Impact of The Global Financial Crisis: Predictions Gone Wrong

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Summary

When the global financial crisis struck, the purveyors of conventional wisdom had it all figured out. Latin American countries would surely mismanage the crisis, as they have in the past. Economies that established partnerships with developed countries could rely on that “insurance” against instability. The growth rate of East Asian economies would not dip below the rates reached in previous decades. And the growth rate of economies, such as Ireland’s, which had enjoyed a “good boom” prior to the crisis, would rebound quickly and relatively painlessly.

Not one of these predictions came to pass.

Indeed, one of the striking aspects of the global financial crisis is how often the facts have contradicted what, according to conventional wisdom, was expected to happen.

- Most Latin American countries learned lessons from past financial crises and established economic stability through sound macroeconomic policies. As a result, the downturn there lasted only fifteen months, and Latin American economies are expected to grow by 5 percent a year—faster than advanced economies.

- Countries such as the Baltic states, which joined the EU in the 1990s, discovered that their embrace of its economic rules and reforms offered little protection from the crisis. Their economies suffered far more than those in Poland and the Czech Republic, which took a more gradual approach to partnership.

- Middle-income economies in East Asia, despite assumptions that because they weathered the crisis so well they would continue to have high growth, have been losing competitiveness in both directions: Low-income economies in the region, with their cheaper labor, have cornered the market on low-tech products, while the developed economies, with their advanced knowledge and skills, dominate the high-tech end. Foreign direct investment, public investment, and private investment have all decreased in the middle-income economies, making growth rates of over 6 percent a year in Malaysia and Thailand far from certain.
Countries considered models in their transition to advanced economies, like Ireland and Spain, were thought to be immune from the most damaging effects of a global economic crisis. But just the opposite occurred. In Ireland, many observers were misled by the country’s two booms: a “good boom” based on sound economic fundamentals, and a “bad boom” following its adoption of the euro.

Another prediction—that people will withdraw support from governing coalitions that react to the crisis by responding to markets rather than voters—may or may not prove to be wrong. Only time will tell.

**Latin America’s Right Decisions**

Latin America has the strongest tradition of mismanaging financial crises. Hence, when the deepest, synchronized global crisis occurred, it was expected that Latin American policy makers would once again adopt consistently wrong decisions, producing a quasi-catastrophic outcome for their economies.

In fact, this time, Latin American governments seem to have done almost everything right in managing a severe external shock. The facts are clear: although a downturn in economic activity was unavoidable, it lasted only fifteen months. The rise in unemployment in Latin American countries was a third of that observed in the most developed economies. And the growth forecast for 2010 and 2011 is positive: Latin American economies are expected to grow by around 5 percent a year, a much better forecast than for the European Union (EU), the United States, and other advanced economies.

How was this positive outcome possible? It seems that, finally, lessons were learned from past financial crises. Most Latin American countries avoided, throughout the 2000s, the “twin deficits” that accumulated during previous economic episodes. They pursued fiscal balance and moderate current account surpluses. Inflation was under control. Exchange rates were not fixed, but flexible. Banks were better regulated and, as a consequence, no toxic assets seem to have been present in any significant amount. Public- and private-sector debt was usually below 40 percent of GDP—considerably lower than in several EU economies.

As a consequence of these sound macroeconomic policies, Latin America has not endured any banking or currency crisis this time. In fact, the main perceived risk for the future is of an entirely different kind: that Latin American economies, in the post-crisis phase, may become victims of their own success. Their economic stability and positive macroeconomic indicators are already attracting massive capital inflows from the United States and other developed economies.

This scenario for an excess of capital inflows has been churned up by low interest rates (close to zero in the United States), excessive liquidity that will only be made worse by the “quantitative easing” recently announced by the Federal Reserve, plus slow growth in developed economies, combined with high interest rate...
differentials with most of the emerging economies and subsequent currency appreciation in the better performing economies of Asia and Latin America.

Leaders in the region warn of a “currency war.” The Financial Times wrote in an editorial that this “could become a monetary tsunami for emerging markets” and “might become the major threat to the global economy.”

Thus, one of the challenges for Latin American leaders in the next two or three years will be how to avoid overheating their economies and the subsequent emergence of bubbles that would push inflation up and force contractionary fiscal and monetary policies. In fact, several countries are already applying different forms of capital controls and reserve accumulation and are stimulating outward flows of domestic savings to prevent overheating and the loss of competitiveness implied by a rapidly appreciating exchange rate.

