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Do Crises Cause Reform? A New Approach to the Conventional Wisdom

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Abstract

Two claims pervade the literature on the political economy of market reforms: that economic crises cause reforms; and that crises matter because they bring into question the validity of the economic model held to be responsible for them. Economic crises are said to spur a process of learning that is conducive to the abandonment of failing models and to the adoption of successful models. But although these claims have become the conventional wisdom, they have been hardly tested empirically due to the lack of agreement on what constitutes a crisis and to difficulties in measuring learning from them. I propose a model of rational learning and apply it to the decisions to adopt an export promotion strategy and to liberalize the capital account. I show that, whereas learning from the 1982 debt crisis seems to have been crucial for the adoption of an export promotion strategy, that crisis and the financial crises of the 1990s did not convey clear lessons about a superior capital account policy.

Resumen

Dos afirmaciones predominan en la literatura sobre las reformas del mercado en la economía política: que las crisis económicas causan reformas; y que éstas importan porque cuestionan la validez del modelo económico vigente hasta entonces. Las crisis económicas se dice, estimulan el proceso de aprendizaje que conduce a abandonar los modelos que han fracasado y adoptar los modelos exitosos. Pero, a pesar de que estas afirmaciones se han convertido en conocimiento común, difícilmente han sido probadas empíricamente a causa de la falta de acuerdos sobre qué constituye una crisis y las dificultades para medir el aprendizaje de ellas. Se propone un modelo de aprendizaje racional que se aplica a las decisiones de adoptar una estrategia de promoción de exportaciones y liberalizar la cuenta de capitales. Así, se muestra cómo las lecciones de la crisis de la deuda de 1982 parecen haber sido cruciales para la implementación de una estrategia de promoción de exportaciones; esa crisis y las crisis financieras de los años noventa no arrojaron lecciones claras sobre qué políticas de cuentas de capitales son mejores.

Introduction

Do crises cause economic reform?[1] According to much of the literature on the topic, there is evidence that countries reform when confronted with adverse economic conditions: recessions, hyperinflations, and big fiscal and external deficits are likely to open the door to reform by triggering particular mechanisms that remove obstacles and opposition to policy change (Nelson, 1990; Grindle and Thomas, 1991; Haggard and Kaufman, 1992; Bates and Krueger, 1993; Haggard and Webb, 1994; Nelson, 1994; Williamson and Haggard, 1994). Yet the so-called crisis hypothesis faces theoretical and empirical challenges.

Theoretically speaking, the hypothesis is considered by some to be tautological and unfalsifiable. As Dani Rodrik (1996) put it, if a crisis is a case of extreme policy failure, there is nothing remarkable about policy reform following a crisis. It is as predictable as smoke following fire. Thus, there is nothing to explain. Other authors contend that there is something to explain if extreme economic hardship alone is conducive to reform. But why do economic conditions have to be not just bad but very bad for a government to undertake reforms?

In this paper, I focus on a particular mechanism linking very bad economic conditions to the probability of reform. According to some authors, a period of deep economic disarray leads to a reassessment of the mapping from policies to outcomes. Politicians hold particular beliefs that contain explanations of good and bad economic results. However, "every now and then, something happens that does not fit the previous image —something that shakes our Bayesian faith in what we used to think" (Harberger, in Tommasi and Velasco, 1995: 18). A period of deep economic disarray is a good candidate for precipitating a loss of faith in the current economic model. Economic crises lead to reform because they question the validity of the economic model employed up to that moment. This is precisely the mechanism that I test here.

The "crisis hypothesis" faces important empirical challenges too. The most obvious is how to operationalize the notion of "crisis". It is striking that a hypothesis that constitutes the conventional wisdom in the policy reform literature has hardly been tested cross-nationally. Most evidence concerning this hypothesis is based on interesting case studies that offer useful but ultimately anecdotal evidence. Overall, as Drazen (2000) states, econometric studies that test it are just as rare. This paper contributes to filling the empirical gap in the literature.

[1] I use the expressions "policy reform", "policy change" and "policy switch" interchangeably to refer to the adoption of market reforms.

I focus on the role that learning from the 1982 debt crisis played in the abandonment of the import substitution strategy of development (*ISS*) and the subsequent adoption by a good number of developing countries of an export promotion model (*EO*). I offer another illustration concerning shocks and capital account liberalization. I enquire whether learning from the European Monetary System (EMS) currency crisis in 1992 and the Mexican peso crisis in late 1994-1995 is related to decisions concerning opening or closing the capital account. I use rational updating to model learning. In particular, in a rational framework shocks are modeled as an increase in the uncertainty of the beliefs that politicians hold about expected outcomes. If governments hold very definite beliefs about what outcomes will follow particular policies, their incentives to scrutinize the evidence are minimal. However, if crises increase politicians' uncertainty about what to expect from policies, then politicians will be more attentive to actual outcomes. In turn, if the results point overwhelmingly to the superiority of one of the policy strategies, a change in policy is predicted as long as politicians choose policies rationally. To the best of my knowledge, this is the first paper that treats empirical learning as the mechanism that mediates between economic crises and policy reform.

According to the results, the 1982 debt shock and ensuing recession do explain the abandonment of the *ISS* and the adoption of the *EO*. Moreover, learning from this shock is relevant to explaining the policy switch, whereas simply learning from others' experience under alternative models of development is not. The increase in the uncertainty of policymakers' beliefs resulting from the 1982 debt shock made them more attentive to evidence that in turn pointed to the superiority of *EO* over *ISS.*

Contrary to this finding, neither learning from others nor learning from the European or Mexican financial crises had any impact on the later trend to liberalize the capital account. I argue that these results are consistent with the evidence concerning the performance of capital account policies. Whereas the performance under *EO* has been superior to that under *ISS* in the sample and the period under study, there is little theoretical or empirical evidence that opening the capital account is good for growth. In particular, there is little systematic evidence that capital account openness helps countries to muddle through financial crises (Eichengreen and Leblang, 2003).

The paper proceeds as follows. In section 1, I briefly review the literature on economic crises and economic reform, with especial reference to *EO* and capital account liberalization. Section 2 explains how crises can be modeled in a rational updating framework. In section 3, I discuss the empirical application of rational updating to cross-national data, the variables, and the results. I conclude in the last section.

1. Economic Crises and Economic Reforms

The crisis hypothesis comes in two versions. According to the first version, bad times (economically speaking) are a necessary condition for governments to launch economic reforms. According to the second version, only ***very*** bad times induce reform. A good number of edited volumes that review the reform experience of many developing countries show that economic disarray is at a best a necessary condition for policy reform; but rarely is it a sufficient one. A crisis may trigger the sense that something needs to be done. Yet taking action depends on whether policymakers have the political capacity to do so. In turn, political capacity relates to the type of political regime. If the regime is a dictatorship, political opposition to reforms can be repressed and institutions more easily circumvented. If the regime is a democracy, political capacity depends on the size of the political mandate and the ability of the incumbent party to assembly a coalition in favor of reform (Haggard and Kauffman, 1992; Nelson, 1990, 1994; Keeler, 1993).

As mentioned in the introduction, the first version of the crisis hypothesis has been considered to be, in general, uninteresting. Yet some scholars consider that the second version of the crisis hypothesis —that countries have to be in ***deep*** trouble to reform— contains an interesting puzzle. However, solving the puzzle requires some consensus on what constitutes ***very*** bad economic conditions as opposed to just ***bad*** economic conditions.

The few authors who have addressed this issue operationalize a crisis as a deterioration of some economic variable above or below a particular threshold or against some previous figure. For example, according to Tornell (1998), a crisis exists if a country's inflation rate is 40% or more and it has increased by 125% or more from the previous year. Tornell also considers a decline of GDP per capita by more than 18% relative to the previous year as an indicator of crisis. Another relevant macroeconomic variable is the balance of payments. In this case, an economic crisis is deemed to exist if a country's level of international reserves is less than the equivalent of three months' worth of imports. Alternative operationalizations can be found in Drazen and Easterly (2001). These authors look at inflation, the black market premium, the growth rate of GDP per capita, the current account deficit, and the public sector deficit. These indicators are roughly similar to those used by Lora (2000) in his study of economic reform in Latin America. Finally, another very used indicator of crisis has to do with abnormally strong market pressures for currency depreciation (Leblang, 2003).

