

CRISIS AND REGULATION

The Economic Crisis and the Developing World: What Next?

*Interview with Robert Wade and
José Antonio Ocampo*

Kevin Gallagher

Some believe that the current financial and economic crises have ended the dominance of the Washington Consensus once and for all. In a ceremony at Tufts University, two eminent international economists, Robert Wade and José Antonio Ocampo, were recently awarded the Leontief Prize for advancing economic thought. They were interviewed by Kevin Gallagher on the many issues affecting the future of developing economies, including trade agreements with the developed world. The perceptive interview and provocative responses provide rare, clear-minded discussion about enlightened policy for the world's poorer nations.

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Q After the October 2008 World Bank and IMF [International Monetary Fund] meetings, a World Bank official was quoted in the *New York Times* as saying, “There is no question that the Washington Consensus is now dead.” Indeed, he said, “It died at the time of the \$700 billion bailout.” However, on the eve of the G20 summit to deal with the financial crisis in November 2008, President George W. Bush proclaimed that the crisis was not a failure of the Washington Consensus and that indeed Washington Consensus–like tools would be needed to get us out of this crisis. Who is right? Is the Washington Consensus dead? Will there be a significant change in the conventional economic system, and what changes might those be?

Wade: There are two sets of questions. The first one is how we get out of the mess. The second is in what direction to steer the reconstruction of the financial system. As for the second, we have to recognize that the banking system is necessarily part of the state in the sense that it is necessarily underwritten by taxpayer guarantees in a way that the auto sector and other “real economy” sectors are not. We should also recognize that many financial products have large “externalities,” like drugs, alcohol, explosives, and weapons of mass destruction. In other words, when these companies go wrong, they have deleterious effects on other parts of the economy. We now have to steer toward financial systems with a bigger core of boring old-style banking, where banks make loans and hold the risks on their own books rather than distribute them to others, as they now do.

Around this core—which needs to be closely regulated—there should be a less closely regulated sector, with more scope for financial innovation. But even that less regulated component has to be restricted to an overall leverage ratio and a requirement that new financial products be certified by a regulatory body to make sure that their risk characteristics can be easily understood and determined by the buyers. Neither of these two conditions exists—at least not in the United States or the United Kingdom, the sites of what I call the New Wall Street System, which has gotten us into all this trouble.

Ocampo: I approach this issue from a slightly different angle. In some sense it is correct that the broad views of the Washington Consensus have hardly been damaged. In other words, I am not totally sure they are dead. It is amazing how much Keynesian policies and a strong intervention of the state in the financial sector, including ownership (even in the United States), have been accepted. At the same time, the comment of President Bush reflects the fact that many things are still alive, not least of them the power of Wall Street and the extent of its influence on the debates on finance.

But we still have to see how serious the industrial world (for example, the IMF) is about conducting Keynesian policies in developing countries. There is a mental dichotomy wherein Keynesian policies are good for the United States but wrong for the developing world. We still have to see how much state intervention is going to be acceptable. This refusal to allow developing countries to adopt countercyclical measures is, of course, the core of the Washington Consensus. It is not clear how many people see this as a change equivalent in dimension to the Great Depression, which altered the prevailing paradigm from free-market economics to high levels of state intervention. I have not seen this happen yet. I think the forces for free market policies that affected the speech of President Bush are still with us.

Wade: I largely agree. After the Asian crisis in 1997, for the first year there was a lot of talk of a new international financial architecture. Then, when it became clear that the crisis was not going to bounce from the periphery to the rich Atlantic economies, the talk largely evaporated. We can expect to see a similar cycle of debate now. At the moment, we are in the “let’s get really serious about structural reform” stage, and there is even talk of a Bretton Woods II. When the crisis is contained and the West begins to recover, the de facto agenda will revert to “How can we muddle through with the minimum of constraints being placed on financial actors?” Wall Street and the City will press to go on with business as before.

