Structural Adjustment and Crises – Which Way Now?

Anis Chowdhury*
University of Western Sydney, Australia
Email: a.chowdhury@uws.edu.au

Abstract: This paper provides a critical evaluation of an orthodox policy framework that came to be known as the “Washington consensus”. The paper traces its ideological and political genesis as it became embodied in World Bank and International Monetary Fund aid conditionalities. Despite following reforms prescribed by the donors as part of aid conditionalities, many developing countries failed to achieve 1960s per capita growth rates. The Washington consensus prescriptions are too restrictive. They not only limited developing countries’ fiscal and policy space to deal with shocks and support structural change, but also increased their vulnerability to crises. The paper calls for governments to play a stronger role in dealing with developmental issues.

Keywords: growth, inequality, poverty, structural adjustment programme

JEL classifications: E6, F32, O11, O24

1. Introduction

In the wake of the current global financial and economic crisis, the orthodoxy in economic policies has come under heavy criticisms. Similar doubts about “free market” policies – characterized by privatization, deregulation and liberalization – were also raised after the Asian financial crisis in 1997-98, but were largely ignored as the crisis did not affect advanced countries in the West. However, this time it is different as the crisis originated in the most advanced country, the US, and quickly engulfed major European countries, including the UK, Germany and France. Thus, many leading economists, and even those policy makers who once promoted market-friendly policies and the idea of a small government, are expressing their doubts on the efficacy of self-regulating markets, and asking for a greater role of the government in regulating the market and stabilizing the economy.¹

This paper aims at providing a critical evaluation of orthodox policies promoted by international financial institutions in developing countries through their loan conditionalities. In particular, it will survey extant literature on impacts of the structural adjustment programme (SAP) and outline a
broad framework for the way forward. It begins with a brief account of some historical context for the ascendancy of the orthodoxy commonly known as the “Washington consensus”, also referred to as neo-classical orthodoxy.\textsuperscript{2}

2. Ascendancy of Neo-classical Orthodoxy

The 1970s was a difficult period for most developing countries, especially in South Asia and Africa, with the breakdown of the Bretton Woods system of fixed exchange rates and commodity and oil price shocks.\textsuperscript{3} This was reflected in the declines in their GDP growth rates (Table 1). The Latin American countries however could maintain their growth rates, mainly by borrowing recycled petro-dollars\textsuperscript{4} from the commercial banks in the US. They faced debt crisis in the 1980s when interest rates rose sharply due to anti-inflationary policy in the US and the UK. Only a small band of economies in East Asia – Singapore, Republic of Korea (South), Taiwan and Hong Kong – could withstand the difficult international economic environment and grew rapidly. They were followed by Malaysia, Thailand and Indonesia in Southeast Asia.

The contrasting experiences of debt-ridden Latin America in the 1980s and the historically unprecedented growth of East Asia over the same period provided the empirical context within which the Washington consensus evolved. It was claimed that the failure of key Latin American economies was due to high inflation – caused by unsustainable fiscal deficits and money creation – and the inefficient, protectionist policy of import substituting industrialization. The contrasting picture in East Asia was of low inflation, fiscal prudence, outward-oriented industrialization and hence robust growth, and sustained declines in poverty.

Thus, the developments in the 1970s and 1980s acted as a catalyst for an ideological shift in the conduct of macroeconomic policy and the role of the state. Debtor countries had no choice but to seek support from the World Bank and the International Monetary Fund (IMF). By the beginning of 1986, 12 of the 15 debtors designated by the then US Secretary of the Treasury, James

\begin{table}[h]
\centering
\caption{Decadal GDP Growth Performance of Developing Regions}
\begin{tabular}{lrrrr}
\hline
\hline
East Asia \textit{minus} China & 6.4 & 7.6 & 7.2 & 5.7 \\
South Asia & 4.2 & 3.0 & 5.8 & 5.3 \\
Latin America & 5.5 & 6.0 & 1.1 & 3.3 \\
Africa & 5.2 & 3.6 & 1.7 & 2.3 \\
\hline
\end{tabular}
\end{table}

Source: Bosworth and Collins (2003): Table 1.
Baker, as top-priority debtors – including Brazil, Mexico, Argentina, and the Philippines – had agreed to SAPs. From 3 per cent of total World Bank lending in 1981, structural adjustment credits rose to 19 per cent in 1986. Five years later, the figure was 25 per cent. By the end of 1992, about 267 SALs (Structural Adjustment Loans) had been approved.

The orthodox policy framework of SAP was vigorously pursued in the 1990s, despite the fact that most Latin American and African countries under SAPs failed to recover, and their average growth rate did not reach 1960-70 or 1970-80 levels (Table 1). It is quite often forgotten that the pre-1970s was the golden age for many developing countries. Evaluating the growth experience of developing countries, the first World Bank (1978: 3-5) concluded:

The developing countries have grown impressively over the past twenty-five years: income per person has increased by almost 3 per cent a year, with the annual growth rate accelerating from about 2 per cent in the 1950s to 3.4 per cent in the 1960s … Moreover, it compared extremely favorably with growth rates achieved by the now developed countries over the period of their industrialization: income per person grew less than 2 per cent a year in most of the industrialized nations of the West over the 100 years of industrialization.

The progress made by developing countries is more impressive considering that their populations have been growing at historically unprecedented rates. During 1950-75, their total population increased at 2.4 per cent a year. This is substantially faster than the population growth rates – typically about 1 per cent a year – that the now developed countries had to contend with during the period of their industrialization.

The above is quite a significant observation, given the fact that developing countries did not have the same recourse as the now developed countries had at the dawn of their industrialization. The leading developed countries had colonies to draw cheap raw-materials from and to sell their finished products to. They also could solve their problem of population growth by large scale migration to the “new lands” and by decimating the indigenous people.

The acceptance of SAP’s conditionalities meant the retreat of the Keynesian compact whereby governments played a significant role in economic stabilization and long-term development. The hallmark of this shift is a smaller government confined only in the realm of property rights, law and order and maintenance of macroeconomic stability, defined as low inflation and balance or surplus government budget. South Asia’s performance appears respectable, mainly due to growth acceleration in India. However, despite the general belief that relates its growth acceleration to the liberalization of 1991, India’s take-off actually began a decade earlier, during the early 1980s and under heavy protectionism (Rodrik, 2004). The stellar performance of East Asia cannot be attributed solely to the kinds of policies of the Washington
consensus. Instead, their policy framework can best be described as a mix of market orientation-cum-heterodoxy. Of the four East Asian newly industrialized economies, Hong Kong is the only one that approximates a free-market ideal. Like Japan before them, South Korea and Taiwan have used extensive trade protection and industrial policy. Singapore had free trade, but also extensive industrial policies.\(^5\)

The shift in economic policy paradigm coincided with the ascendancy of market-fundamentalist conservative politics with the election of Margaret Thatcher in the UK and Ronald Reagan in the US. Their conservative politics’ distrust of governments favoured rule-based policies that constrained discretionary government spending, including the “Gramm-Rudman-Hollings deficit control legislation” in the US and the EU’s Stability and Growth Pact. Furthermore, the dismantling of Soviet Russia and the embrace by East Europe in general of the ethos of a market economy reinforced the ideological supremacy of neoclassical economics over its dirigiste counterparts.\(^6\)

It was in such an atmosphere that “… (t)he so-called “Washington consensus” of US economic officials, the International Monetary Fund (IMF) and the World bank was formed …” (Stiglitz, 1998: 4). The Washington consensus promoted the idea of sound money and fiscal prudence as the pillars of macroeconomic policy, and argued the case for privatization and limited governments, extolling the virtues of a globalization epitomised by free trade and unrestricted capital movements. Achievement of low inflation and balanced budget (and later opening of capital account) became the core of conditionality for the IMF’s rescue packages while the World Bank pursued structural adjustment (privatization, trade liberalization and financial deregulation) through its loan agreements.

