
Synthesis

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Introduction and Main Messages

Development economists are paid to look into the future. They ask not only how things work today, but also how a new policy, program, or project would make them work tomorrow. They view the world and history as a learning process—past and present are just inputs into thinking about what’s coming. It is that appetite for a vision of the future that led us to invite some 40 development economists, most of them from the World Bank’s Poverty Reduction and Economic Management Network—an epicenter of the profession—to tell us what they see on the horizon of their technical disciplines and of their geographic areas of specialization. We did not want their forecasts—those could quickly become outdated, or prove embarrassingly wrong. Rather, we asked them to visualize how key economic policy issues will be dealt with over the next three, four, or five years and which countries will be dealing with what issues.

The timing could not be better. The 2008–09 global financial crisis shook the ground under the conventional wisdom that had been held as true for decades. From what the role of governments should be in markets to which countries will be the engines of the world’s economy, from what people need to leave poverty to what businesses need to stay competitive,

it is all up for reexamination. The disconcerting but exciting search for a new intellectual compact has just begun.

So we set our authors free. They wrote under their own names, independently of their institutional affiliation. We imposed no conceptual framework or limits. Their views were taken “as is,” whether we agreed with them or not. And we allowed writers to speak before we started our search for a common agenda—the equivalent of composing a musical score by first listening to each member of the orchestra play.

This synthesis provides an account of what we heard. It is not meant to be comprehensive. Instead, it picks from each chapter what is new, what is likely to change, and what will be different in the future. Four take-home messages emerge:

1. While the rich world puts its house in order, and macroeconomics and finance get to a new consensus, developing countries will become a (perhaps, “the”) growth engine for the world. Faster technological learning and more South-South integration will fuel that engine.
2. Governments in developing countries will be better—they may even begin to earn the trust of their people.
3. A new, smarter generation of social policy will bring the end of poverty within reach, but inequality is another matter.
4. Staying with sensible policies, many regions of the developing world will break out of their “developing” status and will graduate into something akin to “newly developed.” Africa will eventually join that group. Others, like Eastern Europe, will have a legacy of problems to fix beforehand.

Markets: New Engines, New Ideas

Most developed countries came out of the 2008–09 crisis in bad shape. They are burdened with exploding debts; face massive fiscal adjustments (or solvency crises of unimaginable consequences if they do not adjust); and can expect a slow, medium-term recovery at best. Their consumers will be retrenching, worried by the loss of wealth (think houses and stocks), lack of jobs, and stricter lenders. Will this heavy slog drag down the developing world too? Not necessarily. More likely, emerging economies will become a pulling force for advanced ones—they will become a new engine of global growth.

The short-term economic cycles of developing countries have for decades been, and will continue to be, correlated with those in the G-7. There has been no “decoupling” of cycles. However, long-term growth trends did separate (decouple), almost 20 years ago. In the mid-1990s, developing nations began to grow at their own, much faster pace.¹ Part of this had to do with technological convergence (“catching up” is relatively easy). But mostly it was due to better policies.

This superior performance will go on. In fact, it is projected that, as a group, the size of the developing countries’ economies will surpass that of their developed peers by 2015. How could that happen while the rich world remains stagnant? Because there are several autonomous sources of growth that emerging markets can still tap, as long as they adhere to sensible policies. First, they have room for more leverage in the balance sheets of their public and private sectors. In other words, they will not need to postpone investment for lack of finance (greenfield infrastructure comes to mind). Second, the expansion of the middle classes will permanently raise the level of domestic demand. Third, technological learning and catch-up may speed up, as the cost and risk of transferring knowledge continues to fall. Fourth, trade integration will accelerate with the emergence of production networks that cross borders, and with it, there will be further reallocation of resources (human or otherwise) to higher-productivity activities. Finally, commodity prices will stay high, and commodity revenues will be better managed. The result will be a faster transformation of natural wealth into increases in (or less loss of) productivity. Let us elaborate on the last three sources of autonomous growth (learning, integration, and commodities), because they pose the most direct policy challenges.

If You Want to Grow, Learn

A less developed country is “less developed” not only because it lacks inputs (labor, capital), but also because it uses them less efficiently. In fact, inputs are estimated to account for less than half of the differences in per capita income across nations. The rest is due to the inability to adopt and adapt better technologies to raise productivity. As an engine of growth, the potential of technological learning is huge—and largely untapped. Four global trends have begun to unlock that potential and are bound to continue. First, the vertical decomposition of production

across frontiers allows less advanced countries to insert themselves in supply chains by specializing in single, simpler tasks first. Second, the expansion of “South-South” trade (since 1990, at twice the speed of global trade) increases the availability of technologies that have been tested and adapted to developing-country settings. Third, information and communication technology gets ever cheaper and more widely embraced. Fourth, as the middle class grows in emerging economies, local technological adaptations begin to break even (India’s US\$2,000 Nano car is a good example).

It all looks promising. But, left by themselves, markets may not generate enough learning. Producers tend not to share profitable ideas, and financiers tend not to finance ideas they do not understand. There is room for public policy. What can developing countries do, and what are they likely to do, to spur technological learning? While each country’s reality is different, successful strategies have several common features. They focus on the incentives firms face—competition, taxes, labor laws, corporate governance. They invest in management and worker skills alike. They make sure information spreads quickly to all. They provide public funding where necessary, especially to finance experimentation. They involve all actors, big and small, formal or informal, rich and poor. They are part of an attempt at integration—at benefiting from globalization, not just surviving it. And they constantly benchmark, monitor, evaluate, and adjust.

