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Cycles of conventional wisdom on economic development

PAUL KRUGMAN

The author investigates the phenomenon by which certain economic beliefs are 'known' to be true. Noting how the prevailing orthodoxy in development economics has moved in this century from anti-protectionist, 'sound money' tenets to enthusiasm for intervention, planning and import substitution and back to support for foreign trade and the free market, he examines the extent of economists' understanding of the process of development and contrasts the way economists think with the process by which policy intellectuals and policy-makers adopt certain beliefs about economics by making spurious connections between concepts and then buttress these beliefs by selective anecdotes rather than subjecting them to statistical tests. His conclusion is that the conventional wisdom about development economics—whatever its current content—should be eschewed in favour of rigorous use of economic theory and empirical evidence.

In November 1994 I published an article in *Foreign Affairs* in which I pointed out that several recent studies of Asian growth indicate that a surprisingly high fraction of that growth can be accounted for by measured inputs like capital and formal education, and argued that this observation casts considerable doubt on much of the conventional wisdom about how Asia has grown and what that growth means for the world economy.[1] The article provoked considerable controversy, which was perfectly reasonable: the conclusions that seem to be compelled by quantitative studies of Asian growth are very different from what most people believe, and it is entirely appropriate to subject such heterodox conclusions to a severe cross-examination.

And yet many of the critiques of my article, and of the work that it summarizes, had a somewhat disturbing tone. These critics disagreed with the conclusions, not because they questioned the evidence, but because they found them more or less literally unthinkable. In particular, my comparison between

[1] Paul Krugman, 'The myth of Asia's miracle', *Foreign Affairs* 73: 6, November–December, 1994, pp. 62–78.

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recent Asian growth and the rapid growth era in the former Soviet Union—another case in which a surprisingly high fraction of growth could be accounted for by measured inputs—seemed to produce outrage. Again and again, I encountered a reaction along the following lines: 'You can't compare Soviet growth with Asian growth, because the centrally planned Soviet economy was doomed to fail, while Asian growth is market-directed and therefore guaranteed to succeed.'

What was so striking about these reactions, from the point of view of an economist who worries about growth issues, was their tone of certainty. My readers *knew* that an economic development strategy based on free markets, welcoming foreign investment and export orientation was guaranteed of success. (Actually, some of my readers knew something different: they knew, with equal certainty, that a sophisticated strategy of government intervention was actually the key.) Now this certainty was remarkable, given two facts. First, economists do not know the same things: that is, it is far from clear to economists who study the evidence on development that the ingredients that everyone knows guarantee success actually guarantee anything, or even whether they make much difference. Second, anyone who has followed the history of thought in economic development is aware that 35 years ago one would have found many readers who knew, with equal certainty, just the opposite: that the key elements of a successful development strategy were government planning and import substitution. Indeed, as my article pointed out, *circa* 1960 it was widely taken for granted that centrally planned economies, whatever their other weaknesses, were very good at generating industrial growth.

And there is yet a further irony: if one were to turn the clock back another 35 years, to the 1920s, one would find that the conventional wisdom on economic development (though not under that name) was actually quite similar to the 'Washington consensus' that emerged at the end of the 1980s.

The purpose of this essay is to provide a sceptical economist's view of these cycles of conventional wisdom in development economics—the great sweep from the old-fashioned principles of free markets and sound money to an unquestioning faith in the importance of planning, and back again to the previous verities. Along the way I want to do some amateur sociology, asking why influential people so easily acquire great shared certainty about issues where the evidence is weak or even contrary to their views.

What economists know about development

This article is not mostly about what actually makes some countries successful at developing, while other countries fail; in fact, a central point is how limited our knowledge on the subject really is. Nonetheless, it is necessary as a starting point to provide some background on the subject, and in particular to talk

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about why economists are so much less sure about the roots of development than the conventional wisdom would have us believe.

The measure of our ignorance

When economists study economic development, they generally begin by slightly changing the subject: at least as far as measurement is concerned, what they study is not development as a complex, multifaceted process but simply the growth of some index of output; and they try to explain as much as possible of that measured output growth in terms of the growth of one or more indices of input.

