

# Good Crises? Implications for Developing Countries\*

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## **Abstract**

In this paper I argue that the most important consequences of the current economic crisis for developing countries will not be the direct negative economic effects, which have received the most attention. More important are the induced effects on politics, policy and institutions. In this context I ask: can the crisis provide opportune circumstances for developing countries to reform their institutions? Such a claim is implicit in the discussion by the Obama administration of not wanting to ‘waste a good crisis’ and it is supported by a large social science literature on the implications of crisis for policy reform. I argue, however, that while there exists an optimistic scenario, there is also a pessimistic scenario. I illustrate both scenarios by examining the history of policy and institutional reform in the great depression of the 1930s and show that the consequences of this crisis for policy were very different in independent developing countries than they were in developed countries. I also argue that the recent experience of policy reform since the 1980s in fact provides less support for the ‘good crises’ hypotheses than is commonly believed. Crises may be good or bad, depending on the nature of the political equilibrium in the societies they hit. I conclude with some speculation about Sub-Saharan Africa: though the most likely scenario is that the current shock is not large enough to change the institutional equilibrium in developing countries, if it were, there are circumstances which are consistent with the optimistic scenario.

“You never want a serious crisis to go to waste. What I mean by that is that it is an opportunity to do things you think you could not do before”

Rahm Emanuel<sup>1</sup>

“never waste a good crisis.”

Hilary Clinton speaking at the European Parliament, March 6, 2009

## 1 Introduction

The world is currently in the grip of what will probably turn out to be the most severe economic recession since the 1930s. The recession was essentially triggered by a rising tide of mortgage defaults which because of the way these mortgages had been securitized, ended up undermining the banking system. Even if the financial systems of the developing world do not suffer from the same problems as that of the United States, the United Kingdom or Iceland (a possible ‘advantage of backwardness’), developing countries cannot isolate themselves from the consequences of the crisis and the recession that it has induced.

The recession will impact developing countries in several ways. First, the economic recession in North America and Western Europe is already leading to a large fall in export volumes. Second, the prices of natural resources which developing countries export have fallen. Third, both bank lending and foreign direct investment to developing countries is contracting. Forth, remittances, a major source of income in many developing countries, are falling. Finally, international aid many also fall as recessions gripped western countries find it more difficult to sustain their international commitments in the face of rising unemployment and budget deficits.

Many institutions and people are now proposing various calculations to measure the cost of this crisis for developing countries. They all come to uniformly pessimistic conclusions. The recently released World Bank Global Monitoring Report (World Bank, 2009) predicts that the crisis will result in 50 million extra people living in extreme poverty in 2009 and 200,000 to 400,000 extra infant deaths per year. They conclude “The prospects of reaching the MDGs

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<sup>1</sup>[http://www.youtube.com/watch?v=\\_mzcbXi1Tkk](http://www.youtube.com/watch?v=_mzcbXi1Tkk)

by 2015, already a cause for serious concern, now looks even more distant” (p. xi). This depressing conclusion is mirrored elsewhere, for example by the International Monetary Fund (IMF, 2009), by Action Aid (2009), Oxfam (2009), and by Devarajan (2009).

In this paper, I do not want to challenge these calculations or downplay the extent to which the dissemination of the crisis will cause hardship and increasing poverty in low income countries. The fact that the immediate impact of the crisis will be negative for developing countries seems indisputable. However, I do want to argue that these effects are likely second-order compared to the long run consequences of the crises for policy and institutions. How the politics and institutions of low income countries react to the crisis will be of much greater significance for poverty reduction over the next decade or two than the immediate negative impacts.

What are these consequences likely to be? The tone of the discussion and analysis about the consequences of the economic crises for developing countries is in rather stark contrast to the claims of Rahm Emanuel and Hilary Clinton with their sense that crisis present opportunities. This is because Emanuel and Clinton are looking beyond the immediate economic effects and arguing that a crisis creates a window of opportunity to reform institutions to make political decisions that in ‘normal’ times would be politically infeasible. In this, their remarks are in line with quite a large literature on the political economy of reform which indeed emphasized the role of crises in promoting and facilitating policy reform.

If Emanuel and Clinton are correct, then focusing on the longer-run institutional or policy consequences of the crisis ought to mitigate the pessimism currently being produced. Maybe the short run effects are negative but developing countries have a window of opportunity to make tough decisions and implement reforms which would be politically infeasible in normal of good times.

I think it is right to focus on the institutional and policy consequences because the evidence suggests the importance of historical ‘critical junctures’ in determining the policy orientation of states (Gourevitch, 1986, is the *locus classicus*). Once locked in such policy orientations are highly path dependent and tend to endure over long periods of time and many complete

business cycles so that decisions made at these junctures have very long lived effects.

In this essay I shall argue that despite the focus of Rahm Emanuel, Hilary Clinton and quite a bit of the academic the literature on policy reform on the benefits of crises, there is in fact little systematic evidence in favor of this view. Crises can make things better, but they can also make things much worse. History suggests that both can happen consistent with an optimistic scenario but also suggesting the existence of a pessimistic scenario.

The reason that Rahm Emanuel and Hilary Clinton emphasize optimism is that, in looking at the history of the United States, particularly the policy and institutional reactions to the great depression, they see room for optimism. Indeed, some of the consequences of the depression in the 1930s in the United States were policies of a kind that the current Democratic administration would probably very much like to emulate and they had consequences that many in the Obama administration would approve of.

