



Comment on “A Sustainable Global Economic System after the ‘Great Recession’? Some Lessons from History,” by Giovanni Zanalda

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Most of the discussion on the future of the global economic system after the Great Recession takes a normative angle. What policy conclusions *should* we draw from the crisis of 2007–09? How should the crisis affect the structure, size, and internal incentives of financial institutions, for example? What does it imply for regulatory reform and the role of the state in the financial sector? What does it suggest about the role of existing international institutions? Does it give rise to a case for new cross-border institutional arrangements? What does it imply about how to conduct macro-economic policies in large countries, such as the United States and China?

These are important questions to which answers are being suggested and debated, including in several chapters of this volume. But the consequences of the Great Recession can also be debated from another angle that is just as important but has received less attention: What will be the likely outcome of the crisis for the global economic system? Will the outcome lead to a crisis of capitalism or a backlash against the consensus that has been in place at least since the Reagan-Thatcher era of deregulation and privatization? Will it lead to major new reforms that will make the world economic system safer? Or will it ultimately not lead to very much at all: a few reform attempts, perhaps, that either do not go far enough or are based on a misdiagnosis of the problem? This “positive” or predictive angle is important not only because it is important to prepare for what comes next, but also because it could give rise to “meta-normative” ideas—ideas not so much on how precisely the world should change after the crisis, but on how the political economy of reforms should be influenced in order to achieve a good outcome.

What makes Giovanni Zanalda’s paper interesting and timely is that it speaks to this less explored angle. It does so by analyzing three historical crisis episodes, with

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clear relevance for today. Zanalda's message is that in principle, correct diagnoses of these crises were available even while they were still under way. However, the extent to which these diagnoses were put into practice varied widely. In other words, the three episodes seem to suggest that societies have the opportunity to draw the right conclusions from crises, but do not always take them.

Crises and Reform

When do societies draw the right lessons from history, and when do they either fail to react or—perhaps just as undesirably—overreact? This question is outside the scope of Zanalda's paper and perhaps outside the scope of historiography, which is concerned mainly with getting the specifics of what happened right rather than with identifying regularities across many episodes. However, the question is related to a core question of political economy: what circumstances trigger policy reform? See, for example, classic contributions by Krueger (1993) and Rodrik (1996). Reform typically happens incrementally, as the relative strengths of social groups backing or opposing reforms change over time. But reform can also be triggered by large economic or political shocks, which may suddenly change the perceived interests of a particular group or weaken an incumbent. In this sense, crises can represent an opportunity.

From a political economy angle, it is useful to distinguish between three types of societal reactions to crises. One is that nothing much happens, sometimes in spite of an awareness that reform would be desirable. The seventeenth-century fiscal crisis in Naples that inspired Antonio Serra's treatise, described in Zanalda's paper, serves as an example. Another reaction is that reforms happen, albeit within the context of the existing political and financial order. There are no examples of this in Zanalda's paper, but a recent case that comes to mind is a wave of reform (mostly of monetary institutions and fiscal policy) in Latin America, triggered by the crises of the middle and late 1990s. Finally, crises can lead to wholesale reactions against the status quo. The classic example is a revolution set off by a combination of economic hardship and political shocks (the Russian and French revolutions come to mind). Another example is the Great Depression, which is one of the three crises discussed by Zanalda. Zanalda argues that monetary reforms came too late and were too uncoordinated to mitigate the impact of the Depression. This may well be true. Eventually, however, the Depression led to a sea change in the relationship between the state and the market—the birth of the welfare state—and a new international economic order in the form of the Bretton Woods system.

The three types of crisis reactions differ also from a normative perspective. A failure to reform, by definition, is neutral compared to the status quo (although it may be disappointing to those, like Serra, who believe that the status quo is flawed). Successful reforms, again by definition, are an improvement. The third type of reaction—a shift in economic or political systems against the status quo—cannot be categorized *ex ante* as good or bad. It depends on the nature of the status quo and the system that replaces it.

Reactions to This Crisis: Too Much or Too Little?

Where should we expect the current crisis to take us? Which type of reaction will it trigger?