Contrary to what many critics of economics seem to believe, there is nothing inherent about economic theory that requires that gross domestic product be used as the sole measure of economic growth. Indeed, there are some areas of economics in which theory tells us that it is crucial to disaggregate, to talk about growth as a process with more than one dimension. For example, the standard theoretical analysis of trade and growth—of the impact of foreign growth on domestic real income, and vice versa—reaches the conclusion that the direction of that impact is ambiguous, that growth abroad may either help or hurt us. To decide which way the effect goes, one must disaggregate the growth, asking whether it is biased towards exporting or import-competing sectors. Or, to put it differently, standard economic analysis tells us that if we are to say anything useful about that particular question, a one-dimensional measure of growth is insufficient; it is necessary to take account in at least a crude way of the process of structural change.

The common use of a one-dimensional measure of output to measure economic development is, therefore, not something inherent in economic analysis; it is a deliberate simplification, and like all such simplifications it should be rejected if it seems to miss the main story about what is happening. On the other hand, simplicity is a virtue: if a single number seems to tell us most of what we want to know, insisting that the development process cannot be reduced to any one number, even as a first cut, may sound wise but in fact is simply obscurantist.

So how does a number like GDP per capita do as a measure of development? The answer, surely, is that it does very well—in the sense that it never happens that one finds a country with a low level of GDP that one would want to call developed, or one with a low growth rate that one would call a development success. I like to make this point by asking people to look at a table which shows GDP per capita (measured at purchasing power parities rather than market exchange rates) for a number of countries. My question for people who say that real GDP is a simplistic measure of development is: which country rankings would you like to reverse? Is Malaysia really more developed than Portugal, or than Spain? Is Britain more developed than Germany? I have not

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found anyone who, when pressed on this, wants to change the rankings more than marginally;[2] no matter how much they may claim that a one-dimensional measure like GDP is too crude to capture a complex reality, in practice they cannot find any countries whose level of development is seriously mis-indicated by that measure. To me, this means that development is in fact reasonably thought of as a one-dimensional process, and that GDP is a very good index of progress along that dimension.

Now, while all the evidence suggests that it is indeed possible to reduce development quite successfully to a single index, there is still the question of how that index should best be constructed. The standard method of economic accounting is to measure output at constant prices—that is, to add together the growth in output of apples and oranges by valuing both in the prices of some base year. This procedure can be given a justification in terms of neoclassical economic theory: speaking loosely, theory tells us that the price of a good is equal to its marginal utility, so the growth in output at constant prices should measure the increase in the economy's ability to deliver utility. But you do not have to believe in the precise truth of that theory to regard the calculation of an index of growth using output at constant prices as a reasonable procedure, one that will usually work fairly well. Indeed, it is hard to think of a plausible alternative.

If it is reasonable to collapse output into a single number by valuing goods at constant prices, it is also on the face of it reasonable to do the same with input—that is, to use market returns and wages to combine capital, land and various types of labour into a single index of inputs into production. As in the case of measuring output growth, this procedure may be justified by an appeal to neoclassical economic theory: since in models of competitive markets a factor of production is paid its marginal product, the contribution of an additional unit of, say, capital should be measured by its market return. But again, one need not believe in the precise truth of these models to regard an index of input that aggregates labour and capital at market prices as a sensible construct.

Once one has an index of output and an index of input, however, it is surely natural to compare their growth. And such a comparison is all that is involved in the much misunderstood, often attacked exercise known as 'growth accounting', in which one asks how much of output growth can be explained by growth of labour, how much by growth of capital, how much by increased education, and so on. If growth accounting exercises suggested that most of the

[2] M. ul Haq offers a 'human development index' which includes such direct indicators of welfare as life expectancy: see *Reflections on human development* (Oxford: Oxford University Press, 1995). Countries with enclave mineral economies, especially oil producers, rank much lower on human development than they do on GDP; so do extremely repressive regimes. A few countries that provide universal education and health care rank high for their GDP. But the impressive thing is how little slippage there is between the measures: if we leave out oil producers and communist regimes, the correlation is extremely close. And anyway, being nice is not the same thing as being developed.

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growth of output could in fact be explained by measured inputs, then economists would believe that they understood a lot about economic development. There would still be the question of why some countries are able to mobilize more inputs than others, but it would be a far less agonizing question than the one we really face: why do some countries seem to use their inputs so much better than others?

