# From the Washington Consensus to the Post-Washington Consensus: Retrospect and Prospect

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The past two decades have witnessed major changes in the paradigm of international development assistance. During the 1980s the import-substitution industrialization strategy (ISI) advocating for government market interventions to promote large-scale modern industries gave way to a new paradigm referred to as the Washington Consensus, which identified the market as a universally efficient mechanism to allocate scarce resources and promote economic growth. Scarcely a decade later, in the mid-1990s, the Washington Consensus was replaced by a contrasting paradigm called the Post-Washington Consensus. It emphasized the need for different institutions in different economies and recognized cases in which government market interventions can play a positive role. The post-Washington Consensus focused on poverty reduction, emphasizing the need for delivery to the poor of social services, such as education and health care, by government and civil society. Sustainability of this approach is questioned, however, because of its relative neglect on the provision of production-oriented infrastructure and services needed to supply profitable work opportunities for poor people.

## I. INTRODUCTION

The 1980s to the 1990s witnessed major changes in the paradigm of international development assistance. For the first three decades since developing economies achieved independence after the Second World War (1950s-1970s), their development policy had been dominated by an import-substitution industrialization strategy (ISI) advocating for the promotion of large-scale modern industries by means of strong government interventions in the market, such as trade protection, directed credits, and subsidies. In the 1980s this paradigm gave way to a new paradigm referred to as the Washington Consensus. This new paradigm identified the market as a universally efficient mechanism for allocating scarce resources and promoting economic growth. Under its influence, international financial institutions, particularly the International Monetary Fund (IMF) and the World Bank, actively encouraged governments to dismantle market con-

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trols. Barely a decade later, in the mid-1990s, the Washington Consensus was replaced by a contrasting paradigm called the post-Washington Consensus. It emphasized the need for various institutions in different economies and recognized cases in which market intervention by the government can play a positive role. The Post-Washington Consensus focused on poverty reduction, emphasizing the need for delivery by government and civil society of social services to the poor such as education and health care, and advocaing for the initiative ("ownership") of aid-receiving communities.

This paper aims to review the process of this paradigm change in the past two decades, identifying the forces underlying that shift. It attempts to assess the effects on developing economies—in terms of both economic growth and poverty reduction—in the past and for the future. Following this introduction, Sections II and III, respectively, outline the two major developments that cast doubts on the validity of the Washington Consensus approach, namely, recurrent economic crises in Latin America and the financial crisis in East Asia during the 1990s. Section IV examines the validity of criticisms on the Washington Consensus approach advanced from the Post-Washington Consensus side. Section V discusses implications to developing economies of adopting poverty reduction as an immediate objective of international development assistance under the influence of the Post-Washington Consensus. Finally, Section VI concludes the paper with some projections on possible paradigm changes in the future.

## II. STRUCTURAL ADJUSTMENT POLICIES AND LATIN AMERICAN CRISES

Although the defects of the government-led ISI strategy increasingly became evident through the 1960s and 1970s, the decisive impetus to demolishing this paradigm sprung from the economic crisis of natural resource-based economies, especially in Latin America, following the collapse of the second oil boom in 1981. To overcome the crisis of accumulating external debt corresponding to sharply decreasing world market prices for primary commodities and increasing interest rates, the International Monetary Fund (IMF) and the World Bank began from the early 1980s to stipulate market-oriented reforms by the governments of developing economies as a condition for granting credit. This approach is called "structural adjustment policy" (SAP).

By the beginning of the 1990s the doctrine of neoclassical market liberalism had become an established paradigm in the international development assistance community. Known popularly as the Washington consensus, it advocated the free market as the controlling mechanism for economic activities—except for the supply of public goods—including sound macroeconomic management. Supremacy of this doctrine, however, was short-lived. Its adequacy as a guiding principle of development policies began to be seriously questioned already in the 1990s. The criticism stemmed from several observations: (i) that Latin American economies were not able to sustain economic growth after their recovery from the debt crisis; (ii) that East Asian economies were plunged into crisis in the late 1990s due to a major disruption in regional financial markets; and (iii) that SAP had failed to achieve economic growth and reduced poverty in low-income economies, especially in Africa.

This section investigates the mechanism of recurrent crises in Latin America. First the case of Chile, which took the lead in the SAP reform in Latin America, is examined in some detail. Following that, the experiences of Mexico and Argentina are explored.

### A. Chile: Setting the Stage for Reforms in Latin America

Chile attempted reform as early as the mid-1970s in order to cope with the economic and political crisis created by the socialist policies of the Salvador Allende administration (1970-1973). The military government of Augusto Pinochet (1973-1989) attempted to cut the budget, liberalize trade, and reduce domestic regulations. As a result of its efforts, the rate of inflation that had exceeded 500 percent per year was reduced to double digits by 1977. Economic activity initially dropped due to the deflationary policy but soon recovered with the expansion of exports and the inflow of foreign capital. Chile was able to achieve a gross domestic product (GDP)growth rate as high as 8 percent per year for 1977-1981 (Balassa 1985, Kohama 1995, Corbo 1997).

However, the Chilean economy was hit again by crisis in 1982, corresponding to the collapse of the second oil boom. This crisis stemmed partly from a slump in the international copper market, but more importantly, from incomplete deregulation. Because a fixed exchange rate was maintained while the inflation rate was higher than 30 percent per year, overvaluation of the local currency occurred, resulting in depressed exports and expanded imports. The double-digit inflation continued despite the government's deflationary policy because the wage indexation determining wage hikes, corresponding to past inflation rates, was maintained as a remnant of the populist system (Cardoso and Helwege 1992, 162-6). Despite a worsened balance of trade, the Chilean economy was able to grow so long as foreign capital flowed in. Inevitably, however, economic activity shrunk precipitously as capital flight began under the expectation of currency devaluation corresponding to accumulated outstanding external debts (Balassa 1985).

To cope with the 1982 crisis, Chile accepted conditionalities on loans from the World Bank and IMF and pushed forward structural adjustments such as currency devaluation, deregulation, and privatization of state enterprises. The Chilean economy began to recover from 1984 and has been on a track of sustained growth (Corbo and Fischer 1995, 2894-903) through the 1990s. The exchange rate has been flexible within a crawling band since 1985. A policy orientation toward balanced budgets and market liberalization has been maintained under the civilian government since 1989. While expenditures for education and social welfare program have increased, the tax basis has been strengthened by such means as a value added tax. As a result, not only was stable macroeconomic growth achieved, but growth in agriculture and small- and medium-scale industries (such as farm-product-processing), which had been suppressed under the import substitution industrialization policy, was realized (Imai 1991, Yanagihara 1991).