The key point about the New Wall Street System is that it has enabled these financial firms to regularly inflate asset bubbles (from one asset type to another and from one country to another), then take profits,

survive the burst bubble, and move on to the next asset type and the next country to initiate the next bubble. Through the process, they have been able to generate gigantic profits—to get rates of return of 20 percent and more out of economies growing at 5–7 percent or less, redistributing income upward to themselves and the top percentiles of national income distributions. They have reinvested some of their profits in lobbying legislatures and bribing officials to enable their serial bubble-blowing to continue unimpeded.

It is quite possible that we will return to “business as normal” and will be held hostage to a new set of profit-generating bubbles or “trubbles” by 2015. But two things have happened to change the game, making reversion to the bubble-blowing New Wall Street System possibly less likely. One is the collapse of the investment banks, which were the most powerful actors in the New Wall Street System. And not just in the United States. They were also the strongest influence on financial regulation in the EU, operating from their bases in London. Now their power has been cut. That is one major change to the politics.

The second one—a ray of hope—is the statement by President-elect Barack Obama that the big auto companies should get substantial assistance to stay in business, but the assistance must be conditional on their making a big push into more fuel-efficient, more environmentally sustainable transport. It is certainly unusual in the American context for the government to link industry assistance to performance conditions—though routine in East Asia. As we discuss this, we have to wait and see what kind of proposal will be adopted. In any case, Obama’s statement holds up the promise of a small change from the normal American practice of saying that private industry knows best what is good for it and the country.

Q Yes, it is clear there has been a change in the way that economic policy is talked about. Even if you look at the communiqué of the G20 meeting of November 2008, it has calls for the stimulation of domestic demand. It has calls for more international funds

to help stimulate domestic demand. It calls for countercyclical policies. They even call for a review of derivative markets and credit agencies and want to reform international financial institutions. What is missing from this list? What is it going to take to turn these words into action?

Wade: Missing are measures to restrain inequality. Implicitly the stimulation of domestic demand is to happen within the existing distribution of income. Yet all over the Western world, income inequality has been increasing, at least when measured as the ratio of the income of the top one and top five percentiles to that of the average or the median. The top earners have been lifting off from citizen responsibilities to their societies like hot-air balloonists. Will an effort be made to redistribute domestic demand downward? Certainly in the case of Britain, at the center of the platform of the New Labor government since 1997 has been the idea that it will not touch top incomes. When pressed as to why not, their basic argument is that trickle-down will work; cutting top incomes relative to the average will end up hurting the poor. Allowing top incomes to soar was good electoral strategy, and the British and other governments may be too locked into it to make a change now. But the economics as well as the social psychology of recovery indicate the need for downward redistribution from the top and a stronger sense of a “fate-sharing community.”

Ocampo: Let us take the issue of pro-cyclicality and countercyclicality of regulation. Those of us who have been writing about this for many years welcome that these ideas are finally being discussed seriously.

Wade: But don't be too modest! You were something of a pioneer in calling for countercyclical financial regulation two decades ago. The pity is that you have been joined by few others until recently.

Ocampo: The Bank for International Settlements has been the leading international agency talking about this. Some actors—for example, the Spanish system of regulation—have introduced some of these concepts. But it has not been widespread. When Basel II was being designed, there were strong voices against it. The orthodoxy was still very strong. In terms of demand stimulus, what is still missing is, what are the policies vis-à-vis the developing world going to be like? The

IMF had been talking about “sustainable macroeconomic policies.” That is the language that was included in the 2005 reform proposal by then-managing director Rodrigo de Rato. The word “countercyclical” had long ago completely disappeared from the jargon. So, after the Asian crisis and the criticism that was levied on the fund for pro-cyclical fiscal policies, the IMF moderated its pro-cyclical approach. But when you see the things that it is doing now—for example, the harsh negotiations with Hungary—it looks like the “old package” of pro-cyclical measures involving budget balancing and so on is still with us.

