RECOVERY

THE GLOBAL ECONOMIC CRISIS AND MIDDLE-INCOME COUNTRIES

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SUMMARY

No country has proved immune to the devastating effects of the current global financial crisis. But the middle-income countries of Eastern Europe, Latin America, and East Asia, which previously had achieved significant progress—economically and socially—have shown themselves to be particularly vulnerable. The crisis has highlighted important lessons for these countries, which inhabit a twilight zone between the developed and developing worlds—and those that aspire to join their ranks—as they rebuild.

Successful economic policies pursued in the past do not guarantee these countries' immunity from the crisis. In fact, some Eastern European nations have already shown a limited capacity to learn from other countries' previous financial crises—such as Chile's in 1982, Mexico's in 1994, and East Asia's in 1998.

However, as recession hit the developed countries, those whose exports were most affected were the ones that relied excessively on external demand, as recently shown by some East Asian countries. What seems to be needed is growth that is more balanced between external and domestic demand. In some instances, exports have been too concentrated in terms of both products and markets. More diversified economies should be less vulnerable to external shocks, and exports should incorporate the fruits of a knowledge-based economy to increase their value.

The report concludes that the main challenge in a postcrisis agenda for middle-income countries will be reorienting their development strategies and how they formulate their policies to maximize the creation of high-quality jobs, given the likely persistence of very high rates of unemployment, and discusses the political and economic aspects of the reforms that will be required to fulfill this goal.

INTRODUCTION

One of the good bits of news for the world economy before the current crisis was how well middle-income economies were performing. If we consider Latin America, East Asia, and Eastern Europe between 2003 and 2007, these economies grew at rates of 5.5, 5.7, and 6.6 percent, respectively. Most of them achieved solid budget surpluses that allowed them to reduce debt, as shown in table 1. Latin American economies decreased their public debt from 65 percent of gross domestic product (GDP) to 35 percent in 2007. The reductions for East Asia were from 53 to 45 percent of GDP, whereas Eastern European economies maintained a stable low ratio of 31 percent. Unemployment went down as well—from 11 to 7.5 percent, almost 4 percentage points, in Latin America, and from 12 to 8 percent in Eastern Europe—and it stayed between 5 and 6 percent in East Asia (see table 1).

Middle-income countries are important in their contribution to a stable world economy. They also provide test cases for low-income economies, in the sense that the path pursued to become fully integrated into the world economy through open market policies and practices produces clear benefits for the populations involved. In fact, the strong growth of exports for

Table 1. Key Economic Indicators, 2003–2007

Region	Growth Rate, Real GDP, 2003–2007 (percent; annual average)[a]	Ratio of Public Debt to GDP[b] (percent)		Export Growth, 2003–2007 (percent; annual average)[a]	Unemployment as a Percentage of Total Labor Force[a]	
		2003	2007		2003	2007
Latin America	5.5	65	35	7.0	11.0	7.5
East Asia	5.7	53	45	10.0	5.8	5.3
Eastern Europe	6.6	32	31	11.0	12.0	8.0

Sources: a. World Bank 2008. b. Panizza 2008.

these economies in the 2003–2007 period, with yearly growth rates of between 7 and 11 percent, seemed to point in this direction.

As various experts have warned us, however, middle-income countries could be classified as belonging to the so-called second world, not the developed world (first world) or developing world (third world), but simultaneously sharing characteristics of both. These middle-income countries are conflicted societies, where significant progress can be achieved for a certain period of time, but they are affected by rather frequent growth relapses, social tensions, and political instability. In short, they are societies and economies where not all goes well at the same time, although the predominant trend has been toward more advanced levels of development.

It is within this context that the world financial crisis became a significant new factor to consider when one assesses the medium- and long-term perspectives for these middle-income economies. It is not the purpose of this report to go into an exhaustive analysis of the impact of this crisis. There is abundant, almost daily, information available about it for most of the economies considered here. Instead, this report describes some of the vulnerabilities shown by these economies in confronting the current crisis, and the lessons that can be extracted from them, as well as basic elements that should be incorporated into a postcrisis agenda, as growth and social progress resume.

FIVE QUESTIONS ILLUSTRATING THE VULNERABILITIES OF MIDDLE-INCOME ECONOMIES DURING THE CRISIS

To illustrate some of the vulnerabilities that middle-income economies face as they confront the current world financial crisis, here I offer five straightforward questions and suggest the dilemmas and challenges posed by these questions.

Question 1: Are the sound, persistent economic policies that middle-income economies pursued in the past, and their successful outcomes, a guarantee that these economies will not be derailed by the global financial crisis?

The answer is no.