Unfortunately, however, I shall argue that the impact of the great depression on policy in the United States, or for that matter Sweden and other Western European countries, has limited implications for developing countries. More relevant is the experience of Latin America during the 1930s. Rather than generating political coalitions, policies and institutions which sustained economic growth, the depression in Latin America induced a style of politics, and a model and ideology of economic policy from which the sub-continent still suffers.

It is difficult to say whether the optimistic or the pessimistic scenario is more relevant from the majority of developing countries. It all depends on the magnitude of the crisis and its impact on the distribution of political power in society, whether or not political coalitions reorganize themselves and how interests evolve. Most likely, the crisis will not be large enough to substantially re-form the politics of poor countries. But if, like the great depression, it is sufficiently large, then it is important to recognize that this is where the real action is, not in the first round economic consequences of the negative shock. Unfortunately, it is difficult to distill lessons from the experience of the 1930s for countries in, say Sub-Saharan Africa, because they differ greatly in the nature of their institutions and economic structures. Nevertheless, I shall argue that there is potentially room for optimism and it could be important for international

development institutions to think about how they could make this scenario more likely.

In this paper I use the historical evidence to present two scenarios, the optimistic scenario in section 2 and the pessimistic scenario in section 3. In section 4 I make some conjectures about which scenario is more likely for developing countries. Section 5 concludes.

## 2 The Optimistic Scenario

There are two ways to motivate the optimistic scenario. One is by examining the history of policy change and institutional reforms that were precipitated by the great depression. The other is via the lens of the more recent political economy literature of crises and policy reform.

Though the great depression was the largest economic contraction the world had experienced since the advent of modern economic growth in the late 18th century, in Western Europe and North America it had long run consequences which were associated with much improved economic performance after 1945 and the most rapid rates of economic growth which OECD countries had ever experienced. The depression broke up the political coalition which had supported *laissez faire* capitalism as attempts to counteract the economic contraction by deflation and fiscal retrenchment were unsuccessful. The early depression saw a polarized view of what policies should be adopted, with business and conservative parties emphasizing wage cuts and deflation while newly emerging socialist or labor parties strenuously opposing such policies. In Britain the conflict over cutting unemployment benefits in 1931 split the Labour Party with the leaders Ramsay MacDonald and Philip Snowden being expelled from the party but then entering a coalition with the Conservative Party.

This conflict was resolved when new political coalitions formed which could muster the political support for a new policy vector. The most famous example of this occurred in Sweden after 1933. Here the Social Democrats, who had previously been out of power and opposed by both the Conservatives and the Agrarian Party, formed the ‘green-red’ coalition or ‘cow trade’ with the Agrarians. This log-roll involved protection and high prices for farmers, in exchange for unemployment benefits and pro-union policies for urban workers and a commitment to full employment. By 1938 when the Saltsjöbaden accord was signed, a significant sub-set

of employers had also come aboard in exchange for no strike agreements and peaceful labor relations (Moene and Wallerstein, 2006, on absence of labor peace in Scandinavia prior to this period and Swenson, 2002, for the role of capitalism in these agreements). As Gourevitch (1986, p. 131) points common to all countries in Western Europe and North America was the emergence of

“*cross-sector, cross-class* alliances of groups whose patience with market solutions had run out”.

With the coalescing of these coalitions the path was paved for the emergence of the mixed economy and what Eichengreen (2007) calls “coordinated capitalism.” This mixed economy brought social stability, defused more radical impulses and introduced the types of policies much more appropriate for a new more human capital intensive growth path.

Though many details differed, the general thrust of coalitional politics and policy reforms in the United States bore many similarities with those in Sweden (Gourevitch, 1986, Chapter 4). The election of Franklin Roosevelt in 1932 initiated policy change in the guise of the first New Deal. Roosevelt introduced the National Industrial Recovery Act (NIRA) which created a National Recovery Administration to regulate markets. Farmers received support with the Agricultural Adjustment Act and a whole gamut of employment generating schemes were introduced, such as the Tennessee Valley Authority. Roosevelt initiated the second New Deal after the Democratic victories in the 1934 congressional elections increased his ability to pass legislation through Congress. New measures included the Wagner Act which gave a significant impulse of unionization and collective bargaining and the Social Security Act. Though the Supreme Court ruled that the NIRA was unconstitutional in 1935 later concessions allowed Roosevelt’s new coalition to move forward with its agenda. As in Sweden the coalition involved a compromise between urban labor and agrarian interests along with some parts of the business sector.

The emergence of the mixed economy seems to have had large effects on the wage structure and inequality (see Goldin and Margo, 1992, and Piketty and Saez, 2003) as well as producing the social compromise which sustained such rapid economic growth after 1945.

It is also important to note that the change in political coalitions and policies went along with changes in ideological views about the economy in particular the role of the state and the consequences of unregulated market competition.