By which mechanisms can ***deep*** economic crises facilitate reform? The answers to this question are closely related to the parallel studies on inaction and delay of reforms (see Drazen, 2000, for a summary). In these studies, the basic idea is that vested interests block policy change. Yet, if the ***statu quo*** deteriorates to the point where it is obvious that everybody loses if it is

perpetuated, then reform is possible. An alternative view of inaction emphasizes that policy reform may be blocked due to ***ex ante*** uncertainty about who the winners and who the losers will be in the post-reform scenario (Fernández and Rodrik, 1991). But again, in the midst of deep and persistent economic trouble (for instance, in a hyperinflation), it is certain that everybody loses if stabilization is not undertaken. Thus, deep crises increase state autonomy. All these plausible arguments have been formalized but they have been rarely tested (see Tornell, 1998 for an exception, and Lora, 2000 for a discussion on the mismatch between theory and data).[2]

Note that these approaches to the study of the impact of bad economic conditions on the probability of reform link crises with an increased ***capacity*** for action. A deep crisis can reshuffle vested interests, thus facilitating action. But what determines the ***content*** of the response? If crises enhance governments' autonomy to act, governments' beliefs about what is to be done turn out to be crucial to understanding policy choices. Crises create opportunities for change by increasing state autonomy. State autonomy creates the capacity to implement policy choices. But the content of those policies is at least partly determined by policy-relevant knowledge.

Deep crises generally come with some diagnosis of what causes them. In this sense, the diagnostic conveys some policy content, at the very least, about what should be avoided. I argue that the mechanism that relates deep crises to the ***content*** of the response is learning: the content of the response is the outcome of a process of updating beliefs about which policies do work and which ones do not work (learning). What a deep crisis does is to question the validity of the economic model seen as responsible for the crisis. As Tommasi and Velasco (1995) put it, crises lead to a realization of how costly some previous policies were and to a reassessment of the economic ideas that connect policies to outcomes. Politicians' beliefs about the "right" model of the world do not change frequently. Yet a deep economic crisis can alter those beliefs, leading to a process of social learning (Kahler, 1990, 1992).

The empirical tests of the impact of crises on a wide range of economic policies provide results as diverse as the definitions of crises. Drazen and Easterly (2001) report that hyperinflation and extreme values of the black market premium are indeed followed by reforms.[3] Lora (2000) finds that a falling per capita income is the best predictor of his index of reform (which includes privatization, trade, financial, tax and labor reforms). He also

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[2] An alternative perspective linking very bad economic conditions with increased probability of reform is based on the postulates of prospect theory (Weyland, 1996). According to this cognitive approach to decision making, politicians and the public have different attitudes toward risk depending on whether they are in the so-called domain of gains or domain of losses. A very deep economic crisis places politicians and the public in the domain of big losses, which in turn induces them to take the risk of launching reforms. Reforms are considered to be a risky choice for politicians given the anticipated unpopularity of austerity policies. However, reforms have been sometimes accompanied by boosts in politicians' popularity, not the opposite (Stokes, 2001).

[3] The authors suggest that public sector deficits and bad external accounts attract foreign aid rather than spurring reform.

reports that, in particular for trade reform, the best proxy of crisis is the rate of decline of GDP, whereas for financial reform the best proxy is inflation. Both effects are small in magnitude, though. On the other hand, Milner and Kubota (2005) find no significant impact of falls in GDP per capita, inflation, or the balance of payments on the probability of trade liberalization. Simmons and Elkins (2004: 185) find a significant but also small positive effect of currency crises on capital account openness and exchange rate unification. However, Brune and Guisinguer (2006) find no effect of currency crises on the probability of liberalizing the financial system. Overall, it is hard to compare these results or to draw any clear conclusions from them: not only do the definitions of crises vary but the measures of trade and financial liberalization, the samples and the periods are not comparable.

1.1 Economic Crises and Development Strategies

As I have just observed, deep crises come with some diagnosis of what causes them. Thus, a prescription follows about what should be avoided and what implemented if some successful policy alternative exists. The 1982 debt crisis that the Mexican moratorium inaugurated was considered to be a financial crisis with origins in deep macroeconomic imbalances. Given this diagnosis, the emphasis was placed on stabilization policies to get the macroeconomic fundamentals right and on structural policies aimed at reducing what was considered to be excessive state intervention in turn responsible for the macroeconomic chaos.

Development strategies are packages of policies that aim to allocate resources among domestic industries and social groups. They also shape countries' relations to the global economy.[4] An ***EO*** development strategy consists of trade and industrial policies that do not discriminate between purchases of domestic goods and foreign goods. By contrast, an ***ISS*** strategy favors production for the domestic over the export market. ***ISS*** was identified with the strategy pursued by Latin American New Industrialized Countries (NICs) during the 1950s and 1960s. Two arguments justified the strategy. First, infant industries needed to be protected, at least temporarily. Second, Latin American countries could not generate foreign exchange from their specialization in the export of primary commodities subject to declining terms of trade.

Under ***ISS***, countries like Brazil and Mexico achieved phenomenal rates of growth prior to 1960s. After that, chronic balance of payments crises, increasing public deficits financed by creating new money or recourse to external indebtedness, subsequent inflation and rent-seeking led to the belief that ***ISS*** had outlived its initial purposes. This perception was accentuated by

[4] The literature on this topic is voluminous. See, for instance, Balassa (1980, 1988), Krueger (1983, 1984, 1985, 1990), Bhagwati (1985), Meier (1990), and Gereffi and Wyman (1990).

the parallel experience of the East Asian Tigers. Singapore, Hong Kong, South Korea and Taiwan grew at impressive rates while Latin America stagnated. The success of the former was attributed to the adoption of a strategy of export promotion, in turn inspired by the Japanese experience. ***EO*** promoted growth, even during periods of economic hardship.

The evidence was not ignored in policy circles. Miguel A. Rodríguez, president of the Venezuelan Central Bank, stated that "economists and policy makers in Latin America saw the per capita income growth of the Asian countries over the past twenty years and become more and more convinced that the opening of the economy was the best way to produce a real transformation in Latin American societies" (quoted in Williamson, 1994: 377). Arriagada and Graham (1994: 282) contended that, in Chile, which is considered to be the Latin American tiger, short-term populist strategies were discredited by "the chaos in neighboring countries, [which] made macroeconomic restraint much more politically palatable." According to Jadish Bhagwati (1985: 41) "[m]any developing countries learned the hard way by following IS [import substitution] policies too long and seeing the fortunate few pursuing the EP strategy [export promotion] to do much better. Perhaps learning by others doing and one's undoing is the most common form of education." Based on the contrasting experiences of Latin American and East Asian countries, ***EO*** became the accepted orthodoxy and with it the misleading idea that the state is a drag on economic development (Wade, 1990; Westphal, 1990; Rodrik, 1996, 2003).[5] Thus, the debt crisis opened a debate about alternative development strategies, as a result of which ***EO*** was actively promoted if not imposed by the International Financial Institutions (IFIs) and launched in many developing countries.

Evaluating the results of these alternative development strategies is complicated by the fact that good measures of these strategies, with their many dimensions —average tariffs and their dispersion, quantitative restrictions, export subsidies, tax credits, degree of exchange rate

[5] It is undeniable that the East Asian countries performed remarkably well. But the extent to which this performance can be exclusively attributed to reliance on export promotion is uncertain. Country stories show that *EO* was adopted amidst a very particular constellation of historical, social and political factors. A closer look at countries' experiences reveals that the story of the East Asian miracle was simplified in several aspects. For instance, the *ex post* reading of the East Asian success as primarily the result of the withdrawal of the state overlooks the fact that there are different types of state in terms of size, strength and autonomy, as well as different forms of state intervention. The experience of South Korea with selective intervention and infant industry promotion shows that reducing the bias of the regime may require active state involvement, not the opposite. The most recent cases of India and China also reveal that the best development strategy is one in which export promotion is combined with temporary import protection and considerable doses of state control of the opening process. It is true that the Latin American experience showed that state failures could be disastrous; but the East Asian experience does not establish that markets alone are enough to succeed. Yet in policy circles success was interpreted as clear evidence of the virtues of the market, in contrast to the failures of the state. Accordingly, policy recommendations of neutral development regimes came with broader recommendations to dismantle state intervention. This has been an unfortunate confusion, for it is one thing to promote exports, which was crucial for the East Asian success, and a very different thing to advocate a minimal role for the state, which was not.

overvaluation— are rarely available in a systematic and comparable way. Also, one has to decide what specific outcome may be relevant for politicians who want to learn about the consequences of alternative development strategies. I will take economic growth to be the outcome of interest for policymakers (Bresser ***et al***., 1993).[6] In this respect, empirical evidence on the relationship between openness and growth in developing countries is positive (Wacziarg and Welch, 2003) but weak (Frankel and Romer, 1999). Yet, as Stiglitz summarizes, "(...) there is by and large a consensus among economists —based on a wealth of studies— that trade liberalization brings significant economic gains (...)" (1998: 35).[7]

