

# GLOBALIZATION AND ITS DISCONTENTS

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# FREEDOM TO CHOOSE?

**F**ISCAL AUSTERITY, PRIVATIZATION, and market liberalization were the three pillars of Washington Consensus advice throughout the 1980s and 1990s. The Washington Consensus policies were designed to respond to the very real problems in Latin America, and made considerable sense. In the 1980s, the governments of those countries had often run huge deficits. Losses in inefficient government enterprises contributed to those deficits. Insulated from competition by protectionist measures, inefficient private firms forced customers to pay high prices. Loose monetary policy led to inflation running out of control. Countries cannot persistently run large deficits; and sustained growth is not possible with hyperinflation. Some level of fiscal discipline is required. Most countries would be better off with governments focusing on providing essential public services rather than running enterprises that would arguably perform better in the private sector, and so privatization often makes sense. When trade liberalization—the lowering of tariffs and elimination of other protectionist measures—is done in the right way and at the right pace, so that new jobs are created as inefficient jobs are destroyed, there can be significant efficiency gains.

The problem was that many of these policies became ends in themselves, rather than means to more equitable and sustainable

growth. In doing so, these policies were pushed too far, too fast, and to the exclusion of other policies that were needed.

The results have been far from those intended. Fiscal austerity pushed too far, under the wrong circumstances, can induce recessions, and high interest rates may impede fledgling business enterprises. The IMF vigorously pursued privatization and liberalization, at a pace and in a manner that often imposed very real costs on countries ill-equipped to incur them.

### **Privatization**

In many developing—and developed—countries, governments all too often spend too much energy doing things they shouldn't do. This distracts them from what they should be doing. The problem is not so much that the government is too big, but that it is not doing the right thing. Governments, by and large, have little business running steel mills, and typically make a mess of it. (Although the most efficient steel mills in the world are those established and run by the Korean and Taiwanese governments, they are an exception.) In general, competing private enterprises can perform such functions more efficiently. This is the argument for privatization—converting state-run industries and firms into private ones. However, there are some important preconditions that have to be satisfied before privatization can contribute to an economy's growth. And the way privatization is accomplished makes a great deal of difference.

Unfortunately, the IMF and the World Bank have approached the issues from a narrow ideological perspective—privatization was to be pursued rapidly. Scorecards were kept for the countries making the transition from communism to the market: those who privatized faster were given the high marks. As a result, privatization often did not bring the benefits that were promised. The problems that arose from these failures have created antipathy to the very idea of privatization.

In 1998 I visited some poor villages in Morocco to see the impact that projects undertaken by the World Bank and nongovernmental organizations (NGOs) were having on the lives of the people there. I saw, for instance, how community-based irrigation projects were increasing farm productivity enormously. One project, however, had

failed. An NGO had painstakingly instructed local villagers on raising chickens, an enterprise that the village women could perform as they continued more traditional activities. Originally, the women obtained their seven-day-old chicks from a government enterprise. But when I visited the village, this new enterprise had collapsed. I discussed with villagers and government officials what had gone wrong. The answer was simple: The government had been told by the IMF that it should not be in the business of distributing chicks, so it ceased selling them. It was simply *assumed* that the private sector would immediately fill the gap. Indeed, a new private supplier arrived to provide the villagers with newborn chicks. The death rate of chicks in the first two weeks is high, however, and the private firm was unwilling to provide a guarantee. The villagers simply could not bear the risk of buying chicks that might die in large numbers. Thus, a nascent industry, poised to make a difference in the lives of these poor peasants, was shut down.

The assumption underlying this failure is one that I saw made repeatedly; the IMF simply assumed that markets arise quickly to meet every need, when in fact, many government activities arise because markets have *failed* to provide essential services. Examples abound. Outside the United States, this point often seems obvious. When many European countries created their social security systems and unemployment and disability insurance systems, there were no well-functioning private annuity markets, no private firms that would sell insurance against these risks that played such an important role in individuals' lives. Even when the United States created its social security system, much later, in the depths of the Great Depression as part of the New Deal, private markets for annuities did not work well—and even today one cannot get annuities that insure one against inflation. Again, in the United States, one of the reasons for the creation of the Federal National Mortgage Association (Fannie Mae) was that the private market did not provide mortgages at reasonable terms to low- and middle-income families. In developing countries, these problems are even worse; eliminating the government enterprise may leave a huge gap—and even if eventually the private sector enters, there can be enormous suffering in the meanwhile.

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In Côte d'Ivoire, the telephone company was privatized, as is so often the case, *before* either an adequate regulatory or competition framework was put into place. The government was persuaded by the French firm that purchased the state's assets into giving it a monopoly, not only on the existing telephone services but on new cellular services as well. The private firm raised prices so high that, for instance, university students reportedly could not afford Internet connections, essential to prevent the already huge gap in digital access between rich and poor from widening even further.

The IMF argues that it is far more important to privatize quickly; one can deal with the issues of competition and regulation later. But the danger here is that once a vested interest has been created, it has an incentive, and the money, to maintain its monopoly position, squelching regulation and competition, and distorting the political process along the way. There is a natural reason why the IMF has been less concerned about competition and regulation than it might have been. Privatizing an unregulated monopoly can yield more revenue to the government, and the IMF focuses far more on macroeconomic issues, such as the size of the government's deficit, than on structural issues, such as the efficiency and competitiveness of the industry. Whether the privatized monopolies were more efficient in production than government, they were often more efficient in exploiting their monopoly position; consumers suffered as a result.

Privatization has also come not just at the expense of consumers but at the expense of workers as well. The impact on employment has perhaps been both the major argument for and against privatization, with advocates arguing that only through privatization can unproductive workers be shed, and critics arguing that job cuts occur with no sensitivity to the social costs. There is, in fact, considerable truth in both positions. Privatization often turns state enterprises from losses to profits by trimming the payroll. Economists, however, are supposed to focus on overall efficiency. There are social costs associated with unemployment, *which private firms simply do not take into account*. Given minimal job protections, employers can dismiss workers, with little or no costs, including, at best, minimal severance pay. Privatization has been so widely criticized because, unlike so-called Greenfield investments—investments in new firms as opposed

to private investors taking over existing firms—privatization often destroys jobs rather than creating new ones.

In industrialized countries, the pain of layoffs is acknowledged and somewhat ameliorated by the safety net of unemployment insurance. In less developed countries, the unemployed workers typically do not become a public charge, since there are seldom unemployment insurance schemes. There can be a large social cost nonetheless—manifested, in its worst forms, by urban violence, increased crime, and social and political unrest. But even in the absence of these problems, there are huge costs of unemployment. They include widespread anxiety even among workers who have managed to keep their jobs, a broader sense of alienation, additional financial burdens on family members who manage to remain employed, and the withdrawal of children from school to help support the family. These kinds of social costs endure long past the immediate loss of a job. They are often especially apparent in the case when a firm is sold to foreigners. Domestic firms may at least be attuned to the social context\* and be reluctant to fire workers if they know there are no alternative jobs available. Foreign owners, on the other hand, may feel a greater obligation to their shareholders to maximize stock market value by reducing costs, and less of an obligation to what they will refer to as an “overbloated labor force.”

