# GROWTH IN THE POST CRISIS WORLD

Michael Spence

## MACROECONOMIC STABILITY

Before the crisis, macroeconomic stability was correctly perceived as a necessary but not sufficient condition for sustained growth. There were muted business cycles, shocks, and asset bubbles in the advanced economies, but not really bouts of instability that threatened the balance of these economies. Macroeconomic instability was viewed mainly as a challenge in developing economies. The crisis turned this, and much of the thinking that went with it on its head.

Post crisis, we no longer take macroeconomic stability for granted and must rethink the proposition that emerging economies are inherently more prone to instability than the advanced ones. But the necessary condition remains true and the principle challenge is how to achieve it, domestically and in the global economy. Interdependence and the increasing size of the emerging economies as a group imply that instability and crises originating in one part impair potential economic performance everywhere.

Most of the discussion is devoted to policy and policy frameworks. Certainly policy in several categories is important and needs to be re-thought. But it is, I think, a mistake to focus exclusively on policy. A critical ingredient in creating the recent crisis was the inability of the participants, regulators and private sector participants alike, to accurately perceive risk. The conceptual frameworks for assessing the dynamics of risk proved inadequate. As a result, the presumed self-regulatory properties of the system evidently failed, contributing the crisis. One conclusion I think is clear. We need, as part of the effort to improve the system, to recognize that the models of risk in the financial system are incomplete. It is a challenge and an opportunity for the academic community, among others.

One might assume that the self-regulatory properties will always be missing. The burden would then fall on regulation. I don't agree. I may be wrong, but it seems unwise to assume the conclusion in advance. New and better models of the dynamics of risk will influence the behavior of investors and intermediaries. The recognition that the models are incomplete already has.

Let me turn now to growth dynamics. In advanced countries, long-run growth is driven by innovation and growth in the labor force. Capital deepening has its limits, as Bob Solow's work showed.

In emerging economies, the principal ingredients of sustained high growth are

1. Macroeconomic stability
2. Engagement with the global economy
3. Inbound knowledge transfer
4. Export diversification and structural change
5. Capital deepening, with investment rates in the range of 25 percent to 35 percent of GDP and public sector investment rates in the range of 5-7 percent of GDP. With capital/output ratios in the range of 2.5 to 3.0, these investment rates will support growth in the 7-10 percent range.
6. The high rates of public sector investment raise the return to private sector investment (including FDI), and hence the level of the latter.
7. A pattern of inclusiveness in terms of employment opportunities and access to key elements like education.
8. Policy setting involves decisions under uncertainty with incomplete models, and has a pragmatic and experimental component.

This is a short summary and there is more too it than just this. A fuller treatment can be found in The Growth Report, the principal report of the Commission on Growth and Development and in "The Next Convergence: The Future of Economic

Growth in a Multispeed World", Michael Spence, Farrar, Straus and Giroux, May 2011.

In the future, there will be additional longer term issues. They can be thought of a collection of adding up problems, each of which represents a challenge to the replicability and sustainability of the model where the focus was on the individual developing economy and the presumption was that the global economy was large in relation to it.

An interesting and very recent development is a growing recognition in the large emerging economies that the growth paths of their predecessors and the advanced countries won't work because they put too much strain on a broad range of natural resources and the environment. They are at the beginning therefore of embarking on a new growth path that will involve different patterns of energy consumption, urban density, transportation modes and investment and much more. Their aggregate projected economic size and impact dictates that they take an alternative course, regardless of the paths that advanced countries follow. Projecting out into the future, these countries will account for well over 60 percent of global GDP and especially in the case of China and India, which will lead the shift, they will be individually large. In the language of economics, the incentives will be to a great extent internalized and the free rider problem will be less daunting.

Turning to the crisis, there was some concern in developing countries that the crisis would be misinterpreted as a broad failure of a market-driven capitalist approach to growth, with the result that it would be rejected, notwithstanding past success, and replaced by a more inward looking, state centric and interventionist approach. The argument would be that the global economy is too unstable and dangerous. At least the financial system is less stable than most thought. But by and large, this shifting of strategy and direction has not happened. I suspect that it helped that the recovery was rapid in the major emerging markets. The crisis is now pretty much universally viewed as a failure of the advanced country financial systems, with supporting trends in the global economy that contributed to disguising the growing instability.

Nevertheless there are lessons, too numerous to deal with in detail here. By way of summary, the importance of initial conditions and conservative positioning prior to a crisis (a set of lessons learned during 1997-98) was reinforced by this crisis. The 2008 crisis and the commodity price spike that preceded it also brought to the forefront the importance of paying attention to distributional issues, across household and businesses. There is more attention now being paid to pre-built mechanisms that can be rapidly deployed to counter the adverse income, employment and credit impacts of crises.

