*Discussion Paper*

# A New Development Paradigm Domestic Demand-Led Growth

## WHY IT IS NEEDED & HOW TO MAKE IT HAPPEN

**By Thomas I. Palley**

*(Editor's Note: Critics of the neoliberal model of economic development—one driven by the demands of transnational corporations—have long been saying that this dominant paradigm isnsn't working. It's not producing broad-based economic development at home or abroad. But what's the alternative? As part of its commitment to provide prescriptions as well as timely critiques of U.S. foreign policy, Foreign Policy In Focus is producing this discussion paper by economist Thomas Palley. We welcome your comments. Please send to series editors Tom Barry <tom@irc-online.org> and John Gershman <john@irc-online.org>.)*


### Summary

The Washington consensus, with its emphasis on export-led growth, has failed. It is time for a new development policy agenda that focuses on domestic demand-led growth. Achieving such an outcome will require a new constellation of policies. Domestic demand-led growth rests on four pillars: (1) improved income distribution, (2) good governance, (3) financial stability and space for counter-cyclical stabilization policy, and (4) an adequate, fairly priced supply of development finance. The policies needed to put these pillars in place are (1) labor and democratic rights, (2) appropriate reform and regulation of the financial architecture, and (3) a combination of debt relief, increased foreign aid, and increased development assistance provided through expanded SDRs.


## The Failure of the Washington Consensus and the Need for a New Development Paradigm

For the past two decades the Washington Consensus has guided development policy.[1] This approach triumphed in the late 1970s, when it replaced import-substitution emphasizing development of domestic capacities for domestic use. Now, owing to a decade of economic crises—including Mexico in 1994, East Asia in 1997, Russia in 1998, Brazil in 1999, and Argentina and Turkey in 2000—the Washington Consensus is crumbling.

Proclivity to crisis is one fundamental problem of the Washington consensus. A second fundamental problem is its failure to deliver economic growth. This is evident in Table 1, which shows how world growth has systematically slowed during the period of Washington Consensus dominance, especially in low- and middle-income countries. World growth in the period 1990-96 was slower than the period 1980-89, which in turn was slower than the period 1965-80. A third fundamental problem is the tendency of the Washington consensus policy configuration to worsen income distribution, be it in the industrialized or developing worlds. Thus, not only has growth slowed during the period of Washington consensus ascendancy, but there has also been an increase in income inequality within and between countries (Denninger and Squire, 1996; Milanovic, 1999; Lustig and Deutsch, 1998).

The underlying problem is illustrated by the "Blackwell box" in Figure 1, which shows how workers in both the private and the public sector are boxed in by the Washington Consensus policy mix.[2] Private sector workers are subject to the constant pressures of globalization, while public-sector workers are battered by privatization. And both are battered by the forces of price stability (fiscal and monetary austerity) and labor market flexibility. Under this policy configuration, workers—unionized or not—

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inevitably tend to be excluded from the benefits of rising productivity.

Argentina's recent collapse exemplifies the failure of the Washington consensus. This is because Argentina followed the Washington model as closely as is ever likely to be possible in the real world of policy-making. It liberalized its financial markets, eliminated trade barriers, privatized state assets, flexibilized labor markets, tied its currency to the dollar, and pursued monetary and fiscal austerity in the midst of a deep economic slump bordering on a depression. Its subsequent collapse has irrevocably discredited the Washington Consensus and spotlighted the urgent need for a new development paradigm.

In the wake of the string of recent crises much attention has been focused on the international financial architecture. Remedying the existing crisis-prone architecture is surely a necessary measure, but it is also time to recognize that financial reform is not enough. Instead, there is a larger need for a new development paradigm that emphasizes domestic demand-led growth. Effecting this new paradigm will require a constellation of policy changes that include enhanced labor and political rights, financial market reforms that ensure stable capital flows and temper capital market discipline, and a G-7 global growth agenda that includes adequate fairly priced financing for development.

