5 / The View from the Developing World: Institutions, Global Shocks and Economic Adjustment

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1. Introduction

Economic crises will always be with us. As Reinhart and Rogoff (2009) have documented in detail, periods of economic growth during the past couple of centuries have been interrupted repeatedly by economic shocks. Indeed, economic crises have even buffeted the world economy over the past 60 years, at a time when the global economy has experienced the most sustained period of economic growth in history. These sporadic and unexpected global economic shocks have often resulted in a sharp reduction in investment, a contraction in economic output and, in some cases, sharply lower consumption levels. In this context, this chapter examines how governments in developing countries, in particular, have responded to these types of negative shocks in the aftermath of the global financial crisis of 2008. This chapter also analyses the reasons why the policy response has been adequate in some countries and not in others, and explores the economic and political consequences of an inappropriate policy response.

This global financial crisis resulted in declines in output and growth across virtually all OECD countries. However, the impact of the crisis on low- and middle-income countries was very uneven. Middle-income countries in the near periphery of Western Europe, such as Latvia and Greece, were severely affected. In contrast, a striking feature of the experience of many low- and middle-income countries in Asia and Latin America was how quickly they managed to recover from the economic recession that engulfed almost all of the high-income OECD countries. Despite a dip in growth, China retained its double-digit economic expansion throughout the last decade, followed closely by India, which continued to grow at an average of about 8% per annum. Similarly, economic recovery was impressive in countries as diverse as Brazil, Turkey and South Africa, to the extent that the experience has led some observers to wonder whether developing countries have found the appropriate mix of policies and institutions that has insulated them from the adverse consequences of a global economic shock.

There are three key observations to make with regard to the growth experience of low- and middle-income countries in the aftermath of the 2008 financial crisis. First, the fact that many of the most prominent developing countries continued to do well should not mask the fact that the global crisis did have a substantial negative impact on growth in the developing world, with average growth rates in developing countries declining from around 6% before the crisis to around 3% in 2009. In other words, there was considerable diversity in these countries' performances, with many (especially smaller and more open ones) seeing growth

rates collapse.[1] Second, there is the issue of sustainable growth. Over the past couple of years even the erstwhile success stories of the developing world have stumbled, with India's real GDP growing at 4%, its slowest rate since 2005; economic expansion in Brazil virtually stalling, with real GDP collapsing from 6% in 2007 to 0% in 2009; and even China posting a much weaker real GDP growth rate at 9% in 2009, down from 14% in 2007. Therefore, even these large economies with substantial domestic markets have not been able to sustain their economic growth rates and have increasingly seemed to be handicapped by their own structural and institutional constraints. Third, the financial crisis has exposed the unsustainable nature of policies being pursued by middle-income countries, such as Greece, which helped trigger the eurozone crisis.

This chapter thus focuses on the importance of a country's political and institutional underpinnings to its ability to adapt and adjust in the face of an economic crisis. Given the large number of countries in question and the diverse nature of developing economies in particular, this chapter emphasises the broad mechanisms and common patterns of these countries, rather than individual country-specific case studies. The main themes of this chapter can be summarised as follows.

(i) Heterogeneity in economic adjustment across countries.

While economic shocks are global, economic recovery is very much local. There is considerable heterogeneity in the degree of policy and economic adjustment across countries. These differences in the recovery across countries are not simply because the severity of the shock will differ across countries. Rather, it is because even a symmetric global shock can have very different distributional effects across countries and will thus alter the political response to the crisis.

(ii) The political economy of reform and adjustment.

Some countries alter policies quite promptly, while others suffer from prolonged policy inertia. However, the policy paralysis that often characterises the response to a negative economic shock is not necessarily attributable to ignorance of the appropriate course of action to take. Rather, the policy response is best understood by accounting for the impact of the crisis on the distribution of political power across various groups. Economic shocks can trigger social conflict across groups in a society. As Frieden (2009) has argued, "every crisis is followed by conflict over the distribution of the adjustment burden". The extent to which these unexpected shocks exacerbate conflict depends on both the distributional impact of the shock as well as the strength of existing institutions of conflict management within society. If the shocks reinforce ethnic inequality and there is an absence of social insurance (as is the case in developing countries) and other institutions of conflict management, then political paralysis in policymaking is more likely.

(iii) History and local institutions matter.

While economic principles are universal, their implementation is intermediated through local institutions – which are themselves a product of country-specific history, political institutions and culture. These local differences mean that the task of economic policymaking is much more difficult than it may seem at first glance. This is because policies themselves have to be adapted to local contexts and intermediated through pre-existing social norms and institutions.

1 Berkmen et al. (2012) use cross-country regressions to analyse the factors that affected the response of developing and emerging-market countries to the global economic crisis.

(iv) Practical mechanism design and political constraints.
Policy design is important and should recommend not just the best set of policies, but also what can practically be implemented. Therefore, policy recommendations should take into account incentives of both economic *and* political actors, while also considering existing institutional constraints. Policymakers (with the help of economists) should point out where to seek help with institutional design with the aim of reducing (but *not* eliminating) existing political constraints.

Many periods of economic growth have followed or coincided with the diffusion of economic reform across the developing world. With the spread of economic reform, economic growth that had earlier been largely confined to Europe and North America gradually spread to parts of the developing world. However, the incidence of economic growth has been uneven across time and space. Indeed, sustaining economic reform has often turned out to be quite difficult. Political upheaval, military conflict or economic gridlock have resulted in economic stagnation in some countries and even growth reversals in others. It is important, therefore, to examine in more detail the factors that affect a country's ability to react and adjust to global economic shocks.

2. Globalisation and the political economy of adjustment and reform

Countries differ in their ability to respond to major economic crises. This is not just because good policymaking is difficult and the optimal course of action is sometimes difficult to ascertain. Indeed, inefficiencies abound in all areas of policymaking owing to constraints faced by decision-makers – be they informational, administrative or political. The ability of governments to assimilate new information and to adapt and adjust their policy choices depends on existing policies and institutions. This is in large part because different political institutions may exacerbate or alleviate the ability to carry out reform.

A central message of this Policy Report is the importance of taking into account political considerations. No account of a country's adjustment and recovery would be complete without explicitly incorporating the role of extant political institutions, political and economic exigencies and constraints. In this context, it is important to begin with an overview of the various mechanisms that affect a country's ability to recover from a shock, to make the appropriate policy adjustments and to get it back to a growth trajectory.[2] The various mechanisms are examined in some detail, since it helps to shed light on particular country episodes.

The systematic exploration of how countries (fail to) respond to economic crises started with the confluence of two strands of literature. First, there was the attempt to understand why governments in many developing countries failed to reform policies and institutions, despite low growth, stagnation and overall inefficiency (Rodrik, 1996). Second, there were new developments in the study of political economy. In particular, there was a growing recognition of the power of the public choice critique of traditional policy analysis pioneered by Buchanan and Tullock (1962). This literature emphasised that a policymaker's preferences may be quite distinct from a social planner's and result in inefficient policy choices, i.e. government failure. Therefore, a policymaker's choices may be driven by a desire to stay in office, or giving a very different weight to the preferences of certain individuals (or groups) than a social planner. However, the

2 Much of the discussion in this section closely follows Mukand (2008).

insights from the public choice tradition were not explicitly grounded in a rational choice framework. This is where the literature on time-inconsistency played a crucial role, thanks to the classic contribution of Kydland and Prescott (1977). This literature demonstrated the importance of clearly specifying the policymaker's objectives and accounting for constraints within a framework of optimisation. However, the study of the political underpinnings of policy reform really took off when insights from this new political economy were used to deepen our understanding of economic crises, poverty traps and institutional inefficiencies in developing and transition economies.

Policy reform generally is difficult to achieve. Indeed, understanding the persistence of inefficient policy choices has been one of the central themes of much of the literature on policy reform. It is possible to delineate the mechanisms described in the literature by focusing on two kinds of conflicts that make all policy reform more or less difficult. The first is the distributional conflict between different groups of citizens and individuals, be it as a result of differences in income, occupation, ethnicity or even religion. Given that much of policymaking is an attempt to balance these competing interests, the ability of a society to resolve this conflict is likely to affect its ability to reform. Second, the ability of a society to reform a policy that has failed may be the result of a conflict of interest between politicians and/or policymakers and the public.