Other challenges have to do with the yet unsolved institutional and structural weaknesses that were present in the Latin American region even before the current global crisis. Political instability and violence still exist in several countries in the region. Excessive concentration of exports in a few commodities and a few markets is a structural weakness that might limit the growth potential in the post-crisis phase.

The faster these issues are dealt with, the higher the likelihood that a sustained path of high growth and economic stability will prevail, contradicting predictions made for the Latin American region when the crisis occurred.

**Partnerships No “Insurance” Against Instability**

A second prediction, prevalent before the crisis, was that economies that were more integrated through partnerships with developed countries, particularly when they joined an association such as the EU, had in a sense acquired “insurance” against instability.

That did not happen. In fact, the reverse has been observed: a high contagion effect from EU economies to those in Eastern Europe—the very same countries that had acceded as full members of the EU in the 1990s. A negative 8 percent growth rate for East European economies in 2009 was accompanied by a fall in exports to the EU of 13 percent, a consequence of the severe recession that ravaged EU economies in 2008 and 2009.

Even more interesting is that the economies that suffered most were those that earlier adopted all EU rules, regulations, and economic reforms. The Baltic states in the early 1990s proceeded to drastically liberalize trade and financial flows and to deregulate domestic markets, and later they fixed their exchange rates to the euro.
Once incorporated into the EU, and after radical economic reforms, the Baltic states had several initial advantages in attracting West European capital, loans, and direct investment: wages and taxes were lower, financial regulations were almost nonexistent, and the fixed exchange rate to the euro guaranteed a safe rate of return to foreign capital.

As a result, huge capital inflows accumulated in the 1990s and 2000s. By 2007, banks from the EU were lending the equivalent of 100 percent of GDP to the Baltic economies. Private credit was growing 50 percent a year. Real interest rates were zero or negative in Estonia, Latvia, and Lithuania. This induced an explosion in consumer borrowing and a boom in construction; 75 percent of new investment in the Baltic economies went to those two sectors.

However, as expected, the excess of expenditure generated huge deficits in the balance of payments and the governments’ budgets. As a result of these imbalances, by 2008 inflation was getting out of control, and the Baltic states were losing the initial comparative advantage they had gained upon acceding to the EU.

What followed was financial collapse. By 2009, the GDP of the Baltic states was contracting by 15 to 18 percent; unemployment was close to 20 percent; and inflation was already in a double-digit range. External debt reached 130 percent of GDP in Estonia in 2009 and 160 percent in Latvia. Almost half of the external debt was short term. The appreciation of the domestic currency plus the slowdown in the EU economies led to a fall in exports of close to 25 percent in 2009.

Was this avoidable? Certainly. Poland and the Czech Republic, which chose a more conservative and gradualist approach when adopting EU rules, fared much better. Having opted not to peg their exchange rates to the euro, those countries were able to remain competitive by devaluing their currency when the external shock occurred.

Because they had set clear limits to foreign lending, they did not go through a credit boom and thus did not face the inevitable credit bust following the boom. One result of this cautious, gradual opening to external financial flows is that their external debt as a share of GDP was less than half that of the Baltic economies.

But the export sector did suffer, given that 80 percent of their exports were oriented to the contracting EU market. In fact, exports to the EU from Poland and the Czech Republic fell by 15 percent in 2009, although they recuperated rapidly in 2010. Economic activity reflected the same trend: a negative growth rate in 2009, followed by positive growth rates above 3 percent in 2010. Unemployment for both countries reached 8 percent during the crisis, still less than half that of the Baltics.
Gradual adjustment to EU rules and a more conservative approach to financial deregulation proved to be better “insurance” against external shocks than the alternative implemented by the Baltic states, a second prediction gone wrong.

**Less Competitiveness Equals Greater Vulnerability**

Because the East Asian economies resisted the global financial crisis better than other economies and were able to rebound to previous levels in a short twelve-month period, it was commonly predicted that their growth rates in the future would not fall below those achieved (around 7 percent a year) in the previous decades.

This prediction might prove right for most East Asian economies. But for some, after a clear rebound in growth rates immediately after the financial crisis, a gradual loss of competitiveness (already observed in the last decade) might constitute a binding constraint to achieve growth rates as high as expected for the rest of East Asia. We refer to countries such as Malaysia and Thailand, often described in economic literature as the “middle-income economies” in East Asia. Here the prediction of high growth rates sustainable in the long run might prove wrong.

