WPS5353

Public Disclosure Authorized

Public Disclosure Authorized

Policy Research Working Paper 5353

The Global Financial Crisis and Development Thinking

F. Halsey Rogers

The World Bank
Development Research Group
Human Development and Public Services Team
&
Office of the Chief Economist
June 2010

Policy Research Working Paper 5353

Abstract

The global financial crisis has not only dealt a major blow to the global economy, but also shaken confidence in economic management in the developed world and the economic models that guide it. The crisis has revealed major market failures, especially in the housing bubble and its transmission to the financial system, but also glaring state failures that propagated and exacerbated the crisis. Will the events of the past two years lead to major shifts in thinking about development economics, and should they? This paper assesses that question for several key domains of development thinking, including the market-state balance, macroeconomic management, globalization, development financing, and public spending. On the one hand, changed global circumstances and new awareness of vulnerability should lead to some policy changes, as developing countries take steps to reduce and buffer risks, including risks generated in developed countries. At the same time, the crisis should largely reinforce the Post-Washington Consensus on development that has emerged over the past decade—a world view that aims to achieve private sector-driven growth but sees a facilitating role for the state, promotes engaging with the global economy in ways that advance development, and values pragmatism, experimentation, and evidence-based policymaking over ideology.

This paper—a product of the Human Development and Public Services Team, Development Research Group, and the Office of the Chief Economist—is part of a larger effort in the vice-presidency to understand the sources of development progress, as well as the effects of crises. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at hrogers@worldbank.org.

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the International Bank for Reconstruction and Development/World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.

Produced by the Research Support Team

The global financial crisis and development thinking

F. Halsey Rogers[1]

[1] Senior Economist, Development Research Group, the World Bank. The author is very grateful for comments from Shanta Devarajan, Shahrokh Fardoust, Ariel Fiszbein, Alan Gelb, Steve Knack, and Zia Qureshi. The findings, interpretations, and conclusions expressed in this chapter are entirely those of the author. They do not necessarily represent the views of the World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.

Economic crises typically trigger changes in economic thinking as well as in behavior. The Great Depression made possible the rise of Keynesian economics, which then held sway for more than a generation. Keynesianism took hold not only because it had value as a description of some states of the world, but also because economic disaster opened minds to new ideas. The pain of stagflation in the 1970s and early 1980s raised the stature of monetarist and New Classical approaches, and at the same time spurred the development of an alternative, New Keynesianism, that was compelled to use tools and assumptions borrowed from the New Classicals. And in much of the developing world, the debt-crisis and stagnation of the 1980s increased the legitimacy of alternatives to import-substituting industrialization that had predominated in previous decades. In each case, the intellectual structure for the new thinking had been under construction before the crisis fully hit, but the crisis helped make it habitable for policymakers.

What changes will the current global financial crisis catalyze in thinking about economic development? We should expect that, given the magnitude of the shocks and failures that caused it, the crisis could change the way that policymakers, researchers, and the general public view economic policy – the explicit or implicit models in their heads as they consider economic issues. The extent of the change in views will likely depend on the depth and length of the global recession. Already, for the world as a whole, global GDP and global trade in goods and services are estimated to have declined in 2009 for the first time since World War II (International Monetary Fund 2009; World Bank 2010). The same is true of the collective GDP of the advanced economies, which fell by an estimated 3.2% in 2009 (World Bank 2010). Developing countries' income growth was more rapid before the crisis, so it likely remained positive in 2009, but it too has suffered a severe shock. The crisis has already had major effects on policy in the developed countries, forcing governments to assume new roles in the economy that would have been unthinkable a short time ago. But what about development thinking? Should it, and will it, also shift as a result of the crisis?

Any answer at this point is necessarily preliminary, but this paper lays out some tentative conclusions. Because much of the debate on development strategy over the decades has taken place along the market-vs.-state axis, the first part of the paper is oriented along that axis. We start with a discussion of what the current crisis has revealed about shortcomings of both markets and governments, and then turn to the implications for development thinking. We use that issue as a launching pad to address how development thinking could change in a number of important areas. One conclusion is that in some cases, the crisis serves to ratify changes in thinking that were already well underway in the development arena. But in other areas, the events of the past year should prompt new thinking.

We start by highlighting some areas where the crisis has laid bare certain overly neat models of the way the economy works, and explore what this means for economics generally. We then explore whether and how much development economics might change in response to this changed context, and conclude with a few implications for development policy.

Throughout, the paper's focus is on broad thinking about development strategy and approaches, rather than on what specific policies are appropriate over the short to medium term for developing countries. Clearly, the crisis has changed the global environment dramatically, which in turn has required many macro and micro policy changes by developing-country governments to address and cushion the recession. But our goal here is to assess how the crisis may and should change the underlying development models that guide policymakers and researchers in broad areas of the economy, such as the role of the state and the value of international integration.

The changed context: Market and state failures in the crisis

It is said that success has a thousand fathers, while failure is an orphan. But regardless of whether they are willing to claim their abandoned child, in this case the crisis had many parents. Both market and government failures contributed to the downturn, and there are lessons to be drawn for economic thinking from each.

How the market failed

The crisis has dealt a blow to the framework of economic thought of many people, because it was driven by economic phenomena not predicted by the standard neoclassical textbook model. Most famously, former Fed chairman Alan Greenspan said in Congressional testimony after the crisis broke that he had "found a flaw . . . in the model that I perceived is the critical functioning structure that defines how the world works" and that he had been "very distressed by that fact" (News Hour (PBS) 2008). Greenspan is hardly alone in having his model of the economy sorely challenged by the global financial crisis.

The crisis originated in housing and financial markets, and the neoclassical view of such markets is based on key assumptions that undergird theories about the market's ability to lead to optimal outcomes. One key assumption is that well-functioning markets price assets efficiently, as argued in the efficient market hypothesis – that prices in financial markets, or more generally markets for assets, incorporate all information currently available to market participants (Fama 1970). A central building block in this result is that market participants (and in particular profit-maximizing firms) have a strong incentive both to use and to ferret out information that could increase their profits.

Market efficiency and the housing bubble

The shock waves that coursed through the world economy in 2008, of course, originated in the bursting of the US housing bubble. Housing prices had appreciated rapidly throughout the decade, at rates that were far higher than historical averages. The housing price-rent ratio in major cities also rose rapidly, raising concerns that this was indeed a bubble: homebuyers were paying an ever-increasing multiple of what it would have cost them to live in the house without owning it.

Commentators who favored an efficient-market position offered various explanations for the rapid price rises. One was that land was becoming scarce, especially in the coastal areas that were experiencing the most rapid prices rises, and that therefore homebuyers correctly perceived that supply would not be able to continue to meet demand at current prices. (This story did not explain convincingly why the price-rent ratio would be rising so sharply, however.) A second explanation was that the very low prevailing interest rates justified the higher valuations for housing, because they reduced the cost of servicing mortgage debts. (Left unexplained was whether the effect was symmetrical: would a subsequent rise in interest rates reduce housing prices by the same amount, and if so, how could home-buyers' expectations of continued rapid rises in housing prices be rational?) These "this time it's different" explanations were reminiscent of those offered during the dot-com bubble of the late 1990s.

Some observers, including many research economists, had long argued that housing prices were experiencing a bubble (Baker 2006; Shiller 2006; 2007). Perhaps most prominent was Robert Shiller, who had also correctly predicted the bursting of the dot-com bubble. In the case of housing, Shiller argued that "[i]t does not appear possible to explain the boom in terms of fundamentals such as rents or construction costs", and that instead psychological factors were driving much of the appreciation (Shiller 2007). In particular, homebuyers appeared to believe that prices would continue appreciating at rates far higher than the historical average, or than justified by fundamentals; as a result, they were willing to stretch themselves to the limit to invest in this asset. This bubble behavior was consistent with models from behavioral economics that made room for psychological factors.

The bubble eventually did pop, although much later – and therefore with far more damaging consequences – than many proponents of the bubble view had expected. Moreover, the problem was not limited to the United States. While the US downturn had the most damaging global effects, due to the size of the US economy, other countries such as the UK, Spain, and Ireland also saw bubbles inflate in their housing markets.

Proponents of the efficient market hypothesis have argued that such bubbles should not be taken to undermine the theory. Burton Malkiel, a prominent early proponent, argued before the housing bubble that "periods such as 1999 where 'bubbles' seem to have existed, at least in certain sectors of the market, are fortunately the exception rather than the rule", and that even in such cases earning long-term excess returns off the market anomaly is not possible (Malkiel 2003). But from a public policy perspective, what matters is not so much whether there are opportunities for arbitrage as whether excess volatility in markets has negative externalities that can be anticipated and reduced through government action. Now that the housing bubble has provided a second major "exception" in a decade, these market failures clearly deserve attention.