A Different Kind of Trade

Over the past three decades, global trade grew almost twice as fast as global gross domestic product (GDP). This massive process of commercial integration was made possible by technological revolutions in transport (containerized shipping) and communications technologies and by a dramatic decline in import tariffs. This allowed many developing countries to implement export-led growth strategies that lifted hundreds of millions out of poverty. Some succeeded in sought-after manufacture markets and, more recently, even in services.

But the 2008–09 crisis showed the volatile side of integration. In two years, the volume of world trade fell by a third. International production networks carried country-to-country contagion at staggering speed. Naturally, calls for government intervention have multiplied.

The question is: what kind of intervention will that be? The probability of going back to preglobalization, import-substituting industrial policy is not high, but is not negligible either—concern for unemployment may still trigger protectionism. More likely, public policy will, in most countries, take an “enlightened path” that uses the power of the state to make markets work. This will still involve the traditional prescriptions of sound macroeconomic fundamentals, qualified human capital, and efficient institutions. It will also involve renewed effort at the less glamorous art of facilitating trade, that is, at reducing the cost of moving goods (more competition in logistics markets, faster border agencies), helping exporters survive (stable finance; maintenance of standards, certifications, and licenses), linking export processing zones with local clusters (more flexible zone rules), and enhancing the practical value of export promotion (dissemination of best practices and commercial intelligence).

Strategically, the enlightened path (call it “export-led growth 2.0”) will be defined by two new, powerful trends in global trade. First, South-South integration. With the United States, the eurozone, and Japan forced to “rebalance” their saving-consumption mix in favor of the former, commerce among developing countries will play a much larger role. More advanced emerging markets will account for a larger share of the demand for lower-income countries’ exports. A multipolar pattern of global growth will emerge. In fact, the crisis has only accelerated a decline in the relative importance of rich-country demand that had started almost two decades before. This does not mean that South-South trade will be easy. Consumers in developing countries care more about price than quality or variety. Import tariffs are higher (by several multiples) compared to Organisation for Economic Co-operation and Development (OECD) countries. And investment climates are worse.

Second, the new trade strategies will put a higher premium on diversification—not only of partners, but also of products—as an insurance against volatility. Expect more trade agreements, and more mutual surveillance, among developing countries. And expect innovation to be the new code word for success in trade. The quest for new brands and new niches will dominate the second generation of internal reforms (from incentives for research and development to tertiary education) that can make export-led growth models viable.

Will exchange rate policy be an effective, even common, instrument in the new multipolar, diversification-driven trade framework? Unlikely. The proliferation of production chains, where import content is critical for exports, will not sit well with artificially high exchange rates. For most countries, the cost of managed undervaluation in terms of reserve accumulation and inflationary pressures will prove unbearable. And the uncertainty associated with large exchange rate misalignments will slow export-oriented investments.

In sum, the crisis will not usher in the end of globalization. On the contrary, there will be more integration. But this time, it will take place mostly in the developing world and will be led by those that have more ideas, not necessarily more resources.

Commodities: That Uncomfortable Feeling of Wealth

Over the next five years, commodity prices will be the external variable to watch for developing countries, perhaps more than interest rates. Those prices will stay high until at least 2015, before supply responses and lower relative demand by a burgeoning global middle-class moderate them. And while commodity dependence has been declining for decades, many a developing country's exports and fiscal revenues will remain dominated by natural resources. Is this postcrisis, continuing bonanza good news? The literature on whether commodity wealth is a "curse" is as vast as it is ambivalent. What is certain from empirical evidence is that good policies and good governance are necessary, but not sufficient, conditions for natural riches (especially oil and minerals) to turn into development, that is, necessary to solve the five main problems associated with those riches:

- Dutch Disease (noncommodity exports become less competitive)
- Price volatility (which complicates investment decisions)
- Overborrowing (lenders are laxer with governments that expect to collect lots of cash)
- Sustainability (how much of the natural wealth to preserve for future generations)
- Corruption (the larger the rent, the more voracious the rent-seeking).

But what are those "good" policies and "good" governance? Will the developing world succeed now where it mostly failed in the past? This

time, the odds are in favor of better development outcomes out of high commodity prices. With important differences across countries, democratization has, on average, enhanced citizens' demand for transparency and has improved institutional checks and balances. In parallel, natural resource funds have become more common, and the technology to administer them has improved. Public investment processes, from identification to evaluation, are better than before. Fiscal policy in general is more robust, backed by more rules, better coordination with other agencies of the state (notably, central banks), and a gradual penetration of techniques for results-based management. Monetary anchors are stronger (scores of countries follow, and meet, inflation targets). And while we are still far away from a general acceptance of the prudent "permanent income rule" (that is, from spending only the annuity value of our natural wealth), there is a general sense among policy makers and voters that consumption binges financed by commodity revenues tend to end in tears.

Meanwhile, Policy Wisdom Catches Up with Reality

While autonomous sources fuel growth in the developing world, and help it turn into a global engine, the search for a new consensus around economic policy will continue. The 2008–09 crisis opened the door to a different kind of thinking in international macroeconomics—and closed it on some of the previous orthodoxy. Some now see a bit of inflation (perhaps as high as 5 percent per year) as desirable for countries that pursue inflation targets, because it would allow more space to reduce nominal interest rates when an economy falls in recession. In fact, what to target (consumer, producer, asset, housing, or other prices) is in question. Regulatory parameters and practice in the financial sector have proved to be more critical for real growth than we previously thought, whether through systemic risk, overlending, costly bailouts, or other channels. Floating exchange rate regimes are falling out of favor, since "managed" ones proved to be better at controlling inflation and reducing sudden, unnecessary fluctuations. Controls on the movement of capital across boundaries have become an acceptable tool (they were heretical), almost a price to pay for policy success. Multilateral surveillance is in the cards, initially through the G-20, since the actions of hard-hit, overindebted rich countries cause volatility in many an emerging

market. Fiscal policy advice is bifurcated—between a short-term need for sustained stimulus and a medium-term need for consolidation, and between massive deficits in the developed world and the accumulation of surpluses into sovereign funds in the developing one. From all this, a new paradigm is likely to rise. The profession is in flux.