In fact, the loss of competitiveness has been gradual for these economies in the past decade. In Malaysia, growth rates went down to 4 percent in 2001–2009 after growing at 7 percent a year for several decades. The Thai economy has faced a similar situation.

These middle-income economies in Asia have been losing competitiveness to both low-income and developed economies in East Asia. The low-income economies have gained in competitiveness by turning their abundance of cheap labor into an advantage. This cost advantage allows them to integrate at the lower end of international supply chains by producing low-tech products exported to the rest of the world.

Meanwhile, the developed economies in Asia—Japan, South Korea, Singapore, Hong Kong, and Taiwan-China—have already transited to high-tech manufactures by incorporating advanced knowledge and skills into their productive structures. For them, constant innovation has become an endogenous process, where companies are able to design, produce, and export a wide variety of new high-value-added products.

Those in the middle-income range seem to be losing competitiveness in both directions. The low-tech, assembly-type product lines tend to migrate to such countries as India, China, Vietnam, and Cambodia. The high-tech end is already well established in Japan, South Korea, and Singapore. For those caught in the middle, the share of foreign direct investment they are able to attract has been greatly reduced: In Malaysia, it went down from 8 percent of GDP in 1997 to 2 percent in 2007. A similar trend is observed in Thailand.¹
Total investment as a share of GDP also went down sharply in Malaysia, from 43 percent in 1997 to 14 percent in 2009. In Thailand, it went from 41 percent to 22 percent over the same period. This sharp drop has been the result of not only a lower share of foreign direct investment but also less public investment, which has suffered because of accumulated fiscal imbalances in both countries.

Private investment has followed the same trend. Two factors explain the drop in private investment. One is that private investment has been highly dependent on an unsustainable construction boom. The other is that the investment climate has deteriorated because of highly confrontational politics, inefficient public sectors, corruption, rigidity in labor markets, and scarcity of the skills required to transit to higher-tech products and processes.

Thus, the high-growth prediction as a long-term trend for such countries as Malaysia and Thailand could well be wrong. For the prediction to be right, these middle-income economies should undertake some difficult challenges: They should recuperate previous high investment rates; orient themselves toward skill-intensive new products and processes; and improve the state’s capacity to deal with infrastructure bottlenecks.

These steps could easily be identified as an agenda also applicable to most Latin American economies. As middle-income countries, they seem to share most of the vulnerabilities apparent in some East Asian economies, as described above. For both groups of countries, the future seems less predictable than generally assumed. Growth rates of over 6 percent a year are far from guaranteed.

“Miracles” Don’t Last Forever

Middle-income countries such as Ireland and Spain, which were considered models in their transition to advanced economy status in a two- to three-decade period, might seem to be immune from the most damaging effects of a global economic crisis. In Ireland, healthy economic fundamentals and robust export growth—the consequence of a “good boom”—had boosted GDP from $15,000 per capita in 1985 to $42,000 in 2008; widespread praise for pulling off the “Irish miracle” was indeed deserved.

Given those successful results, a reasonable prediction would have been that after a relatively mild recession as a consequence of the crisis, the Irish economy would have strongly rebounded to, once again, exhibit high growth rates.

That prediction would have been wrong. In fact, what happened is just the opposite: Ireland is confronted with a deep, prolonged recession in which GDP dropped by more than 10 percent in 2009 and 2010 compared with 2008, and unemployment has risen to 15 percent. A collapse of the banking system is costing the Irish economy close to 50 percent of GDP in bailout money. The rescue plan
implemented by the Irish government will imply increasing an already high budget
deficit of 15 percent of GDP in 2009 to 32 percent of GDP in 2010. The financial
bailout agreed upon recently by the Irish government, the EU, and the International
Monetary Fund was an unavoidable consequence of such negative numbers.

What misled so many observers in the case of Ireland is that in the last twenty
years, the Irish economy went through two booms: a healthy “good boom” in the
1990s and a “bad boom” since 1999, when Ireland adopted the euro as a currency
and, thus, accepted that monetary policy would be dictated for Ireland, as it is for
other eurozone members, by the European Central Bank in Frankfurt.

The “good boom” was based on a deliberate policy of attracting foreign
investment, mainly from U.S. multinationals. The corporate tax was initially
eliminated, and then set at 10 percent, later to be increased to 12.5 percent. This
tax rate is still considerably lower than the average corporate tax rates in the EU
of 23.2 percent in 2010.

Exports to the EU market were actively promoted. Wage moderation allowed
the government to control inflationary pressures through tri-annual “social
partnership agreements.” A strong emphasis on quality education, particularly at
the technical level, helped in attracting foreign multinationals.