## The Problems of Export-led Growth

Export-led growth has been at the center of the Washington consensus, and this focus on exporting and trade liberalization has harmed developing countries in several ways.[3] First, it has tilted the focus away from development rooted in domestic market growth. Second, it has placed developing countries in race-to-the-bottom competition with each other. Third, it has placed workers in developing countries in conflict with workers in industrialized countries. And fourth, it has harmed the global economy by creating an environment of excess capacity and deflation. Exporting will always be essential for development to enable countries to pay for imports of capital goods and other needed resources. However, the challenge is to avoid exporting becoming such a dominant focus of policy that it distorts and retards development.

The core theoretical criticism of the simplitic export-led growth is that it suffers from a fallacy of composition whereby it assumes that all countries can grow by relying on demand growth in other countries (Blecker, 2001). When pursued globally, there is a danger of a beggar-thy-neighbor outcome in which all try to grow on the back of demand expansion in other countries, and the result is global excess supply and deflation. For individual countries, export growth represents a way of growing demand. However, if export growth comes at the expense of foreign demand growth, then it may just shift the country composition of growth without raising overall world economic growth.

**Table 1**

**Trends in GDP growth for developing regions & industrialized countries, 1965 - 1996 (average annual % growth)**

| | 1965-1980 | 1980-1989 | 1990-1996 |
|---|---|---|---|
| Low- and middle-income countries | 5.9% | 3.1% | 1.9% |
| High income countries | 3.8 | 3.2 | 1.7 |
| U.S. | 2.7 | 3.0 | 2.5 |
| Japan | 6.6 | 4.1 | 1.2 |
| World | 4.1 | 3.1 | 1.8 |

Source: Singh (1999).

Among industrialized countries the problem of export-led growth takes the form of "demand poaching" with one country stealing demand from another. Amongst developing countries the problem is subtly different. These countries compete with each other to sell in developed country markets, so that the problem becomes one of "export displacement." Developing countries are rivals with each other, and when one country manages to increase its exports it often does so by crowding out the exports of another developing country. This is the fallacy of composition as it applies to the developing world. Export-led development may work when adopted by one or even a few countries, but it takes on a zero-sum dimension when adopted by all.

Export-led development also partakes of other pathologies. One widely identified pathology is the "race to the bottom." To gain competitive advantage in international markets countries compete across every dimension, including work conditions and the environment. To the extent that work conditions and a clean environment are seen as adding to costs, companies have an incentive to minimize requirements. The result is a dynamic that has companies lowering requirements or shifting production to countries in which requirements are lower.[4] In the past, this race to the bottom has been interpreted as a North-South phenomenon, but it is now becoming apparent that the South-South dimension may be even more important. Berik (2001) illustrates this through an examination of the Pakistani soccer ball industry that agreed to do away with child labor, only to find that production then moved to India which had no child labor restrictions.

A second pathology concerns developing country terms of trade. The export-led growth model prompts countries to shift ever more output onto global goods and commodity markets, thereby aggravating the long-standing trend deterioration in developing country terms of trade. This pattern partakes of a vicious cycle since falling export prices compel developing countries to export even more, thereby compounding the downward price pressure. This vicious cycle has long been visible for producers of primary commodities (Prebisch, 1950; Singer, 1950).[5] However, as a result of the transfer of manufacturing capacity to developing countries who lack the consumer markets to buy their own output, the same process may now be present in all but highest-end manufacturing (Muscatelli et al., 1994; Sarkar and Singer, 1991).

*Remedying the existing crisis-prone architecture is surely a necessary measure, but it is also time to recognize that financial reform is not enough.*

A third pathology concerns the impact of export-led growth on financial instability. One channel is the impact of declining terms of trade on countries' abilities to service their foreign debts. Developing countries borrow in hard currency, and as their terms of trade deteriorate it becomes even harder to earn the currency needed to service their debts. A second channel is the unintended creation of excess capacity in the manufacturing export sector. Kaplinsky (1993) argues that this occurred in the Dominican Republic and the Caribbean region, where countries targeted export-led development based on labor-intensive textile production. Ertuk (2001/02) suggests that a similar over-investment boom may have occurred in east Asia, with the initial success of the tiger economies attracting more and more export-oriented production capacity in Thailand, Malaysia, and Indonesia.