Transmission to the financial system

The second major shock was the transmission of the housing market shock into the wider economy through the financial system. The drop in the value of housing -- for many households,

their major asset -- would certainly have sharply reduced consumption anyway, due to the negative wealth effects. Indeed, based on earlier estimates of wealth effects, Baker (2006) predicted that consumption would fall by 2 percent of GDP as the housing bubble deflated. But the unexpected disruption that the home-price collapse caused in the financial sector greatly compounded the damage. Mortgage-backed securities in the portfolios of banks and other financial institutions turned out to be worth far less than their assumed value, dragging down the asset side of the ledger and threatening the solvency of many institutions. Uncertainty and asymmetric information regarding the actual value of mortgage backed securities (MBSs) exacerbated the problem. The market for securities became subject to the "lemons" problem of asymmetric information in which potential buyers, unable to discern which securities were affected by default risk, and obliged to rely on expectations, bias the valuation downwards – since any given price will be more attractive to sellers of risky assets (as in Akerlof 1970). As buyers offer a lower price, sellers are willing only to part with their riskier assets and buyers lower their valuation still further – since it is now the expectation formed on the basis of a riskier pool. This process is iterated until the market collapses. In this case, liquidity dried up and little or no trading of the MBSs could take place. (For a theoretical model that develops this idea in connection with the crisis, see Chari, Shourideh, and Zetlin-Jones (2009).)

Like the housing bubble itself, the extent of the damage to the financial sector was inconsistent with at least a naive version of neoclassical theory. Fundamentally, this stage of the crisis stemmed from financial actors' systematic misperception of the risk in the mortgage-backed securities that they held. The economics of information – the branch of economics that emphasizes the importance of information asymmetries – had long shown that with imperfect or incomplete information, there should be no presumption that market equilibria are optimal from a social standpoint (Akerlof 1970; Spence 1973; Stiglitz 1979). Of course, participants in financial markets had a strong incentive to gather information about the quality of investments, and the market had devised a solution to the problem of gathering information about risks: the bond rating agencies. But Moody's, S&P, and Fitches had consistently given strong investment-grade ratings to the MBSs, paving the way for financial institutions to load up on those investments.[2] As the *Economist* magazine has wryly noted, "[i]f the past decade's financial overengineering was a crime, rating agencies were the getaway driver" (The Economist 2009a). Their failure – and that of the many financial analysts who were supposed to spot problems – means that information problems may deal a more severe blow to the standard model than previously thought.[3]

---

[2] In the case of S&P, this is somewhat ironic, given that since early 2006 the firm has published the Case-Shiller housing price series that provided the most graphic evidence in favor of the "bubble" view.

[3] A quote from Nobel prize winner Robert Lucas indicates the information problem extended well beyond the rating agencies: while defending the overall Chicago approach, he notes that "You had a bunch of guys who thought they knew a lot. It turned out we didn't know a damn thing about the stability of the banking system, so it's back to the drawing board and we'll see what comes out of it" (Islam 2009).

What this implies for economic thinking

Other failures of the market also contributed to the crisis; for example, failures in corporate governance created the mixed incentives faced by the rating agencies, as well as the incentives for excessive risk-taking at many financial firms. But these two failures – the housing bubble and the toxic securities – were at the core of the crisis, and both illustrate shortcomings of a naive neoclassical model. If so many consumers projected the future values of their own houses so poorly, then what does this imply about their ability to make rational decisions about other investments that they know even less about? And if even a data-rich sector like finance suffered from major problems of the sort implied by the economics of information, and those problems could not be bridged by market institutions, how confident can we be that the market equilibrium will be anything like the full-information optimum?

This confluence of events clearly challenges the more doctrinaire free-market views of economics. And indeed, there have been voices among economic conservatives questioning some of the basic precepts of the neoliberal framework. The conservative jurist Richard Posner, an influential Chicago School voice on law and economics, recently argued in the *Wall Street Journal* that part of the Fed's mandate is "to be on the lookout for bubbles, especially housing bubbles . . . Our central bank failed us" (Posner 2009). Home-buyers had gotten it wrong, in part because they "were assured by officials and other experts that they [home prices] were rising because of favorable 'fundamentals'." Leave aside the point that some of these assurances were coming from Posner's fellow conservatives, who simply did not believe that the market could have yielded prices so completely divorced from fundamentals. But what is notable is that here Posner is calling for government action to correct the systematic errors of millions of poorly informed investors. Moreover, in the same article, Posner notes that increased regulation of financial institutions may be necessary (although not, he cautions, in the midst of the recession).

Some economists have responded to these events to call for a wholesale rethinking of modern macroeconomics. Most prominently, Paul Krugman set off a fierce debate within the profession with his recent article, "How Did Economists Get It So Wrong?" (Krugman 2009) In it, he describes macroeconomics as a field whose leading practitioners fell in love with mathematically beautiful models that were too divorced from the real world to be of any use in this crisis. To Krugman, there is far more to be learned from Keynes, who he argues has been rejected and even ignored by the Chicago macro tradition of the past several decades. These charges have provoked an immediate and vocal response from some leading macroeconomists, such as Chicago's John Cochrane, who dismisses Krugman's critique as a caricature of models that were never meant to be taken literally but have led to major policy-relevant insights (Cochrane 2009).

But others have also called for the crisis to spark a wholesale change in the macro field. For example, Willem Buiter, former chief economist of the EBRD, argues that "most mainstream macroeconomic theoretical innovations since the 1970s . . . have turned out to be self-referential, inward-looking distractions at best" and left the academic profession "unprepared when the crisis

struck" (Buiter 2009). Along the same lines, Robert Gordon has called for a return to what he labels "1978-era" macroeconomics that "retain[ed] the best of Keynesian demand-side economics while dropping the negatively sloped inflation-unemployment tradeoff with its neglect of supply shocks" (Gordon 2009). More recently, Olivier Blanchard, who serves now as the director of the IMF's research department, has co-authored a paper calling for a rethinking of macroeconomic policy in the wake of the crisis (Blanchard, Dell'Ariccia, and Mauro 2010). While there is nothing like a consensus developing yet, there is clearly greater unease with some of the assumptions underlying the "modern macro" and even New Keynesian approaches than at any time in recent decades.

How the state failed

Thus it is fair to say that the crisis mounts a challenge to the thought framework underlying some of the more ardent neoliberal policy prescriptions: the "market", broadly defined, did not yield anything like optimality. But at the same time, the crisis has highlighted government failures that underline the complexity of creating the institutional (or soft) infrastructure needed for the market economy to thrive.

Financial regulation

One major area of governance failure was a failure of financial regulation. In a recent speech marking the first anniversary of the Lehman collapse, US Council of Economic Advisors Chair Christina Romer (2009) identified a litany of regulatory gaps and failures:

> What the current crisis has shown us is that this 1930s structure has not kept up with the evolution of financial markets. We now see that there are crucial gaps and weaknesses in our regulatory structure. The most glaring is that the current structure is designed to evaluate individual institutions and no regulator has a mandate to evaluate risk to the entire system. A related gap is that some institutions that potentially pose systemic risk are either not regulated at all or are inadequately regulated because of regulatory arbitrage. A third gap is that the government does not have a resolution mechanism for major non-bank financial institutions. The government currently faces the unacceptable choice between disorganized, catastrophic failure and a taxpayer-funded bailout. Finally, regulation of consumer lending is spread across many agencies, and no agency has consumer financial protection as its central mandate.

Thus the problem was not only one of poor regulation, but also an absence of regulation: many of the institutions taking on excessive risk were not covered by regulatory agencies. In particular, institutions in the "shadow banking system" – investment banks and hedge funds – were not subject to the same prudential regulation as commercial banks were, and so were allowed to leverage themselves highly and invest heavily in what were later dubbed "toxic" securities.

Perhaps this is not a surprise: governance will never be completely consistent, and market participants have incentives to exploit gaps in regulation. A major contributor to the last financial

crisis in the United States, the savings and loan crisis of the 1980s, was an institutional environment that allowed thrifts to go "regulator shopping" – that is, to change their charters in order to fall under the supervision of the more permissive regulatory agency (Akerlof and Romer 1993). It has been argued that the same is true of the boom in finance since the repeal of the Glass-Steagall Act in 1999, as financial institutions surged into new sectors. Growth and expansion may have been easiest for the firms that were subject to the least restrictive regulation. Indeed, one of AIG's main money-making strategies was to sell unregulated credit-default swaps to regulated institutions – a form of "regulatory arbitrage" (Nocera 2009).

Political economy is also an important part of the story. Just as information asymmetries and the real-life behavior of non-*Homo Economicus* individuals are problems for simplistic market-oriented models, rent-seeking behavior and governments that do not act as benevolent and omniscient social planners are problems for a state-led model of the economy. Regulatory gaps in finance were not accidental or exogenous, but endogenous to the political process. Powerful firms, industries, and sectors lobbied to keep their activities as free of regulation as possible (New York Times 2009). In the area of housing finance, too, political pressures on regulators helped reduce lending standards and fuel the housing bubble.