2.1 Distributional conflicts and policy inefficiency

During the 1980s Latin America witnessed a number of macroeconomic crises caused by delays in enacting a stabilisation policy (Rodrik, 1996). The puzzle is, why were these stabilisation policies delayed? In a near classic in this field, Alesina and Drazen (1991) addressed this issue, highlighting the fact that policy reform can be delayed owing to a "war of attrition" between two groups.

Given the uncertainty about the other group's willingness to bear a disproportionate burden of the adjustment costs, each group delays adjustment measures in the hope that the other group caves in first. As a result, the economic crisis worsens before one of the two sides gives in and reform takes place. At its broadest level, the inefficiency in policymaking in democracies generally arises from a commitment problem. Governments which are vulnerable to losing power are often unable to commit to future policy outcomes. This failure to commit can result in inefficient policy choices for a variety of reasons (see Besley and Coate, 1998). In particular, most policy reforms have distributional consequences, resulting in winners and losers. However, there is a time-inconsistency problem with promises of future compensation, as Acemoglu (2003) and Robinson (1996) point out. Therefore, what is key is the inability of a government credibly to commit to compensate losers from economic reform. Not surprisingly, if losers are in a majority (or politically influential), they will be not only be opposed to policy reform, but will be in a position to prevent the implementation of such measures, even if they are efficient. Now, if a government through some form of taxation and transfers could credibly commit to compensate losers for their losses, then policy reform would be much easier to achieve. In part, the difficulty in making credible promises to compensate losers is that the gains and losses from policy choices are spread out over time, while the winners may not have enough resources to compensate the losers up front for their subsequent losses (see Dixit and Londegran, 1996).

However, the inability to compensate losers is not in itself sufficient to explain the failure to introduce policy reforms. If individuals are risk-neutral, then they may well be willing to adopt a policy that results in winners and losers. For

example, consider an economy where 100 risk-neutral voters face the prospect of voting for or against policy reform. If enacted, this policy reform will result in 51 winners, each of whom stands to gain $5, and 49 losers, each of whom stands to lose $1. One might assume that since (in expected terms) all individuals stand to gain from the adoption of this reform, it will always be enacted – regardless of whether the winners compensate the losers or not. However, in an important contribution Fernandez and Rodrik (1991) suggest that this is not the case. They argue that even in a world with risk-neutral agents, individual-specific uncertainty about the identity of winners and losers from a reform may prove to be crucial. In particular, to continue with this example, consider the case where the identity of 49 of the 51 winners is common knowledge. In this case, there is individual-specific uncertainty among the remaining majority about their identity as a winner or a loser. This uncertain majority now has a negative expected payoff from the reform and will vote it down. Therefore, in cases of individual-specific uncertainty, a majority may well vote against a policy, despite the fact that a majority stands to benefit from it.[3] Extending this example still further, Jain and Mukand (2003) show that policy reform may fail to get enacted, despite the existence of tax-transfer compensation instruments. Social conflict across groups, coupled with the failure of a credible and efficient means of conflict resolution, can result in the persistence of inefficient policies.

2.2 Political losers, agency and policy inefficiency

Once in power, politicians reap both economic and non-economic benefits. As such, there may be a failure to enact a policy reform if it adversely affects the rents earned by the incumbent politician. A number of mechanisms have been studied. The prospect of earning rents from a status quo policy can make the adoption of policy reform by the politician much more difficult. Coate and Morris (1999) show that the mere introduction of a policy encourages the affected parties to make investments that increase their willingness to pay for retaining these policies in the future.[4] If, in the period ahead, the efficient policy is no longer the status quo policy, then there may be a problem. Any government attempting to reform the status quo policy is likely to be vulnerable to lobbying by the now entrenched firms.

Indeed, in the presence of policy choice uncertainty, this inefficiency is exacerbated. For instance, many commentators have questioned why US president Lyndon B. Johnson persisted with military escalation in the Vietnam war, even though it was apparent to him (and most others) that such a policy was unlikely to work. Similarly, many analysts have been puzzled by the persistence of policymakers in many Latin American countries to pursue extreme neo-liberal policies, despite the fact that they do not seem to work. Majumdar and Mukand (2004) suggest the reason may be reputational. In particular, suppose that the initial policy choice is a function of the policymaker's ability. In this case, even if the policy seems to be failing, the policymaker may persist with it despite the fact it is not efficient to do so. This is because a policy reversal by the incumbent will call into question his or her competence for choosing such a course of action in

3 Fernandez and Rodrik (1991) argue that this mechanism throws light on the experience of Taiwan and South Korea in the 1970s, and Turkey in the early 1980s. In each case, there was a considerable segment of the population that was opposed to reform before it was enacted. However, once it was introduced, a majority came to back the same reform they had opposed.

4 Coate and Morris (1999) help to throw light on the experience of many countries in the developing world, where tariffs remained in place long after they had been discredited as an effective type of economic policy.

the first place. It is fear of the adverse reputational (and electoral) consequence brought about by such a policy reversal that results in continuing stubbornly with an inefficient policy.

2.3 Lobbying and economic reform

In today's world it is difficult to articulate policies that have not been influenced by special interest groups. Such lobbying can have an important effect on the trajectory of economic adjustment. The importance of lobbying in economic policymaking has long been recognised (see Olson, 1965; Grossman and Helpman, 2002). Suppose that a government is trying to implement a reform package in order to help adjust to a negative economic shock. In this case, firms that stand to benefit are likely to organise themselves and lobby in an attempt to mitigate any adverse effects of these reforms. Such lobbying may slow or derail any attempts at economic reform and prevent a successful adjustment. While plausible, it should be recognised that this argument is incomplete. As observed by Becker (1983), the fact that lobbying exists does not necessarily mean that policy choices will be inefficient. After all, any economic reform that takes place in response to an economic crisis will result in winners and losers. A priori, it is not at all clear why the winners from such reform will not counter-lobby as effectively as the losers. However, as first observed by Grossman and Helpman (2002), economic reform in response to an economic crisis is not only likely to have distributional effects. In fact, there is likely to be an asymmetry in the identity of the winners and losers. The firms that stand to lose from economic reform are likely to be well aware of this. In contrast, in a world with a free entry of firms, many of the future winners do not yet know who they are. Moreover, their rents are likely to be earned in the future, which thus drives a wedge between the effectiveness of the lobby winner (as opposed to the loser), thereby skewing the lobbying process.

2.4 The persistence of beliefs and policies

There is yet another behavioural bias that makes the policy response to a crisis even more sluggish. Agents (be they politicians or citizen voters) do not process information efficiently. So, a priori, one can expect that a crisis produces information for voters and policymakers that calls into question the wisdom of prevailing policies and results in a policy adjustment. Furthermore, citizen voters and governments may not always process information in a rational manner. Information processing may be distorted by a variety of behavioral biases that can cause individuals either to ignore relevant information or, in other instances, put too much weight on this knowledge.[5] There may be a self-confirmatory bias (Rabin and Schrag, 1999), whereby individuals choose only to process information that conforms to their prior beliefs. Alternatively, they may suffer from self-serving biases, whereby information processing is distorted in a systematic manner. These behavioural biases in information processing can add considerable inertia in policy adjustment and help to explain the persistence of policy inefficiency.

5 Kaplan and Mukand (2011) compared the political allegiances of Californians who turned 18 just before and after the September 11th 2001 attacks on the United States, which caused a national shift to the right. They found that voters with birthdays in September were more likely to register as Republicans than voters with birthdays in August. These voters then continued to register as Republicans at higher rates in subsequent elections. It would seem that individuals did not shift their political allegiance in response to new information. Apparently, once a registered Republican, always a Republican.

2.5 Adjustment and institutions

The preceding discussion has outlined a variety of channels that make it difficult for governments to respond quickly to an economic crisis. However, there is an important category of mechanisms that make it difficult for a policymaker to react quickly to a crisis – namely, the role of institutions. For instance, differences in institutional arrangements allow a new prime minister in the United Kingdom to change the course of fiscal policymaking much more quickly than a newly elected president in the United States, where all economic policies have to be ratified by Congress. However, when comparing economic decision-making in the eurozone with the process in the United States, it is striking that the latter moved with considerable alacrity in responding to the banking crises of 2008, compared with the dangerously sluggish response by European policymakers in dealing with the ongoing sovereign debt crisis.