Let me illustrate the argument with three country cases: Chile, Ireland, and Spain. Chile has recently been described by the *Economist* as "one of the world's best-managed economies by almost any yardstick." Its income per capita has increased from $4,500 to $15,000 (at purchasing power parity) in a twenty-year span. Poverty has been reduced from 45 to 13 percent in a similar period. And its economic policies have been well designed "by the book." The opening of its economy has been such that the effective rate of protection is practically zero—in fact, 0.66 percent in 2008—and significant budget surpluses have been achieved in the last twenty years, reducing public debt from 114 to 27 percent of GDP (Panizza 2008) and allowing its government to accumulate the equivalent of 15 percent of GDP in the form of sovereign wealth funds abroad. Its active social policies have been financed through an innovative mixed scheme, consisting of tax revenues and individual savings accounts. Have these positive developments made the Chilean economy less vulnerable to the current crisis? It is too early to tell. But the fact that the nation's unemployment rate is being forecast to reach 11 percent by 2010 indicates that its real economy is still quite vulnerable, in spite of consistently good policies in the past.

Another interesting example is Ireland, which was categorized as a middle-income country twenty years ago, with one of the lowest incomes per capita in Europe at the time. Ireland turned itself into the "Celtic Tiger," becoming, in this short time span, the economy with the highest income per capita in Europe. For a long time, policy makers in current middle-income countries have been studying the "Irish formula" for success in development. And yet Ireland's economy is projected to have negative growth rates of 8 percent in 2009 and 3 percent in 2010, along with high rates of unemployment of about 13 percent in 2010.

Spain is another extremely successful case of how a country can make the transition from the status of a middle-income to a developed economy in a twenty-five-year span. And yet its unemployment rate during the current

crisis has reached 17 percent and is forecast to surpass 20 percent as early as 2010. Half the job losses in Europe are occurring in Spain.

What happened to the successful development formulas pursued by these countries in the past? What do they tell us about vulnerabilities and new challenges for the future? If we can draw a simple lesson, it is not that their development formulas have been wrong (although there certainly have been policy mistakes, including some quite serious ones that are beyond the scope of this report). Instead, the primary lesson that needs to be remembered is that development is a process, where challenges are continuously changing, shocks do occur, and the basic test along the road is the capacity to adjust and adapt, to absorb change, and to promptly make the needed policy corrections.

Therefore, to sum up, as far as development is concerned, there are no magic formulas, no shortcuts, no miracles, and no "models." Economic growth and development is a several-decades proposition that requires consistent policies, persistence in moving in a certain direction, and adaptability to shocks and changes and the opportune correction of policy mistakes.

Question 2: Is cumulative learning arising from the financial crises of the past, or are we witnessing the same mistakes all over again?

The recent experience of one group of middle-income countries, those in Eastern Europe, seems to suggest that we still have a limited capacity to learn from other countries' previous crises.

The Eastern European countries' accession to the European Union implied that they would open their economies to a huge market and to significant capital inflows, which took the form of foreign direct investment by European companies and of loans, both short and long term, from European banks. Thus, both the governments and private sectors of these Eastern European nations thought that belonging to the European Union provided implicit insurance: Continued, uninterrupted access to markets and finance was guaranteed by signing the respective treaties of accession. Increasing public and private spending in the form of a consumption boom did not seem risky at the time.

Soon, however, the economies of the new EU member states began to run the so-called twin deficits: budget deficits and significant imbalances in the current account of the balance of payments. These deficits were largely financed by incurring external debt—particularly in the form of private foreign currency loans. This situation evolved to the point that, by 2007, short-term external debt was equivalent to the total foreign exchange reserves held by these countries' central banks. The twin deficits—plus excessive short-term debt, the accumulation of repayments of long-term debt up front, and insufficient foreign reserves—increased the vulnerability of these economies to sudden reductions in the inflow of net capital.

The indicators that illustrate this as a possible scenario are given in table 2. When compared with other middle-income countries in Latin America and East Asia, the Eastern European economies look much more vulnerable. In fact, the Institute of International Finance predicts that, as a consequence, net capital inflows to Eastern Europe will decrease dramatically, from $254 billion in 2008 to $30 billion in 2009. Moody's (2008) shows high External Vulnerability Indicators for several countries in the region, including Estonia, Latvia, Hungary, and Lithuania.