Nowhere is that flux clearer than in finance. There is broad agreement that inadequate prudential regulation of finance was the main cause (albeit not the only cause) of the global crisis. There is much less agreement on what to do about it. In particular, massive systemic risk was allowed to accumulate on the balance sheet of unregulated institutions and off the balance sheet of regulated ones. Their failure could, and did, bring down the whole system. This has sparked a flurry of reform proposals.

Some of the proposals are focused on the relationship across financial agents—on how one agent's fate is correlated with others'. The core idea is "to tax" (literally or through various forms of capital requirements) institutions that can jeopardize the system, not just because they are "too big" but because they are also "too interconnected". The assumption is that regulation will now reach all agents—the "regulatory perimeter" will expand. In practice, regulators may not have enough information to impose that "tax". So, various proxies for an institution's contribution to systemic risk have been put forward—sheer size of its balance sheet, degree of leverage, maturity mismatches, and so on. All of them are yet to be tested by experience.

Other reform proposals emphasize time, that is, how financial risk changes over the economic cycle. When the economy booms, there is less perceived risk, asset prices rise, and it is easier to borrow. When the economy turns, the opposite happens, perhaps more abruptly. What kind of macroprudential regulations can automatically moderate lending in the upswing and ease it during downturns? Two candidates stand out—procyclical capital requirements and procyclical bank provisioning. Only the latter has actually been deployed (in Spain and, more recently, in Colombia and Peru). But the jury is still out on its impact.

Whether reforms are geared toward interconnectedness or timing, there is another potential reason to render their result uncertain at best: lack of international coordination. If countries (developed and developing) adopt different regulatory standards, then money, risk, and bubbles will

shift to jurisdictions that are less strict or less capable of enforcement. With regulatory wisdom under construction, is there anything macroeconomics can do in the meantime to help financial stability? Possibly. Monetary policy could target asset prices, not just inflation or output gaps, although it may end up promoting inconsistent objectives, or serving none very well. Fiscal policy can help too, especially if it can inject resources in the economy automatically and rapidly during recessions, and if it can avoid giving tax incentives to borrowing (to mortgages, for example). And external financing decisions will also have a bearing on the stability of domestic financial markets—the risk of sudden exchange rate fluctuations will be lower when foreign debts are smaller and reserves are larger.

The bottom line is that the search for financial stability, through regulatory or macroeconomic policy, is just beginning. This is putting developing countries in a bind. Should they wait for new global standards to emerge, or should they tailor their own regulatory strategies? A prime example of that dilemma is happening in Latin America. The region pursued financial stability and financial development through a mix of “getting the macro right” (low inflation, low deficits, low debt), heavy-handed oversight (initially inspired in the 1988 Basel Accord but with oversized capital and liquidity requirements), and entry of reputable foreign banks. The mix did not deliver much in terms of financial development—the depth and reach of, and access to, intermediation remained limited. But it proved resilient. Latin America’s financial system suffered little, if at all, during the global crisis.

This raises many questions. One is about innovation: should Latin American supervisors continue to keep a tight leash on new products, especially those that most agents do not understand (“collective cognition failure”)? Another is whether to regulate by type of institution (separate regulators for banks and nonbanks, for example) or by type of function (say, credit, whoever gives it). A third relates to financial globalization itself: should foreign banks’ local operations be ring-fenced? Fourth, what role should state-owned banks play? For all their weaknesses, they were a useful mechanism to inject liquidity at a time of turmoil. Fifth, would regional regulators have the data to apply countercyclical prudential norms? Sixth, if the world decides to use taxes to handle systemic risk, should Latin America follow, knowing the

many problems with the region's tax system? These are just some of the issues that an actual geographic group of developing countries—a group that did well, mind you—will have to face while “the center” comes up with a new international standard—if it ever does.

Governments: Earning the Trust

There is no evidence that the crisis changed citizens' trust in the state, in either direction. Well before the crisis, that trust was already in long-term decline among advanced countries and was stuck at a very low level among developing ones. And while markets may have lost their shine, governments did not pick up the credit. Data, of course, are limited, and definitions are problematic. But there are good indications that not all institutions of the state are distrusted equally or everywhere: people in rich countries look up to their armed forces and down on political parties; in Latin America, they trust basically nobody; and in very poor places where clientelism takes the space of institutions, they tend to trust the incumbent to deliver privileges. This matters for public policy. Distrustful citizens minimize their relationship with the state—they work in informality, opt out of public education, dodge taxes, settle disputes by their own hand, and stay out of politics. Reforms and, more generally, the emergence of a national strategic vision become much more difficult.

Can “trust in government” be restored or, where it never existed, created? Yes, but the levers of trust vary across stages of development. In OECD countries, the marginal need is for more accountability. There, the state has achieved an adequate level of service provision, even a constant flow of improvement in service quality. But citizens have gotten used to it. They are now more impressed by values in public life—probity, commitment, and responsibility. In contrast, performance seems the missing key to trust in developing countries. Tangible, communicable results are what their voters look for and what they reward (Brazilian governors are pioneers in this). Where clientelism is the tradition, a track record of both accountability and performance is necessary before people risk abandoning the incumbent and begin to rely on institutions.

Of course, all trust building has common elements—performing well in some services raises trust more than in others (health provision

has higher returns than market regulation, for example); expectations are ratcheted up (what you achieved yesterday becomes today's baseline); confidence can be quickly squandered (any suspicion of gaming evaluations is a trustbuster); and a sense of generational betterment gathers support (we appreciate a state that opens opportunities for our children).

