Michael Spence

Chair of the Commission of Growth and Development, winner of 2001 Nobel Prize in Economic Sciences

Growth and development perspectives

Fondazione
Italcementi
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Carlo Pesenti

Obama's America: back to the future
Bergamo, 13 dicembre 2008

Prospects for Developing Countries

- **Long term, the sustained high growth model will continue to work**
  - **Assumes a return to a stable global economic environment**
- **In the short run there are major headwinds**
- **The financial crisis (as of the last two months) has the potential through multiple channels to slow growth quite dramatically**
- **In some countries this may derail it for a longer period (for political as well as economic reasons)**
- **Confidence in the stability of global economy is shaken and will not return right away**
- **Balance of benefits and risks in the global economy may be shifting at least for awhile**
- **Risk mitigation will be a higher priority in growth strategies**

Topics

- **Very brief account of the longer term sustained growth model in developing countries**

- **The impact of the financial and economic crises**

- **Some longer term challenges to developing country and global growth**

Commission on Growth and Development

- Montek Ahluwalia (India), Deputy Chairman, Planning Commission
- Edmar Bacha (Brazil), former President of the National Bank for Economic and Social Development, now in Banco Itau.
- Dr. Boediono (Indonesia), Minister for coordinating Economic Affairs
- Lord John Browne (Great Britain), former CEO, British Petroleum
- Kemal Dervis (Turkey), former Minister of Finance; Head of the UNDP program.
- Alejandro Foxley, (Chile), Minister of Foreign Affairs in Chile, former Finance Minister.
- Duck Soo Han (Korea), Prime Minister, Former Minister of Finance and Deputy Prime Minister
- Goh Chok Tong (Singapore), Senior Minister and Chairman of the Monetary Authority of Singapore.
- Danuta Hübner (Poland), Member of the European Commission
- Carin Jämtin (Sweden), Parliamentarian, former Minister for International Development Cooperation
- Pedro Pablo Kuczynski (Peru), former Prime Minister and former Minister of Finance
- Danny Leipziger (USA), Vice president, World Bank, PREM Network (Vice Chair). Trevor Manuel (South Africa), Minister of Finance
- Mahmoud Mohieldin (Egypt), Minister of Investment
- Ngozi N. Okonjo-Iweala (Nigeria), former Minister of Finance Nigeria, Managing Director, World Bank
- Robert Rubin (USA), Chairman Citigroup, former Secretary of the US Treasury
- Robert Solow (USA), Professor Emeritus, MIT.
- Mike Spence (USA), Stanford University, CA (Chair)
- Sir K. Dwight Venner (Saint Kitts and Nevis), Governor of the Eastern Caribbean Bank (West Indies)
- Ernesto Zedillo (Mexico), former President of Mexico, Director of the Yale Center Study of Globalization
- Zhou Xiaochuan (China), Governor of the People's Bank of China (Central Bank of China).

High Growth Cases

- **There are 13 economies that experienced sustained high growth--defined as 7% per year or more for 25 years or longer, post WW II**
- **Botswana, Brazil, China, Hong Kong (China), Indonesia, Japan, Korea, Malaysia, Malta, Oman, Singapore, Taiwan (China), and Thailand**
- **India and Vietnam are close because of growth accelerations in the past 10-15 years**
- **There may be others because of recent growth accelerations (in part due to demand induced upward shift in the relative price of energy, commodities and food.**
  - **These initial growth accelerations can be transformed into sustainable growth dynamics: rapid employment creation and structural diversification – But it is not easy**

Common Characteristics of the Sustained High Growth Cases (1)

- **Engagement with the global economy**
  - **Demand** *
  - **Knowledge (catch up growth)**

- **High levels (and effectiveness) of savings and public and private investment**
  - **Total 25% of GDP or above***
  - **Public sector 5-7% of GDP***

- **Market incentives and decentralization**
  - **Rapid diversification and incremental productive employment**
  - **Continuing structural transformation**
  - **Resource mobility – especially labor – across sectors**
  - **Rapid urbanization**

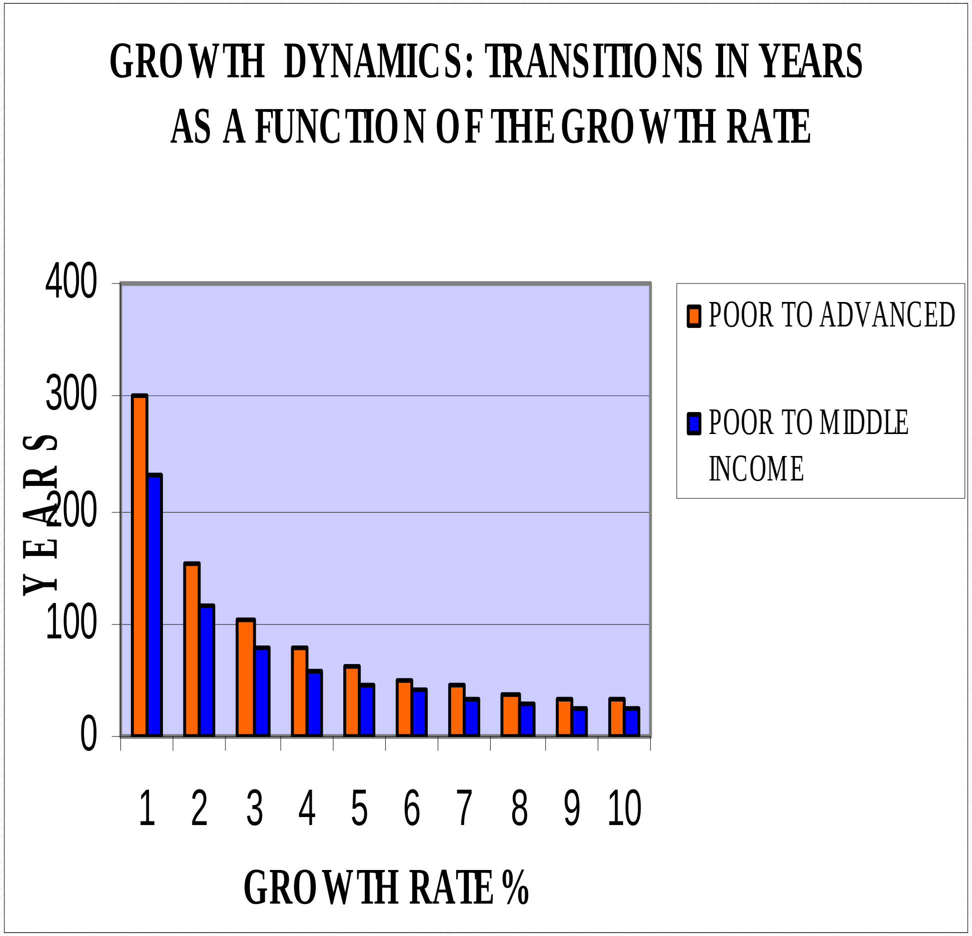
- **Macroeconomic and Financial Stability and Predictability***
  - **Domestically and in global environment***