The net result was the emergence of overcapacity that undermined the financial soundness of these investments. From this perspective, East Asia's financial crisis had an underlying cause located in the real economy, and was not just the result of financial speculation.

A fourth pathology concerns issues of autonomy, the quality of development, and dependency. Here, the argument is that export-led growth, especially when associated with export-processing zones, leads to shallow development with weak linkages into the rest of the economy. In effect, export-led growth replicates patterns of development associated with the earlier "plantation" model of development. This includes exploitation of workers and failure to generate widely shared rising incomes, which makes it difficult to develop domestic markets and autonomously sustainable growth. Instead, growth becomes dependent on growth of export demand, making developing countries vulnerable to slowdowns originating in their export markets. Moreover, this may also make the global economy more volatile as a whole. The logic is that of portfolio theory. When there are many autonomous centers of growth, the likelihood of a global growth slowdown is reduced as such an outcome depends on a slow-down hitting all centers of growth simultaneously. However, if growth of a large segment of the global economy (the developing country bloc) is dependent on growth in another segment (the developed country bloc), all that is needed for a global slow-down is for the leader bloc to slow.

Looking to the future, the systemic contradictions of export-led growth stand to become sharper. Such growth can work for first-comers, but it falls apart once all try to clamber on board the export-led bandwagon. Particularly ominous is China's advent on to the world trading scene. Export-led growth operates via a hierarchical process, with less developed newcomers replacing maturing export economies in which surplus labor supplies have been exhausted and wages are rising. With China's advent, this system may be unworkable. China has huge supplies of labor at rock bottom wages, and population growth ensures that this will hold into the future. It is not clear that any developing country can now enter the system with production costs below those of China, making it impossible for newcomers to enter the hierarchy of export-led growth. If true, the export-led growth paradigm will find itself checkmated. There will be insufficient demand, while new supplier countries will be unable to compete with China.

## Domestic Demand-led Growth and the Case for Core Labor Standards[6]

Given the pathologies of export-led growth, developing countries need a new model of development. In place of export-led growth, with its shallow and exploitative characteristics, countries must look to growth based on internal market development. Once again it should be emphasized that exporting will remain essential as developing countries will still need to export to earn the funds needed to pay back loans incurred to finance growth. Moreover, almost all countries lack large enough domestic markets to sustain self-sufficiency. But that said, the global trading system must be made the servant of domestic development, and domestic development must not be foregone for the sake of international competitive advantage.

The history of the industrialized economies shows that the key to unlocking domestic development is solving the problems of income distribution and imbalance of political power. Deep domestic development requires growing wages and an improved distribution of income. Together, these provide the foundation for a virtuous circle of growth in which rising wages encourage market development, and market development promotes rising wages. Labor standards (prohibitions on discrimination, forced labor, exploitative child labor, and the rights of freedom of association and collective bargaining) and democracy are both key to this new model. Democracy matters because it promotes freedom of association, and freedom of association and collective bargaining then generate improved income distribution and higher wages (Rodrik, 1999; Palley, 2000b).