The next section provides a brief overview of growth performance, poverty and inequality in the countries which can be categorized as highly adjusting under SAPs. Then the paper attempts to relate this record to the SAP’s policy framework – both macro (inflation targeting) and micro (privatization, liberalization and labour and financial deregulation).

3. Macroeconomic Performance

Table 2 presents performance of 20 countries which can be categorized as highly or intensively adjusting. Obviously, the 1980s was a lost decade for many developing countries. Despite following structural adjustment reforms in the 1980s and 1990s, per capita income growth in the 1990s did not recover to the 1960-80s level in most countries. Poverty and inequality also rose in most of the adjusting countries. If growth was held back by the high inflation generated by macroeconomic populism and government interventions in trade, industry and finance and labour market inflexibility, as argued by
Table 2: Performance of Highly Adjusting Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Annual per capita GDP growth (%)</th>
<th>Poverty (million below $1-a-day)</th>
<th>Inequality (Gini)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>2.2 -1.7 3.0 2.5</td>
<td>0*</td>
<td>1.744*</td>
</tr>
<tr>
<td>Bolivia</td>
<td>2.1 -2.6 1.7 1.2</td>
<td>1.109</td>
<td>1.801</td>
</tr>
<tr>
<td>Chile</td>
<td>1.6 1.5 5.3 2.9</td>
<td>0.711</td>
<td>0.116</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>2.5 -3.3 0.5 -2.4</td>
<td>0.583</td>
<td>3.789</td>
</tr>
<tr>
<td>Ghana</td>
<td>-1.0 -0.4 1.7 2.9</td>
<td>5.735</td>
<td>6.759</td>
</tr>
<tr>
<td>Jamaica</td>
<td>0.6 0.3 -0.7 1.1</td>
<td>0.121</td>
<td>0.006</td>
</tr>
<tr>
<td>Kenya</td>
<td>2.7 0.4 -0.3 1.1</td>
<td>6.497</td>
<td>7.02</td>
</tr>
<tr>
<td>Malawi</td>
<td>2.9 -0.5 1.2 0.1</td>
<td>5.449</td>
<td>9.772</td>
</tr>
<tr>
<td>Mauritania</td>
<td>1.6 -1.0 1.4 2.1</td>
<td>0.599</td>
<td>0.396</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.6 -1.0 1.5 0.9</td>
<td>6.801</td>
<td>1.773</td>
</tr>
<tr>
<td>Morocco</td>
<td>2.5 1.4 0.4 3.6</td>
<td>2.056</td>
<td>0.892</td>
</tr>
<tr>
<td>Pakistan</td>
<td>2.8 3.2 1.2 3.1</td>
<td>62.038</td>
<td>35.188</td>
</tr>
<tr>
<td>Philippines</td>
<td>2.8 -1.5 1.0 2.8</td>
<td>15.488</td>
<td>19.130</td>
</tr>
<tr>
<td>Senegal</td>
<td>-0.3 0.1 1.0 1.8</td>
<td>4.123</td>
<td>3.940</td>
</tr>
<tr>
<td>Togo</td>
<td>3.0 -1.9 -0.2 0.6</td>
<td>1.014</td>
<td>2.414</td>
</tr>
<tr>
<td>Tunisia</td>
<td>4.8 1.3 3.1 3.2</td>
<td>0.637</td>
<td>0.101</td>
</tr>
<tr>
<td>Turkey</td>
<td>3.6 2.7 2.2 4.0</td>
<td>2.049</td>
<td>1.960</td>
</tr>
<tr>
<td>Uganda</td>
<td>-0.7 0.3 4.1 2.4</td>
<td>8.644</td>
<td>14.918</td>
</tr>
<tr>
<td>Venezuela</td>
<td>2.6 -1.7 -0.5 1.4</td>
<td>0.970</td>
<td>2.477</td>
</tr>
<tr>
<td>Zambia</td>
<td>0.2 -2.9 -2.1 2.7</td>
<td>3.289</td>
<td>7.38</td>
</tr>
</tbody>
</table>

Note: * Argentina-urban.
the advocates of Washington consensus, the elimination of these obstacles should have unleashed the private sector in full force and as a result economic growth should have accelerated. However that did not happen. “Economic growth rates in those countries that adopted the ‘stabilize, liberalize, and privatize’ agenda has turned out to be low not only in absolute terms, but also relative to other countries that were reluctant reformers and relative to the reforming countries’ own historical experience” (Rodrik, 2004: 1-2). One can, of course, point to special circumstances, such as civil war and health crises in Africa, in attempting to explain the disappointments. But how can one explain the disappointing Latin American story? After pursuing radical reforms mostly under the IMF/World Bank structural adjustment programmes, their performance does not even begin to match the performance under import substitution (Table 1). The story of the transition economies of Eastern Europe has been even worse than Latin America, as most of them experienced negative growth rates, following the Washington consensus inspired reforms and macroeconomic policy-mix.

The growth acceleration since 2000 in some of the countries has been mainly due to the commodity price boom (as in Argentina and Ghana) or due to strong performance of domestic agriculture and the increased inflow of remittances (as in Pakistan and Jamaica). Chile’s relatively impressive performance can be attributed to some unorthodox policy measures that came to be known as heterodox. For example, even when it was consolidating its fiscal situation, its social expenditure rose. Public expenditure on health increased from 1.1 per cent of GDP in 1985 to 2.6 per cent in 1992. Likewise, public expenditure on housing increased from 0.7 per cent GDP in 1985 to 1.3 per cent in 1992, while social security and education expenditure remained constant at around 6.5 per cent and 3.5 per cent of GDP, respectively (Riveros, 1995). It also promoted exports through a set of fiscal incentives and a competitive real exchange rate. This was possible due to Chile’s tax on short-term capital flows in defiance of the orthodox policy prescription.

One of the early evaluations of the SAPs in Latin America noted “the adjustment process has been quite costly, generating drastic declines in real income and important increases in unemployment. In fact, … in a number of Latin American countries in 1986 real per capita GDP was below its 1970 level!” (Edwards, 1988: 2). By comparing the adjusting and non-adjusting countries during 1980-1989, an International Labour Organisation (ILO) study (Khan, 1993: 67) concluded:

the claim that, on average, official adjustment programmes under the auspices of the World Bank and the IMF have performed well, not only by the conventional standards of promoting adjustment and preserving growth but also in terms of protecting the poor, is very hard to substantiate convincingly.
Just before retiring, the then President of the World Bank, James Wolfensohn made a sombre assessment of two decades of experiment with conservative macroeconomic policies and the SAP: “if we take a closer look, we see something else – something alarming. In developing countries, excluding China, at least 100 million more people are living in poverty today than a decade ago. And the gap between rich and poor yawns wider” (Wolfensohn, 2000). Interestingly, China, which according to Wolfensohn, contributed most to the reduction of global poverty in recent decades, did not participate in this experiment. During 1985-1997, the average rate of inflation in China was around 11 per cent and domestic credit grew at an average rate close to 25 per cent (average money supply growth was over 28 per cent). The average real lending rate was less than 1 per cent. It also followed a policy of an undervalued real exchange rate to support exports and to discourage imports. This mix of pro-growth monetary and exchange rate policies produced very rapid GDP growth of about 10 per cent for almost three decades which has helped reduce poverty despite growing inequality. Furthermore, its restricted capital account shielded it from the 1997-1998 East Asian financial crisis.