Common Characteristics
Politics and Leadership

- **Leadership, Governance, and Effective Government**
  - **Political leadership and effective, pragmatic and when needed activist government**
  - **A focus on inclusive growth: combined with persistence and determination**
  - **Long Time Horizons**
  - **Willingness to experiment, in face of uncertainty about policy impacts, and avoidance of paralysis**
  - **Government that acts in the interests of all the citizens of the country – as opposed to itself or subgroups**

Long Time Horizons

- **It takes a minimum of 50 years to make the transition from low to advanced income levels**
- **Persistence and a determined focus on the objective is critical**
- **Major crises will halve the growth rate or worse**
- **Bottlenecks (unanticipated blockages) are the norm in high growth environments – rapid responses are an important dimension of policy and effective government**



Key Ingredients

- **Inclusiveness and equity**
- **Structural Transformation and Competition**
- **Labor Markets, Mobility and Flexibility**
- **Urbanization is a Key Ingredient of Sustained Growth Dynamics**

- **Additional Issues**
  - **Environment**
  - **Energy Subsidies**

Complex and Controversial Areas: Benefits, Risks and the Need to Make Choices

- **Industrial policies – export promotion**
- **Exchange rate management**
- **Pace and sequencing of opening**
  - **Capital account (financial sector)**
  - **Current account (trade in goods and services)**
  - **WTO constraints**
- **Capital controls:**
  - **independent ability to influence inflation and the exchange rate**
- **Reserve accumulation and insurance**
- **Central bank autonomy and coherence of growth strategy**
- **Fiscal stability and sustainability – rules or discretion**

The Financial Crisis and Global Growth

Where Are We Now?

- Considerable damage has already been done
- Major financial institutions will be
  - Gone
  - Transformed,
  - Substantially owned by governments for a period of time
- Equities globally have declined in value by about 30 trillion dollars
  - Starting point $65 trillion
  - Global GDP is about $55 trillion
- Emerging market stock markets down more than 50% on average
- Deleveraging dynamics and asset deflation still in process and accelerating
  - Estimated costs of recapitalizing the financial sector are in the 1 to 2 trillion dollar range and rising rapidly

