The impact of the global financial crisis: What does this tell us about state capacity and political incentives to respond to shocks and manage risks?

Literature review: synthesis of findings

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The main objective of this project is to 'understand the political and governance factors which affect states' ability to effectively respond to external shocks, particularly the global financial crisis, and how policy can be made more responsive and capacity strengthened' (see TORs and ODI proposal)

The main purpose of the literature review was to review the evidence of the effects of the crisis to date and to synthesise existing definitions and propositions about state capacity, which we will then apply – and test out – in the analytical frameworks and through the case studies. To address these issues the literature was organised in two main parts:

- Part 1 provides a brief overview of recent literature and case studies on the effects of the financial crisis in developing countries (e.g. ODI, IDS, IMF and WB), and to identify if and where the political and governance implications have been addressed. The literature review was supplemented by a consultation with southern and northern experts (including those involved in DFID funded ODI research on the crisis) on the key political and governance challenges in responding to the crisis. Part 1 of the literature review is in Annex 1 of this synthesis.

- Part 2 focused on the review of the (mostly academic) literature on state capacity to respond to external economic shocks, drawing on literature, on the Asian financial crisis as well as earlier literature regarding structural adjustment, new institutional economics and impacts of globalisation. Part 2 of the literature review is in Annexes 2 (on state capacity and governance).

- Part 3 reviews some of the recent literature on state capacity and globalisation, placing the current crisis in its historical context.

The key messages and findings of the literature review are summarised in this synthesis.

Part 1: The effects of the global financial crisis on developing countries

Developing countries were severely hit by the global financial crisis, which originated in developed countries in late 2007. Economic growth in emerging and developing economies dropped dramatically from 13.8% in 2007 to 6.1% in 2008, and it fell to 2.1% in 2009 (IMF, 2009a, and 2010). Some regions saw strong economic growth transformed into negative growth in 2009 (e.g. Central and Eastern Europe, and the Commonwealth Independent States), while others experienced significant slowdowns (e.g. sub-Saharan Africa and the Middle East). Looking at the country level, the recent country case studies coordinated by the Overseas Development Institute (ODI) point to a general growth slowdown in all the analyzed developing countries throughout 2008 and 2009 (Te Velde et al., 2009a; 2010). Thanks to unprecedented public action at the national and international level, a slow recovery is expected in the next two years: growth in emerging and developing countries is projected to rise to 6% in 2010 and to accelerate further to 6.3% in 2011 (IMF, 2010).

Nevertheless, these values are significantly below pre-crisis levels and there are still concerns regarding a double-dip recession.

The financial and real channels through which the global financial crisis spread to developing countries are mainly four: private capital flows, remittances, trade and aid (see, among others, Te Velde et al., 2008). The World Bank (200) estimates that as a result of the crisis, 89 million people will be living in extreme poverty (below $1.25 a day) by the end of 2010. According to the ILO (2010), the global number of unemployed will increase by 34 million in 2009 compared with 2007.

National governments implemented a number of policy responses including fiscal, monetary and social policy. There is much variation in how these responses were designed and implemented. However in many country case studies they appear to have been well designed, especially in relation to fiscal, financial and monetary policies to address economic management and there were no major policy reversals (Te Velde et al 2010). The evidence on social policies responses is more patchy and generally speaking less positive (IDS 2008 and ILO 2009).

Institutional and governance dimensions of policy response

The ability of developing countries to respond rapidly and effectively to crisis shocks depends not only on the existence of a reasonable fiscal space and macro-economic stability, but also on a number of governance factors including institutional, administrative and technical capacity. This is widely recognized by the IMF (2009c), World Bank (2009c; 2009e) and many other institutions and organizations worldwide. According to the World Bank (2009c), one quarter of the developing countries exposed to the impacts of the crisis had weak institutional capacity to efficiently and effectively increase public expenditure, to protect vulnerable groups and to reduce poverty.

An analysis of the ODI ten country case studies and follow up consultation reveal that weak state capacity and institutions posed significant challenges for effective and sustainable policy responses to the crisis. What is perhaps less clear is how, in reality, issues related to state capacity and resilience have affected the policy responses and their implementation, and what kinds of incentives are in place (or not) to support longer term reform processes.