My guess is that it is exactly this history of policy reform that Rahm Emanuel and Hilary Clinton have in mind when they talk about not wasting a good crisis. Though the depression had enormously negative social consequences at the time, it also forged a new political and institutional equilibrium which moulded United States policy until it came under attack in the 1980s with the election of Ronald Reagan and the move to the right of the Republican Party. The Obama administration would like to strengthen welfare, improve social policies, particularly broadening the coverage of health insurance. In the response to the crisis, they see not just potentially big Democratic majorities, as in the 1930s, but they also see the scope to put together a political coalition which will be as effective as the one that Roosevelt forged. For the Obama administration this is quite an optimistic scenario.

The idea that crises cause a window of opportunity for policy or institutional reform, emerges as a strong hypothesis in the literature on the political economy of policy reform. Most of this work takes a different perspective than the one I do, however. In particular, it focuses on instances of reform, or lack of reform amongst developing countries, primarily during the 1980s as a consequence of the worldwide debt crisis. The main question asked in what factors distinguished successful from unsuccessful reformers. This produced a very rich literature which certainly saw political factors as paramount and which quite intensively discusses whether or not crises are an important determinant of reform. Other factors analyzed were whether or not authoritarian governments were more likely to reform than democratic ones, the role of leadership, the role of state capacity or organized labor. Though this literature took place in the context of the debt crisis in a context where many Latin American countries were moving away from ISI and policy instruments that had been in place for 50 years, the ultimate conclusions about the role of crises were actually quite mixed. Though some theoretical work did support the idea (Drazen and Grilli, 1994) the case study evidence was quite mixed. Haggard and Williamson (1994, p. 565) for example, conclude for a large group of case studies that “Crisis



is clearly neither a necessary nor a sufficient condition to initiate reform” though they do subsequently that it should be “borne in mind by any reform-minded leader” (p. 589). Nelson (1990, pp. 325-326), again summarizing a large case study project argues “The nature of the crisis itself - its sudden or gradual emergence, its largely exogenous or substantially internal causes, even its severity - has little clear relation to the timing of policy responses in many of our cases.”

Other case study work both supports or contradicts the larger studies. For instance, while Herbst’s (1993) study of the famous reform in Ghana does argue that the crisis of the early 1980s was important in inducing the Rawlings government to change track and adopt reform, Van der Walle’s (2001) overview of the adjustment experience in Sub-Saharan Africa suggests that African economies can fail to reform in the face of continual crises. Indeed, the economy of Ghana had been in decline since the mid 1980s and there are other interpretations of why Rawlings changed policies (e.g. Hutchful, 2002). The wider literature suggests that there was nothing about the poor economic performance for Ghana in the 1980s that led to the policy changes that took place.

The perspective I am proposing in this paper differs from this literature. I think the interesting question is not to ask, for example, whether democratic and politically competitive Sierra Leone will adopt better policies in the face of the current crisis than authoritarian Chad. Rather, the question is whether and how the crisis will change the political equilibrium in these countries in such a way as to change coalitions and the future nature of policy and institutions. As I discuss in the next section, if shocks or even reform processes do not change the underlying political equilibrium, then they will not have long-run consequences for economic growth. Seen from this light, though policy reforms were certainly correlated with economic crises in Argentina and Peru in the late 1980s and early 1990s, in fact there was little change in the political equilibrium of these countries, and as a consequences there was much less ‘reform’ than meets the eye. Similarly, my sense is that the really interesting question for Africa is whether the crisis could change the underlying political game in Sierra Leone, a game which shares many features throughout Africa, including in authoritarian Chad.

The bottom line from the optimistic scenario is that the current crises may stimulate institutional and policy reform. By analogy to what happened in the United States or Western Europe in the 1930s, it may do this by helping to forge and empower a cross-cutting coalition which is in favor of socially desirable and growth promoting policies. Alternatively, by analogy to the literature on the political economy of policy reform, crises are a good time to implement socially desirable reforms which have previously been blocked, or alternatively they herald the infeasibility of the bad old ways of doing things are force change.

### **3 The Pessimistic Scenario**

Though there are grounds for optimism, I now suggest that there is an equally, if not more plausible pessimistic scenario. This is based on several main grounds. First, the weakness of the analogy between what happened in the 1930s in the United States or Western Europe to the current situation in developing countries. I shall argue that the more relevant evidence may come from the institutional and policy changes which were undertaken in Latin America during the 1930s, whose negative economic legacies we are still observing. Second, I shall argue that the optimism which the literature on crises and policy reform generates is misplaced.

While policy and institutional reforms were taking place in the United States and Sweden which helped to underpin the long post World War II economic boom, something very different was happening as the economic crisis which emerged in the wake of the Wall Street crash of 1929 in Latin America. The most important consequence of this was the abandonment of the model of economic growth based on exports and comparative advantage which had dominated Latin America since the 1860s and 1870s. After independence, Latin American countries experienced prolonged political instability and economic stagnation, even decline in some cases (particularly Mexico). This trajectory was changed by a process of state formation and policy reform which began in the second half of the century and was stimulated by the great economic gains to be had by exploiting world markets and exporting commodities such as meat, bananas, coffee, nitrates, wheat, and copper. Though the model of economic growth emerged was very oligarchic and probably coincided with large increases in inequality, it did at least raise living

standards and initiated a process of economic convergence which was sustained until the early 1920s.