Wade: Another example of pro-cyclical destructive policies is that the IMF has insisted that Iceland raise its interest rates from 15 percent to 18 percent in order to “restore confidence,” which is exactly the argument it used in East Asia after the crisis began. In East Asia the very high interest strategy did not work. On the face of it, the IMF’s terms for both Hungary and Iceland suggest it has not changed its spots.

Ocampo: And, of course, there are other, non-macro issues that we still have to see. Robert was mentioning the issue of income distribution. Also, the issues of industrial policy and intellectual property rights are very much part of established orthodoxy.

Q Let me follow up on that, because there is actually a paragraph inside the communiqué that stressed the urgency of concluding the current World Trade Organization (WTO) round of negotiations as part of the solution. What impact would passing a WTO deal have on the crisis?

Ocampo: Well, every time they call for concluding this round (known as the Doha round), it is ironically a good sign that it is not going to be concluded. Furthermore, if we are really going to be re-considering things, I think the whole structure of the WTO needs to be reconsidered, in many ways. I wrote in a paper about the existing power imbalance in the WTO. Every form of subsidy that was used by the developing world was forbidden; every subsidy that was used by the industrial countries was allowed. This is, of course, a rough simplification, but it is essentially quite correct. The industrial world

uses agricultural subsidies, regional subsidies, technological subsidies, and they are all allowed in the WTO. Developing countries used to use export subsidies, regulated investment measures (for example, performance requirements in manufacturing), and other subsidies in general that are forbidden in the WTO.

And on top of that, there was never a serious discussion about what sort of intellectual property regime was good for development. That is a discussion that is increasingly going on at the World Intellectual Property Organization (WIPO). Soft forms of intellectual property protection may make sense, like trademarks. Other forms of stronger

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protection, like patents, make no sense at all. And on services, even though the agreement was flexible, the application of that agreement has been extremely biased because the forms of service that have been liberalized are, again, those of interest to industrial countries, and the other forms have not been there. For instance, we have lots of agreements on financial or telecommunication services, which are of interest to the industrial countries. But we do not have anything on the construction industries or on immigration, where, for example, all the agreements allow for the movement of skilled labor but forbid the movement of unskilled labor. The WTO is one of the best examples of imbalanced agreements that have to be changed.

Actually, I now have a very strong position. I think developing countries were really deceived into getting into this round and should probably just get out altogether. If anything was really imbalanced, it was the outcome of the earlier Uruguay round of trade negotiations. I know that very well: at the time I was Colombia's minister of agriculture. The only thing that we thought we had agreed to was the promise to renegotiate agriculture a couple of years later.

Then the European Union persuaded developing countries to accept the Doha round. We have to remember that the Marrakech agreement

was meant to end the concept of rounds, the Uruguay round was supposed to be the last one, and within the WTO there would be a regular mechanism for negotiation that would not require rounds. It was only because the Europeans really did not want to negotiate about reducing agricultural subsidies that they invented this concept of “balancing” agriculture agreements against agreements in other areas. This is totally unacceptable. This round of negotiations has been a total failure for many years. Fortunately, the developing countries have been successful in eliminating many of the imbalances in the negotiations. But it is still becoming a negotiation between agricultural and industrial concessions.

Wade: You asked about the prospects for concluding a round. Remember that there is not a fixed finishing line that you cross or do not cross. It is possible for victory to be declared with only smiles and photo ops and an agreement to meet again. That may be the outcome of the Doha round.

Also, we should note that this crisis has shifted the distribution of power in the direction of the big developing countries. It is the first time ever that the industrialized countries see their fate as depending on growth in developing countries and on capital injections from developing countries. This change in the zeitgeist is feeding through into a new developing country assertiveness in the WTO. So if the round is “concluded,” it will be concluded on terms more favorable to developing countries than was otherwise going to be the case. I think the developed countries will have to back off from some of the concessions they have been demanding from developing countries. But the danger is that the United States and the EU will try to win the same concessions and even more in bilateral and regional trade agreements.

Q Is the developing world affected differently by the crisis? Should the response be different?