Some country studies (Kenya, Sudan, Zambia, DRC and Ethiopia) make some reference to the specific institutional arrangements adopted in each country as part of the policy response to the crisis. In general, these are coordination mechanisms to ensure communication and consultation between key government departments (e.g. Prime Minister Office and Ministry of Finance) and with other key institutions such as Central Banks. In a minority cases, such as Sudan and Zambia, broader consultative mechanisms or processes have been put in place, involving various stakeholders. In general, little evidence is available to assess the role and effectiveness of these institutional set-ups and mechanisms, in part because their outcomes are often not made public or implemented.

There are some similarities between the ODI case studies in terms of perceptions that governments were initially slow to respond to the crisis (Sudan, Kenya and Ethiopia) or that the initial responses were devised as short term emergency measures (Zambia, Bolivia and Cambodia). Government capacity is part of the explanation for this, particularly in countries confronted by multiple crises and challenges like the DRC. Other explanations include divergence of views within government (e.g. between the Prime Minister’s Office and the Ministry of Finance in Kenya) and corruption and rent seeking which reduce the fiscal space and financial reserves (e.g. Tanzania and Cambodia).

Governance problems and capacity constraints as appear to be common challenges for taking forward effective policy responses to the crisis, especially in the long term. However, even where some analysis on these issues is available (e.g. ODI case studies for Bolivia, Sudan, Ethiopia) it does not appear to be taken into account in the detailed analysis of the sectoral policy responses or in the recommendations for future actions. It is not yet clear how, in practice, the capacity and resilience of state institution (or lack of it) has affected the pace, quality and results of the policy response adopted in these countries. Moreover, there is a lack of evidence regarding the incentives at play and the blockages for a more sustainable and effective reform processes, beyond the immediacy of the crisis. These issues are key to understanding the dynamics underlying developing countries' policy responses to the GFC, and to informing both domestic and international priorities in this area.

ODI's consultation with local experts revealed that in addition to economic and fiscal constraints, many countries, especially in Africa but also in some Asian countries such as Bangladesh, suffered from weak institutional and technical capacity which hampered the response to the crisis. In Sudan, Tanzania, Kenya, Uganda, and Zambia, authorities (i.e. governments and to a lesser extent Central Banks) lacked the needed research and analytical capabilities to identify and quantify the effects of the crisis. In Tanzania, for example, there was no effective monitoring system to assess the crisis impacts on the real sector; in Uganda, the standard analytical tools (such as financial programming) available to the Ministry of Finance and Bank of Uganda were inadequate to understand the effects of the crisis; in Sudan, the staff of the Ministry of Finance and National Economy did not have the needed skills to cope with the crisis shocks, and there were no policy centres or think tanks able to produce policy briefs and recommendations to support the decision-making process. As a result, the design of policies to respond to shocks was initially slow. A lack of implementation capacity has also been identified in countries such as Sudan, Kenya and Uganda.

Part 2: State capacity and response to external economic shocks

Much of the literature on external shocks, and government responses to these shocks, focuses on the specific drivers of the shock and on the role of economic institutions and of economic policy measures taken as a result. As a consequence, issues of political economy and political context – such as the role played by political settlements – have at times been overlooked. This prompted Haggard, in relation to the East Asian crisis, to note that "the striking feature of the debates among economists… is the absence of systematic political analysis" (2000: 7). Yet at the same time there is growing recognition that economic policymaking rarely takes place in a vacuum, as it occurs within a political context in which some hold greater power than others (Bates 1995: 42).

There is increased recognition in the literature that state institutions and governance arrangements are key for responding effectively to external economic shocks and that this is not only a matter of technical or administrative capacity, but also of political capacities and power relations. However, there is less evidence of how in practice political capacities and relations determine or shape specific policy responses to economic crises; the finding that politics and institutions matter is never unpacked to understand how they matter and why. Furthermore, there is a lot of variance in the definition of the relationship between crisis shocks, regime change and political stability. Finally, references to the political settlement and drivers which are likely to be the underlying factors that shape political capacity, political will and ultimately policy responses are not systematically analysed in the literature reviewed (or in the policy analysis of the Global Financial Crisis to date) and would deserve additional research and analysis.