So even in a country that ranks high on usual governance measures, there were gaps in the regulatory environment that led to economic disaster. Nor was it only a case of willful gaps in regulation. Even had the regulatory structures been in place, government would have had to foresee the extent of the vulnerability. But in the case of this crisis, there is little evidence that government had any obvious advantages in information or analytical capacity. Like much of the private sector, the US government – whether the executive branch, the Federal Reserve, or Congress – on the whole does not seem to have seen the financial crisis coming.

Macroeconomic management

In the wake of the crisis, there has been much attention to other perceived government failures at the macro level. One target of criticism has been monetary policy. As noted above, the Fed has been criticized for "allowing" the bubble to inflate. In the wake of the dot-com bust, monetary policy became much more expansionary as the Fed sought to end the recession swiftly. Interest rates remained very loose for several years, even as real-estate values shot up to their historical highs. In retrospect, some commentators argue that the Fed should have tightened monetary policy much sooner to let the air out of the bubble, although there is still much debate about whether in fact central bankers have the tools to prevent asset bubbles while meeting their primary goals of stable prices and full employment (Mishkin 2008; International Monetary Fund 2009; Wolf 2009). Blanchard, Dell'Ariccia, and Mauro (2010) raise other monetary-policy issues in their critique of prevailing macroeconomic theory. Most notably, they suggest that central banks' inflation targets may have been too low, given that the zero lower bound on nominal interest rates limits room for expansionary monetary policy in a crisis. (The possibility of higher inflation targets

drew immediate fire from the editors of the *Economist* (2010), among others, showing that there is no unanimity about this monetary policy lesson either.)

Another area of criticism is fiscal policy. It has been argued that the US was unnecessarily vulnerable to the effects of the crisis because of the large structural fiscal deficit that it ran in recent years. As the IMF has pointed out, much of this deficit was the result of discretionary changes in fiscal policy, including most notably the large tax cuts of 2001 and 2003 (Mühleisen and Towe 2004). Even though the federal government was not alone in failing to foresee the crisis, many commentators at the time pointed out the risks of running a significant deficit during a period of growth.

What this implies for economic thinking

These government failures and others that exacerbated the crisis point to the need for some balance in interpreting the lessons of the past two years. Clearly markets have not behaved as efficiently as some textbook models suggest. At the same time, government action has made it more possible for these market failures to generate a full-fledged crisis. What this suggests, as we shall explain below, is that the spectacular market failures of the crisis should not be taken as a license for governments to insert themselves into new areas unless it is clear that they can outperform or improve the outcomes of the private sector.

HOW SHOULD THE CRISIS INFLUENCE DEVELOPMENT THINKING?

In the remainder of this paper, we turn from how the crisis affects thinking about economics in general to how it affects development economics specifically. Below, we delve into specific areas, but certain broad conclusions along the state-market debate can serve as preface.

How should the experience of the crisis affect the views of developing-country policymakers on development strategies? Perhaps the safest and most sensible answer is that it is premature to draw lessons from this crisis. Without knowing how long it will last, and how rapid and sustained the recovery will be, we cannot know the economic cost of some of the policies that brought us to this point. Since those policies likely had benefits as well – at least in better times, before the "perfect storm" of market and government failures – this makes it impossible to do even notional cost-benefit calculations yet.

Yet the need to make development policy decisions cannot be held in abeyance while researchers puzzle out the lessons of the crisis. At the time of this writing, we are already 20 months into the US recession, and over a year past the Lehman Brothers collapse that led so many dominoes to fall. So it should not be too early to take a first cut at lessons of the crisis. In some cases, the crisis should reinforce lessons that were already, or were already becoming, generally accepted in the development community – but that were not always accepted by those commenting on development from outside the field. In other cases, it raises new questions and will likely spark new debates.

In each case, we open by offering some lessons that have been given further support by the latest crisis. In response to the *Economist's* recent reviews of macroeconomics and financial economics after the crisis (The Economist 2009c; b), the Nobel Prize-winning economist Robert Lucas complained that the reviews were "dominated by the views of people who have seized on the crisis as an opportunity to restate criticisms they had voiced long before 2008" (Lucas 2009). But lessons need not be completely new to be valid. In some debates, including those revisited by the *Economist*, the crisis can lend further weight to arguments that previously seemed sensible.[4] In Bayesian probability language, the crisis may be instructive even if it serves to strengthen our priors about an issue, rather than teaching completely new lessons.

First, as we will discuss in the first section below, the crisis undermines any approach to development that assumes that unrestricted markets are invariably the best tool for promoting growth and improving social welfare. "Market fundamentalism", as it has been labeled by its critics, is less common in development circles than it was a decade ago, but it still has influence. In part, that school of thought was a justified reaction to the statist excesses of the 1950s to 1970s, which led to macroeconomic destabilization and microeconomic distortions and inefficiencies in many countries. Faced with the reality of very poorly performing states dominated by rent-seeking, many researchers and policymakers understandably emphasized the benefits of markets in allocating resources impartially and efficiently.

In development thinking, this played out initially in the "stabilize, privatize, liberalize" mantra of the late 1980s and early 1990s. As a rallying cry, this approach succeeded in spurring change in many countries, probably contributing to the improvements in macroeconomic indicators like inflation rates. But this view was challenged by the East Asian financial crisis of 1997-98, given that a proximate cause of the crisis was the liberalization of the capital account and the financial sector in Thailand and other crisis countries. The slow growth of reforming countries in Eastern Europe and Latin America also presented a challenge: with the move in the direction of freer markets, why was there not a greater payoff? Still, there has continued to be a thrust in development thinking toward reducing regulation, minimizing role of the state, and promoting a small-government model as ideal for development.

The roots of the current crisis suggest that even in its more moderate form, the market fundamentalism view is based on incorrect assumptions about how the world works. It appears too optimistic about the powers of markets to deliver optimal outcomes, without the structure provided by an effective state. The necessary conditions do not apply even in the United States, United Kingdom, and other wealthy countries, despite the institutional advantages that are both cause and

[4] This is also a response to the economist Tyler Cowan's comment on Lucas, in which he wrote that "Overall [Lucas] is correct to reject the view that a single crisis means we should toss out everything we once knew or at least thought we knew. To do that would be overreacting to short-term data, just as some of the guilty parties behind the financial crisis themselves overreacted to short-term price and profit signals" (Cowan 2009). That would indeed be an overreaction; but in development, we are arguing that the crisis reinforces lessons that we were already learning.

consequence of their higher income levels. The conditions are even less likely to apply in most developing countries, where the institutions that support markets are generally far less developed.

At the same time, the crisis underscores the challenges facing government regulation of the private sector. A key role of the state in promoting development is to ensure that infrastructure is provided, and part of the institutional (soft) infrastructure that the state needs to provide is regulatory infrastructure. But this crisis – and the Enron and WorldCom and other scandals from earlier in the decade – have shown what a challenge that is with complex 21st-century markets, again even for relatively well-resourced public agencies in relatively good governance contexts in rich countries (Demirguc-Kunt and Serven 2009). This is especially true in financial markets, where innovation has been very rapid and firms have huge financial incentives to stay ahead of both their competition and the regulators.

On the market-state balance: Reaffirming the emerging post-Washington Consensus

The crisis is widely, and correctly, seen as discrediting the most neoliberal views of economic policy – those that dramatically minimize the role of the state and see government as inevitably the source of problems. The events of the past two years have re-emphasized the lesson that markets can be inefficiently volatile, that this volatility has long-lasting costs, and that good government can help to reduce volatility and improve welfare. In short, government is necessary to help economies function more effectively, and the role of government should go beyond the very limited role sketched out by some free-market advocates.

This lesson should not be a new one: indeed, it has been increasingly clear to much of the development community for a decade or more, after the earlier pendulum swings along the state-market axis. By the late 1990s, and especially in the wake of the East Asian crisis, a new post-Washington Consensus view had begun to be accepted in broader development circles and within the Bretton Woods Institutions.[5] This new view did not discard most of the Washington Consensus principles, given the wide acceptance of the need for macroeconomic stability and greater integration with the world economy. However, it did go well beyond them, particularly in recognizing the important role of the state and the need to allow developing countries to experiment with context-specific economic policies.