In the depression, however, Latin America changed course. There seem to be several reasons for this. One, which had nothing to do with the crisis was the spread of political participation which had been happening since 1900. Countries such as Argentina and Uruguay made strong moves towards democracy and everywhere there was the emergence of more politically active urban groups. More tied to the crises was the impact of the change in relative prices on politics. As in the current crisis, in the 1930s the terms of trade moved dramatically against developing countries. For Latin American countries the relative price of the commodities that they had exported fell. See Table 1. This naturally led to contraction of this sector relative to the urban and manufacturing sectors. This redistribution of wealth along with the previous changes in political participation moved the political equilibrium of these countries away from one which had supported the outward development model. Latin American countries did not respond to the crisis by introducing subsidies to agriculture. Rather, the policy response saw the initiation of the model of development which was to subsequently be called ‘Import Substitution Industrialization’ or ISI.

This policy response took some time to emerge and it did so in the context of the rise of new political movements and parties rooted in the changing economic landscape. In Brazil this was marked by the rise of Getúlio Vargas and the creation of the Estado Novo in 1937, the emergence of APRA under Víctor Haya de la Torre in Peru, the presidency of Lázaro Cárdenas in Mexico between 1934 and 1940, and the rising power of Juan Perón in Argentina after 1943.

The political coalitions that formed in Latin America were very different from those that formed in Sweden or the United States. There was no ‘cow trade’ or ‘red-green’ coalition probably because of the history of highly unequal landownership (something actually heightened by the previous export model) meant that there was no real group of farmers which who urban workers could collaborate. The newly empowered winning coalition was instead an amalgam of urban workers and employers and rural *caudillos* (Gibson, 1997, for a seminal analysis of Argentina and Mexico). There is a clear element of path dependence here. It was

the partial nature of the process of state formation in the 19th century which had left rural *caudillos* strongly entrenched in what Guillermo O'Donnell calls the "brown areas" of Latin America (O'Donnell, 1993). The political strategy of this new coalition also mirrored that of the previous oligarchies in that it was very clientelistic.

It is important to recognize that the switch to ISI was an endogenous response to the formation of this new political coalition and was designed both to sustain it, as well as to redistribute income to it. Gerchunoff (1989) sums up Perónist economic policy in Argentina in the following way, "there was no specific and unified Peronist economic policy, much less a long-term development strategy. In spite of official rhetoric about a plan, the objective - and at times exclusive - priority was ... an economic order capable of maintaining the new distributive model." To speak of a "full-blown Peronist growth strategy" as Shleifer (1997) does, or to characterize Peronist policies as having "the goal of rapid industrialization" and "the intent of building a domestic industrial base behind tariff rates," as Sachs (1990, p. 148) does, is to misunderstand their motivation. There was no such growth strategy. In line with the evaluation of Gerchunoff (1989), Díaz Alejandro (1970, p. 126) concludes, "Peronist policies present a picture of a government interested not so much in industrialization as in a nationalistic and populist policy of increasing the real consumption, employment, and economic security of the masses - and of the new entrepreneurs. It chose these goals even at the expense of capital formation and of the economy's capacity to transform." Elsewhere, in a very relevant passage Díaz Alejandro notes (1970, p. 65),

"The main problem arises in that policies which are best from the viewpoint of economic efficiency (e.g. free, or nearly free, trade) generate an income distribution favorable to the owners of the relatively most abundant factor of production (e.g. land) and therefore strengthen the position of the traditional elite ... long run efficiency and a popular income distribution could only be reconciled by a sophisticated fiscal system, not an easy thing to achieve."

The changes in the economy and their political consequences were accompanied by an ideological shift which ultimately provided an intellectually underpinning for the policies generated

by the new political economy. The collapse of the depression undermined the credibility of the old growth model based on *laissez faire* and free trade. Even though this model had generated quite sustained growth throughout the sub-continent, it was rejected. This was also true of course in Europe, and indeed Latin American countries witnessed European countries raising tariffs and moving away from what Keynes satirized as the ‘Treasury View’. But the policy and institutional mix which emerged from this was very different in Latin America. The main intellectual movement, which ultimately culminated in the 1960s in ‘dependency theory’ and ‘world systems theory’, re-crafted the model of free trade as actually central to the under-development of Latin America. Free trade didn’t lead to the development of Latin America but was rather a part of a system of unequal exchange which allowed rich countries (the ‘core’) to exploit poor countries (‘the periphery’). Indeed, riches and poverty were mirror images of each other and the only reason that there were rich countries is because there were poor countries. The policy conclusion drawn from this political-economic analysis was that Latin American countries should cut themselves off from trade and heavily promote industry which was the way to become developed and something which would not naturally happen otherwise. This policy advice, initially closely associated with economists and social scientists based at CEPAL in Chile working under the leadership of Raúl Prebisch, of course brilliantly justified the policies preferred by the political coalition which had emerged dominant from the 1930s. However, the first real statement of Prebisch’s views was in his famous work of 1950 and he had no influence on policy in Argentina until 1955 when he was recalled from exile (where he had been sent by Perón after being dismissed from the central bank) following Perón’s fall from power.

