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Development Prospects in Light of the Global Financial Crisis

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The world economy has been going through its worst shock since the Second War. In both depth and breadth, the world has not experienced anything of even close severity. All countries have been affected except those entirely cut off from the international financial system; and those are the countries whose per capita incomes are low and stagnant.

Unlike earlier crises, industrial countries are fully part of it. Developing countries are experiencing a downturn not of their making (but that was also true of earlier recessions). But in light of the crisis, there are a number of questions about how developing countries may need to adapt their policies to foster economic growth in light of the crisis. There have been a number of prognosticators who have argued that the financial crisis shows that outer-oriented development strategies are a thing of the past; that the crisis proves that market-based economic policies are misguided, and that new development strategies are needed.

But these conclusions are, in my judgment, in error. In the future, more attention will certainly need to be paid to the financial system and an appropriate regulatory

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framework, capital will likely become more expensive, and these factors alone will make the latitude for misguided policies smaller in the future. However, that is not a prescription for changing economic policy more generally.

To develop the argument a number of issues need to be addressed. They are: 1) role of the financial system; 2) what the outlook for the international economy is in the near, intermediate, and long term. 3) how different countries and groups of countries have been affected so far; and 4) on the basis of considerations for 1 and 2 and 3, what lessons there are for the future.

The Role of the Financial System

In assessing policy options and prospects, a first point to be remember is that a well-functioning financial system is essential for economic growth, and that the more advanced the economy, the more important it is to have a deep and well-functioning system. The vital economic function played by the financial system is to evaluate the risk-reward trade-offs of alternative investment opportunities, selecting those that have the highest risk-adjusted payoffs and enabling different groups of savers to allocate their resources to those investments closest to their own risk-reward preferences.

Any economic history of the industrialized countries must include a record of the development of the financial system alongside the real economy. Starting from a world in which virtually all investments were owner or family-financed (with a consequent failure of highly profitable firms to grow as rapidly as they might and less profitable firms to grow more rapidly than they should), short-term finance developed in a variety of ways among them sharing among guild members, and early banks financing commercial paper.

Longer-term lending, equity finance (which enabled the development of large scale enterprises, today's modern corporations), start-up investors (venture capitalists and angels), and so on all became part of the financial intermediation industry. In passing, let me just note that none of these could have happened without the development of a commercial code and an appropriate set of institutions to enforce contracts and settle disputes.

Numerous studies have documented the strong relationship between level of per capita income and the extent of development of the financial system. In considering how national or international financial architecture might be altered, it is important to remember that the risks in the financial system can often be diminished, but cannot be entirely negated without negative consequences for economic growth. Regulation is needed, but the wrong sorts of regulation or overregulation may lead to stagnation or relatively slow growth. The art will be to find the happy medium.

However, it has long been recognized that financial intermediaries are "special" in a number of ways. An important one of those ways is that many financial institutions, and especially banks, are lending long and borrowing short. They inherently have a mismatch in maturities between their assets and their liabilities. Because the future is inherently uncertain, lenders will not lend without receiving an adequate reward for the risk they are taking. This gives rise to the "risk premium" which borrowers pay to compensate lenders for accepting the risk.

But this can lead to perverse incentives in difficult situations. If a bank recognizes, for example, that its equity is or will be greatly eroded, there will be a strong incentive to "gamble for resurrection," by making highly risky loans. Those loans would naturally

bear higher interest rates because of the risk. If, then, the borrowers are able to repay, the bank is “saved.” If the borrowers are unable to repay, the bank owners will be no worse off, because the bank would have failed anyway.

Thus, there never was a strong case for totally free financial intermediation unless incentives could be found that would induce bank owners and managers to avoid taking on too much risk, especially if they encountered adverse fortunes. The requirements that banks (and other financial institutions) maintain adequate equity relative to the riskiness of their loans are set precisely in order to avoid the perverse behavior that might otherwise arise if banks faced difficulties.

However, regulation itself is difficult and imperfect. The risk classifications in Basel I turned out to be ill-advised in a number of ways, including the categorization of various forms of loans into risk categories. And Basel 2 looks already to be undergoing great scrutiny. The art of regulation is to thwart the perverse incentives that might arise but simultaneously to permit the development of an effective and efficient financial system for evaluating risk-return tradeoffs and appropriately allocating loanable funds. Since a considerable fraction of loanable funds will be devoted to increasing the nation’s capital stock, the efficiency of the financial system is an important determinant of the rate of economic growth.

