Beyond the »Washington Consensus«: Macroeconomic Policies for Development

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In this paper, we argue that a high rate of capital accumulation is vital for economic development[1] and poverty reduction and that improving the efficiency of markets on the micro level (improved allocation of resources) does not necessarily trigger growth. Instead, a stable monetary system with a high »quality« local currency and, in particular, a sustainable balance of payments constellation are key factors. This stands in contrast to the so-called »Washington Consensus«. Along these lines, in the first part of this article we analyse a scenario of underdevelopment and development. We show that the rapid economic growth in China over the last 25 years fits very well in this positive scenario of development. Generally speaking, most East and South Asian developing economies have in recent decades exhibited strong growth, whereas Latin America and Sub-Saharan Africa have stagnated in terms of growth per capita.[2]

The expression »Washington Consensus« was coined to capture the vision of the Washington-based institutions – especially the International Monetary Fund (IMF), the World Bank and the US Treasury – designed to bring about development in Latin America, but later applied to all developing and transition countries. In part two we discuss the Washington Consensus and its later modification. Here, we identify some macroeconomic shortcomings and a lack of clarity. We conclude that macroeconomic policies must play an important and comprehensive role, especially in developing the domestic financial sector, whereas the Washing-

1. Here the term »development« is used in the sense of sustained growth, high enough to contribute to reducing poverty. We are well aware, of course, that development is more than just a matter of growth.
2. From 1980 to 2002 average annual per capita GDP growth (in 1995 US-Dollar) was –0.6 percent in Sub-Saharan Africa, 0.2 percent in Latin America, 3.2 percent in South Asia (India contributes about 75 percent to the region's GDP), and 5.9 percent in East Asia and the Pacific (China being the biggest contributor with 61 percent) (own calculations with World Bank 2004; the figures include only developing countries).

ton Consensus focuses too much on structural measures aimed at improving efficiency at a microeconomic level and on the belief that liberalized markets spontaneously create prosperity and reduce poverty.

Regimes of Underdevelopment and Development

Underdevelopment Regime

The most important single macroeconomic factor that is a necessary precondition for development is a stable domestic currency which is widely accepted by domestic households, banks and firms. Stability of the currency involves low domestic inflation as well as a stable exchange rate. This is also a necessary precondition for a workable financial sector able to offer sufficient credit at low interest rates without a high degree of dollarization,[3] depreciation and inflation risk. It is evident that particularly currencies issued in developing countries have problems competing with the world's leading currencies, as they are depreciation-prone.

The typical underdeveloped country has a high current account deficit and thus an increasing stock of debt in foreign currency.[4] Such a constellation can be stable for a long time – theoretically it can even be sustainable under certain conditions and be connected with high growth. Generally speaking, however, the fragility of the economy increases with increasing gross foreign debt. Even if governments in developing countries follow sound economic policies they will be forced to accept the denomination of external debt in foreign currency. This »original sin« (Eichengreen and Hausmann 1999; Eichengreen, Hausmann and Panizza 2002) – starting to incur external debt in hard currency – which cannot be overcome by developing countries, leads to great vulnerability. The higher the (gross) external indebtedness the greater the danger that indebtedness will lead to a debt crisis. There are two patterns:

a) A country with high foreign debt is confronted with an abrupt refusal on the part of creditors to roll over credits and/or with a sudden out-

3. Dollarization is the unofficial or official use of a hard currency, mainly the US dollar, in parallel with or instead of the local currency.

4. The arithmetical average current account deficit in the 1990s of 100 low- and lower-income countries (less than 2,955 US-Dollar per capita) was 5.9 percent, with maximum deficits of more than 30 percent in some countries. Average growth per capita in low income countries (less than 755 US-Dollar per capita) was –0.5 percent, in lower middle income countries 1.4 percent (cp. Priewe and Herr 2005).

flow of capital. Then the resulting depreciation leads to a serious domestic liquidity and solvency crisis as a sharp depreciation increases the real debt burden of those indebted in foreign currency. This is due to a currency mismatch (debtors realize revenues in domestic currency but have their liabilities in hard currency, see Jeanne and Zettelmeyer 2002). Kaminsky and Reinhart (1999) found that especially in developing countries an exchange rate crisis typically leads to a banking crisis as firms and banks in countries with high foreign debt break down as a result of a strong depreciation.[5] It should be emphasized that current account deficits (even high ones), combined with high growth, may prevail sometimes for long periods, especially if the deficits are used to import investment goods. However, the appearance of a link between growth and current account deficits is deceptive; the longer the imbalance is sustained the greater the risk that strong and often sudden depreciations will ultimately be triggered.[6]