For the fact is that the key both to long-term economic growth and to sustained differences in economic performance between countries seems to be the ability to get more for less—to have output grow faster than input. (The rapid growth of East Asian nations is to some extent an exception, which was the point of my *Foreign Affairs* article; but even here the contrast between East Asian performance and that in, say, Latin America has a good deal to do with the fact that in the latter output has grown by less than input.) This excess of output growth over input growth is sometimes referred to, gracelessly, as the growth in 'total factor productivity'; but it is also referred to simply as the 'residual', that part of economic growth which, in Robert Solow's phrase, is 'the measure of our ignorance'.

It is because a crucial part of economic growth is 'explained' by the residual that economists are generally fairly diffident about economic development. Once you know that something like two-thirds of the rise in per capita income in the United States cannot be accounted for either by increased capital per worker or by higher levels of education, you are likely to be much more cautious in making sweeping generalizations about the sources of American prosperity than someone who has not been disciplined by the numbers.

But is this all that economists know? Aren't there known factors that predict which countries will have favourable 'residuals'?

Can we explain the mystery away?

There has been no shortage of attempts to make the residual go away—to find another set of variables that explain why some countries seem to get more for less. At the risk of considerable violence to both the richness and the confusion that have marked development theory over the years, I would classify such attempts under three headings.

First, there is a recurrent strand of thinking that says that there are good sectors and bad sectors—that inputs, especially labour, have much higher productivity in some kinds of activities than in others. Successful economies, on this view, are the ones that get into the right sectors and therefore make effective use of their resources. In the development economics of the 1940s and 1950s, discussed below, the bad sector was traditional agriculture, where there was supposed to be surplus labour, while the good sector was manufacturing. In the loose set of ideas that is sometimes referred to as 'revisionism' in the United States—a doctrine that focuses mostly on US–Japan trade relations—it is claimed that there are 'high-value' sectors that pay high wages, yield technological spillovers,

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etc., and that the difference between a high-residual economy like Japan and a low-residual economy like the United States can be explained by the fact that one is moving into and the other out of the good sectors.[3]

A second strand of thinking argues that input growth can explain output growth after all, because there are increasing returns: a 10 per cent increase in input, at least of the right kind, can yield a 12 per cent or 15 per cent increase in output. The development theory of the 1950s typically mixed increasing returns in with the surplus labour argument; again, I will turn to this doctrine below. There was a revival of the increasing returns idea in the 1980s, due largely to the work of Paul Romer.[4]

Finally, an influential view has been that the reason some countries do worse than others at increasing output per unit of input is that their governments get in the way, particularly by imposing protectionist restrictions on trade. This view reached its high-water mark as a serious economic proposition with the World Bank's 1987 World Development Report, which found that 'outward oriented' developing countries grew substantially faster than 'inward-oriented' economies.

These three explanations have two things in common. All are interesting and plausible hypotheses which can be rationalized with elegant economic models. And all wilt in the face of actual evidence. The claim that the sectoral composition of employment explains a large part of the differences in international performance was rejected soundly when economists began seriously looking at the actual facts on agricultural labour markets in developing countries; while there is some evidence for industry rents in modern economies, efforts to quantify their importance fall ludicrously short of the claims of the 'revisionists'. Increasing returns may play an important role in explaining regional and international patterns of trade and specialization, but a massive attempt to find evidence of increasing returns in international growth patterns has instead mostly found that national returns to investment are not that different from market returns. And the correlation between 'outward orientation' and growth turns out to be largely in the eye of the beholder: when countries are classified using objective criteria, rather than by researchers whose classification is biased by their knowledge of who has been economically successful, the supposed strong relationship between trade policy and growth melts away.[5]

The point is not that economic development is an ultimately mysterious phenomenon, one that can never be explained by social scientists. In the long run we will surely understand development as well as we understand, say,

[3] See e.g. J. Fallows, *Looking at the sun: the rise of the new East Asian economic and political system* (New York: Pantheon, 1994).

[4] Paul Romer, 'Increasing returns and long run growth', *Journal of Political Economy* 94, 1986, pp. 1002–37.

[5] S. Edwards, 'Openness, trade liberalization, and growth in developing countries', *Journal of Economic Literature* 31, 1993, pp. 1358–93.

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hyperinflations. But we do not have that understanding yet. Right now, economists confronting the phenomenon of development are a bit like geologists confronting mountain ranges before the discovery of plate tectonics: we know a lot about the subject, but can only speculate loosely about ultimate causes.

But while research economists generally show humility about their ability to explain or predict development, influential people in general are far more confident—they know what works and what doesn't. Where does this confidence come from?