Following on the example set by Chile, a number of Latin American economies, including Argentina, Bolivia, Mexico, and Peru, undertook structural adjustment reforms under World Bank and IMF conditionalities. These reforms, together with the international efforts to restructure the debts of defaulting countries by such arrangements as the debt-equity swap (the Brady Plan), were somehow able to quell the decade-long Latin American crisis. Especially noteworthy at that time was Argentina, which began to undertake reform aimed at economic stabilization and liberalization in 1991 under the regime of President Carlos Menem. According to the design of Economic Minister Domingo Cavallo, the domestic currency was pegged to the US dollar with the result of reducing the inflation rate from as high as 4000 percent per year in 1990 to the one digit level within three years. This price stabilization, together with the various measures of liberalization and privatization, was able to set Argentina on the track to economic recovery.

Thus, in the early 1990s an optimistic view prevailed that Latin American economies were firmly set on the track of sustained high economic growth. Within the decade that followed, however, this optimism met deep disappointment upon the re-emergence of recurrent crises and slow growth (Kuczynski and Williamson 2003). It is regrettable but interesting to note that soon after the Latin American economies became confident of having recovered from the debt crisis, they were beset by new crises caused by mismanagement of macroeconomic fundamentals similar to that experienced by Chile following on the success of its earlier reforms in the 1970s. Such recurrent crises can typically be observed in Argentina and Mexico.

### B. Mexico: The Tequila Crisis

The new crisis hit Mexico in 1994-1995 and is commonly referred to as the Tequila Crisis. During the "Lost Decade" of the 1980s, Mexico shared, in common with other Latin American economies, high inf1ation, economic stagnation, and accumulated external debt. The crisis situation in the 1980s had forced Mexico to undertake structural reform necessitating a tight fiscal policy, a fixed exchange rate pegged to the US dollar, and liberalization in international trade and capital movement. By the beginning of the 1990s the positive effects of these policies became manifested in lowered inflation rates and improved current account balance. The ensuing economic growth was augmented by increases in foreign direct investment with the prospect of Mexico's joining the North American Free Trade Agreement (NAFTA).

The problem was that the Mexican government tried to expand fiscal expenditure to attract popular votes in the upcoming presidential election, with the effect of overheating the already rising economy. To achieve this fiscal expansion, the government issued a large amount of short-term bonds denominated in US dollars (*tesobonos).* Subsequent increased deficits in both fiscal balance and current account balance under the prevailing pre-election political uncertainty raised fear among foreign investors of possible default by the Mexican government. In l994 they hurried to recover short-term loans and began the speculative sale of Mexican currency. By year's end the country's foreign currency reserve was exhausted to the point that a currency devaluation and a shift from a fixed to a floating exchange rate became inevitable. Contraction in both private credit and public expenditure reduced the real GDP growth rate from 5 percent per year in 1994 to minus 6 percent in 1995.

However, the recovery of the Mexican economy was surprisingly fast with real GDP rising at the rate of 6 percent within 1996, more than compensating for the 1995 drop. This quick recovery owed much to a large-scale international syndicated loan organized under the lead of the IMF and the United States that succeeded in preventing the country from defaulting. In addition, the depreciation of the peso improved the competitive strength of Mexican products in the world market, coinciding with an increased demand for imports by the US whose economy began booming during this period. Furthermore, the formation of NAFTA in 1994 enabled Mexico to capture a greater share of US imports. In short, the policies prescribed by the IMF were successful, resulting in a V-shaped recovery of the Mexican economy. This occurred, however, in an exceptionally favorable international economic and political environment. Success from the same policies in a different environment cannot be guaranteed.

### C. Argentina: The Collapse of a Paragon

The collapse of the Argentine economy in 2001 represents a great disappointment to the advocates of SAP. Indeed, for nearly a decade preceding this collapse Argentina had been applauded as a paragon of SAP reform (Mussa 2002). Following the dramatic success of controlling the hyperinflation of the Lost Decade within the first three years of the 1991 reform, Argentina's real GDP advanced at an average rate of 4.4 percent per year between 1993 and 1998, even including a significant setback in 1995 due to the influence of the tequila crisis in Mexico.

The core of the policy package that led to this success was the Convertibility Plan in which the Argentine peso was pegged to the US dollar at a one-to-one exchange rate. This dollar peg was very rigid, because the Convertibility Plan followed the so-called "currency board system" by which the central bank is allowed to issue domestic currency at an amount equal to the foreign currency reserves. This Plan was very effective in killing hyperinflation. The associated elimination of risk from exchange rate changes was effective also in attracting loans and investments from abroad. Foreign capital inflows were further facilitated by liberalization of trade and foreign direct investment as well as privatization, in which many state enterprises were sold to foreign companies (Cavallo and Cottani 1997).

Despite its proven effectiveness as an emergency measure to cope with hyperinflation, the long-run sustainability of the Convertibility Plan was questioned. Though the rate of inflation in Argentina was greatly reduced as compared with the 1980s, it continued to be higher than in the United States in the 1990s. Progressive overvaluation of the peso weakened the competitive position of Argentine industries, worsening the balance of trade and increasing unemployment. Underlying this deterioration was the revival of Argentina's traditional disease—lack of governmental fiscal discipline—compromising its successful economic recovery and growth. The consolidated government budget deficit for Argentina, including both central and local governments, increased from near zero in 1993 to exceed 2 percent of GDP in 1998. Meanwhile, the total public debt rose from 29 to 41 percent of GDP, much of it financed by the sale of government bonds to foreign investors in a process similar to the process that resulted in the debt crisis in the 1980s. On the demand side, the pressure of populism for budget expansion continued strong and hard to resist, especially when President Menem was intending to revise the constitution so that he could run for a third term. On the supply side, the government was able to sell its bonds in the international financial market at favorable terms because of high credibility accorded to Argentina for the success in its SAP reform.

The weakened fiscal discipline was more serious than revealed by the data of public debt from 1993 to 1988. During this period the government received a fair amount of revenue from the sale of public enterprises, but that was not a permanent source of income. Also, the government's cost of servicing outstanding foreign debts was reduced temporarily during this period because much of the debt service payment was postponed to later periods as a part of the Brady Plan. The Argentine government failed to take advantage of this opportunity to reduce external debts, instead, it expanded expenditures by borrowing more from abroad. Ironically, the high economic growth fueled by government expenditures increased the confidence in Argentina of the international financial market, and thereby eased external financing of the government's budget deficit. In hindsight, it is clear that economic growth based on such precarious ground could hardly be sustained. Yet, after Argentina successfully avoided the contagion of the tequila crisis in 1995 and proved resistant to the effects of the 1997-1998 financial crisis in East Asia, it established itself as a remarkable success case of SAP reform, that

President Menem was accorded the honor of delivering a triumphal address to the Plenary Session of the Joint IMF-World Bank Annual Meetings in Washington, D. C. in October 1998.