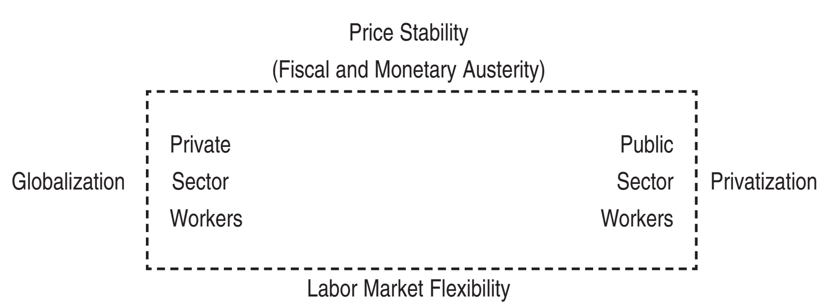
These arguments run counter to mainstream economic thinking that maintains that unions are a market distortion, and that income distribution does not matter for development. In fact, unions are a private sector solution to market failure concerning the huge imbalance of power that exists between individual workers and business. Economic efficiency requires absence of market power, yet real world labor markets are characterized by significant imbalances of power that favor firms over individual workers. This is particularly so in developing countries where workers have few rights and social safety nets are lacking. Moreover, employers' power advantage has been increasing owing to technological and capital markets developments that have increased the mobility of business. Seen in this light, unions remedy the imbalance of power and are a corrective to market failure.

> *East Asia's financial crisis had an underlying cause located in the real economy, and was not just the result of financial speculation.*

**Figure 1**

**The Blackwell box.**

How the Washington consensus policy configuration boxes workers in.




A second contribution of labor standards is promotion of good governance and reduction of corruption. There is now growing recognition that development depends on good governance. The IMF now talks of a "second generation reform" approach.[7] First generation reform was predicated on a hydraulic model of economics, which had the IMF asserting that all that was needed for growth and development was for countries to get their exchange rates, interest rates, and budget deficits right. Now, there is awareness that institutions are essential for development. Transparency, accountability, and good governance help prevent misallocation of resources and guard against kleptocratic government.

Labor standards fit with this new approach. Freedom of association and unions can be viewed as creating the countervailing powers that check such practices. The mainstream counter is that open markets can compete away the problem of corruption, yet the reality is that open markets simply get captured by corruption. The logic of capture is reflected in the problem of bribery. Despite the wastefulness and inefficiency of bribery as a way of doing business, left to itself the market will produce a world in which bribery prevails. This is because every private agent has a private incentive to bribe to try to win business.

The socially optimal outcome involves no bribery, and the only way to achieve this is through legal prohibition of bribery and enforcement of anti-bribery measures. In effect, political action is needed to deal with the problem of bribery. Labor standards and the promotion of the right of freedom of association—which extends beyond just the right to join trade unions—can be viewed as fostering political conditions supportive of such measures.

This ability to potentially rein in corruption may have benefits that extend far wider. A major problem of the existing process of globalization, discussed in the next section, has been the erosion of space for national government policy autonomy. Restoring the space for such autonomy is therefore a goal of critics of globalization. However, simply restoring policy autonomy space is not enough, since that space can be used for good or bad policy. This means that measures must also be implemented to improve the quality of governance, thereby improving the quality of policy. Labor standards can help with this.

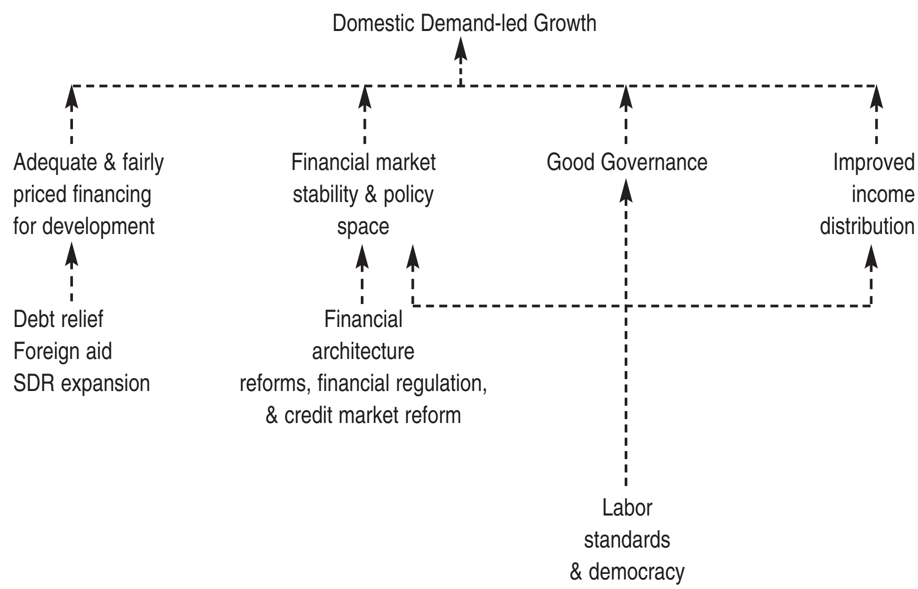
Another argument in favor of labor standards is that by promoting good governance, these standards draw on all elements of civil society, which in turn facilitate economic crisis management. Such reasoning is supported by the experiences of South Korea and Indonesia during the East Asian financial crisis of 1997. In many regards these two countries were similar in terms of stage of economic development, but South Korea had begun a process of democratization and implementation of improved labor standards. As a result, it was able to put together a coherent national response to the crisis, whereas Indonesia found itself politically divided and unable to craft a similar response. Furthermore, there is empirical evidence (Palley, 2001) that countries with improved labor standards appear to be less susceptible to financial crisis. A possible explanation for this finding is that financial markets recognize the benefits of sound civil society institutions and give economies with such institutions more financial space.