The policy and institutional changes that took place have had a lasting negative effect on development in Latin America (Taylor, 1998, for an empirical assessment). Latin America stopped converging to developed country income levels and started diverging. Indeed, the development model and the political coalition only started to come unstuck after the debt crisis initiated by the large increase in real interest rates in the early 1980s. Nevertheless, the changes induced by the 1930s in Latin America, still have enduring effects. I give one

illustration from Iaryczower, Spiller and Tommasi (2002) depicted in Figure 1. This shows the average tenure of Supreme Court judges in the United States and Argentina since 1863, the foundation of the Argentine court. The figure shows that by 1930 the average tenure of the court in Argentina had converged to that of the United States. The first blow to the institutions comes in 1930 following the first military coup. After this in the 1930s there is a recovery until the first Perón government of 1946 (Perón had earlier been in the military junta which had taken power in 1943). When Perón was first democratically elected the Supreme Court had ruled unconstitutional an attempt to create a new national labor relations board. Perón sought the impeachment of 4 or the 5 members of the Court. In the end 3 were removed and the Chamber of Deputies and the Senate supported this. After this the autonomy of the court disintegrated a situation sustained by a sequence of military coups after 1955. The 1946 impeachment established a new norm so that whenever a political transition took place, the incoming regime either replaced the entire existing Supreme Court or impeached most of its members. Yet the autonomy of the court was not re-established even after the return to democracy. In 1990 when the first transition between democratically elected governments occurred, Menem complained that the existing Supreme Court, which had been appointed after the transition to democracy in 1983 by the Radical President Alfonsín, would not support him. He then proposed an expansion of the Court from 5 to 9 members which was duly passed and which allowed him to name 4 new judges (see Helmke, 2004, on this). This evidence on tenure vividly illustrates the institutional legacies of the 1930s in Argentina.

Interestingly, the same pressures were evident in the United States. As I noted above, during Roosevelt's first presidency, the Supreme Court began ruling key elements of the New Deal unconstitutional. Roosevelt responded by proposing that all judges over the age of 70 should be retired (the ones that opposed him). Though the Democrats had big majorities in both houses and Roosevelt had a huge mandate (like Perón), this was widely regarded as an attack on the independence of the court and he had to back down. There is also quite a bit of evidence that New Deal policies had clientelistic aspects (Wright, 1974, for a seminal study)

Ironically, it was the reforms implemented in many Latin American countries apparently

as a consequence of this crisis that fueled a lot of the optimism about the salutary effects of crises for reform.

I now shall argue that this optimism is unwarranted. The debt crisis did lead to some important changes. For one, as I noted above, it led to movements away from the vector of policies associated with ISI, particularly the reduction of many trade barriers. For another, the crisis also led to the re-arrangements of political coalitions, such as the movement of the Peronist party away from the Trade Unions which had previously been a bedrock of its' support. Nevertheless, the debt crisis did not have the effect of re-forming Latin American political coalitions in the same way as the great depression had in Western Europe or North America. It did not lead to large new coalitions with a vested interest in good economic policies or support for a mixed economy which would bring social stability and investment in human capital. Instead, many of the pro-market reforms were co-opted or oligarchized, as in the creation of Carlos Slim, the world's third richest man after Bill Gates and Warren Buffet, and the old political entrepreneurs realized that the new policies could be manipulated to serve clientelistic ends (this process has been best studied in Argentina, see Murillo, 2001, and Levitsky, 2003, and also Roberts, 1995). The basic thrust of this literature in political science is that the political equilibrium in Latin America did not really change in the 1980s and the apparently 'reformed' policy environment was really business as usual with new instruments.

A recent study by Acemoglu, Johnson, Querubín, and Robinson (2008) makes this point more systematically. This paper asks under what circumstances economic policy reform works, focusing on the case of Central Bank independence. The basic argument is that the effects of a particular reform depend on the nature of the political equilibrium when the reform takes place (in the paper measured by the variable 'constraints on the executive' from the Polity IV dataset). When constraints are low, policy reform is ineffective because it can be easily overridden by politicians (the example being the introduction of Central Bank independence in Zimbabwe). When constraints are high, policy is good anyway so that Central Bank independence has no real effect on inflation (as in the United Kingdom). The paper shows that it is at intermediate levels of constraints when reform is needed (monetary policy is bad) and

effective. However, the world is not as simple as this. This is because the authors show that if the political equilibrium does not change, even in this intermediate case, reform in one dimension can lead to disreform in another dimension as politicians use a different instrument to achieve the goal that monetary policy was previously used for. The paper introduces the concept to the See-Saw Effect to characterize this idea. It shows empirically that in the countries with intermediate constraints where the introduction of Central Bank independence reduces inflation, fiscal policy simultaneously deteriorates. This idea is nicely brought out by Figure 2 which shows the data from the paper from Argentina and Colombia. The Figure plots both the normalized inflation rate and government expenditure as a % of GDP. The vertical red line indicates when the Central Bank was made independent, in both countries in the early 1990s as part of the wave of ‘policy reforms’ which have been so intensively studied. What Figure 2 shows is that in both countries, though inflation fell after Central Bank independence had been mandated, fiscal policy simultaneously deteriorated.

#### **4 Which Scenario for Developing Countries?**

The analysis so far leaves open the question of which scenario is more plausible for developing countries? I think by far the most plausible scenario is one of no change - the crisis, bad though it is, will be unlikely to change the political environment enough to lead to a new political equilibrium. The main point of my paper, however, is that we should be focusing not just on what policies to implement to alleviate the negative short run effects of the crisis on poor countries, but we should start thinking about what will happen if the crisis is big enough to shift the political equilibrium.