More generally, one of the key differences in the nature of political institutions is that they embody very different checks and balances. As a rule, it can be argued that autocracies have fewer checks and balances than corresponding democracies. Therefore, it is certainly possible that an autocratic regime will make a much quicker policy adjustment in the face of a crisis than a country with more democratic political institutions. This seems to suggest that authoritarian political systems have an inherent structural advantage that makes it much easier for them to respond to sudden economic shocks, but this advantage has to be balanced against two counter-arguments. First, autocracies lack a smooth political mechanism to replace "bad" leaders. As a result, even if an economic crisis was caused in the first place by the poor policy choices of the leader, the autocrat is unlikely to be pushed out of office. In democracies, by comparison, elections are likely to result in a change of government. Policy persistence for reputational reasons (see Majumdar and Mukand, 2004) is likely to be mitigated as a result of electoral turnover in democracies.

Second, while autocracies may change the direction of policy more quickly, the relevant question is: in what direction? Typically, there is a menu of policy choices available to governments, and they have to select among them. Lacking active and free media as well as an active political opposition, there is no decentralised way to acquire reliable information. Indeed, as Sen (1980) and Besley and Burgess (2002) have pointed out, the availability of information can make democracies more effective in dealing with crises.

Lastly, in can be argued that political constraints themselves play an informational role. The absence of political constraints in an autocratic regime makes it difficult for policymakers to know whether the policy is likely to work and to make the appropriate adjustments in mid-stream. Such course corrections are ubiquitous in democracies.

3. Globalisation, governance and economic adjustment

This section takes a brief look at some prominent episodes of economic adjustment. Each episode is singled out to illustrate some of the key themes of this chapter. The aim is to emphasise the importance of the global context in which these shocks have occurred as well as the role of adaptability of local-level political institutions.

3.1 Response to global economic shocks: through the looking glass

Economic shocks, of course, can have very different origins. These can range from a sharp drop in the price of a country's primary export commodity (such as oil in Mexico in the early 1980s), a banking failure (in the 2008 crisis) or even a political revolution (the collapse of the Soviet Union). These economic shocks reveal imbalances and contradictions underlying the prevailing economic system that might have been easy to paper over and ignore in ordinary times. However, while citizens and policymakers may understand that some adjustment is required to recover from a sudden and sharp shock to the economic system, it is far less clear that they learn the same lesson. In most cases, what these shocks do is increase the likelihood of a shift in the prevailing political equilibrium. Not surprisingly, conflict often ensues. Countries that have been relatively well equipped with good institutions of conflict resolution are much better able to agree on a post-crisis path forward and to take the necessary corrective measures. In the absence of such automatic "institutional" stabilisers, one can expect much greater economic volatility and political paralysis going forward.

Although the primary focus of this section is to examine how global shocks affect domestic politics and serve as a catalyst for institutional change, it is also worth taking note of their impact on multilateral negotiations and bargaining between nations. A brief look at prominent episodes from history is instructive.

a) The Great Depression and the politics of adjustment during the inter-war period

This is the classic example of how inappropriate policy responses at the country level led to a very bad economic shock that could have been restricted to a few countries, but instead evolved into a global depression.

Many of the developments that took place in the German economy during the inter-war period can be traced to the politico-economic dynamic that was triggered by the fiscal burden of paying for war reparations (Ritschl, 2012). Reparations were politically unpopular from the very beginning. In the 1920s Germany was a country where "weak governments had to pay reparations to the victorious belligerents, finance reconstruction, and satisfy massive social demands" (Frieden, 2009). There was no political constituency defending the making of these payments, and the fact that these payments had to be made provided individuals with a convenient excuse not to pay taxes, thereby putting additional pressure on the country's public finances. Unsurprisingly, tax revenues collapsed and the government adopted an increasingly hostile stance to reparations. This made the German economy quite dependent on capital inflows from the United States. However, in 1929 global economic uncertainties caused these capital inflows to dry up and forced Germany, under international pressure, to agree to the Young Plan on reparation payments.

Table 1: The start of the Great Depression and the start of recovery (year/quarter)

Country	Depression Began	Recovery Began
United States	1929:3	1933:2
Great Britain	1930:1	1932:4
Germany	1928:1	1932:3
France	1930:2	1932:3
Canada	1929:2	1933:2
Switzerland	1929:4	1933:1
Italy	1929:3	1933:1
Belgium	1929:3	1932:4
Netherlands	1929:4	1933:2
Sweden	1930:2	1932:3
Denmark	1930:4	1933:2
Poland	1929:1	1933:2
Argentina	1929:2	1932:1
Brazil	1928:3	1931:4
Japan	1930:1	1932:3
India	1929:4	1931:4
South Africa	1930:1	1933:1

Source: Romer (2003).

Between the signing of the Young Plan and its adoption came the Wall Street crash of 1929 (see Ritschl, 2012, for a detailed discussion). This was equivalent to a major fiscal contraction taking place as underlying political tensions came to a head. There was a "war of attrition" between the various socio-political groups, and within a year the finance minister, the governor of the central bank and finally the government had all been pushed out. The only way Germany had been able to paper over the underlying social tensions was by borrowing money from abroad (largely the United States) to finance a consumption boom. When the recession hit Western economies in 1929, this inherent imbalance was no longer sustainable and became a victim to policy errors, which compounded banking failure and the shock to aggregate demand. The degree of recovery and adjustment, however, was quite different across countries. For example, Great Britain experienced a substantial recession in the early 1930s, but in Germany and the United States real GDP fell by almost 25% between 1929 and 1932 (Crafts and Fearon, 2012). While initial conditions across countries were very different, so too were the policy responses and the recovery, as highlighted in Table 1.

In one of the more egregious instances of a wrong-headed policy response, decision-makers in the United States turned inward and enacted the infamous Smoot-Hawley tariffs of 1930. This had a cascading effect, with protectionist barriers going up across much of the world and leading to a collapse in global trade (especially in primary commodities). It not only worsened the crisis in Europe and the United States, but helped spread it to parts of Asia, Africa and Latin America.

Arguably, the policy that was most responsible for impeding a quicker recovery was the reluctance of policymakers to abandon the Gold Standard. As Crafts and Fearon (2012) point out, the recession shock was exacerbated by policymakers' insistence on maintaining high interest rates in Britain in order to safeguard Gold

Standard membership at pre-war parity rates. This was a poor decision to begin with, since it completely ignored the inflation that had taken place in Britain during the intervening period, contributed to the overvaluation (and trade deficits) during the 1920s, and subsequently gave the government much less room for manoeuvre when the crisis hit. Wolf (2008) econometrically studied the reasons why certain countries adhered to the Gold Standard longer than others and argued that those with more democratic institutions were more likely to exit faster since it was politically very costly to go through a painful domestic adjustment.[6]

As Eichengreen and Sachs (1986) conclude, countries that persisted with the Gold Standard had a much slower recovery than others. For instance, Britain abandoned the Gold Standard relatively early (in 1931) and began its recovery much faster than the United States, which devalued its currency two years later. Similarly, Belgium and France were slow to devalue and took more time to recover, while Latin American countries devalued immediately and recovered much faster. Moreover, those countries that remained longer in the Gold Standard also persisted with protectionist barriers. Similarly, there were differences across countries in their willingness to service debt payments. Sovereign default was common throughout the 1930s, and often countries that were quicker to default recovered faster.

There are two aspects of policymaking in the 1930s that are particularly striking. First, many of the policymakers displayed a number of the classic pathologies associated with inefficient policymaking outlined earlier. For instance, there was the classic "war of attrition" between right-wing and left-wing groups over which one would bear the bulk of the burden of fiscal adjustment. Indeed, as argued by Eichengreen (1992), this conflict was particularly acute in the high-inflation countries of the day, such as France and Germany. Reputational factors are also likely to have made some policymakers "invested" in certain policies particularly reluctant to change course in the light of dispiriting economic news (Majumdar and Mukand, 2004).

Second, equally striking is the absence of intermediating institutions that could have helped resolve some of the political economy problems faced by policymakers. There was no independent central bank, no unemployment insurance or stockmarket regulation; banking regulation (or deposit insurance) was inappropriate; and there was absolutely no social security, nor indeed the concept of a welfare state. In fact, many of these were introduced as a result of the overall institutional failure of key economies during this period. It should therefore not be too surprising that social and political conflict worsened at that time and that there was a reactionary turn in a number of countries (see Table 2).

