# Unexpected Outcomes

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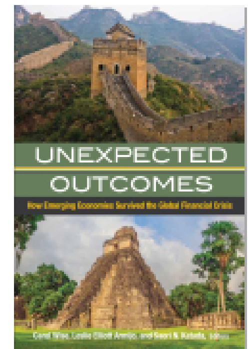


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# 1 *The Puzzle*

One of the more surprising features of the 2008–09 global financial crisis was the comparative ease with which emerging economies in Asia and Latin America rebounded. That rebound was a radical departure from the effects of previous crises on these regions, be it the decade-long recession wreaked on Latin America by the 1982 debt shocks[1] or the financial crisis that dramatically slowed Asian economies in the late 1990s.[2] The quick recovery of emerging economies in 2010–12 was, moreover, instrumental in deterring a full-blown global depression. The lingering phenomenon of the "Great Recession" has largely been limited to the wealthier members of the Organization for Economic Cooperation and Development. Most emerging economies, with the notable exception of those in Eastern Europe, weathered the crisis reasonably well.

The resilience of the emerging economies (EEs) in Asia and Latin America in surviving the global financial crisis (GFC) is all the more striking when one considers the substantial differences that exist among the countries both within and across these regions. The EEs that we consider in this volume differ in terms of size, endowment factors, and the domestic institutions that

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frame economic policymaking. Taking their diversity into account, this introductory chapter summarizes the commonalities and differences among the reforms that they had undertaken before the GFC and the policies that they pursued on the path to recovery in its aftermath. Our focus in this book is on the Pacific Rim, the definition of which we expand to include the important emerging economies of Brazil, Argentina, and India.

This introductory chapter suggests, first, that the ability of these countries as a group to resist the initial financial contagion was due in considerable part to the substantial macroeconomic, financial sector, and trade reforms that EE governments throughout Asia and Latin America had undertaken over the previous two decades. Second, a timely rebound was supported by the implementation of countercyclical policies in major emerging economies.[3] Third, EEs also benefited from some countervailing conditions in the international economy, including high commodity prices since the early 2000s; these conditions were fortuitous, not the result of conscious prior policy choices. Fourth and perhaps most important, old labels used to distinguish neoliberal (market-based)[4] from developmentalist (state-oriented)[5] strategies do not accurately describe the foundations of EE recovery. We argue that policy learning and reforms adopted in response to previous crises prompted EE policymakers to combine both state and market approaches in coping with the GFC.[6] Policy pragmatism trumped ideological rigidity.

## In the Wake of Crisis: What Do the Data Tell Us?

Since the 1980s, calls for financial market deregulation in the United States have arisen on both sides of the political aisle. One result was the passage by Congress of the Financial Services Modernization Act of 1999, which repealed the Glass-Steagall Act of 1933, which had prohibited mergers among investment banks, commercial banks, and insurance companies.[7] The bursting of the dotcom bubble in 2000 followed quickly on the heels of that deregulatory legislation, as did the 9/11 attacks on the United States. Those double recessionary shocks prompted the Federal Reserve to maintain low interest rates from 2000 to 2004, which pumped massive liquidity into both the U.S. economy and global markets.[8] At the same time, newly merged mega-institutions like Citicorp and the Goldman Sachs Group began offering a range of innovative, if not always sound, financial instruments that spurred an unprecedented boom in credit card, personal, and mortgage debt.[9] In 2005 alone, around US$1trillion was issued in interest-only "subprime" mortgages, which

were one of the key financial instruments generated in the new low interest rate environment. However, many of those flexible-rate mortgages fell into default after the Federal Reserve began gradually raising interest rates in 2004–05. The global financial crisis of 2008–09 originated in this high-risk, subprime segment of the U.S. housing market, and it was exacerbated by the creation of various mortgage-backed financial instruments and unregulated derivatives that had attracted investors in the United States and Europe.[10]

Once the U.S. housing bubble burst, the defaults affected heavily leveraged hedge funds as early as the summer of 2007. The crisis quickly spread from the United States and Europe to other parts of the world, driven by massive runs on excessively leveraged private assets, the withdrawal of investments, the sudden collapse of export markets in the advanced economies, and a sharp but temporary decline in commodity prices.[11] As a consequence, according to the World Bank, global growth fell by approximately 5 percentage points from its pre-crisis peak to its trough in 2009, nominal world trade (in U.S. dollars) fell by around 30 percent year-on-year in the first quarter of 2009, and trade volumes fell by more than 15 percent. The magnitude of the losses made this the worst global economic crisis since the 1930s, when the Great Depression spread throughout the world.[12] But the results and pattern of global contagion in this crisis differed from those in previous financial crises in recent decades. Despite initial fears, the emerging economies as a group had a relatively easy go of it and recovered rapidly.

One piece of the puzzle is the fact that poorer countries were already growing faster than those with higher per capita income. Economic theory has long predicted that backward economies, which have considerable absorptive capacity and could ostensibly benefit from imported new technologies, investment capital, and relatively abundant supplies of cheap labor, *should* grow faster than mature industrial economies; however, for many decades they did not.[13] Yet by the late 1990s developing country growth rates were up to the extent that some argued that a "great convergence" was finally under way.[14] Subramanian and Kessler report that, on average, developing countries' growth surpassed that of the United States by about 3.25 percent annually from 2000 to 2007.[15] Table 1-1 shows that in the immediate pre-crisis years of 2005–07, the advanced industrial economies had steady average annual GDP growth of 4.0 percent—but the developing economies grew at an average annual rate of 7.7 percent. Nonetheless, the near universal assumption was that growth in developing economies was both fragile and volatile. Common wisdom held that as long as these economies lagged behind in the implementation of deep structural

Table 1-1. *Crisis and Recovery: Aggregate GDP Growth, Various Economies*[a]
Percent

| *Economy* | *Pre-crisis (2005–07)* | *Crisis (2008–09)* | *Recovery (2010–12)* |
|---|---|---|---|
| World | 5.6 | 0.0 | 3.5 |
| Advanced economies | 4.0 | –1.3 | 2.3 |
| G-7 | 3.7 | –1.5 | 2.3 |
| Developing economies | 7.7 | 1.6 | 4.9 |
| Developing Asia | 9.3 | 3.8 | 6.2 |
| Latin America and the Caribbean | 5.9 | –0.4 | 3.8 |

Sources: Data from International Monetary Fund, *World Economic Outlook*, April 2013.

a. Compound annual growth rates, using purchasing power parity GDP, with aggregates weighted by countries' economic size.

reforms and remained highly dependent on financial inflows from overseas markets, financial crises would continue to plague them. Any subsequent disruptions were expected to be just as severe as those witnessed, for example, in Mexico (1994); Indonesia, Malaysia, Thailand, and South Korea (1997–98); Russia (1998); Brazil (1998–99); and Argentina (2001–02).