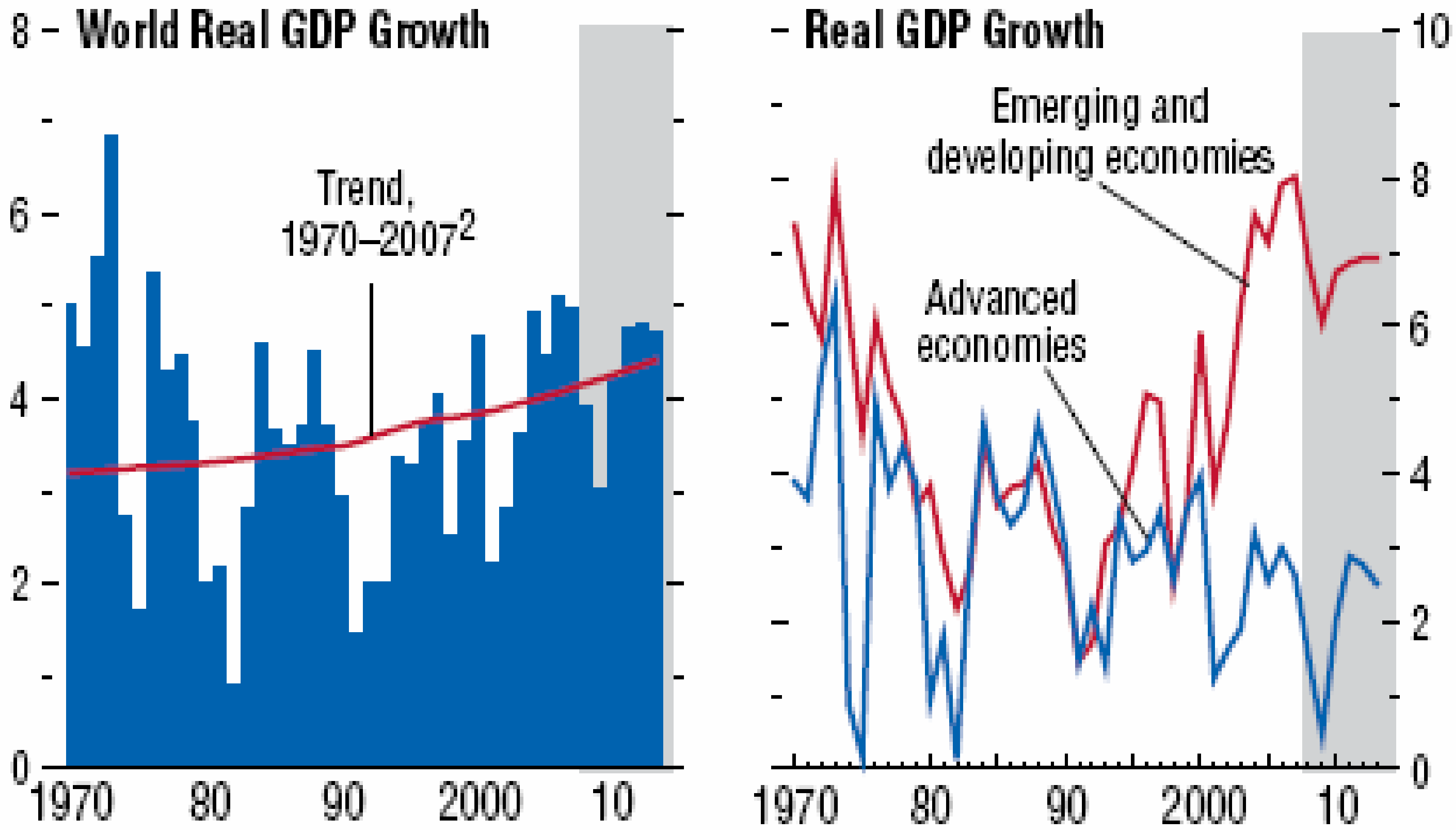
Developing Countries

- Up Until September Tough But Manageable Headwinds
  - Food and energy price shock
  - Food emergency for poor
  - Major inflation issue – now abating
  - Temporary balkanization of agriculture markets
  - Global demand slowing
- But
  - Negligible holdings of toxic assets
  - Post 97-98 much stronger macroeconomic fundamentals
  - Some asset bubbles
  - Variable positioning on fiscal deficits, savings versus investment, trade deficits, reserves

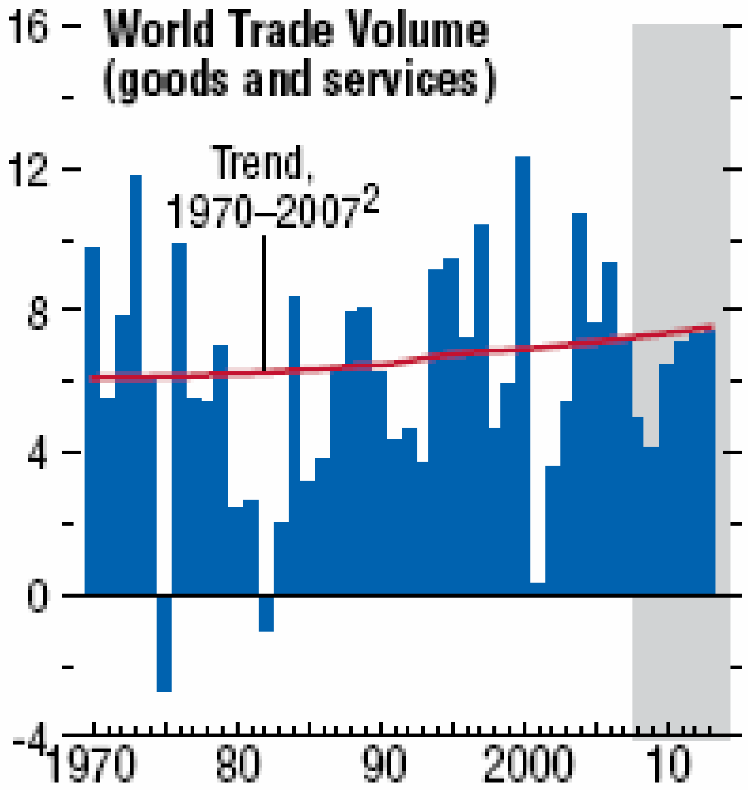
September 2008 Inflexion Point

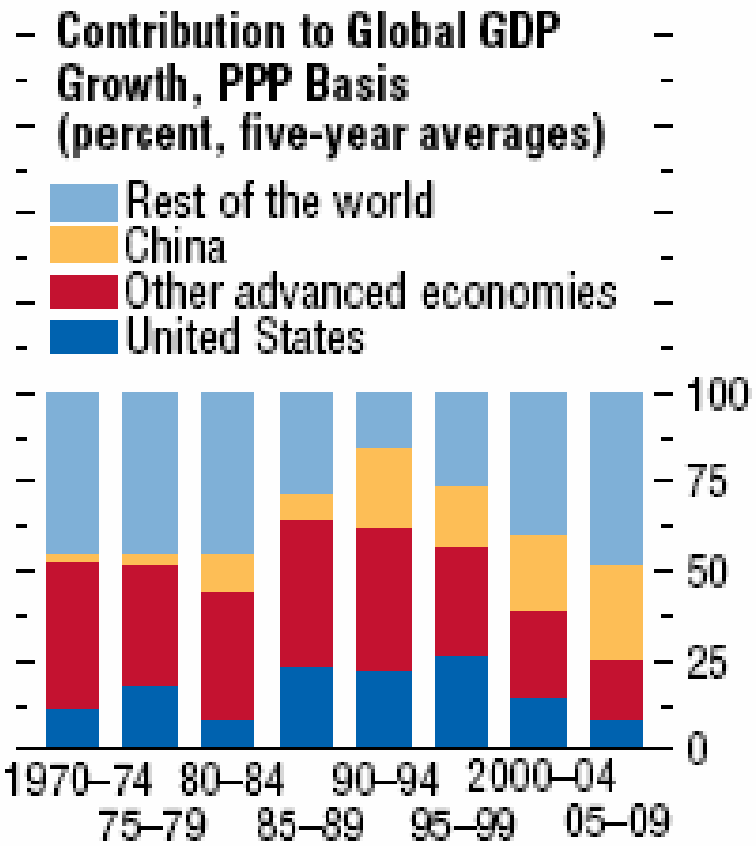
- **Capital is exiting and exchange rates volatile and falling**
  - **Not a flight to safety**
  - **It is a capital vacuum – flight to emergency liquidity and capital adequacy problems in developed economies**
- **Credit tightening is nearly universal**
  - **IMF, Reserves, Dollar Swap Facilities**
- **Global slowdown likely to be much more severe**
- **Commodity prices abating - helpful**
- **Growth will depend entirely on the ability and willingness to use domestic demand to fill in for falling foreign demand**
  - **Varies considerably across countries**