It is important to restructure state enterprises, and privatization is often an effective way to do so. But moving people from low-productivity jobs in state enterprises to unemployment does not increase a country's income, and it certainly does not increase the welfare of the workers. The moral is a simple one, and one to which I shall return repeatedly: Privatization needs to be part of a more comprehensive program, which entails creating jobs *in tandem with* the inevitable job destruction that privatization often entails. Macroeconomic policies, including low interest rates, that help create jobs, have to be put in place. Timing (and sequencing) is everything. These are

\*I saw this forcefully in my discussions in Korea. Private owners showed an enormous social conscience in letting their workers go; they felt that there was a social contract, which they were reluctant to abrogate, even if it meant that they themselves would lose money.

not just issues of pragmatics, of "implementation": these are issues of principle.

Perhaps the most serious concern with privatization, as it has so often been practiced, is corruption. The rhetoric of market fundamentalism asserts that privatization will reduce what economists call the "rent-seeking" activity of government officials who either skim off the profits of government enterprises or award contracts and jobs to their friends. But in contrast to what it was supposed to do, privatization has made matters so much worse that in many countries today privatization is jokingly referred to as "briberization." If a government is corrupt, there is little evidence that privatization will solve the problem. After all, the same corrupt government that mismanaged the firm will also handle the privatization. In country after country, government officials have realized that privatization meant that they no longer needed to be limited to annual profit skimming. By selling a government enterprise at below market price, they could get a significant chunk of the asset value for themselves rather than leaving it for subsequent officeholders. In effect, they could steal today much of what would have been skimmed off by future politicians. Not surprisingly, the rigged privatization process was designed to maximize the amount government ministers could appropriate for themselves, not the amount that would accrue to the government's treasury, let alone the overall efficiency of the economy. As we will see, Russia provides a devastating case study of the harm of "privatization at all costs."

Privatization advocates naively persuaded themselves these costs could be overlooked because the textbooks seemed to say that once private property rights were clearly defined, the new owners would ensure that the assets would be efficiently managed. Thus the situation would improve in the long term even if it was ugly in the short term. They failed to realize that without the appropriate legal structures and market institutions, the new owners might have an incentive to strip assets rather than use them as a basis for expanding industry. As a result, in Russia, and many other countries, privatization failed to be as effective a force for growth as it might have been. Indeed, sometimes it was associated with decline and proved to be a

powerful force for undermining confidence in democratic and market institutions.

### **Liberalization**

Liberalization—the removal of government interference in financial markets, capital markets, and of barriers to trade—has many dimensions. Today, even the IMF agrees that it has pushed that agenda too far—that liberalizing capital and financial markets contributed to the global financial crises of the 1990s and can wreak havoc on a small emerging country.

The one aspect of liberalization that does have widespread support—at least among the elites in the advanced industrial countries—is trade liberalization. But a closer look at how it has worked out in many developing countries serves to illustrate why it is so often so strongly opposed, as seen in the protests in Seattle, Prague, and Washington, DC.

Trade liberalization is supposed to enhance a country's income by forcing resources to move from less productive uses to more productive uses; as economists would say, utilizing comparative advantage. But moving resources from low-productivity uses to *zero* productivity does not enrich a country, and this is what happened all too often under IMF programs. It is easy to destroy jobs, and this is often the immediate impact of trade liberalization, as inefficient industries close down under pressure from international competition. IMF ideology holds that new, more productive jobs will be created as the old, inefficient jobs that have been created behind protectionist walls are eliminated. But that is simply not the case—and few economists have believed in instantaneous job creation, at least since the Great Depression. It takes capital and entrepreneurship to create new firms and jobs, and in developing countries there is often a shortage of the latter, due to lack of education, and of the former, due to lack of bank financing. The IMF in many countries has made matters worse, because its austerity programs often also entailed such high interest rates—sometimes exceeding 20 percent, sometimes exceeding 50 percent, sometimes even exceeding 100 percent—that job and enter-

prise creation would have been an impossibility even in a good economic environment such as the United States. The necessary capital for growth is simply too costly.

The most successful developing countries, those in East Asia, opened themselves to the outside world but did so slowly and in a sequenced way. These countries took advantage of globalization to expand their exports and grew faster as a result. But they dropped protective barriers carefully and systematically, phasing them out only when new jobs were created. They ensured that there was capital available for new job and enterprise creation; and they even took an entrepreneurial role in promoting new enterprises. China is just dismantling its trade barriers, twenty years after its march to the market began, a period in which it grew extremely rapidly.

Those in the United States and the advanced industrialized countries should have found it easy to grasp these concerns. In the last two U.S. presidential campaigns, the candidate Pat Buchanan has exploited American workers' worries about job loss from trade liberalization. Buchanan's themes resonated even in a country with close to full employment (by 1999, the unemployment rate had fallen to under 4 percent), coupled with a good unemployment insurance system and a variety of assistance to help workers move from one job to another. The fact that, even during the booming 1990s, American workers could be so worried about the threat of liberalized trade to their jobs should have led to a greater understanding of the plight of workers in poor developing countries, where they live on the verge of subsistence, often on \$2 a day or less, with no safety net in the form of savings, much less unemployment insurance, and in an economy with 20 percent or more unemployment.

The fact that trade liberalization all too often fails to live up to its promise—but instead simply leads to more unemployment—is why it provokes strong opposition. But the *hypocrisy* of those pushing for trade liberalization—and the way they have pushed it—has no doubt reinforced hostility to trade liberalization. The Western countries pushed trade liberalization for the products that they exported, but at the same time continued to protect those sectors in which competition from developing countries might have threatened their economies. This was one of the bases of the opposition to the new

round of trade negotiations that was supposed to be launched in Seattle; previous rounds of trade negotiations had protected the interests of the advanced industrial countries—or more accurately, special interests within those countries—without concomitant benefits for the lesser developed countries. Protestors pointed out, quite rightly, that the earlier rounds of trade negotiations had lowered trade barriers on industrial goods, from automobiles to machinery, exported by the advanced industrial countries. At the same time, negotiators for these countries maintained their nations' subsidies on agricultural goods and kept closed the markets for these goods and for textiles, where many developing countries have a comparative advantage.

In the most recent Uruguay Round of trade negotiations, the subject of trade in services was introduced. In the end, however, markets were opened mainly for the services exported by the advanced countries—financial services and information technology—but not for maritime and construction services, where the developing countries might have been able to gain a toehold. The United States bragged about the benefits it received. But the developing countries did not get a proportionate share of the gains. One World Bank calculation showed that Sub-Saharan Africa, the poorest region in the world, saw its income decline by more than 2 percent as a result of the trade agreement. There were other examples of inequities that increasingly became the subject of discourse in the developing world, though the issues seldom made it into print in the more developed nations. Bolivia not only brought down its trade barriers to the point that they were lower than those in the United States but also cooperated with the United States in virtually eradicating the growth of coca, the basis of cocaine, even though this crop provided a higher income to its already poor farmers than any alternative. The United States responded, however, by keeping its markets closed to the alternative agriculture products, like sugar, that Bolivia's farmers might have produced for export—had America's markets been open to them.

Developing countries get especially angry over this sort of double standard because of the long history of hypocrisy and inequities. In the nineteenth century the Western powers—many of which had grown through using protectionist policies—had pushed unfair trade

treaties. The most outrageous, perhaps, followed the Opium Wars, when the United Kingdom and France ganged up against a weak China, and together with Russia and the United States forced it, in the Treaty of Tientsin in 1858, not just to make trade and territorial concessions, ensuring it would export the goods the West wanted at low prices, but to open its markets to *opium*, so that millions in China would become addicted. (One might call this an almost diabolical approach to a "balance of trade.") Today, the emerging markets are not forced open under the threat of the use of military might, but through economic power, through the threat of sanctions or the withholding of needed assistance in a time of crisis. While the World Trade Organization was the forum within which international trade agreements were negotiated, U.S. trade negotiators and the IMF have often insisted on going further, accelerating the pace of trade liberalization. The IMF insists on this faster pace of liberalization as a condition for assistance—and countries facing a crisis feel they have no choice but to accede to the Fund's demands.

