



Andrés Velasco

in conversation with
Ann Bernstein

To mark 25 years since its establishment, in November 2020, CDE initiated a series of discussions with global experts and prominent individuals in South Africa on important questions on democracy, business, markets and development. The series was relaunched in 2022 as CDE Conversations. This is the 40th event in the series.

Ann Bernstein: My guest today is Andrés Velasco, Dean of the School of Public Policy at the London School of Economics, whom I last interviewed in 2022. Professor Velasco served as Chile's Minister of Finance from 2006 to 2010, during which his stewardship of the country's copper windfall earned him recognition as the Latin American Finance Minister of the Year. He was also a presidential candidate in Chile and has held professorships at Harvard and Columbia.

For some 35 years, the set of ideas that came to be called the Washington Consensus have shaped debates about economic policy around the world. Now, Professor Velasco and his co-authors have produced a new book, *The London Consensus: Economic Principles for the 21st Century*, which is a direct response to the Washington Consensus.

Andrés, what is or was the Washington Consensus? And why was it so influential?

Andrés Velasco: The Washington Consensus is a collection of policy ideas that gained prominence in the 1990s. It was very influential at the time because conservative governments in the United Kingdom (UK) and United States (US) supported the principles on which the Consensus was based, while the World Bank and International Monetary Fund (IMF) based their policies on it. While it leaves no one indifferent – some people love it, some hate it – we should think about it with cool heads. It was a product of its time. We should evaluate which principles are still relevant and which no longer make sense today. That is the exercise we have undertaken in the book.

Ann Bernstein: So, with a cool head, what in your view was inadequate or wrong about the Washington Consensus? Do you still believe in a market-driven approach to development and fiscal consolidation?

Andrés Velasco: Certain aspects of the Washington Consensus remain valid today. At the macro level, the Latin American experience in the 1990s offers several lessons: large fiscal deficits lead governments to borrow. At some point, more borrowing becomes impossible. The next option is for the government to finance itself by forcing the Central Bank to print money, which is disastrous. In short: fiscal prudence remains a wise strategy. Countries should avoid situations like Argentina, where chronic deficits trigger a crisis every five years, and prevent episodes of hyperinflation seen in Zimbabwe, Bolivia, and Venezuela. Those crises caused massive human suffering, which was avoidable.

Having said that, the Washington Consensus ignored some important issues.

Stabilising the economy and relying on the market are necessary steps towards economic growth, but they are not sufficient. Countries like Poland adopted the Washington Consensus and grew very rapidly, but others like Mexico adopted it and barely grew. South Africa and Chile are somewhere in between. In fact, South Africa and Chile share several similarities. Both became democracies in the 1990s. Both enjoyed a decade or two of fast growth after democratisation, but that economic growth later tapered off. South Africa has maintained reasonable monetary and fiscal policies, and that is essential, but they have not guaranteed growth. That is one area where the Washington Consensus fell short.

Ann Bernstein: One of the points you've made about the Washington Consensus is that its approach to the state, or its view of the state, was simplistic. Can you explain what you mean?

Andrés Velasco: A small state is not necessarily a good state if it is weak. I'll give you two examples, one from Chile and another from the UK. When the pandemic struck in 2020, only two countries in South America had the fiscal space to purchase vaccines for their populations. Those countries were Peru and Chile. Both carried public debt of about 35 per cent of GDP, which gave them ample fiscal space to borrow the money needed for the vaccines. Both countries spent an additional 7/8 per cent of their GDP during the pandemic, but Peru performed poorly, while Chile fared reasonably well. Why did two countries with similar income levels and spending achieve different outcomes?

Chile had invested in building a national network of public health facilities and vaccination centres since the 1950s. It ensured that even in the smallest or most remote towns in the Chilean Andes, Patagonia, and the northern desert, clinics were accessible and capable of administering vaccines. That was not the case in Peru. According to some calculations, Peru could have avoided 90 000 deaths if it had invested in better vaccination facilities. The lesson is clear. Citizens need a government that can provide essential services.

Take another example. By far the most dynamic sector in Britain is finance. The City of London is the largest financial centre in the world. London could not remain the world's leading financial centre without a top-tier legal enforcement system, credible courts, and sophisticated regulation. The Bank of England employs some of the most experienced regulators in the financial sector and other non-banking activities such as insurance and cryptocurrencies. Again, without a capable state, Britain could not be the financial powerhouse it is today.

Ann Bernstein: You argue that the Washington Consensus really failed, not because of its belief in markets, but because it neglected institutions, inequality, and political legitimacy. Do you think that the consensus was right for its time and place but that it is inadequate today?

Andrés Velasco: The Washington Consensus addressed certain priorities that were right at the time – like letting the price system work in Poland and shrinking the fiscal deficit in Brazil – but it neglected other priorities involving growth and politics. It paid little attention to whether a given reform programme would work in country-specific contexts – whether in South Africa, Nigeria, Indonesia or Turkey – or whether local political conditions were conducive to particular reforms.