But in the postcrisis world, what will be the most effective trust builders for governments of developing countries? Primarily, four: manage professionally, spend wisely, borrow little, and account well for your assets.

Fiscal Quality

Most advanced countries face a postcrisis period in which fiscal adjustment will be the norm. They need more revenues and less expenditure. Their priority is quantity. In contrast, developing countries came in and out of the crisis with relatively strong fiscal positions and see a horizon of solvency, especially those that export commodities. This gives them an opportunity to improve the functioning of fiscal policy—their priority is quality. There are several reasons to believe that many of them will seize the opportunity.

First, fiscal policy may start leaning more “against the wind,” that is, may become more countercyclical. This is not just because of the proliferation of “medium-term budget frameworks”, “fiscal rules”, and “fiscal responsibility laws”, many of which were in place before the crisis. There are also the political rewards that accrued to leaders that had previously accumulated funds and could spend them at the outset of the global recession. Imitation is likely.

Second, independent fiscal agencies will be more common. They will increasingly become the credible, neutral parties that monitor compliance with fiscal norms, cost out initiatives, evaluate impact, and validate forecasts—credit rating agencies do some of this, but lost credibility during the crisis.

Third, more commodity revenue will flow into sovereign wealth funds. Their value will not be only financial; they will also foster a culture of transparency and professionalism in other areas of the treasury. One of those areas will be the management of the state's nonfinancial assets. Why insist on transparency in, say, an oil-driven wealth fund if the state-owned oil company operates in secrecy?

Fourth, more governments will adopt performance-based management, initially through results-based budgeting. The technology to define, measure, and disseminate standards has improved. So it is easier to hold governments accountable, especially at the subnational level where governors and mayors are in closer contact with their constituents. And fifth, the process of decentralizing fiscal decision making down to states and municipalities is mutating into “devolution” from the state to the citizen. The logistical mechanisms to transfer cash directly to the poor (from debit cards to cell phones) are now in place in many developing (and developed) countries. It is just a matter of time before those mechanisms will be used for other public services and for all social strata. This kind of state-citizen relationship will improve the quality of fiscal outlays—better targeting, smarter design, less duplication, and more progressivity.

Public Expenditure: Spring Cleaning

On average, the hope that countries would respond to the crisis through increases in public expenditure that would both sustain aggregate demand in the short run and, at the same time, contribute to long-term growth proved too optimistic. Things may turn out better in the postcrisis. Worries about fiscal sustainability may facilitate a “spring-cleaning,” that is, a push for sharper targeting, more effective budget institutions, and lower costs in delivering public services. Old-fashioned, across-the-board cuts and freezes are unlikely—most governments have learned to replace the ax with the scalpel. Even in 2009, growth in all-important social spending among developing nations slowed but did not stall (from above 5 percent per year to just under 2 percent), and it is expected to return to its previous trend in about three years.²

More important, the 10 early lessons of 2009 are being heeded in the design of public expenditure plans. First, policy responses must be tailored to country circumstances (from fiscal space and initial debt levels to monitoring capacity and political maturity). Second, the risk of a double-dip global recession cannot be assumed away. Third, medium-term budgetary frameworks help anchor expectations. Fourth, actual service delivery is still the key to credibility. Fifth, ministries of finance need neutral and professional project evaluation capacity. Sixth, line ministries need implementation capacity. Seventh, public-private partnerships in

infrastructure are very useful, but there should be no rush into long-term obligations. Eighth, electorates love to know how money is being spent (see the popularity of expenditure-tracking Web sites in the United States and Brazil). Ninth, a large-enough crisis will bend any fiscal rule, and rightly so. And, tenth, it cannot be assumed that donor funding will not be cut.

Debt Management Will Get Tougher

The crisis brought respect to public debt managers in developing countries. Over the previous decades, they had lightened debt burdens both by arranging outright repayments and by engineering better terms for the remaining liabilities (lower interest rates, longer maturities, more local currency). Their offices became more professional, more independent, and more transparent—not unlike most central banks. All this proved handy, almost visionary, when the world's financial markets entered a tailspin. But for all their new craftiness, those debt managers had been operating in a favorable global landscape—growth, prudent policies, financial innovation, and, for low-income countries, plenty of debt relief.

That placid landscape has drastically changed and is now mined with new risks that will put debt management capacity to the test. The recovery in the G-7 may falter or keep growth minimal for years. The fiscal adjustment necessary among advanced economies to bring their debts down to sustainable levels may prove politically impossible. So a sovereign debt crisis among them cannot be assumed away. Financial regulation is, as mentioned earlier, in flux and may get Balkanized if each country follows its own, uncoordinated path toward financial reregulation. In the medium term, international interest rates have only one way to go—up. Developing countries are seeing their currencies appreciate—in some cases, out of speculative capital movements across borders. Plenty of contingent liabilities have been incurred by the state to inject capital into banks, soothe depositors, back corporate obligations, or guarantee returns on private infrastructure investments. If debt managers in developing countries can successfully navigate these uncharted waters, they will deserve much more than respect.