Ocampo: The current crisis has hit the developing countries quite hard. One of the reasons is that most developing countries are actually

quite open to trade now due to the influence of the Washington. We now have many export-oriented economies. The new idea of decoupling could mean turning back to the internal market, which some may do. China has given some signs of that. But the fall in commodities prices has been painful. They were already falling in mid-2008, but the collapse of commodity prices particularly since mid-September 2008 has been dramatic. I can recall few historical cases in which commodities have collapsed so quickly and so deeply, and many of the miracles in the developing world—particularly in South America and Africa—were based on high commodities prices. In the financial arena, there are fewer vulnerable economies. I sense that the worst cases were the central and eastern European cases, which have high current account deficits. They are being hit hard. However, they are members of the EU, which earns them special financial treatment, an approach that developing countries have not had in the past, with the exception of Mexico in 1994.

In this crisis, the collapse of stock markets has been worse in developing countries than in industrial countries, and the credit markets have been hurt. A new phenomenon in the third world is multinationals, many of which until recently incurred debt in order to expand. We will see how many survive a prolonged crisis. In some cases, their net worth is lower than their debt. One prominent example is CEMEX, probably the largest cement company in the hemisphere. CEMEX, because it bought a U.S. company, was heavily in debt, and some people are saying that the company may not survive. The developing country multinationals are usually in the larger economies, of course, such as India.

Q. China has had a development strategy that deviates significantly from the Washington Consensus. And now, in the wake of the crisis, China has not responded in the way that the United States and European countries have. Perhaps the Chinese are the Keynesians of the twenty-first century, given that they are pouring hundreds of billions of dollars into infrastructure and other areas of domestic demand. This is on top of years of spending on innovation, research and development, higher education, and

state-owned enterprises. What will the impact of China's stimulus policy, and its model of development more generally, be in developing countries?

Ocampo: Very few have the capacity that China has because it has a high level of foreign reserves and, most important, a huge current account surplus. So it has the capacity to expand. But you can see that even developing countries that have current account surpluses or small deficits are being significantly affected. Now, will there be a return of the internal market in developing countries? There is not a lot of discussion of that yet. But if this crisis turns out to be long, it might; it might look more into not only national but also regional and subregional markets as a basis for expansion. The other part of the question is whether Chinese growth is likely to have beneficial spillover for other developing countries. In recent years the major spillover was high commodity demand in China, and therefore prices in general. But that seems gone. I do not see other benefits coming that will be as powerful. I was one of the pessimists early in the commodities boom. I said that the boom in agricultural prices was a bit ephemeral; we have not even returned to level of the 1970s. But I became fairly convinced that Chinese growth had somehow increased the price of minerals, including energy products, for the longer run. The collapse of metals prices has been so dramatic, however, that one of the major linkages of China with the developing world has been broken. If China expands and does not demand more commodities from developing countries, what will it demand? Perhaps it will instead demand more from developed countries, because it will turn to higher-technology goods. The next phase may not be similar to the one recently seen. As the work that Kevin has done with Roberto Porzecanski shows, only four commodities (soybean, copper, beef, and iron and iron ore) have been sold to China, and this represents a small proportion of Latin American exports.

Wade: The question of whether China is likely to be, in some sense, a model also has another side, which is China's willingness to present itself as a model. Even though China looks like a shiny model compared to the United States in the current crisis, it is striking how

unwilling Chinese leaders have been to exercise any kind of leadership in international bodies. The Japanese have behaved similarly. Neither they nor the Chinese have tried to compete with the American, British, and European leadership of these organizations. Both have been content to follow along behind, partly because they themselves were not the object of the policies they consented to for others. The paradox is that they simultaneously aspire to be recognized as major states on the world stage while acting diffidently in helping to shape the world economic order.