The accumulation of these types of imbalances is not a new or unique phenomenon in recent history. Chile's financial crisis in 1982 included some of

Table 2. Current Account and Debt Ratios, 2003–2007

Region	Current Account as Percentage of GDP (annual average)[a]		Ratio of External Debt to GDP, 2008 (percent)[b]	Private External Debt as Percentage of Total External Debt, 2008[b]	Ratio of Reserves to Short-Term External Debt, 2007[c] (percent)
	2003–2007	2008–2010			
Eastern Europe	−9.2	−7.2	89.4	85.6	102
Latin America	2.7	−0.9	26.6	63.6	341
East Asia	7.5	6.0	32.0	83.3	285

Sources: a. IMF 2009b. b. Joint Bank for International Settlements–IMF–Organization for Economic Cooperation and Development–World Bank statistics on external debt. c. Joint Bank for International Settlements–IMF–Organization for Economic Cooperation and Development–World Bank statistics on external debt and World Bank 2008.

the same characteristics. A similar picture was present in the "Tequila Crisis" in Mexico in the mid-1990s. In this case, as currently with Eastern Europe, the government of Mexico and the country's private sector thought that accession to the North American Free Trade Agreement (NAFTA) would provide a safety net, in the form of ever larger capital inflows from the United States, to cover the country's increasing current account and budget deficits. Again, the Asian crisis of the late 1990s shared the same traits—among them, that high private sector indebtedness was at the root of the crisis in all these events.

Will it happen again? The rapid reaction of multilateral institutions to provide the necessary financing for the Eastern European economies is a good omen. But the final outcome will be heavily influenced by the "animal spirits" of investors and consumers, and their expectations concerning the likelihood of a fast, positive resolution of the crisis.

Have the lessons from previous crises been learned? Apparently not. What is most amazing is that with the previous events still present in the memory of both public and private actors in other middle-income countries, that experience did not prevent the very same sequence of events from recurring. A tentative conclusion is that the learning process tends to be indigenous to the countries that suffer it. Only then do they develop the political capacity and necessary consensus to change norms and regulations and thus avoid making the same mistakes again. But it seems that nations do not learn from shocking experiences that did not originate in their own economic environment. As far as financial crises are concerned, history will tend to repeat itself in other people's countries.

Question 3: In a globalized world, are exports still the main engine of growth?

Conventional wisdom has it that in a globalized economy, success in export growth is a strong indication of the economy's degree of competitiveness, efficiency of production, and entrepreneurial capacity. The cases most often mentioned are those of the East Asian economies, the so-called Asian Tigers.

And yet, when one looks at a comparative sample of middle-income countries in Latin America and East Asia, it is the latter that have been hurt the most by the economic crisis, in terms of levels of economic activity. These areas of the world were not affected by the twin deficits syndrome or by a financial crisis. The main difference seems to lie in the relative importance of exports as a component of aggregate demand. As the recession hit the developed countries, the most affected were those that relied excessively on export growth. The data for the East Asian countries in 2009 seem to confirm this. On average, their GDP will fall 4.3 percent, while the growth rates of the Latin American nations will be close to zero, instead of the high negative rates faced by the East Asian economies.

As has been pointed out by various analysts, an excessive emphasis on external demand, at the expense of growth in domestic consumption, has made some of the East Asian economies more vulnerable to a global reces-

Table 3. Private Consumption and Exports as Percentage Shares of GDP, 2008

Country	Private Consumption as a Share of GDP	Exports as a Share of GDP
China	33	42
South Korea	54	46
Malaysia	45	110
Singapore	38	230
Argentina	59	24
Brazil	61	14
Chile	55	47
Colombia	63	17
Mexico	65	28
United States	70	11
United Kingdom	63	26
Germany	57	47

Source: World Bank 2008.

sion. The data for the share of private consumption in total demand, and that of exports, are shown in table 3 for selected East Asian, Latin American, and developed economies.

These data seem to reinforce the point that the East Asian economies have placed too much emphasis on exports and not enough on domestic demand. This point has been emphasized in recent reports from the International Monetary Fund (IMF 2009a, 2009b). Surprisingly, it is the IMF that is suggesting that the East Asian governments should spend more on infrastructure, public health and housing, education and job training, generating incentives for less saving and more consumption by households.

The lesson to be drawn seems obvious: What is needed is growth that is more balanced between external and domestic demand. This is now apparent, but it clearly has not been practiced by some of the successful economies of East Asia.

Question 4: Most middle-income countries have come to accept the view that free trade is a powerful mechanism to increase the potential growth rate of the economy. Is it a sufficient condition for more dynamic growth?

The last two decades have seen a systematic movement toward free trade. In spite of the current stagnation in the Doha Round of multilateral trade negotiations, most middle-income countries have been active in negotiating bilateral and regional free trade agreements (FTAs), which have greatly facilitated access to foreign markets.

The strategies pursued in negotiating free access to markets have varied. Some countries, like Mexico, have heavily relied on arrangements like NAFTA in finding a destination for their exports. Others have pursued "open regionalism" as a strategy, simultaneously negotiating with different regional blocs or individual countries, as opportunities emerge. This has been the case for countries like Chile and Brazil (Da Motta and Rios 2009).