The formation of conventional wisdoms

How non-economists think about economics

Any economist who has spent time trying to communicate with policy-minded intellectuals who do not have a technical training in the field quickly realizes that there are deep differences in perceptions, not only about how the economy works, but in what it means to engage in economic analysis. By and large, policy intellectuals who hold strong views about economics do not arrive at these views in the way professional economists do; indeed, they do not think in at all the same way.

The economist's style of thought was perhaps best summarized in the title of a classic book by Thomas Schelling, *Micromotives and macrobehaviour.* That is, economists generally believe that they have 'explained' something when they can show how interesting collective phenomena might arise from the interaction of individual, usually self-interested behaviour—higher-level, aggregative phenomena are to be explained in terms of lower-level 'microfoundations'. Economists believe, for example, that they understand hyperinflations. The story works like this: faced with an inflation whose root cause is government printing of money, individuals try to reduce the amount of cash they hold; but the individual efforts to get rid of cash push up prices all the faster, leading to still more efforts to reduce cash holdings, and so on. The higher-level phenomenon, the hyperinflation, is explained in terms of lower-level behaviour, the efforts of individuals to economize on cash holdings. Not all economic theory succeeds in deriving macrobehaviour from micromotives, but that is always the goal.

The shocking discovery an economist who tries to communicate with a broader, though still elite, audience quickly makes is that non-economists don't think that way. Conventional wisdoms on economics do not involve stories in which higher-level phenomena can be derived from individual behaviour. Instead, they typically simply assert a relationship between one high-level phenomenon and another; they bolt together prefabricated concepts, rather than try to understand what they are made of.

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Consider, for example, the relationship between protectionism and the business cycle. It is widely believed (except by economists) that protectionism causes economic slumps—that the Smoot-Hawley tariff caused the Great Depression, that the failure of the GATT negotiations would have caused a global recession. But what is the process by which one causes the other? This is never spelled out—for good reason, because the economic logic of such a connection is at best quite weak (tariffs are a fiscal contraction, import quotas may raise prices and therefore reduce the real money supply). The large number of influential people who believe in this connection simply take two mental boxes and draw an arrow from one to the other; they do not regard it as necessary to look inside the boxes to justify that arrow. Such justification as there is comes from a sort of visceral sense of linkage—protectionism is bad, recessions are bad, bad things must go together—backed by a vague sense that their view is confirmed by the lessons of history.

It is the same with economic development. The conventional wisdom of the moment says that free markets and sound money will produce rapid economic growth. This view has a visceral appeal given the current political climate: free markets and sound money are good things, so is growth, so they must go together. And it can be justified by a selective reading of history—just compare Argentina and Hong Kong. But there are, as economists would say, no microfoundations.

Why does a particular view about economic development become conventional wisdom—that is, a belief that is held with great conviction by a large number of influential people?

Economic beliefs as cultural artefacts

It is very difficult to talk about conventional wisdom in development economics without engaging in pop sociology. Put simply: views about what works in economic development may be to some extent explained by an appeal to evidence, but the contrast between the diffidence of the professional researchers and the certainty of the non-economists can only be understood by thinking of economic beliefs as cultural artefacts, almost as a fashion statement.

The important point is that although development is a vast process involving billions of people, *thinking* about development generally takes place in a kind of village of bankers, policy-makers and policy intellectuals (rarely including the academic researchers), who meet each other frequently, read each other's articles and speeches and generally constitute a quite close-knit community.[6] It has often been observed that such interlocking social groupings tend at any

[6] In the 1970s—during the fairly brief reign of demands for a New International Economic Order—there was a piece of anonymous doggerel entitled 'The development set' circulating among universities. I have lost my copy, but recall the lines 'In Sheraton hotels in scattered nations / We damn multinational corporations'.

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given time to converge on a conventional wisdom, about economics among many other things. People believe certain stories because everyone important tells them; and people tell those stories because everyone important believes them. Indeed, when a conventional wisdom is at its fullest strength one's agreement with that conventional wisdom becomes almost a litmus test of one's suitability to be taken seriously.