Through all of these channels, labor standards can help put in place the income-distribution and political conditions necessary to sustain domestic demand-led growth. But the benefits of labor standards do not end there. Labor standards can also benefit the international economy by helping solve the contradictions of export-led growth. As noted above, trade and exports will remain a vital necessary ingredient of development, but the challenge is to avoid the pitfalls of export-led growth. By improving income distribution and increasing the space for domestic consumption, the growing productive capacity of developing countries will be subtly tilted away from world markets. This should help mitigate the problem of declining terms of trade that has so afflicted developing countries, both in their traditional role as primary commodity producers and in their newer role as producers of lower-end manufactured goods.

Labor standards can also help block off the race to bottom, that has an incentive structure paralleling that of the problem of bribery—which can be viewed as a race to the bottom in corporate business practice. In an export-led growth world every country tries to gain international competitive advantage by exploiting every possible margin. Good competition focuses on productivity and quality; bad competition eats away at workplace safety, the environment, and income distribution. Labor standards can contribute to ruling out the bad competition outcome by blocking countries from gaining competitive advantage by eroding standards.

**Figure 2**

**The policy configuration needed for domestic demand-led growth.**




## Financial Market Reforms Needed for Domestic Demand-led Growth

Not only is it necessary to get the microeconomic structure of labor markets right, domestic demand-led growth also requires that countries get the macroeconomic environment right. This is where design of the international financial architecture and provision of adequate development financing becomes critical.

Under current arrangements developing countries are subject to damaging “stop-go” cycles of boom and bust. This pattern results in huge risk premia that are required to compensate investors for the danger of “sudden-stops,” and these huge risk premia then become self-fulfilling by making an eventual sudden stop almost inevitable. In this fashion, market forces have locked developing countries into a permanent high cost of capital trap. Further compounding the damage, capital markets also require that governments pursue policies of fiscal austerity or face punishment of even higher interest rates.

The macroeconomic problems confronting developing economies are highlighted by considering economic policy in recession. Industrialized country policymakers respond to negative demand shocks with counter-cyclical macroeconomic stabilization policies. This includes having their central banks lower interest rates, and running larger government budget deficits. In stark contrast, developing countries are forced by international capital markets to respond to negative demand shocks with highly pro-cyclical policies. To prevent sudden and massive capital flight, developing country central banks are forced to raise interest rates, and fiscal authorities are forced to reduce budget deficits. This is the exact opposite of the policy mix adopted by industrialized countries.