Instead, it was the advanced industrial economies that suffered a deep contraction during and long after the global financial crisis. Average annual GDP growth for the countries in the Organization for Economic Cooperation and Development fell to –1.3 percent in 2008–09; the equivalent figure for the G-7 major advanced economies was –1.5 percent. The burden of maintaining global growth had shifted decisively to the developing countries, which grew by an average of 1.6 percent annually on the same GDP-weighted basis in 2008–09. Even Latin America and the Caribbean—which includes Mexico, Central America, and the Caribbean Basin countries, all of which were closely tied to the hard-hit U.S. economy—shrank less than half a percentage point in 2008–09. These patterns hold not merely in the aggregate but for most of the major economies among the advanced industrial, Asian developing, and Latin American developing countries. Among the 14 large emerging economies shown in table 1-2, only Venezuela—which has been the least inclined to implement modernizing reforms since the debt crisis of the 1980s—failed to recover on par with the countries shown in table 1-2.[16]

Nonetheless, this collective emerging market resistance to the 2008–09 shock has not yet resulted in the recuperation of pre-crisis growth rates, and growth recently has slowed in a number of emerging economies in our sample, including Argentina, Brazil, China, India, and Korea.[17] Although this selec-

Table 1-2. *Crisis and Recovery: National GDP Growth, Various Countries*[a]
Percent

| *Country* | *Pre-crisis (2005–07)* | *Crisis (2008–09)* | *Recovery (2010–12)* |
|---|---|---|---|
| Canada | 3.6 | –1.0 | 2.8 |
| France | 3.6 | –1.2 | 1.9 |
| Germany | 4.5 | –2.1 | 2.6 |
| Italy | 3.3 | –2.4 | 0.6 |
| Japan | 3.4 | –2.4 | 1.8 |
| United Kingdom | 4.1 | –1.6 | 1.7 |
| **G-7 mean** | **3.7** | **–1.7** | **2.0** |
| China | 11.0 | 5.0 | 7.0 |
| India | 8.6 | 2.9 | 5.2 |
| Indonesia | 6.0 | 2.7 | 5.6 |
| Korea | 5.5 | 0.6 | 3.2 |
| Malaysia | 6.0 | –0.3 | 4.5 |
| Philippines | 6.0 | 1.0 | 4.8 |
| Thailand | 5.5 | –0.7 | 3.5 |
| **Asian 7 mean**[b] | **6.9** | **1.6** | **4.8** |
| Argentina | 7.8 | 0.9 | 4.9 |
| Brazil | 5.4 | 0.3 | 2.5 |
| Chile | 5.8 | 0.0 | 5.1 |
| Colombia | 6.6 | 1.3 | 4.9 |
| Mexico | 4.9 | –2.6 | 3.9 |
| Peru | 7.6 | 0.9 | 5.7 |
| Venezuela | 6.3 | –3.6 | 0.7 |
| **Latin American 7 mean**[c] | **6.3** | **–0.4** | **4.0** |

Sources: Data from International Monetary Fund, *World Economic Outlook*, April 2013.

a. Compound annual growth rates, using purchasing power parity GDP, with unweighted means.

b. The Asian 7 countries include China, India, Indonesia, Korea, Malaysia, the Philippines, and Thailand.

c. The Latin American 7 countries include Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

tive slowing confirms the need for deeper structural reforms in several countries,[18] it does not negate the unprecedented achievement of developing and emerging economies as a group in rebounding from the global financial crisis. Moreover, although EE post-crisis growth rates have not yet recovered, they remain well above those in the advanced industrial countries when growth is measured both by aggregate rates weighted by economic size (as in table 1-1) and by simple group means (as in table 1-2). Subramanian and

Kessler calculate that in 2010–12 the mean growth rate of developing economies as a group remained about 3 percent above the U.S. growth rate.[19] What explains the resilience of most emerging economies in the face of the most daunting financial crisis to hit the global economy in more than seven decades?

## The Missing Crisis: Contending Explanations

Both Latin America and Asia have had their share of tough times in recovering from earlier disruptions. Most fresh are memories of the "lost decade" in Latin America, which was triggered by the 1982 debt crisis, and the massive downturn in the Asian economies in the aftermath of the Asian financial crisis of the late 1990s.[20] In each case, major internal policy debates took place in economic ministries in Latin America, Asia, and beyond over what went wrong and what could be done to restore stability and growth in these crisis-ridden countries and regions. The standing explanations of these crises in the literature differed with respect to the weight given to domestic/institutional and international/systemic variables as causes of the crises. The domestic/institutional explanation, for example, faulted sovereign borrowers for failing to properly channel funds lent by foreign commercial banks into the kinds of macro-stabilization and microeconomic restructuring projects for which they were ostensibly borrowed; the international/systemic explanation stance blamed private international financiers for imposing the costs of their own poor lending decisions almost solely on borrowers.[21]

The subsequent prescriptions for policy reform offered by each camp were, unsurprisingly, quite different. They also reflected the usual divide between neoliberals, who called for economic opening and more market-based solutions to crises, and developmentalists, who called for more targeted public policies and strategic state intervention. In the end, the need for massive International Monetary Fund–backed bailout packages in both regions—Latin America in the 1980s and Asia in the 1990s—meant that market liberalizers, who dominated the international financial institutions (IFIs) and could impose obligatory conditions on borrowers, prevailed. Most countries were induced to adopt austerity measures in order to make balance-of-payments adjustments. It is that time-worn recipe that gradually morphed into what has been termed the "Washington Consensus,"[22] a package of measures based on liberalization, privatization, and deregulation that by the late 1990s had been

implemented in varying degrees throughout the developing and post-communist world.