The literature review revealed a number of useful concepts which could be usefully integrated in the analytical framework for the case studies. These include different forms of state capacity, economic flexibility and policy adaptability, autonomy and notions of bureaucracy.

a) State capacity

Issues of state capacity to respond to external shocks range from technical and administrative to more institutional and political dimensions.

Nelson defines state capacity as the "**capacity to generate informed and objective analysis** of economic problems and options", with an emphasis on the number of experienced and trained analytical staff in economic agencies (and the extent to which they agree on a common analysis), the authority of central economic agencies (for example, in terms of the constitutional and legal framework), and the levels of managerial capacity (Nelson 1990: 21-22).

Another aspect of state capacity to respond to crisis is that of **policy choices and implementation** capacity. For example, for Stallings, policy choices will be determined by the political interests or coalitions which have the most influence over the government in question, and these choices will in turn depend on the analysis and judgement made about the crisis (Stallings 1990: 113). Implementation is more complex, as it can be affected by the particular dynamics in a state (for example, the level of centralised control or authority) and by the nature of the political settlement and rules of the game (including power dynamics between political interests).

Grindle has also examined the key dimensions of state capacity, and how economic crisis can affect these dimensions (Grindle 1996: 8). She unpacks state capacity into four key dimensions – **institutional, technical, administrative and political capacity**, and compares what states ought to have in terms of capacity and how this is likely to be affected by sustained economic and political crises.

In seeking to examine state capacity, we will therefore need to distinguish between different dimensions of capacity.

Summary of key concepts:[1]

Concept	Definition	Key variables
Technical capacity	Includes capacity to generate analysis of economic problems and options as well as the ability to set and manage macroeconomic policies	Level of experience and training of analytical staff in economic agencies; authority of central economic agencies (Ministry of finance, central bank etc); levels of managerial capacity. (Also Nelson 1990)
Implementation capacity	The extent to which policies can be delivered	Particular dynamics of the state (e.g. level of centralised control); nature of political settlement and rules of the game; access to resources; role of external actors (Stallings 1990)
Administrative capacity	The effective administration of basic pubic services and infrastructure	Ability to deliver basic services; ability to mediate social and economic demands within administrative processes.
Institutional capacity	The 'rule of the game'; the legal and constitutional frameworks which regulate economic and political	Authority and legitimacy of the government; levels of societal agreement on rules.

[1] Drawn from Grindle (1996) unless otherwise stated.

	interactions	
Political capacity	The channels of representation and mediation between citizens and the state	Levels of responsiveness of political leaders, levels of civil society activism, role of special interests

b) <u>Economic flexibility and adaptability</u>

There has been some analysis of the extent to which flexibility and adaptability can decrease vulnerability and strengthen responsiveness to external shocks. In general, the overriding focus has been on economic flexibility, but there is some recognition of the extent to which this can be shaped and affected by the wider political context. The work of Killick and others, for example, has sought to explore what contributes to economic **flexibility** and adaptability. For Killick, economies with flexible structures, which can more quickly adjust, can achieve faster development than those which are rigid. For Killick, the key dimensions of economic flexibility include responsiveness (in other words, the ability of governments to respond to external shocks) and the ability to innovate, linked to entrepreneurship (at individual, firm and state levels) (Ibid: 10). Killick recognises the importance of politics in shaping flexibility and responsiveness – for example, noting that a government which is insecure, corrupt or repressive is unlikely to respond quickly to changes in economic performance. Similarly, he notes that in the face of widespread public rejection, government may respond in ways not previously thought politically feasible (Ibid: 12).

Linked to discussions of flexibility are issues of **adaptability**. For Seddon and Belton-Jones, economic flexibility depends on policy adaptability, defined as the need for effective insulation from short-term pressures (such as from special interest groups), combined with responsiveness to the longer term needs of the economy and of civil society (1995: 326). While these factors clearly have political underpinnings, there has been little analysis of the specific features of this.