That said, there will always be financial crises. Perhaps the first lesson of this (as well as past) financial crisis is that it would be foolhardy to expect it would never happen again. Even so, the timing, proximate causes, and nature of any future crisis will be different from those of the past. The best that can be done by individual countries is to develop their own financial systems in accordance with good regulatory practice, while

supporting the development of international norms, regulations, or cooperative regimes to address some of the international aspects of financial regulation.

While financial crises are painful, and we must seek to understand their causes and implement policies that will reduce, if not eliminate, their negative impact, it should also be remembered that there are worse things than crises. Researchers have shown that countries that have had financial crises have on average grown more rapidly than countries that have not; the reason is that the financial systems in the crisis countries, although imperfect, generated more credit and a higher rate of return than in countries where there was financial stability through heavy regulation with resulting lower growth rates.¹

The point is dramatically illustrated by the comparative experience of Korea and India. The chart shows the per capita incomes of Korea and India in the period since 1960. As can be seen the two countries started at about the same level of per capita income. But Korean economic growth was considerably faster. Korea, however, had the major crisis of 1997, which shows clearly on the graph. India did not have such a crisis, as can be seen by the continuous (but slower at least until the 1990s) upward slope of the Indian per capita income line. I think most people, if they knew that their choices for the future were between the Korean growth rate-cum-crisis, and the Indian rate-sans-crisis, for the next half century, they would choose the Korean experience for their countries. Thus, while measures to reduce the magnitude of crisis are urgently needed, care must be taken that those measures do not so stifle the financial system as to greatly reduce growth rates.

¹ Romain Ranci re, Aaron Tornell, and Frank Westermann, "Systemic Crises and Growth," Quarterly Journal of Economics, Vol. 123, No. 1, 2008, pp. 359-406.

In this regard, one additional lesson, which is valid for all countries, is worth noting. Until this crisis, the tendency among policy makers and academics had been to regard finance as a field separate from macroeconomics. One of the fundamental lessons of the crisis is that finance is an integral part of macroeconomics and vice versa (how else could the real economy have been so affected by the financial system?). It seems virtually certain that, over the next few years, many economists and finance specialists will be working to understand better the interrelations between finance and macroeconomics.

Causes of the Crisis

A first question is the causes of the crisis. There will surely be analyses and studies for a long time to come, as researchers seek to understand better what happened and why. At present, there is broad understanding of the following features.

First of all, there are several levels of analysis. While there is little doubt that the while the crisis was financial, it has also been, and is, “real.” The first apparent difficulties took place in the housing sector, and it was concerns about the degree to which home loans would become nonperforming in various portfolios that marked the beginning of the crisis. (I should mention that when I say concerns, that really covers two things: the actual rate of nonperforming loans – NPLs – and the uncertainty about who held how many). But the factors that immediately led to crisis: housing bubble (in some countries); then the mortgage crisis; then the financial crash themselves had causes.

But that immediately raises the question as to why there was a housing bubble. One factor, certainly, was low real interest rates. The years 2002-2007 had seen the most rapid period of inflation-free economic growth that had been experienced in human history

(except, perhaps, in postwar reconstruction or recovery from natural disaster). One of the reasons for that growth had been that the world had experienced very low real interest rates. The demand for housing ownership is highly sensitive to the real interest rate and low real interest rates were certainly a major factor in the housing boom.

In addition, low real interest rates led to a “search for yield” as investors sought a higher return than was available with safe assets. That led many portfolio managers and individual investors to increase the share of their assets invested in emerging markets (where spreads were inordinately low) and other risky ventures, which also contributed to the financial crisis.