Bromhead et al. (2012) document the dramatic increase in the share of votes (and seats) for anti-system parties in the aftermath of the crisis of 1929. Most dramatic perhaps was the shift in Germany, where the share of the vote going to protest parties more than quadrupled over the 1928-32 period. This increase in the share of the vote of fascist parties on the right and communist parties on the left holds useful cautionary lessons for developing countries, which are typically characterised by weak institutions of conflict resolution and few adequate safety nets. A negative economic shock in this context can cause economic insecurity and unemployment. Normally one might expect that this would result in the removal of the political party in government that was responsible for the mess, but the experience in Europe during the inter-war period demonstrates that

6 See Box 2 in Chapter 1 for a more complete discussion of the role of the Gold Standard.

Table 2: The rise of the extreme left and fascist right

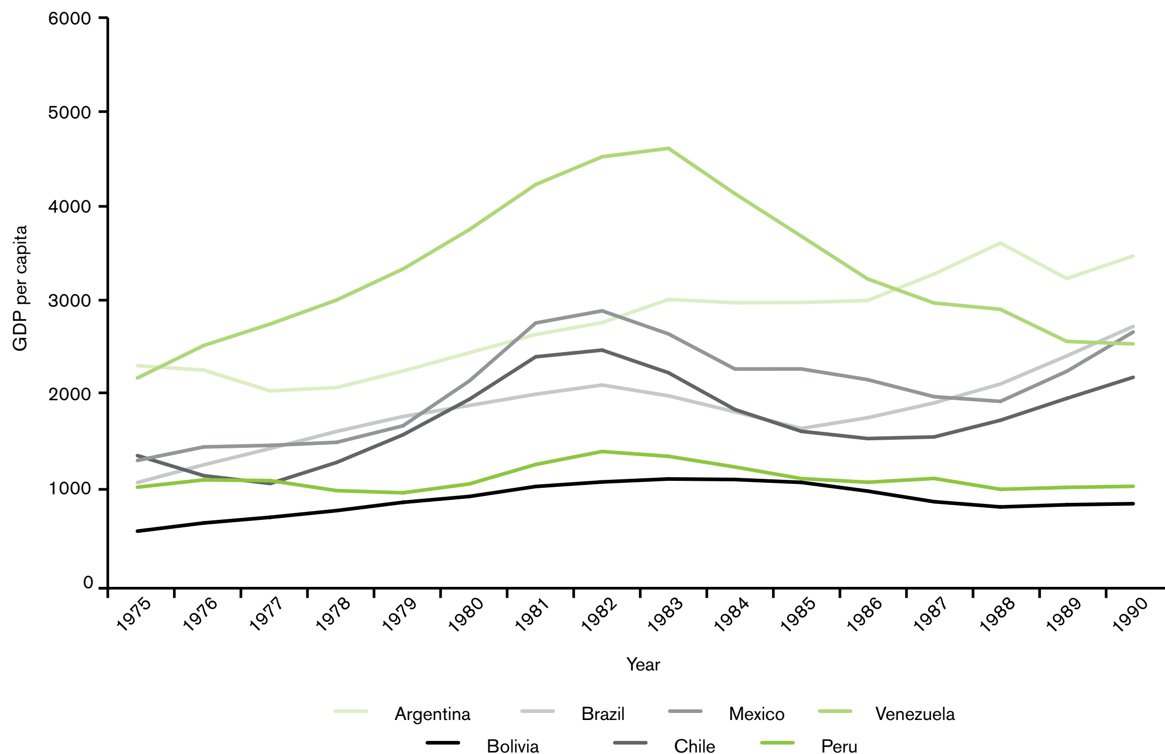
	Last Pre 1929			Peak Post 1929			Coup/End Demo		% Change	% Change
	% seats	% votes	Year	% seats	% votes	Year	(post-1929)	Year	seats	votes
Argentina	0	0	1928	0	0.5	1930	YES	1930	0	0.5
Australia	0	0	1929	0	1.3	1934	NO	–	0	1.3
Austria	7.2	8.5	*	10.8	9.8	1930	YES	1933	3.6	1.4
Belgium	6.4	8.2	1929	22.8	24.7	1936	NO	–	16.4	16.5
Bulgaria	0	2.5	1927	11.4	13	1931	YES	1934	11.4	10.5
Canada	0	0	1926	0	0.7	1935	NO	–	0	0.7
Chile	0	0	1925	8.2	7.7	1937	NO	–	8.2	7.7
Czechoslovakia	16		1929	32.4	25.5	1935	NO	–	16.4	NA
Denmark	0	0.3	1929	2.7	4.2	1939	NO	–	2.7	3.9
Finland	25.5	28	1929	21	19	1930	NO	–	-4.5	-9
France	8.9		1928	19.8	–	1936	NO	–	10.9	–
Germany	13.4	13.2	1928	59.6	58.3	1932	YES	1933	46.2	45.1
Greece	0.4	6.7	1928	7.3	9.7	1936	YES	1936	6.9	3
Hungary	0.8	3.8	1926	17.4	22.8	1939	NO	–	16.6	19
Ireland	0.7	1.1	1927	0	0.1	1932	NO	–	-0.7	-1
Italy	11	6.2	1921	NA	NA		YES	–	NA	NA
The Netherlands	2	2	1929	7	7.8	1937	NO	–	5	5.6
New Zealand	0	0	1928	0	0.1	1935	NO	–	0	0.1
Norway	2	4	1927	0	4	1933	NO	–	-2	0
Poland	1.1	1.9	1928	NA	NA		NO	–	NA	NA
Romania	0	1.2	1928	27.2	25.1	1937	YES	1938	27.2	23.9
Spain	–	–		16.2	–	1936	YES	1936	NA	NA
Sweden	3.5	6.4	1928	3.5	8.9	1932	NO	–	0	2.5
Switzerland	1	1.8	1928	2.1	2.6	1939	NO	–	1.1	0.8
United Kingdom	0	0.2	1929	0.2	0.1	1935	NO	–	0.2	-0.1
United States	0	0	1928	0	0		NO	–	0	0
Uruguay	0.8	1.3	1928	1.6	2	1931	YES	1933	0.8	0.7
Yugoslavia	0	0	1927	NA	NA		NO	–	NA	NA
MEAN	**3.73**	**3.89**		**10.85**	**10.77**				**7.43**	**6.77**
MEDIAN	**0.8**	**1.8**		**7**	**7.6**				**2.7**	**1.4**

Notes: * Last votes data are for 1923, last seats data for 1927. "Pre-1929" elections include those held in 1929. Coup/End Demo refers to any suspension of democracy, be it by physical force or by peaceful takeover by an authoritarian regime.
Source: Bromhead et al. (2012).

something much more pernicious occurred. It is not just that the incumbent party was replaced by the opposition. Voters instead gravitated towards extremist political parties.

The rise of extreme left-wing parties in Venezuela, Ecuador and Bolivia in the past decade, as well as the rise of nationalist sentiment in China, suggests that this analysis is of contemporary relevance. Glaeser (2004) argues that this rise in extremism is particularly likely in countries where the media are tightly controlled, democratic institutions are weak and inequality and social cleavages are significant. In these circumstances two kinds of political competition are possible: competition within the class dimension (rich versus poor) or social conflict (ethnic/religious/racial). In order to keep taxes low, however, the rich are likely to subsidise and encourage political

Figure 1: GDP per capita (current US$), 1979-87



Source: World Development Indicators CD-ROM, World Bank (2011).

competition on the social dimension. As a result, during periods of high uncertainty, and in the absence of free media and adequate social safety nets, a country's body politic is particularly vulnerable to indoctrination and extremist politics.