Almost immediately after this pinnacle, the Argentine economy began to roll downhill with a serious recession setting in from 1999. Expansion of government spending, an important support of the 1996-1998 economic boom, came to a halt. Revenue from the sale of state enterprises diminished as planned privatization came closer to completion. Meanwhile debt service payments on sovereign bonds, postponed to later years under the Brady Plan, were bound to increase over time. The central government's payments on external debts rose from US$2.6 billion in 1993 to $6.5 billion in 1998 (Mussa 2002, 14). Squeezed between reduced nonrecurrent revenues and increased debt-service obligations, the government was forced to borrow even more from abroad in the face of insurmountable domestic resistance to budget cuts. Increasing government debt relative to GDP under a worsening economic slump stirred anxiety among Argentina's foreign investors whose memory of that country's default in the previous crisis was still fresh. Consequently, the inflow of external credit narrowed as reflected in sharp increases in the interest charged from late 2000 on newly issued government bonds. An attempt by Economic Minister Ricardo Lopez-Murphy to reduce public spending was not only opposed by the Peronist-dominated congress but was also not supported by President Ferdinand de la Rua.

By 2001 it had become obvious that the Convertibility Plan could not be maintained. While Domingo Cavallo, who was re-appointed as Economic Minister after Lopez-Murphy's resignation, tried to salvage it through emergency modifications, depositors ran to banks to withdraw their savings in dollars. In November the bank run escalated and the foreign currency reserves were quickly exhausted, forcing the termination of the dollar-peg system. The government ordered a bank holiday and reopened them with a limitation on cash withdrawals. Infuriated depositors triggered riots, which swept the country and resulted in the downfall of the de la Rua regime in December. Economic stagnation set in and social and political instability became prolonged, with still no visible sign of recovery by 2003.

## D. The Cycles of Crisis

The cycles of the three economies in Latin America, moving from crisis to crisis as reviewed above, is striking in their similarity. All three cases, including the first cycle of Chile's reform (from recovery in the late 1970s to bust in the early 1980s) involved fixed exchange rates, or pegging the domestic currency to the US dollar as a principal instrument to counter hyperinflation. This fixing of exchange rates simultaneously with efforts to balance the government budget proved extremely effective in killing hyperinflation within a short period. However, as the immediate crisis was resolved and economic recovery proceeded, fiscal discipline tended to weaken, resulting in a widening of the government's budgetary deficit. Given the low domestic saving rate in Latin America, much of the budget deficit was financed by borrowing from abroad. At the same time, pressure from the increased government spending caused aggregate demand to exceed supply. The resulting inflation relative to that of the United States appreciated the real rate of foreign exchange and increased the balance of trade deficit. External debts accumulated as an inevitable consequence of financing the dual deficits of current account and government budget, causing credibility in the international financial market to be lost to the point that the inflow of foreign capital stopped. It became difficult for the government to finance the budget deficit from external credits, forcing it to print more money to close the gap.

From this point, a vicious circle ensued: from accelerated inflation to increased overvaluation of domestic currency; to reduced exports and increased imports; to worsened recession and unemployment; and to the further narrowing of credit inflow. At that stage, capital flight and currency speculation flared up and forced termination of the dollar-peg system, involving not only economic but also social and political crises.

One obvious factor underlying these recurrent crises, emerging along such a common policy cycle, was prolonged adherence to the fixed exchange rate after hyperinflation was successfully contained. A more fundamental factor, however, was a lack of fiscal discipline under populism, which seems to be strongly affecting the minds of Latin American people as a kind of social norm.

## III. THE FINANCIAL CRISIS IN EAST ASIA

The so-called "high-performing economies" of East Asia, which had been widely hailed as miraculous (World Bank 1993), were suddenly attacked in 1997 by a storm of financial disruption followed by sharp contractions in their GDP. Even though strong government interventions for the promotion of target industries had distinguished these economies from the neoclassical paradigm, their rapid economic growth was associated with significant progress in liberalizing foreign trade and international financial transactions. As such, the sudden setback of these economies cast doubt on the effectiveness and sustainability of market-based development under globalization.

### A. Structure of the Capital Account Crisis

Unlike Latin America, the high-performing East Asian economies were characterized by high domestic saving rates and sound fiscal management so that they were insulated from the dangers of government accumulated external debt and eventual insolvency. The Asian crisis occurred because there was a sudden recall of loans from foreign creditors. These recalls created a liquidity shortage in private banks and firms to meet increased debt-service obligations. Unlike in Latin America, where changes in the current account balance induced changes in the capital account balance, in Asia it was the changes in the capital account owing to the herd behavior of foreign creditors that induced changes in the current account. For this reason, the Asian crisis is appropriately called a "capital account crisis", in contrast to the "current account crisis" of Latin America (Yoshitomi and Ohno 1999, Yoshitomi and ADBI Staff 2003). By its nature this situation is similar to a "bank run", in which depositors, panicked by the rumor of their bank's imminent insolvency, swarm to withdraw their deposits, forcing bankruptcy from a liquidity shortage even though the bank may actually be soundly managed, solvent, and earning sufficient profits to meet debt services to depositors under normal conditions.[1] Since the classic work of Kindleberger (1978), it has been known that economies with an open capital account are vulnerable to this kind of crisis. But how did it occur in East Asia in 1997 and on such a regionwide scale?

The "miracle" growth of East Asia had been supported, to a significant degree, by large inflows of foreign capital. Out of their own wish to further capital inflows, together with the demands of the IMF and the US Department of the Treasury, the East Asian governments began to liberalize financial transactions from abroad from the early 1990s. Most boldly, Thailand opened an offshore market called the Bangkok International Banking Facility (BIBF). Ordinarily the offshore market is an institution to mediate financial transactions among nonresidents. Nevertheless, residents of Thailand were allowed to participate in the BIBF. Given the large spreads in interest rates between Thailand and high-income economies, domestic banks rushed to borrow from foreign banks in order to lend to domestic firms, either directly or through nonbank financial companies. Indonesia, Republic of Korea (Korea) and Malaysia did not create similar offshore markets, but they liberalized capital imports, prompting domestic banks and nonbanks to increase borrowing from foreign banks. This process was facilitated by the absence of a currency devaluation risk under the *de facto* dollar-pegged fixed exchange rate commonly adopted in these economies.[2]

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[1]For the emergence of this kind of crisis, some emphasize the role of accidental shock to trigger the panic (Obstfeld 1996), while others emphasize the importance of deterioration in economic fundamentals (Krugman 1979).