To make matters worse, the debt management capacity that developing countries have built over the past decade has jurisdiction and

control over the liabilities of the central (federal) government only. But much of the growth in public indebtedness is taking place at the subnational level (states, provinces, municipalities), where capacity and transparency are at best limited. By now, about a third of all public debt in, for example, Brazil is owed by subnationals. The numbers are not small (30 percent of GDP in India, to name one case). The borrowing is driven by the decentralization of public services (and, implicitly, of political power), the speed of urbanization, and, until the 2008–09 crisis, the competitive pressure on lenders to find new clients. What are the main risks? First is the fact that sovereign credit ratings cap subsovereign ones, and any turbulence in the macroeconomic fundamentals of the country as a whole derails subnational financing plans, no matter how well thought out. Second is the precariousness of ex ante regulatory frameworks for subnational borrowing (who decides who is allowed to borrow how much) and of ex-post mechanisms for resolving insolvencies (how a province or a city goes through bankruptcy). Third is the growing volume of contingent liabilities that subnationals carry, from the special-purpose vehicles so popular among China's local authorities that want to finance infrastructure, to the pension promises made to local civil servants in Brazil. The standards for disclosure and the accounting rules for these kinds of contingencies vary widely in quality—when they are followed at all. And, fourth, the level of competition in subnational lending still leaves a lot to be desired. Usually a municipal bank or equivalent dominates, keeping borrowing costs unnecessarily high and borrowing options unnecessarily narrow.

Asset Management: The Time of Sovereign Wealth Funds

Two global factors will increase the size and number of sovereign wealth funds. On the one hand, interest rates in the G-7 will stay low for a while. Seeking higher returns, capital will flow into promising developing countries. Those countries' central banks will accumulate foreign currency reserves and will try to invest them in something more profitable than the traditional U.S. Treasury Bills. On the other hand, in resource-rich economies, the combination of higher commodity prices and more fiscal discipline will drive cash accumulation in governments' books. It is

estimated that, by 2017, sovereign wealth funds might hold assets worth US\$17 trillion (roughly the size of the U.S. economy), of which up to US\$5 trillion (five times Mexico's economy) could be invested in emerging markets. And that is before any geostrategic consideration—like securing priority access to energy.

Will all this be a repeat of the 1980s recycling of oil money into a debt crisis? Probably not. Much of the new investment flow will be South-South and will go into long-term positions: China buying African assets is a prime example. Recipient nations have stronger fundamentals, including a lot less debt. Monitoring and reporting techniques have improved. And, being part of the balance sheet of the state, the funds and their operations enter into the scrutiny of creditworthiness calculations. This does not mean that sovereign capital flows will be riskless for the recipients—their purchases (sales) can cause price bubbles (busts) if the local financial market is small; politically motivated sudden repatriations are not unthinkable; and many subcontract part of their portfolio to highly leveraged hedge funds. But they will become a major source of external financing.

People: The Beginning of the End of Poverty

The world is beginning to win the war against poverty. Over the past 30 years, the proportion of people living on US\$1.25 a day or less fell by half—to less than a quarter. The trend is also clear when using each country's own definition of poverty. Hunger, a bottom-line indicator of progress, is falling too. The 2008–09 crisis pushed some 60 million people into poverty, but it is unlikely to have much permanent impact on the downward direction in global poverty counts. Of course, differences across regions are significant—in China, 400 million people are no longer poor, while in Sub-Saharan Africa, about half the population still is. And inequality remains a tall and diverging order—it is contracting slowly from high levels in places like Brazil and rising rapidly from low levels in others like China. But having fewer poor people makes it easier to deal with inequality.

More fundamentally, there is now a budding consensus on what reduces poverty: it is the combination of fast and sustained growth

(more jobs), stable consumer prices (no inflation), and targeted redistribution (subsidies only to the poor). If these are going in the right direction, where should poverty fighters focus next? On better jobs (productivity), more human opportunity (equity), lower risk (social protection), less discrimination (gender), and easier cross-border help (remittances).

A Job, a Chance, and a Hedge

Labor income is the main source of revenue for poor households. It is so important that, in the least developed countries, poverty is higher among the employed—unemployment is a luxury people cannot afford. So their only way out of poverty is through earning more from their work. What matters to reduce poverty is not just jobs, but also how productive that employment is. This points toward a more efficient allocation of resources in the economy as a whole and to the broad agenda of reforms that make an economy more competitive. It also points toward something much closer to the individual: skills, both cognitive (say, critical thinking or communication ability) and noncognitive (say, attitude toward newness or sense of responsibility).

At the same time, it is now possible to measure how important personal circumstances—like skin color, birthplace, or gender—are in a child's probability of accessing the services—like education, clean water, or the Internet—necessary to succeed in life. That measure, called the Human Opportunity Index (Molinas and others 2010), opened the door for social policy to focus on giving everybody not just the same rewards, but also the same chances—not just on equality, but also on equity. A few countries, mostly in Latin America, now evaluate existing social programs, and design new ones, with equality of opportunity in mind. Others will follow.

Crises, new and old, have shown how fragile social progress is. A few quarters of recession, a sudden inflationary spike, or a natural disaster occur, and poverty counts skyrocket—and stay sky-high for years. The technology to protect the middle class from slipping into poverty, and the poor from sinking even deeper, is still rudimentary in the developing world. Unemployment benefits, when they exist at all, cover only formal workers, who usually are a minority. Public works programs are not very useful when the problem is not unemployment

but a sudden contraction in real wages. And direct transfers are difficult to expand in a hurry without endangering the quality of their targeting.

Treat Women Fairly

The 2008–09 crisis, and the spikes in international food and fuel prices that preceded it, also highlighted the crude economic consequence of gender inequality—it slows growth when you need it the most. Women saw the crisis hit hard the sectors where they are disproportionately represented (informal self-employment, assembly-line manufacturing exports, and high-value agricultural exports). They responded by seeking further participation in the labor market, formal or informal. And in general, when governments reacted, they focused on the right short-term priorities, like attaching child-care facilities to public works programs, channeling through mothers all direct cash transfers to households, expanding nutritional supplementation for infants, and reaching female farmers with production inputs.