Matters are perhaps worse still when the United States acts unilaterally rather than behind the cloak of the WTO. The U.S. Trade Representative or the Department of Commerce, often prodded by special interests within the United States, brings an accusation against a foreign country; there is then a review process—involving only the U.S. government—with a decision made by the United States, after which sanctions are brought against the offending country. The United States sets itself up as prosecutor, judge, and jury. There is a quasi-judicial process, but the cards are stacked: both the rules and the judges favor a finding of guilty. When this arsenal is brought against other industrial countries, Europe and Japan, they have the resources to defend themselves; when it comes to the developing countries, even large ones like India and China, it is an unfair match. The ill will that results is far out of proportion to any possible gain for the United States. The process itself does little to reinforce confidence in a just international trading system.

The rhetoric the United States uses to push its position adds to the image of a superpower willing to throw its weight around for its own special interests. Mickey Kantor, when he was the U.S. Trade Representative in the first Clinton administration, wanted to push China to

open its markets faster. The 1994 Uruguay Round negotiations, in which he himself had played a major role, established the WTO and set ground rules for members. The agreement had quite rightly provided a longer adjustment period for developing countries. At the time, the World Bank, and every economist, treats China—with its per capita income of \$450—not only as a developing country but also as a low-income developing country. But Kantor was a hard negotiator. He insisted that it was a developed country, and should therefore have a quick transition.

Kantor had some leverage because China needed U.S. approval in order to join the WTO. The United States–China agreement that eventually led to China's being admitted to the WTO in November 2001 illustrates two aspects of the contradictions of the U.S. position. While the United States dragged out the bargaining with its unreasonable insistence that China was really a developed country, China began the adjustment process itself. In effect, unwittingly, the United States gave China the extra time it had wanted. But the agreement itself illustrates the double standards and inequity at play here. Ironically, while the United States insisted that China adjust quickly, as if it were a developed country—and because China had used the prolonged bargaining time well, it was able to accede to those demands—the United States also demanded, in effect, that America be treated as if *it* were a less developed country, that it be given not just the ten years of adjustment for lowering its barrier against textile imports that had been part of the 1994 negotiations, but an additional four years.

What is particularly disturbing is how special interests can undermine both U.S. credibility and broader national interests. This was seen most forcefully in April 1999, when Premier Zhu Rongji came to the United States partly to finish off negotiations for China's admission to the World Trade Organization, a move that was essential for the world trading regime—how could one of the largest trading countries be excluded?—but also for the market reforms in China itself. Over the opposition of the U.S. Trade Representative and the State Department, the U.S. Treasury insisted on a provision for faster liberalization of China's financial markets. China was quite rightly worried; it was precisely such liberalization that had led to the finan-

cial crises in neighboring countries in East Asia, at such costs. China had been spared because of its wise policies.

This American demand for liberalization of financial markets in China would not help secure global economic stability. It was made to serve the narrow interests of the financial community in the United States, which Treasury vigorously represents. Wall Street rightly believed that China represented a potential vast market for its financial services, and it was important that Wall Street get in, establish a strong toehold, before others. How shortsighted this was! It was clear that China would eventually be opened up. Hurrying the process up by a year or two can surely make little difference, except that Wall Street worries that its competitive advantage may disappear over time, as financial institutions in Europe and elsewhere catch up to the short-term advantages of their Wall Street competitors. But the potential cost was enormous. In the immediate aftermath of the Asian financial crisis, it was impossible for China to accede to Treasury's demands. For China, maintaining stability is essential; it could not risk policies that had proved so destabilizing elsewhere. Zhu Rongji was forced to return to China without a signed agreement. There had long been a struggle inside China between those pushing for and against reform. Those opposing reform argued that the West was seeking to weaken China, and would never sign a fair agreement. A successful end to the negotiations would have helped to secure the positions of the reformers in the Chinese government and added strength to the reform movement. As it turned out, Zhu Rongji and the reform movement for which he stood, were discredited, and the reformists' power and influence were curtailed. Fortunately, the damage was only temporary, but still, the U.S. Treasury had shown how much it was willing to risk to pursue its special agenda.

EVEN THOUGH AN unfair trade agenda was pushed, at least there was a considerable body of theory and evidence that trade liberalization would, if implemented properly, be a good thing. The case for financial market liberalization was far more problematic. Many countries do have financial regulations that serve little purpose other than to increase profits of some special interest group, and these should be stripped away. But all countries regulate their financial markets, and

excessive zeal in deregulation has brought on massive problems in capital markets even in developed countries around the world. To cite one example, the infamous savings-and-loan debacle in the United States, while it was a key factor in precipitating the 1991 recession and cost American taxpayers upward of \$200 billion, was one of the least expensive (as a percentage of GDP) bailouts that deregulation has brought on, just as the U.S. recession was one of the mildest compared to ones in other economies that suffered similar crises.

While the more advanced industrialized countries, with their sophisticated institutions, were learning the hard lessons of financial deregulation, the IMF was carrying this Reagan-Thatcher message to the developing countries, countries which were particularly ill-equipped to manage what has proven, under the best of circumstances, to be a difficult task fraught with risks. Whereas the more advanced industrial countries did not attempt capital market liberalization until late in their development—European nations waited until the 1970s to get rid of their capital market controls—the developing nations have been encouraged to do so quickly.

The consequences—economic recession—of banking crises brought on by capital market deregulation, while painful for developed countries, were much more serious for developing countries. The poor countries have no safety net to soften the impact of recession. In addition, the limited competition in financial markets meant that liberalization did not always bring the promised benefits of lower interest rates. Instead, farmers sometimes found that they had to pay higher interest rates, making it more difficult for them to buy the seed and fertilizer necessary to eke out their bare subsistence living.

And as bad as premature and badly managed trade liberalization was for developing countries, in many ways capital market liberalization was even worse. Capital market liberalization entails stripping away the regulations intended to control the flow of hot money in and out of the country—short-term loans and contracts that are usually no more than bets on exchange rate movements. This speculative money cannot be used to build factories or create jobs—companies don't make long-term investments using money that can be pulled out on a moment's notice—and indeed, the risk that such hot money

brings with it makes long-term investments in a developing country even less attractive. The adverse effects on growth are even greater. To manage the risks associated with these volatile capital flows, countries are routinely advised to set aside in their reserves an amount equal to their short-term foreign-denominated loans. To see what this implies, assume that a firm in a small developing country accepts a short-term \$100 million loan from an American bank, paying 18 percent interest. Prudential policy on the part of the country would require that it would add \$100 million to reserves. Typically reserves are held in U.S. Treasury bills, which recently paid around 4 percent. In effect, the country is simultaneously borrowing from the United States at 18 percent and lending to the United States at 2 percent. The country as a whole has no more resources available for investing. American banks may make a tidy profit and the United States as a whole gains \$16 million a year in interest. But it is hard to see how this allows the developing country to grow faster. Put this way, it clearly makes no sense. There is a further problem: a mismatch of incentives. With capital market liberalization, it is firms in a country's private sector that get to decide whether to borrow short-term funds from the American banks, but it is the government that must accommodate itself, adding to its reserves if it wishes to maintain its prudential standing.