Q. Didn't you write an article in the *New Left Review* in 1996 about how Japanese officials in the Ministry of Finance prompted the World Bank to undertake a research project on the whole of the East Asian region (which the bank had never looked at as a whole before, though it had written reports on Latin American and sub-Saharan Africa)? The Japanese hoped that the study—which was published in 1994 under the title *The East Asian Miracle*—would show that their model of development was different from the Washington Consensus and more effective?

Wade: Indeed. But that Japanese initiative was an exception. It paid the World Bank at least \$1.5 million, and the resulting study made hardly any concession to its conviction that industry policy and complementary growth-enhancing governance helped to produce transformative growth in East Asia. Ever since then, it has largely taken a passive stance.

Q. And you believe that China is also shy about advertising its alternative development model as one for some countries to emulate?

Wade: Yes, some countries could certainly learn about good development policies and good growth-enhancing governance not only from China but also Taiwan, South Korea, and, earlier, Japan. But neither China nor the others are keen to advertise these to the rest of the world. China is very preoccupied with building up domestic demand, especially in its western region, and does not want to assume responsibility for being a leader of the world economic agenda.

More's the pity, because what is clear is that, when development

performance is measured in terms of converging or diverging growth—that is, in terms of whether the ratio of developing countries' incomes is rising faster or slower than the North's—then development has not been working. Put aside for the moment the question of what has been happening to poverty. Divergent growth dominates convergent growth; the caravan of lagging countries is becoming longer. This, together with the earlier doubling of world labor supply after the entry of China, India, and the other “emerging markets,” generates the “overproduction” problem or insufficient-demand problem to which the explosive growth of finance was a response. China's experience has a lot to teach about how to generate convergent or catch-up growth, and it is a loss to the world that its government is not prepared to take a leadership role in promoting the ideas that have guided its practice.

Q. Before the crisis a few other things were starting to be talked about in the world economy for the first time in a long time, for example, the food crisis. As a former agriculture minister, José Antonio Ocampo, do you believe commodities prices will continue to spiral downward? Was the food crisis due to the rapidly rising prices a signal that we need to pay more attention to agriculture?

Ocampo: I was one of those who did not believe that we were facing a permanent increase in food prices. But there are some deep and important issues here. Agricultural research has always been biased in favor of temperate-zone agriculture. Tropical agriculture has always been underresearched. Now there has been talk, and I hope it continues, of a green revolution in Africa, which I think is very interesting. What the food crisis made clear is how deeply unprepared developing countries are for a major increase in the price of the goods most consumed by the poor. They lack any mechanism for managing high prices or physical scarcity of certain foodstuffs. State intervention is needed to do more agricultural research and to develop stabilizing stocks of crucial foodstuffs. Also a mechanism should be put in place to provide subsidies for the poor when their major staples are very expensive.

Q. As these countries were growing so fast, some were saying, “It took a lot of time, but finally the Washington Consensus has

worked and there has been a take-off in these countries.” To what extent is that argument valid?

Wade: If you delete the countries with extremely distorted policy regimes and extremely unstable governments, the evidence suggests that there is not much connection between further market liberalization and subsequent improved economic performance, still less between improvements in “good governance” (rule of law, property rights, corruption, etc.) and subsequent improved economic performance. The rapid growth of developing countries in the aggregate from 2002 to 2007 owed a great deal to rapidly rising commodity prices driven by fast growth in China. Now that commodity prices have been collapsing, developing country growth rates are falling and the number of those living poverty is rising, and we have returned to “divergence” dynamics for many developing countries and the “twin peaks” of income distribution on a world scale. To offset these tendencies, the solution is to build up growth-enhancing governance capacities, drawing inspiration from American, German, East Asian, and certain periods of Brazilian history.

Ocampo: My general sense is that there is a mythology that growth will stall unless more and more reform is put in place. A supplement in the *Financial Times* argued that Mexico is not growing very rapidly because reforms have stopped. It is amazing how much that concept still arises in the debate, which implies that developing countries grew quickly as a result of the reforms. There is very little solid evidence that growth has been high because of reforms. If anything, we have to restart the debate. Most developing countries are going to be damaged significantly, even China.

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