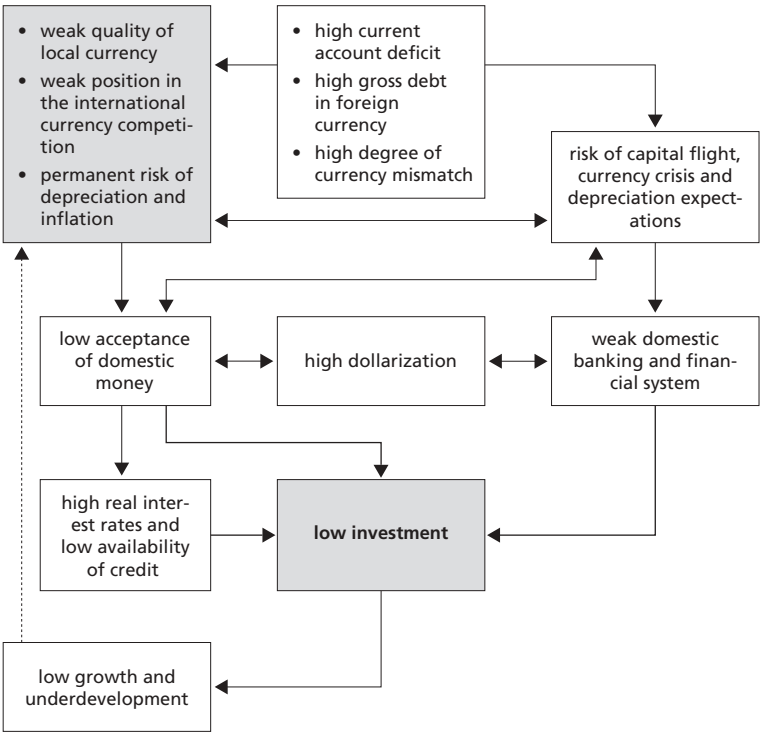
b) Most low income countries – especially the heavily indebted poor countries (HIPC) – have little access to commercial external finance and hence depend on credits from international institutions and foreign governments. These capital flows are relatively stable as donors normally do not cease to give credits. The problem facing these countries is that their current account deficit is not sustainable and that they grow slowly in a situation of permanent over-indebtedness. Debt relief improves the situation until after some time over-indebtedness returns (Easterly 2002).

As rational economic agents know the disastrous consequences of over-indebtedness and devaluations, high current account deficits and high gross foreign debt weaken the reputation of the domestic currency. This leads to a risk premium with substantially higher real (i.e. inflation-adjusted) interest rates in developing countries and leads to an even less equal income distribution.

Countries with high foreign debt in foreign currency are afraid of devaluing and thus tend to delay devaluation even if they have huge current account deficits. Such a policy is detrimental to exports and the reputa-

5. The Asian crisis in 1997 and the Russian crisis in 1998 are good examples of these effects. In both cases the central bank could not help and the financial system collapsed. For an overview of such twin crises see Kaminsky and Reinhart (1999).
6. Potentially, the depreciation risk can be attenuated under a global currency system with fixed exchange rates like the Bretton Woods system 1944–73.

Figure 1:
Underdevelopment Regime



tion of the local currency. Capital flight has to be reduced or necessary capital imports have to be stimulated with high interest rates. Countries in such a situation are caught in a dilemma. Depreciation could destroy the domestic financial system because of too high foreign debt, and avoiding devaluation requires additional foreign debt and higher debt servicing. Since the current account deficits in such countries are partially paid for by policy loans or donations, these »soft budget constraints« can delay necessary adjustments. The currency crises in Russia in 1998 – despite a current account surplus – and Argentina in 2002 are two telling examples of the scenario described. Both countries accumulated unsustainable foreign debt, and in both cases extreme depreciations occurred

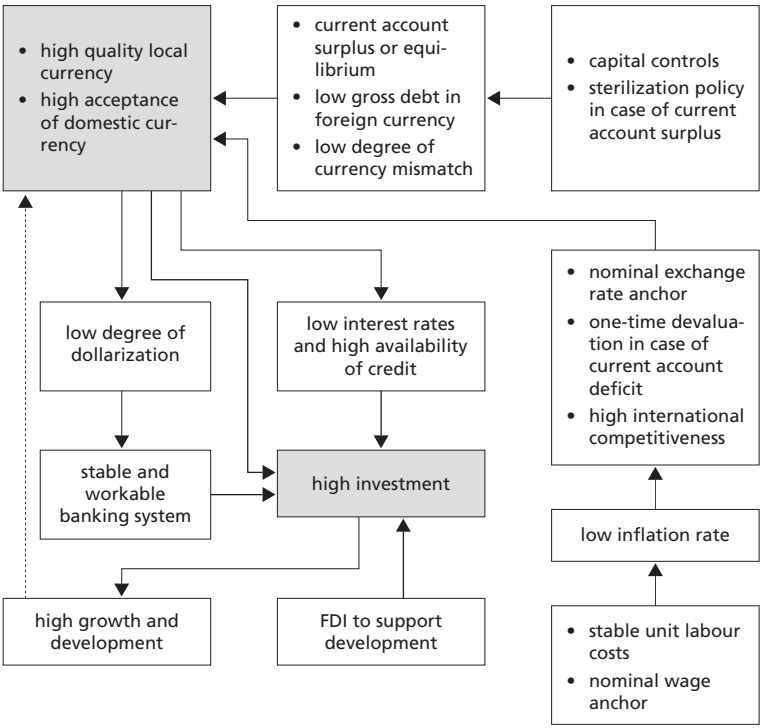
with disastrous effects on the domestic financial system (Stiglitz 2002; Mussa 2003; Teunissen and Akkerman 2003).

Any external shock, sometimes even minor ones, from the world economy or from inside the country – and shocks are more likely in developing countries, with their often fragile economic, social and political systems – can trigger a financial crisis. In such a situation, economic agents prefer to retain a large share of their financial wealth in dollars or euros: if it is kept abroad, it is capital flight; if it is kept inside the country, it is dollarization. The results are high interest rates and an unstable domestic banking system. To put it differently, the country is not able to issue a domestic currency which is sufficiently accepted by wealth owners, resulting in high interest rates, high dollarization and a lack of credit. The overall effect is low investment and low growth. The bad economic performance of the country provides no scope for improving acceptance of the domestic currency. Even a stable price level and a stable exchange rate may not be able to improve the quality of the domestic currency, reduce dollarization and give the Central Bank the opportunity to cut interest rates and stimulate credit supply, as long as negative expectations prevail. The »wait-and-see« attitude stressed by Dornbusch (1990) prevents re-acceptance of domestic money, so the country gets stuck on an underdevelopment path. Figure 1 presents a typical underdevelopment regime.