In recent debates over the missing crisis in the emerging market countries both during and after 2008–09, both sides seem to be claiming victory. Market-oriented analysts point to the success of prior neoliberal reforms in preparing emerging economies to defend their financial sectors from the kinds of contagion that spread so quickly across emerging markets when the Mexican peso collapsed in 1994 and the Thai baht crashed in 1997.[23] The fact that the recent contagion emanated from the United States and subsequently from Western Europe makes the continued macroeconomic stability and growth within the emerging market countries all the more impressive. Although the global financial crisis highlighted massive market failures in the OECD bloc, the pro-market chorus has been quick to claim the EE rebound as a victory of its own. Meanwhile, those with a more heterodox bent argue that EE staying power in the 2000s rests just as much on strategic interventions and innovative public policies.[24]

Our approach to sorting out some of these claims is intentionally eclectic, drawing on both quantitative and qualitative evidence from the now vast secondary literature and from our case studies. What such a methodology loses in parsimony it gains by bringing together contending explanations that are seldom considered jointly. A second novel element of our analytical strategy is our intentional focus on the experiences of larger emerging economies. Rather than following the typical econometric practice of considering each country's experience as a single observation and assigning equal weight to each in arriving at eventual research findings, we argue that there are both economic and political reasons to pay particular attention to regional leaders and larger economies. Given that regions such as East Asia and South America have trading patterns that are somewhat intraregionally integrated and that economic ideas and practices also diffuse intraregionally, it makes economic sense to focus on the bigger economies. In addition, our interest in evaluating the causal role of pre-crisis government policy choices leads us to concentrate on those countries whose material, cultural, and political capabilities tend to make them sources of regional policy innovation and diffusion.

We have generated three broad hypotheses drawn from the long-running debates over the virtues of policies that lean more heavily toward the market ("neoliberal") and those of more proactive policies undertaken by the state

("developmentalist"). We also consider an alternative explanation: the presence of countervailing international conditions—for example, the decade-long commodity price boom that took off in 2003 and the phenomenon of historically low interest rates in the G-7 bloc since the 2000–03 global recession, both of which have provided readily available liquidity and capital inflows to many EEs. These external factors are less related to national policy choices and obviously cannot be taken for granted in the future. The contending explanations are summarized in table 1-3, which divides each explanation into components plausibly related to surviving the initial shock ("crisis resistance") and those tied to resumption of the respectable growth rates ("crisis recovery") depicted in tables 1-1 and 1-2.

Our first hypothesis suggests that the critical factor in enabling crisis resistance among the majority of Asian and Latin American EEs was the presence of *prior pro-market (neoliberal) macroeconomic reforms.* That is, if economic distortions created by state intervention had been the main source of prolonged economic hardship in developing countries in the past,[25] then the basic package of macroeconomic reforms implemented in the 1990s by a number of East Asian and Latin American countries under the auspices of the Washington Consensus (WC) had given policymakers in those countries the tools necessary to survive the shocks of 2008–09. A related proposition under this same umbrella hypothesis is that prior monetary and fiscal reforms—including reduction in budget deficits, stabilization of inflation, and key institutional reforms, such as granting greater operational independence to central banks—were necessary to give incumbent governments the macroeconomic "space" that they needed to implement the kinds of countercyclical policies that ultimately saved the day for these countries in 2008–09. During earlier crises, heavily indebted national governments across the Pacific Rim were in no position to finance local variants of the countercyclical policies that the United States implemented so forcefully in 2009.[26]

Hypothesis 2, which posits the importance of *prior financial sector reforms,* comes in two versions, one neoliberal and the other developmentalist. The neoliberal version holds that by the time that the global financial crisis struck in 2007–09, emerging economies on both sides of the Pacific had instituted substantial reforms to deepen and liberalize their financial sectors and that those reforms are what accounted for EEs' resilience when the GFC struck. Reforms typically included lowering barriers to entry into the banking sector (and thus reducing oligopolistic rents long enjoyed by domestic commercial banks), freeing interest rates, improving bank balance sheet transparency, and

Table 1-3. *Hypotheses Regarding the Quick Rebound of Emerging Economies*

| *Hypothesis* | *Effects on crisis resistance* | *Effects on crisis recovery* |
|---|---|---|
| 1. Prior (neoliberal) macroeconomic reforms | Strong economies with sound public finances are better able to resist crises. | Fiscal and monetary "space" enables countercyclical policies. |
| 2. Prior financial reforms (neoliberal and/or developmentalist) | Strong, independent central bank and private banks help to avoid twin crises (neoliberal).<br>Foreign exchange reserves can act as a buffer (developmentalist). | State banks speed recovery (developmentalist).<br>Foreign exchange reserves support policy space. |
| 3. Prior trade reforms (neoliberal and/or developmentalist) | An open trade regime bolsters economic growth (neoliberal).<br>State promotion increases exports (developmentalist).<br>Diversified trade reduces vulnerability. | Effects are the same as those for crisis resistance. |
| 4. Countervailing international conditions | Resistance is due to luck more than to explicit emerging economy policies. | Recovery is due to luck more than to emerging economy policies, countercyclical or otherwise. |

Source: Authors' hypotheses.

recapitalizing banks once the problem of nonperforming loans had been adequately addressed.[27] Micro-level reforms in the banking and financial sectors rendered these EEs less susceptible to the "twin crises" of earlier times, which inevitably combined a currency (foreign exchange) shock with a domestic banking crisis.