But the true impact will likely be felt for, and by, a generation, since it is estimated that a 1 percent drop in per capita GDP raises infant mortality by twice as much for girls as for boys. In fact, the future priorities of gender policy will be defined by demographic dynamics. Countries still facing demographic “explosions” (mostly in Sub-Saharan Africa) will continue to prioritize maternal health and family planning services, especially among teenage mothers, who are about a hundred times more likely to die during childbirth than their Western European peers. Two-thirds of developing countries are, instead, in demographic transition, with large working-age populations relative to children and the elderly. Here, the gender priority is in women’s effective participation in the labor markets, primarily through skill formation and support to entrepreneurship. A smaller, but growing, group of countries (all of them in Eastern Europe) are experiencing demographic “implosions,” with rapidly aging populations. This has exposed the dearth of, and the need for, social security for women, a legacy of comparatively lower labor market participation, higher informality, and smaller salaries. Finally, two dozen countries are trapped by armed conflicts or by chronic diseases (like HIV/AIDS) in an “hourglass” demography: they are depleted of working-age adults. While wars affect men much

more than women, three-quarters of HIV-positive, young African adults (age 15–24) are female.

Poor-to-poor Transfers

Past financial collapses and natural disasters in individual, migrant-sending countries had been shown to increase the remittances those migrants wire home—to help the family in trouble or to buy local assets on the cheap. But how remittances would react to a global crisis was unknown. The answer came in 2009: they are resilient, even countercyclical. Overall, remittances to developing countries fell by just 6 percent, to some US\$300 billion, and are projected to grow again, albeit more slowly. That relative stability is a blessing: for many recipient economies, remittances are the largest source of foreign currency—larger than any export, private financing, or official aid. As such, they even feature high in sovereign credit ratings (Bangladesh, the Philippines).

What kept remittances going? For starters, a global crisis, one that affected all countries, caused little change in the stock of migrants abroad (why return if things are bad everywhere?). Not even financial incentives convinced migrants to leave the Czech Republic, Japan, or Spain. Charity played a part too: remittances are usually a small part of the migrant's income at destination, so he or she can afford to send extra cash to help relatives cope with the downturn. Exchange rate movements in favor of the U.S. dollar made investing in assets at the countries of origin cheaper; this “sale effect” was patent in, for example, Ethiopia, India, and Pakistan. Tightening borders to shield native workers from competition made migrants less willing to leave (it is more difficult to come back) and their remittances more stable. And those that did leave took their accumulated savings with them, making the total flow of remittances even bigger.

If remittances are so large and so stable, is there anything governments can do to leverage them into faster economic development? Yes, plenty. First and foremost, there is too little competition and transparency in remittance markets, where transfer fees tend to be unrelated to cost (usually, and unjustifiably, a fixed percentage of the value remitted). Subsidizing banks' marketing (Pakistan), mobile money-transfer technology (Kenya), or settlement systems (the Philippines) is worth an experiment. Funding investment projects with “diaspora bonds,” that is,

securities that are targeted to migrants who may feel more comfortable with local regulatory standards, has proven useful (El Salvador). Bilateral efforts to establish guest-worker programs (for example, between Europe and India) have served well both origin and destination countries—and have taken some of the political pressure out of immigration debates.

Developing Regions: The Path to “Newly Developed”

How does the new horizon of markets, governments, and people translate in each geographic region of the developing world? How will it impact their challenges—and their opportunities? It is difficult to draw a single conclusion. Their initial conditions are just too different—from physical endowments and human capital to cultural preference and political systems. Still, a sense of optimism is in order. While the remaining risks are large—a sovereign default in an advanced economy or a “bubble-like” explosion in a large emerging-market exporter—the fundamentals are solid. Developing countries have, on average, done their homework and are likely to stay with sensible policies. More fundamentally, their citizens’ feeling of prosperity will make it increasingly implausible for leaders to radically change course—close their economies to the world, abuse the public treasury, jeopardize investment flows. The opposite is more likely. That will mean a new development stage (and status) for regions like East Asia, Latin America, South Asia, and, soon, Africa. The Middle East and North Africa will get a new opportunity to take off. Things will for a while be more complicated for Eastern Europe (its legacy problems need to be solved first) and for small states (their size will not make it easier to adjust to the new global reality).

Africa: Takeoff Time

In the decade up to 2007, Africa gave us a glimpse of what it is capable of. Growth was fast and sustained. Poverty fell by almost 10 percentage points (when measured at US\$1.25 or less per person per day). Median inflation was halved. High commodity prices and more foreign aid, private capital flows, and remittances all played a part in that performance. But the ingredient that made the difference, the one that was not present in previous booms, was better economic management. Sure, too many African countries remain trapped in conflict, which makes prosperity

impossible. But most were beginning to trace a promising development path. In came the global crisis, with its destruction of export demand, capital flows, remittances, and prospects for further aid. Growth stayed positive, but slowed to a trickle. This had an immediate human cost—it is estimated that for each percentage point of growth lost, the region sees 30,000 additional children die before their first birthday. By and large, governments responded as well as they could—lowering taxes, enlarging safety nets, spending some of the windfall that they had saved. The questions now are: Can Africa return to its previous path when the world recovers? Can it make that path even more promising?

Yes, it can. But it will have to show more than good macroeconomics and address the four structural challenges that still tie it down. First, its massive infrastructure gaps. The needs are so large (some US\$50 billion per year) that no single government can afford them. The challenge is how to attract the private sector to take more long-term “Africa risk.” Second, its difficult demographics. For some countries, this means reigning in still-explosive fertility rates. For others, it means employing the bulge of youth (some 10 million per year) that is beginning to arrive at the labor market. Third, the quality of its state institutions. Public services, from education and health to sanitation and security, have rarely been up to par or commensurate with the resources they absorb. And fourth, making the case for, and the most of, additional foreign aid. In a postcrisis world where traditional donor countries face huge budget problems themselves, keeping past promises of larger assistance (like the Gleneagles commitment) will not be easy. Ironically, the chances that aid could help Africa transform itself have never been higher.