What went wrong? What role did macroeconomic policy mix and microeconomic reforms of SAPs play in the disappointing growth performance? We endeavour to examine this issue next.

4. The Role of Macroeconomic Policy Mix

The centrepiece of the IMF’s macroeconomic policy advice has been inflation targeting and stabilization of public and external debt. Thus, common features of the policy-mix have been an inflation target of around 3 per cent and a primary budget surplus or at least a balanced primary budget. This is despite its own internal research (Khan and Senhadji, 2000) showing a threshold inflation rate of 11-12 per cent beyond which inflation might have negative consequences for economic growth. Likewise the IMF’s advice on fiscal consolidation or budget surplus has been contrary to its internal survey paper (Hemming et al., 2002). For example, it reported research findings involving 101 developing countries using the World Bank data, covering 1960-95. The research found evidence that “large fiscal consolidations result in lower saving” (Hemming et al., 2002: 35). The study also concluded that the fiscal multipliers are positive, especially when there is an accompanying monetary expansion with limited inflationary consequences. The most revealing finding of the IMF survey has been, “Increased government spending does not substitute for private spending, it enhances the productivity of labour and capital”.

It would be pertinent to quote from the World Bank’s Lessons from the 1990s (World Bank, 2005: 95), where it notes:
Macroeconomic policies improved in a majority of developing countries in the 1990s, but the expected growth benefits failed to materialise, at least to the extent that many observers had forecast. In addition, a series of financial crises severely depressed growth and worsened poverty... [B]oth slow growth and multiple crises were symptoms of deficiencies in the design and execution of the pro-growth reform strategies that were adopted in the 1990s with macroeconomic stability as their centerpiece.

A number of growth-retarding factors can be identified that resulted from the Washington consensus macroeconomic policy mix. Most important among them are: (a) declines in public investment and (b) volatility of output growth.

**Trends in Public Investment**

As can be seen from Figure 1, there have been precipitous declines in public investment since the early 1980s in both Latin America and Sub Saharan Africa, the two regions which experienced growth slowdowns. The declines in public investment were a direct result of excessive focus on attaining budget sustainability with little regard for the composition of government expenditure. In most cases, the budget was brought to a balance or surplus by cutting public investment instead of by raising taxes, as cutting non-discretionary expenditure such as public sector salary or subsidies was politically more difficult. Developing countries generally face significant problems with regard to tax administration. Other than advising to improve the efficiency of tax administration, the IMF/World Bank programmes showed aversion to direct taxes due to fundamental ideological inclination towards a smaller government. The removal of trade-related taxes and various tax incentives to allure foreign investors seriously eroded the fiscal space for many developing countries, as the declines in revenues were not matched by expected increases in indirect consumption based taxes, such as value added tax (VAT). Thus, the developing countries were faced with a difficult task of improving their fiscal balance while their revenues were falling. The situation was made worse as the declines in public investment were not matched by increases in private investment as hoped.

Reviewing the situation, an IMF report prepared in consultation with the World Bank and the Inter-American Development Bank (IMF, 2004: 3) notes:

The share of public investment in GDP, and especially the share of infrastructure investment, has declined during the last three decades in a number of countries, particularly in Latin America. Since the private sector has not increased infrastructure investment as hoped for, significant infrastructure gaps have emerged in several countries. These gaps may adversely affect the growth potential of the affected countries and limit targeted improvements in social indicators.
Figure 1: Public Investment in Latin America and Africa

**Latin America**

<table>
<thead>
<tr>
<th>Year</th>
<th>Argentina</th>
<th>Mexico</th>
<th>Chile</th>
<th>LA Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Sub Saharan Africa**

<table>
<thead>
<tr>
<th>Year</th>
<th>Malawi</th>
<th>Kenya</th>
<th>Tunisia</th>
<th>Mauritius</th>
<th>Cote d'Ivoire</th>
<th>SAA Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The report also acknowledges that fiscal analysis and policy which focuses on the overall fiscal balance and gross public debt, may have unduly constrained the ability of countries to take advantage of increased opportunities to finance high-quality infrastructure projects. Research at the Inter-American Development Bank finds that public investment in infrastructure in the period 1987-2001 was negatively affected by IMF adjustment loans. Interestingly, it also finds that debt increases were associated with higher public infrastructure investment, an effect that was robust to the inclusion of many other fiscal and macroeconomic variables (Lora, 2007).

The agricultural sector suffered the most from declines in public investment, as public spending in agriculture has plummeted across developing countries in recent years. In Africa, public spending in agriculture fell from 6.4 per cent of total public spending in 1980 to 5 per cent in 2004. In Asia it fell from 14.8 to 7.4 per cent and Latin America saw a decline of 66 per cent from 8 to 2.7 per cent of total public spending in agriculture (see Akroyd and Smith, 2007; ILO, 2008).

In many countries the declines in public investment, especially in infrastructure, were not matched by a rise in private investment. Instead, in many instances, private investment also fell. For example in Tanzania as observed by the World Bank (2001: xvi):

Private investment, currently at 14 per cent of GDP, has not responded quickly to the reform measures undertaken since the late 1980s and has not compensated for the decline of public investment. …… The weak response of private investment to economic reforms may also be related to the decline in complementary public investment (in the form of the provision of basic infrastructure and human and institutional capital), that is necessary for raising the overall absorptive capacity of the economy.

This is not surprising in light of the findings of Aschauer (1989a, 1989b, 1993), Buiter (1977) and Munnell (1992) that public investment complements private investment by enhancing the productivity of existing resources. High quality infrastructural base and utility services can, in fact, lower the cost of business and hence crowd-in private investment. Thus, it would be pertinent at this juncture to refer to the observation in the 2006 interim report of the IMF and World Bank’s Development Committee. The report notes that debts and deficits are useful indicators for “… controlling the growth of government liabilities, but (they) offer little indication of longer term effects on government assets or on economic growth. Conceptually, the long-term impact is better captured by examining the impact of fiscal policy on government net worth.” The report argues that “… there is clearly a need for fiscal policy to incorporate, as best as possible, the likely impact of the level and composition of expenditure and taxation on long-term growth …” (Development Committee, 2006: i).
The above observation is clearly supported by the recent experience of a number of African countries. For example, since 2000, the economy of Ghana grew at an average rate of 5.24 per cent, making it one of the fastest growing economies in Sub Saharan Africa. The Ghanaian economy is projected to achieve a record growth rate of 9.94 per cent in 2011. During the previous decade, Ghana’s growth rate hovered around 4 per cent. A number of factors, including expansionary fiscal policies to support public sector investments in fixed capital formation and large public sector investments in agriculture, explain the robust growth performance of the Ghanaian economy. The gross fixed capital formation in Ghana, for example, grew at an annual rate of 14.2 per cent between 2000 and 2008, peaking at 44.5 per cent in 2005. The growth rate of fixed capital formation in low income countries averaged 9.7 per cent during the same period. A significant portion of investments in fixed capitals came from the public sector. Ghana’s robust economic performance in recent years shows the critical role of public investment, especially in agriculture and infrastructure, in driving economic growth.