The developmentalist stance on prior financial reforms holds that along with incremental interest rate liberalization and gradual banking deregulation, the governments of many EEs intentionally retained or created a number of defensive financial policy tools that both limited the effects of the initial crisis and

enabled them to rekindle growth more quickly. One developmentalist financial policy was the setting of some controls on potentially volatile inflows of portfolio capital—for example, by lowering taxes on longer-term, more stable inflows, such as foreign direct investment (FDI).[28] Other policies included building up foreign exchange reserves as insurance against speculative attacks on the currency and relying on state-owned banks to channel fiscal stimulus funds, especially with regard to the implementation of countercyclical policies.[29]

Hypothesis 3 suggests that the critical determining factor was *prior trade reforms,* also undertaken in response to the wave of EE financial crises in the 1980s and 1990s. Neither the mainstream neoliberal nor the developmentalist stance on trade posits a direct relationship between prior trade reforms and the ability to fight off international financial contagion, but two positions can be inferred. As with financial reform, there exists both a neoliberal and a developmentalist concept of trade reform. Far-reaching trade liberalization was a major prong of the pro-market Washington Consensus. In the neoclassical model of market-determined comparative advantage, countries cannot influence their trading patterns nor should they try, because doing so simply introduces inefficiencies. However, the WC assumes that a free trading state will develop a stronger, faster-growing economy than a country less integrated into the global economy. Deep trade integration ("hyperglobalization," in the words of Subramanian and Kessler[30]) ostensibly nurtures strong, resilient economies that are better able to withstand crises.[31]

In contrast, the developmentalist approach to trade assumes a global economy rife with market failures, implying the need for governments to intervene in order to nurture targeted sectors, capture external markets, and reduce economic vulnerabilities. Under such conditions, trade integration must be managed.[32] In particular, it is important for the state to regulate trade with the explicit goal of promoting exports that promise to increase a given country's competitive ranking in the global economy. Although both neoliberals and developmentalists generally support the goal of diversifying exports and trading partners as a way to reduce volatility in the demand for a country's products, the two may differ in how involved the government should be in engineering that outcome.

Each of these three hypotheses assumes that the surprisingly mild crisis experienced in 2008–09 by emerging economies around the Pacific Rim (and by Brazil and India) resulted from deliberate policy choices made by their governments as a result of policy learning from the earlier financial crises (and sometimes external pressure, as with conditions imposed by IFIs). A

fourth hypothesis suggests that the relatively good performance of emerging economies in 2008–09 and thereafter was not a matter of economic policy learning; rather, EEs simply benefited from fortuitous *countervailing external conditions.* That is, the milder effect of the global financial crisis on emerging economies in Asia and Latin America raises the possibility that their quick recovery was due to such global environmental circumstances as high commodity prices and low international interest rates. In other words, the luck of the draw helped to foster EE recovery once financial contagion originating in the United States and Europe had been effectively resisted.

To a great extent, the high-commodity-prices theory reflects the extraordinary rise of China over the past 30 years and the fact that China has reached a stage in its ambitious export-led growth model that now requires massive inputs of such commodities as copper, petroleum, iron ore, fishmeal, and soybeans—precisely those resources that are abundant in Latin America (see table 1-4).[33] The low interest rates argument is the flip side of the enduring difficulties that the advanced industrial countries have experienced in fully recovering from the Great Recession. In other words, the sluggish growth rates that continue to plague the United States and Western Europe (minus Germany) have led to historically unprecedented government decisions to maintain a loose monetary policy in hopes of reviving business activity, investment, and job creation.[34] Coupled with near-zero interest rates in the United States since 2008, this loose monetary policy has provided a strong impetus for massive outflows of private capital into EEs, which have offered yield-seeking investors substantially higher returns. Of course, to rely on capital inflows stimulated by stagnant global growth, a commodity price boom, and countercyclical policies in the major advanced economies is a very risky and unreliable strategy. In the country case studies that follow, only Argentina flirted with this option in the post-GFC period, with results that were less than appealing.

## Plan of the Book

Again, our approach here is eclectic. Although we acknowledge the substantial differences in historical development trajectories and policy choices among the countries chosen here, what unites them is a subtle yet important similarity in their policy responses to the global financial crisis. While their responses themselves defy neat categorization, the overall trend since the GFC and thereafter has been toward adopting pragmatic and flexible policies, not

Table 1-4. *Annual Commodity Price Trends in Real Dollars, 2000–13*

| *Year* | *Copper ($/metric ton)* | *Crude oil ($/ barrel)* | *Soybeans ($/metric ton)* | *Iron ore ($/dry metric ton)* | *Fishmeal ($/metric ton)* |
|---|---|---|---|---|---|
| 2000 | 2,279.38 | 35.48 | 266.26 | 36.19 | 519.11 |
| 2001 | 2,061.05 | 31.80 | 255.73 | 39.22 | 635.53 |
| 2002 | 2,060.54 | 32.94 | 281.00 | 38.73 | 800.60 |
| 2003 | 2,234.60 | 36.30 | 331.58 | 40.13 | 767.05 |
| 2004 | 3,370.60 | 44.38 | 360.48 | 44.57 | 762.81 |
| 2005 | 4,194.64 | 60.88 | 313.20 | 74.11 | 833.43 |
| 2006 | 7,475.17 | 71.49 | 298.74 | 77.10 | 1,296.99 |
| 2007 | 7,459.13 | 74.52 | 402.44 | 128.88 | 1,233.63 |
| 2008 | 6,764.19 | 94.32 | 508.43 | 151.69 | 1,101.86 |
| 2009 | 5,338.61 | 64.02 | 452.94 | 82.91 | 1,275.37 |
| 2010 | 7,534.78 | 79.04 | 449.80 | 145.86 | 1,687.50 |
| 2011 | 8,103.66 | 95.47 | 496.29 | 153.99 | 1,411.24 |
| 2012 | 7,400.30 | 97.60 | 549.67 | 119.43 | 1,448.33 |
| 2013 | 6,913.32 | 98.13 | 507.66 | 127.63 | 1,647.37 |

Source: World Bank Global Economic Monitor (GEM) Commodities (http://databank.worldbank.org/data/views/variableselection/selectvariables.aspx?source=global-economic-monitor-%28gem%29-commodities).

some of the staunch dogmas that prevailed during earlier times. We begin with the Asian case studies, including separate chapters on China, Korea, and India and a fourth chapter that analyzes the economic performance and policy responses of countries within the Southeast Asian bloc. We then turn to the Latin American cases, beginning with a chapter that provides a view of the region as a whole vis-à-vis the GFC. That is followed by two chapters on the top EEs in the region, one comparing the responses of Argentina and Brazil to the crisis and the other analyzing Mexico's response.