The adherents of a conventional wisdom do not, of course, regard themselves as simply adhering to a fashion. They believe that the evidence supports their view.[7] But that evidence is invariably selective, consisting of anecdotes chosen to buttress a case, rather than studies that try to test it. The virtues of free trade and putting out a welcome mat for foreign investors in promoting growth are illustrated by comparing Singapore and Hong Kong with India; the fact that it is quite difficult to demonstrate that, say, booming Thailand is any less protectionist than the stagnant Philippines, or the failure of complete openness to foreign investors and free access to the North American market to sustain rapid income growth in Puerto Rico are not brought into the story. (Personally, like most economists, I am in fact in favour of free trade and free investment flows; but they are surely given too much credit.) Nonetheless, the combination of the apparent universality with which sensible people hold a view, and the repeated telling of anecdotes that support that view, can create a sense of great certainty about matters that are in reality highly uncertain.

Equipped with this loose model of conventional wisdoms, then, let us take a whirlwind tour of the evolution of conventional wisdom on development in this century.

Development economics in the age of the money doctors

During the late 1980s, when free-market reforms began to spread through much of the developing world (and then to the former communist countries), often accompanied by draconian stabilization programmes devised by Western advisers, a number of historians immediately noticed that such events had happened before. Before 1930 a number of countries (or, in a few cases, colonies) also sought economic stabilization, generally with an eye to gaining the confidence of foreign investors; and like the modern transition economies they drew on the advice of foreign, mostly American consultants. Even the figure of Jeffrey Sachs was prefigured by Princeton's Walter Kemmerer, famous for many years as the 'money doctor'.[8] It is therefore interesting to touch briefly on the content of the development orthodoxy of the day.

[7] There is also often some interesting economic theory supporting the conventional wisdom. But, as we will see in the case of interventionist development economics, the conventional wisdom typically puts far more weight on speculative models than they really deserve.

[8] P. Drake, *The money doctor in the Andes: the Kemmerer missions, 1923–1933* (Durham, NC: Duke University Press, 1989).

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Kemmerer and his colleagues did not think of themselves as doing development economics. Nonetheless, the accounts of his programmes and the debates that accompanied them indicate that the basic philosophy of economic policy was one that seems very familiar in the 1990s. Countries should have stable currencies, preferably pegged to gold; in order to do so, they required solid fiscal foundations. Such currency stability, along with well-written securities laws, would encourage foreign investment and hence growth. The government's role in the economy was to be limited to traditional functions. While Kemmerer missions often recommended tariffs and export duties, these were purely fiscal in intent; free trade was still the ideal, and deliberate use of protection to promote industry was never part of his plans.

It is also clear that in the pre-1930 era the orthodoxy of sound money and free markets was sustained not only by the cultural character of the conventional wisdom but also by the acceptance of that conventional wisdom by international investors. Basically, countries that adhered to the orthodoxy were able to attract substantial flows of capital, while those that did not were largely excluded from world capital markets. In a way that is familiar from the 'emerging markets' boom of recent years, a country that was 'Kemmererized' did not have to wait for the putative benefits of good policies in higher long-run growth: it received an immediate pay-off in the form of capital inflows and the resulting domestic boom.

The odd thing is that, from the evidence available at the time, one might easily have drawn quite different conclusions about what was essential for economic development. Of the nations whose growth might have served as a model for developing countries, the United States, Canada and Germany had all industrialized behind tariff barriers. The United States had industrialized during the Civil War and for years afterwards while possessing a paper currency, the greenback, completely without gold backing. And for that matter the richest of the Latin American nations, Argentina, had not been a bastion of monetary stability. In other words, the faith that the orthodox economic prescriptions were really right was just that—a faith, based on at best selective reading of the evidence.

The collapse of the pre-1930 conventional wisdom was, of course, precipitated by the Great Depression. Plunging exports, the devaluation of advanced countries' currencies and the drying-up of capital flows made attempts to cling to the gold standard ruinously costly and eventually impossible; orthodox central bankers and governments who tried to hold on too long were discredited. Import restrictions, imposed at first largely for balance of payments reasons, soon became valued as ways to promote industrialization. By the end of the Second World War the conditions were right for the emergence of a new conventional wisdom on development.

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The postwar development consensus

It is a disconcerting experience for a modern policy intellectual to read what important, seemingly sensible people had to say about economic development 35 or 40 years ago. Bauer has summarized what nearly everyone thought as follows: 'External trade is at best ineffective for the economic advance of less developed countries, and more often it is damaging ... economic unresponsiveness and lack of enterprise are well-nigh universal within the less developed world. Therefore, if significant economic advance is to be achieved, governments have an indispensable as well as a comprehensive role.'[9] This view seems incredibly antique in these days of export-led development, in which the phrase 'global marketplace' has taken on a nearly sacred aura, the dynamism of the private sector is placed on a pedestal and scepticism of government competence is pervasive. Yet it was so firmly held for a number of years that even now one finds its essentials reappearing in the views of somewhat out-of-it commentators.