As a result, the Irish economy grew at 7 percent a year from 1990 to 1999; exports
rose 15 percent a year; and unemployment went down from 16 percent in 1986
to 3.7 percent in 2001. In fact, employment grew more than 60 percent in 1990–
1999, helped by strong immigration, among other factors.

As soon as the euro was adopted in 1999, Ireland was flooded with EU financing.
Bank lending increased from 60 percent of GDP in 1997 to 200 percent in 2008
and 290 percent in 2009. A significant share of that (50 percent) was interbank
lending from EU banks. This led to a drastic reduction in real interest rates, from
around 9 percent in 1990 to negative real interest rates throughout the 2000s.

What followed was predictable but ignored: a huge housing and construction boom.
The share of these sectors grew from 5 percent of GDP in 1995 to 20 percent in
2007. At the same time, wages were growing at a rate 40 percent higher than the
EU, with the consequent loss of competitiveness. Exports suffered, given that
exchange rate devaluation was not an option for eurozone members. Indebted Irish
consumers could not pay back the loans, nor could the construction companies.
Financial collapse followed, at a colossal cost to the Irish Treasury, and there is the
recurrent likelihood of a sovereign debt default by the Irish government.

The damage to Ireland’s economy was as unexpected as it was devastating. As
recently as February 2010, two respected Irish economists were compiling a
collection of papers for a book titled *What Did We Do Right? Global Perspectives on
Ireland’s “Miracle.”*
One of the many lessons of the recent Irish experience has to do with the risks involved when a country—consumers, bankers, government officials—becomes used to the notion of a “given”: a permanent growth in income of 6 to 7 percent a year, regardless of how it is financed. This inevitably leads to a high propensity to consume and high indebtedness by individuals, companies, banks, and government. Besides, as a critic has mordantly observed: “In Ireland, politicians and financiers drink in the same bars.” Apparently, they jointly celebrated the Irish success, while huge financial imbalances were accumulating.

The recent experience of Spain and Greece is not too different from what has been described for Ireland. Portugal, with its own peculiarities, seems to follow a similar path.

**Political Backlash Is Worth the Risk**

At the depth of a financial crisis, governments must do what the markets tell them in order to avoid default and financial collapse. However, listening to the markets instead of voters can generate a severe political backlash. In the face of double-digit reductions in output and wages and dramatic increases in unemployment forced by the kind of macro adjustments required to regain investors’ confidence, people will withdraw support from the government. Anger and disenchantment will prevail. Social protests will further weaken governing coalitions. It will be only a matter of time before the opposition gains power.

This is a well-accepted prediction in political circles. Will it be the political outcome of the current crisis? Not necessarily. Certainly, the results of the U.S. midterm elections last fall point in this direction. Ireland’s Fianna Fáil party sustained the worst shellacking of a sitting government in the country’s electoral history. And doubtless, in many other countries—Spain, Greece, Portugal—public opinion polls show an erosion of popular support for political parties in power as a result of the crisis.

But at the same time, what is most surprising is that in spite of being unpopular, governments in Europe are generally having success in passing tough legislation in their parliaments, reducing public expenditures, increasing taxes, and laying off or severely reducing the wages of public-sector workers. There seems to be more resilience in politicians and citizens during the current crisis than might have been expected.

A very surprising response is what happened in Latvia, whose economy took the biggest hit in all of Europe. In 2009, Latvia’s GDP fell by 18 percent, and unemployment topped 20 percent. The current account deficit reached 25 percent of GDP. The fiscal balance sheet showed a deficit of close to 10 percent of GDP.
The Latvian government reacted by implementing the toughest adjustment in the EU context: imposing huge budget cuts, increasing taxes, and reducing public-sector wages—in some cases by as much as 35 percent. A general election was then called, and the prime minister and the governing coalition running on a platform of continuing tough adjustment policies were reelected with close to 60 percent of the vote. It was an outcome no one could have predicted. The government of Estonia faced an almost identical scenario recently, with Prime Minister Andrus Ansip winning reelection with 57 percent of the vote in spite of the tough adjustment policies pushed by his government up to the election.

What factors might have influenced these results? The first has to do with the hard-won political and economic transitions that former communist countries had to go through since 1989 in order to be where they are today.