**Growth Volatility**

Figure 2 presents coefficients of variation of annual growth rates by decades for regional economies. As can be seen, both Latin American and African economies experienced increased volatile growth in the 1980s and 1990s. This is markedly different from the experience of the Southeast Asian economies, which grew rapidly in the 1980s and 1990s (until hit by the financial crisis in 1997-98).

There is a growing body of empirical research that finds a robust, negative cross-country relationship between growth and volatility. They also find a significant negative correlation between growth and medium-term business cycle fluctuations (see for example, Ramey and Ramey, 1995; Kroft and Lloyd-Ellis, 2002 and Aysan, 2006). One of the causes of increased output growth volatility has been pro-cyclical macroeconomic policy aimed at price level stability and fiscal sustainability. It is well known that when macroeconomic policies target price stability, it causes excessive fluctuations in output as the burden of adjustment falls on only one variable (output). Most developing countries are prone to supply shocks due to their high dependence on agriculture and imported energy. Output fluctuations will be greater when macroeconomic policies remain focused on price stability in the face of such shocks (Chowdhury, 2006).

The focus on price stability is argued on the belief that it would create favourable conditions for private investment, capital inflows and exports, which should eventually spur growth. Thus, the decline in output and hence employment is expected to be short-lived. It is this belief that was behind
the IMF’s advice to Indonesia to raise interest rates and restrain government expenditure at the height of the crisis in 1997-98. Indonesia remained faithful to this advice even when it left the IMF programme, and followed contractionary monetary policy to contain inflation coming from recent hikes in food and energy prices in the international markets. The same was observed in many other developing countries.

Many of the developing countries also do not have the “policy space” to conduct counter-cyclical macroeconomic policies in response to shocks. This stems from two sources. First, the requirement to keep budget in balance or fiscal sustainability forces them to cut expenditure during downturns as revenue falls. Second, countries with an open capital account cannot pursue...
an autonomous monetary policy, control the exchange rate and maintain an open capital account. While all three are potentially feasible, only two are possible at any point in time.

Additionally, most developing countries do not have resources or “fiscal space” to undertake large scale counter-cyclical measures. As noted earlier, there has been significant reduction in trade-related revenues following trade liberalization in many developing countries. Various fiscal incentives and tax cuts aimed at alluring private investment have also cut into their fiscal space.

In sum, declines in public investment and excessive growth volatility, which had adverse impacts on overall growth performance of many developing countries, especially in Latin America, Africa and transition economies of East Europe, were results of the Washington consensus inspired macro-economic policy mixes and policy reforms. They have not only compressed both policy and fiscal space for conducting counter cyclical policy measures to smoothen output volatility, but in fact, contributed to excessive volatility, and hence retarded growth. The stability of nominal macroeconomic variables, such as inflation and fiscal balance, failed to generate much hoped for private sector investment.

**Impact on Poverty and Inequality**

The disappointing growth performance obviously slowed poverty reduction. Conservative macroeconomic policies of the Washington consensus also have contributed to the rise in inequality, and hence further impaired poverty reduction efforts.

Conservative monetary policy aimed at lower inflation is claimed to be good for the poor. Since wage adjustments typically fall behind price rises, inflation reduces the real wage. Since most of the poor are wages earners, the share of the income of the poor in the national income declines vis-à-vis that of profit earners. If there are any savings, the poor mostly hold it in money. Inflation reduces the real value of money holdings. If inflation is unanticipated, the poor will be harmed even more disproportionately as they have a weaker bargaining power and are generally unable to hedge against inflation.

However, one can present a number of counter arguments. First, if the real wage declines due to inflation then employment should rise. Therefore, the employment effect of inflation can outweigh the real wage effect on poverty. This is likely to be the case, as the inflation elasticity (real wage) of poverty is found to be significantly less than the output (employment) elasticity of poverty. For example, one IMF study by Ghura et al. (2002) using pooled data from a cross-section of 85 countries has found the inflation elasticity of the income of the poor to be 0.03 as opposed to the output (employment) elasticity of 0.94.
Furthermore, as explained above, the conservative macroeconomic policy framework increased the volatility of output and employment. Output variability has a negative impact on both poverty and inequality (see Romer and Romer, 1999, for cross-country evidence). Empirical studies find that the bottom two income quintiles suffer disproportionately from volatile swings in income (Laursen and Mahajan, 2005; Breen and Garcia-Penalosa, 2005). This happens as poor unskilled workers are first to lose jobs and it takes much longer for the job market to recover than output. They do not have diversified sources of income, and are less mobile between sectors and areas. Reductions in public expenditure on health, education and other social programmes in order to maintain fiscal balance, especially during economic downturns also disproportionately affect the poor. The inability of the poor to cope with negative shocks can result in a loss of human capital. Poor families are found to remove their children from school when family income suddenly falls. Income instability also impacts negatively on their nutritional status, as necessary cutbacks of food are made.

5. The Role of Microeconomic Reforms

The main components of the microeconomic reform agenda of SAPs are: trade liberalization, financial sector deregulation, privatization, and labour market flexibility. We examine each of these in this section.

Trade Liberalization

As noted earlier, the high performing Asian countries have provided the main reference point for the rise of the neo-liberal agenda and the push for microeconomic reforms. The economies of Japan, the Republic of Korea, the Taiwan Province of China, Singapore, Hong Kong, Malaysia, Indonesia and Thailand have recorded some of the highest GDP growth rates in the world – averaging approximately 6 per cent per annum from 1965 until 1990 – and also some of the highest rates of export growth, averaging more than 10 per cent per annum. Thus, quite often, their spectacular economic success has been linked to exports or outward orientation, notwithstanding the 1997-98 economic crisis in East Asia. However, this success has hardly been based on free trade or laissez-faire policies. For example, Japan and South Korea have been very interventionist, pursuing export promotion on the basis of import substitution (see Amsden, 1989; Chowdhury and Islam, 1993). According to the World Bank (1993), what is important for growth is not whether the free market rules or the government intervenes, but getting the fundamentals for growth right, including government control of financial markets to lower the cost of capital, policies to promote exports and protect domestic industry.
A later study by the World Bank (2002) of both economic growth and equality in developing countries from 1977 to 1997 found that the more globalized (as measured by trade relative to GDP) countries enjoyed faster economic growth, but did not experience significant changes in income inequality. However, as Rodrik (2001) points out, “buried in the pages of the report is also a startling admission: the countries that integrated into the world economy most rapidly were not necessarily those that adopted the most pro-trade policies”. According to Rodrik (2001: 1):

For the first time, the Bank is acknowledging that trade liberalization may not be an effective instrument, not just for stimulating growth, but even for integration in world markets. It is admitting, in an underhanded manner, that its repeated assertions about the benefits of globalization do not carry direct implications for how trade policy should be conducted in developing countries. In other words, the Bank is beginning to face up to a reality that is obvious to anyone who looks at the empirical record with an open mind: Rapid integration into global markets is a consequence, not of trade liberalization or adherence to WTO strictures per se, but of successful growth strategies with often highly idiosyncratic characteristics.13

Thus, both World Bank studies (1993, 2002) recognise that high growth was not necessarily due to trade liberalization or export-orientation. What matters most is the successful growth strategies based on countries’ own historical and socio-economic circumstances. The large body of empirical work, mainly comprising cross-country growth regressions that claimed a positive causal relationship between trade liberalization and growth suffer from serious methodological flaws, which are widely documented. After careful evaluation of the major cross-country empirical work, Hallak and Levinsohn (2004: 3) note, “When we ask whether the results are informative for the practice of trade policy, we conclude that the answer is no”.14 A later study which addresses some flaws of earlier studies finds likely positive links between trade and economic growth, but doubts the ability of developing countries to gain productivity growth through trade liberalization. To do so, it may well be necessary to invest enough in appropriate education and training facilities (see Andersen and Babula, 2008). However, by removing an important source of revenue through tariff reductions – not compensated for by other sources of revenue – trade liberalization further restricts governments’ fiscal space for such productivity enhancing investment. There is a large body of literature that attributes the rise in inequality to globalisation and the structural adjustment programmes (see for example, Jomo and Baudot, 2007).