Zanalda's implicit fear is that the global crisis of 2007–09 might end like the Naples crisis of 1610: namely, with a failure to take action or at least the right action. This is certainly one possibility. However, based on historical precedent (beyond the three episodes studied in the paper), the opposite also has plausibility; namely, that the ongoing crisis will trigger a reaction, and possibly an *overreaction*, against the status quo. The crisis has been billed as a crisis of capitalism, coming at the end of an era of relatively unfettered private activity (albeit possibly distorted by public safety nets), particularly in the financial sector. More important, it seems to share some of the traits of previous crises that did lead to large reactions. It has been large, synchronized (in the sense that it has affected many countries at the same time and for similar reasons), and there appears to be a clear culprit: financial capitalism.

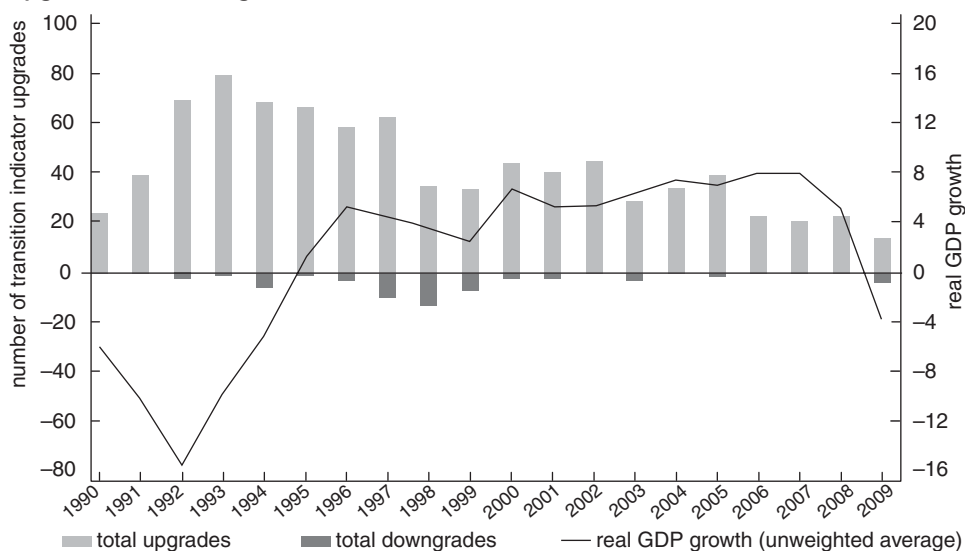
From the perspective of developing and emerging-market countries, which are the focus of this conference, three recent precedents come to mind.

First is the Latin American debt crisis of the 1980s. While this crisis was triggered by external shocks, the underlying vulnerability of the region (in the form of high public debt and inability of the region to “grow out” of the initial shock) reflected the failure of the state-led development model that the region had adopted in the 1950s and 1960s (Fraga 2004). The crisis led to the replacement of this model by the “Washington Consensus” (Williamson 1990), emphasizing a different and in some ways more limited role for the state (namely, to secure property rights and provide social safety nets rather than to plan and lead the process of industrialization), external liberalization, and a greater role for the private sector.

Second is the Asian crisis of 1997–98, which led to the collapse of incumbent regimes (most famously, the Suharto regime in Indonesia), a backlash against the “crony capitalism” that accompanied these regimes, and a wave of reforms. These included improved financial regulation, better corporate governance, a clearer separation between public and private sectors, and more competition (Kochhar, Loun-gani, and Stone 1998; Lane and others 1999; Asian Development Bank 1998, 1999, 2000).

Third is the crisis in the Russian Federation and neighboring transition economies in 1998–99. In the political arena, the anti-status quo reaction to this crisis was comparatively muted (for details, see EBRD 2009, ch. 6). However, the crisis had a significant short-term effect on economic reforms—in the opposite direction as the previous two crises. In the five years preceding the crisis, reforms proceeded briskly, with an average of 66 “upgrades” a year on the transition indicator scale of the European Bank for Reconstruction and Development (EBRD) for the transition region as a whole. But in 1998, only 35 transition indicator upgrades were awarded, and 13 downgrades were issued in nine countries (Belarus, Latvia, Romania, Russia, Serbia, Turkmenistan, Ukraine, Uzbekistan, and the former Yugoslavia). With only 34 upgrades and seven downgrades, 1999 was also a bad year for reform (see figure 1).

FIGURE 1.
Upgrades and Downgrades in the EBRD Transition Indicators, 1990–2009



Source: EBRD 2009.