Behind this perverse forced policy response lies the economics of capital markets predicated upon unrestrained capital mobility. The natural impetus of individual investors is to protect their principal, which puts pressures on other investors and on the economy in general. In an environment of high indebtedness, runs for the exit can impose large costs on all. Herd behavior in small markets generates extreme volatility, and it also generates pro-cyclical capital flows. Thus, in good times the herd rushes in, resulting in large asset price gains that encourage further capital inflows. Conversely, in bad times the herd rushes out, resulting in large asset price losses that encourage further capital outflows. In sum, developing country economies are twice cursed. First, their markets are more volatile and more subject to pro-cyclical capital flows. Second, policymakers in developing countries are held hostage by market forces and compelled to adopt pro-cyclical monetary and fiscal policies.

The problem of capital flows interacts with the problem of exchange rates. Under fixed exchange rates, developing country policy is especially hostage to threats of exit and speculation, which compel policies of permanent austerity. In times of boom there is also a moral hazard regarding exchange rate risk expectations, with the belief that the exchange rate is fixed leading to over-borrowing of foreign currency denominated debt. This then exposes economies to foreign debt crises. Under flexible exchange rates borrowers are obliged to pay a significant exchange rate risk premium to compensate for the possibility of sharp depreciations, and countries are also pressured to pursue tight monetary policies to prove commitment to price stability. In effect, developing countries are caught in a pincer. The two blades are high market interest rates and tight monetary policy, and the force closing the pincer is capital mobility and the threat of capital flight. The solution is clear. Developing countries need to rein in the threat of capital exit. That is why measures such as the Tobin tax, Chilean-style speed bumps, and appropriate regulation of financial markets are so important.

*That is why measures such as the Tobin tax, Chilean-style speed bumps, and appropriate regulation of financial markets are so important.*

All too often the above measures are discussed in terms of "crisis prevention," yet even greater importance attaches to their ability to fashion a macroeconomic environment with less pro-cyclical capital flows and reduced pressures for policy austerity. In particular, by restraining the capacity for sudden capital flight, these reforms create more space for counter-cyclical monetary and fiscal stabilization policy of the sort practiced by developed countries. A third benefit is that such measures can also reduce the level of foreign exchange reserves that developing countries need to hold to defend their currencies and financial systems. These reserves are very costly since developing countries must borrow at high interest rates and then re-deposit reserves at much lower rates in the U.S. money market. Moreover, Baker and Walentin (2001) have documented that reserve holdings have risen significantly as a percentage of GDP over the period of Washington consensus ascendancy. Reducing reserve holdings can therefore diminish the enormous interest burden that developing countries carry.

Finally, in addition to measures to stabilize inflows and outflows of capital, there is also a need for internal domestic financial reforms that can increase domestic access to credit. In the business sector there is a need for increased micro- and meso-finance that can liberate the entrepreneurial potential of small- and medium-scale business. In the household sector there is need for the development of mortgage markets that foster widespread home ownership. Expanding home ownership is especially important as it can yield an array of development benefits. First, it can enhance political stability by contributing to the emergence of a vested middle class. Second, it stands to generate construction jobs, and it also promises to grow the manufacturing sector by increasing the demand for building construction materials and home fixtures. Third, mortgage markets and home ownership can promote financial development, with mortgages providing a new form of financial investment, and homes providing new sources of household wealth and collateral. Moreover, all of this is done by mobilizing domestic saving rather than relying on foreign borrowing, because home construction is predominantly local.

## Global Growth and Finance for Development

In addition to changing the institutional structure of labor markets and the financial architecture, successful domestic demand-led growth will also need changes in G-7 policy. Here, the challenge is how to reconstruct the global economy so that it does not rely on just the single engine of U.S. growth. This is becoming increasingly urgent since a decade of debt-financed expansion means that the U.S. may be approaching debt saturation, If that happens, the U.S. will be unable to borrow as before, and the global economy could face a sharp slowdown in demand growth. In light of this, it is critical that Europe and Japan undertake expansionary macroeconomic policies.