IMF Forecasts Oct 2008

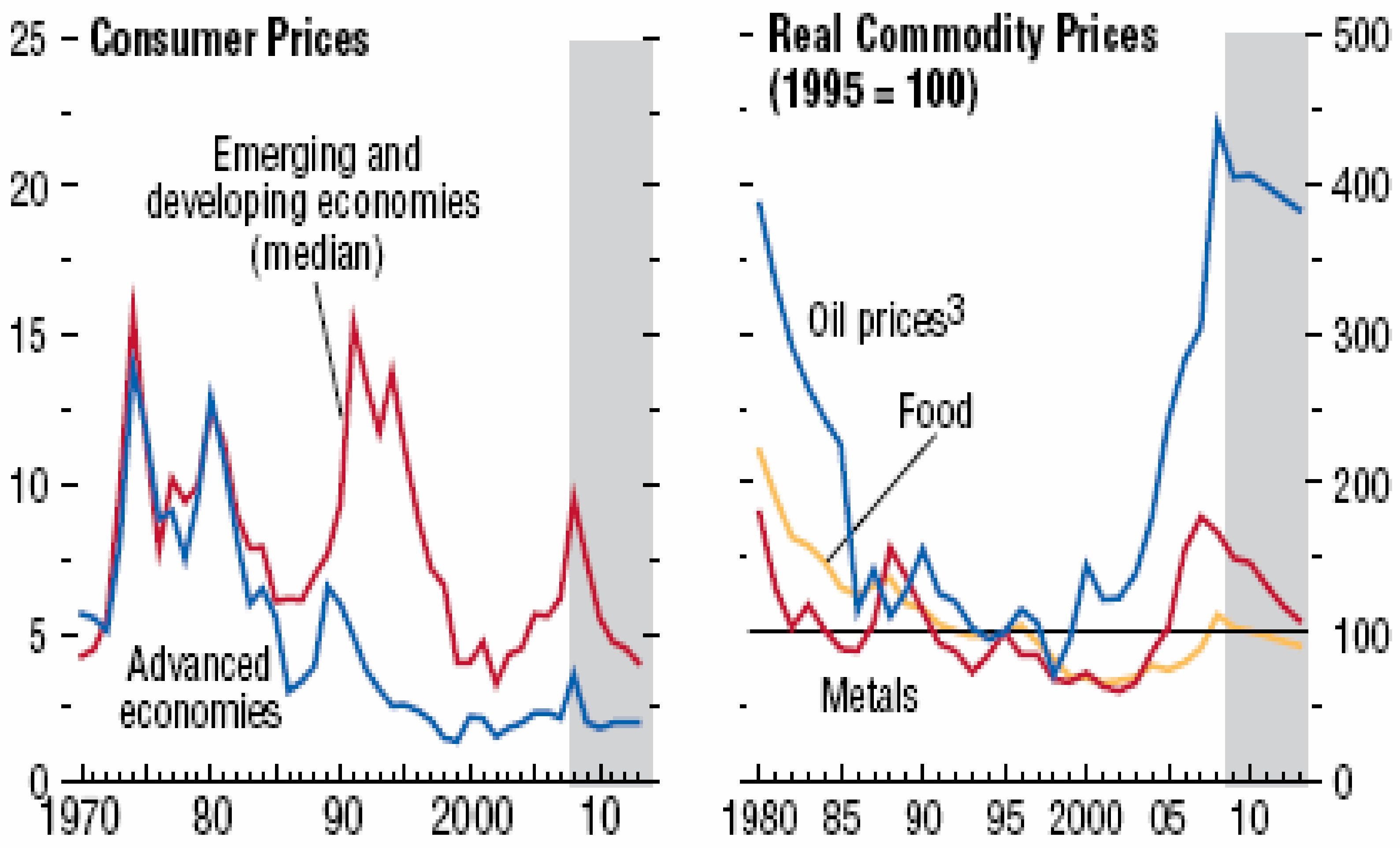


IMF Forecasts Oct 2008
These are now too optimistic especially for developing countries