Development Regime

Figure 2 depicts a macroeconomic scenario which is beneficial for sustained growth. Policies are actively geared towards the most vital point for development: the creation of an accepted national currency and the stimulation of investment. A high quality domestic currency can only be attained if price-level stability, exchange-rate stability (not necessarily fixed exchange rates) and sufficient growth can be realized over a longer period. Price-level stability and the accumulation of trust in the domestic currency in developing countries is directly related to exchange-rate stability as the exchange rate is the best indicator of whether a currency is keeping up with the international currency competition. Nominal exchange-rate stability and high international competitiveness – the latter is also a precondition for development – can only be achieved simultaneously if domestic costs are stable. The most important single domestic cost factor is wages, depending on the prevalence of wage-labor in the country. Hence nominal wage increases should follow average productivity growth (plus target

Figure 2:
Development Regime



inflation rate) – this is a »nominal wage anchor« which underpins exchange-rate stability (»nominal exchange rate anchor«).

Active macroeconomic policy includes striving for a current account surplus or a balanced current account. The lower the stock of foreign debt the easier it is for a country to achieve such a constellation. Current account surpluses and low debt in foreign currency seem to be the most efficient lever in convincing economic agents that depreciations are unlikely and the domestic banking system is stable. Increasing exports in combination with a surplus in the current account lead to export-led growth. In fact, export and investment demand can be considered superior demand engines for growth, especially in developing countries. The

higher the acceptance of the domestic currency the lower the domestic interest rate as the reputation of the domestic currency is built up and fears of devaluation and systemic domestic failures in the banking system vanish.

> The world economy would create less destabilizing shocks for developing countries if there were more exchange rate stability between the US-dollar, the euro and the yen, and if at the same time there was a mechanism which could stabilize the current account balances of developing and developed countries.

When growth starts, it is very likely that capital imports will increase. If capital imports become too high they push a country into a constellation of current account deficits.[7] To prevent the destruction of the positive development scenario, appropriate capital import controls can be used (Eichengreen 1999), as well as other measures such as increases in foreign reserves or stimulation of selected capital exports. In such a situation all types of capital inflow, except foreign direct investment (FDI) and some long-term credits from international institutions like the World Bank, should be discouraged or even suppressed. FDI has the advantage that the exchange rate risk is on the side of the investor and that it increases the likelihood of transfers of technology and management skills and helps establish the creation of export channels. A central bank can combine FDI inflows with current account surpluses by building up foreign reserves.[8]

The macroeconomic constellation described here is likely to reduce capital flight and dollarization.[9] High-growth economies like Germany during the 1950s, Taiwan for decades after the Second World War, China

7. By definition, with constant international reserves net capital imports are reflected in a current account deficit and vice versa.
8. In this case a sterilization policy on the part of the central bank is necessary to neutralize the growth of local money after hard currency inflows have been exchanged into local currency. Sterilization is only possible to a certain extent.
9. In the first phase of such a development, de-dollarization should be supported by discriminating in favor of domestic foreign currency deposits. Several options, such as higher reserve requirements for foreign currency deposits, are feasible in reaching this aim (Baliño, Bennett and Borensztein 1999).

in the 1980s and 1990s and Ireland in the 1990s combined export growth, current account surpluses, stable exchange rates, high domestic investment, FDI inflows and high GDP growth.

Obviously not all countries can have a current account surplus and follow the ideal development strategy of a country considered in isolation. If every country in the world strives for a current account surplus the world economy will acquire a restrictive and destabilizing bias. The world economy would create less destabilizing shocks for developing countries if there were more exchange rate stability between the US-dollar, the euro and the yen, *and* if at the same time there was a mechanism which could stabilize the current account balances of developing and developed countries. A global regime with an equilibrium mechanism is possible only if there is a supranational institution which organizes cooperation between countries and is able to stimulate adjustment mechanisms in case current account deficits occur. Such a supranational institution could follow the ideas of the international »Clearing Union« proposed by Keynes after the Second World War (Keynes 1969; Davidson 1999). This would require a new world currency system.

The Chinese Example

It is well known that mainland China experienced constant high GDP growth of about 9 percent p.a. between 1978 and 2004, unprecedented in economic history (China Statistical Yearbook 2004). Although the data may be flawed, there is no doubt that the growth performance was and remains outstanding, especially in comparison to Latin American countries which have, to a large extent, followed the Washington Consensus. In many respects, China has taken an alternative policy track, especially in matters of (i) trade liberalization (export promotion as well as continued import substitution, high degree of protectionism with respect to imports and exports, even strong provincial barriers for domestic trade), (ii) privatization (dominance of enterprise reforms in state-owned enterprises and banks, little privatization before the end of the 1990s), (iii) financial liberalization (government controlled interest rates, strict capital import and export controls), and (iv) exchange rate regime (fixed exchange rate since the mid 1990s). The Chinese performance certainly has many causes. Some are more country-specific, others are of general importance (see OECD 2002). Here, we shall consider the following preconditions of this growth regime (Herr and Priewe 1999; Herr 2002b).