East Asia and Pacific: A “New Normal”

The countries of East Asia are leading the world out of its economic and financial crisis and may well become the new engine of global growth. Their response to the crisis was swift and effective, based on large fiscal and monetary stimuli. Their postcrisis macrofundamentals are strong—low inflation, low debt, and low fiscal deficits. Growth is returning to its trademark high path, especially in all-important China. But the region is about to face “a new normal,” one in which the growth in the United States, Japan, and the eurozone will be slow or nonexistent. This will shrink East Asia’s export markets and may increase the cost of its financing.

How should East Asia respond to that new normal? Can it complete its exemplary march toward development? Yes, but only if it tackles its pending agenda of structural reforms. That agenda varies significantly across countries. China needs “rebalancing”: its capital-intensive, industry-led, export-oriented model does not create enough jobs, consumes too much energy, is environmentally unsustainable, and depends on an external demand that may remain weak for years. That model now needs to be complemented by the expansion of domestic consumption and by a larger role for the service sector, something that points to public investment in health and education and to the removal of distortions in the pricing of capital, energy, and land. For the middle-income countries of East Asia (Indonesia, Malaysia, the Philippines, and Thailand), the challenge is to move up the value chain; they still lack the necessary physical and human capital to break into knowledge- and innovation-based markets. In turn, trade facilitation is the key for the low-income economies of East Asia (Cambodia, the Lao People’s Democratic Republic, and Vietnam) to break into the production networks of the region; they are in the right neighborhood and ought to make the most of it. The Pacific Islands will continue to face the problems associated with small scale; their hope is in new telecommunication technologies, subregional integration, and better aid coordination. Nor have the commodity exporters of the region (Mongolia, Papua New Guinea, and Timor Leste) benefited from revenue stabilization techniques; adopting, and respecting, medium-term fiscal frameworks is a priority for them.

Despite the many differences across its countries, East Asia does have a common regional agenda around two issues: its own economic integration and its adaptation to and mitigation of climate change. The former calls for better logistics, lowering of mutual investment barriers, liberalization of trade in services, more fluid coordination in financial market regulation, and intraregional labor migration. The latter could be well served by directing a part of the region’s impressive investment levels toward greener technologies.

Eastern Europe and Central Asia: Dealing With a Heavy Legacy

Following the fall of the Berlin Wall, Eastern Europe and Central Asia (ECA) experienced two decades of rapid growth, rising living standards,

middle-class expansion, institutional development, and integration into the European Union (de jure or de facto). But the global crisis hit ECA hard—harder than any other region in the world—and reversed many of its earlier achievements. It also unmasked a critical weakness behind the region's success: its unsustainable dependence on foreign savings. ECA was living beyond its means, and the abundance of external financing had allowed it to indulge in public and private expenditures that it could not afford. Further, much of the public expenditure was achieving little and inequitable results.

This lays bare the policy agenda going forward, an agenda that is relevant to virtually all countries in the region in spite of their many natural, economic, and scale differences. First, the region will need to recover, and eventually accelerate, growth with fewer resources—in other words, through increases in productivity. This calls for more efficiency in the use of public resources (fiscal consolidation), a better investment climate (tax, customs, and regulatory reform), a consolidated financial industry (especially, domestic banking), an enhanced energy and transport infrastructure, and a constant search for new market niches through innovation. Second, focalization and accountability will be required to improve the efficiency, quality, and fairness of social services (health, education, social security). This could not come too soon, for ECA's population is rapidly aging, and the viability of its production capacity is being challenged by the imperatives of climate change (notably, the central-planning legacy of high energy consumption).

Latin America: A New Maturity

The global financial crisis had a mild impact on Latin America, especially when compared with past experience. This time, there were no debt defaults, bank runs, collapsing currencies, inflationary spikes, capital flight, or bursts of emigration. Growth came to a standstill and poverty increased (by some 8 million people), but there was no economic or social meltdown. Efforts over the previous decade at better macroeconomic management and smarter social programs paid off. Perhaps more important, the crisis and the recovery opened the possibility of a new level of quality in the region's policies, the possibility of a new maturity in how Latin America seeks development.

First, independent fiscal agencies will, in various forms, become common. Countercyclical fiscal policy—the simple idea of saving in good times to spend more in bad ones—was tested in the region for the first time during the crisis (in Chile) and proved to be politically very popular. This will foster imitation. Much as, 10 years ago, Latin America left behind its history of high inflation by giving control of money creation to independent central banks, the idea of neutral oversight of fiscal expenditures cannot be too far behind. This will complement well the various forms of fiscal rules, frameworks, and pacts with which Latin American countries have been experimenting. And it will come in handy if commodity revenues continue to flow apace and lead to the emergence of sovereign wealth funds.

Second, success in trade will depend less on new free trade agreements than on new products. With rich-country partners expected to remain stagnant and local currencies already traveling on a long-term trend of appreciation, additional commercial penetration will have to come from new brands—that is, from innovation. The problem is that few regional countries provide environments where innovation can happen, ranging from intellectual property rights that are protected to universities that talk to businesses.

Third, having sailed through the crisis unharmed, Latin American financial sectors will see reform at both ends of the technical spectrum. On one side, the international regulatory wisdom will shift toward more (and, hopefully, better) oversight by the state over matters like systemic risk, countercyclical bank provisioning, and nonbank intermediaries. How much of that will the region adopt, adapt, or avoid? On the other side, political pressure will reach a tipping point to raise competitive pressure in, and widen access to, financial services for the poor.