The rise of the interventionist conventional wisdom had several elements. First, there were some genuinely interesting new economic ideas. Development economists in the postwar years had difficulties in formalizing their ideas, so that these ideas dropped out of academic circulation for a generation after 1960; but in recent years it has become clear that it is possible to construct extremely elegant, interesting models that are close in spirit to the development literature of the 1940s and 1950s.[10]

A case in point is Paul Rosenstein-Rodan's concept of the Big Push.[11] We imagine an economy in which workers can be employed either in a low-productivity traditional sector or in a high-productivity modern sector (which for some reason, such as unionization or simple inertia, must pay a higher wage than the traditional sector). Modern production, however, involves economies of scale, so that the profitability of investment in that sector depends on the expected size of the market. What Rosenstein-Rodan pointed out was that this simple story implies the possibility of a low-level underdevelopment trap: firms do not invest in the modern sector, because there is insufficient demand, but demand is insufficient because the sector is too small. Government intervention to coordinate a wholesale move into the modern sector can therefore effect an economic transformation that no individual investor can achieve.

It's an attractive and exciting story, both intellectually and for its policy implications. Yet surely anyone who takes the details seriously would be

[9] P. Bauer, 'Remembrance of studies past', in G. Meier and D. Seers, eds, *Pioneers in development* (Oxford: Oxford University Press, 1984).

[10] For a discussion see P. Krugman, 'The fall and rise of development economics', in L. Rodwin and D. Schon, eds, *Rethinking the development experience* (Washington DC: The Brookings Institution, 1994).

[11] P. Rosenstein-Rodan, 'Problems of industrialization of Eastern and Southeastern Europe', *Economic Journal*, June–September 1943.

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cautious about using it as the basis for development strategy. It is, after all, only a speculative model; even within the model an underdevelopment trap is only something that can happen, not something that must happen. In particular, a formal model makes it clear that the absolute size of the domestic market plays a crucial role in determining whether a low-level trap exists. Developing countries differ greatly in size: a story that depends on market size could work either for India or for Uruguay, not for both.

So why did models along these lines acquire such influence? Because they fitted in with a conventional wisdom that was developing for other reasons. One of these reasons was that the import restrictions imposed for balance of payments reasons in many developing countries during the 1930s had become institutionalized. A foreign development adviser who urged a return to pre-1930 trade policies circa 1955 would have been opposing powerful vested interests; one who instead discerned a higher economic rationality in import controls was likely to meet with a far better reception. This need not have involved conscious pandering to powerful interests (although it sometimes surely did). The point is simply that it is very difficult for someone to be a player in the world of policy discussion as opposed to research while claiming that the policies followed by much of the world are irrational, and that the policy-makers who implement them are fools and knaves. This is true even though, without doubt, many policies and policy-makers fit that description extremely well.

Finally, the development orthodoxy of the early postwar years must be understood in the context of recent experience. The Depression had hardly inspired confidence in the effectiveness and wisdom of free markets and sound money; indeed, nations which were quick to abandon the gold standard and/or had resorted freely to import restrictions had generally weathered the 1930s better than those which clung to older orthodoxy. Meanwhile, government planning had, to most perceptions, proved highly effective. Not only was the Soviet Union at the time a byword for industrial transformation, but Western nations had effectively turned themselves into planned economies for the war, with impressive results. One can hardly blame observers of the time for having a distrust of markets and a high opinion of the potential effectiveness of government intervention.

And yet while it is not that hard to explain why a development strategy that involved heavy government intervention, and in particular import restrictions to promote industrialization, became popular, it is remarkable how few challenges were offered to that orthodoxy. Not only were the economic models underlying this orthodoxy clever but flimsy; the whole strategy was entirely speculative, in the sense that there were no examples of its success. America and Germany may have used tariffs to promote industrialization, but on close observation their policies bore little resemblance to the highly selective import restrictions of postwar developing countries. Nobody had developed with the kind of foreign exchange and credit allocation that became widespread in the developing world. The Soviet Union was regarded as a success story, but

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Stalinist planning bore little resemblance to the strategies actually being implemented in the developing countries. It is a little hard to see why anyone thought these strategies would succeed; it is very hard to understand why almost everyone who mattered knew that this was the correct path, except by invoking the cultural aspect of economic conventional wisdom. Almost all serious people endorsed the idea of development through import-substituting industrialization, so of course it had to be right.