This is highly uncertain but one thing seems clear to me. A key part of the change in the 1930s which had adverse long-run effects was an intellectual one. One of potentially vert first-order effects of the current crisis could be that it influences the ideological climate in a way which provides a justification for very poor economic policies in developing countries (Acemoglu, 2009). The fact that the crisis has been created by imprudent behavior, including quite a bit of well publicized venality by prominent agents in the financial sector, runs the



risk of providing political support in developing countries for ‘heterodox alternatives’ (see Subramanian, 2009, on why so far there is remarkably little of this). They way that the crisis is being dealt with in the United States is also adding fuel to this (Johnson, 2009, for an acidic attack on the cronyism and lack of transparency evident in the way that the Obama administration is dealing with this, see also Mian, Sufi and Trebbi, 2009, who show that higher campaign contributions from the financial services industry are associated with an increased likelihood of voting in favor of the EESA, a bill which transfers wealth from tax payers to the financial services industry). Moreover, it will strike many in the developing world as paradoxical that the policy response of the United States and the United Kingdom to institutional failures and poor governance in the financial sector is to massively loosen monetary and fiscal policy. This is very far from what a developing country would be told to do in this circumstance. Possibly, this makes sense, the United States may be able to deal with budget deficits over 10% of GDP while few developing countries could, but a great deal of justification needs to be undertaken. Apart from the lack of transparency in the bail-outs of the financial sector, de facto nationalizations and the massive subsidies for car manufacturers, Obama’s response to the crisis has large elements of populism. One is represented by things such as the restrictions on H1-B visa applications on firms taking stimulus money but laying off United States’ citizens. This may play well politically, but a key driving force behind the long-run economic growth of the United States is certainly the fact that it has been a magnet for human capital throughout the world. Impeding this mobility will only have long run adverse effects on the growth rate in the United States.

All these features will provide grist to the mill of those in developing countries, such as President Chávez in Venezuela or President Morales in Bolivia, who already reject the policy agenda of the international community.

Intellectual currents aside, do the present circumstances of, say, Sub-Saharan Africa suggest that the optimistic or pessimistic strategy is more likely? Like Latin America of the 1930s, Africa is currently experiencing a very adverse terms of trade shock. This will generate many of the same domestic changes, including a decline in sectors based on natural resource extraction,

mining and some forms of commodity export. In itself, this might not be a bad thing in Africa. Most African economies desperately need to diversify their economies and begin to develop successful internationally competitive industries and it is possible that this shock will help this.<sup>2</sup> Of course this is not the shock that created the red-green coalition in Western Europe and the United States, but it is unlikely in the current situation that the shock will have the same consequences as it did in Latin America in the 1930s. For one, international institutions which advocate free trade are far too powerful to allow the wholesale adoption of autarchy in African countries and the anti-trade policies which urban elites adopted in the 1960s and 1970s. So urban groups which may benefit from the shock in the terms of trade will not have available many of the instruments which were previously used to create and redistribute rents. If this makes the return to rent seeking lower, it could raise the relative attractiveness of investing in productive activities and lead to a much more dynamic private sector. Of course Africa has been characterized by heavy urban bias at the expense of economic efficiency (Bates, 1981) but this is also unlikely to recur given the democratization of the continent since 1990. Finally, an interesting difference between the politics of Africa and Latin America is that even if there was urban bias in the 1960s and 1970s, the ethnic basis of many political parties can create a cross-cutting cleavage which raises the possibility of an African type of red-green coalition. In Sierra Leone, for example the All People's Congress party is strong in Freetown, the main urban area, party because of a history of migration in the north of country, but it is also strong in the rural areas of Temneland and Limba country. It has interests which straddle rural and urban, just like the red-green coalition. This coalition can push for broader social policies and social insurance of precisely the form demanded in Sweden in the 1930s or the coalition formed by Roosevelt. It may also help to build social stability.

This being said the Latin America situation shows that there can be heavy path dependence of political strategies. The reason why Peronism was so damaging to the economy was not simply because of the coalition on which it was based, but also because of the highly clientelistic way in which it used policy instruments. This clientelism was something deeply embedded in

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<sup>2</sup>This hypothesis is proposed by Ishac Diwan: <http://blogs.worldbank.org/meetings/category/tags/voices>

Argentina politics prior to Perón and unfortunately it is also very prevalent in Africa.

## 5 Conclusions

In this paper I have emphasized that the most important aspect of the current economic crisis for developing countries are the long-run implications for policies and institutions. Though there are very bad short run effects which will cause a lot of suffering and may further jeopardize the 2015 MDGs the real issue is whether the crisis will change the political equilibrium of poor countries. This suggests that along with policies aimed at offsetting some of the immediate negative effects of the economic recession, international institutions such as the World Bank and newly empowered International Monetary Fund should be focusing squarely on how the crisis may influence political coalitions and institutions in poor countries and whether the current negative shock will be sufficiently large to change the political equilibrium.