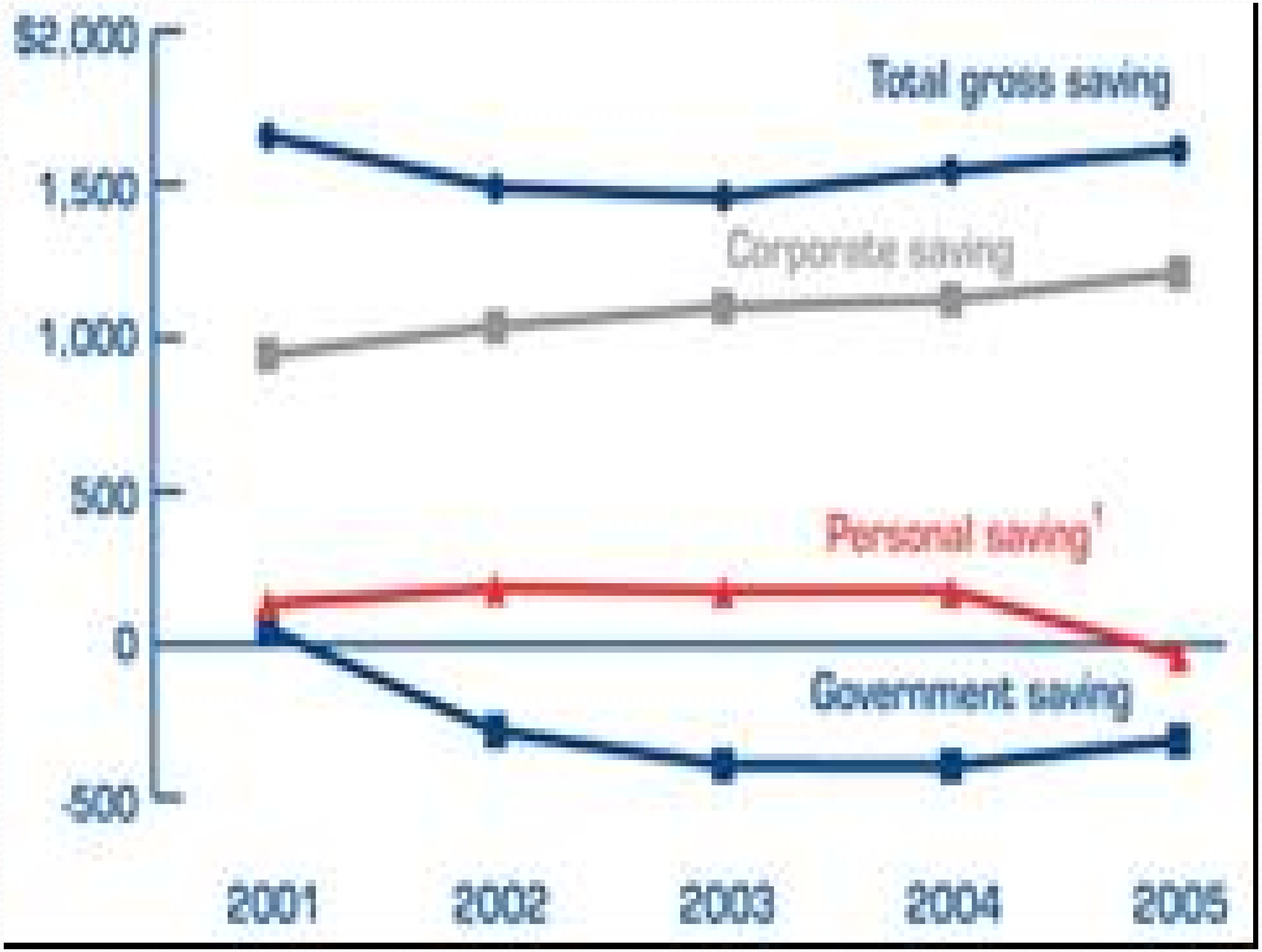




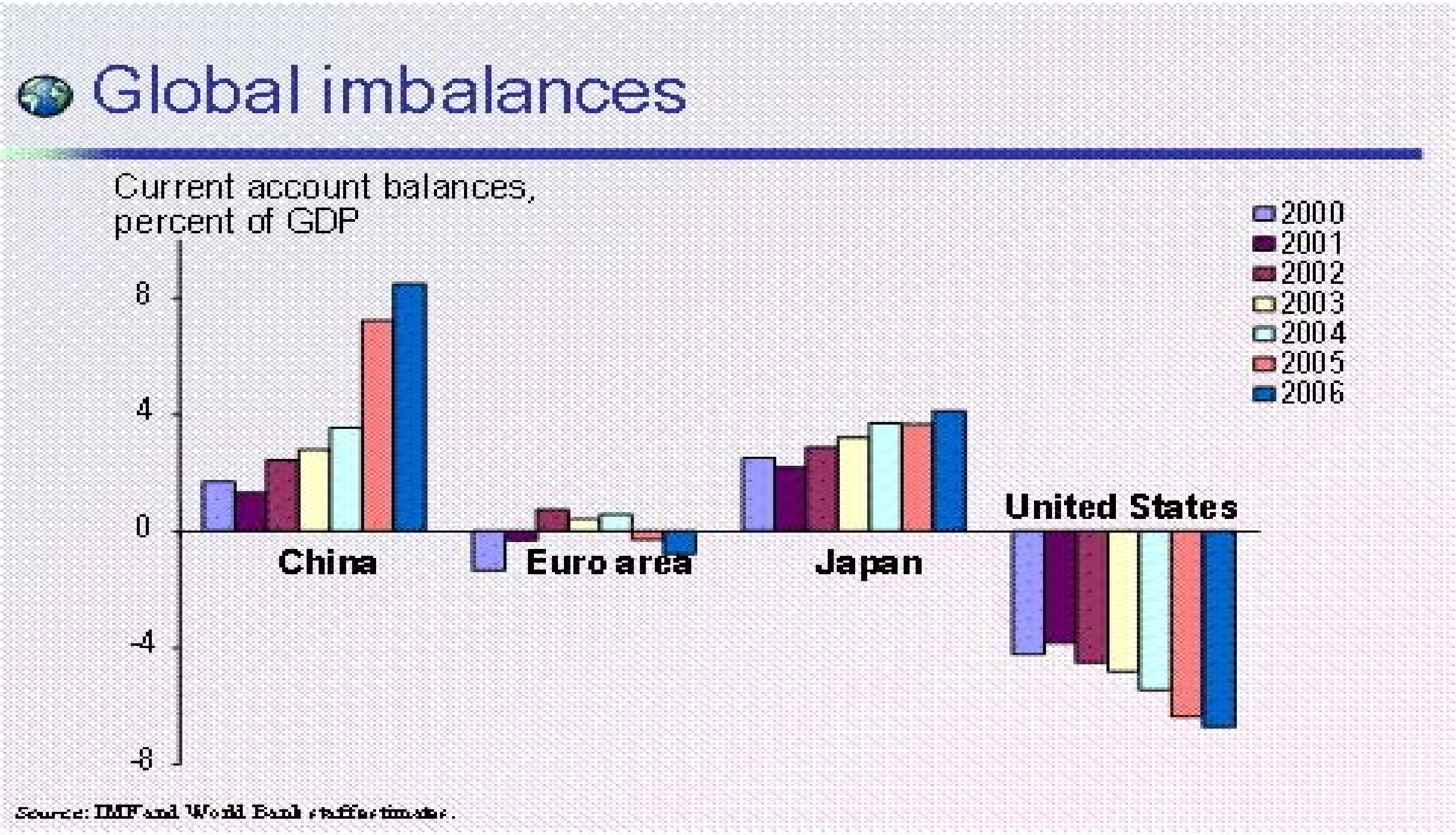
IMF Forecasts Oct 2008
Developing Countries have an Inflation Challenge