One way to trace the development of this post-Washington Consensus is to follow it in major World Bank reports and speeches. The major retrospective on 30 years of rapid East Asian growth, the East Asian Miracle (World Bank 1993), gave greater credit for growth to active state leadership than had the World Bank reports of the late 1980s. Starting in the mid-1990s, James Wolfensohn's approach to development as World Bank president emphasized not only dealing with

---

[5] Ravi Kanbur (2009) traces the emergence of this post-Washington Consensus view to several other events as well: the sharp economic decline in the early years of the transition in the former Soviet and Eastern bloc countries; the rapid growth of China and India, which had rejected some features of liberal orthodoxy; disappointing growth rates in liberalizing economies in Africa and Latin America; and rapid increases in inequality in some fast-growing countries.

corruption (government failure) but also helping poor countries develop country-owned poverty reduction strategies, which government was to take a lead in designing and implementing. In that same period, the Bank's chief economist, Joseph Stiglitz, gave a major address calling for state and market to be viewed as complements, not substitutes: he emphasized that the market could not operate effectively without the institutional infrastructure provided by the state, while the efficiencies of the market could make the state operate more effectively (Stiglitz 1998). The official World Bank strategy, set out in 2001, summarized development as being founded on two pillars – creating a good investment climate and investing in people – that both required an active government role (World Bank 2001; Stern, Dethier, and Rogers 2005). And the *World Development Report 2002: Building Institutions for Markets*, drove home the message that markets could not function without a conducive institutional environment and that this environment would have to be created or at least nurtured by the state.[6]

More recently, the Bank's PREM Network published *Economic Growth in the 1990s*, which addressed the uneven returns to policy reforms in the 1990s. It concluded that that there is no straightforward or universal recipe for development (including just freeing markets), and that governments should have room to experiment with different institutional structures that might be conducive to growth (World Bank 2005). Dani Rodrik, a prominent critic of neoliberal views on development, cited that report as "an important marker in [the] intellectual terrain" of development approaches with an admirable "emphasis on humility, policy diversity, selective and modest reforms, and experimentation" (Rodrik 2006).[7] And finally, last year's Spence Commission report on growth and development echoed and further developed these conclusions. It emphasized that markets are essential for resource allocation, but that "mature markets rely on deep institutional underpinnings, institutions that define property rights, enforce contracts, convey prices, and bridge informational gaps between buyers and sellers" (Commission on Growth and Development 2008). It also argued that, given uncertainty about the optimal set of policies and institutions for promoting growth, "[o]rthodoxies apply only so far", and the mantra of "'stabilize, privatize, and liberalize' . . . defines the role of government too narrowly". Governments should not be afraid to experiment with policies and institutions to determine what works best to promote growth in a particular context.

In short, there has already been widespread rethinking of the neoliberal approach to development in the development community, including in the corridors of power, since at least the mid-1990s. Krugman's recent broadside on modern macro, mentioned above, challenges the field

---

[6] Indeed, a review of this decade's *World Development Reports* belies the notion that development thinking has been in the grip of neoliberalism. Topics like sustainable development (2003) and climate change (2010), equity and development (2006), and education and health for poor people (2004) predominate. Only the investment climate WDR (2005) lines up closely with neoliberal concerns, and even it underlines the important (if not broad) role for government in the economy. These reports suggest not a shift away from reliance on markets, by any means, but Note that they show not a move away from markets, but a move toward a sensible middle ground. In the case of the WDR 2004, for example, they actually make more room for markets and market-like mechanisms in an arena that has long been state-dominated.

[7] To be fair, Rodrik was involved in the preparation of the report, but as an outsider he would have lacked the power to either initiate the project or get the final report approved.

of economics to reject the vision of "a perfect, frictionless market system" and "reconcile itself to a less alluring vision – that of a market economy that has many virtues but that is also shot through with flaws and frictions" (Krugman 2009). But in development, these "flaws and frictions" are all too evident – whether in the form of labor-market frictions, financial-market failures due to asymmetric information, norms and customs that impede market development, or other market imperfections. In the face of this evidence, it is difficult for development economics to stay unmoored from reality for too long. Yet while this post-Washington Consensus view has gained traction in recent years, it has not converted everyone. It runs up against the tendency to look for neat, sound-bite solutions to development, or for mono-causal explanations of growth (Adelman 2001). "Get prices right" is a more memorable slogan than (for example) "experiment with institutional frameworks to make government more effective, predictable, and accountable for results, while creating the hard and soft infrastructure for private-sector-driven growth".

Thus on the question of the respective roles of the market and state, the crisis reinforces the past decade's movement toward a balanced, less ideological approach. This approach gives primacy to the private sector as driver of growth, employment, and productivity, but recognizes that government may need to create the road network, metaphorically and literally, on which private firms can drive.

But how far should this intellectual rebalancing go? As discussed above, the crisis increases doubts about the ability of the market to achieve optimal outcomes on its own, even in the wealthy countries. If prices can become so unhinged from fundamentals and market players can be so wrong about risk in highly developed markets, one might argue, how can we be confident that highly imperfect markets in poor and emerging economies will correctly recognize potentially profitable business opportunities? Clearly, this observation does not automatically translate into a justification for greater state intervention to promote development. Whether state intervention is warranted depends on whether, at the margin, the state with all its shortcomings can nevertheless improve outcomes through greater involvement.[8]

Nevertheless, the crisis has clearly created new opportunities for an activist state. In part, this is simply due to the exigencies of responding to the crisis itself. In the United States, the bastion of market economics, government has assumed major ownership roles in the financial sector and the auto industry – roles that would have been unimaginable just two years ago. At least for the moment, this could lend ammunition to those in developing countries who believe that, under certain circumstances, a developmental state needs to take a strong leadership role.

One idea that could gain new traction is the possibility of using industrial policy to accelerate development. For years, critics have argued that even the US government uses industrial policy without naming it as such – for example, through defense contracts that finance innovation in aerospace and information technology, or through sometimes-long-lived "temporary" quantitative

---

[8] On reading this section, one colleague suggested that what matters is "whether a country has a comparative advantage in lack of government failure".

controls on imports of automobiles or steel. Several of the East Asian tigers more explicitly used industrial policy to address what they saw as problems of information or coordination that the market would not solve on its own. A large literature continues to debate whether this activist state role accelerated or hindered progress, but the new legitimacy for state action is likely to clear the way, at least temporarily, for more governments to try to emulate East Asia.

Calls for industrial policy have come from a number of quarters. Dani Rodrik, as noted earlier, cites a need for industrial policy as a replacement for the less intrusive but now less viable approach of undervaluing the exchange rate (Rodrik 2009). For countries to reap the gains associated with innovation and industrial diversification into tradable goods, he would have governments provide subsidies to promising new industries. Current World Bank chief economist Justin Lin has also called for industrial policy as an approach to dealing with the information and coordination problems, while emphasizing that the support should go only to firms and industries that can exploit the country's areas of comparative advantage (Lin and Chang 2009; Lin 2009).[9]

At the same time, this movement toward a more active state will run up against counterarguments citing, among other concerns, the state failures in the current crisis. As noted above, the crisis underscores that getting governance right is very difficult, because of technical complexity of regulating modern economies, the ever-present danger of political interference and rent-seeking, and weaknesses in corporate governance. Even if growth can co-exist with poor governance indicators (as in Bangladesh in recent years, for example), there will be many doubts about mixing an actively interventionist state and poor governance.

A major line of rebuttal on industrial policy specifically is to argue that we simply do not have evidence that industrial policy has worked in the past as a growth strategy – that for every East Asian success story, we have numerous other developing-country cases in which industrial-policy-style state intervention has been associated with poor growth performance, so East Asian successes could be random (Easterly 2009). Even among those who believe that state intervention has been successful in East Asia, many have long doubted that it could work in the different institutional settings in sub-Saharan Africa, or South Asia, or Latin America, or elsewhere. Some will argue that developed economies should now be added to that list: Simon Johnson, former chief economist at the IMF, has argued since the crisis struck that U.S. financial policy is in the grips of a "financial oligarchy" that "has effectively captured the government" (Johnson 2009).[10] In the face of failures

[9] Columbia University professor and former Colombian minister of finance Jose-Antonio Ocampo struck a similar note at a recent conference on development thinking, saying that "maybe we are in for a new phase of industrial policies." He referred to "the hardcore of the Washington consensus in this area . . . that the best industrial policy was to have no industrial policy. That element of the Washington consensus, I think, is going to die. And I think for good . . . [T]here are many good alternatives and the Asians have shown that it is possible to [have] . . . sensible industrial policies."

[10] Rodrik takes this point as evidence that growth – which the United States has certainly had in abundance over the years – is not contingent on good governance, and he concludes that therefore "the financial crisis has killed the governance reform agenda" as part of a growth strategy. By this he means that good governance, while a worthy goal on its own merits, is not necessarily a prerequisite for growth; he could add that it is clearly very difficult to achieve. But it

of financial-market regulation and perceived bailouts of the wealthy in the United States, critics will likely argue that this approach would not even work well in many developed countries, despite their more highly regarded governance structures.[11]

On macroeconomic management: The implications of the end of the Great Moderation

Another challenge to mainstream development thinking, alluded to above, is the shock to confidence in macroeconomic management. One widely noted change in thinking that has resulted from the crisis is that it is clear the Great Moderation has ended. This term referred to the decline in macroeconomic volatility since the early 1980s that was thought to reflect improvements in macroeconomic management, and in particular of the policy of the Federal Reserve and other central banks. Ben Bernanke, then a Fed governor, argued in 2004 that while structural factors and good luck explained part of the reduction in volatility, "improvements in monetary policy . . . have probably been an important source of the Great Moderation" (Bernanke 2004). Central banks were thought to have learned from the mistakes of the 1930s – when they kept monetary policy too tight – and the 1970s – when they allowed it to become too loose.