The IMF, in arguing for capital market liberalization, relied on simplistic reasoning: Free markets are more efficient, greater efficiency allowed for faster growth. It ignored arguments such as the one just given, and put forward some further specious contentions, for instance, that without liberalization, countries would not be able to attract foreign capital, and especially direct investment. The Fund's economists have never laid claim to being great theorists; its claim to expertise lay in its global experience and its mastery of the data. Yet strikingly, not even the data supported the Fund's conclusions. China, which received the largest amount of foreign investment, did not follow any of the Western prescriptions (other than macrostability)—prudently forestalling full capital market liberalization. Broader statistical studies confirmed the finding that using the IMF's own definitions of liberalization, it did not entail faster growth or higher investment.

While China demonstrated that capital market liberalization was

not needed to attract funds, the fact of the matter was that, given the high savings rates in East Asia (30–40% of GDP, in contrast to 18% in the United States and 17–30% in Europe), the region hardly needed additional funds; it already faced a daunting challenge in investing the flow of savings well.

The advocates of liberalization put forth another argument, one that looks particularly laughable in light of the global financial crisis that began in 1997, that liberalization would enhance stability by diversifying the sources of funding. The notion was that in times of downturn, countries could call upon foreigners to make up for a shortfall in domestic funds. The IMF economists were supposed to be practical people, well versed in the ways of the world. Surely, they must have known that bankers prefer to lend to those who do not need their funds; surely they must have seen how it is when countries face difficulties, that foreign lenders pull their money out—exacerbating the economic downturn.

While we shall take a closer look at why liberalization—especially when undertaken prematurely, before strong financial institutions are in place—increased instability, one fact remains clear: instability is not only bad for economic growth, but the costs of the instability are disproportionately borne by the poor.

### **The Role of Foreign Investment**

Foreign investment is not one of the three main pillars of the Washington Consensus, but it is a key part of the new globalization. According to the Washington Consensus, growth occurs through liberalization, “freeing up” markets. Privatization, liberalization, and macrostability are supposed to create a climate to attract investment, including from abroad. This investment creates growth. Foreign business brings with it technical expertise and access to foreign markets, creating new employment possibilities. Foreign companies also have access to sources of finance, especially important in those developing countries where local financial institutions are weak. Foreign direct investment has played an important role in many—but not all—of the most successful development stories in countries such as Singapore and Malaysia and even China.

Having said this, there are some real downsides. When foreign businesses come in they often destroy local competitors, quashing the ambitions of the small businessmen who had hoped to develop homegrown industry. There are many examples of this. Soft drinks manufacturers around the world have been overwhelmed by the entrance of Coca-Cola and Pepsi into their home markets. Local ice cream manufacturers find they are unable to compete with Unilever's ice cream products.

One way to think about it is to recall the controversy in the United States over the large chains of drugstores and convenience stores. When Wal\*Mart comes into a community, there are often strong protests from local firms, who fear (rightly) that they will be displaced. Local shopkeepers worry they won't be able to compete with Wal\*Mart, with its enormous buying power. People living in small towns worry about what will happen to the character of the community if all local stores are destroyed. These same concerns are a thousand times stronger in developing countries. Although such concerns are legitimate, one has to maintain a perspective: the reason that Wal\*Mart is successful is that it provides goods to consumers at lower prices. The more efficient delivery of goods and services to poor individuals within developing countries is all the more important, given how close to subsistence so many live.

But critics raise several points. In the absence of strong (or effectively enforced) competition laws, after the international firm drives out the local competition it uses its monopoly power to raise prices. The benefits of low-prices were short-lived.

Part of what is at stake is a matter of pacing; local businesses claim that, if they are given time, they can adapt and respond to the competition, that they can produce goods efficiently, that preserving local businesses is important for the strengthening of the local community, both economically and socially. The problem, of course, is that all too often policies first described as a temporary protection from foreign competition become permanent.

Many of the multinationals have done less than they might to improve the working conditions in the developing countries. Only gradually have they come to recognize the lessons that they learned all too slowly at home. Providing better working conditions may

actually enhance worker productivity, and lower overall costs—or at least not raise costs very much.

Banking is another area where foreign companies often overrun local ones. The large American banks can provide greater security for depositors than do small local banks (unless the local government provides deposit insurance). The U.S. government has been pushing for opening up of financial markets in developing nations. The advantages are clear: the increased competition can lead to improved services. The greater financial strength of the foreign banks can enhance financial stability. Still, the threat foreign banks pose to the local banking sector is very real. Indeed, there was an extended debate in the United States on the same issue. National banking was resisted (until the Clinton administration, under Wall Street influence, reversed the traditional position of the Democratic Party) for fear that funds would flow to the major money centers, like New York, starving the outlying areas of needed funds. Argentina shows the dangers. There, before the collapse in 2001, the domestic banking industry had become dominated by foreign-owned banks, and while the banks easily provide funds to multinationals, and even large domestic firms, small and medium-size firms complained of a lack of access to capital. International banks' expertise—and information base—lies in lending to their traditional clients. Eventually, they may expand into these other niches, or new financial institutions may arise to address these gaps. And the lack of growth—to which the lack of finance contributed—was pivotal in that country's collapse. Within Argentina, the problem was widely recognized; the government took some limited steps to fill the credit gap. But government lending could not make up for the market's failure.

Argentina's experience illustrates some basic lessons. The IMF and the World Bank have been stressing the importance of bank stability. It is easy to create sound banks, banks that do not lose money because of bad loans—simply require them to invest in U.S. Treasury bills. The challenge is not just to create sound banks but also to create sound banks that provide credit for growth. Argentina has shown how the failure to do that may itself lead to macroinstability. Because of a lack of growth it has had mounting fiscal deficits, and as the IMF forced cutbacks in expenditures and increases in taxes, a vicious

downward spiral of economic decline and social unrest was set in motion.

Bolivia provides yet another example where foreign banks have contributed to macroeconomic instability. In 2001, a foreign bank that loomed large in the Bolivian economy suddenly decided, given the increased global risks, to pull back on lending. The sudden change in the credit supply helped plunge the economy into an even deeper economic downturn than falling commodity prices and the global economic slowdown were already bringing about.

There are additional concerns with respect to the intrusion of foreign banks. Domestic banks are more sensitive to what used to be called "window guidance"—subtle forms of influence by the central bank, for example, to expand credit when the economy needs stimulus and contract it when there are signs of overheating. Foreign banks are far less likely to be responsive to such signals. Similarly, domestic banks are far more likely to be responsive to pressure to address basic holes in the credit system—unserved and underserved groups, such as minorities and disadvantaged regions. In the United States, with one of the most developed credit markets, these gaps were felt to be so important that the Community Reinvestment Act (CRA) was passed in 1977, which imposed requirements on banks to lend to these underserved groups and areas. The CRA has been an important, if controversial, way of achieving critical social goals.

Finance, however, is not the only area in which foreign direct investment has been a mixed blessing. In some cases, new investors persuaded (often with bribes) governments to grant them special privileges, such as tariff protection. In many cases, the U.S., French, or governments of other advanced industrial countries weighed in—reinforcing the view within developing countries that it was perfectly appropriate for governments to meddle in and presumably receive payments from the private sector. In some cases, the role of government seemed relatively innocuous (although not necessarily uncorrupt). When U.S. Secretary of Commerce Ron Brown traveled abroad, he was accompanied by U.S. business people trying to make contacts with and gain entry into these emerging markets. Presumably, the chances of getting a seat on the plane were enhanced if one made significant campaign contributions.