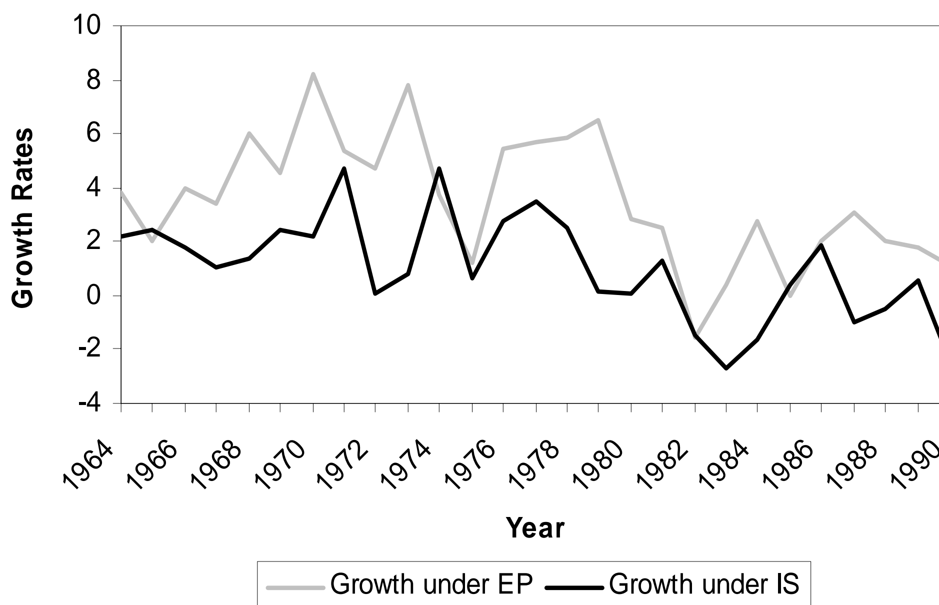
To make an argument based on learning from policy outcomes, it is crucial to have a sense of what that actual experience was in terms of economic growth under both development strategies. The figures below rely on data on development strategies from the World Bank Report (1987), which provided a list of developing countries classified under ***EO*** and ***ISS*** before and after the 1973 oil crisis**.** These data were complemented with IMF data on trade liberalization in the developing countries in the 1980s (1992, 1994). The database covers 51 developing countries in Africa, East Asia, South Asia and Latin America between 1964 and 1990, amounting to a total of 1,341 country-year observations.

Figure 1 shows the average rates of growth in the sample for the period of study under one and the other development strategy. As it is possible to see, on average countries under an ***EO*** development strategy performed better than countries under an ***ISS*** throughout the period. In particular, for the purpose of this paper, it is interesting to emphasize that the average rates of growth of countries under ***EO*** during the period following the 1982 debt crisis were better than the rates of growth of those countries under ***ISS***. It is also important to stress that average rates of growth under ***ISS*** reached their trough in 1984, that is, two years after the crisis broke. In the database, overall rates of growth were 1.18% for the 957 country-years under ***ISS*** and 3.13% for the 384 country years under ***EO***.

[6] Politicians may want to learn about other policy outcomes: for instance, the rate of unemployment, inflation, or the public deficit. The model can be easily extended to those outcomes.

[7] Performance under alternative trade regimes has also been the object of voluminous research. Summaries can be found in Edwards (1989), and Harrison and Revenga (1995). A critical review of what is known about the relationship between trade and economic growth can be found in Rodrik and Ramírez (2000).

Figure 1. Average Rates of Growth under EP and IS, Developing Countries, 1964-1990



Note: 51 developing countries.
Own data from several sources: World Bank, ***World Development Report*** (1987), M. Kelly and A. McGuirck, ***1992 IMF Report in Issues and Developments in International Trade Policy***, and World Bank Discussion Papers ***Trade Policy Reform in Developing Countries since 1985***, 1994a, 1994b.

During this period, policy choices converged toward more open trade regimes. Developing countries engaged in the liberalization of their trade regimes. And even if not all of them carried the reforms so far as to change their development strategy, many succeeded in reducing the bias of their regimes. According to my data, toward the beginning of the decade around 20% of the countries in the data-set were classified as having an open or relatively open development strategy. The trend began to change in the mid-1980s and, by the end of the decade, 60% of the countries had adopted the change.

In sum, there is an apparent relationship between the relative performance of the two development strategies, the 1982 crisis and the subsequent recession, and the trend toward the adoption of more open trade regimes. Preliminary evidence seems to back the results in Lora (2000), who relates falls in GDP per capita (more than any other indicator of crisis) to trade liberalization. The lessons learned from the shock in terms of the superiority of ***EO*** are quite uncontroversial not only among economists but also among policy practitioners —although controversy remains concerning the would-be role of the state in development. All in all, I expect to find a

significant relationship between learning from the 1982 shock and the probability of adopting ***EO***.

1.2 Economic Crises and the Capital Account

The impact that economic shocks may have had on decisions concerning the capital account has to be different in view of what we know about the rationale and the consequences of this policy.

The trend toward capital account liberalization began later, partly in response to the greater mobility of goods and production. With more and more opportunities to evade domestic controls and with multinational corporations (MNCs) demanding guarantees that they would be able to move their funds and benefits in and out the country, capital account openness appeared as the response to an inescapable reality with which domestic governments have to deal. A different, more active reason to open the capital account could be the alleged benefits that incoming capital may bring. For instance, especially in developing countries, inflows of capital can make up for scarce local savings and, crucially, help to finance development. If that is the case and inflows of capital are regarded as good for economic development, governments would have lifted capital controls in order to attract those flows. Yet, from both theoretical and empirical points of view, there is no consensus on whether capital account openness is good or bad for growth. The results of widely cited studies on the topic (Rodrik, 1998; Obstfeld, 1998; Soto, 2000; Edwards, 2001a, 2001b) are conflicting, although a majority seems to back the claim that an open capital account promotes growth, subject to a host of caveats.[8] What is important to emphasize for the argument in this article is that, contrary to the adoption of ***EO,*** the decision to open the capital account does not appear to have been the direct consequence of any lesson associated with an economic shock. On the contrary, what the financial shocks of the mid and late 1990s have done is precisely to question the pace and sequencing of previous decisions to liberalize capital movements.

During the 1990s, several countries experienced severe speculative attacks. In 1992, a number of European currencies suffered devaluations (those of Spain, Portugal and Ireland) or were forced to abandon the European Monetary System (EMS) as a result of speculative runs against them (Finland, the UK, Italy, Sweden and Norway). In 1994-1995, the Mexican peso suffered the same fate, affecting other countries in the region as the result

[8] Whereas the theory points in this direction, there are important issues of sequencing and prudential regulation that, if ignored in practice, may cause much more harm than good (Knight, 1998; Edwards, 1999). The financial crises of the 1990s, to which I devote a subsection, have been related to mistakes in the implementation of financial liberalization; but these mistakes do not invalidate the general case in favor of a careful and well-designed opening. Edwards (2001a) also warns that the positive effect of financial liberalization may accrue to countries with a certain level of economic development, but not to the least developed ones.

of what was known as the "Tequila effect". In 1997-1998, several Asian countries experienced similar attacks, starting with the baht in Thailand. The "Asian flu" soon affected Malaysia, the Philippines and Indonesia. This flu proved to be capable of transatlantic travel, forcing the floating of the Brazilian real in 1999. Similar episodes include the financial crisis in Russia in 1998 and the Argentine traumatic abandonment of the currency board in late 2001/early 2002 (Mishkin, 1996; Mussa, 2002).

Unlike the 1982 debt crisis, which was caused by sharp macroeconomic imbalances, the new crises could not be explained in terms of high inflation, big current account deficits or rigid exchange-rate arrangements. On the contrary, the so called second-generation crises were the consequence of financial panics that led investors ***en masse*** to try to get rid of the currency in question. Being sketchy, the ***ex post*** reading of these financial panics has pointed to credit booms and imprudent behavior on the part of investors following the financial liberalization undertaken in the early 1990s as the main cause.[9]

Two issues are relevant from the point of view of learning from the crises. First, according to many analysts, the unconditional promotion of capital account liberalization downplayed issues of sequencing and prudential regulation, which proved catastrophic. Second, there is a less consensual view about what to do in the face of these crises. Does the reimposition of capital controls helps to ameliorate the recession or, conversely, does it deepen the crisis? Some authors claim that, once reimposed, capital controls tend to stay, which sends a very negative signal to investors. Thus, using capital controls only delays the very much needed return of capital inflows, postponing economic recovery. This has been the official stance adopted by the IMF in its rescue packages for the victims of financial crises. On the other hand, some authors argue that imposing capital controls, as long as they are temporary, helps countries to muddle through the crisis without having to increase interest rates, which would only worsen the recession. The experience of some countries, notably Malaysia under Mahathir in 1998, seems to support this view.[10] Unfortunately, empirical research going beyond particular cases is scarce. According to some studies, capital controls do help to counter the recession caused by shocks to the system (Eichengreen and Leblang, 2003).