But with the current crisis, economists are no longer confident that policymakers in even relatively well-governed countries can prevent crises. It now appears that modern capitalist economies are too complex for policymakers always to anticipate the next possible source of crisis, and that these uncertainties can be compounded by political economy constraints on action.

The end of the Great Moderation has at least two implications for developing countries. First, it means that countries will need to be realistic about their ability to moderate swings in their domestic economies. Volatility is clearly not the province only of poorly governed countries. Indeed, relatively well-run economies may be more susceptible to certain types of risks: asset-price bubbles, and thus subsequent collapses, are likely to be especially large in the economies that global markets view as best-managed or most promising. This was the fate suffered by the East Asian economies in the 1990s, and the US economy in this decade – economies with flaws, but overall very attractive to investors before the crisis. Despite the relatively good performance of macroeconomic management in developing countries to date since the crisis broke, these experiences caution against overconfidence and excessive risk-taking. For example, the IMF

---

could also be the case that in this area of finance, U.S. governance has worsened in recent years, and that we are already seeing the costs in terms of forgone growth.

[11] Indeed, even those who acknowledge the importance of the state's role in development may wish to move in the opposite direction, so great is their certainty that most governments cannot be trusted to exercise discretion in ways that will spur development. The macroeconomist Paul Romer, who with Lucas sparked the rebirth of growth economics in the 1980s, now argues that many governments cannot be trusted with providing basic services like public security and education, let alone implementing industrial policy. Long-term growth and development is too important to be left to these governments, in his view. Romer is therefore promoting what he calls a "charter cities" movement (www.chartercities.org), in which countries would outsource administrative control of particular cities and many of the functions of government to other proven providers (including from the developed countries).

concludes in a recent *World Economic Outlook* that "policymakers should react more strongly to signs of increasing macrofinancial risk", including responding to asset bubbles with stronger macroprudential regulation (International Monetary Fund 2009).

Second, it means that not only do countries have to worry about domestically generated risks, but they also have to worry about risks generated by developed-country crises. To some extent, this has always been the case, due to the smaller market size and export concentration of many developing countries. It's often said that "when the United States sneezes, Mexico catches a cold". In the latest crisis, however, the United States caught the flu, and the consequences are commensurately more serious for Mexico and other developing countries that are integrated with advanced economies. Mexico in particular has suffered its worst downturn since the 1930s, with GDP falling 7.1 percent in 2009 (World Bank 2010, 131-132). Developing countries will need to factor into their calculations the possibility of major crises that are not due to domestic mismanagement or even terms-of-trade shifts.

This has led some observers to argue that the prevalence of crises is growing. Ravi Kanbur wrote recently, for example, that "for developing countries, periodic crises are likely to be the 'new normal'", with "major country level shocks over which the country has no control" (Kanbur 2009). As a result, countries are likely to want to focus more on reducing vulnerability to external shocks and improving systems of social protection. On the former, some countries may to be attracted to mechanisms for reducing volatility of external capital flows (discussed below), although this will still leave them vulnerable to trade and other channels of transmission. On the social protection front, Kanbur argues that a leading lesson of the crisis is the need for improvements in this area. He argues that social protection needs to be a system, not just a set of components, and that it needs to be in place well before crises hit. While it is too late to put together such a system for this crisis, Kanbur argues that his must be a priority for the medium-term future. The system should be flexible, so that it is possible to scale it up rapidly during crises – and, equally important, to scale it down after the crisis to mitigate fiscal costs (Kanbur 2009).

A second change in mindset that is emerging is in the predominant conceptual model. It has become clear that the efficiency of markets cannot be taken for granted, even in case of thick, active markets like financial markets. Irrationality can persist for a long time, in the form of bubbles, and can have major macro consequences, even in relatively well-governed economies. Greater awareness of this fact will reduce the appeal of economic world views and policies that rely heavily on the infallibility of markets. In political economy terms, there is likely to be greater mistrust of such policies; unfortunately, this mistrust could block not only misguided policies but also much-needed reforms.

There will also likely be greater recognition of the advances of the past 20 years in the field of behavioral economics. Behavioral finance is much better suited to explaining bubbles than are mathematically elegant neoclassical finance models, as Krugman has pointed out. But behavioral economics has implications that will be relevant to policy in a number of other fields besides

finance. To take one important example, behavioral economics has underlined the way actual long-term decision-making of individuals deviates from that of the hyper-rational, perfectly informed Homo Economicus of the textbook models, and has shown that default options (especially for retirement investing) are far more important than predicted by neoclassical models. These findings have important implications for the design of pension programs, and specifically for the question of whether and how to rely on individuals' own decisions to fund their retirements (see, for example, Benartzi and Thaler 2007).

None of this is to say that an alternative, statist world view will or should wrest preeminence in development from the more neoclassical model. The experience of the 1970s and 1980s is recent enough that memories of the costs of that approach have not faded. Arvind Subramanian argues that there has been a "decoupling" of this debate in the developed and developing world: in many developing countries, he argues, the idea of a larger state role remains unattractive, and there "there has been no such existential angst about capitalism, no serious questioning of the role of the market" (Subramanian 2009b). He argues that this is in part because the state still has a major role in the financial sector and elsewhere in the economy, and so "the issue is not how to claw back the role of the state so much as how to continue reducing its role in the gradual and pragmatic manner that these countries have been doing over the last two decades." Nevertheless, the models underlying macroeconomic policy will have to adapt, so that they can catch up with the more pragmatically oriented policy of the post-Washington Consensus era.

One encouraging lesson from this crisis – a provisional lesson, but an important one – is that macroeconomic management in many developing countries is stronger than it was at the time of previous crises. On the whole, governments have responded responsibly by providing some fiscal stimulus where possible but not resorting to populist measures that would ultimately deepen the crisis. Former Mexican policymaker Santiago Levy argues that this shows that the consensus for macroeconomic stability has become more ingrained among developing-country policymakers and publics (Levy 2009). And the IMF notes approvingly that in Latin America and the Caribbean – a region where macro management has responded poorly to some shocks in the past – during this crisis "stronger policy frameworks . . . promoted resilience and allowed timely policy responses to support economic activity" (International Monetary Fund 2009, Ch. 2). Similarly, the World Bank's chief economist for Sub-Saharan Africa, Shanta Devarajan, notes that African governments have largely enacted "orthodox responses to a heterodox shock" and have maintained and even accelerated their reform programs since the crisis hit (Devarajan 2009).

At the same time, this strong response should not distract us from the origins and size of the crisis to which these countries have been forced to respond. Together with the experience of the 1990s, the current crisis should underscore the size of the macroeconomic risks faced by developing countries. Not only are the risks large, but they are not confined to the "poor performers". In the mid-1990s, it was Latin American countries that had been particularly successful at improving their attractiveness to foreign investors that ended up suffering from sudden speculative attacks and crises. In the East Asian financial crisis of 1997-98, the victims were the countries that had been the

one great success story of development up to that point: the East Asian Tigers. In each case, the victims had made policy mistakes, but the punishment seemed disproportionately large to many observers. This time, that is even truer. On top of the homegrown crises, countries need to worry even more about crises imported from trading and investment partners.

On globalization and development: New recognition of risks, and a possible challenge to export-led growth strategies

A central tenet of both the Washington Consensus and the emerging post-Washington Consensus views has been that integration with the global economy through trade and through foreign direct investment is beneficial to growth. Especially since the East Asian crisis, many in the development community have questioned whether the benefits of international portfolio capital and high levels of foreign debt outweigh the vulnerabilities that they create, but most have not questioned the virtues of integration itself. International trade and FDI increase efficiency and introduce new technologies to the economy, helping to make possible GDP growth rates far greater than those achievable before the postwar period. So far in this decade, developing countries appear to have benefitted greatly from increased global trade and investment, which has helped to keep their GDP growth rates well above those of the rich countries for nearly the entire decade (International Monetary Fund 2009, Ch. 1). As a result, they likely entered this crisis substantially wealthier than they would have been in the absence of their increased integration. Moreover, greater integration allows countries to diversify idiosyncratic risks, for example by importing food to smooth over a crop failure.

At the same time, greater integration creates new risks for developing countries. Of course, this is not the first time in this wave of globalization that substantial numbers of developing countries have been hit by an internationally transmitted shock. Indeed, it has been argued that the number of major crises is increasing, despite the purported risk-sharing benefits of integration. But other recent emerging-market crises – for example, in Latin America in the mid-1990s, or in East Asia and Russia in 1997-98 – could plausibly be blamed on the victims. Those crises originated in emerging markets, and spread to their neighbors or others that shared characteristics with them. The fault lay in poor exchange rate management, or inadequate supervision of foreign borrowing, or "crony capitalism".