If you look at the original Williamson document, the only discussion of politics is the politics of Washington, D.C. Will the U.S. Treasury like this? Will the U.S. Congress fund this? There's zero discussion of politics in emerging and developing countries. That is the politics that matters most because, if they are to work, policies must be credible.

For example, if a developing country lowers tariffs and opens up the economy, investors have to believe those lower tariffs will be in place for the next 25 years. If they believe that the tariffs may be low today but most likely high again tomorrow, they will increase imports a lot while the tariffs are low, which will probably cause the Central Bank to run out of foreign currency reserves, leading to a financial crisis. Non-credible policy is not just ineffective; it is often counterproductive.

The only effective way to make policies credible is to make them politically legitimate. That is why many IMF adjustment programmes in developing countries in the '80s and '90s lasted only as long as the IMF programme remained in force. Because these policies were not politically legitimate, once the IMF left, governments often threw the IMF rulebook out the window.

The other big issue about politics is that a country can follow good economic policies at a given point in time, but those policies could have political consequences that create harm in the long run. For example, I regard free trade as a good thing, but I am perfectly willing to recognise that, in the US, free trade policies had the effect of causing concentrated economic pain in certain regions, particularly in the American Midwest. If you look at the people who voted for Donald Trump and endorse authoritarian and populist policies, they often are in those left-behind states.

So, even if you are a free trader, you need to think like a chess player and look five or six moves ahead. By not looking ahead far enough, those who promoted free trade in the 1990s, ignored the political consequences of those policies, and the US and the world are paying the price for it now.

Ann Bernstein: Let's turn now to the London Consensus. Talk to us about the big new ideas that you're advocating and what they mean for policymakers.

Andrés Velasco: Let me begin with a disclaimer. Rather than promoting Ten Commandments that should be applied across the board, as the Washington Consensus did, we are urging economists to behave more like doctors when recommending an economic strategy for a particular country. Instead of prescribing the same medicine to countries regardless of their symptoms, economists need to diagnose each country very carefully and then offer what a statistician would call 'state contingent advice'.

Nevertheless, just like doctors, economists need to draw on the accumulated knowledge of their discipline and draw on established economic principles. The London Consensus should primarily be seen as an attempt to distil essential principles that practitioners and economists can use to pick the right policies.

The first principle recognises that higher incomes remain critically important for improving welfare, people care not just about money, but also about their general well-being, their communities and the neighbourhoods where they and their families live.

The second is that growth is much harder to achieve than the Washington Consensus suggested. Growth does not result simply from reducing government intervention. For growth to happen, countries need to create an ecosystem in which government and the private sector collaborate. It is also not enough to just improve education or the rule of law. What matters is how the kind of education a country produces complements with the growth trajectory along which a country is travelling. For example, Germany has many engineering schools, which provide it with the skills it needs to maintain its position as a manufacturing powerhouse.

The third principle recognises the growing importance of volatility and the costs it can impose. The Washington Consensus focused on macro volatility, and that made sense. But in the years since we have been reminded that there are many other kinds of volatility. The 2008/09 global financial crisis was caused by bad financial sector regulation. Then COVID-19 prompted another kind of crisis, in which government told workers not to work and firms not to produce. It was followed by the criminal Russian invasion of Ukraine, and now the misguided war in the Middle East, which have disrupted the global economy and spiked energy prices. Governments have had to become insurers of last resort because citizens cannot insure themselves against these unexpected upheavals. Government must therefore have the fiscal space to be ready to cushion people from these shocks. Which means that during good times, governments must be very prudent, lower their debt levels and keep their house in order.

I have already touched on the other two principles. Without an able government, all the other principles do not really matter very much. Plus, good economics requires good politics.

Those five principles can help to organise the thinking of economists in what is a very complex world. They will lead to different policy recommendations in different countries. For instance, a capable state will allow countries like Ireland, Sweden or Singapore, with a strong public sector and a history of productive collaborations with the private sector, to implement an effective industrial policy. But weak or corrupt states should approach industrial policy with caution and maybe avoid it altogether. In essence, our principles are much more sensitive to context than the Washington Consensus ever was.

Ann Bernstein: I want to push back in a few areas. So, the London set of ideas wants us to focus more on place-based growth. Your consensus urges that we think more about the left-behind places and about regional development. There is a strong counterview in development economics that using subsidies to encourage firms to go to uneconomic places is expensive and usually does not work.

Andrés Velasco: Focusing on the location of production is less radical or controversial than you are suggesting. Citizens of developing countries need to think about the location of production because if most production remains in rich countries, developing countries will have little chance of achieving growth. Any conversation about development is essentially about attracting firms to locate to your country. Industry location is not given; it is the outcome of policy. And if that is true across countries, it must also be true within countries.

The circumstances which make a place attractive or not vary massively over time. Decades ago, if someone had told me that the south of China was going to be the world's industrial powerhouse, I would have found that unbelievable. Back then, China was poor. It lacked infrastructure, it had an uneducated population, and it was governed by an authoritarian regime. Today, almost every firm in the world wants to locate in Shanghai.