How much influence did the emergence of this orthodoxy have on actual economic policies? Without doubt, many countries would have tried to develop behind import quotas even without the sanction of a conventional wisdom—indeed, in much of the developing world the quotas came first, the rationales later. Yet ideas do matter: a small country whose leadership has gone to the LSE or Harvard, whose finance minister regularly attends Bank–Fund meetings, is unlikely to follow policies that are flatly at odds with the conventional wisdom of the decade.

The power of ideas over development policy has become apparent with the collapse of the postwar development ideology and the emergence of a new but oddly familiar set of ideas.

The Washington consensus

As the 1980s drew to a close, John Williamson noticed that a new conventional wisdom was emerging about economic policy in developing countries.[12] Because the people whose collective beliefs define the conventional wisdom mostly work in or at least frequently visit Washington DC, he called this new collective wisdom the 'Washington consensus'. Williamson's original definition was, admittedly, of a rather complex set of ten propositions, some of them still tinged by some residual Keynesianism. But almost immediately the phrase 'Washington consensus' came to mean a simple prescription for economic policy, one that would have seemed almost entirely familiar to Walter Kennerer: sound money and free markets, including both free trade and privatization of state and enterprises. The important policies and active government role of the postwar development consensus were completely rejected.

Where did this new consensus come from?

As in the case of the postwar consensus, academic writings played an important role in laying the groundwork for the new conventional wisdom. During the 1960s and the 1970s there had been growing criticism, both empirical and theoretical, of import-substitution policies. Researchers who estimated effective rates of protection found that these rates varied wildly across sectors, in ways that made little apparent economic sense—and also that in

[12] J. Williamson, 'What Washington means by policy reform', in J. Williamson, ed., *Latin American adjustment: how much has happened?* (Washington DC: Institute for International Economics, 1990).

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many cases they were absurdly high. Theorists suggested that policies intended to promote development had unintended consequences, such as urban unemployment and resources wasted in rent-seeking; empirical work suggested that countries which had followed the postwar development consensus tended to have lower growth rates than those which had maintained relatively open economies (although, as noted above, these studies have not stood up well under examination).

These academic criticisms would not, however, have been enough to change the policy wisdom on their own. What surely played a far more important role were two striking events: the explosive growth of a few newly industrializing economies, and the collapse of centrally planned economies.

The term 'newly industrializing country' appears to have first come into use in the late 1970s. The intellectual climate of the 1970s now seems almost as remote as that of the 1950s: it was a time when development debates often seemed to start from the presupposition that there was a permanent division of the world into manufacturing and primary exporters, and that the only question was how to change the rules of the game in favour of the latter. Meanwhile a group of developing countries was growing with stunning speed, and a distinctive feature of that growth was a surge of manufactured exports. When this reality became too conspicuous to be dismissed as an aberration, it shook up conventional views in a way that no amount of scholarly argument could have done. Remember that conventional wisdom is backed by anecdotes rather than statistical tests; for people accustomed to anecdotes about the necessity of planned, inward-looking growth, the necessity of fitting in the story of South Korea or Taiwan was simply a conversation-stopper.

The decline and eventual collapse of the central planning model also contributed to undermining the development orthodoxy. In a way this made little sense: the development strategies followed by India or Brazil bore very little resemblance to those of Brezhnev's Russia. But just as the apparent triumph of the Stalinist system gave interventionism everywhere a kind of positive aura during the early postwar years, the decay of that system, first into a byword for inefficiency and then into a downward spiral, undermined the prestige of anything that sounded like a planned economy. (I also suspect, though I have not been able to document this, that the rise of Japan subtly undermined the prestige of the left around the world. After all, it was supposed to be the socialist nations that would mount a challenge to Western dominance; it must have been very disturbing to see a capitalist nation achieve the kind of economic overtaking of the West that communism had promised but never delivered.)

Finally, the economic disruptions of the debt crisis both pushed governments to try something new and pushed them in certain directions. For example, the urgent need to re-establish credibility after severe inflation made hard-money policies such as a commitment to a fixed exchange rate attractive; the need to attract foreign capital after being excluded from capital markets by the debt crisis made hostility to multinational corporations seem irresponsible and a welcoming attitude sheer common sense.