In the past twenty years, there have been areas of policies in which there is a diversity of views and practice. There has been some convergence of views but it is certainly incomplete. The major areas in which there is this kind of diversity are (1) industrial and export diversification policy, (2) the pace and sequencing of opening up the current account (an area influenced by the WTO rules and negotiations), and (3) the capital account and in particular the use and mis-use of capital controls on various types of cross border capital flows, and reserve accumulation. The crisis has not substantially changed the positioning, at one level. But there has been some shift. The importance of a domestically owned component of the banking system is now widely understood. The credibility of the open capital account position (pushed before the 97-98 crisis and then modified somewhat in the aftermath) was further reduced by the unexpected instability in the advanced country financial systems and the need to take defensive action, first against the rapid capital outflows and then in the post-crisis environment, the need to offset some of the effects of large inflows, in particular inflation, asset price bubbles and rapid appreciation of the currency. On balance, the crisis has reinforced the pragmatic, somewhat gradual, step-by-step approach, without however, negating the risks of extended over- or under-valuation. The risks of these two are asymmetric and quite different with respect to timing. The less well understood one is under-valuation, which eventually achieves its negative effect by damaging the incentives for structural transformation of the economy and hence the underpinnings of growth.

The crisis hit developing countries through two channels. One was the rapid exodus of capital and a resultant credit tightening, combined with downward pressure on the currency. The second was a precipitous drop in trade and hence aggregate demand. On the credit side, central banks moved quickly and in collaboration with domestic financial institutions, preventing a drying up of credit. Reserves were used to moderate the pace of net capital outflows on the private side of the current account. Collaboration among central banks was significant and important.

On the trade side, there wasn't much place to hide. Countries varied in their capacity for fiscal stimulus and used what capacity they had. China, with the largest capacity, used it in the form of a two-year stimulus program amounting to 9 percent of GDP a year, and combined it with a rapid and dramatic easing of credit that has left some residual problems, probably manageable. With the help of a rapid bounce back in trade, including among the major emerging markets, and these policy responses, emerging economies bounced back, and experienced the V-shaped recovery that was hoped for and to some extent mistakenly expected in the advanced countries, where balance sheet damage in the financial and household sectors was much greater. The recovery in terms of magnitude and speed came in China, then India and Brazil in that order. There is no question that this has given the emerging economies a greater sense of resilience and confidence as a result, and rightly so.

The effectiveness of the crisis response does not guarantee a return to pre-crisis growth patterns in the face of weak recoveries in the major markets of the advanced countries. So the central unsettled question in 2009 was whether the EM's could sustain their growth in the context of a global economy that was being held back by the advanced economies. The answer now appears to be that they can. This is a new feature of the global economy. Ten years ago, the dependencies in terms of markets and aggregate demand would have been such that growth in the advanced economies was required to sustain the demand side of the growth in EM's. This has to do with composition as well as the size of EM demand. It now appears that the EM's have reached an aggregate size, a level of income (which shifts the composition of demand), and a pattern of direct intra-EM trade that is capable of sustaining this growth. However decoupling is not a zero-one matter. A major downturn in Europe or North America would subtract enough demand to slow growth in the EM's. Similarly, persistently high unemployment or low growth in advanced countries could cause a rise in protectionist measures, which if large enough would reduce external demand enough to impact trade and growth. Thus far that has not happened. Finally, China's growth is a large and growing part of the EM total. Therefore China's ability to sustain growth through the middle income transition, a stage of growth and development that it is entering, will be a third decisive factor. China is the largest trading partner on the export side for a growing list of countries including Japan, Korea, India, and of course, pretty much all of its smaller Asian neighbors. It is the largest trading partner (share of imports plus exports) for 6 of the G20 countries.

The rising systemic importance of the EM's has created new challenges. For China and prospectively for India, it has caused their global impacts and responsibilities to expand at relatively low levels of per capita income by historical standards. This is the direct result of sustained high growth over long periods of time in countries with populations approaching 20 percent of the world's population each. Neither they nor their predecessors, nor for that matter the global system as a whole has figured out how to deal with this; how to balance the complex requirements of sustaining growth and development domestically with the need to adapt to the changing environment to achieve stability in the system as a whole. It is clear that the balancing approach is the right one. A narrow focus on the domestic agenda is no longer feasible.

The implications are several. Much of the post war global system involved a hybrid, in which the advanced countries adopted policies designed to promote growth but also keep the system stable. The developing countries with relatively little systemic impact on the system as a whole (because of small size), were essentially free to focus on policies that promoted growth. With the increasing size of the latter, this convenient hybrid won't continue to work. An example is the exchange rate system, with floating market determined rates for advanced countries, and managed currencies and capital accounts in developing countries, in varying forms, depending on size, state of development and other factors. The challenge now is to build a new system that achieves goals of equity and fairness and stability, but that also recognizes that open capital accounts and purely market determined exchange rates probably entail too much risk for the systemically important EM's. A case in point is the expansion of interventions in capital flows in the post-crisis period to manage and limit the adverse impacts of large capital inflows that stem in part from the accommodative monetary policies in advanced countries.

In a longer term perspective, EM's are a double edged sword for the advanced countries. They lower the cost of many goods, and represent growing external market opportunities. But they also present challenges in terms of employment and scope in the tradable part of the advanced economies. And there are potential income distribution effects that are hard to manage.