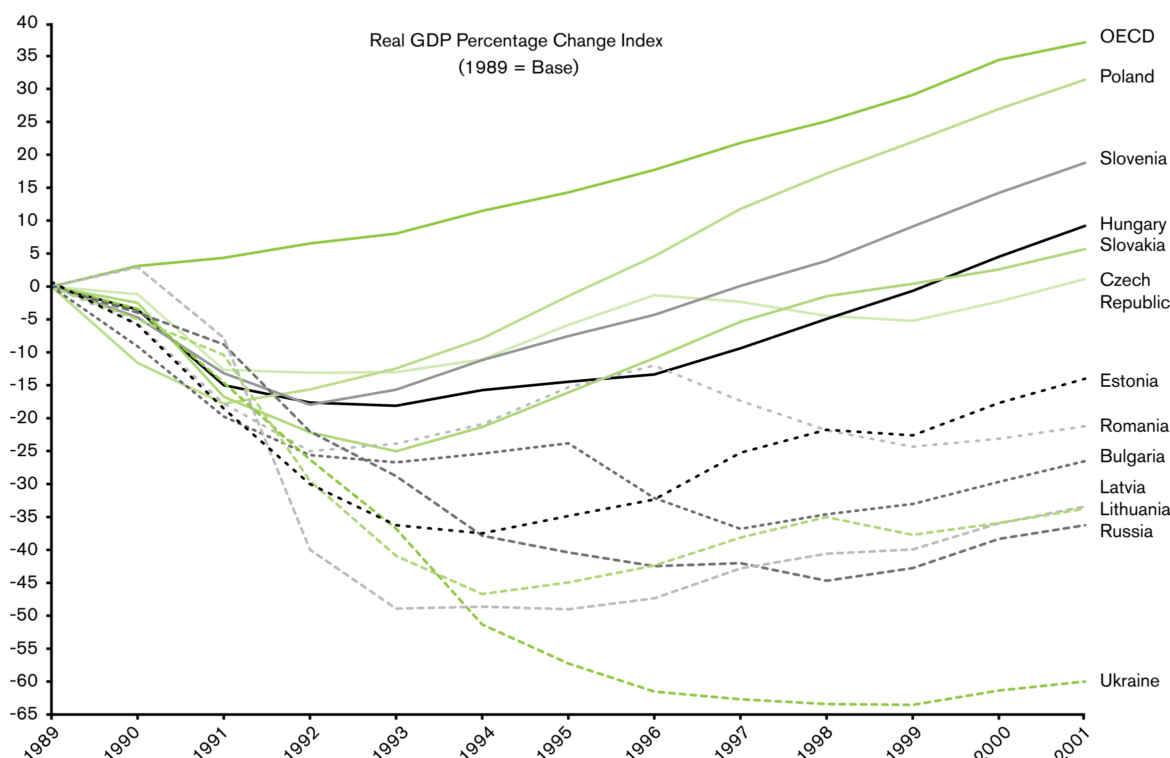
b) Growth and the politics of adjustment in developing and transition economies

Despite the significant differences in the nature of "shocks" and the considerable heterogeneity among developing and transition economies, in this context it is nonetheless appropriate to examine them together because there are some common lessons to be drawn, beginning with a brief description of the Latin American debt crisis, followed by a look at growth and recovery in the transition economies in the aftermath of the collapse of the Soviet Union in 1991, and finally the post-1998 currency crisis in Asia. This will highlight some of the common themes that emerge from these three very different types of crisis.

Much of the investment in Latin America in the 1970s and early 1980s had been facilitated by borrowing money from international capital markets. Compounding the risks involved was the fact that many of these Latin American countries had run up large trade and fiscal deficits during the 1970s. However, the crisis was really triggered by the Volcker shock of 1979, when the United States raised its interest rates. What might well have been simply a significant recession instead became a full-blown economic implosion that resulted in a lost decade for much of the continent (see Figure 1).

As Diaz-Alejandro (1988) argues, the magnitude of the crisis could not be attributed merely to the size of the external shock; its interaction with the "risky or faulty domestic policies led to a crisis of severe depth and length, one that neither shocks nor bad policy alone could have generated". So why did so many countries enact policies that were unlikely to spur an economic recovery?

Figure 2: Collapse and recovery in Eastern Europe



Note: Graph plots percentage changes in the real GDP index over time.
Source: Svejnar (2001).

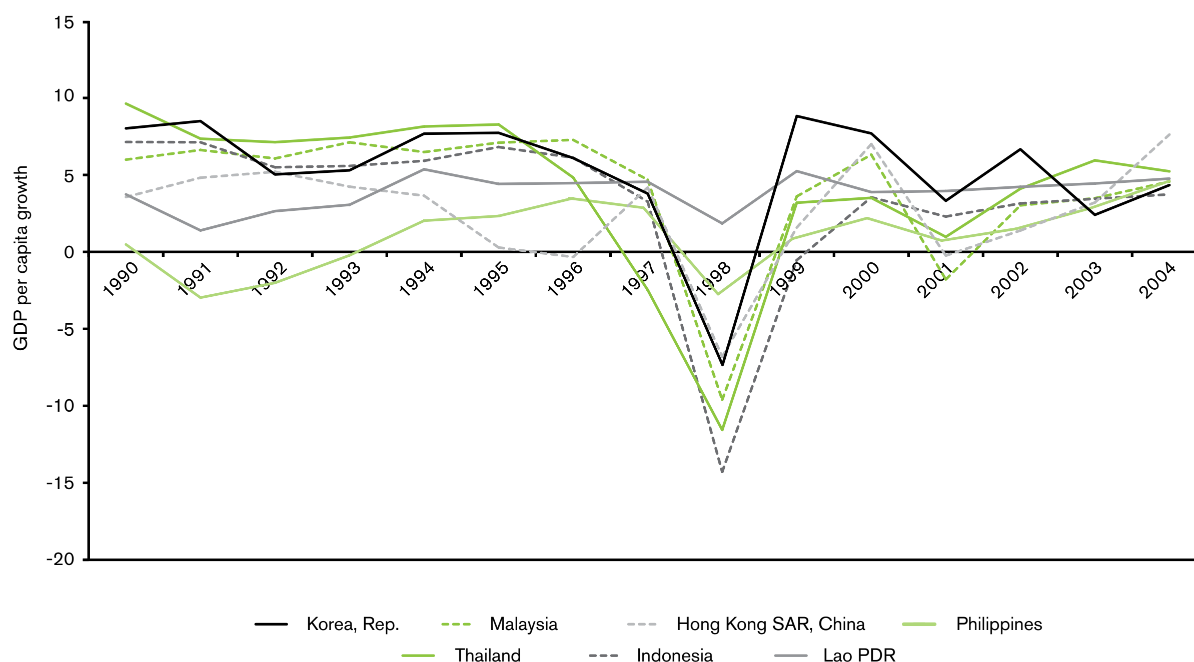
A similar question can be asked when it comes to the experience of the transition economies. The sudden unravelling and collapse of the Soviet Union in 1991 was a large negative economic shock to the former Socialist countries of Europe. Output declined in each of these countries, and in some instances precipitously so. For example, output in Moldova, Ukraine, Armenia, Azerbaijan and Georgia declined by more than 60% within a few years. Indeed, adjustment and recovery were so slow that even a decade later virtually all of these countries had yet to rebound to their pre-crisis levels of per-capita income (see Figure 2).

Here again there were major differences in the ability of these countries to adjust and get their economic recovery back on track. In the aftermath of the collapse of the socialist experiment all these countries were now searching for new policies and institutions. Why is it that only a few of them succeeded in choosing the appropriate set of policies and institutions?

Perhaps the greatest variance in the recovery from an economic shock is illustrated by the experience of Asian countries in the aftermath of the 1997-98 currency crisis. The decision to float the Thai baht in 1997 triggered capital flight and a severe currency crisis throughout the region, with nominal exchange-rate depreciation exceeding 50% in South Korea, Indonesia, Malaysia, the Philippines and Thailand. As Figure 3 reveals, growth recovered relatively quickly in most countries of the region, but why were there such differences in the rate of growth?

The sudden collapse in growth following the onset of the Asian currency crisis had immediate political ramifications in South Korea, with voters electing a long-time dissident, Kim Dae-jung, as president within a month of the outbreak of the crisis. Similarly, the crisis resulted in the electoral defeat of the ruling party in Thailand. Indonesia, meanwhile, suffered a very different fate. The absence of

Figure 3: Annual per-capita growth, 1990-2004 (%)



Source: World Development Indicators CD-ROM, World Bank (2011).

democratic institutions to manage socio-economic conflict meant that Indonesia's severe economic contraction had a major distributional impact. Not only was the population divided along ethnic and regional lines, but even the political elite was fractured. The resulting political revolution brought about the collapse of the 31-year regime of President Suharto and his authoritarian single-party system.

The failure of adjustment policies and measures to promote growth and economic recovery in Latin America, the transition economies and parts of Asia points to some general lessons. But first, it is instructive to illustrate this puzzle by examining the data in Table 3.

Table 3: Summary indicators for per-capita GDP growth, by decade

	1960s	1970s	1980s	1990s
	All available countries			
Mean (unweighted)	2.96%	2.16%	0.73%	0.38%
Standard deviation	2.45%	2.58%	2.46%	3.13%
Co efficient of variation	0.83	1.20	3.35	8.33
No. of countries	90	100	109	130
	Constant sample of countries			
Mean (unweighted)	2.82%	2.30%	0.81%	1.20%
Mean (population-weighted)	2.10%	2.45%	3.45%	3.84%
Standard deviation	2.08%	2.43%	2.47%	2.26%
Co efficient of variation	0.74	1.06	3.05	1.88
No. of countries	87	87	87	87

Source: World Development Indicators CD-ROM, World Bank (2011).