According to other authors, controls on capital inflows, but not on capital outflows, help to prevent and overcome financial crises, and even the former

[9] Chang (1999) gives an excellent account of financial crises in emerging markets.

[10] China and Venezuela are two other frequently cited examples of the successful imposition of capital controls to fend off contagion in the face of financial crises. However, some authors argue that positive results from closure, particularly in China, are exceptions to the rule.

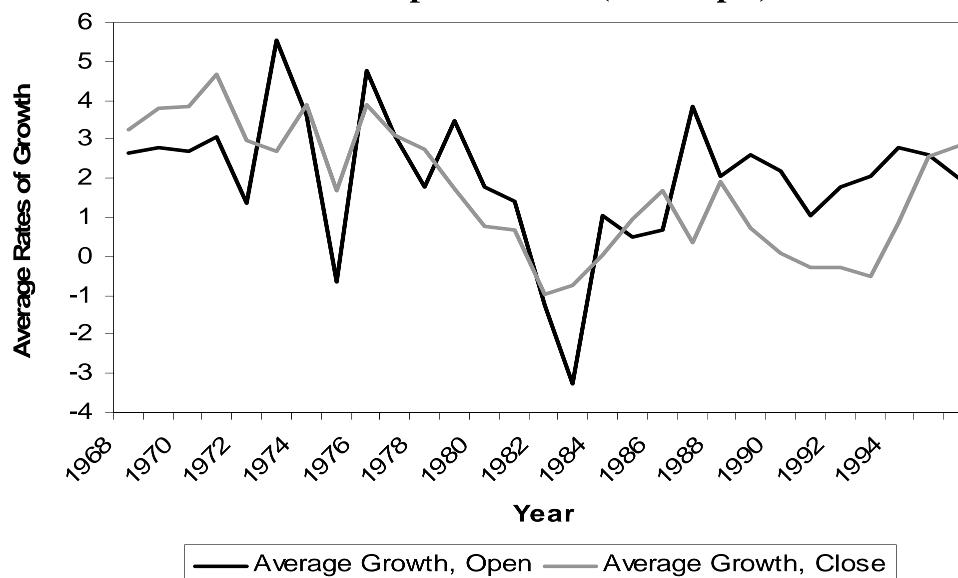
are subject to caveats (Edwards, 1999). Overall, many aspects of financial liberalization remain obscure.[11]

Again, given that the mechanism of learning as stipulated in this study is crucially related to the outcomes in terms of growth achieved by countries under alternative policies, it is important to have a descriptive picture of associated growth figures in the sample and period under study. In the data-set I use, there are 3,178 country-year observations that correspond to 129 developed and developing countries grouped in nine regions for the period 1968 through 1996.[12] Overall, 548 country-year observations are under an open capital account. The average rate of growth for those countries and years was 1.96%. This figure was 1.56% for the 2,630 country-year observations under capital account closure. These average figures point to a relatively mild difference in favor of capital account openness.

Figure 2 compares the results in terms of growth under open and closed capital accounts for developed, developing and transitional countries. The conclusion that can be drawn from this figure is that countries with an open capital account have experienced deeper recessions in the event of an external shock than have countries with a closed capital account. However, outside the periods of economic crises, countries with an open capital account seem to do better. Also, it seems that having an open capital account is not a hindrance to resuming growth after shocks. Quite the contrary: apparently, countries with an open capital account experience somewhat faster recoveries in post-shock periods.

[11] Political accounts have emphasized that whether or not to impose capital controls in the event of a financial crisis may actually not be a choice (Haggard and Maxfield, 1997; Lukauskas and Minushkin, 2000). Countries that have a long-standing reputation for macroeconomic stability can afford to impose controls without scaring off investors (say, South Korea). However, countries with a less credible macroeconomic record may simply not be able to impose controls if they want to signal a credible commitment to policies that investors do value (for instance, Mexico).

[12] The regions are sub-Saharan Africa, South Asia, Southeast Asia, Pacific Islands/Oceania, Latin American, Middle East/ North Africa, Eastern Europe and Soviet Union, Caribbean and non-Iberic America and Industrial Countries.



Note: Based on 129 developed, transitional and developing countries. Data on capital account liberalization comes from the International Monetary Fund, *Annual Exchange Arrangements and Restrictions* (various issues).

In my opinion, this visual evidence lends support to the argument in Eichengreen and Leblang (2003). According to these authors, the studies that explore the relationship between capital account openness and economic growth provide inconclusive results because they do not take crises into account. According to the authors, capital controls are good for muddling through crises; however, in non-crisis periods capital controls cause the misallocation of investments and result in less efficient outcomes. These effects work in opposite directions. Hence, it is not surprising that the studies that measure the impact of capital controls averaging over crises and non-crisis periods are unable to reach clear conclusions regarding the relationship between capital account openness and growth. Certainly, the view that capital controls are a good solution for deep recessions in the event of crises is not consensual (Edwards, 1999). This is a further reason to enquire about the possible impact that financial crises may have had on the process of learning about the consequences of capital account liberalization.[13]

[13] Also, one should not overstate the pace of capital account liberalization. Whereas at the beginning of the period 29% of countries had an open capital account, the figure is roughly the same at the end of the period under study. The years in between were mostly years of capital account closure. The increase in openness observed toward the end of the period does not seem to have been motivated by an increase in openness in developing and transitional countries. Despite the upward trend that is observed in this group toward the end of the period, the percentage of countries with an open capital account was smaller in 1996 (18%) than in 1968 (32%). Of course, talking about developing countries as a uniform group is a fiction. These aggregate figures hide important contrasts. For instance,

In sum, learning could have been *(1)* about the risks of a too-rapid financial liberalization, *(2)* about the convenience of closing the capital account in the event of a run against one's currency to prevent a deeper recession, and *(3)* about the pace of economic recovery after a financial crisis with and without capital controls. However, given the prevailing lack of consensus, particularly about points *(2)* and *(3)*, and considering that the lessons of these crises are still being digested by analysts and policymakers, I do not expect learning from these financial crises to have been a major cause of policy decisions concerning the capital account.

The abandonment of the *ISS* appears related to the lessons associated with the debt crises; however, the move toward more open capital accounts does not appear related to it. On the contrary, what later financial crises have questioned is precisely the pace of previous capital account liberalization. There is an inconclusive discussion and inconclusive evidence on what the best response is in the face of a financial crisis. Thus, the lessons about what should be avoided or embraced are not clear. Given the accounts above, what is known in theoretical terms about the relationship between these two policies and economic growth, and in the light of the preliminary empirical evidence just summarized, I hypothesize that ***learning from the 1982 crisis did affect the decision to liberalize the trade regime whereas this crisis and other financial crises of the 1990s did not affect the decision to open or close the capital account***.

The causal relation between economic crises and learning from them is suggestive but it is hard to grasp empirically.[14] In order to have an empirical test of this relationship, defining what constitutes a crisis is far from the most difficult challenge. The real challenge is to find a convincing operationalization of learning, that is, of the updating of beliefs in view of the outcomes of alternative policies. I explain in section 2 how we can start tackling the relationship between economic shocks, learning and the launching of market reforms using rational updating.

In the empirical section, I also account for other possible explanations for reform. Some of these explanations have to do with purely domestic factors, such as the size of the country, the political regime, and the degree of openness. Other mechanisms have to do with international factors such the

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in sub-Saharan Africa a meager 6% of country-year observations fall under an open capital account, while in Latin America the figure is 36%. It goes without saying that the transitional countries have their particular story, going from complete closure to complete openness in a very short span of time. The opposite is the case for the advanced countries, which are mostly responsible for the overall increase in openness observed in the period. In this group, a high 85% of countries were open by 1996. Thus, whereas the data reveals that there has certainly been a shift toward more open capital accounts toward the end of the period, it is as important not to overstate this trend as it is not to underestimate the persistent variability among regions (see Brune and Guisinguer, 2006, for a similar discussion).