In other cases, one government was called in to countervail the weight of another. In Côte d'Ivoire while the French government supported the French Telecom's attempt to exclude competition from an independent (American) cell phone company, the U.S. government pushed the claims of the American firm. But in many cases, governments went well beyond the realm of what was reasonable. In Argentina, the French government reportedly weighed in pushing for a rewriting of the terms of concessions for a water utility (Aguas Argentinas), after the French parent company (Suez Lyonnaise) that had signed the agreements found them less profitable than it had thought.

Perhaps of greatest concern has been the role of governments, including the American government, in pushing nations to live up to agreements that were vastly unfair to the developing countries, and often signed by corrupt governments in those countries. In Indonesia, at the 1994 meeting of leaders of APEC (Asia-Pacific Economic Cooperation) held at Jakarta, President Clinton encouraged American firms to come into Indonesia. Many did so, and often at highly favorable terms (with suggestions of corruption "greasing" the wheels—to the disadvantage of the people of Indonesia). The World Bank similarly encouraged private power deals there and in other countries, such as Pakistan. These contracts entailed provisions where the government was committed to purchasing large quantities of electricity at very high prices (the so-called take or pay clauses). The private sector got the profits; the government bore the risk. That was bad enough. But when the corrupt governments were overthrown (Mohammed Suharto in Indonesia in 1998, Nawaz Sharif in Pakistan in 1999), the U.S. government put pressure on the governments to fulfill the contract, rather than default or at least renegotiate the terms of the contract. There is, in fact, a long history of "unfair" contracts, which Western governments have used their muscle to enforce.<sup>1</sup>

There is more to the list of legitimate complaints against foreign direct investment. Such investment often flourishes only because of special privileges extracted from the government. While standard economics focuses on the *distortions* of incentives that result from such privileges, there is a far more insidious aspect: often those privi-

leges are the result of corruption, the bribery of government officials. The foreign direct investment comes only at the price of undermining democratic processes. This is particularly true for investments in mining, oil, and other natural resources, where foreigners have a real incentive to obtain the concessions at low prices.

Moreover, such investments have other adverse effects—and often do not promote growth. The income that mining concessions brings can be invaluable but development is a transformation of society. An investment in a mine—say in a remote region of a country—does little to assist the development transformation, beyond the resources that it generates. It can help create a dual economy, an economy in which there are pockets of wealth. But a dual economy is not a developed economy. Indeed, the inflow of resources can sometimes actually impede development, through a mechanism that is called the “Dutch Disease.” The inflow of capital leads to an appreciation of the currency, making imports cheap and exports expensive. The name comes from the Netherlands experience following the discovery of gas in the North Sea. Natural gas sales drove the Dutch currency up, seriously hurting the country’s other export industries. It presented a challenging but solvable problem for that country; but for developing countries, the problem may be especially difficult.

Worse still, the availability of resources can alter incentives: as we saw in chapter 2, rather than devoting energy to creating wealth, in many countries that are well-endowed with resources, efforts are directed at appropriating the income (which economists refer to as “rents”) associated with the natural resources.

The international financial institutions tended to ignore the problems I have outlined. Instead, the IMF’s prescription for job creation—when it focused on that issue—was simple: Eliminate government intervention (in the form of oppressive regulation), reduce taxes, get inflation as low as possible, and invite foreign entrepreneurs in. In a sense, even here policy reflected the colonial mentality described in the previous chapter: of course, the developing countries would have to rely on foreigners for entrepreneurship. Never mind the remarkable successes of Korea and Japan, in which foreign investment played no role. In many cases, as in Singapore, China, and Malaysia, which kept the abuses of foreign investment in check, foreign direct invest-

ment played a critical role, not so much for the capital (which, given the high savings rate, was not really needed) or even for the entrepreneurship, but for the access to markets and new technology that it brought along.

### Sequencing and Pacing

Perhaps of all the IMF's blunders, it is the mistakes in sequencing and pacing, and the failure to be sensitive to the broader social context, that have received the most attention—forcing liberalization before safety nets were put in place, before there was an adequate regulatory framework, before the countries could withstand the adverse consequences of the sudden changes in market sentiment that are part and parcel of modern capitalism; forcing policies that led to job destruction before the essentials for job creation were in place; forcing privatization before there were adequate competition and regulatory frameworks. Many of the sequencing mistakes reflected fundamental misunderstandings of both economic and political processes, misunderstandings that were particularly associated with those who believed in market fundamentalism. They argued, for instance, that once private property rights were established, all else would follow naturally—including the institutions and the kinds of legal structures that make market economies work.

Behind the free market ideology there is a model, often attributed to Adam Smith, which argues that market forces—the profit motive—drive the economy to efficient outcomes *as if by an invisible hand*. One of the great achievements of modern economics is to show the sense in which, and the conditions under which, Smith's conclusion is correct. It turns out that these conditions are highly restrictive.<sup>2</sup> Indeed, more recent advances in economic theory—ironically occurring precisely during the period of the most relentless pursuit of the Washington Consensus policies—have shown that whenever information is imperfect and markets incomplete, which is to say always, *and especially in developing countries*, then the invisible hand works most imperfectly. Significantly, there are desirable government interventions which, in principle, can improve upon the efficiency of the

market. These restrictions on the conditions under which markets result in efficiency are important—many of the key activities of government can be understood as responses to the resulting market failures. If information were perfect, we now know, there would be little role for financial markets—and little role for financial market regulation. If competition were automatically perfect, there would be no role for antitrust authorities.

The Washington Consensus policies, however, were based on a simplistic model of the market economy, the competitive equilibrium model, in which Adam Smith's invisible hand works, and works perfectly. Because in this model there is no need for government—that is, free, unfettered, "liberal" markets work perfectly—the Washington Consensus policies are sometimes referred to as "neo-liberal," based on "market fundamentalism," a resuscitation of the laissez-faire policies that were popular in some circles in the nineteenth century. In the aftermath of the Great Depression and the recognition of other failings of the market system, from massive inequality to unlivable cities marred by pollution and decay, these free market policies have been widely rejected in the more advanced industrial countries, though within these countries there remains an active debate about the appropriate balance between government and markets.

EVEN IF SMITH'S invisible hand theory were relevant for advanced industrialized countries, the required conditions are not satisfied in developing countries. The market system requires clearly established property rights and the courts to enforce them; but often these are absent in developing countries. The market system requires competition and perfect information. But competition is limited and information is far from perfect—and well-functioning competitive markets can't be established overnight. The theory says that an efficient market economy requires that *all* of the assumptions be satisfied. In some cases, reforms in one area, without accompanying reforms in others, may actually make matters worse. This is the issue of sequencing. Ideology ignores these matters; it says simply move as quickly to a market economy as you can. But economic theory and history show how disastrous it can be to ignore sequencing.

The mistakes in trade, capital market liberalization, and privatiza-

tion described earlier represent sequencing errors on a grand scale. The smaller-scale sequencing mistakes are even less noticed in the Western press. They constitute the day-to-day tragedies of IMF policies that affect the already desperately poor in the developing world. For example, many countries have marketing boards that purchase agricultural produce from the farmers and market it domestically and internationally. They often are a source of inefficiency and corruption, with farmers getting only a fraction of the ultimate price. Even though it makes little sense for the government to be engaged in this business, if the government suddenly gets out of it, it does not mean a vibrant competitive private sector will emerge automatically.

