ideas of the United States and Europe are becoming less dominant. Those of emerging-market countries -- states that have become significant funders of the international financial institutions -- are being given greater weight.

All this signals a clear shift in the development agenda. Traditionally, this was an agenda generated in the developed world that was implemented in -- and, indeed, often imposed on -- the developing world. The United States, Europe, and Japan will continue to be significant sources of economic resources and ideas, but the emerging markets are now entering this arena and will become significant players. Countries such as Brazil, China, India, and South Africa will be both donors and recipients of resources for development and of best practices for how to use them. A large portion of the world's poor live within their borders, yet they have achieved new respect on the global scene in economic, political, and intellectual terms. In fact, development has never been something that the rich bestowed on the poor but rather something the poor achieved for themselves. It appears that the Western powers are finally waking up to this truth in light of a financial crisis that, for them, is by no means over.
America's problem is not purely economic but stems from the distortion of competition in politics. The Founders envisioned factions competing against each other on a level playing field in the political sphere (See Federalist #10). They never envisioned giving powerful multinational corporations constitutional rights to spend money to influence elections. Individual citizens cannot compete with the concentrated political and economic power of corporations. By using political influence to reduce their accountability, large corporations have also distorted competition in the economy. Indeed, were the Founders to return today, they would see many similarities between the power of multinational corporations that are unaccountable to the electorate, and the King against whom a revolution was fought.

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