This time, by contrast, the developing countries are recognized to be largely blameless for the crisis[12], and the trade channel has been a major cause of the shocks they are experiencing. Global export volumes dropped by an astounding 24 percent between early 2008 and early 2009, dealing a major shock to the economies of successful manufacturing exporters (World Bank 2009, p. 13). Thus essentially because of market failures and poor regulation and economic management in the rich countries, the developing world has seen its income growth slow by more than 6 percentage

[12] An exception is the large export-surplus countries, most notably China, that are argued to have helped precipitate the crisis with the external imbalances that resulted from their exchange-rate policies. We address this question below.

points in 2009 compared with 2007 (International Monetary Fund 2009, Ch. 1). Conceptually it was understood that this was a possibility, but going through the experience is driving the lesson home. It is hard to believe that it will not have consequences for development thinking. Emerging-market governments may be able to do nothing to prevent crises in rich countries, but they can take steps to limit their vulnerability to those shocks.

Another issue raised by the crisis – perhaps not a "lesson" yet, since the jury is still out – is the way it may affect export-led growth strategies. In the development strategy arena, one point that has characterized the emerging post-Washington Consensus is a belief that export orientation is beneficial for growth and development. This strategy is sometimes characterized as adopting a "mild bias" toward exports or taking strong positive steps for "export facilitation", for various reasons. First, it ensures that a country will be more integrated with the global economy, which can accelerate technological advance in the trading country. Second, it can increase the average productivity of the home-country firms, by winnowing out the least productive and providing an opportunity for the most productive to grow more rapidly. Third, if it is adopted in conjunction with reduced protection of domestic markets, this strategy can reduce incentives for rent-seeking. This sort of export orientation has been a central element in the growth strategies of most of the rapid developers of the past half-century.

Might this mild bias toward exports in growth strategy now be questioned, in light of the major external imbalances that helped make the crisis possible? Although it makes little sense to blame the global "saving glut" for bubble psychology and regulatory failures, the quantity of money recycled from export surpluses almost certainly exacerbated those underlying problems. Now, in the wake of the crisis, it is widely expected that the US balance-of-payments deficit will need to fall to more sustainable levels, as the US household saving rate rises from its near-zero rates of recent years. Already, in the first year of the crisis, the shock to global trade has been larger than originally expected. Over the longer term, a fall in net US imports will reduce demand for net exports, crowding the space that potentially export-led growers may be jostling to fill. John Williamson recently argued that "mercantilist models are not sustainable" (Williamson 2009), by which he means that the export-surplus strategy that has characterized some major emerging-market exporters in recent years (especially since the East Asian Financial Crisis) will no longer be viable in this environment. Dani Rodrik puts the dilemma this way in a recent paper: "On the one hand, global macro stability requires that we prevent external imbalances from getting too large. On the other hand, growth in poor nations requires that the world economy be able to absorb a rapid increase in the supply of tradables produced in the developing world" (Rodrik 2009).

An imminent decline in net exports from developing countries would not necessarily require moving away from an export-led growth strategy. If the benefits from that strategy come primarily from the process of exporting, importing, and engaging with the global economy, then a net export surplus may not be necessary. But even so, there is a question of how countries could implement a strategy designed to promote rapid export growth. Export-oriented strategies have historically given a boost to tradeables by keeping the real exchange rate undervalued. Rodrik argues that the

common approach of encouraging a mildly undervalued currency will no longer be tenable, because of the need to redress global macro imbalances. He argues that instead, it may possible to achieve similar boost to the profitability of tradeables through explicit industrial policy, in order to promote manufactures and other non-traditional industries.

The long-term effect of the crisis on development thinking about globalization, then, is likely to be two-fold. First, there will be greater awareness among policymakers and researchers of the risks that come with integration, which offset better-known risk-dampening effects of integration. Policies toward trade, finance, and social protection will likely change as a result. Second, changes in the global development context as a result of rebalancing could reduce the attractiveness of export-led growth or, at a minimum, require new approaches and instruments to achieve it.

On financing development: Reinforcing the dangers of relying on debt

The newly rediscovered macroeconomic volatility has underlined the dangers posed by excessive reliance on others to finance development. The risks are clear at the country level, where this crisis has once again provided evidence that external debt and portfolio investment are not stable and reliable sources of financing. The dangers of excessive reliance on external debt have been shown in previous crises – the East Asian financial crisis, and before that the Tequila Crisis, and before that the debt crisis of the 1980s. Before, borrowing countries could perhaps reassure themselves that if they managed their own economies and finances well, then they had little to fear from debt financing. Korea, for example, financed the early stages of its rapid development with large external borrowing, at the cost of only one brief but sharp downturn in 1980. But recent crises have emphasized that interest spreads can rise and credit availability can dry up for reasons that are completely exogenous to the borrower, such as bad economic news afflicting other borrowers, or more recently financial troubles afflicting foreign banks in their home countries.

What is the alternative? We have also seen again in this crisis that reliance on external equity financing in the form of foreign direct investment carries considerably less risk. FDI has dropped off by much less than other sources of external financing, as noted earlier. But more importantly, high levels of domestic savings appear to shield countries from these exogenous crises. Most notable is the case of China, which entered this crisis with a very high national saving rate and therefore had none of the vulnerabilities posed by being a large net borrower. By contrast, the developing countries as a whole saw their reliance on external financing rise over the past two years, from 6.2 percent of GDP in 2006 to an estimated 7.8 percent of GDP this year, according to the *Global Development Finance 2009* (World Bank 2009). In 25 of 98 countries, the ratio exceeded 20 percent of GDP.

What is true of countries is also true of governments. The fiscal effects of the crisis underline the risks to developing countries of running large fiscal deficits during periods of growth, such as the past five or six years. Governments need to "keep their powder dry" in good times, so that they can afford to adopt countercyclical fiscal policy during the crises that will inevitably come.

Danny Leipziger, the former senior World Bank policymaker, notes the importance of "self-insurance", saying that "one of the lessons of the crisis is that those with fiscal space did a lot better" (Leipziger 2009). John Williamson gives the examples of Chile and China, both of which had the freedom to act after the crisis hit because of the structural fiscal surpluses they were running before it. Williamson contrasts this with countries like Pakistan and Ukraine, which had not had the same ability to use fiscal policy to buffer the effects of the crisis (Williamson 2009). Blanchard and his co-authors (2010) draw the same lesson, urging governments to set lower target debt levels and create more fiscal space in good times so that they have room to respond with fiscal stimulus in a crisis.

Another likely finance-related lesson that developing-country governments will likely draw from the crisis is that the elaborate technical models wielded by the private-sector financial experts may not be very reliable. For example, international finance economist Barry Eichengreen (who cannot be characterized as an academic stone-thrower) devotes a recent article to indicting the "value at risk models" to which many Wall Street firms unwisely entrusted their risk-management decisions, as well as the peer pressures and financial pressures that led academic financial economists to place such faith in them (Eichengreen 2009). If foreign financial firms cannot be trusted to carry out correct analyses of questions on which their survival depends, developing-country governments may in fairness doubt whether those firms will correctly analyze risks to the host countries. Arvind Subramanian argues that the crisis will mark the end of what he calls the "foreign finance fetish model", and Devesh Kapur similarly predicts that we are likely to see much greater skepticism in the future about opening to foreign financial firms (Kapur 2009; Subramanian 2009a)

On a related note, the crisis gives further impetus to debates about the developmental impacts of capital-account liberalization (see, for example, Chowdhury 2009). It will likely further reduce pressures on countries to open capital accounts, where they have not already, and it may also increase the willingness of researchers and policymakers to consider measures that tax or otherwise discourage rapid inflows or outflows of foreign capital. Leipziger, who was also the vice-chair of the recent Commission on Growth and Development, cites the role of capital as one of the four areas where some "supplemental views" may be necessary in the wake of the crisis (Leipziger 2009). Given the volatility of foreign capital (not including FDI), he says, Chile did the right thing in discriminating against short-term capital in the 1980s. Again, this agnosticism about capital-account liberalization is not new in Washington: any great ardor for the issue within the IFIs cooled in the wake of the East Asian crisis, and they have not tended to push the issue in recent years. But the crisis will lend further support to those who favor a gradualist approach.

On public spending and development: Strengthened emphasis on quality and efficiency

The issue of public spending has not been at the forefront of the "crisis and development thinking" discussion, but it may soon be. The crisis is likely to strengthen recent efforts to focus more on the quality and efficiency of service delivery, which has replaced the former emphasis on budget allocations to the social sectors and on quantities of schooling delivered. One of the major

budgetary costs for most governments is the provision of education and health services. The recession has already led to tightened fiscal circumstances, which will inevitably put pressure on those services. Unless the global economy recovers quickly, domestically or externally financed stimulus packages will not be able to offset these pressures indefinitely. At the same time, households' ability to contribute to their services, in the form of copayments or school-related fees, will decline – at least relative to the trend, and in some cases in absolute terms as well.