Why begin with China? Because it has become the top emerging market destination for foreign direct investment and has risen to the upper ranks of world trade more quickly than any other developing country in the post–World War II period. Especially since its accession in 2001 to the World Trade Organization (WTO), China has engaged economically—through trade, loans, aid, and investment—in every region of the global economy, in developed and developing countries alike, and it currently accounts for about 25 percent of world reserves. In a matter of just a decade, China has displaced Germany as the top exporter of goods to the rest of the world and in the

process "has gone from being one of the most insignificant high-technology exporters to the number-one high-technology manufacturer in the world."[35] In the heat of the 2008–09 crisis, China's fiscal stimulus effort was on par—in absolute terms and as a share of domestic GDP—with the stimulus packages implemented by the United States, Germany, and Japan.

China has thus mattered immensely for the recovery of the global economy since the 2008–09 debacle. In contrast with the shocks of the global financial crisis in the other Asian cases examined here, the shocks to China's economy were transmitted through a drop in demand for exports to Europe and North America rather than through the financial system. As table 1-5 shows, China's total trade (exports and imports) with Europe accounted for 19.7 percent of China's total trade in 2007 but dropped to 17.7 percent by 2012. China's trade with North America, which stood at 15.3 percent of total Chinese trade in 2007, was down to 13.9 percent by 2012. In chapter 2, Shaun Breslin notes that the Chinese Communist Party leadership had already expressed the need to modify the country's long-standing policy of export-led growth in order to foster more efficient domestic investment and spur domestic consumption. Other negative offshoots of the prevailing development strategy—including rampant corruption, dire pollution, and rising income inequality—also brought the government's single-minded focus on export-led growth into question. Although the GFC was both a trade shock for China and a confirmation of the need to shift the focus of the country's development strategy, Breslin emphasizes that the responses of the Chinese leadership were on the financial side, akin to those of other countries analyzed in this volume.

Breslin assesses how the hypotheses presented earlier in this chapter hold up in the Chinese case. Fearing social instability if an economic slowdown were to trigger widespread unemployment, the Chinese authorities moved quickly to implement a vast stimulus package that the International Monetary Fund declared a "quick, determined, and effective" response to the crisis.[36] That, Breslin argues, could not have occurred in the absence of credible macroeconomic reforms prior to the global financial crisis. Moreover, the previous implementation of financial sector and banking reforms enabled the disbursement of the stimulus funds through state-held domestic banks and other financial levers controlled by the government. Ironically, even though China's countercyclical policy responses to the GFC failed to follow neoliberal prescriptions, the strategy worked and even won praise from the IFIs. As other chapters in this volume show, China's rapid recovery was a boost for some of the other EEs in both Asia and South America.

Table 1-5. *Distribution of China's Trade with the World*

Percent

| *Country/region* | *2000* | *2001* | *2002* | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *2012* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Destination of China's exports* | | | | | | | | | | | | | |
| Asia | 53.1 | 53.0 | 52.6 | 50.8 | 49.8 | 48.1 | 47.0 | 46.6 | 46.4 | 47.3 | 46.4 | 47.4 | 49.1 |
| Africa | 2.0 | 2.3 | 2.1 | 2.3 | 2.3 | 2.5 | 2.8 | 3.1 | 3.6 | 4.0 | 3.8 | 3.8 | 4.2 |
| Europe | 18.3 | 18.5 | 17.9 | 20.1 | 20.6 | 21.7 | 22.2 | 23.6 | 24.0 | 22.0 | 22.5 | 21.8 | 19.3 |
| Latin America and the Caribbean | 2.9 | 3.1 | 2.9 | 2.7 | 3.1 | 3.1 | 3.7 | 4.2 | 5.0 | 4.8 | 5.8 | 6.4 | 6.6 |
| North America | 22.2 | 21.7 | 22.8 | 22.4 | 22.5 | 22.9 | 22.6 | 20.7 | 19.2 | 19.9 | 19.4 | 18.4 | 18.6 |
| Oceania | 1.6 | 1.5 | 1.6 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.8 | 2.1 | 2.1 | 2.2 | 2.2 |
| *Origin of China's imports* | *2000* | *2001* | *2002* | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *2012* |
| Asia | 62.8 | 60.4 | 65.0 | 66.1 | 65.8 | 66.9 | 66.4 | 64.9 | 62.0 | 60.0 | 59.9 | 57.8 | 57.3 |
| Africa | 2.5 | 2.0 | 1.8 | 2.0 | 2.8 | 3.2 | 3.6 | 3.8 | 4.9 | 4.3 | 4.8 | 5.4 | 6.2 |
| Europe | 18.1 | 19.9 | 17.6 | 16.9 | 15.9 | 14.6 | 14.5 | 14.6 | 14.8 | 16.1 | 15.6 | 16.5 | 15.8 |
| Latin America and the Caribbean | 2.4 | 2.8 | 2.8 | 3.6 | 3.9 | 4.1 | 4.3 | 5.3 | 6.3 | 6.4 | 6.6 | 6.9 | 7.0 |
| North America | 11.6 | 12.4 | 10.5 | 9.3 | 9.3 | 8.5 | 8.5 | 8.4 | 8.3 | 8.9 | 8.4 | 8.3 | 8.6 |
| Oceania | 2.6 | 2.6 | 2.3 | 2.1 | 2.4 | 2.7 | 2.7 | 3.0 | 3.6 | 4.2 | 4.7 | 5.1 | 5.1 |
| *Percent of total China trade* | *2000* | *2001* | *2002* | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *2012* |
| Asia | 57.7 | 56.5 | 58.5 | 58.2 | 57.6 | 56.8 | 55.7 | 54.6 | 53.3 | 53.1 | 52.7 | 52.3 | 53.0 |
| Africa | 2.2 | 2.1 | 2.0 | 2.2 | 2.6 | 2.8 | 3.2 | 3.4 | 4.2 | 4.1 | 4.3 | 4.6 | 5.1 |
| Europe | 18.2 | 19.2 | 17.8 | 18.6 | 18.3 | 18.4 | 18.8 | 19.7 | 20.0 | 19.3 | 19.3 | 19.3 | 17.7 |
| Latin America and the Caribbean | 2.7 | 2.9 | 2.9 | 3.2 | 3.5 | 3.5 | 4.0 | 4.7 | 5.6 | 5.5 | 6.2 | 6.6 | 6.8 |
| North America | 17.2 | 17.2 | 16.9 | 16.0 | 16.0 | 16.2 | 16.2 | 15.3 | 14.4 | 14.9 | 14.2 | 13.6 | 13.9 |
| Oceania | 2.1 | 2.0 | 2.0 | 1.9 | 2.0 | 2.2 | 2.1 | 2.3 | 2.6 | 3.1 | 3.3 | 3.6 | 3.5 |