[14] Kahler (1992: 124) presents these difficulties very clearly: "The investigation of shared beliefs is not an impossible empirical task but, once again, it has rarely been attempted in a rigorous fashion. Nor have alternative explanations for policy change been carefully compared to an explanation based on change in ideology or beliefs."

pressure exerted by IFIs or emulating the policies that others adopt. For some authors, the availability of external funding delays the adoption of reforms unless the funding is conditional (Lora, 2000; Drazen and Easterly, 2001). Many others consider politicians' room for maneuver to be greater than a hypothesis of coercion may lead one to think (Nelson, 1990; Kahler, 1992; Stallings, 1992; Haggard and Webb, 1994; Weyland, 2005). Contagion or emulation is a similar mechanism to learning. However, emulation does not imply an efficient use of ***all*** available information or an improved understanding of cause and effect relations. Thus, in the empirical section, I will test models of the form:

PROBABILITY OF REFORM = F (LEARNING, COERCION, EMULATION, DOMESTIC CONTROLS)

2. Learning, Shocks and Policy Reform

I first describe the use of rational updating to model learning. I also explain how an economic shock can be modeled in a rational updating framework. I then sketch the relationship between learning from shocks and subsequent policy choices. I will keep the technicalities at a minimum, since I have explained them elsewhere (Meseguer, 2006a, 2006b). Instead, I will rely on concepts, intuition and graphs to explain the basics of this approach.[15]

Learning is an intuitive and simple concept, yet one that is hard to operationalize. The basic idea is that policymakers have prior beliefs about the economic outcomes that will follow the adoption of a particular policy. The world is an excellent laboratory that provides politicians with information about how the policy in question has performed elsewhere. Politicians can learn from that experience, updating their beliefs about the efficacy of a policy after seeing its performance.

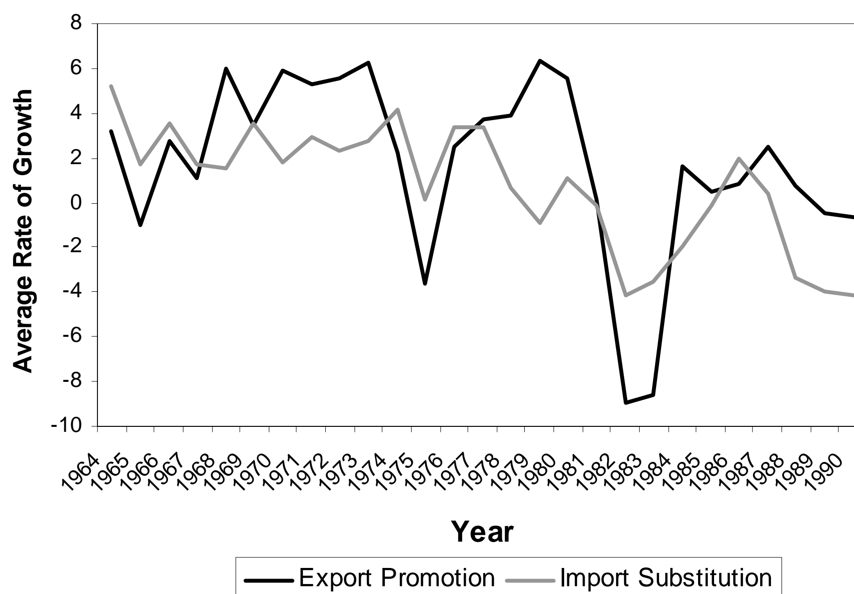
Learning requires that politicians hold prior beliefs with some uncertainty. If governments do hold very certain beliefs about what the results of implementing a particular policy will be, then they will ignore the available information since they do not need it. On the other hand, if politicians prefer a policy but are very uncertain about its possible performance, they have a significant incentive to pay attention to what the available experience of that particular policy in the past or in other countries can reveal. Thus, the first prerequisite for learning to take place is that prior beliefs entail some uncertainty. The typical way to model prior beliefs is by means of a probability distribution in which an expected average rate of growth under, for example, ***ISS*** is attributed a particular variance —***i.e.***, uncertainty. By definition, if governments are dogmatic, that is, if they hold beliefs with no uncertainty, they will not learn.

[15] This section is based on Leamer (1991), Gelman *et al.* (2004), West and Harrison (1997), Lee (1997), and Gill (2002).

The available evidence, however, also matters. Two aspects of it in particular will determine the extent to which what you see will eventually prevail over what you initially believe. Imagine that a politician holds very uncertain beliefs about whether her country will experience a boom following the adoption of an export promotion strategy. However, the experience of ***many*** countries shows that export promotion is conducive to high rates of growth. Thus, the quantity and quality of the available information matter. The latter will be most useful when it is abundant (many countries) and when it is consistent (all of them growing). If the evidence is not abundant or is noisy or both, there will be little to learn from it. A scenario of "maximum learning" entails ***(1)*** politicians holding very uncertain prior beliefs about outcomes of policies and ***(2)*** abundant and consistent evidence concerning the outcomes of a policy. In this scenario, Bayesian updating yields a very powerful result: politicians will converge in their posterior beliefs (beliefs updated with the available information) regardless of their initial priors. This result is very important since it means that one of the main criticisms of Bayesians —namely, that the choice of priors drives their results— does not hold if evidence is abundant. Note also that, if the choice of policies is driven by politicians' posterior beliefs, then convergence will be not only in posterior beliefs but also in policy choices. The distinction between rational learning and rational choice is important and hopefully will be clear from the illustration below. It means that, within the framework I aim to test, not only do politicians have to be rational learners but they also have to make rational choices in order to see convergence in policy choices. An illustration follows.

Figure 3 shows the ***observed*** average rates of growth under ***EO*** and under ***ISS*** in Latin America in the period 1964 through 1990. These figures do not include rates of growth for Costa Rica, which is the country whose policy choices I explore. It is sensible to expect governments to choose the policy that performs better. Had Costa Rican governments used this criterion of choice, they would have embarked on export orientation in 1968, again between 1970 and 1973, and again in the periods 1977–1981, 1984–1985, and 1987–1990. These are the spells in which, in Latin America, average rates of growth under ***EO*** were greater than the average rates of growth under ***ISS***. Thus, Costa Rica would have changed its development strategy nine times. However, according to my data, Costa Rica changed it only twice: it switched to import substitution in 1974 and liberalized its trade regime in 1986.

Figure 3. Average Region Rates of Growth in Latin America (1964-1990)



It is known that policy switches are rare and that policy persistence is more the rule than the exception. Therefore, the comparison of observed rates of growth under alternative policies seems not to be a good characterization of the policy choice process. The latter better fits a pattern of change, continuity and change rather than of frequent switches.

Does the comparison of posterior beliefs about growth after observing the world provide a more realistic portrait of policy choices than the comparison of observed growth? In a rational framework, the observed outcomes are used as the basis for sequential updating. The updating starts with an expectation of growth following alternative policies and a variance attached to that expectation (prior beliefs). Governments update this expectation after observing the average rate of growth of the countries that implemented, say, *ISS* in the region (available experience). As equation *(1)* shows, the posterior beliefs about expected growth (μ_t) are a compromise between the prior beliefs (μ_{t-1}) and the average observed growth ($\overline{x_t}$) for each point in time. The weight given to the observed experience is positively related to the size of the observed sample (*n*). The parameter τ_t is the posterior for the factor that relates the prior beliefs about the variance of the results and the observed variance. This updating process takes place year after year, with the posterior beliefs of one year being the prior beliefs of the following one. As explained above, average rates of growth as well as the variance of results matter. Thus, the beliefs about the variability of results are also updated. For each country *I*:

$$\mu_{it} = \frac{\tau_{i,t-1}}{\tau_{i,t}} \mu_{i,t-1} + \frac{n}{\tau_{i,t}} \overline{x_{i,t}} = \rho\mu_{i,t-1} + (1-\rho)\overline{x_{i,t}}; 0 < \rho < 1 \qquad (1)$$

$$s_{i,t}^2 = \frac{\mathbf{S}_{i,t}}{\upsilon_{i,t}} \qquad (2)$$

$\mathbf{S}_{i,t}$ is the posterior for the sum of squares,[16] and $\upsilon_{i,t}$ is the posterior for the degrees of freedom. A very important piece of information in equation *(1)* is the rate of adaptation to new data (*1-ρ*). The closer this rate is to 1, the greater the weight given to actual rates of growth as opposed to the prior beliefs about growth in the formation of posteriors. As Figure 4 shows, if initial prior beliefs are vague, the rate of adaptation to new data goes to 0 very fast (black line). Such a property entails that learning takes place swiftly at the beginning of the time series. Later in the updating process, new information has much less impact on the formation of posterior beliefs. In other words, beliefs tend to endure. This feature poses a legitimate question: does such a low receptivity to new information make rational updating useful in predicting policy switches?