As a consequence of the different strategies pursued, in the case of Mexico, exports have been heavily concentrated in the NAFTA member nations, and within NAFTA mainly in the U.S. market. As shown in table 4, 87 percent of Mexico's exports went to the North American market, and only 2 percent to Asia, 5 percent to Europe, and 5 percent to Latin America. In the cases of Brazil and Chile, the open regionalism strategy produced a much more balanced access to different areas of the world's markets, as also shown in table 4.

It should be no surprise, then, that when the U.S. economy was hit by the financial crisis and subsequent recession, the Mexican economy suffered the most, with a –4 percent rate of growth of GDP for 2009. Conversely, because Brazilian and Chilean exports have been more diversified in terms of external markets, these two countries can expect a less significant deceleration in their growth perspective.

The Chilean case is an interesting one because, in spite of Chile's success in signing FTAs with fifty-eight countries across the world—in Europe, North America, and the Asia-Pacific region—and with most Latin American economies, and thus having free access to a potential market of 3.5 billion consumers, the benefits in raising its economy's growth potential have

Table 4. Percentage Shares of Exports Going to Different Markets, 2006

	Destination Market			
Exporting Country	North America	European Union	Latin America	Asia
Chile	18	27	17	35
Brazil	20	23	24	20
Mexico	87	5	5	3

Sources: Micco (2008), based on data from United Nations Commodity Trade Statistics Database.

not been fully realized. This situation in Chile has been mainly caused by the heavy concentration in commodities, which represent a large proportion of its total exports. This is a common characteristic shared with most Latin American economies. In fact, table 5 compares export concentration indexes for Latin America (breaking out Chile and Venezuela), East Asia, and Eastern Europe. It is quite clear that East Asia and Eastern Europe have managed to diversify their export basket much more. In fact, eleven of the nineteen principal exporters in Latin America are specialized in primary goods (Mulder 2006).

This commodity-based export growth has both short-term and long-term implications. In the short run, and facing world recession, the prices of commodities fall. The adverse terms of trade have had the most impact in those countries with a more concentrated export composition. This explains in part the slowdown in growth for several of the primary producers in Latin America.

But there are also long-term implications for growth strategies. If, as we think it does, the current crisis opens an opportunity to better connect short-term vulnerabilities with needed reformulations in long-term growth strategies, the area of export concentration needs to be examined.

The Chilean economy again provides a striking example. As mentioned above, Chile has pursued a strategy of gaining access to foreign markets by signing FTAs with a very large number of countries. A recent empirical study shows that its export growth has indeed been impressive. But it also indicates that 85 percent of this growth is explained by increases in traditional exports going to traditional markets. Only 10 percent of exports go to the new markets made accessible because of FTAs, and just 5 percent of

Table 5. Export Concentration Index, 2006

Exporting Region or Country	Herfindahl-Hirschman Index
Latin America	31
Chile	39
Venezuela	91
East Asia	21
Eastern Europe	13

Sources: World Bank 2008.
Note: The Herfindahl-Hirschman Index is a measure of the degree of export concentration within a country. The values of the Herfindahl-Hirschman Index range between 0 for no concentration and 100 for maximum concentration.

Table 6. Average Annual Growth Rates of Real GDP (percent), 1973–1989 and 1990–2007

Region	1973–1989	1990–2007
Latin America	3.3	3.1
East Asia	7.4	7.5
World	3.3	2.9

Source: World Bank 2008.

export expansion consists of new products not previously exported. This pattern is not exclusive to Chile but is also common to many Latin American economies (Amurgo-Pacheco and Pierola 2007).

In contrast, the East Asian economies have succeeded in diversifying exports, adding value to natural products and becoming more active in manufacturing. This process has been accompanied by a heavy investment in human resources, research and development, information technologies, and infrastructure.

More diversified economies should be less vulnerable to external shocks, ceteris paribus. They also usually have higher growth rates, as a comparison between the East Asian and Latin American nations and their growth performance in the last twenty years clearly indicates, as shown in table 6.

Question 5: What will be the dominant issue for middle-income countries in the next decade: price stability, the regulation of financial markets, or employment?

It will certainly be employment—particularly job creation and labor productivity. As has been described elsewhere, the current recession is going to have devastating effects on aggregate demand in most countries. It is highly synchronized; there are multiple sudden stops in credits for consumers and exporters; and given that rates of inflation are falling, the adjustment to falling demand will not be through reduced real wages but almost exclusively through higher unemployment (Reinhart and Rogoff 2009). What is being predicted is that unemployment in middle-income countries, and particularly in Latin America, will easily increase to at least 10 percent of the labor force and will stay above a normal level for at least four to five years (IDB 2009).

High political risks are involved when the unemployment rate stays very high for such a sustained period of time. The stability of governments is at stake, as well as the temptation to look for populist shortcuts in order to "appear" to be solving the problem.