USA: Expenditure Exceeds Output

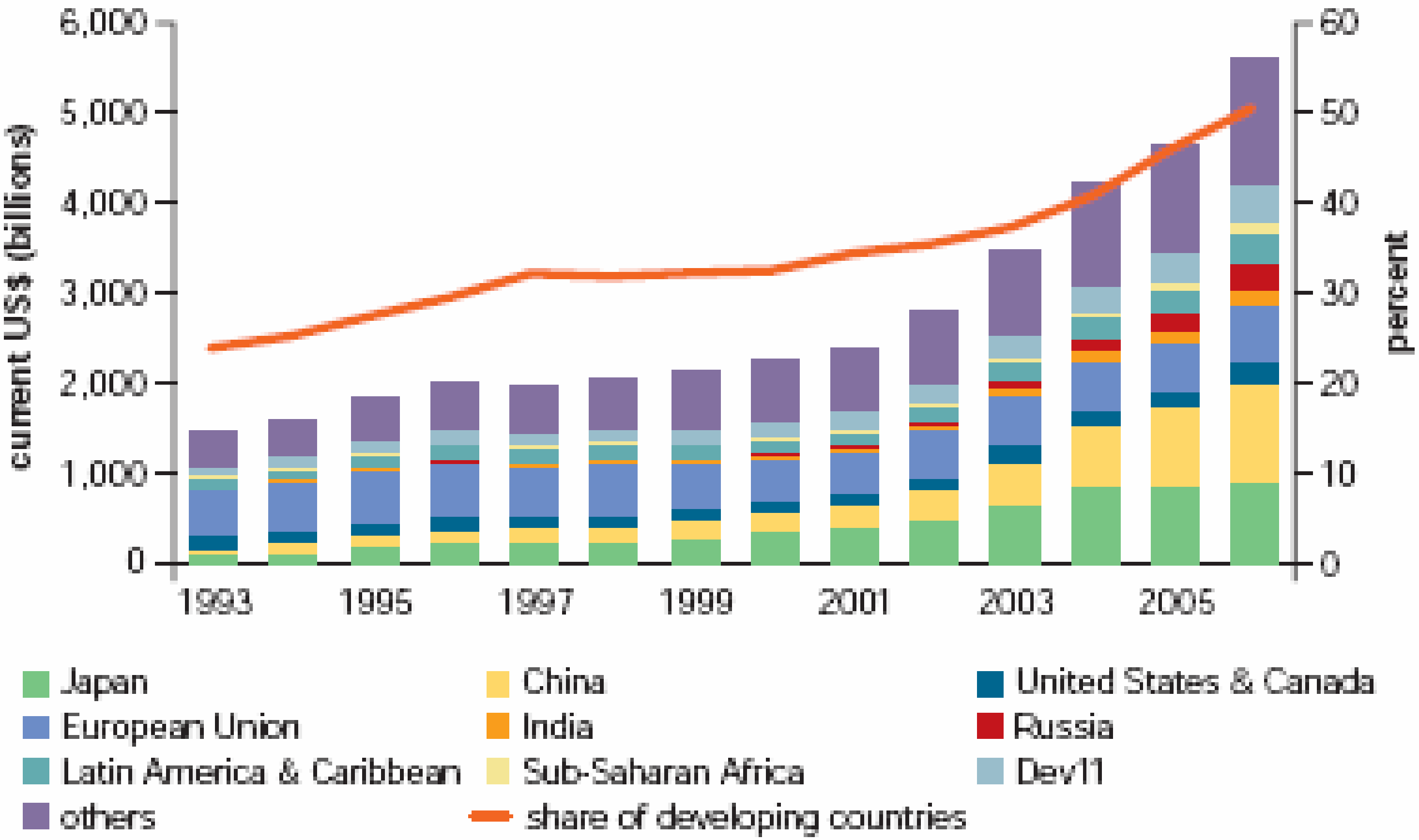


Global Imbalances



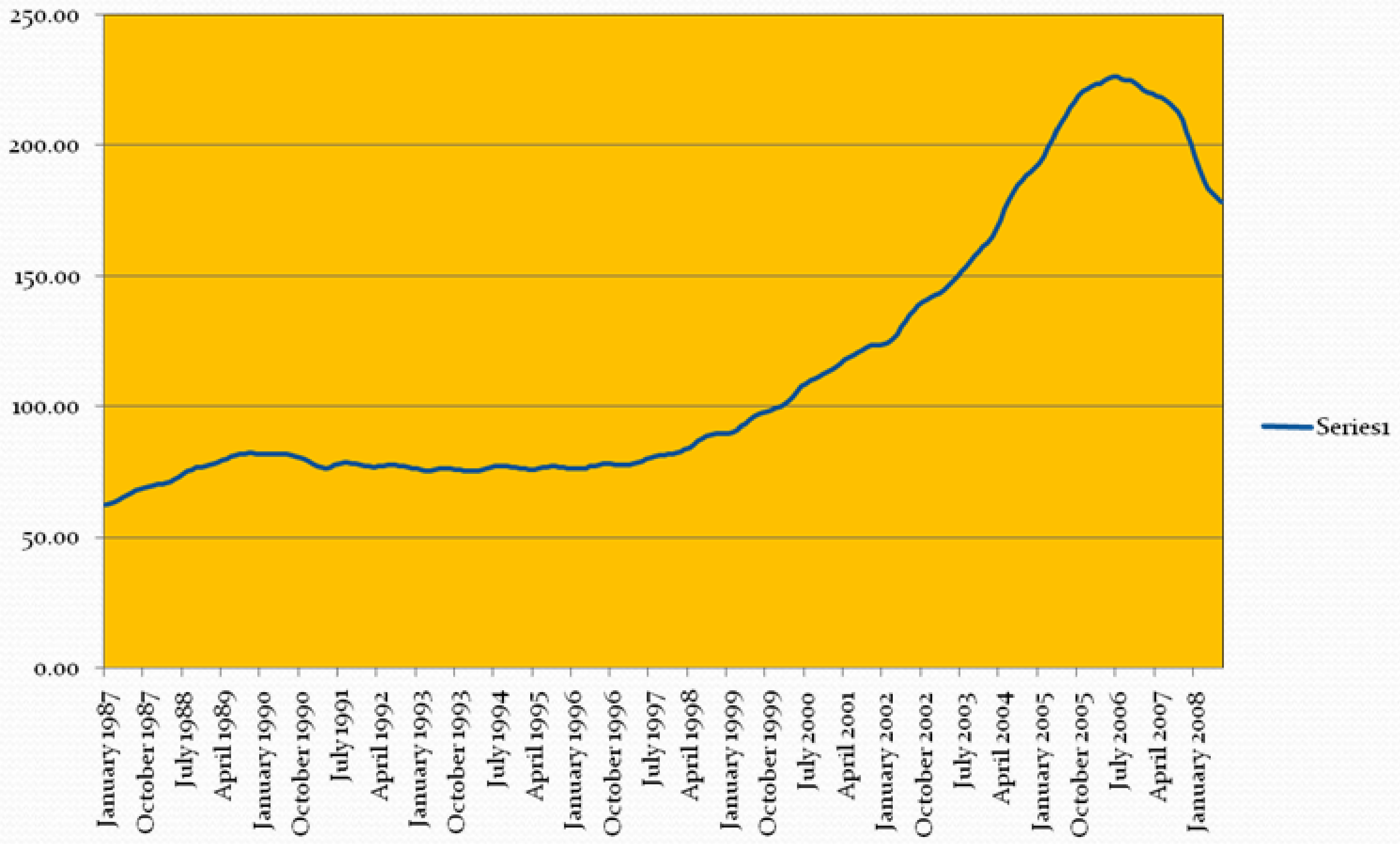
6.11.3 Buildup of Reserves in Developing Countries, 1993–2006