During the heyday of the "Washington Consensus" in the 1980s and 1990s there was considerable agreement (at least in the policymaking community) about what were appropriate economic policies.[7] However, these decades actually witnessed only modest growth levels and greater growth heterogeneity. Therefore the question is: why was growth so disappointing and more uneven (in contrast to the 1960s and 1970s) in a period when policymakers and economists were seemingly on the same page when it came to fostering economic convergence?

One explanation is that divergence took place because countries, in fact, did not converge in terms of the policies they enacted. While possible, this seems unlikely. Several empirical studies have shown that there has been greater convergence in policies pursued across countries (especially in Latin America) in recent decades. Furthermore, the two countries that blatantly ignored the Washington Consensus policy recommendations are the two that have grown the fastest, namely China and India. Hence, something else has clearly been at work, and indeed adjustment and growth across countries has differed for very much the same reasons.

(i) History and local institutions matter

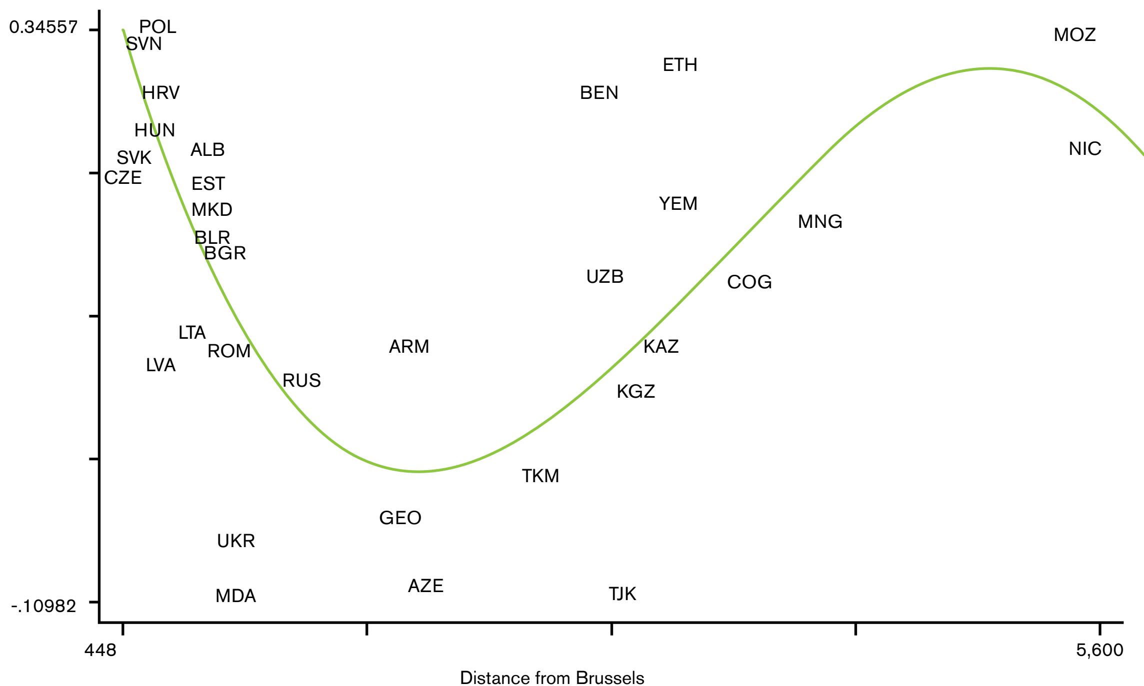
One of the striking aspects of many countries' adjustment and growth experiences is that they adopted policies for recovery that did not account for the underlying differences in their institutions, culture or environment. Even if economic principles are universal, their implementation is intermediated through local institutions – which are themselves a product of particular political institutions and a country-specific history and culture. These local differences mean that the task of economic policymaking is much more difficult than it may seem at first glance. In other words, policies themselves have to be adapted to the local context.

Therefore, even if policymakers react to shocks by mechanically following the policy recommendations of the IMF or the World Bank, there will be considerable heterogeneity in their success or failure. This becomes evident when looking at the experience of the transition economies in the aftermath of the Soviet Union's collapse in 1991. With socialism discredited, all the countries of the former Soviet Union were now searching for an appropriate set of policies and institutions suited to the new political and economic dispensation. Mukand and Rodrik (2005) argue that in order to facilitate a recovery in economic growth, these transition countries chose to imitate the policies and institutions of successful countries nearby, namely those in Western Europe. However, while countries in the near periphery (such as Hungary and the Czech Republic) made efficient policy choices by imitating West European-style policies and institutions to facilitate their growth and recovery, this was not the case with countries in the intermediate periphery of Eastern Europe (such as Moldova and Georgia).

Mukand and Rodrik (2005) argue that countries such as Moldova and Ukraine will have a political imperative to inefficiently ignore their local context and history and blindly imitate West European policies and institutions without adapting them to the local context. In contrast, countries in the far periphery (most of the Central Asian Republics) are outside this area of influence and will feel no such political compulsion to inefficiently imitate the West European model – given their history, culture and institutional tradition, this would be "a bridge too far". They will thus experiment and adapt – sometimes with spectacular results, and at

7 The term was coined by Williamson (1990) to encapsulate the set of neo-liberal economic policies that were being promoted by the World Bank and the IMF during this period: privatisation, market fundamentalism and trade and financial liberalisation.

Figure 4: Economic recovery in transition economies



Note: The vertical axis is the average growth rate over the period 1991-2001. The horizontal axis is the distance from Brussels (in miles).
Source: Mukand and Rodrik (2005).

other times with disastrous outcomes. In effect, recovery and adjustment will have a U-shaped relationship in distance from a successful leader, in this case Western Europe. Figure 4 provides evidence in support of this mechanism. Countries in the neighbourhood of Western Europe perform well, as do countries in the far periphery, but those countries at an intermediate distance (Moldova, Azerbaijan, Georgia) do particularly badly.

The lesson that countries should adopt policies and institutions that are of relevance to their local institutional context and history is pertinent to Latin American and Asian countries as well. In both cases, politicians and policymakers acquiesced to the wishes of the international capital markets or the diktat of the IMF. This resulted in ignoring their own local context and inefficiently pursuing policies that "the market wants to see", rather than policies that had the greatest chance of success in spurring an economic recovery (Krugman, 2000; Mukand 2006).

(ii) Institutions to manage conflict

Economic shocks have distributional effects and may trigger latent conflict among socio-economic groups in a society. Recovery from a severe economic shock requires time for the requisite structural adjustments to take place, and then for firms to start investing and growing. However, equally importantly, politicians and policymakers should be aware that they have time to implement the appropriate set of policies to generate a recovery. The optimal policy will be difficult to implement if the time horizon required for it to generate a recovery is longer than the political time horizon available (i.e. the next election). It is precisely here that a country's institutions of conflict management become important. If a country lacks an adequate safety net, then even a modest rise in unemployment can be politically costly to the incumbent. Social unrest, strikes and political

protest are likely to make accommodation and compromise particularly difficult. This makes incumbent policymakers prone to adopting quick-fix solutions that paper over problems rather than produce genuine and lasting reforms.

The importance of having good institutions of conflict management is exemplified by the case of Latin America, both during the debt crisis of the 1980s and after. In the debt crisis that began in 1982 the decline in incomes was steep (around 20%) in Argentina, Mexico and Venezuela, and more than 10% in Brazil. It was only in Peru that drops in real income approached those of the Great Depression in the United States. However, the recovery in Brazil was much more gradual. While per-capita income in the United States recovered to pre-crisis levels within a decade, it took Argentina close to 13 years, and Mexico, Brazil and Venezuela even longer. What is striking is not just that it took much longer for these countries to adjust, but how different the Latin American policy response was to that of the United States. The Great Depression resulted in major institutional innovations that expanded the role of government, from social security through to public works, unemployment insurance and banking regulation. In Latin America, not only was there no such expansion of government, but it led to another cycle of austerity and low growth in the 1990s, followed by deficits, growth and inflation – and more recently the prospect of economic collapse.