In some forecasting models, the shape of the rate of adaptation to new data is altered with an "intervention" (West and Harrison, 1997). The intervention allows the incorporation in the updating process of external information —for instance, a shock— that carries with it a high level of uncertainty. Modeling the uncertainty attached to a shock —attributing a greater variance to politicians' beliefs— makes the decision-maker automatically more attentive to observed results (grey line). Thus, the two lines overlap but diverge in 1983 after the intervention is modeled for the priors that year. The intervention was introduced in 1983 under the assumption that the growth consequences of the shock are felt with a lag.

From a substantive point of view, modeling the shock makes perfect sense. Policymaking occurs mostly according to a pattern of continuity in which mild ups and downs in outcomes do not bring into question the validity of the economic model. However, an external shock —like the one that happened in 1982— that deeply affected the performance of the economy increases dramatically the uncertainty about the "correct" economic model. Reasonably, this increased uncertainty makes policymakers more attentive to

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[16] $\mathbf{S}_{i,t} = S_{i,t-1} + S_{i,t} + \frac{\tau_{i,t-1} n(\overline{x_{i,t}} - \mu_{i,t-1})^2}{\tau_{i,t}}$ where $S_{i,t}$ is the observed sample sum of squares.

the information that actual outcomes could reveal about the validity of alternative policies.

Figure 4. Rate of Adaptation to New Information

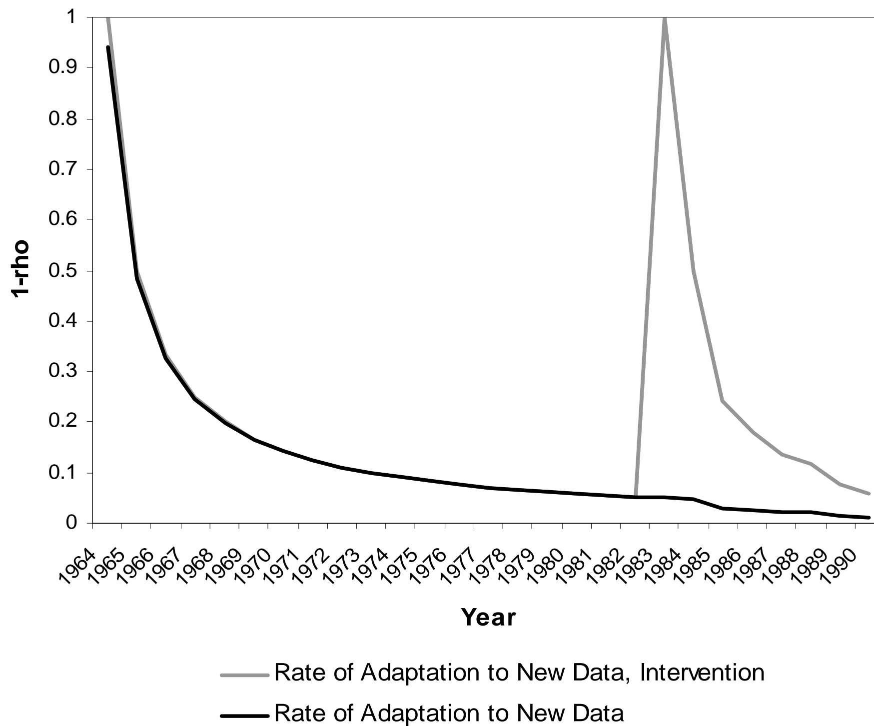
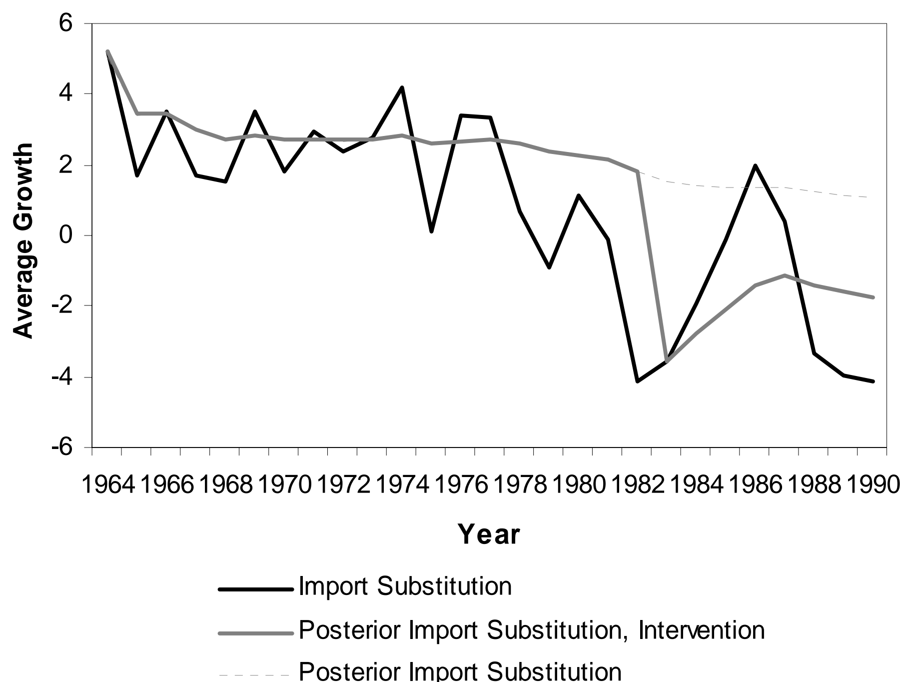


Figure 5 is based on the same data as Figure 3 but refers to *ISS* rates of growth only. It shows the series of the ***observed*** rates of growth under import substitution (black line) and the ***posterior beliefs*** about average rates of growth under the same development strategy (solid and broken grey lines). These two series of posterior beliefs are the same until 1983. I modeled an intervention in one of the posterior series —simply attributing more variance to the prior beliefs that year to account for the greater uncertainty about the correct model of the world following the 1982 shock. As a result of modeling this intervention, this particular posterior series (solid grey line) matches much more closely the actual series as opposed to the posterior series in which the shock was not accounted for (broken grey line).

Figure 5. Observed Rates of Growth and Posterior beliefs (with and without intervention, Import Substitution). Latin America



The posterior series are posterior average results calculated with equation *(1)*. For instance, for year 1964, some prior belief is combined with actual average results in the region for the same year. The rate of adaptation to new data determines how much weight the observation will receive relative to the prior. The intervention in 1983 –increase in prior uncertainty for that year– approaches the posterior belief to the actual observation.

Finally, Figure 6 compares the ***posterior beliefs*** about growth under ***ISS*** and under ***EO*** when an intervention is modeled in 1983 in the updating of the both series. A comparison with its "sister" Figure 3 shows that both series of posterior beliefs are smoother than the original ones, which is consistent with the observation that beliefs tend to endure. However, after conditioning on the actual data ***and*** the economic shock, the actual rates of growth under both policy alternatives greatly affect the formation of the posterior beliefs, which match closely the observed rates of growth. As a result of modeling this intervention, the switch to ***EO*** in the mid-1980s is anticipated. Note that at least in Latin America —but ***not*** in the whole sample, as I showed above— countries under ***EO*** experienced a deeper yet shorter recession than the countries under ***ISS*** following the 1982 crisis**.** Importantly, the posterior series accounts for the faster recovery of those countries in the region under an ***EO*** development strategy.

Figure 6. Posterior Beliefs based on Regional Experience after modeling the shock, Export Promotion and Import Substitution, Latin America

It is very important to make clear that this operationalization of learning does not automatically entail that politicians will switch policies. Policymakers may be rational learners and yet they may ***not choose*** policies rationally for a host of political reasons (strong interests or institutions that oppose; strong public opinion against reforms, and so on and so forth). Thus, rational choices do not automatically follow rational learning. Moreover, policymakers may be rational learners, and yet the evidence may be so confusing that, even if one is a rational learner and makes rational choices, a change of policy may not be justified on the basis of experience alone. If the evidence is confusing, it may be perfectly rational not to switch policies. I emphasize this point to make clear that by making governments more attentive to actual performance by modeling an intervention I am not artificially "forcing" them to change the course of their policies. In other words, interventions are not a ***post hoc*** strategy to accommodate reality. In particular, the two policies I explore illustrate my point very well. Modeling the debt crisis is crucial to understanding the switch to ***EO*** in the developing world. This is because the rates of growth in the sample and the period under study are in favor of ***EO***. However, modeling this crisis and other financial crises of the 1990s does not explain the openness or closure of the capital account. This latter result is consistent with the fact that neither in theory

nor in practice is capital account liberalization better for growth than capital closure, particularly during turbulent times.[17]

3. Model and Results

I present the results of two explanatory models of the decision to adopt ***EO*** and of the decision to open the capital account. The explanatory variables are (*a*) the difference in posterior beliefs about growth and (*b*) its volatility under and not under an ***EO*** strategy, and with and without an open capital account —calculated as just illustrated. These are the proxies for LEARNING. I enquire whether learning from economic shocks as opposed to learning from others ***and*** learning from shocks did affect the decision to adopt those policies. I control for other alternative explanations of policy choices and for domestic factors that might have affected decisions regarding the development strategy and the capital account.