It would be pertinent to end the discussion on trade liberalisation by quoting the World Bank (2005: 133) itself:

There are many possible ways to open an economy. The challenge for policy makers is to identify which best suits their country’s political economy,
institutional constraints, and initial conditions. As these vary from country to country, it is not surprising that there is a striking heterogeneity in country experiences regarding the timing and pace of reforms.

**Financial Liberalization**

The arguments for financial liberalization also rest on the supposed link between financial development and economic growth. There are two dimensions of financial liberalization: (a) domestic financial sector deregulation and (b) opening of the capital account.

It is claimed that one of the reasons for poor growth performance of many developing countries was administratively-determined, very low (in some cases negative) real interest rates which discourage savings and encourage inefficient use of capital. Thus, financial liberalization – primarily involving deregulation of interest rates – would lead to higher levels of savings. Liberalization would also channel funds to finance more productive projects. Therefore, an increase in real interest rates following liberalization should encourage saving and expand the supply of credit available to domestic investors, thereby enabling the economy to grow more quickly. This growth-promoting effect of domestic financial sector deregulation should be enhanced by opening the capital account of the balance of payments. This would allow more foreign capital to flow into the country attracted by higher domestic real interest rates.

While increases in real interest rates have often been the outcome of liberalization episodes, their impact on domestic saving and investment has been mixed (Reinhart and Tokatlidis, 2005; Galbis, 1993). McKinnon and Pill (1999: 20), who himself provided the theoretical rationale for financial liberalization, has acknowledged that financial liberalization may lead to episodes of “overborrowing”. This overborrowing syndrome may be magnified when domestic liberalisation is coupled with capital account liberalization. Additionally, the vulnerability of a country to exchange rate fluctuations increases when the rising levels of debt are denominated in a foreign currency. Banking crises are often preceded by financial liberalization – indeed, liberalization often leads to crisis (Kaminsky and Reinhart, 1999). A World Bank study (Demirgüç-Kunt and Detragiache, 1999) of 53 countries for the period 1980-1995 found that banking crises were more likely to occur in liberalized financial systems. One reason why China, India and Vietnam remained relatively unaffected by the contagion from the Asian financial crisis was their tight controls on short-term capital flows.

The financial crises between 1994 and 2002 pushed approximately 40 million to 60 million people into poverty, and possibly as many as almost 100 million, out of a total of 800 million people (Cline, 2002). By far the largest
impact occurred in Indonesia, with this country’s large income decline and large base of population in poverty.

Thus, by the end of the last decade, financial liberalization had become the single most controversial policy prescription. After the currency crises in East Asia and Russia, the debate shifted from when to liberalize the capital account to whether it should be liberalized at all. Rodrik (1998), for example, argues that there is no evidence in the data that countries without capital controls have grown faster, invested more, or experienced lower inflation.

Significantly, Aizenman (2005) found no evidence of a “growth bonus” associated with increasing the foreign financing share. On the other hand, the evidence suggests just the opposite – throughout the 1990s, countries and regions with higher self-financing ratios grew significantly faster than countries and regions with lower self-financing ratios. The positive and economically significant effect of self-financing ratios on real per capita GDP growth was confirmed by the study’s cross-country regression and panel/cross-sectional time-series covering 1970-2000. Paradoxically, capital account openness saw capital flowing out of developing countries and helped advanced countries (especially the US) fund their unsustainable consumption boom and asset price bubbles in recent years.

Despite these findings, the IMF continued to oppose capital account liberalization. Its economists have argued both that capital controls are costly because they induce distortions to resource allocation and that they are not effective because they are easily evaded. But there is a contradiction between these arguments – if controls have no effect, how can they be distortionary? In 2005, the Independent Evaluation Office of the IMF found that to deal with large capital inflows, the IMF advocated tightening fiscal policy and to allow their exchange rates to appreciate or to accumulate reserves. But exchange rates can overshoot, with consequences for the competitiveness of a country’s exports. And if reserves are adequate, then further accumulation is not optimal.

Only in the wake of the current crisis does there seem to be some reluctant acceptance of the idea that “capital controls are a legitimate part of the toolkit … in certain circumstances” (Ostry et al., 2010: 15). The IMF study finds that GDP fell less sharply during the financial crisis in countries that already had capital control measures in place. It also found that the composition of inflows seems to matter. For example, countries with more foreign direct investment (FDI) in the financial sector suffered bigger growth collapses during the crisis. Unlike other types of FDI, these flows contribute to debt growth because they include lending from parent banks to local subsidiaries. It observes, “the use of capital controls was associated with avoiding some of the worst growth outcomes” (Ostry et al., 2010: 13).
The World Bank too seems to have bitten the bullet. In a recent publication (World Bank, 2009: 47-48) it concluded, “Capital restrictions might be unavoidable as a last resort to prevent or mitigate the crisis effects. … Capital controls might need to be imposed as a last resort to help mitigate a financial crisis and stabilize macroeconomic developments”.

Finally, financial sector deregulation led to privatization of state owned financial institutions and in most cases, abandoning specialised financial institutions to subsidise and direct credit to Small and Medium Enterprises (SMEs) and agriculture. As a result, in many developing countries, financial deregulation has adversely affected rural banking. Unprofitable rural branches of commercial banks have closed, making access to credit more difficult for farmers. Privatization has also reduced the developmental role of governments, resulting in poor performance of SMEs and agriculture, with adverse impacts for employment and poverty reduction.

It would be most pertinent to conclude this section by quoting from a recent IMF study (Christiansen et al., 2009: 1, emphasis added) which simultaneously assesses the relationship between economic performance and three groups of economic reforms: domestic finance, trade, and the capital account.

Among these, domestic financial reforms, and trade reforms, are robustly associated with economic growth, but only in middle-income countries. In contrast, we do not find any systematic positive relationship between capital account liberalization and economic growth. Moreover, the effect of domestic financial reforms on economic growth in middle-income countries is explained by improvements in measured aggregate TFP growth, not by higher aggregate investment.

Privatization

Privatization is one of the core policies that have endured since the days of adjustment programmes. It acquired its own momentum and became a panacea for all that was wrong with the economies of developing countries. However, there are relatively few studies assessing the growth impact of privatization in developing countries. One early influential study is of 63 developing countries (Cook and Uchida, 2003). This study attempts to empirically analyze the effects of privatization on economic growth during the period 1988-1997. Controlling for other important factors that can influence growth, the authors found (contrary to theory and some previous studies) a robust negative correlation between privatization and economic growth in developing countries. They suggest that a possible reason for a negative correlation between privatization and economic growth is the lack of competition in the private sector in the developing countries. Adams
(2008) examined the impact of privatization on economic growth and income inequality in 82 developing countries between 1991 and 2002, and did not find any significant impact on either.