As a result, the need to increase cost-effectiveness of service delivery – getting the biggest possible bang in outcomes for the buck – will become ever more salient. This lesson has been clear for some time, especially since the *World Development Report 2004: Making Services Work for Poor People* planted its flag for the cause (World Bank 2003). Arvind Subramanian noted recently that in many developing countries, the question of effectiveness of service delivery is more a topic of debate than the size of the state (Subramanian 2009a). The crisis thus creates an opportunity to continue the trend toward greater policy attention to quality and efficiency.

The discussion of public spending is closely linked with the emerging post-Washington Consensus on the roles of market and state. Judgments about the appropriateness of a given service-delivery strategy increasingly depend on measured results, rather than ideology alone. In schools where public schools are failing badly in their mission of educating students, for example, policymakers should be open to experimenting with alternative delivery mechanisms, including greater use of private education (Patrinos, Barrera-Osorio, and Guaqueta 2009). At the same time, policymakers need to be aware of the potential equity costs of relying too heavily on market-driven solutions. By requiring hard choices, the crisis may contribute to the trend toward focusing on effectiveness and promote evaluation of different delivery mechanisms.

IMPLICATIONS FOR THE INTERNATIONAL FINANCIAL INSTITUTIONS

The main goal of this paper has been to assess how the crisis should affect the thinking that guides developing-country policymakers, rather than the activities of any specific actor in the development field. Before closing, however, this section provides a brief coda with a few preliminary thoughts on the lessons for the international financial institutions, or IFIs.

Implications for development policy

We have argued that one set of lessons from the crisis reinforces changes in development thinking that were already well underway. A critic might argue that, even if one concedes that point, the changes in thinking were not well reflected in the policies of international financial institutions. In the World Bank case, for example, views of the central research and analytical units that write most reports on development thinking could fail to have much influence over the regional vice presidencies that oversee lending and advisory programs for clients.

It is beyond the scope of this paper to review the sweeping landscape of IFI policy in different sectors over the past decade and assess whether or not it has shifted to reflect prevailing development thinking. Nevertheless, in certain areas it is clear that parallel changes have occurred in operational practice. In the area of infrastructure, for example, great enthusiasm for private-sector participation in infrastructure during the mid-1990s has given way to a more tempered recognition that in some sectors and settings, governments must provide most of the infrastructure. In the area of international finance, the past decade has not typically seen World Bank teams exhorting governments to open capital accounts.[13] And more broadly, lending and policy advice have reflected the growing recognition that much of the hard work of development lies in figuring out an institutional framework and governance structure that will promote private-sector growth and innovation.

Perhaps the broadest implication for policy is that IFIs and government policymakers alike need to re-examine carefully the models, explicit or implicit, on which their preferred policies are based. If the policy assumes implicitly that market prices never deviate far from fundamentals, then it is important to consider how a sharp departure from that assumption (even if rare) would affect the policy's effectiveness. If the policy is not robust to external shocks that are completely beyond the control of governments, then the severity of those potential consequences should be taken into account.[14] And if the policy is predicated on the assumption that governments will be not only public-spirited but also far-seeing, then it may be worth revamping the policy so that it is more robust to errors by government officials.

Beyond its implications for the state-market debate, the crisis poses other issues concerning the role and policies of the IFIs. A central policy question raised by the crisis – relating to macroeconomic volatility, globalization, and finance areas discussed above – is to what extent the IFIs will be able to provide insurance against large exogenous shocks. As a result of previous crises, especially the East Asian crisis of 1997-98, many developing countries have taken to heart the lesson that crisis prevention and response require high levels of self-insurance through reserve accumulation. Credible insurance provided by the IFIs could lessen developing countries' need to accumulate such large quantities of reserves, freeing up those funds for use in development and perhaps reducing global imbalances. The IFIs have tried to play that role in this crisis, responding with a surge of financing and with instruments designed to meet this insurance need. For example, the IMF now offers a Flexible Credit Line for countries with very strong fundamentals and policies, as well as a new short-term liquidity facility which may reduce the need for self-insurance. To increase the IMF's ability to backstop global capital flows, the G-20 agreed in April 2009 to triple the Fund's lending capacity to $750 billion. And in the fiscal year ending in June 2009, the World

[13] Nor is this just true of the Bank; already in its October 2001 *World Economic Outlook* (Chapter 4), for example, the IMF was explicit about the risks of capital-account liberalization and the weakness of the relationship between opening and subsequent growth.

[14] As one reviewer of this paper has pointed out, one of the difficulties of dealing with such tail events is that "it is difficult to know how to factor them in" when they combine very small probabilities with very poor outcomes. A first step would be at least to recognize that the small probability exists.

Bank nearly tripled its IBRD lending to middle-income countries and substantially increased its IDA lending to low-income countries. In the years ahead, the international community will need to reassess what more needs to be done along these lines to reduce the developing world's vulnerability to future crises.

Implications for development research

At the same time, the crisis will doubtless lead to shifts in the agenda for research conducted or commissioned by the IFIs. Some of these changes are directly connected with the crisis. The crisis underlines the need to better understand the sources of volatility, so that developing countries will know at least what risks they are exposed to, if not when those risks may be realized as actual shocks. More generally, there is a clear need to explore further the domestic and international conditions under which globalization of goods and services, including financial services, benefit developing countries. One element of this agenda is helping to map out an international architecture that will be more conducive to development. These topics are not new ones, by any means, and previous crises provided more than enough reason to pursue them. But the global and largely exogenous (to developing countries) nature of the current shock should provide further impetus to this research.

On the microeconomic front, the need to understand progress against poverty remains paramount. So too does the importance of understanding how to improve the efficiency and quality of service delivery in health, education, social protection, infrastructure, and other areas. These areas have already received considerable attention in recent years, but the macroeconomic slowdown and fiscal pressures further increase the urgency of understanding how to move forward and may also create policy openings for research to have influence.

Over the past five years, one of the more heated and interesting debates within mainstream development microeconomic research has concerned the place of randomized trials of development interventions. That the debate has been able to focus on methodology may be a sign that so many researchers have implicitly accepted some version of the post-Washington Consensus and have moved beyond a stale and overly stark state-versus-market debate. Instead, many young researchers have focused on the randomized controlled trials that are increasingly used to evaluate micro development interventions. The recent award of the prestigious Clark Medal to Esther Duflo, a leading proponent of the use of RCTs to tackle development problems, shows how accepted this approach has become. But the rapid rise of this methodological approach has also roused critics; the issue being debated is not whether it can sometimes be useful, but whether RCTs merit a uniquely privileged evidentiary status (Deaton 2009; Ravallion 2009b). The global financial crisis can be interpreted as both supporting the move toward RCTs and raising cautions about it. On the one hand, it reinforces the less ideological context of the past few years that has allowed a greater focus on micro interventions and improved methods of identifying their effects. But on the other hand, it reinforces the notion that many of the most important questions are macro in nature and are not amenable to neat RCT methodologies. World Bank research director Martin Ravallion addresses

this tension in a recent outline of new research directions, saying that "[t]he subject of development economics needs to return to tackling the big questions of poverty in the world and how to eliminate it, but to do so with all the power that the subject's modern [methodological and theoretical] artillery can provide" (Ravallion 2009a). The crisis will likely make this approach more attractive.

Conclusion

Where should we come down, on balance, on the question of new development thinking after the crisis? We have argued here that the experience of the past two years has underscored the wisdom of continuing some shifts that were already underway in development economics, while also pointing in newer directions. On the question of the mix of market and state in the economy, it reaffirms the value of not relying blindly on the strengths of either. The crisis showed again that both markets and governments can fail spectacularly, and that while markets must ultimately be the drivers of growth, good government is needed to create the conditions for markets to work well and to reduce volatility and vulnerability. On macroeconomic management, the crisis has exposed new risks and underscores both the difficulty of managing them and the need to buffer shocks. With the end of the Great Moderation, the developing countries will need to take into account risks in developed economies as they set their own policies. On global integration too, the lesson is that even growth-promoting integration brings risks even as it mitigates others, and that countries may need to adapt their export-led growth strategies to accommodate global rebalancing. In the area of finance for development, the crisis underscores the dangers of relying excessively on debt financing and may reduce the allure of foreign finance and financial liberalization. And in the area of public spending, it will further strengthen the move toward a focus on the efficiency and quality of spending in the social sectors. In short, the global crisis does provide new information in key policy areas, but it need not provoke any crisis of confidence in the current state and direction of development thinking.

Yet while many advances in thinking were already underway well before the crisis, the events of the past two years have clearly buttressed them. And over the longer term, the crisis could have its biggest effects on the development thinking of those who are not development specialists. In many cases, policy prescriptions from policymakers and researchers from outside the development field have relied on implicit or explicit models that assume that developing-country markets function much more like textbook models than is actually the case. Many have also tended to assume that developing-country governments had very low capabilities and that, contrary to the historical evidence, countries with even mildly interventionist states would tend to become mired in rent-seeking and economic stagnation. But the opposite occurs as well: some of those giving advice are well aware of theoretical market failures but too optimistic about state capabilities. One salutary effect of the crisis may therefore be a more realistic view of actual conditions. In the face of such glaring failures of both markets and states in their own countries, developed-country economists and policymakers may think twice before assuming that either functions smoothly in a developing-

country context.   This restraint could reinforce the trend in development thinking toward a post-Washington Consensus that –while still strongly market-oriented – is less ideological, more pragmatic, and more empirically grounded.