Tables 1 and 2 show the dynamic probit estimations of the probability of switching to ***EO*** and of opening the capital account. The dependent variables are dichotomous, taking the value of 1 for the countries and years under an ***EO*** strategy and an open capital account respectively. The dynamic probit model gives estimates of the probability of adopting these policies and of remaining under them.[18] Given data constraints, I report only the estimations concerning the probability of adopting these policies.[19] To save space, the list of variables used in the study, countries, years of entry and the spells under the policies can be obtained from the author upon request.

I use three different model specifications. The first one includes LEARNING VARIABLES, which were calculated using rational updating. For the development strategies model, I calculated several series of posterior beliefs about growth under ***EO*** and ***ISS*** —the same procedure was followed for the capital account model. Since both pieces of information are likely to affect the decision to switch policies, the posterior beliefs are about average results and about the variability of results under both development strategies. I structured the available information in three geographic groups: own past experience under alternative policies, experience in the region under alternative policies and experience in the world (excluding own and regional

[17] It is also important to note a limitation of these "interventions". Shocks will have an impact on the formation of posterior beliefs as long as they have consequences for growth rates. Imagine a political shock that does not produce a global recession of any magnitude but nonetheless has strong implications for determining the correct economic model. The collapse of communist rule in the late 1980s and early 1990s fits this description. It was a political watershed that clearly affected politicians' views about the viability of the command economy, discrediting that policy option. However, the economic consequences of that event in terms of global rates of growth were not as sweeping as the political consequences. Thus, using an intervention to model that political shock is likely to have no clear consequences in terms of posterior beliefs and policy choices.

[18] See Amemiya (1985). For applications, see Vreeland (2003).

[19] The results for the capital account illustration are available from the author. Due to the very low number of transitions to import substitution, the estimates of continuity were not reliable for this policy illustration.

experience). The justification for this structuring of information at three levels is that the informative value of particular experiences increases with historical, cultural, and institutional similarities. It seems reasonable to hypothesize that politicians learn somewhat selectively on the basis of geographic propinquity or linguistic, historical and cultural similarities (Robinson, 1998; Hacking, 1997; Weyland, 2005). For instance, Enrique Iglesias, former president of the Inter-American Development Bank, contended that "the ideas developed in the North during the Reagan-Thatcher era were very important in Latin America, but the Chilean experience was far more significant in so far as it provided a viable model. The success of the Chilean experience was very much noted by other regional leaders" (quoted in Williamson, 1994: 493-94).

The learning variables are the ***difference*** in posterior beliefs about growth under ***EO*** with respect to ***ISS***, and the ***difference*** in posterior beliefs about variance of results under ***EO*** with respect to ***ISS***. I expect the probability of adopting ***EO*** to be positively related to this difference in posterior beliefs about average growth results. However, how the variance of results affects the probability of a switch in policies depends on governments' attitudes toward risk. If governments are risk averse, the probability of switching to a particular policy will be inversely related to the posterior beliefs about the variance of results. But if governments are risk prone and feel seduced by some outstanding policy experience that, however, has been disastrous elsewhere, then we could find a positive relationship between a high variability of results and the probability of adopting a policy. The empirical test will inform us about governments' attitudes toward risk.

The second specification adds two additional mechanisms whereby export orientation and capital account liberalization may have spread. On the one hand, governments may have emulated each other without actually learning from each other. Emulation does not entail a better understanding of the links between policies and outcomes (Meseguer, 2005). Emulation entails that governments adopt policies because they see many other countries adopting that policy, which in turn is interpreted as acceptance of that policy as "good" (Broz, 2002). Also, governments are likely to imitate the policies of high-status countries on the assumption that they know better. I operationalize EMULATION as the sheer number of other countries contemporaneously under an ***EO*** strategy and an open capital account. I anticipate a positive relationship between seeing many others under a policy and adopting it.

The second diffusion mechanism I explore is outright coercion by the International Monetary Fund (IMF). The IMF exchanges loans for policies. It advocates both export promotion and capital account liberalization, including these policies among the conditions for receiving the Fund's money. Whether the IMF is persuading or coercing is not clear, though. According to a number

of scholars, IFIs teach and persuade instead of coercing. What appears as imposition may actually be a case of "technocratic alignment", that is, a coincidence of interests between IFIs and local policymaking cadres socialized in the same set of ideas (Nelson, 1990; Stallings, 1992; Kahler, 1992; Haggard and Webb, 1994). As is standard in international political economy research, I operationalize coercion through a dummy variable that takes the value of 1 if a particular country in a particular year is under an IMF agreement. I expect the presence of an IMF agreement to be positively related to the probability of switching to ***EO*** and to an open capital account.

The third specification accounts for the possible impact of crises on learning and on policy choices. Thus, this specification is the crucial one for the argument that is being tested in this paper. It includes other control variables and the intervention to account for the 1982 crisis (for the development strategies model) and the 1982, 1992 EMS and 1994 peso crises (for the capital account model). The posterior belief series was calculated by introducing an intervention in the years after the crisis. The prior beliefs for those years were specified as high uncertainty priors, which dramatically increased the rate of adaptation to observed data. The intervention makes the posterior beliefs match closely the observed results.

For the development strategies model, I controlled for the size of the country (SIZE), the political regime (REGIME), and the holding of elections (LAGGED ELECTIONS). Small countries are expected to be more open. In developing countries, democratization entailed enfranchising labor. Labor is the abundant factor in these countries and, according to the Stolper-Samuelson predictions, labor is the main beneficiary of opening to trade (Milner and Kubota, 2005). Thus, a positive relationship is anticipated between democracy and trade opening. Finally, governments are expected to introduce reforms immediately after elections to take advantage of honeymoon periods.

For the capital account model, I included as controls also the political regime (REGIME), the degree of openness of the country (OPENNESS), one cultural trait that according to Simmons and Elkins is (surprisingly) related to the probability of opening the capital account (SHARED RELIGION), and two variables that take into account the impact that competing for trade or for the same pool of international capital may have had on the decision to open the capital account (TRADE COMPETITION, CAPITAL COMPETITION).

Two results for the two policy choices —one contrasting and one shared— merit some discussion. First, learning from economic shocks or, in other words, increased uncertainty about the validity of the alternative models of development was crucial to explaining the adoption of ***EO*** strategies but not the adoption of capital account liberalization. Learning from the experience of others ***only*** could not explain the decision to open. In fact, the baseline model ***(1)*** in Table 1 shows that policymakers maintained a persistent risk-

averse attitude in view of available experience and this regardless of the level —own, region, world— of available experience. It is true that rates of growth were in general higher under ***EO*** than under ***ISS***, as Figure 1 shows. However, the good performance under ***EO*** seems to have been exclusively an East Asian phenomenon. In this region, even under ***ISS***, rates of growth were remarkable. Moreover, the growth figures were outstanding in the region even in the crisis period 1974-1985. But a comparison with outcomes outside East Asia suggests that high growth was a phenomenon rather specific to this particular location. A high variability of results under the same development strategy pervades the data. For instance, in 1986 rates of growth under ***EO*** ranged from 8.29% in Taiwan and 9.6% in Korea to —4.56% and— 6.01% in Bolivia and Mexico respectively. In Latin America, figures such as those cited coexisted with the better performance of Chile (3.02%) or Uruguay (8.74%). The variability of results under ***ISI*** is even greater.[20] This volatility can explain the consistent risk-averse behavior that the model suggests.

However, when the posterior beliefs account for the impact of the shock [model ***(3)***, Table 1], learning from average results with and without an ***EO*** strategy is positively related to the probability of adopting this development strategy. This is an important result. In particular, the regional experience seems to have a very important impact. Setting all the independent variables to their means but moving the posterior beliefs based on regional experience from their minimum to their maximum increases the predicted probability of liberalizing to 85%. However, it is also important to emphasize that the two alternative mechanisms of policy convergence that I considered (EMULATION and COERCION) are positively related to the probability of adopting ***EO***. Countries under IMF agreements were more likely to adopt export promotion, although the marginal effect of this variable is low (2% more likely to liberalize being under an IMF agreement). Also, it seems that countries adopted ***EO*** because many others adopted it too. Overall, the story of the switch to more open trade regimes is one of learning from the 1982 shock, emulating others and outside pressure. Somewhat surprisingly, none of the domestic controls I included turned out to be significant, and only LAGGED ELECTION showed the expected sign. The adoption of ***EO*** for want of more refined domestic operationalizations appears internationally driven.