The three episodes suggest, first, that an anti–status quo reaction during and after the ongoing crisis is plausible. Second, if it does occur, it would most likely be directed against market reform, along the lines of the reactions to the 1998–99 crisis in the Russian Federation. From the point of view of development, this would be highly regrettable, since the reforms share some credit (with a favorable external environment) for generating good growth in developing countries since the late 1990s. Even from a pure stability point of view, the emerging markets have done relatively well in this crisis, in part because of macro-institutions and financial sector reforms since the last wave of crises (EBRD 2009, box 1.2). This is the first major financial crisis that has not hit the developing world harder than the advanced countries, at least since the new era of financial integration began in the early 1970s. Even the transition region, which was exceptionally hard-hit in terms of decline in average output, has proven resilient in the sense that the crisis has not led to currency collapses and financial meltdowns (EBRD 2009, ch. 1).

Evidence from the Transition Region

For this reason, the possibility of an anti–status quo reaction to the crisis in the transition region has been a significant concern to the EBRD and other proponents of reform. But what is the evidence? Just over 12 months into the crisis proper—following the collapse of Lehman Brothers in September of 2008 and the sudden stop of capital flows to emerging markets in the last quarter of that year—it is too

early to draw definitive conclusions. However, some initial observations are worth reporting.

Most obviously, the reform reversals that followed the Russian crisis have been largely absent. For the period from mid-2008 until the third quarter of 2009, which coincides almost with the most virulent period of the crisis in emerging Europe, the EBRD *Transition Report 2009* identifies only four transition reversals. Moreover, the report emphasizes that at least three of these reversals, which refer to nationalizations in Latvia, Montenegro, and Kazakhstan, can be justified as part of the crisis response strategies of the three countries. Compared to the aftermath of the 1998 Russian crisis, the ongoing crisis in the transition region is noteworthy mainly for what has not happened: a resort to protectionism, capital controls, and nationalizations on a broad scale, let alone sovereign default. While the scope of the state has been expanded in many countries—most notably, in Kazakhstan—the rationale for this has been no different from crisis-related bank nationalizations in the United Kingdom, for example.

But what if the reform reversals still lie ahead of us? If the crisis leads to a significant shift in public opinion—and, via elections, in political power—it could still trigger transition reversals in the future. One source that may provide answers in this respect is the next round of the EBRD–World Bank Life in Transition survey, which will go into the field in the first half of 2010 and allow a comparison with reform attitudes in the region at the time of the first round of the survey in 2004–05. In the meantime, government changes in the transition region can provide some clues. The EBRD *Transition Report 2009* (EBRD 2009, box 6.2) examines all elections and political turnover from January 2008 until September 2009 and finds no evidence of a political shift against market reforms. The declared policy stance of governments appears to have either remained the same or (in eight out of the 29 EBRD countries of operations) become more reform friendly. On this basis, it appears unlikely that the region will witness a strong backlash against reforms, at least in the near future.

Conclusions

From the perspective of developing countries and transition economies, the main concern in this crisis is not so much that it may lead to reform inaction, although this is also a concern, particularly with respect to the financial sector, but that it may lead to a reversal of previous market-oriented reforms. This would be a tragedy, in part because many reforms of the last decade have contributed to an improvement in macroeconomic and financial fundamentals that has *strengthened* the resilience of developing countries during this crisis. Fortunately, evidence from the transition region so far does not support the idea that a backlash is under way.

However, we should not draw too much comfort from this fact. As fiscal needs in the advanced countries absorb a larger share of world saving, private capital flowing to developing countries will likely be more scarce and more expensive in the medium term. This, in turn, will put a premium on new reform in areas such as education, health, and infrastructure that can unlock domestic sources of growth, particularly in

the transition region, which has relied excessively on foreign financing. Generating the requisite fiscal space is likely to require fiscal-structural reforms. With the core supporters of reform—the middle class—under the stress of high unemployment, household debt, and falling housing prices, the appetite for new reform efforts is likely to be weak. Hence, Zanalda’s main worry—that the crisis of 2009 may be a missed opportunity in much the same way as the Naples crisis of the 1610s—could yet come true. Preventing reform from stagnating will require applying the same policy effort to the postcrisis reform agenda as governments and international institutions have applied to the crisis response in the past 18 months.

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