What accounts for this very different policy response to an economic crisis in Latin America on the one hand, and the Asian response to the currency crisis or that of the United States after the Great Depression on the other? A key factor is the underlying structural inequality in Latin America, which is over 2.5 times higher than in Asia, with the average ratio between the highest and lowest quintile more than 21 in Latin America and closer to 9 in East Asia. This income inequality is further reinforced by sectoral antagonisms in Latin America, with politically powerful oligarchies resisting land reform.

In sharp contrast, in East Asia (especially Japan, Taiwan and parts of South Korea) there had been major land reform that broke up old oligarchies (Kaufman and Stallings, 1991). In Latin America, the wealthy in the agricultural sector and the industrial sector could lobby jointly to prevent high effective rates of taxation, either through lower tax rates or lax enforcement by government. This made it much more difficult for governments to have a sufficiently wide tax base to financially underwrite institutional innovations such as unemployment insurance, social security and worker retraining that would have made it much easier for the populace to overcome the effects of external economic shocks (Dornbusch and Edwards, 1990). It is this absence of a social compact among contending political and economic groups that has made it much harder for Latin America to insulate its population from economic shocks.[8] Furthermore, most Latin American countries (with the partial exception of Colombia) are relatively nascent democracies with inadequate levels of political participation. This is of relevance, because there is strong econometric evidence to suggest that lack of adequate political participation is correlated with volatility in growth and inflation (Rodrik, 1998b).[9]

8 Political competition within groups in Brazil has often had an ethnic and class dimension that has limited their ability to achieve a compromise and make appropriate adjustments in the face of an external shock (Rodrik, 1998a). Therefore, numerous plans to stabilise the Brazilian economy during the 1980s were only tried half-heartedly as a political "war of attrition" resulted in successively higher inflation until it topped 2,000% in 1990.

9 Acemoglu et al. (2003) show that countries with imperfect political institutions are often plagued by much more volatile economic policies.

The contrasting experiences of South Korea and Indonesia tell a similar story. South Korea is a relatively egalitarian society with few regional or ethnic cleavages and with a well-established (if small) safety net. In contrast, in the 1990s Indonesia was an ethnically and geographically diverse country with few institutions of conflict management, either at the political level (being an authoritarian one-party state) or at the economic level (no de facto safety net). Not surprisingly, Indonesia suffered through a political revolution, while South Korea managed to adapt and prosper.

More recently, the ongoing Greek debt crisis also suggests that a country's institutions of conflict management are important. Kollintzas and Vassilatos (2012) argue that there are fundamental fissures in Greek society, not only between the elite (the "insiders" in their terminology) and the populace (the "outsiders"), but also within the elite itself. Eurozone membership resulted in greater access to capital and funds for Greece. The way these conflicts were resolved was through the political parties, unions and bureaucracy by increasing wages and hiring in the public sector. As Kollintzas and Vassilatos point out, wages in the government sector in Greece were 60% higher than the euro area average and more than twice the country's private-sector wage rate. The cost of high wages was exacerbated by the fact that the Greek public sector witnessed a significant rise in employment, so that on the eve of the crisis its relative size was much greater than in the rest of Europe. This lack of institutional checks and balances on the expenditure side was compounded by poor accountability and a lack of effort on the revenue side.

Kollintzas and Vassilatos (2012) argue that the effective tax rate in Greece is half that of the rest of Europe. The absence of effective institutions for conflict management ensured that when the fiscal situation changed and the government was forced to cut subsidies and limit public-sector handouts there was a political crisis, with no government capable of getting the squabbling political factions to agree to a deal. As a result, Greece has since suffered through government turnover, political and social unrest and a rise in ultra-nationalist and anti-immigrant political parties, such as Golden Dawn.

3.2 Globalisation, growth and governance

Globalisation is a double-edged sword. It can help or hinder a country's prospects of adjustment and recovery from an economic shock. Of course, the impact will depend not only on the nature of globalisation (in trade, capital flows, migration and so on), but also on the specific mix of local and global factors that can drive recovery and growth within a country.

On the one hand, globalisation makes a country vulnerable to terms-of-trade shocks. Similarly, an unexpected rise in interest rates or a banking crisis in the United States, for example, can trigger capital flight into or out of a country. Hence, a country that is better integrated into the world economy is more vulnerable to the transmission of international shocks. However, if the country is suffering, in particular, from economic problems whose origins are domestic, then a globalised economy is at a considerable advantage. Indeed, China can take advantage of strong global demand for its products even when the domestic economy is in a slump. Therefore, whether a country recovers and adjusts relatively fast or not depends (in part) on the global context, namely whether the recession is local or global. During the Asian currency crisis, for example, South Korea found it relatively easy to adjust and recover since there was a strong global demand for its exports.

The relationship between the forces of globalisation and governance has been the focus of considerable attention in recent years. One view (Summers, 2000; Obstfeld, 1998) is that globalisation has a positive impact on governance. Proponents of this view argue that in a globalising world where information is freely available and capital is mobile, governments are forced to be more disciplined and governance is improved. In essence, this is the moral hazard argument. The threat of capital flight can act as a stick, forcing governments to improve budgetary discipline and improve governance. Indeed, recent empirical work by Kose et al. (2006) and Mishkin (2007) suggests that the main benefits from the globalisation of capital flows are "collateral", such as improved market discipline and good governance.

In contrast, a more skeptical view regarding the impact of globalisation on governance is held by Rodrik and Subramaniam (2009), Stiglitz (2010) and Krugman (2000). They argue that the globalisation of capital flows can provide the wrong incentives to governments and actually result in indiscipline and (mis)governance. These two sharply differing views on the incentive effects of globalisation are difficult to reconcile. In part this is because the relationship between globalisation and good governance is a complex one and the empirical evidence on this issue, in so far as it exists, is rather mixed. In this context, an issue of interest is whether globalisation and the threat of capital flight can "discipline" countries and promote "good" governance. This question is raised by Blouin et al. (2011), who develop a conceptual framework to address this issue.

The theoretical framework has two key features. First, it allows for a country's institutions of governance to be imperfect. Besley and Persson (2011) identify an inefficiency that lies at the heart of all decision-making within government – an inability by governmental actors to pre-commit to enacting efficient policies. However, the framework also allows for another commitment problem – this time with respect to investors. In particular, it assumes that investors are unable to pre-commit to retaining investment in the host country. In other words, in the light of new information investors may either keep their investment or engage in capital flight. The framework then analyses the impact on governance of the globalisation of capital in the context of these twin commitment problems.

In this framework, the globalisation of capital (driven by the lower costs of international capital mobility) can exacerbate the threat of capital flight. It demonstrates that the key relationship to be analysed is how this increased threat of capital flight affects the incentive problem that plagues much of governmental decision-making. On the one hand, it shows that the exacerbated threat of capital flight may constrain the set of actions taken by the government. Indeed, in doing so, the globalisation of capital may shackle governments in a "golden straitjacket" and have a positive "incentive" effect on decision-making within government. This suggests that the standard view about the disciplining role of globalisation may indeed be correct.

On the other hand, it seems a more nuanced view is also in order. It is not merely the increased threat of capital flight which accompanies the globalisation of capital that is of relevance. Rather, the impact of globalisation on incentives within government depends on the structure of the country's economy. If a country has strong economic fundamentals (for example, a structurally diversified export sector) and is less sensitive to random shocks in the global economy, then globalisation is likely to have a positive incentive effect.

The globalisation of capital works as a "discipline" device so long as capital flight is mainly triggered by actions within government and is not caused by the volatility of the global economy. In contrast, if random changes in the external environment have the potential to provoke capital flight, then this may have perverse effects. In this case, the threat of capital flight overly disciplines governments, resulting in a negative incentive "effect" and (mis)governance. This is key, since it suggests that the impact of globalisation on governance can go either way.

Blouin et al. (2011) further analyse the predictions of the framework using the 1994 Mexican currency crisis, which resulted in an increase in uncertainty in international financial markets. They find evidence to support the prediction that the impact of this uncertainty on governance would be highest for those countries that are perceived to be "similar" to Mexico and have relatively weak institutional "state capacity".