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Nonetheless, the completeness with which the conventional wisdom embraced pre-1930 views about economic policy is remarkable, given that many of the reasons why those views were abandoned remain as valid as ever, and have been joined by some new ones.

Consider first monetary and exchange rate policy. In the 1930s most of the world dropped off the gold standard, not because of a loss of moral fibre, but because it turned out that to remain on that standard in the face of deflationary pressures was to put the economy through a severe and prolonged slump. While some countries have abused exchange rate flexibility, using it to allow them to pursue highly inflationary policies, there is no evidence that the argument against a gold standard or an approximation thereto (like Argentina's peg of the peso to the dollar) is any weaker now than it was 60 years ago. On the contrary: both disastrous experiences like the Argentine *tablita* at the beginning of the 1980s and the EMS crisis in 1992, and favourable experiences like the US ability to combine sharp dollar devaluations with quiescent inflation, demonstrate that some exchange rate flexibility remains useful, and that forsaking that flexibility can be quite costly. How did it become an article of faith that giving up that flexibility for the sake of credibility and discipline was necessarily a desirable trade-off?

Or consider the role of free trade and an absence of government intervention in fostering economic development. Surely the conclusion that this is the key cannot be based on observing the success of the group of nations that the World Bank now calls HPAEs, 'high performance Asian economies'. It is not so much that the HPAEs demonstrate the opposite, as some commentators claim—that the growth of Japan or South Korea should be attributed to government intervention; rather, the main point about Asian growth is its protean character: the policies followed in rapidly growing Asian economies have been sufficiently varied and ambiguous that observers who are determined to draw conclusions can find whatever they want, and those who try to avoid predetermined conclusions find themselves still largely at a loss when they are done. South Korea has surely not followed the kind of free trade, pro-foreign-investment policies that the current orthodoxy says are the key to growth. Some would say that its trade policy has been less distorting than that of less successful nations, but that is far from being established to everyone's satisfaction. On the other hand, Taiwan certainly does not fit the managed-economy, industrial-policy paradigm that some challengers to the current orthodoxy offer as an alternative. When all is said and done, there appear to be two distinctive features that are common to all the fast-growing economies, neither of which can be clearly attributed to government policy: high shares of exports in GDP, and high national savings rates. There are no obvious lessons about what governments in less successful regions should do.

In other words, the Washington consensus is, as an economic doctrine and as a cultural phenomenon, not all that different from the postwar development orthodoxy. It is a view that is based on some interesting, stimulating, but essentially speculative academic work—work that suggests possibilities, but by no

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means proves or even makes a compelling empirical case that those possible stories are really the right ones. It is based on powerful but selectively read lessons of experience—experience that in the light of some future orthodoxy may be held to have little relevance, or even to have quite different implications. And yet the Washington consensus, like the postwar orthodoxy, is a doctrine that everyone who matters knows with certainty to be true. And because it is known to be the truth, it has a profound influence on actual policies in the real world.

Conclusions

This has been a fairly cynical article, but not in the usual way. It is often argued that government policies, including those aimed at economic development, do not in fact serve their expressed goal. Usually, however, it is argued that bad ideas flourish because they are in the interest of powerful groups. Without doubt that happens, but my emphasis here has been on a different source of bad ideas: the herd-like behaviour of policy intellectuals and policy-makers, who too often fall in thrall to a conventional view that commands such universal approval that nobody dares question it. Nowadays we wonder how the postwar orthodoxy could have commanded such allegiance; but surely we will some day wonder the same about today's unquestioned truths.

Of course, the policy-maker does not have the same luxury as the academic; one may be sceptical, but in the end one must do something. The main practical advice here is the same as that on the bumper sticker: Question Authority. By that I do not mean ignore the results of research, or the opinions of experts. In fact, it means just the opposite: listen to the technical experts, but ignore the wise men. There was a long stretch in the 1960s when academic research had called the postwar orthodoxy into question, but serious people dismissed it. Surely the history of the developing world would have been happier if wisdom had received less respect and research more. Similarly, there have been many warnings from researchers that at least some elements of the Washington consensus are unwarranted; but bankers and finance ministers think they know better. They don't. There is no wisdom on economic development, and there are no wise men. There is only economic theory, imperfect as it is, and empirical evidence; we should try to use them.

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