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ECONOMIC VIEWPOINT

Notes by Danny Leipziger, Professor of International Business

What Have Developing Countries Learned from the Crisis?

The Great Recession has broken many shibboleths. New doubts have been raised about the effectiveness of fiscal and monetary policies when confidence is damaged. Concerns about competitive depreciations have fostered the term "currency wars." And capital flows, long sought after, are now considered anathema to some emerging market economies. Has the economic policy paradigm irrevocably shifted? And what does this mean for developing countries?

In its supplement to the Growth Report, the Spence Commission on Growth and Development argued that its basic finding that export openness was a key ingredient of rapid growth was still valid post crisis. However, the commission did aver that the returns from that strategy might be lower in coming years. Others, such as Mohamed El-Erian, have spoken of the "new normal," a sea change in the economic landscape. Should developing countries proceed with the previous economic growth paradigm or should governments take away new lessons from this crisis?

The answer is probably some of the old and some of the new. In the category of old, just as Mexico, Korea and Thailand suffered through liquidity crises as a result of poor financial regulation, that admonition applies even more to all nations today. Without proper regulation, the public costs of damage control are simply staggering. Investing in stronger regulation was always wise policy. Nowadays, it's indispensable.

Similarly, unsustainable imbalances, whether in fiscal accounts or in external payments, are also recipes for future disaster. But most developing countries have neither the government-fueled export engine of China (supported by prodigious savings) nor the reserve currency status of the dollar that helped the US run its twin imbalances. Macro-economic management is, therefore, not a luxury, but a necessity for all economies, rich and poor alike. But this is not new.

What is new is that countries may no longer be so receptive to capital inflows, and may seek to deter them (in Brazil's case by taxing) as they appreciate the exchange rate and harm exports. The view that some capital inflows might be damaging was foreseen in Chile in the 1990s, when an extra reserve requirement was levied to deter easily reversible flows seeking yields. That case notwithstanding, capital controls—not to prevent outflows but, rather, to deter inflows—are a new phenomenon. Financial instability that abruptly cut credit access has also led to more domestic means of financing through development banks and other state entities, a trend that will continue.

The decibel level around joblessness in the rich countries has risen, and unless wealthier nations deal with persistently high unemployment, protectionism is inevitable. The answer for developing countries is a much more diversified strategy, less reliant on US markets, more reliant on Asian markets, but also more focused on internal industrial development. That approach leads inevitably to talk of industrial policy. Very few countries have been able to stimulate economic transformations without resorting to protection. The lesson here is not to fall into the protectionist trap, while still providing incentives for industrial development. As Professor Dani Rodrik has argued, the new growth paradigm may feature more government rather than less.

The final lesson is that smarter risk management, higher reserve levels and fiscal space have all served developing countries well in this crisis. Without these buffers, the downturns would have been more severe, and in poor countries there is very little margin to maneuver. Best to be more cautious and not entertain the risks that the OECD countries took because the price of bailouts and subsequent economic adjustment is simply too high. The final lesson is that rich countries are not immune to policy mistakes, a small comfort under the circumstances. ■

Send comments to dleipzig@gwu.edu