Thus, a preliminary conclusion is that a key component of any postcrisis agenda for middle-income countries should be job creation and upgrading job skills. These will require deep changes in the way labor markets operate. Labor market reform is a contentious issue in most countries (OECD 2006). There are too many vested interests, and there can thus be multiple vetoes of such a reform's specific aspects. Nor do fragmented politics and ideological posturing help.

It seems that labor market reform is the single most important challenge, and yet it is the most politically constrained. The only factor that may open space for reform is the crisis itself. Because of its nature, a constantly increasing number of people feel that job insecurity is the most pressing concern for them and their families. This widely shared concern opens up the possibility of reform.

Why is it so difficult to move ahead with labor reform? Let me illustrate with the Latin American economies. One key feature in Latin America is the persistence of dual labor markets. One segment of the market, the "for-

Table 7. The Informal Sector in the Labor Market, 2003

Region or Country	Ratio of Informal Economy to GDP (percent)
Latin America	38.0
East Asia	31.0
Eastern Europe	33.0
United States	8.4
Japan	11.0

Source: Schneider 2006.

mal sector," consists of workers in the public sector and in most large firms, who have permanent jobs with indefinite labor contracts, and who are covered for health and unemployment risks as well as social security.

The other segment of the labor market, often referred to as the "informal sector," consists of workers with short-term labor contracts who constantly rotate between jobs, workers without any type of contract, and self-employed people. These workers are the "outsiders," because they do not belong to labor unions that would represent them and are generally not covered by social security, health, or unemployment insurance. This segment of the labor force represents about a third of GDP for middle-income countries, and only about 10 percent in advanced developed economies, as shown in table 7.

The "insiders" resist change for obvious reasons. The "outsiders" do not have a real capacity to negotiate. Employers face a labor market where, in order to lay off workers with permanent jobs, they have to make high severance payments. Thus, employers have an incentive to hire short-term workers and mainly those people who belong to the noncovered, informal segment of the labor market. These workers' wages are lower, their social security costs are nonexistent, and ending labor contracts with them does not carry any cost.

This structural feature of the labor market has implications for the growth potential of the economy, because highly rotating low-wage jobs tend to be low-skill jobs, and neither firms nor workers have a particular incentive to invest in upgrading skills. Conversely, labor markets in many middle-income countries particularly tend to punish two groups of the population, in terms of their access to jobs: women and those in the age bracket of fif-

Table 8. Labor Force Participation Rates for Women, Regions With Middle-Income Countries Compared With Selected Developed Economies, 2007 (percent)

Region or Country	Rate
Latin America	52.6
East Asia	52.3
Eastern Europe	49.0
United States	59.0
United Kingdom	56.0
Denmark	61.0
Finland	58.0

Source: World Bank 2008.

Table 9. Labor Force Participation Rates for Youth, Regions With Middle-Income Countries Compared With Selected Developed Economies, 2007 (percent)

Region or Country	Rate
Latin America	49.2
East Asia	45.1
Eastern Europe	30.7
United States	58.4
United Kingdom	65.5
Denmark	66.3
Finland	52.0

Source: "Key Indicators of the Labour Market," International Labor Organization, http://www.ilo.org/public/english/employment/strat/kilm.

teen to twenty-four years. In middle-income countries, the participation in the labor force of these two groups is abnormally low, when compared with developed economies, as indicated in tables 8 and 9. This is a source of deep-rooted income inequalities, and it also limits the growth potential of the economy by subtracting the contribution that more participation by women and young people could make to growth.

The description just given constitutes a widely shared diagnosis of the main existing constraints on the creation of more and better jobs by middle-income economies (IDB 2009). It also establishes a possible framework for labor market reform, which has three main aspects.

First, new legislation will be required that reduces the costs of hiring and firing by firms, thus increasing market flexibility. If accompanied by a significant improvement in unemployment insurance, this scheme could be palatable for workers on both the regulated and unregulated sides of the labor market. Denmark implemented these types of reforms in the 1990s, and more recently Austria did so in 2003, quite successfully and with broad political support.

Second, inducing a higher labor force participation rate for women and young people should be a high priority. Women's participation in the labor force in Latin America is about 40 to 50 percent, whereas in the European Union it reaches 65 to 70 percent. For people in the age bracket of fifteen to twenty-four years, the participation rates in Latin America, East Asia, and Eastern Europe are, respectively, 49, 45, and 31 percent, compared with more than 65 percent in the United Kingdom and Denmark (see table 9). These are human resources that are not contributing, as they could, to higher economic growth. Increasing participation rates for women will require, at least, massive investment to provide universal support for day care centers and preschool infrastructure, subsidies for firms that hire women from low-income families, and upgrading job training facilities, both for women and for unemployed youth.

Third, these countries also need to improve and upgrade skills for those already working. This means committing additional resources, as comparative figures for Latin America, the United States, and the European Union demonstrate. The United States and the United Kingdom invest five times more in efforts to upgrade skills, as a share of GDP, than does Latin America. And the European Union invests ten times more in on-the-job training programs.

