International Policy Centre for Inclusive Growth

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Is the Washington Consensus Dead?

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The recent G20 meeting in London elevated the International Monetary Fund (IMF) to a new level. Its lending capacity was tripled to US$750 billion. In the aftermath of World War II, the IMF was established to deal with declining commodity prices and deteriorating international trade. During the oil price shocks of the 1970s the IMF became lender of last resort, mainly to countries with balance of payments problems. The debt crisis of the early 1980s in Latin America gave the Fund further impetus. By the mid 1980s the IMF and the World Bank had become policy architects in low-income countries. The 1998 Asian financial crisis brought the IMF to the forefront of crisis management. In 2009, we are again at another milestone—the Fund is back with even greater influence.

The IMF's past lending practices, however, do not make good reading. The Fund has shoved the Washington Consensus down the throats of low- and middle-income countries, often with heavy conditionalities. According to Williamson (2000: 251), "I invented the term 'Washington Consensus' to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries". The advice included fiscal discipline; cutting tax rates; interest rate liberalisation; competitive exchange rates; trade liberalisation; liberalisation of capital flows; privatisation; and deregulation of prices and markets.

The IMF argued that its conditionalities were designed to prevent moral hazard and adverse selection; to provide credibility to reforms; and to show commitment to policy change. It applied the principal-agent problem to development finance. In private financial markets there is an asymmetry of information. Adverse selection blurs the distinction between a viable borrower and a potential defaulter. Moral hazard provides the wrong incentive for the borrower to engage in risky actions. Similarly, the IMF argues, concessionary lending may be an incentive for borrowers to deliberately seek balance of payments crises in order to acquire funding, and hence the need for conditionalities.

Will the IMF provide the new resources under a post-Washington Consensus arrangement? Will the financing be free of conditionalities? The answer is no. Washington Consensus polices and the associated conditionalities are alive and well. As of today, the policy prescriptions are the same as those listed by Williamson. If history is a guide to the future, they are unlikely to change soon.

In 2008 alone there were 224 types of conditionalities imposed on 15 countries. The table lists just eight of them. The highest conditionality is in the area of fiscal reforms, followed by financial liberalisation, privatisation, trade reforms, exchange rate adjustments and price liberalisation. Conditionalities are also highest in the least developed countries.

IMF Policy Prescriptions and Conditionalities Imposed in 2008

Djibouti	Introduce law to set single-rate VAT at 7 per cent by 2009.
Honduras	Adjust tariffs in the electricity sector in line with cost recovery. Raise interest rate by 25 basis points.
Mali	Eliminate all customs exemptions.
Niger	Reduce the rate of profit tax from 35 to 30 per cent.
Pakistan	Eliminate electricity tariff subsidies.
Republic of Congo	Introduce commercialisation and phase out fuel price subsidies by 2011.
Ukraine	Prohibit multiple currency practices. Achieve a fiscal balance of zero.
Zambia	Adjust tariffs in the electricity sector in line with cost recovery.

Source: IMF MONA online database.

The simple truth is that conditionalities are paternalistic. They are meant to alter behaviour and induce changes in economic, political and social structures. They also serve as a sort of collateral; in some cases they are a form of coercion to ensure adoption of otherwise unpalatable reforms. Conditionalities trigger conflicts between the recipient country's objectives and those of the lender. The lender enjoys bargaining power over financially dependent recipients through control of credit tranches. The outcome is usually in favour of the lender, whose catalytic function and seal of approval give it powerful leverage. For this reason alone, conditional lending erodes ownership of reforms.

Developing countries are in critical need of capital flows. Besides the impact of the current global recession, they still need external finance to supplement domestic savings. Aid and multilateral credit have been disappointing. As Moyo (2009) argues, what low-income countries require are portfolio finance. These types of capital flows require high credit ratings. The IMF could create mechanisms for the development of bond markets. It would act as the underwriter, providing sovereign guarantee schemes to protect the bondholders against possible default. This would lay the foundations for the much needed aid exit strategy, instead of perpetuating a failed consensus along with gratuitous and punitive conditional lending practices.

References:

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Moyo, Dambisa (2009). *Dead Aid: Why Aid Is Not Working and How There Is Another Way for Africa.* London, Allen Lane.

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