(1) The requirements of *macroeconomic stability* dominate over optimal allocation of resources. However, under conditions of high growth, structural adjustments were implemented in a country-specific way (Rodrik 2003). Compared to the textbook model of a competitive market economy based on private ownership, undistorted prices (as well as wages, interest rates, and exchange rates), and market-friendly institutions, China was – and still is, albeit to a diminishing extent – a highly regulated, distorted market economy with a high rate of politically managed allocation, especially in the banking system. In other words, adjustment issues are clearly subordinated to growth and price-stability requirements.

(2) *Macroeconomic policies* are aimed chiefly at stimulating investment to achieve the high growth rates necessary for social stability under the present political system. Inflation ran out of control twice, in the late 1980s (18 percent in 1988) and in the early 1990s (24 percent in 1994). In both cases there was a soft landing. Besides these lapses, the degree of price stability was quite strong. After 1998, in the aftermath of the Asian crisis, a slight deflation emerged but it was overcome in 2003. The exchange rate tied to the US dollar serves as a nominal anchor. The exchange rate has been de facto fixed since the one-off 50 percent devaluation in 1993/94, managed by strong central bank interventions and control of the capital account (Xie and Zhang 2003; Sommer 2002). Since China's entry into the World Trade Organization (WTO) in 2002, the current account is by now almost fully liberalized after a reform period of more than twenty years. However, capital account transactions are strongly controlled or prohibited (though they are gradually being liberalized). Capital export is still highly regulated; more or less only FDI is allowed as a type of capital import. Therefore, the capital account controls function as a firewall for an autonomous and highly independent monetary policy. Recently the strict capital controls have been relaxed to some extent.

One of the key elements of the Chinese macroeconomic concept is keeping the current account in balance or, better, in slight surplus and accumulating foreign exchange reserves (with reserves greater than gross foreign debt, the latter being very low in international comparison). We do not know whether this concept is based on a clear and rational strategy or whether it is the unintentional result of economic or political »instincts«. Apparently, there is a strong historical fear of becoming dependent on overseas creditors. The Chinese currency is expected to take over the function of a regional anchor currency in the future, and a constellation of current account surplus combined with increasing reserves is

thought likely to induce appreciation expectations, thus hardening the local money. The reputation of the Renminbi is high. Dollarization is not a problem (in 2003 less than 6 percent of all deposits in China were in foreign currency – see Table 2 in the next section) in spite of the fact that foreign currency deposits in domestic banks are allowed.

(3) The *financial system* is still far from being domestically liberalized (see Herr 2002). It is dominated by the four big state-owned commercial banks which mainly provide state-owned enterprises with finance, thereby following a gradualist approach to hard budget constraints. The nexus of state-owned banks and state-owned enterprises is the demand-side backbone of high investment dynamics as the engine of high growth (32 percent gross investment/GDP ratio in the 1990s). In addition to the – comparatively – dynamic state-owned enterprise sector, China – since 1978 – has supported the growth of collectively owned enterprises, mostly small and medium-sized firms. Since the 1970s, FDI in the form of joint ventures as well as privately owned companies has gained importance (since the mid 1990s FDI has contributed 10–15 percent to gross domestic capital formation). Despite its under-developed, non-competitive, and distorted characteristics – with non-performing loans amounting to an estimated 30 percent – the financial sector does not jeopardize price stability, but contributes to growth. According to the gradualist transition approach, soft policy loans are slowly being phased out but are still tolerated to a certain extent, especially in the agricultural sector. One of the most amazing facts about the Chinese financial system is the ratio of domestic bank loans as a percentage of GDP: at 166.2 percent (2002) it ranks among the values of high-income countries, and is more than three times greater on average than those of low-income countries (see Table 3 in the next section). The bank-centred financial system with a certain amount of policy loans, low interest rates, low foreign debt and little dollarization has contributed to high Chinese growth. All in all, in China the domestic financial sector has been well able to fulfill its macroeconomic function of financing investment; as long as the financial distortions do not endanger financial stability, such a system is well suited to promote growth and macro-stability during a long development and transition period.[10]

10. Aziz and Duenwald (2002) argue that in China the correlation between finance and growth is misleading as most of the credit has gone to state-owned enterprises and not to the faster growing non-state sector. This is true and also problematic for future development. However, the authors do not take into account the fact that the

The Washington Consensus and the Augmented Washington Consensus

The model for development presented above and the Chinese case differ essentially from the approach to development proposed by the so-called »Washington Consensus.« The term »Washington Consensus« was introduced by John Williamson in the early 1990s to express what he thought would be the lowest common denominator of policy advice of Washington-based institutions at that time. Williamson (1990) captured the Washington Consensus in ten points (see Table 1).[11] Subsequently, Williamson's original ideas were interpreted in a more »neoliberal« fashion which became dominant. Important divergences concern the idea of corner solutions in exchange rate policies (either fully flexible or fully fixed exchange rates), the neglect of the notion of »competitive« exchange rates and the de facto pressure to liberalize cross-border capital flows. Williamson holds that »his« consensus broke down in the mid 1990s when the US Treasury pushed policies in the direction we have referred to.

> The Augmented Washington Consensus did add some important points – especially the social dimension of development and the important role of institutions – and thus was clearly an improvement. However, it did not stress or revise the macroeconomics of development policy.

Countries following the Washington Consensus closely are scarcely to be found in the list of the best growth performers. Policies in China (or India), for example, differed fundamentally from the Washington blueprint, and in spite of this were a tremendous success (Herr and Priewe 1999). On the other hand, Russia – following a shock strategy incorpo-

state sector was a growth engine which has served to boost the non-state sector too. In addition there is a huge gray and informal credit market in China, which also expanded very quickly (Naughton 1988).