Several West African countries got out of the marketing board business under pressure from the IMF and World Bank. In some cases, it seemed to work; but in others, when the marketing board disappeared, a system of local monopolies developed. Limited capital restricted entry into this market. Few peasants could afford to buy a truck to carry their produce to market. They couldn't borrow the requisite funds either, given the lack of well-functioning banks. In some cases, people were able to get trucks to transport their goods, and the market did function initially; but then this lucrative business became the provenance of the local mafia. In either situation, the net benefits that the IMF and the World Bank promised did not materialize. Government revenue was lowered, the peasants were little if any better off than before, and a few local businessmen (mafiosi and politicians) were much better off.

Many marketing boards also engage in a policy of uniform pricing—paying farmers the same price no matter where they are located. While seemingly “fair,” economists object to this policy because it effectively requires those farmers near markets to subsidize those far away. With market competition, farmers farther away from the place where the goods are actually sold receive lower prices; in effect, they bear the costs of transporting their goods to the market. The IMF forced one African country to abandon its uniform pricing before an adequate road system was in place. The price received by those in more isolated places was suddenly lowered markedly, as they had to bear the costs of transportation. As a result, incomes in some of the poorest rural regions in the country plummeted, and wide-

spread hardship ensued. The IMF pricing scheme may have had some slight benefits in terms of increased efficiency, but we have to weigh these benefits against the social costs. Proper sequencing and pacing might have enabled one to gradually achieve the efficiency gains without these costs.

There is a more fundamental criticism of the IMF/Washington Consensus approach: It does not acknowledge that development requires a transformation of society. Uganda grasped this in its radical elimination of all school fees, something that budget accountants focusing solely on revenues and costs simply could not understand. Part of the mantra of development economics today is a stress on universal primary education, including educating girls. Countless studies have shown that countries, like those in East Asia, which have invested in primary education, including education of girls, have done better. But in some very poor countries, such as those in Africa, it has been very difficult to achieve high enrollment rates, especially for girls. The reason is simple: poor families have barely enough to survive; they see little direct benefit from educating their daughters, and the education systems have been oriented to enhancing opportunities mainly through jobs in the urban sector considered more suitable for boys. Most countries, facing severe budgetary constraints, have followed the Washington Consensus advice that fees should be charged. Their reasoning: statistical studies showed that small fees had little impact on school enrollment. But Uganda's President Museveni thought otherwise. He knew that he had to create a culture in which the expectation was that everyone went to school. And he knew he couldn't do that so long as there were any fees charged. So he ignored the advice of the outside experts and simply abolished all school fees. Enrollments soared. As each family saw others sending all of their children to school, it too decided to send its girls to school. What the simplistic statistical studies ignored is the power of *systemic* change.

If IMF strategies had simply failed to accomplish the full potential of development, that would have been bad enough. But the failures in many places have set back the development agenda, by unnecessarily corroding the very fabric of society. It is inevitable that the

process of development and rapid change puts enormous stresses on society. Traditional authorities are challenged, traditional relationships are reassessed. That is why successful development pays careful attention to social stability—a major lesson not only of the story of Botswana in the previous chapter but also of Indonesia in the next, where the IMF insisted on abolishing subsidies for food and kerosene (the fuel used for cooking by the poor) just as IMF policies had exacerbated the country's recession, with incomes and wages falling and unemployment soaring. The riots that ensued tore the country's social fabric, exacerbating the ongoing depression. Abolishing the subsidies was not only bad social policy; it was bad economic policy.

These were not the first IMF-inspired riots, and had the IMF advice been followed more broadly, there surely would have been more. In 1995, I was in Jordan for a meeting with the crown prince and other senior government officials, when the IMF argued for cutting food subsidies to improve the government's budget. They had almost succeeded in getting agreement when King Hussein intervened and put a stop to it. He enjoyed his post, was doing a marvelous job, and wanted to keep it. In the highly volatile Middle East, food-inspired riots could well have overturned the government, and with that the fragile peace in the region. Weighed against the meager possible improvement in the budget situation, these events would have been far more harmful to the goal of prosperity. The IMF's narrow economic view made it impossible for it to consider these issues in their broader context.

Such riots are, however, like the tip of an iceberg: they bring to everyone's attention the simple fact that the social and political context cannot be ignored. But there were other problems. While in the 1980s Latin America needed to have its budgets brought into better balance and inflation brought under control, excessive austerity led to high unemployment, without an adequate safety net, which in turn contributed to high levels of urban violence, an environment hardly conducive to investment. Civil strife in Africa has been a major factor setting back its development agenda. Studies at the World Bank show that such strife is systematically related to adverse economic factors, including unemployment that can be produced

by excessive austerity. Moderate inflation may not be ideal for creating an environment for investment, but violence and civil strife are even worse.

We recognize today that there is a “social contract” that binds citizens together, and with their government. When government policies abrogate that social contract, citizens may not honor their “contracts” with each other, or with the government. Maintaining that social contract is particularly important, and difficult, in the midst of the social upheavals that so frequently accompany the development transformation. In the green eye-shaded calculations of the IMF macroeconomics there is, too often, no room for these concerns.

### **Trickle-Down Economics**

Part of the social contract entails “fairness,” that the poor share in the gains of society as it grows, and that the rich share in the pains of society in times of crisis. The Washington Consensus policies paid little attention to issues of distribution or “fairness.” If pressed, many of its proponents would argue that the best way to help the poor is to make the economy grow. They believe in trickle-down economics. *Eventually*, it is asserted, the benefits of that growth *trickle down* even to the poor. Trickle-down economics was never much more than just a belief, an article of faith. Pauperism seemed to grow in nineteenth-century England even though the country as a whole prospered. Growth in America in the 1980s provided the most recent dramatic example: while the economy grew, those at the bottom saw their real incomes decline. The Clinton administration had argued strongly against trickle-down economics; it believed that there had to be active programs to help the poor. And when I left the White House to go to the World Bank, I brought with me the same skepticism of trickle-down economics; if this had not worked in the United States, why would it work in developing countries? While it is true that sustained reductions in poverty cannot be attained without robust economic growth, the converse is not true: growth need not benefit all. It is not true that “a rising tide lifts all boats.” Sometimes, a quickly rising tide, especially when accompanied by a storm, dashes weaker boats against the shore, smashing them to smithereens.

In spite of the obvious problems confronting trickle-down economics, it has a good intellectual pedigree. One Nobel Prize winner, Arthur Lewis, argued that inequality was good for development and economic growth, since the rich save more than the poor, and the key to growth was capital accumulation. Another Nobel Prize winner, Simon Kuznets, argued that while in the initial stages of development inequality increased, later on the trend was reversed.<sup>3</sup>

THE HISTORY OF the past fifty years has, however, not supported these theories and hypotheses. As we will see in the next chapter, East Asian countries—South Korea, China, Taiwan, Japan—showed that high savings did not require high inequality, that one could achieve rapid growth without a substantial increase in inequality. Because the governments did not believe that growth would automatically benefit the poor, and because they believed that greater *equality* would actually enhance growth, governments in the region took active steps to ensure that the rising tide of growth did lift most boats, that wage inequalities were kept in bounds, that some educational opportunity was extended to all. Their policies led to social and political stability, which in turn contributed to an economic environment in which businesses flourished. Tapping new reservoirs of talent provided the energy and human skills that contributed to the dynamism of the region.