A G-7 growth agenda will increase demand for developing country exports, thereby providing the finance to pay for imports needed as part of domestic demand-led growth. However, developing countries will also need other financial assistance. Debt relief should be one source, there being a need to wipe clear some of the obligations run up as part of the failed Washington consensus experiment. These debts are now a millstone around developing country economies. They are ethically unjustifiable, and they also exert a negative externality on the entire global economy.

A second source of finance is aid from industrialized countries. As a share of GDP, such aid has fallen dramatically over the past two decades. Critics of aid point to the fact that it is dominated in absolute terms by the volume of private capital flows, and they then conclude that aid is an obsolete form of development finance. Such analysis is fundamentally flawed.

First, aid has fallen in relative terms in part because industrialized countries have not grown the amounts they give. Second, private capital flows have brought with them considerable systemic negatives, as discussed earlier. Third, private flows have resulted in recurrent financial crises in which creditors have been repeatedly bailed out, and they have also created the debt crisis that is now dragging down much of the developing world.

Fourth, even if private flows were without these drawbacks, there would remain a case for public aid. Private flows are best for private projects in which benefits and costs are private and fully internalized. That is when market forces work best. Yet, much of the development problem is related to the accumulation of public capital (roads, schools, governance systems) in which benefits are widely dispersed and not capturable by the provider through the price mechanism. This speaks to the need for public investment, but private financing of public investment is harder to accomplish because of lack of identifiable, dedicated streams of revenues to pay back the loans.

These considerations suggest that the reliance on private capital flows may have gone too far, and there is a need to boost the level of publicly provided development finance. Foreign aid is one possible source. A second is an expansion of IMF special drawing right (SDR) facilities, as proposed by Soros (2002), with developed countries giving the SDRs they receive under the expansion to the developing countries.

Lastly, not only has there been excessive reliance on private capital flows, but the process of capital market liberalization may have inadvertently made it more difficult for developing country small businesses to get funding. This is because liberalization has led to the takeover of nationally owned banks by foreign-owned multinational banks, and these banks may be less inclined to lend to small enterprises in developing countries. Evidence suggestive of such a possibility comes from studies of the lending practices of large and small banks in the U.S. (Berger, et al., 2002; Keeton, 1995). These studies find that smaller banks do a better job lending to relational customers for whom credit information is impacted rather than being transparent.

## New Policy Constellation Needed for Domestic Demand-led Growth

The Washington consensus, with its emphasis on export-led growth, has failed. It is time now for a new development policy agenda that focuses on domestic demand-led growth. Achieving such an outcome will require a new constellation of policies, as illustrated in Figure 2. Domestic demand-led growth rests on four pillars: (1) improved income distribution, (2) good governance, (3) financial stability, credit market reform, and space for counter-cyclical stabilization policy, and (4) an adequate fairly priced supply of development finance.

The policies needed to put these pillars in place are (1) labor and democratic rights, (2) appropriate reform and regulation of the financial architecture, and (3) a combination of debt relief, increased foreign aid, and increased development assistance provided through expanded SDRs. Of particular interest is the multidimensional contribution of labor rights and democracy. This is an instance where there is no trade-off between ethically right and efficient economic policy.

## Endnotes

1. The Washington consensus emphasizes five key policies: (1) trade liberalization and export-led growth, (2) financial market liberalization and financial capital mobility, (3) fiscal and monetary austerity, (4) privatization, and (5) labor market flexibility.

2. The Blackwell box is the creation of my former colleague at the AFL-CIO, Ron Blackwell.

3. The arguments in this section are drawn from Palley (2000a).

4. Evidence of a race to the bottom in the context of NAFTA is provided by Bronfenbrenner (1996, 1997, 2000).

5. The problems of export-led growth are particularly acute for poor agricultural economies. Not only are they hit by the declining terms of trade problem that results from increased global supplies, but the shift to cash-crop production also tends to render the food supply fragile and vulnerable. Ghana is an example of this.

6. Arguments in this section are drawn from Palley (1999).

7. In November 1999 the IMF organized a conference titled Second Generation Reforms in Washington, DC, at which the new thinking was explicitly laid out.

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