11. See also Williamson (2000) and Kuczynski and Williamson (2003). It should be mentioned that, in fact, the Washington Consensus takes into account the local context only to a limited extent and is applied uniformly to all developing countries (Rodrik 2003). The remedy suggested for overcoming the Asian crisis in 1997, for example, was much the same as the one proposed for solving crises in Latin America a decade earlier (Stiglitz 2002). Moreover, the Consensus was applied to transition countries although Williamson had addressed only Latin America.

rating liberalization, stabilization and privatization which was more in line with the Consensus – failed utterly (Stiglitz 2002). Furthermore, the Mexican crisis in 1994 and even more the Asian Crisis in 1997 – which was a major surprise for the Washington institutions – followed by the Russian crisis in 1998 did not fit into the framework of the Washington Consensus. Argentina, to take another example, which followed the ideas of the Washington Consensus (at least to a large extent), can hardly be considered a success either.[12]

In the 1990s, the role of institutions was re-invented, especially as they were neglected in the original Consensus. Rodrik (2003) proposed an »Augmented Washington Consensus« which added ten further »commandments« underscoring the role of institutions and good governance (see Table 1).

Most of the twenty points concern improvements in resource allocation with the aim of increasing productivity and competition. Therefore, privatization, abolishing national monopolies, improving property rights, reducing corruption, enhancing competition, cutting subsidies »to get prices right,« abandoning barriers to domestic and international flows of goods and finance are in focus. The aim is to implement what is conceived as a truly free market economy. Free trade and financial liberalization, which after an adjustment process include more or less all capital account transactions, are important ingredients of such structural adjustments. The vision of the old and the new consensus is that macroeconomic policies have to provide a stable framework which allows markets to unfold. Thus macro-policies have to secure the preconditions for economic growth, which themselves will be triggered endogenously after structural adjustment policies are implemented. The Augmented Washington Consensus did add some important points – especially the social dimension of development and the important role of institutions – and thus was clearly an improvement. However, it did not stress or revise the macroeconomics of development policy.

12. Mussa (2003) argues that Argentina failed as the result of a misguided fiscal policy. Fiscal policy in Argentina certainly was not optimal, but it cannot explain the deep crisis. Without dollarization and high foreign debt the collapse of the currency board would not have had such disastrous effects. Strangely enough, Mussa does not even address the key point in relation to fiscal policy, namely the fact that the budget deficit was mainly denominated in hard currency, thus causing currency mismatch.

Table 1:
The Washington Consensus and the Augmented Washington Consensus

Washington Consensus (Williamson 1989)	*Augmented Washington Consensus (Rodrik 2003) (additions to the original 10-point-list)*
1. Reduction of budget deficit to a non-inflationary level 2. Redirection of public expenditure to areas such as education, infrastructure, etc. 3. Tax reforms to lower marginal rates, broadening the tax base 4. Transition to market-determined interest rates (financial liberalization) 5. Sufficiently competitive exchange rates which induce a rapid growth in non-traditional exports 6. External trade: removal of quantitative trade restrictions; tariff reductions 7. Abolition of barriers to foreign direct investment 8. Privatization of state-owned enterprises 9. Deregulation for »start-ups,« general abolition of restraints on competition 10. Better protection of property rights, particularly in the informal sector	1. Corporate governance 2. Anti-corruption 3. Flexible labor markets 4. Adherence to WTO discipline 5. Adherence to international financial codes and standards 6. »Prudent« capital account opening 7. Non-intermediate exchange rate regimes (completely fixed or completely flexible exchange rates, corner solutions) 8. Independent central bank/inflation targeting 9. Social safety nets 10. Targeting poverty reduction (for example the Heavily Indebted Poor Countries Initiative)

The macro-policies addressed in the Washington and Augmented Washington Consensuses can be summarized as follows: (i) absence of too high inflation – sometimes it refers to single-digit inflation rates as

tolerable (World Bank 2003), (ii) balanced or close to balanced public budgets, (iii) not excessive current account deficits, and (iv) either flexible or completely fixed exchange rate regimes. The main instruments for achieving these goals are tight monetary policies favoring control of the broad money supply or reaching an inflation target and tight fiscal policies focusing on the retrenchment of government expenditures.

Furthermore, if both stabilization and adjustment policies are agreed and implemented, preferential loans can be made by the Washington institutions and other donors. This type of finance is regarded as preceding private capital flows, comprising all kinds of finance, such as bank credits, portfolio investment or FDI which are intended to make up for the shortcomings of the domestic financial sector and the lack of domestic savings. Hence, developing countries are seen as emerging financial markets which offer a higher rate of return for capital (due to higher risks) and have to be included in the global financial system. This will probably lead to a high capital inflow in developing countries, which are considered essential for rapid development. It is argued that foreign savings should be added to domestic savings, resulting in higher domestic investment (in line with the old savings gap theory of Chenery and Strout 1966). This approach requires a long period of current account deficits and an accumulation of foreign debt in developing countries until »take-off« is achieved.

Apart from the aforementioned causal link between microeconomic reforms and overall economic growth, we see a lack of clarity in five areas of macro policy:

Neglect of Dollarization

Dollarization is the use of hard currency in a developing country for holding wealth, giving credit or expressing the price of wages and goods. It is a sign that agents do not trust the national currency as they expect high inflation and/or high depreciation. During the second half of the 1990s in developing and transition countries dollarization increased and became a widespread phenomenon (see Table 2).