Privatization has been nowhere so intense as in transition economies. Jesiah and Rajan (2008) examined the effect of privatization on various economic issues – such as GDP growth, budget deficit, external debt, openness, trade and current deficit and private investment – in a transition economy, Ethiopia. Their empirical results show that the effect of privatization on these economic variables in general is fragile, indicating the insignificance of privatization in the economic growth of the country. Bennett et al. (2007) estimated a cross-country (transition) panel growth model for 1990-2003. They found only voucher privatization to have been significantly associated with faster growth. Moreover, neither private sector development _per se_ nor capital market development exercised a significant influence.

Privatization of public utilities received the most attention, and opposition to it in poor countries seems nearly universal. Public utilities, such as electricity and water are natural monopolies and government intervention – in one form or another – is traditionally thought to be both desirable and essential, in order to ensure the overall welfare of society. Privatization of public utilities has been severely criticised for worsening the lives of the poor. The profit-seeking private organizations are unlikely to take the poorest and least advantaged people into consideration when developing or repairing public utilities infrastructure. Moreover, in almost all cases, the immediate result of privatization has been a rate hike for the middle class and abandonment of services in regions that yield less profit, which are generally home to the poorest citizens (Penketh, 2002).

Even a major World Bank study (Trujillo et al., 2002) found no significant GDP per capita gain in the privatization of public utilities, despite arguing that privatization has economic merit. Thus, Barlow and Clarke described the World Bank’s water privatization schemes in developing countries as the “quiet imposition of a for-profit system of water delivery” which leaves “millions of people without access to water” (Barlow and Clarke, 2004). On the other hand, privatisation has longer-term implications in terms of revenues foregone and the reduced ability of the government to invest in economic and social sectors, even though there may be one-off revenue gains from sales.

It is generally acknowledged that there are winners and losers with privatization. The number of losers can be unexpectedly large if the method and process of privatization and how it is implemented are seriously flawed (e.g. lack of transparency leading to state-owned assets being appropriated at minuscule amounts by those with political connections, absence of regulatory institutions leading to transfer of monopoly rents from public to private sector,
improper design and inadequate control of the privatization process leading to asset stripping).

Finally, an additional immediate effect of most privatizations is often loss of employment. This is not only because there tends to be substantial overstaffing in public enterprises, but also because the new owners typically prefer to begin with less employees than they need to allow for greater flexibility. In addition, there are the linkage and multiplier effects of privatization related changes. Employment conditions can be adversely affected in upstream and downstream activities, as well as in the local community through the indirect demand effects of workers’ incomes. An ILO (1998) study showed that utility privatisation in developing countries has significant employment reducing effects, sometimes affecting up to 50 per cent of the workforce.

**Labour Market Flexibility**

The creation of productive new jobs and decent work opportunities for all is vital for poverty reduction and enhancing social inclusion through economic empowerment. However, within the structural adjustment framework, labour market policies such as minimum wage, employment protection or severance pays are seen as barriers to employment growth, especially in the formal sector. The prevailing wisdom was summarized in the World Bank’s *World Development Report 1990* (p. 63):

> Labour market policies – minimum wages, job security regulations, and social security – are usually intended to raise welfare or reduce exploitation. But they actually work to raise the cost of labour in the formal sector and reduce labour demand … increase the supply of labour to the rural and urban informal sectors, and thus depress labour incomes where most of the poor are found.

Furthermore, World Bank and IMF economists also worried that labour institutions would undermine structural adjustment programmes designed to cure balance of payments deficits or other economic problems. In their analysis, elimination of a balance of payments deficit requires a country to shift resources from non-traded goods and services to traded goods sectors. In advocating against selective trade and industry policies as instruments for structural change, they argue that the least costly way to achieve this is to devalue the currency, which raises the price of tradable goods and services relative to non-tradable goods and services and thus attracts resources into the traded sectors. Since devaluation is likely to cause inflation due to high import prices, organised unions or other institutions are feared to resist devaluation in an attempt to protect real wages from falling which would then offset the impacts of devaluation on moving resources in the desired direction.
It is claimed, therefore, that the removal of these regulations would enhance labour market efficiency as well as international competitiveness, leading to employment growth. In short, the creation of “flexible” labour markets is seen as a requirement for boosting domestic and foreign private sector investment. Thus, the World Bank in one of its flagship publications, *Doing Business* (See the World Bank’s “Doing Business website”), included an Employing Workers Indicator (EWI), which ranks countries on the basis of information pertaining to such issues as minimum wage levels, maximum work hours per week, requirements for advanced notice for layoffs, and severance pay. This ranking of countries created a strong incentive among the governments in developing countries to compete in dismantling labour regulations, even when they signed up to ILO’s various conventions on labour standards and decent work. The dilution of labour standards and regulations has been one of the main reasons for the rise in working poor and earnings inequality, even in developed countries.17

There are, however, several challenges to market-oriented orthodox views about labour market regulations. For example, a plethora of efficiency wage theories argues that higher than equilibrium (or average) real wages can reduce worker shirking (Shapiro and Stiglitz, 1984), reduce labour turnover (Salop, 1979) and increase labour productivity. In an influential study of the United States, Card and Krueger (1995) showed that the introduction of minimum wages had no negative effect on employment levels. Baker *et al.*, (2002) examined the evidence for the widespread belief that labour market rigidities are largely responsible for high unemployment in OECD countries and that labour market deregulation is therefore the best route to raising employment rates. They found that previous cross-country studies showing a strong relation between unemployment and institutions was not robust to alternative definitions of the variables. Their results suggest a yawning gap between the confidence with which the case for labour market deregulation has been asserted and the evidence that the regulating institutions are the culprits. They find it even less evident that further weakening of social and collective protections for workers will have significant positive impacts on employment prospects. They further note that the generosity of unemployment insurance, the level of the minimum wage, and the extent of employee rights in case of dismissal have direct impacts on large numbers of people, whether at work or not.

A leading labour economist, Richard Freeman (2009) has surveyed extant literature on the impact of government regulations and collective bargaining on labour market outcomes in developing countries. According to his survey, most studies find modest adverse effects of the minimum wage on employment, but it raises the total income of low paid workers. Other mandated benefits are also found to have similar effects on employment
and workers’ income. This means that reductions in either minimum wage or mandated benefits would have a modest employment effect, but a large negative impact on the number of working poor. The survey found that cross-country regressions yielded inconclusive results on the impact of labour regulations on growth. The studies also did not find much difference in the adjustment responses of countries to economic shocks, such as balance of payments problems, by the strength of labour institutions. Other studies, such as Berg and Kucera (2008), conclude that one cannot, on the basis of the available evidence, uphold the view that deregulating labour markets will lead to faster job creation and more growth.

Freeman (2009) found that labour institutions can be critical when countries experience great change, as in China’s growth spurt and Argentina’s preservation of social stability and democracy after its 2001-2002 economic collapse. The survey concludes with the observation that cooperative labour relations tend to produce better economic outcomes.

These theoretical and empirical challenges did not stop the policy drive to increase labour market flexibility. In many countries moves to increase labour market flexibility have in fact resulted in insecure work statuses, variable periods and intensity of employment and variable levels and forms of income (Standing, 2008). This trend has been accompanied by increasing formalization of work, especially in developing countries. Globalization and outsourcing also created a heightened sense of fear and insecurity among workers in industrial countries. Economic insecurity, hence vulnerability to poverty, increased for workers over these years, even during the boom years.18

At long last it seems the international financial institutions that have seen labour market regulations as villains have also recognized the damage caused by their policy prescriptions and ranking game. For example, the World Bank, the progenitor of the EWI, has decided in April 2009 to exclude EWI from its survey.19 Likewise, the OECD position no longer reflects the confident proclamations of the mid-1990s.20 It concedes that it is not easy to identify a unique and optimal set of labour market institutions that engender and sustain economic prosperity. A variety of regulatory regimes that govern the labour market are compatible with good economic performance.