Summary of key concepts:

Concept	**Definition**	**Key variables**
Flexibility	Responsiveness to external shocks and ability to innovate (entrepreneurship)	Availability and accessibility of relevant information; role of incentives; formal and informal norms and institutions which shape how actors will respond to information and incentives.
Policy adaptability	The need for effective insulation from short-term pressures as well as longer term responsiveness to economy and civil society	The nature of the political settlement; the degree of autonomy of the state including from special interests.

c) <u>Autonomy and notions of bureaucracy</u>

There is a wide ranging literature which builds on Weberian notions of bureaucracy, and looks at example of autonomy, in response “the tendency to equate capacity with insulation” (Ibid: 176). For Evans, what is key for more effective (or ‘transformative’) state capacity is “a combination of internal coherence and external connectedness that can be called embedded autonomy” (Ibid.). He recognises that states cannot be completely insulated from society but rather are embedded in a dense network of social ties which structure political elite interactions, including with business actors. Others have similarly stressed the extent to which macroeconomic stability can be “profoundly affected by the political security of governmental elites and the extent of their independence from the pull of short-term distributive political pressures" (Haggard and Kaufman 1992: 271).

Callaghy refers to the '**ability to insulate**' the state, which is affected by five key factors. Firstly, how the economic crisis is viewed by rulers and how this then affects the commitment to reform; secondly, the extent to which decision-making can be influenced by "the technocratic half of the *dualistic decision-making structures*"; thirdly, the level of government autonomy from socio-political interests; fourthly, the capacity of the state and overall levels of reform before the crisis; and finally, external influence (for example, by donors) will also have an impact (Ibid: 263).

Summary of key concepts:

Concept	**Definition**	**Key variables**
Embedded autonomy	Refers to both internal coherence and to external connectedness with wider political context and networks	Predictable, coherent and functioning bureaucracy; network of social and political ties, including with business actors
Ability to insulate	The extent to which technocratic aspects of decision making can be isolated from political pressures	Perception of crisis and commitment to reform; nature of dualistic decision making structures between technocratic and political elements and level of government autonomy from political interests; capacity of the state; role of external actors

d) <u>Political settlements and political interests</u>

Underlying the above concepts of state capacity, flexibility/adaptability and autonomy are notions of political settlements, power dynamics and political interests. These issues are currently the least explored in the existing literature, and will form a primary focus for this study.

Authoritarian regimes were conventionally seen as better placed to respond to economic shocks, because of their autonomy from political pressures. However, there is growing convergence that this is not necessarily the case, and that rather than focusing on regime type it may be more helpful to focus on some specific political variables such as electoral cycles, which may significantly affect the response to shocks (Nelson 1990). Similarly, Haggard and Kaufman have critiqued the commonly held view that external shocks increase the likelihood of regime change, and they focus instead on the conditions under which shocks might lead to such political change (Haggard and Kaufman 1992). This is linked to the nature of the political settlement, as shown in Stallings' research into crises in the 1980s in Chile, Peru and Colombia. She found that the weak political settlement in Peru contributed to a change of government and different adjustment policies, whereas in Colombia, the political alliance placed boundaries on the types of policies which could be followed (Stallings 1990). The lack of evidence of the implications of political settlements and political interests, and dynamics, mean that for each selected case study country, we will need to go deeper into our analysis to pinpoint the specific variables which seem to shape the nature of the political settlement and contribute to more or less effective policy responses.

Part 3: Globalisation and state capacity

Whether globalisation strengthens or hinders national states' capacity to respond to economic and other types of external shocks is an open debate in academic circles, or so it appears from an analysis of the literature.

There are a number of reasons cited to support the hypotheses that globalisation has severely undermined states' capacity. These include:

- The internationalisation of production networks (embodied by the rise of multinational corporations as powerful actors) and potential footloose nature of corporations
- Rise of international finance and increased international capital flows
- Constraints on policy space arising from international policy norms/requirements

In contrast to these arguments, the majority of the authors in the literature surveyed maintained the perspective that states still have the potential to continue to play an important role in protecting the well-being of their citizens and retain significant capacity for policy autonomy:

- Challenging the collapse of the welfare state: the insulating effect of state spending in highly 'open' economies
- Uniformity of state policies being overstated and national institutions continuing to be significant
- Capacity of the state to adapt the 'toolbox' and develop new forms of capacity to meet the need of globalisation.
- Differentiated state capacity to resist imposition of formal and informal policy constraints, but also to take advantage of opportunities offered by globalisation.