[2]Before the crisis, the domestic currencies of Malaysia and Thailand were pegged to the weighted average of several currencies (so-called "currency basket") but, because the weight of the US dollar was dominant in the basket, their exchange rates were virtually fixed to the US dollar. In Indonesia and Republic of Korea, the exchange rates were allowed to move only within very narrow bands. Before and after the crisis, Hong Kong, China continued to strictly peg its currency to a US dollar under the open capital account by adhering to the currency board system, in which domestic currency is issued from commercial banks for the pledge of their foreign currency reserves. In the crisis period Hong Kong, China suffered a serious recession because it was necessary to sharply raise interest rates to defend its currency value. In contrast,

Capital imports under the open capital account with fixed exchange rates were greatly augmented by optimism, even euphoria, at the prospect of growth in East Asian economies. This reaction was due to the exceptionally high economic growth of this region over the previous three decades, especially the uninterrupted growth over the ten-year period from the mid-l980s. So long as both the lending institutions and the borrowing enterprises interpolated past growth into the future, the large investment that looked to produce excess capacity relative to current demand could easily be justified by the expected market expansion.

It was a common practice in East Asian economies that, when major business enterprises were about to fail, bankruptcy was avoided by government intervention, with the use of administrative guidance and other means, to organize directed credits and company mergers. It was also a common characteristic of these economies that prudent banking regulations—minimum equity ratio, audit and disclosure of corporate financial data, and deposit insurance systems and bankruptcy procedures—were not well developed. The weakness of rules to make market transactions more transparent and less prone to risk, together with the strong reliance of private firms on rescue by the government, promoted moral hazard, encouraging banks to advance loans to high-risk projects without sufficient monitoring. Under these conditions, it was almost inevitable that a major investment boom occurred based mainly on foreign credits, resulting in a real asset bubble as well as excess manufacturing capacity in these economies.

In Bangkok, for example, the heated construction boom created excess building capacity for office and residence. The vacancy rate rose, pushing down the rate of return to building investment below bank lending rates. Yet investments in real estate continued, with the expectation of capital gain from asset price appreciation. The expectation began to reverse when Finance One, Thailand's largest nonbank financial company, defaulted in February 1997 when a major real estate agent failed to service its debt. Fearing that the default would spread to other financial institutions, foreign banks hurried to recover their loans as soon as the maturity dates arrived. Rapid capital outflows resulted immediately because foreign commercial banks' credits were mostly short-term. Meanwhile, speculative sales of the Thai baht flared up. Counter purchases by the Thai central bank quickly exhausted US$28 billion out of a foreign reserve of US$30 billion before the fixed exchange rate was finally switched to a floating exchange rate system on 2 July 1997. This crisis in Thailand quickly spread like a contagious disease to other high-performing economies in East Asia, including Indonesia, Korea, and Malaysia.

In Korea, overinvestment in the capacity of manufacturing production relative to current demand became evident by the beginning of 1997. Hambo Steel,

People's Republic of China with its regulated capital account was able to maintain its fixed exchange rate without suffering recession.

ranked 14th among *chaebols*, went bankrupt in January of that year. Soon after, six other chaebols fell into near bankruptcy. Such symptoms of a worsening business environment in the domestic economy, coinciding with the financial crisis transpiring in Thailand, reduced foreign lenders' confidence in the Korean economy and prompted them to recover short-term credits. Korea's foreign currency reserves were rapidly exhausted, making it inevitable that an emergency rescue loan would be sought from the IMF. The band within which the exchange rate was allowed to fluctuate was widened in November, followed by a shift to a complete float in December 1997.

In both Korea and Thailand, the crises emerged from the herd behavior of foreign investors who rushed to recover their loans out of fear that the boom was turning into a bust. The fear was not entirely groundless, but was rooted in a deterioration of fundamentals that was reflected in microeconomic indicators such as decreased rates of return to firms' investment as well as macroeconomic indicators such as increased incremental capital-output ratios (Coresetti et al., table 6).

In Indonesia, the incremental capital-output ratio did not rise as had been the case in Korea and Thailand. Neither did external debt increase relative to GDP. However, Indonesia was highly vulnerable to the risk of liquidity shortage because of its high debt-GDP ratio as well as the high share of its short-term to total external debt. For Indonesia, the crisis in Thailand served as an alarm clock to arouse the latent fear of its investors.[3] The fear of political instability rising toward the end of the Suharto regime prompted widespread capital flight, especially among the business circle of ethnic Chinese.

The crisis of Indonesia was the severest in East Asia. From July 1997 to August 1998, the rate of depreciation of the local currency relative to the US dollar was 70 percent in Indonesia compared with 36 percent in Thailand, 34 percent in Korea, and 32 percent in Malaysia (Hayami 2001, 269). Correspondingly, in 1998 when the full brunt of the crisis was felt, real GDP in Indonesia decreased by 13 percent, compared with 11 percent in Thailand and 7 percent in both Korea and Malaysia (Asian Development Bank 2002, 203). The severity of the crisis in Indonesia strongly supports the idea that political stability under a credible government is one of the most important fundamentals to sustained economic stability and growth.

It is worth noting that the economies that suffered such major damage were those that maintained a fixed exchange rate under an open capital account. In contrast, in Singapore and Taipei,China, where a system of managed float in the exchange rate was adopted before the crisis, the depreciation of the local currency from July 1997 to August 1998 was less than 20 percent, and real GDP did not decline even in 1998. In fact, GDP in Taipei,China increased by 5 percent. It is also

[3]This "wake-up call" effect is considered the dominant factor underlying the regionwide contagion of the crisis (Goldstein 1998).

noteworthy that the People's Republic of China (PRC), whose government continued tight controls on foreign exchange transactions, achieved a 2 percent growth of real GDP in 1998, while maintaining a fixed exchange rate. These observations confirm that the immediate cause of the 1997 crisis in Asia was the package of open capital account and fixed exchange rate, as predicted by the theory of international finance (Kindleberger 1978, Eichengreen 1999).

The impact of the financial crisis on economic activities in the real sector was especially severe in high-performing Asian economies that were characterized by heavy reliance on bank lending in corporate finance. In 1996 the debt-equity ratio in the corporate sector was higher than 2 in Indonesia and Thailand and as high as 3 in Korea, compared with only 1 in the United States (Asian Development Bank 1999, 27). Firms so heavily dependent on bank loans were highly vulnerable to credit contraction. Thus, when a credit crunch emerged with the withdrawal of short-term credits by foreign banks, widespread bankruptcy and unemployment became unavoidable. In this way the crisis in the financial sector created a major downturn in the real sector.

To recapitulate, the financial crisis that hit East Asia in 1997 is considered to have resulted from liberalizing international capital movements under the fixed exchange rate in the absence of adequate and prudent regulations due to the euphoria created by the extraordinary level of past economic growth. The open capital account, coupled with high optimism about future business but without proper risk-management systems, created a large investment boom fed by liberal provision of credit from abroad. This investment boom went bust when the confidence of foreign investors was shaken by the bankruptcy of domestic firms owing to excess investment relative to current demand. A financial panic similar to a bank run followed. The sharp credit contraction that resulted from the sudden shift from capital inflows to capital outflows throttled real economic activity, culminating in the economywide crisis.