The world's largest city is Jakarta, the capital of Indonesia. On average, a resident spends two hours commuting to work in the morning and another two hours in the afternoon travelling home. So, four hours of the day are wasted in a cramped minibus in dense traffic. Productivity during those hours is zero and the quality of life is equally low. Jakarta is an extreme example of a phenomenon that residents of Johannesburg, São Paulo, Lagos and Mexico City know very well. By contrast, the quality of public transport in London makes travel there much more efficient. The Tube may be old and occasionally creaky, but it reaches almost every part of the city. People can travel between southwest London and central London in about half an hour, safely and reliably. All these things matter massively for productivity, and for countries' ability to attract capital and talent.

Governments cannot attract competitive firms to cities where talented professionals do not want to live. The first step to spur more economic activity in these cities is to make them more attractive to live and work in. Investments in transport and infrastructure can make left-behind regions more competitive long before governments resort to protectionist measures. The idea is that we cannot be indifferent to the location of economic activity, not across countries, and certainly not within countries.

Ann Bernstein: If one prioritises people's welfare over growth, how does one deal with the creative destruction at the heart of any market-based economy, where firms must close because there are better ways to use capital?

Andrés Velasco: First, I must emphasise again that for the average Indian, South African or Brazilian, growth is indispensable. Second, I completely agree that creative destruction means that some sectors will have to shrink or become obsolete. Instinctively, the first instinct governments often have is to protect people's jobs. The idea, rather, should be to protect people, not their jobs. This requires much stronger systems of unemployment insurance than most developing countries currently provide. People who lose their jobs need the financial security and peace of mind to search for new opportunities that match their skills and abilities. Governments also need

to invest far more in retraining. You cannot simply tell workers that their industry, company or occupation is disappearing and wish them luck. Scandinavian countries typically spend between 2 and 4 per cent of GDP on what they call active labour market policies. Chile spends about 0.3 per cent. The difference is enormous.

More broadly, we need to pay more attention to the quality of people's lives. To return to my theme of liveable cities, citizens of middle-income countries should not have to spend four hours a day in traffic. Long commutes damage well-being, strain family life and reduce the time parents spend raising their children. We can do something about that.

This also relates to place-based policies. We have empirical evidence today that moving young and economically active people out of their communities creates negative multiplier effects, often accelerating the decline of those communities. The people who remain behind become less productive, and the local economy weakens. We then see a range of associated social problems emerging, including higher rates of family breakdown, divorce, substance abuse and crime. Should we simply tell people to leave and then deal with the negative social consequences in a left-behind town? Or should we think a little more carefully about the possibilities of job creation in that town, so we have families that are not broken? Even from a narrow public finance perspective, that may be a good investment.

Ann Bernstein: One of the big arguments that I've heard you make previously, which is also embodied in the London Consensus, is that ideas matter more than interests. How do you reconcile that with the powerful vested interests that we see in global politics today?

Andrés Velasco: Anybody involved in politics knows that people lobby to advance their interests. Those interests often shape policy debates and outcomes. But at the same time, I am struck by how often people vote against what appear to be their own economic interests. I am not convinced that Donald Trump has done much for unemployed former steelworkers in the American Midwest, yet many of them continue to support him. I am also struck by the fact that policy fads have taken over the world in a way that is very hard to connect to interests – or to data, for that matter.

Take the debate about trade. Twenty-five years ago, many people argued that the World Trade Organisation was harmful because trade disadvantaged poor countries. Young people marched against trade and rallied around the idea that globalisation was hurting the developing world. But years later, the same people have become convinced that the opposite is true: that trade is bad for rich countries because it destroys jobs in the north of England or the American Midwest. Neither case makes that much sense to me, but ideas frequently become identity markers and take on a life of their own.

This means that those of us in the business of producing ideas have a big responsibility. Bad ideas sometimes influence policy in ways that can be both detrimental and long-lasting. We should combat that.

Ann Bernstein: You have made a very persuasive case against a one-size-fits-all approach to economic development, and what you've provided through the London Consensus is a framework for picking the right policy for a particular country. If you were to sit down with a reforming leader in South Africa today, which principles from the London Consensus or insights would influence your conversation about what to do?

Andrés Velasco: First of all, South Africa's performance over the last 35 years shows that economic growth is not guaranteed and hinges on a very delicate balance between good politics and good economics. If you go back to 2000 or 2005, the world often pointed to South Africa and Chile as the two outstanding examples of successful

democratic transitions. Both countries attracted admiration for the way they had moved from authoritarian systems to democratic governance while also achieving meaningful economic progress. Today, however, nobody is looking at South Africa as a model of exceptional policymaking. The current coalition government appears to be governing more effectively than some previous administrations, but they haven't yet pursued the reforms needed to get the country back to growth.

The Washington Consensus was not wrong to emphasise that fiscal prudence and debt aversion are important starting points for sound economic management. At one point, many observers regarded South Africa's fiscal and monetary policies and its Treasury and Reserve Bank as exemplary, and responsible for a healthy macro-economy. That too, has become much less the case in recent years. I would urge South Africans to find their way back to macro stability while pursuing with more vigour, a politically viable way of reigniting the country's growth engine.

Ann Bernstein: Andrés, thank you for a lively and fascinating conversation.

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