But that low real interest rates were a major factor encouraging the housing bubble and investment in risky assets more generally only raises the next question, which is why real interest rates were so low. At that deeper level, much of the blame must, in my judgment, go to global imbalances. As everyone knows, the United States ran large current account deficits during the years prior to the crisis, while China had large current account surpluses (to be sure, oil exporters and a few others contributed significantly to the surpluses, but China and the U.S. were the major players). While focus has been on the American deficits, it seems unarguable that if U.S. hadn't run large current account deficits, either there would have been a global recession earlier or some other countries would have had to make their economic policies more expansionary. In the longer term, the world will need to adopt a system, probably rules-based, resolution of unsustainable global imbalances, or we can have the same sort of difficulties at some (reasonably distant) future date. But for the next decade, at least, it is unlikely that a buildup could again occur (although there may be other problems that I will discuss).

Outlook for the International Economy

It is obvious that the prospects for developing countries and emerging markets will be better the healthier the growth of the international economy. Here, there are two issues. First, there is the question as to the sort of economic growth that will emerge over the medium and longer term. Second, there is a question, not totally unrelated, as to the extent to which the trend toward increasing openness and deeper integration of national economies will continue.

Turning to the first question, many observers have questioned whether the industrial economies can resume the rates of economic growth that they enjoyed in the two decades prior to the crisis. There are several bases for skepticism: 1) concern that consumers and firms will want to restore their balance sheets by saving much of any increase in income when recovery does start; 2) belief that part of earlier growth was unsustainable and cannot be repeated; and 3) focus on fiscal deficits and build up of government debt in the industrial countries may result in “crowding out” of private investment, and therefore impair growth prospects.

The first concern is essentially one for the short and intermediate term, say the next five years. It posits that, after the bottom is reached (hopefully soon), the upturn will be slow, because of balance sheet considerations. Offsetting that is the rapid increase in aggregate demand that can be expected in some countries where large fiscal stimuli have been applied and are beginning to take effect. Whether balance sheet or aggregate demand effects will dominate is difficult to say, but even if balance sheet effects do constitute a drag on the rate of economic growth in the industrial countries, the outlook

would be for a gradual acceleration of the growth rate over time. Some countries with very high savings rates, most notably China, will almost certainly realize that it is in their self-interest to encourage the expansion of domestic consumption relative to GDP, which would and should take up some of the slack as those in the previously low-saving countries save more.

The second concern arises from the observation that earlier growth was spurred in significant part by the increase in indebtedness of households and corporations in the industrial countries. While that is certainly true, it is also true that China, India, and others grew rapidly while accumulating assets, and as they continue to grow rapidly in the future, they will become more important as a source of international demand. While some of the industrial countries may grow more slowly than they did in the middle of this decade, other countries may accelerate their growth, and there seems little basis for pessimism over the medium or longer term about world growth prospects because much of that growth was financed by unsustainable borrowing. It will, of course, require a rebalancing of sources of demand, with China and other surplus countries spurring their own domestic consumption and reducing their current account surpluses, but that is in any event in those countries' interests, and probably would have happened even without the crisis.

The third consideration – crowding out by the public sector – is the one to which most attention needs to be given. The IMF estimates that the public debt of the industrial countries will increase by about 85 percentage points over the period between now and 2015. As recovery progresses, it is likely that higher real interest rates will be needed to induce the holding of the public debt. Moreover, the aging of populations in the industrial

countries and some others is certain to place increased fiscal burdens on governments, even beyond those resulting from the current crisis. Hence, both intermediate and longer-run considerations suggest that a higher real interest rate and cost of capital will prevail than in earlier years.

Hence, policy makers in developing countries will face scarcer capital, either in the form of reduced capital inflows altogether, or in the form of higher real interest rates to induce the desired inflows. In terms of the economic environment going forward, higher real capital costs are likely to be a significant factor once the upturn has become entrenched.

On balance, the argument that world economic growth will inevitably be slower in the future than in the past is weak. With appropriate policies, it is quite possible that growth could resume, with less structural weaknesses than were present in the “global imbalances” years.

Impact of the Crisis on Developing Countries to Date

Initial discussion of “delinking” of emerging markets and other developing countries from the industrial countries, should they enter a recession, was predicated on the assumption that the recession would be confined largely to one or a few industrial countries and would have about the same severity and duration as earlier recessions. As both its magnitude and its breadth exceeded all predictions, the impact on developing countries and emerging markets has been greater than anticipated.