If it does there is an optimistic scenario, as envisioned by Rahm Emanuel and Hilary Clinton, which suggests that crises can provide opportune moments for reform. This scenario is real, but there is an equally real pessimistic scenario. I argue that based on the evidence from the 1930s or the 1980s, while Rahm Emanuel and Hilary Clinton may be correct that the optimistic scenario is the right one for the United States, the pessimistic scenario was the one which emerged for developing countries during the great depression. Nevertheless, the circumstances today in Africa are different from those that faced Latin America, so simple conclusions cannot be drawn from this. Indeed, my impression is that there is room for guarded optimism in the case of Sub-Saharan Africa though the path dependent nature of what happened in Latin America in the 1930s should caution us against over-optimism.

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Table 1

*Price and quantity changes for exports, net barter of trade and export purchasing power, 1932 (1928 = 100)*

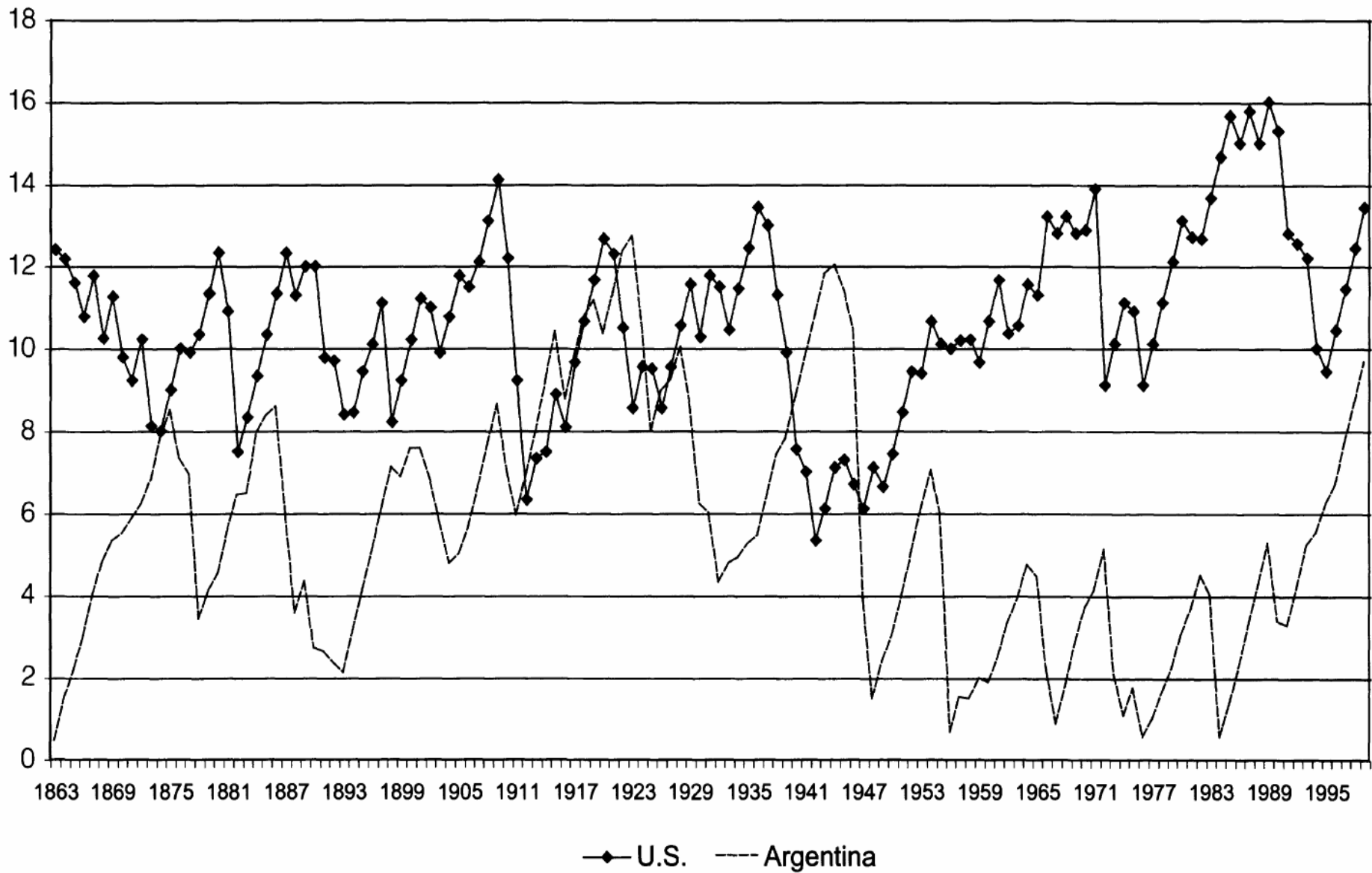
| Country            | Export prices   | Export volumes   | Net barter terms of trade | Purchasing power of exports |
|--------------------|-----------------|------------------|---------------------------|-----------------------------|
| Argentina          | 37              | 88               | 68                        | 60                          |
| Bolivia            | 79 <sup>a</sup> | 48 <sup>a</sup>  | n/a                       | n/a                         |
| Brazil             | 43              | 86               | 65                        | 56                          |
| Chile              | 47              | 31               | 57                        | 17                          |
| Colombia           | 48              | 102              | 63                        | 65                          |
| Costa Rica         | 54              | 81               | 78                        | 65                          |
| Dominican Republic | 55 <sup>b</sup> | 106 <sup>b</sup> | 81 <sup>b</sup>           | 87 <sup>b</sup>             |
| Ecuador            | 51              | 83               | 74                        | 60                          |
| El Salvador        | 30              | 75               | 52                        | 38                          |
| Guatemala          | 37              | 101              | 54                        | 55                          |
| Haiti              | 49 <sup>b</sup> | 104 <sup>b</sup> | n/a                       | n/a                         |
| Honduras           | 91              | 101              | 130                       | 133                         |
| Mexico             | 49              | 58               | 64                        | 37                          |
| Nicaragua          | 50              | 78               | 71                        | 59                          |
| Peru               | 39              | 76               | 62                        | 43                          |
| Venezuela          | 81              | 100              | 101                       | 100                         |
| Latin America      | 36              | 78               | 56                        | 43                          |