Source: Calculation based on Comprehensive Economic, Industry and Corporate Data (CEIC Data) (www.ceicdata.com).

In South Korea, which Barbara Stallings writes about in chapter 3, the drastic fiscal and monetary contraction (largely imposed by the IFIs) that the country experienced in the throes of the Asian financial crisis (AFC) stands in striking contrast to its much milder experience in 2008–09. The formidable macroeconomic and financial sector reforms undertaken by the government in the decade following the AFC makes this perhaps the strongest example of policy learning in this volume. The Korean case also exhibits a compelling combination of developmentalist strategies from the 1960s through the mid-1990s, followed by deep market-based reforms from the late 1990s onward. Although near-complete financial liberalization had left Korea vulnerable to capital outflows when the global financial crisis struck and the country's GDP plummeted for three economic quarters beginning in late 2008, the government was on solid ground when it came to confronting the crisis. The emergency bank restructuring implemented in the aftermath of the Asian financial crisis was one vital factor, because, as a result of restructuring, the financial sector had strong capital adequacy, a low level of nonperforming loans, and few toxic assets going into the global financial crisis.

Korea's previously tight monetary policy also gave the government the leeway necessary to lower interest rates at the height of the external shock. Like the other countries analyzed here, Korea was sitting on an arsenal of foreign exchange reserves, and policymakers stood ready to deploy them to combat financial contagion. The government infused a fiscal stimulus into the economy that was second only to China's stimulus among the Asian EEs; in addition, like China, Korea relied on its policy banks to implement countercyclical measures to fend off shocks from the GFC. Stallings points to the country's recently rediscovered tradition of macroprudential management, reflected in its surplus position in both the current account and the national budget, as crucial to its ability to quickly rebound from the GFC. On the trade side, Korea was able to rely on China, which became its top trading partner in 2004, and Chinese demand for Korean exports helped to offset the drop in demand from Europe and the United States. Stallings notes that because its liberal economy was so well run and because government officials were willing to act assertively when the need arose, Korea was able to weather the GFC successfully.

India sits at the other end of the continuum from Korea and to a certain extent from China. In the two latter countries, domestic politics was obviously an important consideration when it came to quelling the impact of the GFC. However, in India, they were at center stage. In addition, India's reform timeline

was much shorter than that of China or of Korea, as the country did not embark on a serious program of market reform and structural adjustment until the early 1990s. As a result, there was a considerable backlog of reforms to be made, along with serious rifts within the political and policymaking establishment over whether further reforms should take a developmentalist or a neoliberal direction. Furthermore, there was a good deal of acrimony over the pace at which reforms should be enacted. For most of the 2000s, the prevailing government coalition resisted liberalization and deep reform of the banking and financial sector. On the upside, the virtually nonexistent exposure of Indian banks and financial entities to the mortgage-backed securities and other toxic assets that originated on Wall Street in the 2000s meant that financial contagion was readily resisted when the GFC struck. On the downside, the severe credit crunch in Europe and the United States left India's trading companies and other corporate institutions scrambling to secure credit.

On the political front, John Echeverri-Gent details in chapter 4 how the timing of India's national elections coincided with the outbreak of the global financial crisis. In anticipation of the vote, the government had already adopted an expansionary economic policy; as a result, the Reserve Bank of India (RBI) was able to maintain the policy already in place when the GFC hit, and that amounted to a considerable fiscal stimulus. Monetary expansion, however, was not painless: it led to mounting deficits, persistent inflation, a dramatic depreciation of the rupee, and abrupt outflows of portfolio investment. The RBI responded, among other ways, by raising the interest rate ceiling on foreign currency deposits and easing restrictions on external commercial borrowing. The policy responses were far from perfect, but the Indian economy did rebound from the crisis until growth slowed in 2012. India's quick recovery was assisted by a heterodox—and largely fortuitous—policy mix that combined cautious prior liberalizing reforms; credit extended through state banks; prior trade liberalization that had reoriented trade away from the recessionary North Atlantic countries and more toward Asia; election-related debt waivers; and public works employment projects. As with the other countries profiled in this volume, it helped considerably to have some macroeconomic room to maneuver.

The final Asian chapter in the volume covers the experiences of the Southeast Asian countries, which are smaller and less developed that the countries discussed thus far. In chapter 5 Mark Beeson describes the ten countries that belong to the Association of Southeast Asian Nations (ASEAN) as being more politically, economically, and ethnically diverse than their larger Asian neighbors.[37] The three largest ASEAN countries—Indonesia, Malaysia, and Thai-

land—were also the ones most stricken by the AFC in 1997–98. Like Korea, these countries exhibited some policy learning from their AFC experience. Each had accumulated significant foreign currency reserves and had the wherewithal to avoid a repeat of the twin banking and currency crises that sent all of them into a tailspin in the late 1990s. Still, Beeson emphasizes that most of these countries had very limited scope for adopting creative emergency policies to fend off the GFC.