REFERENCES

Adelman, I. (2001). Fallacies in Development Theory and their Implications for Policy. *Frontiers of Development Economics: The Future in Perspective*. G. M. Meier and J. E. Stiglitz. Washington, DC, World Bank: 103-134.

Akerlof, G. A. (1970). "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics* 84 3: 488-500.

Akerlof, G. A. and P. M. Romer (1993). "Looting: The Economic Underworld of Bankruptcy for Profit." *Brookings Papers on Economic Activity* 2: 1-60.

Baker, D. (2006). "The Menace of an Unchecked Housing Bubble." *Economists' Voice* 3 4: 1-5.

Benartzi, S. and R. H. Thaler (2007). "Heuristics and Biases in Retirement Savings Behavior." *Journal of Economic Perspectives* 21 3: 81-104.

Bernanke, B. S. (2004). *The Great Moderation*. Remarks at the Meetings of the Eastern Economic Association, Washington, DC.

Blanchard, O., G. Dell'Ariccia and P. Mauro (2010). Rethinking Macroeconomic Policy. *IMF Staff Position Note SPN/10/03*.

Buiter, W. (2009) "The unfortunate uselessness of most 'state of the art' academic monetary economics." *blogs.ft.com/maverecon (March 3)*.

Chari, V. V., A. Shourideh and A. Zetlin-Jones (2009). "Collapse of Reputation in Secondary Loan Markets." University of Minnesota.

Chowdhury, A. (2009) "Financial Crises: Revisiting Capital Account Liberalization." *VoxEU.org*.

Cochrane, J. (2009). How did Paul Krugman get it so Wrong? University of Chicago. .

Commission on Growth and Development (2008). The Growth Report: Strategies for Sustained Growth and Inclusive Development. Washington, DC: World Bank, on behalf of the Commission on Growth and Development.

Deaton, A. (2009). "Instruments of Development: Randomization in the tropics, and the search for the elusive keys to economic development." Princeton University.

Demirguc-Kunt, A. and L. Serven (2009). "Are All the Sacred Cows Dead? Implications of the Financial Crisis for Macro and Financial Policies." World Bank Policy Research Working Paper Series: 4807.

Devarajan, S. (2009) "African Economic Policies and the Global Crisis: Orthodox Responses to a Heterodox Shock?" *Africa Can . . . End Poverty (blog)*, August 9.

Easterly, W. (2009). The Anarchy of Success. *New York Review of Books*.

Eichengreen, B. (2009) "The Last Temptation of Risk." *The National Interest Online*.

Fama, E. F. (1970). "Efficient Capital Markets: A Review of Theory and Empirical Work." *Journal of Finance* 25 2: 383-417.

Gordon, R. J. (2009). Is Modern Macro or 1978-era Macro More Relevant to the Understanding of the Current Economic Crisis? Northwestern University.

International Monetary Fund (2009). *World Economic Outlook: Sustaining the Recovery*. Washington, DC, International Monetary Fund.

Islam, F. (2009) "Chicago defends itself against Keynesian attacks." *blogs.channel4.com*.

Johnson, S. (2009). "The Quiet Coup." *Atlantic Monthly*.

Kanbur, R. (2009). The Crisis, Economic Development Thinking, and Protecting the Poor. Washington, DC, Presentation to the World Bank Executive Board.

Kapur, D. (2009). Comments at the "New Ideas in Development after the Financial Crisis" conference, Washington, DC, Center for Global Development and the School of Advanced International Studies.

Krugman, P. (2009). "How Did Economists Get It So Wrong?" *New York Times* (September 6).

Leipziger, D. (2009). Comments at the "New Ideas in Development after the Financial Crisis" conference, Washington, DC, Center for Global Development and the School of Advanced International Studies.

Levy, S. (2009). Comments at the "New Ideas in Development after the Financial Crisis" conference, Washington, DC, Center for Global Development and the School of Advanced International Studies.

Lin, J. and H.-J. Chang (2009). "Should Industrial Policy in Developing Countries Conform to Comparative Avantage or Defy It? A Debate Between Justin Lin and Ha-Joon Chang." *Development Policy Review* 27(5): 483-502.

Lin, J. Y. (2009). *Economic Development and Transition: Thought, Strategy, and Viability*. Cambridge, Cambridge University Press.

Lucas, R. E., Jr. (2009). "In defence of the dismal science." *The Economist* (August 6).

Malkiel, B. G. (2003). "The Efficient Market Hypothesis and Its Critics." *Journal of Economic Perspectives* 17 1: 59-82.

Mishkin, F. S. (2008). How should we respond to asset price bubbles? *Wharton Financial Institutions Center and Oliver Wyman Institute's Annual Financial Risk Roundtable (May 15).*

Mühleisen, M. and C. Towe, Eds. (2004). *U.S. Fiscal Policies and Priorities for Long-Run Stability*. Washington, DC, International Monetary Fund.

New York Times (2009). "Regulator Shopping [Editorial]." *New York Times* (May 21).

News Hour (PBS). (2008). "Greenspan Admits 'Flaw' to Congress, Predicts More Economic Problems." October 23. Retrieved August 3, 2009.

Nocera, J. (2009). "Propping Up a House of Cards." *New York Times* (March 2).

Patrinos, H. A., F. Barrera-Osorio and J. Guaqueta (2009). *The Role and Impact of Public-Private Partnerships in Education*. Washington, D.C., World Bank.

Posner, R. A. (2009). "Capitalism in Crisis: It's hard to run a safe banking system when the central bank is recklessly easy." *Wall Street Journal* (May 7), A17.

Ravallion, M. (2009a). "Rethinking Priorities for Research in Development Economics." Washington, DC: World Bank.

--- (2009b). "Should the Randomistas Rule?" *Economists' Voice* 6 2.

Rodrik, D. (2006). "Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform." *Journal of Economic Literature* 44 4: 973-87.

--- (2009). "Growth after the crisis." Cambridge, MA: Harvard Kennedy School.

Romer, C. (2009). Back from the Brink. Speech to the Federal Reserve Bank of Chicago, September 24.

Shiller, R. J. (2006). "Long-Term Perspectives on the Current Boom in Home Prices." *Economists' Voice* 3 4: 1-11.

--- (2007). Understanding Recent Trends in House Prices and Home Ownership. National Bureau of Economic Research, Inc, NBER Working Papers, 13553.

Spence, M. (1973). "Job Market Signaling." *The Quarterly Journal of Economics* 87(3): 355-374.

Stern, N., J.-J. Dethier and F. H. Rogers (2005). *Growth and Empowerment: Making Development Happen*, Munich Lectures in Economics. Cambridge and London: MIT Press.

Stiglitz, J. E. (1979). "Equilibrium in Product Markets with Imperfect Information." *American Economic Review* 69 2: 339-45.

--- (1998). An Agenda for Development in the Twenty-First Century. *Annual Bank Conference on Development Economics 1997*. J. E. Stiglitz and B. Pleskovic. Washington, DC, World Bank.

Subramanian, A. (2009a). Comments at the "New Ideas in Development after the Financial Crisis" conference, Washington, DC, Center for Global Development and the School of Advanced International Studies.

--- (2009b) "Coupled Economies, Decoupled Debates." *VoxEU.org*.

The Economist (2009a). Downgraded (Reforming finance: Rating agencies). *The Economist*.(July 23).

--- (2009b). Financial economics: Efficiency and beyond. *Economist*.(July 16).

--- (2009c). The state of economics: The other-worldly philosophers. *Economist*.(July 16).

--- (2010). Radical thoughts on 19th Street: A higher inflation target for central banks would be a bad idea. *The Economist*.(February 18).

Williamson, J. (2009). Comments at the "New Ideas in Development after the Financial Crisis" conference, Washington, DC, Center for Global Development and the School of Advanced International Studies.

Wolf, M. (2009). "Central banks must target more than just inflation." *Financial Times* (May 5).

World Bank (1993). *The East Asian miracle: Economic growth and public policy*. World Bank Policy Research Report series. Oxford and New York, Oxford University Press.

--- (2001). World Bank Group Strategic Framework. Washington, DC.

--- (2003). *World Development Report 2004: Making services work for poor people*. Washington, DC, Oxford University Press for the World Bank.

--- (2005). *Economic Growth in the 1990s: Learning from a Decade of Reform*. Washington, D.C., Author.

--- (2009). Global Development Finance 2009: Charting a Global Recovery Washington, DC: World Bank.

--- (2010). *Global Economic Prospects 2010: Crisis, Finance, and Growth*. Washington, DC, World Bank.