Fourth, the focus of social policy will begin to shift from equality toward equity. This will be facilitated by two new technologies that were discussed before: (a) the individualized relationship between the state and the poor that was built in 13 countries of the region to make conditional cash transfer programs possible; and (b) the emergence of the Human Opportunity Index, a statistical tool that measures how personal circumstances affect the chances children have in life.

Fifth, new technologies will also spur a new contract between Latin Americans and their state. Management by results will become more common, as people demand of their governments, whether national or local, the best performance standards that they see elsewhere—from education to security. Monitoring and evaluation techniques will be in high demand. In a gradual but visible transformation, the individualized mechanisms to transfer resources mentioned above will push the decentralization of state functions—a process that gained unstoppable momentum over the past two decades—to its natural consequence: devolution. There will be fewer intermediaries between the makers of public policy and those that are supposed to benefit from it.

Middle East and North Africa: One More Chance

The countries of the Middle East and North Africa (MENA) felt the crisis in different ways. Those in the Gulf Cooperation Council were hit on three fronts: lower oil prices, a credit freeze, and the bursting of the real estate bubble. Less integrated into global financial markets, the developing oil exporters suffered mostly from the sudden loss of value of their main export. And the oil importers saw a collapse in trade (especially with Europe), a contraction in remittances, and a cooling of foreign direct investment. All this exacerbated the region's chronic unemployment problem. It is not easy to see how MENA will create the 40 million new jobs it needs over the next decade, just to keep up with its young demographics.

The solution to that fundamental problem, and the key to unlocking MENA's enormous potential, has not changed much with the crisis (and varies very little across countries): the door has to open for a new generation of private entrepreneurs to emerge and for women to join economic life. There has been no lack of reforms in the business environment over the past decade (the Arab Republic of Egypt led the way). But private investment did not respond—it lingers at half the level of East Asia—and manufacturing productivity did not improve—it stayed at half the level of Turkey. Why? Because many of the reforms were captured by unreformed institutions that favor connected, incumbent firms. The benefit of newcomers bringing state-of-the-art management, technological innovation, and the sheer energy to imagine brands and open markets did not materialize. Real competition has not started.

More critical, the region is yet to use the talent of its women. Ironically, they are more likely to attend university than men. But, on average, only one in four joins the labor force—much less the political leadership. Some progress has been made, notably in reducing fertility rates. However, at the current speed, the challenge of building a vibrant economy that can stand up to world standards will go unmet.

South Asia: An Opportunity to Transform

South Asia withstood the crisis better than any other area of the world and was the first to return to its growth path. The problem is that that path is not fast enough or inclusive enough to deal with the 1 billion people that subsist in the region on less than US\$2 a day—the largest concentration of the world’s poor. This defines a very specific policy agenda, one that attends to medium-term macroeconomic needs while it transforms the fundamental tenants by which South Asian societies live.

On the first front, high fiscal deficits and high public debt leave little fiscal space to spend on priority social programs and critical infrastructure gaps. This is hardly surprising, since tax collection is dismal (India aside, the tax burden hovers at around 10 percent of GDP) and much of what is collected is spent on untargeted subsidies (to oil, electricity, fertilizers, food, and many other things) or unproductive purposes (military expenditures or pay raises to the civil service). This puts a premium on attracting (“crowding-in”) the private sector to fund infrastructure, something that is fortunately beginning to happen (Bangladesh, Bhutan, India, Pakistan). But more fiscal discipline should also help deal with another looming threat—settling on a higher inflation rate than before the crisis (around 10 percent). That would make poverty reduction even more difficult.

Beyond better macroeconomics, a deeper transformation is at stake. South Asians are demanding better and cleaner governments—governments that can deliver results—not just because corruption and inefficiency are slowing private initiative, but also because better governance is necessary to seize the four opportunities (“the four dividends,” if you will) that the region faces. First is ending the violent conflicts for which this part of the world stands out. A “peace dividend” in the form of a 2-to-3-percentage-point increase in the rate of long-term

growth is possible. Second, there could be a “demographic dividend” in the changing shape of the population pyramid: 150 million new workers will have to be incorporated into the labor force over the coming decade. This will be no easy task, because half of today’s population is illiterate. Third, an “urbanization dividend” lies behind the fact that South Asia is very densely populated, but very scantily urbanized. Economies of scale and of agglomeration wait to be exploited. Fourth is an “integration dividend.” The region is embracing the global trade rebalancing with gusto. China has overtaken the United States as India’s largest trading partner, and South-South trade now dominates exports from Bangladesh, Pakistan, and Sri Lanka. Further, the new destinations are boosting manufacturing, a sector that was relatively dormant.

In Conclusion

While some regions will do better than others, and some technical areas will be clearer than others, there is no question that the horizon of economic policy for developing countries is promising—risky, yes, but promising. The rebalancing of global growth toward, at the very least, a multiplicity of engines will give the developing world a new relevance. It will validate the many sensible policy positions that, on the whole, sheltered that world from the 2008–09 crisis. And it will give a new sense that governments can do good things, notably eliminate poverty.

There is, however, a humbling lesson behind that optimistic horizon—the large gap between what we think we know and what we actually know. Before the crisis, our “grip” on macroeconomic and financial policy was almost a certainty. Advanced economies could do no wrong. Government action was bad until proven otherwise. Attachment to a rich, western market was all we needed to be rich and western. Those and many other certitudes proved to be subprime truths. So this book, and the many readings on the future that it contains, should be kept in perspective.

Notes

1. The decoupling in trends is observed even when unusually fast-growing economies, like China and India, are taken out of the data sample.
2. Eastern Europe may be the exception.
3. See Molinas and others 2010.

Reference

Molinas, J., R. Paes de Barro, J. Saavedra, and M. Giugale. 2010. *Do Our Children Have a Chance? The 2010 Human Opportunity Report for Latin America and the Caribbean*. Washington, DC: World Bank.