Dollarization is a double-edged sword as it makes the domestic banking system inherently fragile:

a) Dollarization produces a dangerous currency mismatch, as banks, firms, households and the government may have debts in dollars and revenues in domestic currency.

Table 2:
Dollarization – Foreign Currency Deposits to Total Deposits (%)

Regions	*Number of countries*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
South America	8	45.8	46.1	49.4	53.2	54.0	55.9
Transition Economies	26	37.3	38.9	43.5	44.3	46.9	47.7
Middle East	7	36.5	37.2	37.7	37.5	38.2	41.9
Africa	14	27.9	27.3	27.8	28.9	32.7	33.2
Asia	13	24.9	28.0	26.8	28.8	28.7	28.2
Central America and Mexico	7	20.6	20.8	22.0	22.1	22.5	24.7
Caribbean	10	6.3	7.6	6.8	6.7	6.1	6.2
Developed Countries	14	7.4	7.5	7.5	6.7	7.0	6.6

Source: De Nicoló, Honohan and Ize (2003, p. 6).

b) For countries with high dollarization a »lender of last resort« (i.e. the central bank always providing sufficient liquidity for the banking system) exists only for the part of the financial system working with domestic currency.
c) Because of currency mismatch, there is a strong incentive for banks to invest abroad. Altogether, dollarization reduces the availability of credit in domestic currency and increases interest rates for credits in foreign and domestic currency, as compared with a situation in which the same amount of deposits is held only in local currency (Honohan and Shi 2003).[13]

13. High market determined interest rates in liberalized credit markets can lead to distorted credit allocation as good debtors drop out and risk-prone debtors are selected (Stiglitz 1992). This effect is usually not discussed when the liberalization of financial systems is recommended.

d) The greater the extent of dollarization the smaller the room to manoeuver for monetary policy. In a state of high dollarization financial wealth in domestic currency can only increase in line with the increase in wealth in foreign currency. Otherwise domestic wealth will be immediately exchanged into foreign currency.[14] The volume of credit expansion in the domestic economy, which is necessary to prevent depreciation and inflation (through increased prices for imports), may become so small that credits for investment are almost unavailable. If they are available, they are extremely costly or their volume may even be too small to prevent a permanent lack of liquidity. Increasing dollarization is identical with portfolio shifts from domestic to foreign currency. If there are insufficient capital imports, leading to the negative effect of higher indebtedness in foreign currency, an increasing degree of dollarization leads to inflation, and finally to higher domestic interest rates.

Obviously, the issue of dollarization has been neglected in development macroeconomics and regarded as an issue of minor impact. There are plenty of publications stressing the disadvantages of dollarization (for example, World Bank 2002, IMF 2003), but there seems to be no clear commitment under the Washington Consensus to seriously combat dollarization as a precondition for a stable financial system and sustainable development.

A country that cannot provide the domestic currency with sufficient trust will hardly be able to establish coherent economic mechanisms. Instead, the economy will be divided into a domestic currency segment, an unstable foreign currency segment, and – due to a lack of liquidity – undynamic barter and subsistence segments. If the domestic currency segment is inflationary, the erosion of the monetary system continues and dollarization even increases. If the domestic currency sector is stable with respect to inflation, credit expansion in this sector is likely to be so restricted that growth is repressed and in extreme cases the shortage of liquidity will stimulate the barter and subsistence segments of the economy.

14. Assume the banking system in a developing country creates 100 units of domestic currency by extending credit to the public. If the population prefers to keep 80 percent of its monetary wealth in dollars, 80 units of domestic currency will immediately be exchanged into dollars. This will lead to a depreciation of the local currency in the case of flexible exchange rates. If the central bank is not willing to accept this, monetary policy has to become more restrictive to reduce credit creation and to stabilize the exchange rate. Investment will drop sharply.

Neglect of the Domestic Financial System

The domestic financial sector using domestic currency is one of the strategic sectors in developing countries in relation to stimulating investment. In conventional theories, finance automatically follows the real economy or a lack of domestic finance can be compensated by foreign finance. Much of the discussion about structural adjustment in the financial sector focuses on the debates on »repressed« (i.e. regulated, mainly with respect to interest rates) versus liberalized finance. The bi-polar view is not very conducive as both alternatives involve severe shortcomings. We call for more attention to be paid to the macroeconomic framework of the financial sector and appropriate institution-building, including adequate regulations. Prior to facilitating cross-border opening of financial flows, a stable domestic financial system must be shaped. As dollarization makes a financial system inherently vulnerable, the degree of dollarization has to be reduced to a low level as a precondition for a sound financial system.

Investment in fixed assets is the key factor in growth and development. In line with investment, human capital formation and technical progress must and can take place. However, we do not agree that investment should be financed from foreign sources. Basically, a domestic financial system always has the potential to finance investment with domestic credit. Among others, Schumpeter (1934) argued that development is possible only if innovative entrepreneurs obtain bank credits to invest. What is necessary is *new* credit created first of all by the banking system with the help of the central bank. Savings under such an approach will be created subsequently out of the new income stimulated by investment.[15]

It is frequently argued that financial systems in developing countries are shallow and too small to be efficient, therefore making it necessary to access the huge and sophisticated global financial markets (for example, World Bank 2001). However, even among poor countries there are sometimes huge differences as regards financial depth (see Table 3).