Severe economic and inflationary crisis persisted for several years after the collapse of the Soviet Union. Subsequently, Latvia and other East European countries were accepted into the community of free, democratic Western societies. The next step of formally joining the EU also required tough adjustment to the rules and regulations imposed by Brussels. Adapting to these new conditions usually means that workers are displaced from noncompetitive sectors. Public-sector employment is reduced, and a generalized perception of more economic insecurity prevails. And yet, the effort to adjust was considered by new members, including Latvia and Estonia, as an acceptable cost for being incorporated as full EU members. Concerns about backsliding in terms of economic stability and political freedoms may also have been a factor explaining the recent support for governments in Latvia and Estonia that were not afraid to tackle the difficult adjustment required by the massive financial crisis.

Finally, it has to be remembered that Latvia and Estonia had enjoyed a clear recent success: economies growing at 7 percent a year for more than a decade. Paying a high cost for getting back to such dynamic growth apparently became politically acceptable.

The case of the Baltics seems to prove the point that, under exceptional circumstances, it is possible that voters in a democracy are capable of accepting economic sacrifices, rather than seeking immediate benefits, if a viable future for the nation is at stake.

Is this a lesson that can be generalized? Certainly not. In most consolidated democracies, what will prevail as a consequence of the financial crisis, and the costs associated with it, will be a weakened government with scarce room to adjust and undertake the structural reforms needed to regain sustainable long-term growth. This, then, is a prediction that in all likelihood will prove right, unless exceptional leadership can persuade voters otherwise.
How to Avoid Policy Mistakes Next Time

The analysis of predictions gone wrong allows us to draw some tentative lessons, so as to avoid similar outcomes in the future.

- Solid macroeconomic management sustained through time to avoid accumulating balance of payments and fiscal deficits provides the best insurance against external shocks such as the current global financial crisis. It ameliorates the impact and allows economies to resume growth more rapidly. The recent experience of most emerging economies—including the “bad boys” in the past, Latin America—is eloquent enough.

- The transition from middle-income status to becoming an advanced economy works better when the process of incorporating the rules and institutions of the developed economies is carried out gradually. The process of accession to the EU is a good example. Countries such as the Baltic states, which gave away too soon the possibility of defining their own exchange rate policy by adopting the euro, or of constraining capital inflows when required, or of regulating their financial institutions—all suffered major recessionary impact. The more gradualist approach—including holding off on adopting the euro as a common currency, not allowing unlimited borrowing from the European banks, and establishing strict regulatory norms for domestic financial institutions—produced better results for countries such as the Czech Republic and Poland.

- It is a rocky path from being a middle-income economy to being an advanced one. Backsliding, or suddenly losing dynamism in the growth process, is always a possibility. It has happened in such countries as Malaysia, Thailand, Argentina, and Mexico, as well as in so-called periphery economies in Europe (Greece, Spain, Portugal, Ireland), where the financial crisis showed their huge vulnerabilities in terms of their fiscal and current account positions, their rigidities in the labor markets, and in their exchange rate policies. Backsliding for these “miracle economies” has been dramatic.

- An early understanding of why a “good boom,” like the one experienced by Ireland, Spain, and Greece in the 1990s, may turn into a “bad boom” in the next decade is a key to ameliorating the impact of external shocks in the future. Early indicators of a bad boom are an excess of expenditures over GDP accumulated for several years, a rapidly expanding government debt, and high private indebtedness. All these factors usually lead to an explosive increase in external debt that forces severe adjustment policies. Prudent policies put in place at the right time, which gradually put a brake on the “bad boom” in a timely fashion, are a high-priority issue when looking at the future.
The political reaction of the electorate, when faced with tough austerity measures imposed by the government, is not necessarily to press for a change in those who govern. Recent European experience suggests that electorates do complain and protest, but, in the end, they tend to behave more responsibly than might be expected. Often they become passive supporters of policies they do not like, such as budget cuts, tax increases, and wage reductions. This unexpected reaction is reinforced when political leaders are able to define the policy dilemmas at stake as implying broader issues such as membership in the EU, perceived external threats affecting national security, or even self-esteem as a nation. Additionally, when deciding the type and intensity of the adjustment required by the crisis, a bipartisan approach would certainly help in producing fast results and a more positive reaction from the sectors most affected by the economic adjustment.

Notes

1 Not only do foreign investment and factories migrate, but also high-skilled workers who look for jobs in the more technologically advanced economies in the region. This migration of high-skilled labor has been particularly significant in Malaysia.

2 Today, 120,000 pages of EU legal norms have to be implemented by country candidates in order to join the EU.

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References


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