It should first be pointed out, however, that although there have serious repercussions for developing countries and emerging markets, they have been far less

relative to the impulse from the industrial countries than might have been expected based on experience in earlier recessions. Not only did most countries experience rapid growth in the five years prior to the crisis, they also managed to tame their fiscal policies to a considerable degree. As such, many entered 2008 in much better fiscal and monetary shape than they had entered earlier periods of downturns in world trade and capital flows.

One of the impacts on developing countries is the severe reduction in capital flows and credit from industrial countries' financial institutions. For some countries, the drying up of foreign credit has itself been a major source of difficulty, especially if the countries were earlier incurring large current account deficits.

But for most countries, the differences lie in other areas. To a first approximation, they can be divided along two lines. On one hand, countries can be classified as oil exporters, other commodity exporters, and exporters of manufactures. And, within that classification, there are degrees of reliance on foreign trade. On the other hand, some entered into the current period in much better condition, based on their fiscal stance and level of indebtedness, than others.

Countries worst off include those that are both heavily dependent on one or more primary commodities whose prices have fallen drastically and also have with relatively high fiscal deficits and high debt-GDP ratios. Argentina is an example of such a country: exports consist largely of primary commodities, and constitute a sizeable fraction of GDP. Simultaneously Argentina's debt-to-GDP ratio is high, not even counting the unstructured external debt still outstanding. Meanwhile, Argentina's inflation rate was officially around 12 percent pre crisis, but economists regarded 23-27 percent as a more realistic number, and the government was appropriating pension funds in order to finance

its activities. Clearly, there is little scope in such countries for countercyclical fiscal policy (as there were deficits during good years), and the impact of commodity price declines could be large.

By contrast, Chile, had had a budget law requiring a 0.5 percent of GDP fiscal surplus in the structural budget for some time, had accumulated funds during the years of high copper prices, and had little debt. While still impacted by the slowdown in economic activity and the sharp drop in copper prices, the Chilean government had more than enough fiscal space to adopt a stimulus package. In contrast, in most prior recessions, the Chilean government had been forced to take procyclical fiscal tightening because of the starting fiscal position. Most forecasts of Chilean GDP in 2009 are for real GDP to be about the same as in 2008.

Likewise, one can contrast other countries. India and China are both exporters of manufactures, but China's exports are a much larger percentage of GDP than India's. China has large reserves and has had huge current account surpluses. India, meanwhile, has a high (above 80 percent) debt-to-GDP ratio and had a large fiscal deficit (above 5 percent) in the last fiscal year. The country has sizeable reserves, but very little fiscal space given the already large fiscal deficit and the debt level. It is likely to be less able to undertake policies sustaining GDP than China, even though China's dependence on manufactured imports is considerably greater.

One can classify countries along these lines and in general the larger the initial fiscal deficits and debt and the more dependent the countries on exports of primary commodities whose prices had fallen sharply, the greater has been the relative severity of the impact of the current economic slowdown.

Worse, for countries with high initial debt levels and fiscal deficits, the room for offsetting fiscal action is severely restricted. Indeed, there are some countries where fiscal consolidation may even prove stimulative, in that the crowding out effects of the fiscal situation are sufficiently serious so that reducing the deficit may increase domestic demand.

Few developing countries, however, have thus far been able to adopt structural balance rules of the type that Chile (and several industrial countries) have. One lesson for the future is the desirability of such rules as a means of greatly reducing the impact of slowdowns of the world economy on them. If the real interest rate in the world economy rises as anticipated, this will become even more important in the future than in the past.

Development Policies in Light of the Global Outlook

The outlook for the international economy as a whole is for growth that is no faster, and possibly slower, than the growth realized in the past very successful years. It is for an international economy with higher real interest rates, and, hopefully, with smaller global imbalances.

The lessons for development policy stem from these observations. Outer oriented growth strategies, and integration with the international economy will still bring benefits, although they may be somewhat smaller than in the past (although growth will still be more rapid than if countries attempt to reinstate tariff and other barriers to imports). And, as long as any slowdown in overall growth is not the result of, or accompanied by, increased protection in the global economy, the benefits to integration will be sizeable. With the recession, there is a risk that some policy makers will increase protection, which

in turn would lead to retaliation by others. Major increases in trade barriers would serve as a significant damper on world economic growth in the longer term, with the largest impact on those emerging markets dependent on trade and on poor countries whose best hopes for more rapid growth lie in opening up their economies.

