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Learning and economic policy choices

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Abstract

This paper investigates whether governments embark on market-oriented reforms as a result of learning. I assume that governments are rational learners who update initial beliefs about the effectiveness of different policies and choose policies on the basis of the updated beliefs. The model of learning is applied to four policy choices: the decision to grant independence to central banks, the decision to liberalize trade, the decision to privatize, and the decision to enter into agreements with the IMF. I also explore whether convergence toward neo-liberal economic policies results from external imposition or simple imitation. I find that learning, in isolation from or in combination with the other mechanisms, explains the decision to liberalize trade, to privatize, and to enter into agreements with the IMF, while none of the mechanisms of convergence explains why governments grant independence to central banks.

JEL classification: D83; D78
Keywords: Economic policy reform; Learning; Emulation; Coercion; Policy convergence

1. Introduction

In much of the developing world, the 1980s and 1990s were decades of radical economic change. Whereas in the 1960s and 1970s, the prevailing model of development was based on state intervention and inward-looking policies, the 1980s and 1990s were

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more characterized by the advocacy of market-oriented reforms. These reforms, packaged under the so-called Washington Consensus, aimed to open up national economies and to reduce the role of the state.[1] The extent of the consensus became so broad that some referred to 'universal convergence' (Williamson, 1990; Williamson and Haggard, 1994; Biersteker, 1995; Rodrick, 1996).[2]

A widespread explanation for economic reforms is that governments learned from the experiences of alternative models of development. Learning changes the mapping from policies to economic outcomes and changes beliefs about the consequences of actions and the strategies in a changing economic environment (Kahler, 1990, 1992; Hall, 1993; Biersteker, 1995; Tommasi and Velasco, 1995; Haggard and Webb, 1994; Maravall, 1997; Krueger, 1993).

Yet the learning hypothesis remains untested and the question remains unanswered whether governments switched to market-oriented policies as a result of learning. The story of 'universal convergence' can be described in the following way: the model of inward-oriented industrialization, epitomized by the experience of many Latin American countries in the 1960s and 1970s, resulted in resounding failure. The bias against exports caused balance of payments crises; devaluations, inflation and fiscal indiscipline became common; and governments borrowed massively from abroad to close the external and fiscal gaps. At the beginning of the 1980s, Mexico's debt moratorium alarmed foreign creditors, who cut off lending. Without credit to finance the pervasive fiscal deficits, governments resorted to the printing press, which resulted in hyperinflations and economic stagnation. Moreover, the proliferation of controls and trade protection was an invitation to tax evasion, rent seeking, and corruption (Tommasi and Velasco, 1995. p. 1–3; Krueger, 1993, 1997).

In clear contrast, Chile and the East Asian tigers (Korea, Singapore, Hong Kong and Taiwan) achieved high rates of growth by relying on market mechanisms and greater integration in the world economy. The hallmark of this strategy was export promotion policy, taken to be the quintessential illustration of virtuous policy for a small state.[3] The collapse of communist rule in Eastern Europe and the former Soviet Union provided the final blow to the idea that state control and pervasive government intervention were requisites for development.

The changes in the South and the East took place amidst a neo-liberal revolution in the North. At the beginning of the 1980s, Conservatives in Great Britain and Republicans in the U. S. undertook campaigns against 'big government'. The neo-liberal revolution put an

[1] The Washington Consensus comprises ten policy prescriptions: fiscal discipline, adjustment of public expenditure priorities, tax reform, financial liberalization, exchange rate adjustment, trade liberalization, promotion of foreign direct investment, privatization, deregulation and support of property rights (Williamson, 1993; Williamson and Haggard, 1994). For stylistic reasons, I refer to these measures as 'market reforms' and 'neo-liberal program'.

[2] John Williamson acknowledges the existence of broad areas of disagreement in the Washington Consensus. See Williamson (1993) for a discussion. Also, note that the global trend toward market-oriented policies has not precluded the existence of differences in the timing of reforms, in speed and intensity as well as sought outcomes.

[3] On the success of the Asian tigers, and other aspects including the role of economic freedom, see Paldam (2003).