Since China is a key factor in global and EM growth, it is worth devoting a few words to the challenges on that front. As note above, China is entering the middle income transition, a passage that has slowed many of its predecessors. The known high speed middle income transitions are thus far confined to the economies of Japan, Korea, Taiwan, Singapore and Hong Kong.

There are at least five linked transitions embedded in the next phase of growth – ones that are envisaged in the 12$^{th}$ five-year plan: a) change its growth model or supply side structure, as its labor costs rise, global market shares get large enough to limit expansion, and advanced countries' growth momentum along with the tailwind that went with it, declines for an unknown period of time; b) rebalance demand, from investment and exports to domestic consumption; c) accommodate a rapidly urbanizing population, and ensure the incentives are structured so as to lead to as orderly a process as is possible; d) build the social infrastructure necessary for a achieving a harmonious society with special emphasis on opportunity; and e) take on international responsibilities for stability, growth and sustainability, including tackling climate change, commensurate with its growing size and systemic impact.

The challenge at this point is implementation. One needed set of reforms and system changes involves the allocation of capital in the government and state owned enterprise sectors. Here there is a portion of the investment portfolio that is tending toward low private and social return investments, driven--it is suspected--more by the availability of funds than by returns. This is a deceptive trap; such investment constitutes aggregate demand and supports growth in the short run, but lacks the intertemporal multiplier effects of high return investments. Eventually the growth engine slows down. So the challenge will be to build the market and institutional mechanisms to redirect these funds to household income, higher return investments, or important social services and social insurance systems.

Let me conclude this discussion of various aspects of growth in the global economy with structural issues of a longer term nature in the advanced economies. These are related indirectly to the crisis in that the patterns of growth in the global economy preceding the crisis had the side effect of hiding some of the structural changes.

Based on some recent work on the changing structure of the US economy, one can begin to bring the issues into focus. Here I can only hint at the analysis. In the US economy in the 18 years immediately prior to the crisis, the economy produced a net increment of 27 million jobs. Virtually all (98 percent) of them were in the non-tradable part of the economy, with the leading sectors in terms of size and increments being government, health care, retail, construction, and hotels restaurants and food service. On the tradable side, value added grew, but employment did not. Within the tradable sector, a number of high value added per employee service sectors grew: finance, computer design and engineering, management of enterprises, consulting. The remainder, consisting of manufacturing sectors which have long and complex value added chains, experienced value added increases and employment declines. The net effect was rapidly rising value added per person in the tradable sector combined with negligible net employment growth.

It is fairly clear that the underlying trend is the movement offshore of a growing subset of the supply chains in manufacturing and some tradable services. Overlaid on top is a pattern of rapid technological advance, some of which is labor saving in nature. In some ways, in the face of these trends, it is remarkable that there wasn't an obvious employment problem.

The unbalanced and unsustainable pattern of growth leading up the crisis, with excess consumption as a key component, appears to have allowed the non-tradable sector to absorb most of the incremental labor force, and delayed the arrival of market forces that would have caused a different pattern of structural change. There is at least a question about whether pre-crisis employment patterns will continue in the post crisis period. One view is that this is a long difficult recovery by historical standards, but not much more than that. I believe first that the US cannot return to the pre-crisis mixture of aggregate demand with zero household savings and that the lost aggregate demand will have to be replaced by investment and foreign demand. The latter implies an expansion in the tradable sector and probably an expansion in the scope of the tradable sector.

In addition, restoring competitiveness in an expanded part of the tradable sector may have consequences for incomes and the income distribution. Certainly the pre-crisis trends in income distribution included relatively rapid increases in incomes at the upper end of the spectrum and low to flat incomes in the mid-range.

There is much more to be done on this front, including a detailed assessment of the structural shifts in other advanced economies, which are presumably subject to similar global market forces, but which appear to respond in different ways, generating different outcomes in terms of structure, employment and income distribution.

We were going to get to this stage in the global economy, with or without a crisis. Perhaps the crisis has brought the structural and distributional issues into focus more quickly. The distributional impacts of the evolution of the post-war global economy for several decades were largely benign, with a successful post-war recovery in the advanced countries followed by 2.5 percent real growth and little serious unemployment. In parallel, the developing economies with varying starting points engaged with the global economy, found avenues for inbound knowledge transfer and a large advanced country demand, and accelerated to previously unknown sustained high growth rates. After several decades of this pattern, the developing economies are larger and richer. Given the way the market forces and growth dynamics work, it seems likely that we are entering a more challenging period from the standpoint of distributional issues, and relatively uncharted territory.

Looking forward then, the major new policy challenges related to growth, both domestically and internationally, seem to fall into two categories: sustainability or adding up problems, and distribution.

There is no particular reason to think that institutional and policy adaptation combined with human ingenuity, will prove inadequate to the task. But it will take time to bring these evolving new issues into focus, a prerequisite for dealing with them.