Instead, the ASEAN bloc was able to ride out the 2008–09 crisis on the tailwinds of the large fiscal stimulus packages deployed by both China and Japan. Its ability to take that approach was facilitated by the increased integration of these countries into cross-border production of manufactured goods and intra-industry trade involving primarily the Chinese market. Table 1-5 shows that China's total trade with Asia held steady from 2008 to 2012. In 2010, the China-ASEAN Free Trade Area (CAFTA) had gone into effect, which reduced average weighted tariffs on covered goods down to less than 1 percent across CAFTA. Much of that trade is embedded in global production chains, and most countries in Southeast Asia still rely heavily on the United States and Europe to import their finished products. But despite the region's high external economic integration and heightened dependence on the Chinese market, China's recovery had positive multiplier effects for this smaller group of nations. Unfortunately, the reverse also holds true: in the event of an AFC-style crash in China, the economies of these Southeast Asian countries would be severely tested.

The Latin American cases are introduced in chapter 6 in an overview of the region by Eric Hershberg that emphasizes how widely these countries vary in terms of their development, ongoing economic strategies, and responses to the global financial crisis. Despite its diversity, Latin America differs from the similarly heterogeneous Asian bloc in at least two main ways. First, it has shown a stronger affinity for WC-style reforms since the early 1990s, with Chile, Mexico, and Peru leading the pack. Many Latin American countries implemented much of the WC agenda by reducing public debt, slashing trade protections, deregulating commercial banks, and promoting deeper stock markets. Yet when the dust had finally settled on the GFC, Latin American policy responses, in general, reflected the flexibility and pragmatism that previously had been more emblematic of the Asian EEs.

A second contrast with Asia is that Latin America has, on average, benefited greatly from the decade-long commodity boom that took off in 2003. Especially for such South American countries as Argentina, Brazil, Chile, and Peru,

the sale of the commodities that appear in table 1-4 was a huge boon. With China as their main customer, all four countries have lessened their trade dependence on the U.S. market. But not all of these lottery winners kept their wits about them when the global financial crisis struck. Brazil, Chile, Colombia, and Peru did best; all had undertaken prior macroeconomic reforms and considerable financial sector modernization and had achieved some trade diversification, including by strengthening their commercial ties with China. With high reserves, current account and budgetary surpluses, and the cultivation of strong technocratic expertise, these countries led in crafting effective countercyclical policy packages in 2008–09. Argentina and Venezuela, on the other hand, continued with the same populist, expansionary policies that they had embraced off and on for the past two decades. That approach served to mitigate the shocks from the crisis, but it was hardly cohesive and did little to put either country on the path to sustainable growth.

Hershberg also stresses that the effect of the global financial crisis on Mexico, Central America, and some of the Caribbean countries was much less benign and their recovery was slower. That is partly because these countries are bound more closely to the U.S. market and therefore were on the frontlines of the contagion that spread so quickly in 2008. For the countries in this group, the shocks were transmitted largely through the abrupt contraction in trade and remittances, and Mexico was the hardest hit. Its lack of excess commodities to sell to China and the massive flow of Chinese manufactured imports into the country since the advent of the 2000s has placed tremendous stress on Mexico's current account for the past decade. Remarkably, Mexican policymakers actually raised interest rates and adopted procyclical policies when the GFC erupted—an ironic response, since deep macroeconomic and banking sector reforms in the 1990s meant that Mexico was well-positioned to adopt the full range of countercyclical measures undertaken by its South American counterparts. A severe recession finally led the government to loosen its monetary and fiscal policy, but some of the country's excess economic pain was self-inflicted.

The final two chapters on Latin American EEs elaborate on the cases of Argentina, Brazil, and Mexico. In chapter 7, Carol Wise and Maria Antonieta Del Tedesco Lins undertake a comparative political economy analysis of prior reforms and domestic policy responses to the global financial crisis of Brazil and Argentina. Whereas Brazil has stuck with a more gradual strategy of economic opening and structural reform since 1994, Argentina embraced a more

rapid implementation of market reforms along the lines of the Washington Consensus in the early 1990s. Brazil thus moved steadily toward reform of its banking and financial sector and adoption of macroprudential measures such as inflation targeting, fiscal overhaul, and a floating exchange rate. Argentina, on the other hand, resorted to a fixed exchange rate from 1991 to 2001 that distracted from the kinds of fiscal, monetary, and overall macroprudential reforms that served its South American neighbors so well in the throes of the GFC. Wise and Lins emphasize that despite Argentina's 2001–02 financial meltdown, the country's policy learning curve from the 1990s still accounted for the government's ability to survive the GFC; moreover, thanks to the commodity lottery, up until the crisis Argentina had succeeded in balancing its budget, achieving equilibrium in its external accounts, and rallying a large fiscal stimulus when the crisis hit.

But this is where Brazil and Argentina part ways. Despite the global financial crisis, Brazilian policymakers never lost sight of the macroprudential goals that they had set for themselves back in the 1990s.[38] To combat inflation, monetary policy remained tight and measures were imposed to deter speculative capital inflows. Fiscal policy was lenient, and Brazil's national development bank (BNDES) was tasked with infusing liquidity into the real economy through the country's public banks. Brazil, in other words, implemented a pragmatic combination of state and market-based policies to weather the worst of the GFC. Wise and Lins argue that while Argentina still had a chance to get back on the path to macro-stability with steady growth when the crisis erupted, it instead continued a populist-style spending spree that eradicated any semblance of equilibrium. Old-fashioned financial repression has set in, including negative interest rates, double-digit inflation, multiple exchange rates, and controls on capital outflows. The slowing of growth in Brazil since 2012 suggests the need for a further round of structural reforms to address the impediments to productivity and efficiency. The same could be said for Argentina, although political leaders and policymakers there appear to have simply given up on the notion of structural reform for the time being.