### B. Market Failure vs. Government Failure

Such a crisis could have been avoided if policies had been taken to limit domestic demand before the economy became overheated. As the open macroeconomic theory by Mundell (1968) and Fleming (1962) predicts, financial policies to control money supply and interest rates are not effective in controlling domestic demand where international capital movement is not regulated and the exchange rate is fixed. Unfortunately, while in such cases fiscal policies may be effective in theory, it is usually very difficult politically to cut budgetary expenditure before the economy becomes really overheated. East Asian economies such as Korea and Thailand were no exception to this rule of political economy.

It was almost inevitable that extraordinarily rapid and uninterrupted economic growth in Asian NIEs and high-performing ASEAN countries for more than ten years from the mid-l980s would end in a recession in the late 1990s even without liberalization in international capital movements. If the capital account were not open, however, the investment boom spurred by optimism would have been financed mainly by domestic bank credit creation. If that had been the case, excess investment over savings would have caused inflation. A corresponding appreciation of the real exchange rate should have resulted in a major deficit in the current account balance, which would have forced devaluation of the domestic currency as well as adoption of financial policies to curb inflation such as raising the central bank's rediscount rate. The economic recession that would have resulted from credit contraction, however, would likely have been modest compared with the situation under an open capital account, because inflation should have worked as an early warning to trigger financial policies to prevent the economy from overheating.

Viewed from this angle, the financial crisis in East Asia must be considered a market failure resulting from imperfect market information. The euphoria that inflated the economic bubble and the subsequent sudden pessimism resulting in its burst were the products of imperfect information in the international capital market.[4] That the information was imperfect is clearly illustrated by the fact that even credit-rating agencies, such as Moody's and Standard and Poor's, which are supposedly the best informed of business conditions, did not change the sovereign debt rating of Thailand before July 1997, though corporate bond ratings were previously lowered.

Capital account crises of this nature can be prevented if the domestic financial sector is closed against the international market. However, the other type of crisis could well have arisen under a closed capital account, as occurred in the Latin American debt crisis of the 1980s. Since the crisis in Latin America resulted mainly from spendthrift and imprudent government borrowing, it can appropriately be called government failure. This experience as compared with the financial crisis in East Asia clearly shows that government failure under a regulated capital

[4]There is no denying that the newly industrialized economies and the Association of Southeast Asian Nations were facing several unfavorable factors in the 1990s. First, the competitive strength in the export of labor-intensive manufactures weakened relative to People's Republic of China and Mexico as the result of their currency devaluation in 1994 and 1995-1996, respectively. Second, competition from Japan intensified following the depreciation of the yen after 1995. Moreover, the high investment in manufacturing that had been enhanced by the prospect of greater international competition resulting from the progress of regional integration and trade liberalization within East Asia began to create excess production capacity (McKinnon and Pill 1996, Suehiro 1999). Shinohara (1998) added evidence in support of the hypothesis that 1997 coincided with the trough of the medium-run business cycle—about ten years for East Asia—the so-called Kuznets cycle. While these factors should have been significant, it is unlikely that the Asian financial crisis would have been so severe and widespread had not the capital account been liberalized under euphoria on future business prospects without due prudential supervision and regulation.

account could be no less serious than market failure under a liberalized capital account. In fact, as the experiences of Argentina and Mexico show, a crisis based on government failure can occur irrespective of whether the capital account is open or closed.

Characterization of the East Asian crisis as a market failure does not mean that governments in this region were not responsible in this failure. On the contrary, their responsibility was grave, for failing to provide appropriate prudent supervision and regulation of risky transactions in the international financial market. This failure may legitimately be called a government failure, as it was failure in fulfilling the basic mandate of government, i.e., the provision of appropriate public goods. Yet, the fact remains that profit-seeking private agents, misguided by imperfect information, were directly responsible for creating the crisis in East Asia. In this respect the East Asia crisis differs from the Latin American crisis that stemmed directly from the behavior of politicians and bureaucrats.

### C. Overcoming the Asian Financial Crisis

When the capital account crisis emerged in Asia, multilateral lending institutions, especially the IMF, failed to understand that the nature of this crisis was different from previous crises in Latin America and elsewhere. Therefore, when the IMF organized emergency loans for the crisis-hit economies, it imposed on them the same kinds of conditionalities, such as cutting the government budget and raising the Central Bank rediscount rate, as it had applied in Latin America to curb domestic demand and improve the current balance of payments. Such policies, when applied to a capital account crisis characterized by sharp credit contraction, simply intensified the credit crunch and aggravated the economic recession (Radelet and Sachs 1998, Yoshitomi and ADBI Staff 2003). Other conditionalities, geared to deregulation and liberalization, such as abolition of government-directed credits and removal of monopoly by state enterprises or government-connected enterprises, were not relevant as emergency measures to cope with the sudden crisis. These were also criticized as being undue interventions in domestic affairs and going beyond the mandate of IMF (Feldstein 1998). The most fundamental criticism against the IMF in the context of the Asian crisis was that it had exerted pressure on developing countries to open their capital account prematurely before the crisis, without due regard for the need to strengthen their financial market institutions (Bhagwati 1998, Stiglitz 2002).

Despite such policy mistakes, recovery of the crisis-hit Asian economies was fast. Within the years 1999 and 2000, they were able to more than compensate for the major drop in real GDP in 1998 (with the exception of Indonesia, handicapped by continued political instability). Especially remarkable was the growth of Korea's GDP, at 11 percent in 1999 and 9 percent in 2000, as compared with the drop of 7 percent in 1998. Major reforms by the Korean government in banking institutions, corporate governance, and labor relations, pushed through under the crisis situation, yielded high pay-off under the excellent fundamentals in East Asia including sound fiscal management and high savings rates.

## IV. MISAPPLICATION AND LIMITATION OF THE WASHINGTON CONSENSUS

The strategy aimed at accelerating the growth of developing economies based on the efficiency-enhancing power of free markets, which was established as a paradigm under the popular title of the Washington Consensus by the early 1990s, has been replaced by a new paradigm quickly, in less than a decade. The nature of the new strategy and the factors underlying the paradigm change shall be discussed in this section.

The term "Washington Consensus" was coined by John Williamson, a former World Bank manager, to characterize consensus reached among economists in three important agencies with headquarters in Washington, D. C.—the IMF, the World Bank, and the US Treasury Department—on the "the lowest common denominator of policy advice being addressed…. to Latin American countries as of 1989" (Williamson 2000, 251). It was understood as an economic doctrine in support of SAP under the guidance of the IMF and the World Bank. The early success of SAP in containing the Latin American debt crisis elevated the Consensus to the status of a paradigm but its credibility was sharply reduced by the failure of the IMF in applying SAP to the recurrent crisis in Argentina and to the Asian financial crisis, as explained in the previous section. However, which elements of the Consensus were really responsible for the failures have not been made quite clear.