<sup>a</sup> 1929 = 100

<sup>b</sup> 1930 = 100

Source: **Bulmer-Thomas, Victor (2003)** *The Economic History of Latin America since Independence*, 2nd Edition, New York: Cambridge University Press. Table 7.2 p. 192.

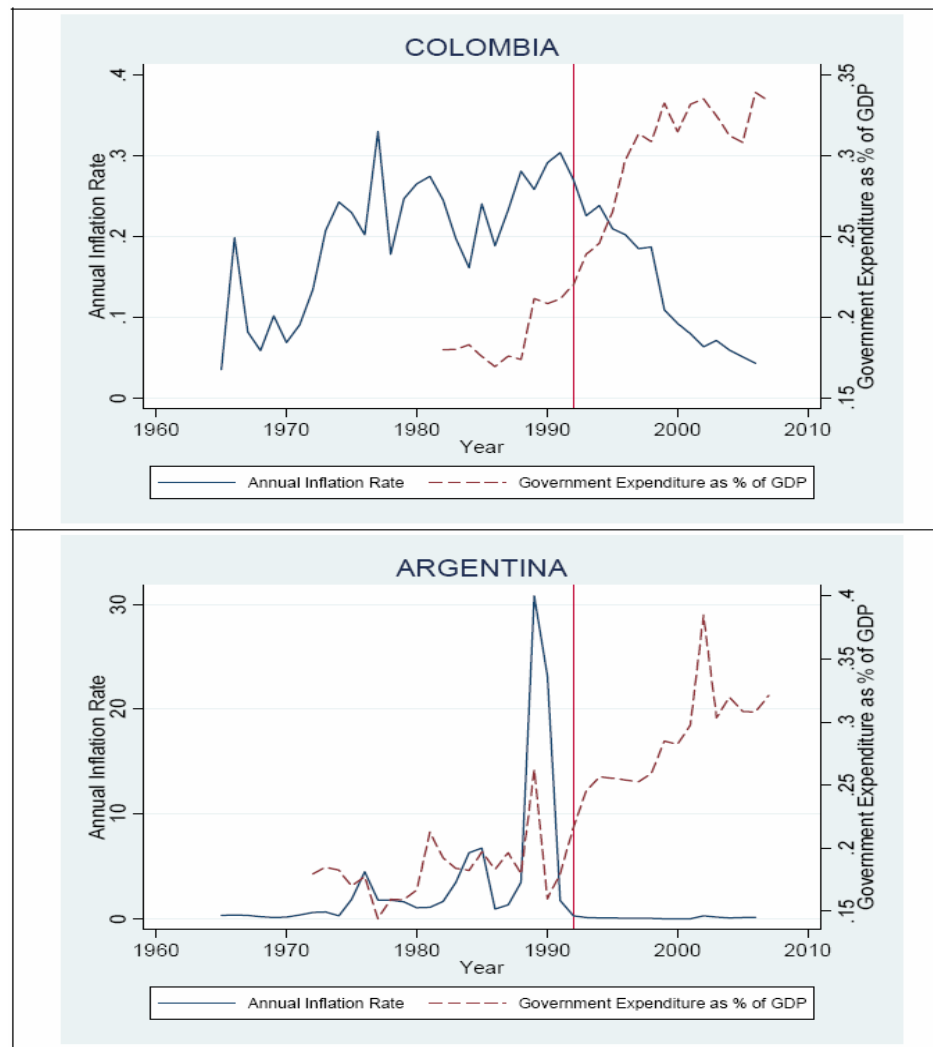
**FIGURE 1 Supreme Court Justices Tenure in Argentina and the U.S., 1863–1999**



Source: Iaryczower, Mathias, Pablo T. Spiller and Mariano Tommasi (2002) "Judicial Independence in Unstable Environments," *American Journal of Political Science*, 46, 699-716.



# Figure 2: The See-Saw Effect in Colombia and Argentina



Note: Annual Inflation Rate (scale on the left vertical axis) corresponds to the annual variation in the consumer price index reported in the International Financial Statistics (IMF). Government expenditure data (scale on the right vertical axis) are from World Economic Outlook (IMF). Vertical line shows the year of major Central Bank reform taken from Jácome and Vasquez (2005).

Source: **Acemoglu, Daron, Simon Johnson, Pablo Querubín, and James A. Robinson (2008)** “When Does Policy Reform Work? The Case of Central Bank Independence,” *Brookings Papers on Economic Activity*, 351-421.