Indeed, there is a clear link between domestic bank credits (relative to GDP) and the development of countries. In general, low-income countries have a low percentage of domestic bank credits to GDP, whereas de-

15. Keynes (1937) developed similar arguments and the modern circuit models drawing on Schumpeter and Keynes see banks as necessary »circuit starters« for investment and production (Bossone and Abdourahmane 2002).

Table 3:
Domestic Credit Provided by the Banking Sector and the Trade Balance in 2002 (% of GDP)

	Domestic credit as percentage of GDP*	*Trade balance as percentage of GDP*
High Income Countries	168.5	0.0
Middle Income Countries	82.9	3.4
Low Income Countries	48.6	0.4
China	166.4	3.0
South Africa	150.9	3.4
Brazil	64.8	2.1
Indonesia	59.9	6.9
India	58.5	−0.4
Vietnam	44.8	−4.0
Russian Federation	26.6	10.8
Nigeria	25.3	−5.9
Belarus	17.5	−4.4
Uganda	15.4	−15.4
Mozambique	13.2	−14.7

Note: * Domestic credit includes domestic credit in foreign currency.

Source: World Bank (2004).

veloped countries have a percentage about three times higher. The financial system in Uganda or Belarus, to choose two examples, is even more poorly developed in spite of their trade and current account deficits. When Uganda liberalized the financial sector, financial depth did not improve. China is an outstanding example, as already mentioned. Starting from a very low level, Vietnam too could improve its financial depth considerably. There is no compelling argument that low-income countries

are condemned to have a shallow financial sector and hence *must* depend on foreign finance. Instead, it is the shape of financial institutions and the concomitant monetary policy that matter.

Inflation Target and Sources of Inflation

How much price stability do developing countries need? The World Bank claims that less than 10 percent is considered to be sufficient (World Bank 2003a). Bruno and Easterly (1995) are even more indulgent. However, under conditions of global currency competition with free capital mobility and the pending risk of capital flight, developing countries need a higher degree of price stability. The benchmarks are set by the dominant strong currencies and their inflation rates. Deviations from these benchmarks result in permanent depreciation, a lower reputation for the domestic currency, capital outflows, and weakening of the domestic financial sector, including higher interest rates – to mention some of the economic costs of too high inflation. In other words, low inflation, hard as it may be to achieve and sustain, needs much more consideration. Higher inflation might be tolerable if strong capital controls reduce the intensity of international currency competition.

> Fighting inflation by reducing aggregate demand via a restrictive monetary policy may become extremely costly in developing countries. This, however, is the standard recipe of the Washington Consensus.

Concerning the sources of inflation, analysis should focus on the causes of cost-push inflation accommodated by the monetary authorities.[16] Contrary to the traditional viewpoint, depreciations and wage-price spirals are the most prevalent source of inflation in developing countries. Typically an inflationary process is triggered and/or intensified by depreciation. The latter will create an inflationary push as import prices go up. As in this case real incomes fall it becomes likely that nominal wages will increase and an escalating inflationary process get under way. Non-accommodation of such cost-push inflation leads to an ex-

16. The idea of cost inflation draws on Keynes (1930). Keynes distinguished between cost and demand inflation. For him cost inflation is at the heart of inflationary processes (see also Herr and Priewe 2003 and Herr 2002a).

tremely tight monetary policy, which prevents development and threatens the functioning of the domestic financial system. In empirical surveys it was found that in strong inflationary processes in most cases depreciation came first and as a result the money supply went up (Fischer, Sahay and Végh 2002). In many developing countries with low growth rates, a devaluation-wage-price spiral in combination with a restrictive monetary policy to fight inflation leads to low domestic demand and production. The more strongly integrated international goods markets are, the stronger the pass-through from depreciation to inflation (Rojas-Suarez 2003, pp. 146 ff). And the higher the dollarization – for example, in case of indexation of domestic prices and wages in foreign currencies – the more direct the pass-through (Ize and Parrado 2002; IMF 2003). Muddling-through between the fight against inflation and the need not to reduce aggregate demand too much, typically leads to a situation of low growth and continuing inflationary problems (stagflation).

The conclusion is that an inflationary process has to be stopped by stable nominal exchange rates as a nominal anchor and a complimentary nominal wage anchor backing the exchange rate anchor. If these two anchors hold, monetary policy is relieved from fighting inflationary processes and can better support growth. Fighting inflation by reducing aggregate demand via a restrictive monetary policy may become extremely costly in developing countries. This, however, is the standard recipe of the Washington Consensus.

Fixed or Flexible Exchange Rates?

Orthodox monetarist theory favors flexible exchange rates, whereas the Washington and the Augmented Washington Consensus accepted that absolutely tight exchange rates (like currency boards) might also be feasible. By recommending extremely contrasting exchange rate regimes, the macroeconomic guidelines are not very clear, especially as it remains unresolved how to maintain absolutely fixed exchange rates if this regime is chosen (Baliño, Bennett and Borensztein 1999). Foreign reserves for exchange rate interventions will suffice only in the short run, and even very high interest rates can hardly defend exchange rates if confidence in the domestic currency breaks down, as experienced in many countries. The traditional bi-polar view on either fixed or flexible regimes seems somewhat beyond reality and practice, since almost all countries avoid (and must avoid) too high fluctuations of exchange rates (see Calvo and Rein-

hart 2002) and too many countries opting for absolutely fixed exchange rates had to give up the peg. On the other hand, there is much evidence that free floating will lead to strong fluctuations that are in no way connected to »fundamentals«, to more inflation and to external debt shocks, as mentioned above. It is vital for developing countries to stabilize the nominal exchange rate against a hard currency or a basket of hard currencies and at the same time have the possibility of realigning the exchange rate. This can be done by different exchange rate regimes, for example fixed but adjustable exchange rates or flexible exchange rates with extensive central bank interventions (managed floating).