It seems obvious that a pro-employment agenda would require substantial additional resources and legislative changes that would benefit some and hurt others. This is a typical prisoner's dilemma. The challenge is to persuade both "insiders" and "outsiders" that everybody will gain if there is cooperation instead of confrontation. Rather than being the cause of a redistributive dispute, labor market modernization and a pro-jobs policy thus should be perceived as a public good that will, in the medium to long term, benefit all. Indeed, successful reform would likely generate more and better-quality jobs. It would enhance labor productivity and, hence, the ability to better compete in world markets in postcrisis scenarios.

LESSONS FOR THE POLITICAL ECONOMY OF A POSTCRISIS NEW AGENDA

The differentiated impact of the financial crisis on middle-income countries points to several areas of policy vulnerability, some of which may require significant policy changes, and others of which may require deeper structural transformation. Neither will be easy to achieve. Here, I discuss some of the political economy issues that will constrain or facilitate the changes required.

The Political Economy of Macroeconomic Change: Permanent Fiscal Austerity

Let me illustrate this issue with what has been observed in Latin American economies. These countries did achieve budget surpluses for several years before the global financial shock. But the notion of fiscal austerity was not one that, in previous times, had been embedded in the political culture of Latin American politicians or society. Thus the observed budget surpluses of the last five years were exceptional. They occurred because of the bonanza implied by extremely high commodity prices. In fact, these countries spent 80 percent of their abnormally high tax revenues and saved only 20 percent, enough to show a statistical budget surplus (IDB 2008).

We now know that these countries' budget surpluses will be required for several years to provide a rainy day fund for a significant fiscal stimulus for economies that fall into recession. Current estimates point in the direction of an extended period of four or five years, before GDP levels recuperate to precrisis levels. This would suggest that governments will need to finance successive fiscal stimulus efforts by increasing public debt, unless public savings have been accumulated for a large number of years and not

spent, as has been the case for Chile, which has more than 15 percent of its GDP deposited in such funds.

If public debt amounts to, say, more than 60 percent of GDP, governments will find it increasingly difficult to borrow the difference. Country risk will shoot up and, at some point, there may be sudden stops in capital inflows. This is the type of scenario that the Latin American economies lived through in previous financial crises, and that the Eastern European economies are currently experiencing, where capital inflows decreased from 10 percent to –1 percent of GDP in 2009.

Justifying budget surpluses as a permanent long-term objective in preparation for facing future crises becomes increasingly difficult in the face of such repetitive and negative scenarios of boom and bust. What we have learned is that to avoid such a scenario, nations may be required to take an extended intertemporal view: to accumulate enough public savings in the form of sovereign funds that will not be spent for many years, except as a countercyclical instrument during future crises or financial shocks. But this type of permanent, strict austerity will not be easy to justify for the political establishment in countries where politicians must face frequent elections and where poverty and income inequalities are still hard facts of life.

The Political Economy of Regulation

The Eastern European economies provide a prima facie case of a situation in which financial regulation was not there to prevent over-indebtedness on the part of households, companies, and the public sector. This behavior is made easier when there is an abundant supply of cheap loans from domestic financial institutions or foreign banks.

The need for an overhaul of the domestic regulatory framework seems an obvious and urgent task. But what cannot be ignored in the Eastern European case is the fact that foreign banks, mainly European ones, had a lot to do with the financial bubble created in the Eastern and Central European countries. It is difficult to explain, for example, that the Austrian banks lent to these economies the equivalent of 70 percent of Austria's GDP, without financial regulators in that country alerting those concerned of the high risk that this might imply for both lenders and borrowers.

This is why the reform of regulatory frameworks requires comprehensive and very difficult institutional changes. The International Monetary Fund has recently argued for reforms in middle-income countries that include four main components (IMF 2009b): (1) systemic regulation, meaning that all financial institutions must be incorporated in an inclusive supervisory framework—not only banks but also insurance companies, investment funds, mutual funds, and other companies operating with mortgages, derivatives, and so on; (2) "consolidated supervision," referring to financial conglomerates, international banks, regional banks, and other related financial institutions, which should be supervised not only at the national level but also in coordination with regulators in the advanced economies; (3) an avoidance of the procyclical nature of capital requirements, and of provisions required from banks and other financial institutions, which should be increased during boom years so as to be better able to deal with nonperforming loans in downswings; and (4) supervision by central banks of the price of assets, to anticipate and regulate when systemic risk emerges.