Elsewhere, where governments adopted the Washington Consensus policies, the poor have benefited less from growth. In Latin America, growth has not been accompanied by a reduction in inequality, or even a reduction in poverty. In some cases poverty has actually increased, as evidenced by the urban slums that dot the landscape. The IMF talks with pride about the progress Latin America has made in market reforms over the past decade (though somewhat more quietly after the collapse of the star student Argentina in 2001, and the recession and stagnation that have afflicted many of the “reform” countries during the past five years), but has said less about the numbers in poverty.

Clearly, growth alone does not always improve the lives of all a country’s people. Not surprisingly, the phrase “trickle-down” has disappeared from the policy debate. But, in a slightly mutated form, the

idea is still alive. I call the new variant *trickle-down-plus*. It holds that growth is necessary and *almost* sufficient for reducing poverty—implying that the best strategy is simply to focus on growth, while mentioning issues like female education and health. But proponents of trickle-down-plus failed to implement policies that would effectively address either broader concerns of poverty or even specific issues such as the education of women. In practice, the advocates of trickle-down-plus continued with much the same policies as before, with much the same adverse effects. The overly stringent “adjustment policies” in country after country forced cutbacks in education and health: in Thailand, as a result, not only did female prostitution increase but expenditures on AIDS were cut way back; and what had been one of the world’s most successful programs in fighting aids had a major setback.

The irony was that one of the major proponents of trickle-down-plus was the U.S. Treasury under the Clinton administration. Within the administration, in domestic politics, there was a wide spectrum of views, from New Democrats, who wanted to see a more limited role for government, to Old Democrats, who looked for more government intervention. But the central view, reflected in the annual Economic Report of the President (prepared by the Council of Economic Advisers), argued strongly against trickle-down economics—or even trickle-down-plus. Here was the U.S. Treasury pushing policies on other countries that, had they been advocated for the United States, would have been strongly contested *within the administration*, and almost surely defeated. The reason for this seeming inconsistency was simple: The IMF and the World Bank were part of Treasury’s turf, an arena in which, with few exceptions, they were allowed to push their perspectives, just as other departments, within their domains, could push theirs.

## PRIORITIES AND STRATEGIES

It is important not only to look at what the IMF puts on its agenda, but what it leaves off. Stabilization is on the agenda; job creation is off. Taxation, and its adverse effects, are on the agenda; land reform is

off. There is money to bail out banks but not to pay for improved education and health services, let alone to bail out workers who are thrown out of their jobs as a result of the IMF's macroeconomic mismanagement.

Many of the items that were not on the Washington Consensus might bring both higher growth and greater equality. Land reform itself illustrates the choices at stake in many countries. In many developing countries, a few rich people own most of the land. The vast majority of the people work as tenant farmers, keeping only half, or less, of what they produce. This is termed *sharecropping*. The sharecropping system weakens incentives—where they share equally with the landowners, the effects are the same as a 50 percent tax on poor farmers. The IMF rails against high tax rates that are imposed against the rich, pointing out how they destroy incentives, but nary a word is spoken about these hidden taxes. Land reform, done properly, peacefully, and legally, ensuring that workers get not only land but access to credit, and the extension services that teach them about new seeds and planting techniques, could provide an enormous boost to output. But land reform represents a fundamental change in the structure of society, one that those in the elite that populates the finance ministries, those with whom the international financial institutions interact, do not necessarily like. If these institutions were really concerned about growth and poverty alleviation, they would have paid considerable attention to the issue: land reform preceded several of the most successful instances of development, such as those in Korea and Taiwan.

Another neglected item was financial sector regulation. Focusing on the Latin American crisis of the early 1980s, the IMF maintained that crises were caused by imprudent fiscal policies and loose monetary policies. But crises around the world had revealed a third source of instability, inadequate financial sector regulation. Yet the IMF pushed for reducing regulations—until the East Asia crisis forced it to change course. If land reform and financial sector regulation were underemphasized by the IMF and the Washington Consensus, in many places inflation was overemphasized. Of course, in regions like Latin America where inflation had been rampant, it deserved attention. But an *excessive* focus on inflation by the IMF led to high

interest rates and high exchange rates, creating unemployment but not growth. Financial markets may have been pleased with the low inflation numbers, but workers—and those concerned with poverty—were not happy with the low growth and the high unemployment numbers.

Fortunately, poverty reduction has become an increasingly important development priority. We saw earlier that the trickle-down-plus strategies have not worked. Still, it is true that, on average, countries that have grown faster have done a better job of reducing poverty, as China and East Asia amply demonstrate. It is also true that poverty eradication requires resources, resources that can only be obtained with growth. Thus the existence of a correlation between growth and poverty reduction should come as no surprise. But this correlation does not prove that trickle-down strategies (or trickle-down-plus) constitute the best way to attack poverty. On the contrary, the statistics show that some countries have grown without reducing poverty, and some countries have been much more successful in reducing poverty, at any given growth rate, than others. The issue is not whether one is in favor of or against growth. In some ways, the growth/poverty debate seemed pointless. After all, almost everyone believes in growth.

The question has to do with the impact of *particular policies*. Some policies promote growth but have little effect on poverty; some promote growth but actually increase poverty; and some promote growth and reduce poverty at the same time. The last are called pro-poor growth strategies. Sometimes there are policies which are “win-win,” policies like land reform or better access to education for the poor which hold out the promise of enhanced growth and greater equality. But many times there are trade-offs. Sometimes trade liberalization might enhance growth, but at the same time, at least in the short run, there will be increased poverty—especially if it is done rapidly—as some workers are thrown out of a job. And sometimes, there are lose-lose policies, policies for which there is little if any gain in growth but a significant increase in inequality. For many countries, capital market liberalization represents an example. The growth-poverty debate is about development strategies—strategies that look

for policies that reduce poverty as they promote growth, that shun policies that increase poverty with little if any gain in growth, and that, in assessing situations where there are trade-offs, put a heavy weight on the impact on the poor.

Understanding the choices requires understanding the causes and nature of poverty. It is not that the poor are lazy; they often work harder, with longer hours, than those who are far better off. Many are caught in a series of vicious spirals: lack of food leads to ill health, which limits their earning ability, leading to still poorer health. Barely surviving, they cannot send their children to school, and without an education, their children are condemned to a life of poverty. Poverty is passed along from one generation to another. Poor farmers cannot afford to pay the money for the fertilizers and high-yielding seeds that would increase their productivity.

This is but one of many vicious cycles facing the poor. Partha Dasgupta of Cambridge University has emphasized another. In poor countries, like Nepal, the impoverished have no source of energy other than the neighboring forests; but as they strip the forests for the bare necessities of heating and cooking, the soil erodes, and as the environment degrades, they are condemned to a life of ever-increasing poverty.

Along with poverty come feelings of powerlessness. For its 2000 *World Development Report*, the World Bank interviewed thousands of poor in an exercise that was called *The Voices of the Poor*. Several themes—hardly unexpected—emerge. The poor feel that they are voiceless, and that they do not have control over their own destiny. They are buffeted by forces beyond their control.