The extent to which capital controls are appropriate has been central to the debate on the design of the international financial architecture. The position of the IMF for most of the past two decades has been clear: a country can only reap the gains of financial globalisation if capital controls are reduced or scrapped. This view has been echoed by many economists, including Edwards (1999) and Dornbusch and Edwards (1998). In contrast, Rodrik (1998a), Bhagwati (1998) and Eichengreen (2001) are much more sympathetic to the idea of imposing restrictions on capital mobility. More recently, an IMF Staff Position Paper (2010) suggested an evolution in the Fund's thinking, arguing that under some conditions capital controls can well be part of a policymaker's toolkit. This picture is further muddied by the fact that the empirical evidence does not offer a clear answer. Blouin et al. (2011) argue that the absence of consensus (at a theoretical as well as an empirical level) on the usefulness of capital controls is understandable, as arguments made by both sides of the debate may be of relevance. Two factors are important: the quality of a country's institutional state capacity and the overall uncertainty in the external economic environment. Arguments for controls are strongest perhaps when a country's institutional state capacity is relatively weak and the country is vulnerable to capital flight arising from an uncertain and volatile global economic environment. As a result, the adoption of capital controls is recommended in a specific set of circumstances.

4. Political mechanism design and institutional reform

What institutional and policy innovations will facilitate recovery in the face of a negative shock? An important message of this chapter is that all policy recommendations should have two dimensions. The first is the policy recommendation that describes the first-best policy on an explicit normative criterion. However, any such policy should be extended to account explicitly for existing political constraints. There is, of course, a view held by many in the Chicago school of economics (see Stigler, 1971) that if there was a politically feasible welfare-enhancing policy, it would already be in place, but this is questionable. Indeed, there are low-hanging fruits to be picked, and the role of economists should be to help policymakers find them and assist with institutional design, aiming to reduce (but *not* eliminate) existing political constraints. It is in this spirit that the following general observations about the art (and science) of policymaking and institutional design are made.

Policy adjustment and reform are particularly difficult in periods of economic crisis. First, national income declines, and this results in much greater competition for dividing up a smaller pie. In addition, economic reform creates winners and losers, and the distributional implications engender conflict and political impediments. Potential losers from reform will vote and lobby to prevent reform being enacted. At first glance, therefore, one may presume that the institutions best suited for an efficient response to an economic crisis are those that enable political actors to circumvent these political constraints, but that would be a mistake. Political institutions that enable the credible compensation of losers by the winners of reforms would not just be efficient but also Pareto improving.

However, there are a variety of factors that make it difficult for policymakers to achieve the Pareto outcome. First, the challenge faced by policymakers is how to design a credible tax-transfer mechanism when they lack adequate information. In particular, it may be difficult to gauge the size of the gains or losses that an individual experiences. If government cannot easily evaluate the size of the gains or losses, it becomes impossible to design an efficient tax-transfer mechanism to ensure that the winners compensate the losers. This is because the winners will have an incentive to hide their winnings and losers will tend to exaggerate their losses. Second, it is particularly difficult for the policymaker credibly to promise that the winners will compensate the losers and not attempt to lobby or influence the political process in their favour.

However, the challenge faced by policymakers extends beyond the adequate design of compensatory transfers. In particular, policymaking is by its very nature rife with uncertainty. A priori, it may not be clear whether the policy is efficient in the first place. If policymakers are able to use institutional procedures to sidestep political constraints, then it may result in the implementation of inefficient policies. After all, an authoritarian ruler can enact policies (including reform) without any political resistance. Political constraints serve an important informational purpose, providing information to policymakers that the reform is inefficient – that there will be too many losers, or that the losers will not be compensated. For example, the military draft in the Unite States was eliminated after the Vietnam war because it made it politically difficult to wage war – especially in those places where the national interest was not self-evident. This is because the draft forced ordinary citizens to learn about how the war was progressing and to assess how appropriate it was. Indeed, in the absence of a draft, the general public can easily insulate itself from the costs of a military conflict, and this makes it easier for governments to wage wars, even if they are inefficient. The absence of institutional checks and balances, therefore, can be politically costly (Acemoglu, Robinson and Torvik, 2011).

Arguably, the adoption of the European Constitution has been engineered by an elite determined to circumvent political resistance to aspects of the EU project at the country-wide level. This may have been helpful politically for the elite, but it resulted in a European project that was sometimes lacking in popular legitimacy. The absence of political constraints may well have exacerbated the European crisis and made it more difficult for member countries to reform. At the same time, political constraints are generally possible to overcome, and losers should not have complete veto power. The president of the United States cannot enact policy without the consent of Congress. As the wrangle in Congress over the budget deficit showed in August and September 2012, political constraints that are too high result in the opposite problem – it

becomes too difficult to enact reform. Ideally, therefore, institutions should be designed to ensure that political constraints are neither too high nor too low.

So, how can the design of institutions facilitate the introduction of economic reforms? The most fundamental challenge is one of commitment of compensation. Of course, a first-order institutional innovation that provides some degree of commitment is provided by the introduction of democracy itself. As Acemoglu and Robinson (2000) have argued, democracies are political institutions that ensure that the median voter's tax-transfer preferences are implemented.

It is much more difficult to ensure that a political leader in an authoritarian country can be induced to implement economic reforms. One strategy is the use of network externalities. For example, in the case of the EU, the main advantage of becoming a member is a reduction in the transaction costs of trade and investment. The main benefit of staying outside the EU is the ability of a country to conduct an independent monetary and fiscal policy. As more countries join the EU, the direct benefit of membership goes up, since it provides access to a potentially larger market. However, what is striking is that even if these benefits were negligible, there may be a greater incentive to join the EU for countries outside the bloc, since joiners can transmit larger common shocks to non-member countries. As the EU becomes larger, it becomes increasingly costly to remain outside, and political leaders may feel trapped into joining an institution such as the EU, even though, initially, it may not have been in the country's interest.

A second strategy is to take advantage of an authoritarian leader's (shorter) time horizon, especially if it is in a period of political uncertainty. It may then be possible to get the leader to agree to a policy change well into the future in exchange for a monetary or political bribe today. The question, however, is how to ensure that the political leader does not change his or her mind in the future. The example of a political leader who has promised to support a future environmental treaty can be instructive. If in exchange for an incentive by, say, the World Bank the leader changes the legislation to make it easier for companies to operate in the "green" sector, firms will enter this sector and grow and become economically powerful. In future, if the political leader then decides not to support the environmental legislation, he or she can be lobbied by the green sector in the country to adhere to earlier promises.

In the context of democratic institutions, there are a few general strategies to increase political support for economic reform. First, the sequencing of reforms can be important. Typically, most economic reforms are a number of policies that have been bundled together. For instance, the initial success of a reform programme can either strengthen or weaken the support for its continuation (Roland, 2000; Jain et al., 2011). In this case, it is important that leaders build on the success of the initial phase to generate political support for subsequent stages of the reform package. Second, it helps if governments can design reform in a way so as to ensure that rents are preserved for those who are already in the system. This helps to diffuse political opposition and, indeed, is the strategy pursued by China with regard to the agricultural sector. China was successful in reforming the agricultural sector by introducing dual-track reform. Rents were preserved under the old system, but reforms were introduced for new entrants, and this "grandfathering" of individuals earning rents helped to diffuse political resistance to the reform and made it politically sustainable.

5. Policy conclusions

- The global financial crisis of 2008 had a dramatic and adverse impact on economic growth across the developed world. The response in the developing world was quite heterogeneous, with some emerging-market countries recovering relatively quickly and others suffering from a prolonged recession. However, even in the more successful countries it has been increasingly difficult to sustain high growth rates. As this chapter has emphasised, a country's policy response is driven by the nature of the political institutions that underpin economic policymaking and how the crisis affects the underlying political equilibrium. Given the heterogeneity in the factors that underpin the political equilibrium as well as the intensity of economic shocks, it is not surprising that economic recovery has varied greatly across countries.
- It is important to stress, therefore, that there are no one-size-fits-all recipes that can be suitable for every developing country. Indeed, the appropriate policy response to an economic crisis is unlikely to be identical across countries. This is because countries' institutions, culture and social norms inevitably differ a great deal. Even though economic principles are uniform, the "appropriate" policy is intermediated through these local institutional realities. As a result, it is essential to treat policy recommendations and diktat for institutional reform from the IMF or others with some caution. Countries will have to continue to experiment, and it is only through trial and error that it will be possible to know with absolute certainty what is the appropriate policy response. However, it is clear that countries need time, and policymakers need political space to experiment and to work out the most appropriate way forward. It is important, therefore, that countries develop good institutions of conflict resolution, as these will help leaders to buy time to experiment and to avoid taking a myopic view when crafting the optimal policy response to an economic shock.

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