Unfortunately, however, the ghost of labour market flexibility still haunts, even when the recent financial crisis has made it painfully clear that there is a need for better regulation of the capital market. For example, a recent OECD working paper (Brixiova, 2009: 2) has argued, “More flexible labour markets will be a key adjustment mechanism during the recession as well as in the medium term … ”. In a lead article, The Economist (2009) has pinned its hopes on a renewed commitment to a global agenda of labour market flexibility in order to cope with world-wide job losses and enact an employment-led recovery.
6. Which Way Now?

The way forward requires a fundamental shift away from the current paradigm of the Washington or so-called post-Washington consensus. However, old practices and ideas die hard. This is especially evident from some very recent publications of the IMF. While there is some recognition of the limits of the orthodox policy-mixes, their contributions to the crises, and the need for rethinking, the message is still not bold enough. The conclusions are presented with a list of caveats and warnings about likely costs of shifts away from the orthodoxy. For example, Blanchard et al. (2010: 16) on rethinking macroeconomic policy concluded, “In many ways, the general policy framework should remain the same”. Although they raised the possibility of relaxing the inflation target for developed economies from 2 per cent to 4 per cent, they could not suggest it unequivocally. They even did not consider the case for developing countries.

Likewise on the question of capital controls, Ostry et al. (2010: 15) couched it in the following words, “While controls can be helpful to individual countries under certain conditions, their widespread use could have deleterious effects on the efficient allocation of investment across countries, and harm prospects for global recovery and growth”.

The Growth Commission (2010: 3) within the World Bank appears much bolder, when it concludes, “The crisis delegitimized an influential school of thought, which held that many financial markets could be left to their own devices, because the self-interest of participants would limit the risks they took” and suggests (p. 25):

For poorer countries, seeking to develop their financial systems, … [t]he balance probably needs to shift back toward the essential functions of the financial system: safe savings channels, credit provision to various sectors of the economy, and a means to spread risk to those best placed to bear it.

But it adds, “Abandon the outward-looking, market-driven growth strategy because of financial failures in the advanced countries” to the list of “bad ideas” that policy makers should avoid, essentially implying that in general the orthodoxy should prevail.

Nonetheless, there seems to be some consensus growing on the need to move away from the “one size fits all” kind of prescriptive approach, and to have greater variations in the policy mix depending on the situation of a particular country. Here we summarize what is emerging as a broader policy framework for developing countries.

Macroeconomic policies should aim at both short-term stability and long-term development. That is, the focus should be on both price and employment stabilization in the short-term and supporting productivity
growth and structural change in the long-term. This recognizes the right to decent employment of every able and willing citizen, and the direct link between decent jobs and poverty. Thus, the government must assume the responsibility as an “employer of last resort”. This could include various job guarantee schemes and maintenance of more employees in state-run enterprises than necessary.

**Fiscal policy** should assume the dominant role at all times, not just when monetary policy loses its effectiveness. It must be recognised that both the level and composition of government expenditure can have significant impacts on growth, poverty and inequality. It means abandoning the narrow concept of “sound” finance or fiscal sustainability, measured by debt/GDP ratio. Instead, the concept of “functional” finance, which evaluates government finance based on its impacts, must be adopted. From this perspective, a better measure of fiscal sustainability seems to be debt/wealth ratio as government debt (expenditure) creates income generating wealth. This means debt will be sustainable if government expenditure is geared to productivity and growth enhancing physical and human capital. That is, governments still need to guard against unproductive expenditures.

**Fiscal space** needs to be enhanced by a renewed commitment to domestic resource mobilisation. Developing country governments must abandon tax-competition in the hope of attracting FDI. They should also institute “self-insurance” through accumulating fiscal resources during boom periods and using such resources to finance expansionary policies or targeted interventions during a downturn. What is important, however, is not to be tempted to regard such national funds as a time-bound operation that is wound up once the global recession is over. This approach is costly and inefficient. The goal of a “stabilization fund” is to create the necessary fiscal space to sustain investments in human capital and basic infrastructure across business cycles and to scale up programmes pertaining to passive and active labour market policies to cope with external shocks.

**Monetary and exchange rate** policies should play a supporting role, and should accommodate each government’s fiscal need for development activities and counter-cyclical measures. This means a more active coordination between fiscal and monetary authorities and ditching the central bank independence. Confidence of the private sector about macroeconomic policies rests more on the credibility of government’s commitment to counter-cyclical measures and long-term development rather than on a fixed target of low inflation. The simple reason for this is that it reduces uncertainty about future profit expectations.

**Capital control** measures should be part of the macroeconomic policy mix. In addition to protecting the economies from destabilising impacts of short-term capital flows, capital controls will enhance government’s policy
space. This will allow depreciation of the exchange rate and expansionary policies in response to external shocks. Capital account openness should not be viewed as an all-or-nothing proposition. The increased importance of equity flows has increased the effective scope of a capital account policy of semi-openness. A capital account can be open to equity flows – both portfolio and FDI, but restricted for money and bond flows.

Financial sector policies should be aimed at preventing both systemic and market failures. Thus, there should be enough prudential regulation for safe-guarding both depositors and the payments systems, and to ensure uninterrupted flows of credit. Given the importance of bank-based financing for long-term investment to accelerate structural change, there has to also be economic regulation of the financial sector. Restraints on both deposit and lending rates can achieve both stability and development objectives. The role of the state-owned and specialized financial institutions for development needs, especially of the agricultural sector and SMEs has to be evaluated from the perspective of costs of market failure.

Trade liberalization and privatization should be much more nuanced, based on lessons from history. Trade policy should be linked to industrial policy in that both must aim to bring about structural change and accelerate productivity growth. Agriculture and SMEs must be given priority, especially for allocation of credit. State-owned enterprises’ (SOEs) performance should not be evaluated solely based on bookkeeping “bottom lines” as they often have other objectives, such as employment creation or social protection. Employment in SOEs may be a better way of providing social security than social security payments from the point of view of self-esteem, learning by doing and reciprocal obligations. Privatization must not ignore employment conditions and likely job losses, as they affect poverty, especially of the working poor. Similarly, provision of utilities must remain inclusive regardless of ownership. Public utilities, if privatized, must stipulate mandatory adequate service provisions to disadvantaged groups and areas.

Industrialization and structural change cannot be left to forces of the market and dictates of the international division of labour. The state needs to play a much more active role in creating competitive advantage and accelerating structural change. This is all the more important in the face of challenges posed by rapid technological innovation and global warming. There is now a broad consensus that significant amounts of “green investment”, much of it upfront, will be needed to address climate change mitigation, adaptation and challenges to environmental sustainability. Existing financial and fiscal incentives favour “dirty” over “clean” investments. Transforming investment behaviour through incentives is probably the greatest challenge for inducing much more green investment, and the state has to play a critical leading role.
Labour market flexibility should not be taken to mean only downward flexibility of wages. Flexibility should, instead, be understood in its widest aspects to include flexibility in job mobility – both vertical and horizontal – and flexibility in work hours and conditions to balance the work and family needs. There are strong reasons and sound evidence to support the view that the global economic downturn should be taken as an opportunity to reinforce the value of protecting and respecting workers’ rights – as is enshrined in the ILO’s core labour standards. There should be adequate protection of employment conditions as well as active labour market programmes in place.