Current Account Deficits and Net Capital Imports?

John Williamson called for »competitive« exchange rates, but neglected to produce a clear definition. The exchange rate is competitive, according to our understanding, if a current account equilibrium can be achieved. However, in spite of the weak empirical and theoretical background of the savings-gap model, it is still widely used in international institutions and ministries (Easterly 1999). A balance of payments regime with long-lasting current account deficits as a result of an »import-led strategy« of development has fundamental disadvantages. As long as developing countries cannot finance the current account deficit and capital exports with FDI and portfolio investment in the form of shares, they build up foreign debt. Portfolio investment as short-time finance can destabilize domestic stock markets and exchange rates in developing countries and is potentially unstable. If current account deficits are financed with FDI, risks can be kept low.

> The avoidance of a current account deficit and of a substantial gross foreign debt is the best basis of development in a world with volatile international capital movements and an unstable global economy.

Discussions about balance of payments deficits and foreign debt have focused repeatedly on »good« and »bad« foreign debts; private foreign debt is conceived as tenable compared to financing budget deficits in foreign currency. It has been overlooked that high external debt – particularly when accompanied by currency mismatch – makes a country vulnerable to shocks which in developing countries cannot be avoided, regard-

less of the individual debtor. Prudence in financial liberalization is mentioned in the Augmented Washington Consensus, but the actual policy of international institutions and Western governments too often presses developing countries to open their doors to capital flows much too early. The avoidance of a current account deficit and of a substantial gross foreign debt is the best basis of development in a world with volatile international capital movements and an unstable global economy. It must also be recognized that countries with high foreign debt in foreign currency tend to loosen the exchange rate as an adjustment instrument. Especially if the exchange rate cannot be kept stable, foreign debt must be low. Keeping vulnerability in check and maintaining a certain degree of economic-policy autonomy are strong arguments against substantial foreign debt.

The most favorable constellation for development seems to be a current account surplus and a stable nominal exchange rate, without sacrificing growth by cutting imports necessary for capital accumulation. If this is not feasible, a balanced current account should be accomplished; a realignment of the exchange rate may be necessary to implement this objective. If low-income countries are facing a high current account deficit, financed mainly by concessional loans (as is the case in most poor sub-Saharan countries), priority should be given to gradually reducing the current account deficit, in particular by improving the domestic financial sector and by export promotion policies. Also, grants are better than preferential loans as they do not aggravate external indebtedness. Moreover, debt relief can alleviate the current account if fresh new debt can be avoided.

Conclusions

In our positive scenario presented in Figure 2 we did not stress improvements in the allocation of productive factors which are so much at the heart of the policy recommendations of international institutions. This does not mean that we do not want to increase allocation efficiency or improve institutions. However, we believe that only stable macroeconomic development and integration into the world economy, which makes the country independent of unstable international capital movements, are capable of paving the way to deepening allocation improvements. Allocation reforms – or structural adjustments – without a stable macroeco-

nomic constellation are doomed to fail and can even worsen economic performance. In brief, favorable conditions for the accumulation of fixed capital matter more for growth than focusing on more market-determined allocation.

Theoretically, even the best allocation (or perfect performance in structural adjustment) does not automatically guarantee growth and capital accumulation. Improved efficiency can even go together with low growth or recession; long-run positive effects may never be realized if short-run problems cannot be overcome and a »bad« development path is followed. For instance, privatizing loss-making state-owned enterprises may improve microeconomic efficiency, but may be accompanied by strong output losses and increased unemployment. Alternatively, perfecting domestic capital markets by lifting capital controls can trigger a wave of capital outflows. There is no automatic market mechanism that offsets such setbacks. The notorious hopes for »the long run« may be in vain. Vice versa, there can be high growth due to favorable macroeconomic conditions despite sub-optimal allocation. China is an example. Therefore, more attention has to be paid to the macroeconomic forces of growth separately from adjustment issues on a micro level. Of course, improvements on the micro level should take place continuously.

In the field of development it is often not possible to realize the best solution. Typically, there are trade-offs. For example, in case of a conflict between stabilization and growth on the one hand and optimal structural adjustment on the other, there is no doubt that growth is more important, even more as it can improve the economic, social and political conditions for structural reforms which require a long period of time.

Capital controls are a good example. They are commonly regarded as an awkward and old-fashioned instrument from the age preceding the globalization of finance. If stable exchange rates, a current account balance or even surplus, and low foreign debt are regarded as necessary – although not sufficient – preconditions for growth and development, there is a conflict of goals. Capital import controls can help to keep the balance of payments in equilibrium. Premature liberalization of cross-border capital flows can smash or suffocate the domestic financial sector, which, however, is crucial for development.

Taken altogether, every measure contributing to reduce dollarization and strengthen the local currency and trust in the domestic financial system is a step in the right direction. More attention needs to be paid to the quality of the local currency. When domestic money can fulfill all of its

basic functions (including its function as a store of value), the financial system can potentially provide the finance needed for a credit-, investment-, and income-creating process. Current account equilibrium or surplus (or at least gradually reduced deficits) are among the best means of building up the reputation of the domestic currency and at the same time stimulating aggregate demand.

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