This rather detailed description of changes suggested by none other than the guardian of orthodoxy and good financial behavior, the International Monetary Fund, serves the purpose of calling attention to the enormous challenge that is the political economy of regulatory reform. And this can be illustrated even more clearly by quoting from the editorial page in a recent issue of the *Economist,* referring to the difficulties of changing regulation: "Financiers tend to gain the advantage over their overseers. They are better paid, better qualified and more influential than the regulators. Legislators are easily seduced by booms and lobbies. Voters are ignorant and bored by regulation." It would be hard to find a more accurate description of the difficulties that must be faced when one attempts to undertake a systemic overhaul of regulatory frameworks, either in advanced or middle-income economies.

The Political Economy of Export-Based Growth

The analysis of export-led growth given above points to the lesson that exports do not constitute a magic formula for higher growth dynamics—and that, when countries face a financial and real economic shock of a magnitude such as the current one, vulnerabilities do emerge. For some middle-income countries, such as in those in East Asia, too many exports

at the expense of domestic demand have meant that when advanced economies have entered into recession, these middle-income nations have been most severely hit with substantial negative growth rates for exports—for example, for the period from April 2008 to April 2009, –8 percent in South Korea and Malaysia, –18 percent in Taiwan, and –13 percent in Singapore.

The prescription in this case has been rather obvious: to induce lower savings and higher consumption on the part of households. What instruments can be used to accomplish this? Most politicians would say: Reduce taxes or expand credit so that people spend more. But solving the problem is not that simple. As the economist Franco Modigliani demonstrated many years ago, household consumption depends not only on current income but, to a larger extent, also on "permanent income," wealth accumulated by households. In other words, while the value of assets held by households does not recuperate to "normal" levels, almost any stimulus designed by governments will be saved rather than spent. This is why governments in East Asia are using a fiscal stimulus in the form of public investment in infrastructure and the social sectors as a way of rebalancing the composition of aggregate demand between exports and domestic components.

In East Asia, it is clear that the expansion of public investment will indirectly improve consumers' confidence, to the extent that there is significant job creation involved. Investment by the government in creating a social safety net can also have a favorable impact on consumers' attitudes. If consumers feel more protected when facing catastrophic circumstances regarding health, the loss of a job, extreme poverty, social security, and so on, they will be induced to have more of a propensity to spend and less to keep precautionary savings. However, in the final analysis, what the East Asian countries will probably face is a race between a fiscal stimulus sustained for several years, with the concomitant increase in public debt, and the speed at which consumers will dare to resume their normal levels of spending—levels required not only to revive growth but also to help correct the structural imbalance between consumption and exports that aggravates the recessionary shock felt by most of the East Asian economies during the current crisis.

Both structural imbalances in production and safety nets for consumers to permanently shift part of their high savings ratios (in the case of East Asia)

into consumption are changes that cannot be implemented overnight by enlightened policy makers. The former require a broad discussion of strategic goals between governments and the private sector. And the latter require engaging the national legislature, social organizations, and labor in their design.

The other issue concerning export-led growth is whether to persist in opening the domestic economy and to continue pushing for multilateral trade liberalization agreements, such as the long-postponed Doha Round. This question will be more difficult to answer as the current recession becomes an L-shaped one—that is, the longer it takes for output and employment levels in advanced economies to recuperate. Negative signs, such as the "buy American" legislation recently passed by the U.S. Congress, invite retaliation, as is already happening. But such protectionism will also make it more and more difficult for progressive politicians in the developing world to persist in a free trade approach in their political discourse.

The other related issue is how to deal with the fact that middle-income economies have succeeded in increasing exports substantially but that the resulting composition of exports has been too concentrated in terms of product (for example, natural resources in most of Latin America; few manufacturing products like cars, electronics, and other durable goods in Asia; and the *maquiladoras* in Mexico) or too concentrated in terms of markets (the U.S. market for Mexico; the European Union for the Eastern European economies). The solution for this situation is again rather obvious: It is better to diversify what is exported, both in terms of products and markets. But the real dilemma is not between exporting commodities or manufactures but whether there is a continuous process of incorporating value in exports—be they natural resources, services, or manufactures—so that new niches are constantly emerging in the markets where access has been negotiated through FTAs.

THE NEED TO GET SMART

The real question, then, is what needs to be done for exports to increase in value. And the answer is well known: incorporate knowledge. Moving toward a knowledge-based economy will increasingly become a necessary condition for any export-led strategy to be really successful—that is, to consistently increase productivity and improve the economy's competitiveness. In the globalized economy, and more so as a consequence of the current crisis, the challenge of how to persuade society to seriously make this turn toward high-quality education, research and development, joint private-public partnerships to develop innovative visions of the future, and the like is becoming one of the key strategic issues for middle-income economies, particularly in Latin America.

Meeting this challenge of moving toward a knowledge-based economy is obviously connected to the employment-centered strategy described earlier in this report. The changes required in the quality of the labor force, in the way labor markets operate in order to increase productivity, and in the new institutions required to provide economic security to those changing or losing jobs are all essential to accelerate the transition toward a knowledge-based economy. Implementing these reforms again represents a major challenge for governments and policy makers (OECD 2009).