Over the last decade, developing countries have started accumulating substantial reserves.

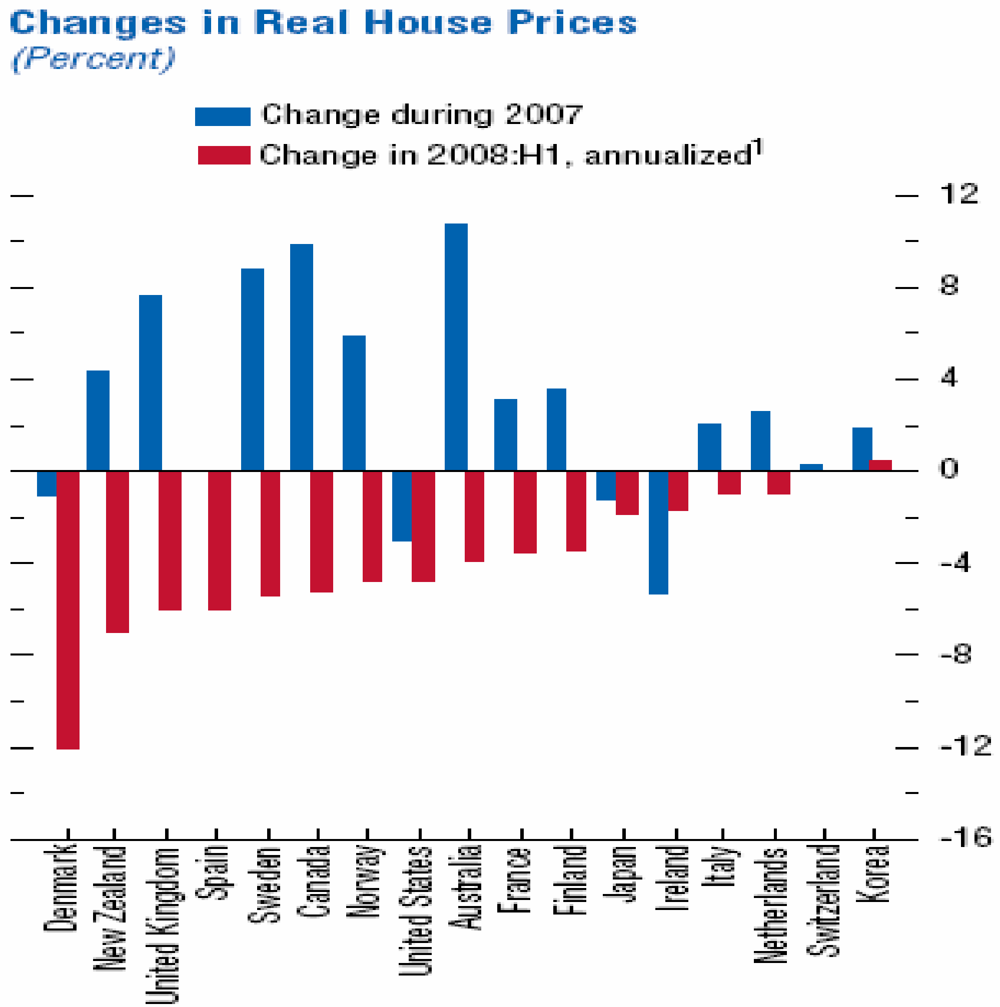


Source: World Bank, World Development Indicators 2007.