[20] Elsewhere I show that, at least for Latin American, what explains trade opening is not lessons from the world but only lessons from the East Asian experience. In terms of Bayesian learning, it makes full sense that learning from a regional experience which was very consistent had a much greater impact than learning from experience —that in the world— which was very noisy. See Meseguer (2005) for details.

Dependent Variable = EO	Baseline Model (1)	Alternative Diffusion Mechanisms (2)	Intervention and Other Controls (4)
CONSTANT	**-2.91***** (-4.12)	**-4.62***** (-4.99)	**-7.51***** (-4.62)
OWN EXPERIENCE			
AVERAGE RESULTS	**0.05*** (1.84)	0.03 (0.92)	**0.06*** (1.78)
VARIABILITY OF RESULTS	**-0.09**** (-2.41)	-0.06 (-1.46)	-0.07 (-1.52)
REGIONAL EXPERIENCE			
AVERAGE RESULTS	0.11 (1.03)	**0.26*** (1.91)	**0.33***** (3.05)
VARIABILITY OF RESULTS	-0.05 (-0.45)	-0.04 (-0.29)	**-0.22**** (-1.96)
WORLD EXPERIENCE			
AVERAGE RESULTS	0.04 (0.41)	0.17 (1.20)	**0.28**** (2.12)
VARIABILITY OF RESULTS	-0.29 (-1.33)	-0.28 (-1.02)	**-0.59***** (-3.05)
EMULATION		**0.72***** (4.79)	**0.76***** (4.53)
IMF		**0.50**** (2.47)	**0.50**** (2.27)
REGIME			0.23 (0.81)
SIZE			0.07 (0.36)
LAGGED ELECTION			0.01 (0.05)
p-value for F	0.000	0.000	0.000
1s and 0s correctly predicted	97%	97%	97%
Observations	1171	1171	1171

The capital account illustration contrasts with the development strategies illustration in that learning either from others' experience or learning from economic shocks does not explain the decision to open up the capital account, as I hypothesized. There is only one significant result concerning learning in specifications ***(1)*** and ***(2)***, and it is that learning from the experience in the world (excluding one's own and regional experience) is positively related to the probability of opening the capital account. However, this is not a robust result in the specification that considers the impact of financial crises [model ***(3)***, Table 2].

The result that both policy choices share is that being under an IMF agreement appears also positively associated with the probability of opening

the capital account. This finding is persuasive, and goes against recent research that surprisingly found no relationship between being under an IMF agreement and the likelihood of opening the capital account (Simmons and Elkins, 2004; Brune and Guisinguer, 2006; Quinn and Toyoda, forthcoming). It is also relevant because it shows that IMF policy prescriptions based on shaky evidence and inconclusive scholarly debate actually influenced countries' policy decisions. Finally, regarding other controls, it is clear that more open countries were also more likely to allow capital in and out. In accordance with Simmons and Elkins (2004), competing for the same pool of capital and trade competition were two important (and always robust) explanations of the decision to liberalize the capital account. The decision was unrelated to herding on what others were doing and was unrelated to whether countries shared the same religion or not, a result that Simmons and Elkins report (2004).

Dependent Variable: Capital account openness	**Baseline Model (1)**	**Alternative Diffusion Mechanisms (2)**	**Intervention and Other Controls (3)**
CONSTANT	**-2.00*** (-9.41)**	**-3.00*** (-6.65)	**-3.32*** (-4.09)
OWN EXPERIENCE			
AVERAGE RESULTS	-0.003 (-0.17)	-0.01 (-0.80)	-0.04 (-1.59)
VARIABILITY OF RESULTS	**0.12*** (2.95)	**0.14*** (3.30)	0.07 (1.09)
REGIONAL EXPERIENCE			
AVERAGE RESULTS	0.01 (0.49)	-0.002 (-0.08)	-0.1e-2 (-0.03)
VARIABILITY OF RESULTS	0.06 (1.37)	0.06 (1.29)	0.08 (1.35)
WORLD EXPERIENCE			
AVERAGE RESULTS	**0.38*** (3.72)	**0.26** (2.08)	0.15 (1.27)
VARIABILITY OF RESULTS	-0.08 (-0.92)	**-0.16* (-1.69)	-0.08 (-0.87)
EMULATION		**0.34** (2.20)	-0.31 (-0.83)
IMF		**0.31** (2.13)	**0.57** (2.59)
REGIME			-0.07 (-0.38)
OPENNESS			**0.004** (1.99)
CAPITAL COMPETITION			**0.30*** (3.20)
TRADE COMPETITION			**0.15** (2.48)
RELIGION PARTNERS			0.06 (0.68)
p-value for F	0.000	0.000	0.000
1s and 0s correctly predicted	98%	98%	98%
Observations	3,049	3,049	2,307

Overall, the results confirm what up to now has been mainly a widespread contention in the literature on the politics of policy reform: policies change because politicians learn from experience. However, the claim does not apply to all policies, and it is not independent of the business cycle. Learning from the experience of others is relevant to explaining the adoption of ***EO*** but only after modeling the 1982 shock. The result is compatible with the theory and a

wealth of studies that show export orientation to be good for growth. This result is also compatible with the findings in Lora (2000) that relate gaps in GDP growth to be the best predictor of trade openness in Latin America. The 1982 crisis spurred the debate about the negative consequences of ***ISS*** as opposed to ***EO***. In many case study accounts, the comparison between these contrasting experiences is pervasive, and the process of social learning that followed from it is constantly referred to as an important reason for the adoption of export promotion. This paper showed that these anecdotal accounts of learning do withstand more systematic scrutiny.

For capital account policies, there is neither a clear theory nor a wealth of studies showing that an open capital account is positive for growth. The financial crises of the 1990s questioned the rationale behind a too rapid and too imprudent financial opening. A parallel debate took place on whether to open or close the capital account when confronted with financial crises. Neither the theory nor the evidence was clear about what worked best. Against this background, it is easy to understand the lack of relationship I found among learning, financial crises and capital account liberalization.

In June 2006, Alan García was elected president of Peru for the second time. During his first term in office (1985-1990) his heterodox economic policies led Peru into an economic debacle with inflation rates up to 7,000%. After his second victory, he reassured Peruvians by making clear that he had learned from past mistakes, which would not be repeated. It took García seeing his country on the verge of collapse to learn the lesson. Overall, politicians seem to learn and switch course against the background of economic disaster and confronted with evidence about an alternative policy whose results are not too confusing.

Conclusion

In this paper, I systematically explored the role that learning from economic shocks as opposed to learning from others during normal times played in two policy decisions: adopting export promotion and opening the capital account. By so doing, I put to the test the widespread view that learning from policy mistakes and successes triggered a process of social learning that in turn led to the abandonment of statist policies and to the adoption of liberal economic policies. A deep economic crisis questions the validity of the economic model seen as responsible for it. It draws politicians' attention to what works as opposed to what has failed, and increases politicians' uncertainty about the outcomes of policies.

In the case of development strategies, the 1982 debt shock was diagnosed as the result of the wrong interventionist policies. At the same time that much of the developing world was experiencing a deep recession, East Asian countries muddled through the crisis quickly and without experiencing as much economic disarray. All the elements that spur learning were there: a theoretical diagnosis of failure, a theoretical diagnosis of success, and consistent evidence of the superiority of one policy over another. Learning from the 1982 shock appears consequential for the switch toward more openness.

However, other shocks do not come with such clear theoretical diagnosis, evidence does not point to a clearly superior policy alternative, and policy failures cannot be attributed easily to a particular one. The financial crises of the 1990s —of which admittedly only a few have been considered here and probably not the most relevant ones from the point of view of "lessons"— did not convey uncontroversial lessons in particular about how to react to them. Whereas some consensus emerged to the effect that imprudent capital account openness was responsible for the financial crises, the reaction to them —whether to impose controls or to remain open— was hotly debated. The theory was not clear. Neither was the available experience. It is, then, easy to argue that learning from the crises played a contingent role in decisions concerning the capital account. The empirical tests back up this intuition and conventional wisdom.

This paper presented a first attempt to systematically test two related pieces of conventional wisdom: that crises cause reform and that they do so because crises spur a process of learning. Overall, the learning process seems to be relevant but not independently of the theoretical consensus and the empirical consistency that exists regarding policy failures and policy successes, as the illustrations showed.

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