THE NEED FOR A NEW AGENDA

What emerges from this analysis is the need for a new, multilayered agenda of significant institutional and policy changes. The current crisis, paradoxically, may provide more political space to make these kinds of changes possible, given the widely shared experience of severe economic insecurity by all relevant actors in society. There is a need to act, even if it requires questioning conventional wisdom in such central aspects as the role of the state and the market in postcrisis conditions.

In the context of the current economic and financial crisis, one advantage of what is now happening in public discussion is that there are fewer "I know it all" or "The markets will fix it" approaches. Fewer economists are telling policy makers "We told you so." Instead, the shared sentiment for both politicians and decision makers and regulators is "How could we not have seen what was coming?"

Much explaining and persuading will be required for a multilayered program of reforms to be undertaken and accepted by the general public. Essentially, a new conventional wisdom will need to emerge encompassing six main points:

- Markets will work better if there is more regulation, not less.
- What is produced and traded should be more in accord with the needed new, high-quality jobs.
- Labor and education reforms should be undertaken. To be successful, these will need to be supported by a wide spectrum of political opinion.

- Time will be needed to gradually expand coverage in basic social services until all participants in the labor force, both so-called insiders and outsiders, are included.

- The only way to introduce flexibility in the labor market will be to point toward guaranteed universal social security, health care, and unemployment insurance coverage for workers with different types of employment contracts.

- All these changes will require additional resources, and some countries have more of a margin to increase tax revenues than others. For those with little margin, innovative formulas relying on a mix of public revenues, targeted household savings, and solidarity funds should be tried, as some countries in Latin America and Europe are experimenting with.

In fact, the postcrisis agenda provides an opportunity to plant the seeds of a "politics for exceptional times." A useful exercise might be to look at the experiences of similar midsize countries that two or three decades ago were where most Eastern European, East Asian, and Latin American economies are today in terms of income per capita. These countries were faced at the time with severe external shocks or a domestic economic crisis, and they succeeded in turning the crisis into an opportunity for deep structural changes that led to higher growth, better social policies, and a better democracy. These midsize countries thus faced similar challenges to the ones faced today by the economies of Eastern Europe, East Asia, and Latin America. They can be considered "like-minded countries" in the sense that they share certain structural characteristics: midsize to small-sized economies, somewhat on the periphery of world markets but highly globalized, whose export composition was or is heavily concentrated in natural resources. Among them, the experiences of Finland, Australia, New Zealand, Ireland, Spain, and Portugal are particularly relevant. (For a comparative study of their development experience in the last three decades, see IDB and Ministry of Foreign Affairs of Chile 2009.)

A consistent component in the experiences of these similar midsize countries was that a more consensus-oriented politics emerged. When faced with critical circumstances, most relevant actors, both public and private, agreed on the need to agree—to share a long-term perspective on where the

country needed to go or what it wanted to be, and on some of the steps that had to be taken to gradually move in that direction.

These countries also learned that politics in a democracy is competitive by nature, so there is a limited time span for reaching an agreement on the fundamentals. But they also learned from experience that even when political competition and differentiation on policy issues emerged, it was always possible to design alternative ways and various shapes of consensus building, even with more partial, limited objectives, that still allowed the country to move in the right direction.

Of course, the permanent challenge for those in government will be that an adequate policy response to the crisis will require decisiveness on the part of political leaders. This will mean reacting quickly and providing solutions at a rapid pace, not necessarily consistent with the time required to build a consensus—or even to provide a basis in political legitimacy for decisions made by the executive concerning the main reforms that are needed.

Here we are in the presence of a typical trade-off between what Francis Fukuyama and other political scientists have called the simultaneous need for decisiveness and resoluteness and for legitimacy in decision making, particularly in critical areas where reforms are as essential as those suggested in this report. Consensus building takes time and, thus, debilitates decisiveness. Conversely, however, reforms undertaken with bipartisan support acquire a legitimacy that will make them more permanent.

This is a dilemma that all democracies face. The problems change, but there are always pressing issues for which various alternative formulas are available. For instance, for many years to come, European societies will be facing the aging of their populations, underfunded social security systems, and overtaxed populations. Health care reform in the United States is another example. Likewise, the race toward competitiveness in an economic environment that is ever more globalized is a challenge for all developing countries.

Those countries that more quickly find the right political equation for change will not only lead the way for others but will also position themselves to better compete in world markets and have a more significant voice

on the world stage. The fact that the middle-income countries discussed in this paper have proved themselves in the last several years to be up to this challenge indicates that the postcrisis agenda is achievable. But success will rest not only in the right policy design. What is scarcer and more badly needed is high-quality politics—a politics for exceptional times.

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