The above framework essentially calls for re-inventing the role of the state. However, states or governments are seen as incapable (lack of administrative skills and fiscal space) at best or corrupt (ravaged by rent-seeking and predatory behaviour) at worst. The donor community generally believe in the latter state of the government and hence has been pushing a “good governance” agenda as a pre-requisite for development and growth. It assumes a homogenous world in which poor countries should have the same institutional characteristics as rich countries, but are affected by pathologies (corruption, lack of democracy, State failures, market failures, etc.) that prevent them from catching up. So, according to this agenda, the pre-requisite for growth and development is the cure of the pathologies and thereby establishing good governance.

However, this agenda is fraught with problems. First, there is a good deal of confusion about what is meant by good governance. Second, this view of the world is founded on the absolute independence of the political and economic spheres when it comes to their effects on societies. Third, there is no theoretical or empirical basis linking good governance to growth or development. Although all developed countries of today have good governance (mature democracy, low level of corruption, etc.), these did not precede their economic transformation. In fact, as Chang (2005: 1) has pointed out the new attention to good governance is not “the result of an innocent scholastic awakening. Rather, it is … an attempt to cope with the continued failures of orthodox policies in the real world.” Instead of recognizing that the orthodox policy-mixes are themselves flawed, and have contributed to the growth failures, the good governance agenda attempts to put the burden of failure on the so called pathologies or ills of the developing countries themselves.

The limitations of the good governance agenda have been recognized by the Department for International Development (DFID) of the UK (DFID, 2003: 12), when it concluded:

Many economic reform programmes identify weak governance as the key constraint, and then ask what to do about it. But if getting good government is
itself a long-term endeavour, and integrally linked to economic and social change, a more useful question may be how to get growth in spite of weak governance. Instead of pursuing systemic reform to support an ambitious policy agenda, it may be better to take a more incremental approach, looking for a few feasible reforms which target key constraints. Instead of trying to make the context fit the policies, it may be better to start with the context.

Therefore, the focus should be on key institutions (especially pertaining to human resources and capacity building) and enhancing fiscal space. In time, and through the process of the expansion of the state’s administrative capacity and fiscal space, countries can achieve social and economic transformation and create institutions of good governance that suit their specific historical contexts.

Notes
* The author is grateful to anonymous referees for their insightful comments. However, the usual caveats apply. The author is currently working as Senior Economic Affairs Officer in the Office of the Under-Secretary-General, Department of Economic and Social Affairs, United Nations. The views expressed here are personal and do not necessarily reflect the views of the UN.
1. See for example, Blanchard et al. (2010), and Growth Commission (2010).
2. Standing (1999) identifies intellectual roots of the shift in the ascendancy of the Chicago school of law and economics in the 1970s that saw the rise of monetarism and supply-side economics.
3. Industrialised countries, too, faced for the first time stagflation caused mainly by oil price shocks.
4. Deposits in the western banks of oil exporting countries, which enjoyed windfalls from oil price hikes.
6. Drawing on Brenner (1998), Sender (1999: 101) argues that its origin lies in “the ideological shift that occurred within the United States, the United Kingdom, and many other developed economies during the late 1970s, constituting an important element of the “employers’ offensive” associated with Reagan and Thatcher.”
7. Argentina, in the 1990s, followed the IMF/World Bank programmes most strictly under the guidance of its economy minister, Domingo Cavallo. However, the unemployment rate soared from 6.5 per cent in 1991 to over 17 per cent in 1995, the number of people living in poverty increased from 22 per cent in 1993 to over 27 per cent in 1995, and the Gini coefficient (a conventional measure of inequality) rose from 0.45 in 1992 to 0.47 in 1995.
9. China followed a combination of expansionary and restrictive fiscal policy during this period – the overall budget deficit was only -1.7 per cent of GDP. Since the Asian crisis in 1997-98, China has switched to a combination of restrictive monetary policy and expansionary fiscal policy – the overall budget deficit during
1998-2006 was slightly over 3 per cent of GDP, while growth of money supply (M2) and domestic credit slowed to around 16 per cent. The average inflation rate during the later period was 1 per cent and the average real lending rate was around 5 per cent.


11. An IMF study (Brahmbhatt and Dadush, 1996), found in a sample of 93 developing countries that the fast integrators included most of the rapidly growing East Asian exporting economies, while the weakly and slowly integrating group included most of the low income countries of sub-Saharan Africa and some of the middle-income countries in Latin America.

12. Yet, after reviewing the Latin American experience, Edwards (1988: 50) noted, “Indeed, the historical evidence clearly shows that those countries that have pursued successfully export promotion (i.e., the East Asian nations), have had a trade regime substantially more liberal than those countries that have followed indiscriminatory import substitution based on protectionism. A crucial question, however, is how much trade liberalization is needed. … Although outward orientation requires some trade liberalization, there are no reasons – either theoretical or empirical – that suggest that the “optimal” degree of liberalization implies zero, or even very low, tariffs coupled with no government intervention in any sphere of the development process. The successful experiences with export led growth in the East Asian countries support this view; although in these countries the trade regime has been significantly liberal, government intervention has been important and tariffs have never been anything close to zero or a very low (i.e., 10-15 per cent) uniform level.”

13. The admission comes when the report describes its sample of “more globalized” countries: “We label the top third ‘more globalized’ without in any sense implying that they adopted pro-trade policies. The rise in trade may have been due to other policies or even to pure chance” (World Bank, 2002: 34).

14. For a similar conclusion, see Rodriguez (2007).

15. See Deraniyagala (2003) for a discussion of this in the case of Nepal. Also see Chowdhury (2002) for some evidence from Bangladesh.

16. At the 1995 World Summit for Social Development in Copenhagen, world leaders acknowledged the link between the creation of productive employment and poverty reduction and committed to taking national and international actions to promote full and productive employment. The 2005 World Summit revived this commitment with a renewed sense of urgency. The General Assembly of the United Nations decided to include a new employment target – “Achieve full and productive employment and decent work for all, including women and young people” – under the Millennium Development Goal 1 – Poverty Reduction.


19. See the World Bank’s “Doing Business website”.


21. See Beveridge (1945) for the original idea. According to Beveridge, this “means having always more vacant jobs than unemployed [people], not slightly fewer
jobs. It means that the jobs are at fair wages, of such a kind, and so located that the unemployed [people] can reasonably be expected to take them; it means, by consequence, that the normal lag between losing a job and finding another will be very short” (p. 18). See for an analysis of its applicability in developing countries, Wray (2007).

22. For example, in a situation like the current global crisis or the stagnation of Japan in the 1990s, many orthodox economists, including those at the IMF and the World Bank, favour fiscal stimulus as the effectiveness of monetary easing hits its limit with interest rates hovering near zero. But they consider this only a short-term measure until the monetary policy regains its effectiveness.

23. See Domar (1946: 801, 804) who notes, “… that deficit financing may have some effect on income … has received a different treatment. Opponents of deficit financing often disregard it completely, or imply, without any proof, that income will not rise as fast as the debt …. There is something inherently odd about any economy with a continuous stream of investment expenditures and a stationary national income”.

24. See Lerner (1943) who notes: “The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound” (Lerner, 1943: 39, emphasis in original).

25. For a comprehensive survey, see Meisel and Ould-Aoudia (2007). Also see Khan (2009).

References


*World Development Indicators* (various issues) for growth (p. 6).