But if real interest rates are higher, and capital is therefore more expensive, a key implication is that efficient use of unskilled labor, and efforts to increase productivity of labor, especially by investments in health and education, will become more important than ever. As capital becomes more expensive, it will generally raise the optimal labor-capital ratio for goods production, which should be to the advantage of unskilled-labor abundant countries, and to the advantage of those countries accumulating productive human capital.

Especially as industrial countries go through the demographic transition, and have a much higher fraction of older people in their population, investments in developing countries with relatively abundant supplies of unskilled and skilled labor will become increasingly attractive. But investment will flow only to countries where returns are attractive, and they will be attractive primarily in countries that have business-friendly investment climates including especially open trade regimes, have invested in the health and education of their population, and have flexible labor markets.

For countries meeting those criteria, the opportunities even in a slower-growth world will be substantial. It would be to the advantage of savers in developed countries (where scarce labor will dampen returns to capital) to invest abroad where labor is more abundant, and it will be in the interest of developing countries and their workers to encourage these investments.

These longer-term goals cannot, however, be achieved overnight. Especially when it comes to education and health, investments in human capital have long lead times. Countries where those investments are already considerable and increase now will be in the best position to take advantage of the post-crisis longer-term economic landscape.

But, as already noted, even as countries adapt their policy framework to sustain growth in the new circumstances, the growth of the international economy will affect them. The higher that growth, the greater will be the payoff for appropriate policies. For that reason, it is incumbent on leaders in developing countries to participate far more actively than they have in the past in international forums, especially when issues surrounding the open multilateral trading system are under review. Korea, the host country for this conference, has done well in making the case for keeping trade open, and should be supported by all developing (and developed) countries.

To date, developing countries have to a large extent been free riders on the open multilateral trading system, benefiting from reductions of tariffs and other trade barriers negotiated at the WTO primarily among developed countries, while simultaneously unilaterally undertaking trade liberalization without binding tariffs. Some of the dangers for the international economy of this practice were seen in late 2008 and early 2009, as a number of countries took advantage of the space between bound and actual tariffs to raise their tariffs against imports. Much of the protection that resulted was by one developing country against another.

But even more important, protectionism not only hurts the country undertaking it but invites retaliation, especially in difficult economic conditions, such as the present. Strong political leadership is needed to resist protectionism during the crisis. Trade

barriers are politically much easier to raise than to lower. Raising a trade barrier meets the approval of people within the industry; and those who are adversely affected (as consumers pay more or get lower quality for some goods, as businesses pay more for their inputs and are therefore disadvantaged in competing in export markets, and as overall growth slows), usually do not recognize the extent to which they are disadvantaged, and certainly not immediately.

As Korean experience amply demonstrates, the opportunity to use international markets is vitally important for rapid economic growth, especially in the early stages of development. No country has sustained rapid growth behind high and rising walls of protection, and no developing country has sustained a successful long-term development strategy without opening up to international markets.

The reasons why liberal trade and trade opening are so powerful a stimulus to growth are not entirely understood. But some of the benefits, such as increased competition for domestic producers and access to international best practice, clearly depend more on openness than they do on the export opportunities that increase with open trade strategies. Even slower growth of the international economy would not deprive countries with outer oriented trade strategies.

Protecting and enhancing the open multilateral trading system ought to be a top priority for developing countries' leaders in international forums. Success would raise global growth prospects while simultaneously supporting the economies of those developing countries.

A leaner world economy, with less scope for policy mistakes, can be expected in the future. The graying of developed country populations can prove advantageous for

developing countries that adapt their own policies appropriately. The falling labor-capital ratio in developed countries can lead to a shift in comparative advantage to even more labor-intensive activities in developing countries. In an appropriate economic environment, which includes the rule of law, a good commercial code, enforcement of property rights, attention to the productivity of labor through education and other social expenditures, and a flexible market, the rewards in terms of growth and rising living may be even greater than in the past. The problems arising from fiscal crowding out the demographic shift in developed countries provide an opportunity for developing countries to use the international economy to their great benefit.