According to Williamson (1993 and 2000), the Washington Consensus consists of the following 10 basic principles:

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| Principle 1: | Fiscal discipline |
| Principle 2: | Concentration of public expenditure on public goods including education, health, and infrastructure |
| Principle3: | Tax reform toward broadening the tax base with moderate marginal tax rates |
| Principle 4: | Interest rates to be market determined and positive |
| Principle 5: | Competitive exchange rates |
| Principle 6: | Trade liberalization |
| Principle 7: | Openness to foreign direct investment |
| Principle 8: | Privatization of state enterprises |
| Principle 9: | Deregulation or abolishment of regulations that impede entry or restrict competition, except for those justified on safety, environmental, and consumer protection grounds, and prudential oversight of financial institutions |
| Principle 10: | Legal security for property rights |

If these "ten commandments" really comprise its doctrine, the Washington Consensus, per se, could not have been the source of the IMF's mistakes. As previously observed, the open capital account coupled with the fixed exchange rate represented a critical institutional condition underlying the emergence of the crises in both Asia and Latin America. Yet, Williamson's manifesto did not include liberalization of international capital movements in general, including short-term credits and portfolio investments, though it did include the liberalization of foreign direct investment (Principle 8). And while it recommended the setting of exchange rates at competitive levels (Principle 5), it did not recommend that they be fixed. Thus, the improvements necessary to the system for controlling foreign exchange transactions, as discussed in the previous section, are fully compatible with the Washington Consensus as described by Williamson. More importantly, his manifesto strongly recommended fiscal discipline to prevent government budget deficits from accumulating into debt burdens of unmanageable levels (Principle 1). Related recommendations were the strengthening of the tax base (Principle 3) and the concentration of government expenditures on public goods (Principle 2).

If the IMF had guided the Argentine government according to these principles, especially numbers 1 and 5, the tragedy in 2002 would have been avoided. Also, if the IMF had been aware of the economic conditions under which the tight fiscal policy along Principle 1 can be effectively applied, the damage of the 1997 crisis on East Asian economies could have been significantly reduced. Thus, the failure of the Washington Consensus as a guiding principle of international development assistance should not be inferred from the failures of the IMF-led structural adjustment policy in the late 1990s and early 2000s. On the contrary, if adherence to the Consensus in pursuit of SAP had been more faithful and complete, perhaps more adequately adjusted for country-specific cultural traditions and social environments as well as economic conditions, middle-income economies in Asia and Latin America would have more satisfactorily been set on track for genuinely sustainable economic development.[5]

A more valid criticism of SAP is its apparent inability to promote growth and reduce poverty in low-income economies. Poor achievements in those areas, especially in Sub-Saharan Africa, have been amply documented (World Bank Country Economics Department 1988, 1990, 1992). Indeed, in the heyday of SAP, from 1987 to 1996, the number of people living below the poverty line of one US dollar per day in Sub-Saharan Africa increased by one third, and nearly half the total population continued to live below this poverty threshold. In South Asia, the

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[5]Along this logic, Kuczynski and Williamson (2003) argued that the first condition to restart economic growth in Latin America is to push through the "first generation reforms" embodied in the original Washington Consensus, which should be reinforced by additional reforms such as the liberalization of labor markets and the improvement of civil service and judiciary systems.

region home to the largest population below the poverty line, the share of people living on less than one dollar per day decreased but the absolute number continued to increase (World Bank *World Development Report 2000/2001,* 23). Even in some middle-income economies, mass poverty persists, especially in the countryside far from main development currents. The rapid pace of globalization has made even these remote areas visible to all. The persistent poverty as revealed has inevitably become a major public concern, hurting the humanitarian conscience of affluent people and escalating the frustration of poor people to levels of desperation and violence. The disappointing performance of SAP in achieving economic growth in low-income economies at speeds sufficiently rapid to reduce poverty significantly cast doubt on its relevance as a strategy of international development.

Serious doubt has also been cast on the basic premise of the Washington Consensus, improvement in economic efficiency through the mechanism of the free market, and on the SAP approach that it supported. Ishikawa (1994) and Stiglitz (2002), among others, argued that while the SAP approach may be effective in middle-income economies with relatively well-developed market organizations, it is ineffective in "customary economies" characterized by an underdeveloped market, where markets are highly imperfect or even nonexistent under severe information imperfection; the SAP reforms of liberalization, deregulation, and privatization not only failed to improve such economies but often made them less efficient with an increased incidence of market failure. Thus, contrary to the SAP prescription, Ishikawa and Stiglitz considered active government intervention in resource allocation, including the promotion of infant industries by such means as border protection, subsidies, and state enterprises, to play an important role in promoting the development of these economies.

The general perception, conveyed under the influence of the Washington Consensus, that the free market system is broadly and universally efficient in enhancing economic growth has also waned. A major contributing factor is emphasis being placed on the critical importance to economic development of appropriate institutions, institutions that differ across economies on different historical paths. Argument in support of this has gained increasing currency with the prominence of comparative institutional analysis (North 1981 and 1990, Williamson 1985, Aoki 2001, Greif 2004). Empirical evidence has also accumulated. One example is Malaysia's escape from the Asian financial crisis by strengthening government regulations on international capital movements. Even better illustrative examples are evident in the remarkable economic growth performances of some transition economies, such as the PRC and Vietnam, under much stronger government command and guidance (including the closed capital account) than in traditional market-based economies.

These arguments and examples have made the development assistance community increasingly aware of the need to incorporate into the design of development policy country-specific institutions based on a proper understanding of cultural values and social norms as well as development stages. This awareness of the critical importance of institutions in recipient countries has become one of the major pillars of a new paradigm of international development assistance, characterized as the "Post-Washington Consensus" (Stiglitz 1998).

## V. POVERTY REDUCTION AS AN IMMEDIATE OBJECTIVE

Another major pillar of the Post-Washington Consensus is the identification of poverty reduction as an immediate objective of development assistance rather as a consequence of the economic growth the assistance is designed to stimulate. By nature, market competition is a strong instrument for increasing economic efficiency, but not an instrument for improving equity. If poverty reduction is considered an overarching immediate objective, nonmarket instruments may have to be used to redistribute market-produced income in favor of the poor. Moreover, if poverty is viewed not simply as receipt of less than a socially allowable minimum subsistence income, but also as a restriction in human capability in the sense used by Sen (1999), then social services such as education, health, and social safety nets must be delivered to the poor through nonmarket channels. Linking these two pillars brings to the fore the importance of nonmarket institutions such as government and civil society.