And the poor feel insecure. Not only is their income uncertain—changes in economic circumstances beyond their control can lead to lower real wages and a loss of jobs, dramatically illustrated by the East Asia crisis—but they face health risks and continual threats of violence, sometimes from other poor people trying against all odds to meet the needs of their family, sometimes from police and others in positions of authority. While those in developed countries fret about the inadequacies of health insurance, those in developing countries must get by without any form of insurance—no unemployment

insurance, no health insurance, no retirement insurance. The only safety net is provided by family and community, which is why it is so important, in the process of development, to do what one can to preserve these bonds.

To ameliorate the insecurity—whether the capriciousness of an exploitative boss or the capriciousness of a market increasingly buffeted by international storms—workers have fought for greater job security. But as hard as workers have fought for “decent jobs,” the IMF has fought for what it euphemistically called “labor market flexibility,” which sounds like little more than making the labor market work better but as applied has been simply a code name for lower wages, and less job protection.

Not all the downsides of the Washington Consensus policies for the poor could have been foreseen, but by now they are clear. We have seen how trade liberalization *accompanied by high interest rates* is an almost certain recipe for job destruction and unemployment creation—at the expense of the poor. Financial market liberalization *unaccompanied by an appropriate regulatory structure* is an almost certain recipe for economic instability—and may well lead to higher, not lower interest rates, making it harder for poor farmers to buy the seeds and fertilizer that can raise them above subsistence. Privatization, *unaccompanied by competition policies and oversight to ensure that monopoly powers are not abused*, can lead to higher, not lower, prices for consumers. Fiscal austerity, *pursued blindly*, in the wrong circumstances, can lead to high unemployment and a shredding of the social contract.

If the IMF underestimated the risks to the poor of its development strategies, it also underestimated the long-term social and political costs of policies that devastated the middle class, enriching a few at the top, and overestimated the benefits of its market fundamentalist policies. The middle classes have traditionally been the group that has pushed for the rule of law, that has pushed for universal public education, that has pushed for the creation of a social safety net. These are essential elements of a healthy economy and the erosion of the middle class has led to a concomitant erosion of support for these important reforms.

At the same time that it underestimated the costs of its programs, the IMF overestimated the benefits. Take the problem of unemployment. To the IMF and others who believe that when markets function normally demand must equal supply, unemployment is a symptom of an interference in the free workings of the market. Wages are too high (for instance, because of union power). The obvious remedy to unemployment was to lower wages; lower wages will increase the demand for labor, bringing more people onto employment rolls. While modern economic theory (in particular, theories based on asymmetric information and incomplete contracts) has explained why even with highly competitive markets, including labor markets, unemployment can persist—so the argument that says that unemployment must be due to unions or government minimum wages is simply wrong—there is another criticism of the strategy of lowering wages. Lower wages *might* lead some firms to hire a few more workers; but the number of newly hired workers may be relatively few, and the misery caused by the lower wages on all the other workers might be very grave. Employers and owners of capital might be quite happy, as they see their profits soar. These will endorse the IMF/market fundamentalist model with its policy prescriptions with enthusiasm! Asking people in developing countries to pay for schools is another example of this narrow worldview. Those who said charges should be imposed argued that there would be little effect on enrollment and that the government needed the revenue badly. The irony here was that the simplistic models miscalculated the impact on enrollment of eliminating school fees; by failing to take into account the *systemic* effects of policy, not only did they fail to take into account the broader impacts on society, they even failed in the more narrow attempts to estimate accurately the consequences for school enrollment.

If the IMF had an overly optimistic view of the markets, it had an overly pessimistic view of government; if government was not the root of all evil, it certainly was more part of the problem than the solution. But the lack of concern about the poor was not just a matter of views of markets and government, views that said that markets would take care of everything and government would only make

matters worse; it was also a matter of values—how concerned we should be about the poor and who should bear what risks.

THE RESULTS OF the policies enforced by Washington Consensus have not been encouraging: for most countries embracing its tenets development has been slow, and where growth has occurred, the benefits have not been shared equally; crises have been mismanaged; the transition from communism to a market economy (as we shall see) has been a disappointment. Inside the developing world, the questions run deep. Those who followed the prescriptions, endured the austerity, are asking: When do we see the fruits? In much of Latin America, after a short burst of growth in the early 1990s, stagnation and recession have set in. The growth was not sustained—some might say not sustainable. Indeed, at this juncture, the growth record of the so-called post-reform era looks no better, and in some countries much worse, than in the pre-reform import substitution period (when countries used protectionist policies to help domestic industries compete against imports) of the 1950s and 1960s. The average annual growth rate in the region in the 1990s, at 2.9 percent after the reforms, was just more than half that in the 1960s at 5.4 percent. In retrospect, the growth strategies of the 1950s and 1960s were not sustained (critics would say they were unsustainable); but the slight upsurge in growth in the early 1990s also did not last (these also, critics would say, were unsustainable). Indeed, critics of the Washington Consensus point out that the burst of growth in the early nineties was little more than a catch-up, not even making up for the lost decade of the eighties, the decade after the last major crisis, during which growth stagnated. Throughout the region people are asking, has reform failed, or has globalization failed? The distinction is perhaps artificial—globalization was at the center of the reforms. Even in the countries that have managed some growth, such as Mexico, the benefits have accrued largely to the upper 30 percent, and have been even more concentrated in the top 10 percent. Those at the bottom have gained little; many are even worse off.

The Washington consensus reforms have exposed countries to greater risk, and the risks have been borne disproportionately by

those least able to cope with them. Just as in many countries the pacing and sequencing of reforms has resulted in job destruction outmatching job creation, so too has the exposure to risk outmatched the ability to create institutions for coping with risk, including effective safety nets.

There were, of course, important messages in the Washington Consensus, including lessons about fiscal and monetary prudence, lessons which were well understood by the countries that succeeded; but most did not have to learn them from the IMF.

Sometimes the IMF and the World Bank have unfairly taken the blame for the messages they deliver—no one likes to be told that they have to live within their means. But the criticism of the international economic institutions goes deeper: while there was much that was good on their development agenda, even reforms that are desirable in the long run have to be implemented carefully. It's now widely accepted that pacing and sequencing cannot be ignored. But even more important, there is more to development than these lessons suggest. There *are* alternative strategies—strategies that differ not only in emphases but even in policies; strategies, for instance, which include land reform but do not include capital market liberalization, which provide for competition policies before privatization, which ensure that job creation accompanies trade liberalization.

These alternatives made use of markets, but recognized that there was an important role for government as well. They recognized the importance of reform, but that reforms needed to be paced and sequenced. They saw change not just as a matter of economics, but as part of a broader evolution of society. They recognized that for long-term success, there had to be broad support of the reforms, and if there was to be broad support, the benefits had to be broadly distributed.

We have already called attention to some of these successes: the limited successes in Africa, for instance, in Uganda, Ethiopia, and Botswana; and the broader successes in East Asia, including China. In chapter 5, we shall take a closer look at some of the successes in transition, such as Poland. The successes show that development and transition are possible; the successes in development are well beyond that

which almost anyone imagined a half century ago. The fact that so many of the success cases followed strategies that were markedly different from those of the Washington Consensus is telling.

Each time and each country is different. Would other countries have met the same success if they had followed East Asia's strategy? Would the strategies which worked a quarter of a century ago work in today's global economy? Economists can disagree about the answers to these questions. But countries need to consider the alternatives and, through democratic political processes, make these choices for themselves. It should be—and it should have been—the task of the international economic institutions to provide the countries the wherewithal to make these *informed* choices on their own, with an understanding of the consequences and risks of each. The essence of freedom is the right to make a choice—and to accept the responsibility that comes with it.