The final chapter is Gerardo Esquivel's examination of Mexico. In chapter 8, Esquivel focuses less on pre-crisis reforms than on fortuitous—and largely favorable—external factors that affected Mexico's economy during the first decade of the 2000s, including strong economic growth in the United States, rising oil prices, and high remittances from Mexicans living and working abroad. These positive factors bolstered Mexico's balance of payments

and fostered the accumulation of foreign exchange reserves. However, given the dependence of the country's exports on the U.S. market and the sharp contraction in U.S. consumer demand, the global financial crisis hit the Mexican economy disproportionately hard. Esquivel argues that despite the sharp contraction, Mexican policymakers underestimated the magnitude of the crisis and therefore took far too long to act.

Despite praise for Mexico's eventual economic recovery and strong growth in 2010–12, Esquivel cautions that unemployment is still high and per capita output is anemic. Much of the recovery, he notes, was simply a bounce back from the plunge in GDP growth that occurred in 2008–09. Although Mexico was the first of the emerging economies to jump on the neoliberal bandwagon, Esquivel emphasizes that consecutive administrations since the late 1980s relied too much on market tenets and macroeconomic prudence at the expense of crucial structural reforms in the realm of fiscal, regulatory, and antitrust policy. That sheds some light on why Mexico took by far the biggest hit from the GFC and why the country's pre- and post-crisis growth rates have been among the lowest in the LAC-7, the seven largest economies in Latin American and the Caribbean (see table 1-2).[39]

## Summing Up

This chapter begins with a set of hypotheses concerning the rapid recovery of the Pacific Rim emerging markets in the wake of the 2008–09 global financial crisis. These hypotheses are probed throughout the country case studies that follow and are thoroughly discussed in the concluding chapter of this volume. Inherent in the discussion in this chapter are three assertions. First, institutional innovations and policy learning from the experience of coping with previous crises assisted emerging market policymakers around the Pacific Rim and in Brazil, Argentina, and India in weathering the GFC and its rocky aftermath. Second, policymakers in emerging economies stepped outside their usual comfort zones to embrace a combination of market-based and state-oriented policies that served them especially well in the face of the crisis and made long-standing policy labels such as "neoliberal" and "developmentalist" less relevant. Finally, the combination of longer-run macroeconomic and institutional reform and the increased confidence to engage in more flexible policy approaches has enabled emerging economies to cope effectively with ongoing global challenges, including high levels of capital liquidity since 2008. Obviously, there are outliers in our country sample, especially on the Latin

America side, and the weight that can be assigned to our causal variables differs considerably across countries and regions.

What stands out in the majority of the cases analyzed in this volume is a steady but marked pattern of improvement in the key macroeconomic indicators (inflation, external debt, and public debt) and an ongoing, albeit variable, pattern of financial sector reform. Despite different reform trajectories in Asia (gradual reform, higher growth since the 1980s) and Latin America ("big bang" reform, lower growth until it hit the commodity lottery in 2003), the economic indicators for these emerging economies are converging across the Pacific Rim. In other words, while there is considerable variation in the choice of economic restructuring programs, the timelines involved, and the actual policies employed, the bulk of countries in our database appear to be approaching the same destination. When we analyzed longer-run patterns of macroeconomic and institutional reform, two groups emerged. Chile, Mexico, and Korea all relied more heavily on a market-based reform strategy, while still tweaking some strategic levers (capital controls, state banks) along the way; Brazil, China, and India came down much more heavily on the side of state-led reform strategies, with market reforms embraced at the margin but implemented nonetheless.

The management of capital inflows has been the most obvious challenge for all of the EEs in our sample but especially for the South American countries in their efforts to cope successfully with ongoing global economic challenges. To date the track record reflects a strong commitment among the EEs to combat currency appreciation and inflationary pressures, with the shadow of earlier financial crises as a constant reminder of how quickly the economy can unravel when policymakers depart from the basics. However, as the European Union continues to sort out its own banking crises and the U.S. Federal Reserve remains committed to a zero–interest rate policy, many of the emerging economies will continue to attract unusually high capital inflows. We therefore expect that the kinds of agility that we have seen thus far—including the resort to some types of taxes and regulations that even some International Monetary Fund staffers have recommended—will become increasingly common in the more market-oriented countries in our sample. With the emergence of these countries—led by China, the motor for global growth and the locus of global liquidity in the post-GFC period—a profound structural shift is under way. With that, some ideological blinders are finally dropping off, with pragmatism trumping dogmatism and flexibility in policy approaches beginning to have greater sway.

## Notes

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10. Michael Lewis, *The Big Short* (New York: W.W. Norton and Company, 2010).

11. See Roubini and Mihm, *Crisis Economics,* and Philip Arestis and Elias Karakitsos, *The Post "Great Recession" U.S. Economy: Implications for Financial Markets and the Economy* (New York: Palgrave Macmillan, 2010).

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OFFICEOFCE/Resources/870892-1197314973189/NewFaceofLAC_AnnualMtgs Report_Eng.pdf).

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14. Alfredo Saad-Filho, "The 'Rise of the South': Global Convergence at Last?," *New Political Economy,* vol. 10, no. 4 (2014). This author warns that while there are signs of convergence in the empirical data, it is important not to exaggerate these claims.

15. Arvind Subramanian and Martin Kessler, "The Hyperglobalization of Trade and Its Future," Working Paper 13-6 (Washington: Peterson Institute for Economics, July 2013), p. 3. See also Dani Rodrik, "The Past, Present, and Future of Economic Growth," *Towards a Better Global Economy Project* (Switzerland: Global Citizen Foundation, 2013) (www.gcf.ch/?page_id=5758).

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35. Kevin Gallagher and Roberto Porzecanski, *The Dragon in the Room: China and the Future of Latin American Industrialization* (Stanford University Press, 2010).

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39. The LAC-7 includes Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.