The Washington Consensus did recognize the important role of government in supplying social services such as education and health care (Principle 3 in Williamson's list). However, the Post-Washington Consensus went even further in recognizing also the possibility of government corruption and collusion such that poor people would be excluded *de facto* from access to these services. To counter this possibility, the new paradigm emphasizes strengthening the voice and power of poor people ("empowerment") and maximizing the initiative of aid-recipient communities ("ownership") in the design of development assistance.

The advocates of SAP under the influence of the Washington Consensus would not have disagreed with identification of poverty reduction as the ultimate goal of development assistance. Yet, explicitly or implicitly they left the task of poverty reduction to the "trickle down" effect from economic growth. Dissatisfaction with this increased with the obvious persistence of dire poverty and misery among people in low-income economies. Public impatience with development assistance according to the SAP strategy grew in civil society in high-income donor countries, culminating in open (often violent) protests against the IMF and the World Bank as well as the WTO.

Antiglobalization and antigrowth advocacy was directed, to a significant degree, at the obvious adverse effects of some SAP policies. In some cases, privatization created opportunities for the power elite to grab state enterprises to form private monopolies; this, together with ill-conceived reductions in subsidies on basic necessities, such as food and energy, in the drive to "get prices right", imposed serious burdens on those living at the margin. At the same time, many activists seem to be driven by a popular presumption that globalization promoted via SAP benefited big business, especially multinational corporations, at the expense of poor peasants, cottage industries, and urban slum residents unable to find formal employment—an image akin to that of Karl Marx's vision of the industrializing West in the $19^{th}$ century. Correct or not, their voices were a prime force in elevating the post-Washington Consensus to the paradigm of development assistance in the first decade of the new millennium. After the attack on the World Trade Center, New York on 11 September 2001, this view was reinforced by fear of terrorism and the belief that poverty is a contributing factor.

Like any other paradigm, the Post-Washington Consensus came to be construed beyond its original economic context. In particular, it came to be applied broadly to the poverty-oriented development assistance approach of the late 1990s, spearheaded by the World Bank. In fact, the World Bank, as the dominant development institution, had aimed at reducing poverty since long before the 1990s. Although it is not mentioned in the World Bank's founding documents, poverty reduction had been a stated goal since the early 1970s, when then President Robert McNamara declared it to be such. The 1970s marked an attempt to improve living standards in the absence of growth, when the previously dominant strategy of import-substitution industrialization proved to be incapable of bringing economic growth to developing countries. The main vehicle for this was "Basic Human Needs", a campaign initiated by the International Labour Organisation in 1976. The idea was that the priority for development assistance by both bilateral and multilateral agencies should move from building large-scale industries and infrastructure to guaranteeing to poor people conditions adequate to meet their basic human needs defined as: (i) the minimum requirement of a family for its own consumption, including but not limited to food, clothing, and shelter; and (ii) essential services provided by and for the community, including drinking water, sanitation, education, and health facilities (Streeten et al. 1981). To meet these needs, there would have to be significant government involvement, which was quite compatible with the views of that time. By its thrust, this approach is considered a precursor to the Post-Washington Consensus. Enthusiasm for the Basic Needs approach was short lived, however. It was found to be difficult to sustain improvement in living standards without economic growth; at the same time the SAP approach was then demonstrating a fresh possibility for accelerating growth in developing economies.

Under the SAP regime, poverty reduction continued on the agenda of the World Bank, realizable through the instrumentality of economic growth. But as SAP and the Washington Consensus ebbed, poverty reduction ceased to be an adjunct of growth and became an immediate goal in itself. The shift can be seen in a comparison of the World Bank *World Development Report 1990* (*WDR*) subtitled "Poverty", and the *WDR 2000*, subtitled "Attacking Poverty." The former, while highlighting poverty reduction and spotlighting the importance of people, still juxtaposed poverty reduction with growth. It proposed that an effective poverty reduction strategy would consist of: (i) making production systems as labor-intensive as possible to increase labor employment and income, (ii) increasing government expenditure on training and education to increase the capacity of the poor to participate in the economy, and (iii) providing social safety nets for those who cannot be productive. The *WDR 2000*, in contrast, put poverty reduction in human development terms and stressed the development of pro-poor institutions that could promote opportunity, facilitate empowerment, and enhance security.

The World Bank's operational shift to the Post-Washington Consensus was officially endorsed by James Wolfensohn, appointed president of the World Bank Group in 1995. He declared the Bank motto to be "Our dream is a world without poverty" and began to pursue "pro-poor" development. Reorientation of the organization toward poverty reduction was promoted under three axioms: (i) the overarching goal of development assistance is poverty reduction; (ii) poverty is more than lack of purchasing power but includes a range of economic, social, and political deprivations; (iii) poverty reduction will not be possible in the absence of viable institutions through which people can participate in and take ownership of the development process. By adopting this platform, social and political ramifications, which the Washington Consensus had avoided, were embraced by the Post-Washington Consensus.

The methodology for implementing the Post-Washington Consensus was an array of interlocking, mutually reinforcing processes. Collectively they have come to be referred to as the PRSP process. PRSP stands for "poverty reduction strategy paper", a comprehensive, detailed document prepared by a developing country explaining its own plan for reducing poverty. One of the weaknesses of SAP had been that conditionalities were imposed and often did not engage the recipient government or people. This weakness is rectified in the PRSP process because the strategy is prepared with full participation by the government and is expected to engender a sense of ownership and commitment to the objectives. In PRSP preparation, the government is to be in the driver's seat. Although initiated by the World Bank, the PRSP process has been widely accepted at all levels of development effort and most aid agencies have incorporated it or otherwise made it compatible with their own programs.

The PRSP must include four core elements: (i) a description of the country's participatory process; (ii) a poverty diagnosis; (iii) targets, indicators, and monitoring systems; and (iv) priority public actions, which should be summarized in tabular form for a three-year time horizon. PRSPs are the basis for concessional assistance from both the IMF and the World Bank, including debt relief under the HIPC (Heavily Indebted Poor Country) Initiative so that its acceptance by the joint WB/IMF assessment committee is very important. That step involves an examination by the committee, which looks at a number of items according to the particular country but which will include the following: adequacy of poverty data; medium-term and long-term poverty reduction goals; provision of adequate monitoring systems; macroeconomic framework that does not undermine the private sector but is consistent with the poverty reduction objectives; and policy environment, allowance for a safety net, fiscal choices, and financing plan (domestic and external flows, including aid).

The dramatic shift in the orientation of the World Bank's activities has been paralleled with changes in other international organizations with mandates for international development assistance. In the mid-1990s, the Organization for Economic Cooperation and Development (OECD) formulated a list of quantified goals to be met by a set date, the International Development Targets (IDTs). In 2000, the United Nations adopted essentially the same list as its Millennium Development Goals (MDGs) to begin with the goal of halving, between 1990 and 2015, the proportion of people whose income is less than one dollar a day and the proportion of people who suffer hunger. It is important to note that all the goals specified in MDGs are related to quality of life and no target is stipulated for economic growth, reflecting the current mode of the development assistance community to set poverty reduction as the immediate goal rather than the consequence of economic growth.

## V. THE POST-WASHINGTON CONSENSUS PROSPECT: A CONCLUDING REMARK

By the first years of this millennium the Post-Washington Consensus has become firmly established as the principal guidepost to policies for developing economies. In the context of theory, while the Washington Consensus was confined rather narrowly to standard neoclassical economics, relying on market competition for efficient resource allocation, the Post-Washington Consensus broadened the scope to include nonmarket factors such as social norms and power balances, drawing heavily on the recent achievements of institutional economics. As such, the Post-Washington Consensus may appear to be a better recipe for developing economies characterized by underdeveloped markets. But, is it really so?

### A. Market versus State

The attack on SAP reforms by Ishikawa (1994) and Stiglitz (2002), referred to earlier, grew out of their recognition that reforms to reduce government control and intervention will be ineffective or even damaging in low-income economies. This is because market failures arising from such reforms will inevitably be very large where the market is highly imperfect under severe information imperfection. While this argument is theoretically valid, it may be refuted on the grounds that in the economies characterized by high degrees of information imperfection, government failures may be even more damaging than market failures. This is likely to be especially the case in Africa where national boundaries were determined through the politics of colonial powers and, therefore, national integrity and government authority have been very weakly established.

The Washington Consensus emerged as an antithesis to the import substitution industrialization strategy. It aimed to correct the government failures that loomed very large under the ISI regime. Similarly, the Post-Washington Consensus is an antithesis to the SAP strategy, aiming to correct the failures of liberalized markets by increasing the government role in resource allocation. Such a sequence of paradigm changes resembles the shift from mercantilism to Adam Smith's doctrine of market liberalism, and further to Friedrich List's strategy of infant industry protection (Hayami 2001, 229-36). Whether to increase the role of government relative to market or vice versa is an eternal topic in debates over policy choice for development. The net social gain from the replacement of one strategy (e.g., Smith's) by another (e.g., List's) is the sum of differences in both government failures and market failures associated with the two strategies, a sum that varies country by country depending on social tradition and development stage. Thus, in contemplating the strengthening of government role for any developing economy along the guidelines of the Post-Washington Consensus, corresponding changes in the respective failures must be assessed very carefully and objectively. If the decision is based on an ideological preconception, it will prove to be devastating. Policymakers must always be aware of the danger of being trapped by a "consensus" on any kind of "paradigm."

The same caution should apply to reforms of the SAP type, aimed at reducing government intervention. In this case, maximum care must be taken that the reform plan is consistent with county-specific conditions, in terms of reform instruments and time sequences of implementation, to prevent market failures from looming large. Failures of SAP, as amply illustrated by Easterly (2001) and Stiglitz (2002), are invaluable lessons for future market-oriented reforms.

### B. Growth versus Equity

Besides the choice between the market and the state, the two consensuses are different in their relative emphases on growth and equity. By identifying poverty reduction as an immediate goal instead of a consequence of economic growth, the Post-Washington Consensus advocates that a greater share of public resources be allocated for the delivery of social services to the poor rather than for strengthening the productive capacity of the economy. The MDGs, for example, stipulate no target for increased production or productivity of any sort. Though not explicitly stated, it appears that programs in the Post-Washington Consensus context are strongly oriented toward improving the quality of life of the poor through redistribution of social income in their favor.

There is nothing wrong with this equity orientation if it is consistent with the social preference of the world community. There is a danger, however, that strong emphasis on social services might result in underinvestment in the productive capacity of sectors from which the poor earn their livelihood. Typically, the majority of poor people live mainly on returns to their labor applied to agriculture, small-scale manufacture, and petty trade. If the productivity and profitability of these sectors are not increased, how can poverty reduction be sustainable? The wide diffusion of primary education and health care, as emphasized in MDGs and other pro-poor development plans, is of course an indispensable foundation for upgrading the productive capacity of people. However, vocational education and training, which are vitally important to support the development of agriculture, small-scale manufacture, and commerce is being neglected or receiving insufficient attention. The critical need for public investments in production-oriented infrastructure in general is not being properly emphasized. This is true for agricultural as well as industrial research and extension to produce and disseminate profitable technologies to small farmers and manufacturers, for irrigation and rural electrification to make water and power available to them, and for roads and communication systems by which producers and traders in remote marginal areas can have access to wide markets. All such investments generate economic growth while at the same time contributing directly to the reduction of poverty. Here there is no tradeoff between growth and equity, so long as these supports are properly chosen and targeted.

It is important to recognize that significant decreases in development assistance on production infrastructure and services did not begin with the Post-Washington Consensus but it began under the Washington Consensus. With its strong belief in the efficiency of the market mechanism, the Washington Consensus advocated leaving investment in production infrastructure to private funds mobilized by the market, which was considered possible so long as the proposed investment projects could be expected to yield high financial returns. Correspondingly, investments in hard infrastructure, such as roads, railways, and electricity, were greatly reduced in the programs of development assistance, especially in the World Bank. Even agricultural research and irrigation investments, which are vital to billions of poor farmers, were curtailed. The advocacy for leaving production infrastructure to private initiative was a reasonable corrective to the bias of ISI strategy of concentrating development resources in large-scale, capital-intensive industries, but it is critically flawed when applied to infrastructure critical to small farms, cottage industry, and petty trade. Their production scale is too small to internalize gains from any infrastructure project adequate to pay its cost. And they are too numerous to effectively organize collective actions for producing their own infrastructure (Olson 1965). As such, the public-goods characteristics of production infrastructure and services to poor people are no weaker than the public-goods characteristics of social services to them. Therefore, the supply of production infrastructure critically needed for the support of their economic activities cannot rely on private markets alone.

As most clearly elucidated by Schultz (1964), broad-based growth of low-income economies is possible only when public programs supply profitable production opportunities for poor people. Indeed, the failures of both ISI and SAP in supplying sufficient support to these production activities is believed to underlie their failures in achieving both economic growth and poverty reduction in low-income economies over the past half century. The success of East Asia in this regard is considered to underlie its economic miracle and distinguish it from other regions, such as Africa (Plateau and Hayami 1998).

The importance of delivering social services to the poor for improving the quality of their lives cannot be overemphasized. However, if poverty reduction programs under the influence of the Post-Washington Consensus are so structured that public resource allocation for the supply of social services becomes so disproportionately large that it results in underinvestment in production-oriented infrastructure and services, then such programs will likely prove counterproductive to the goal of poverty reduction itself. Unless this risk is duly recognized and avoided, the current bandwagon of poverty reduction may well replicate the fate of the equally enthusiastic Basic Human Needs approach of three decades ago: relegated to a comment in the history books.

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