Case-Shiller House Price Index Composite USA



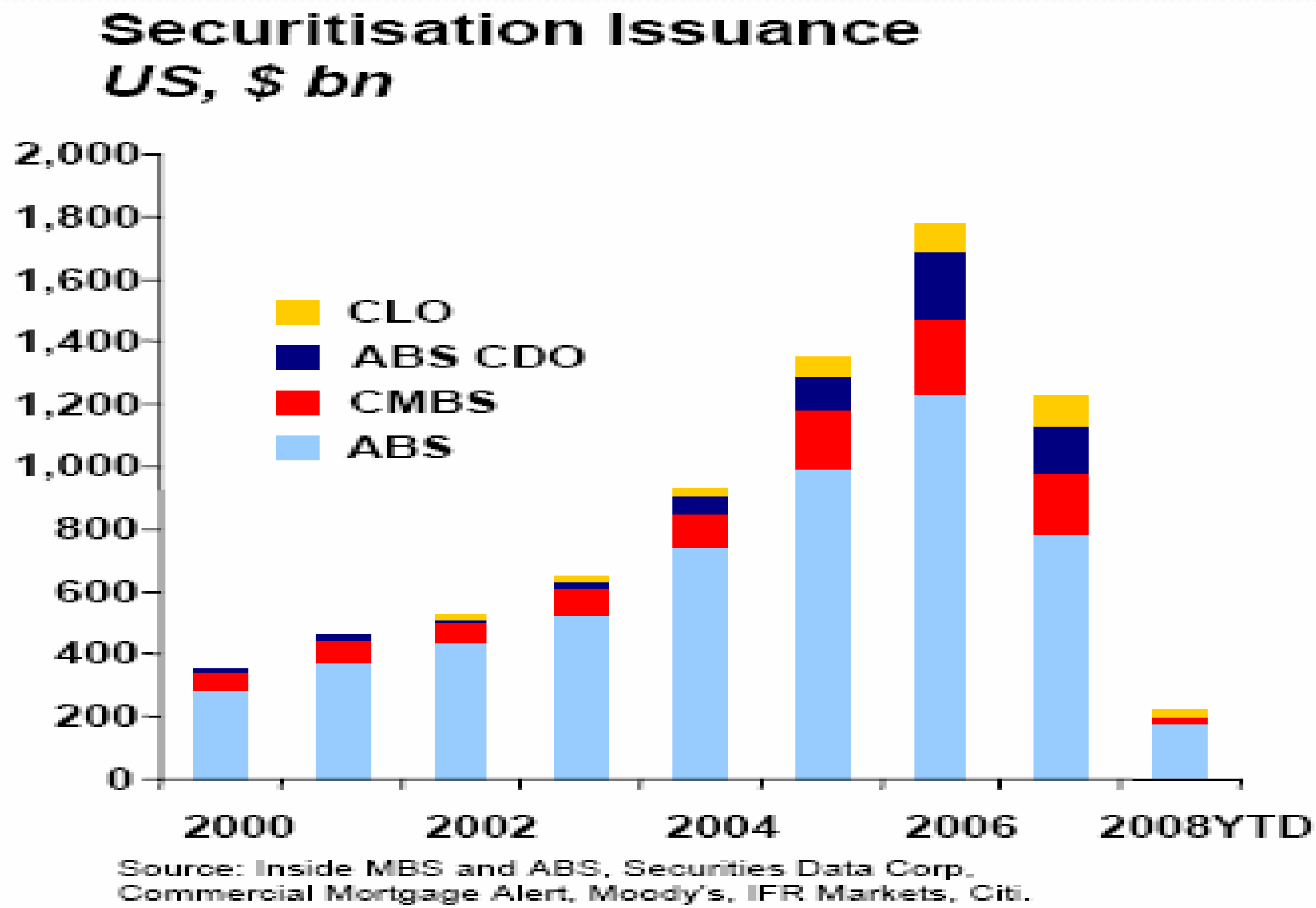
Housing Prices Globally



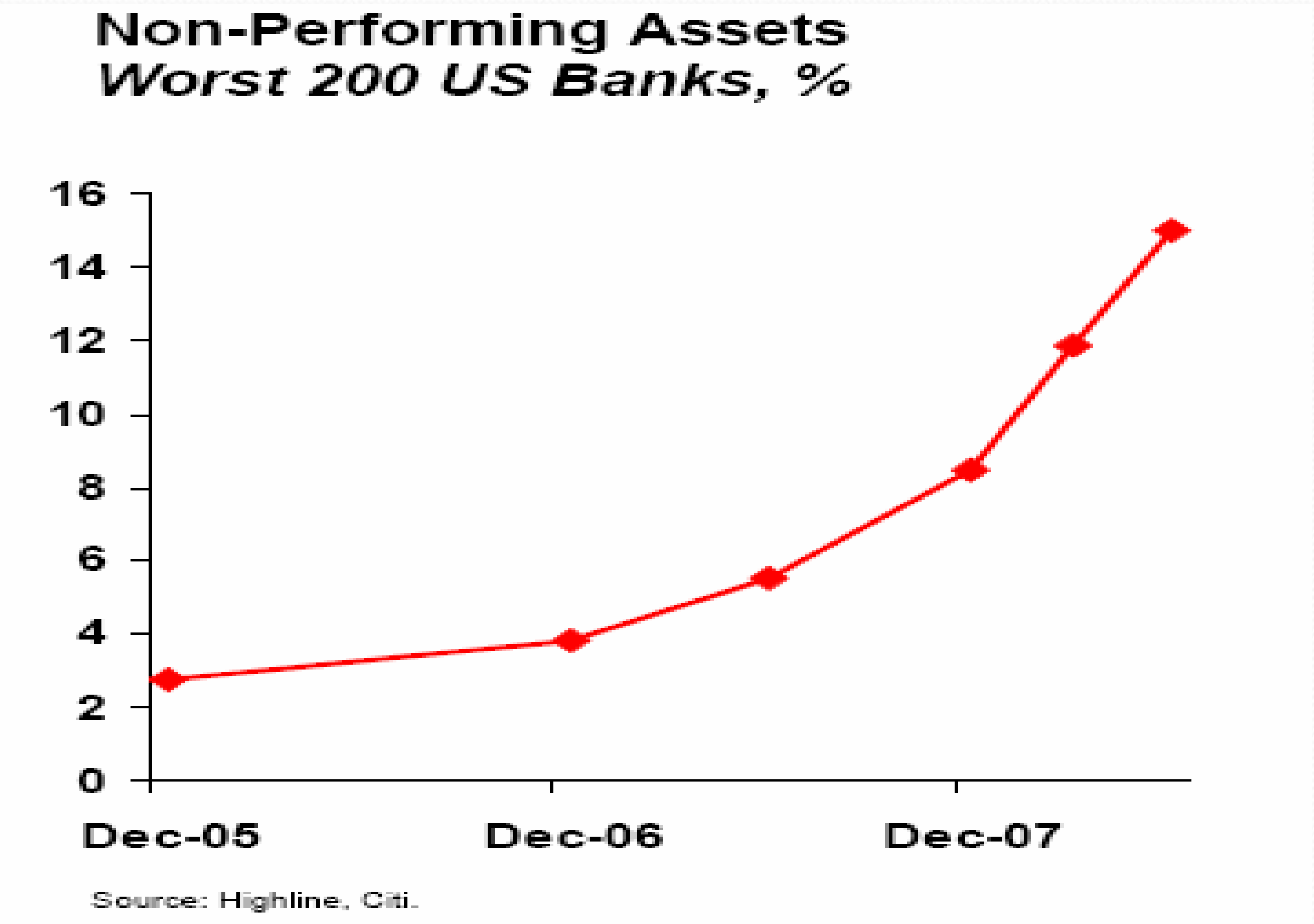
Sources: Organization for Economic Cooperation and Development; and IMF staff calculations.

[1]Change in 2008:H1, annualized, for Canada, Denmark, France, Ireland, Italy, Japan, New Zealand, and United States.

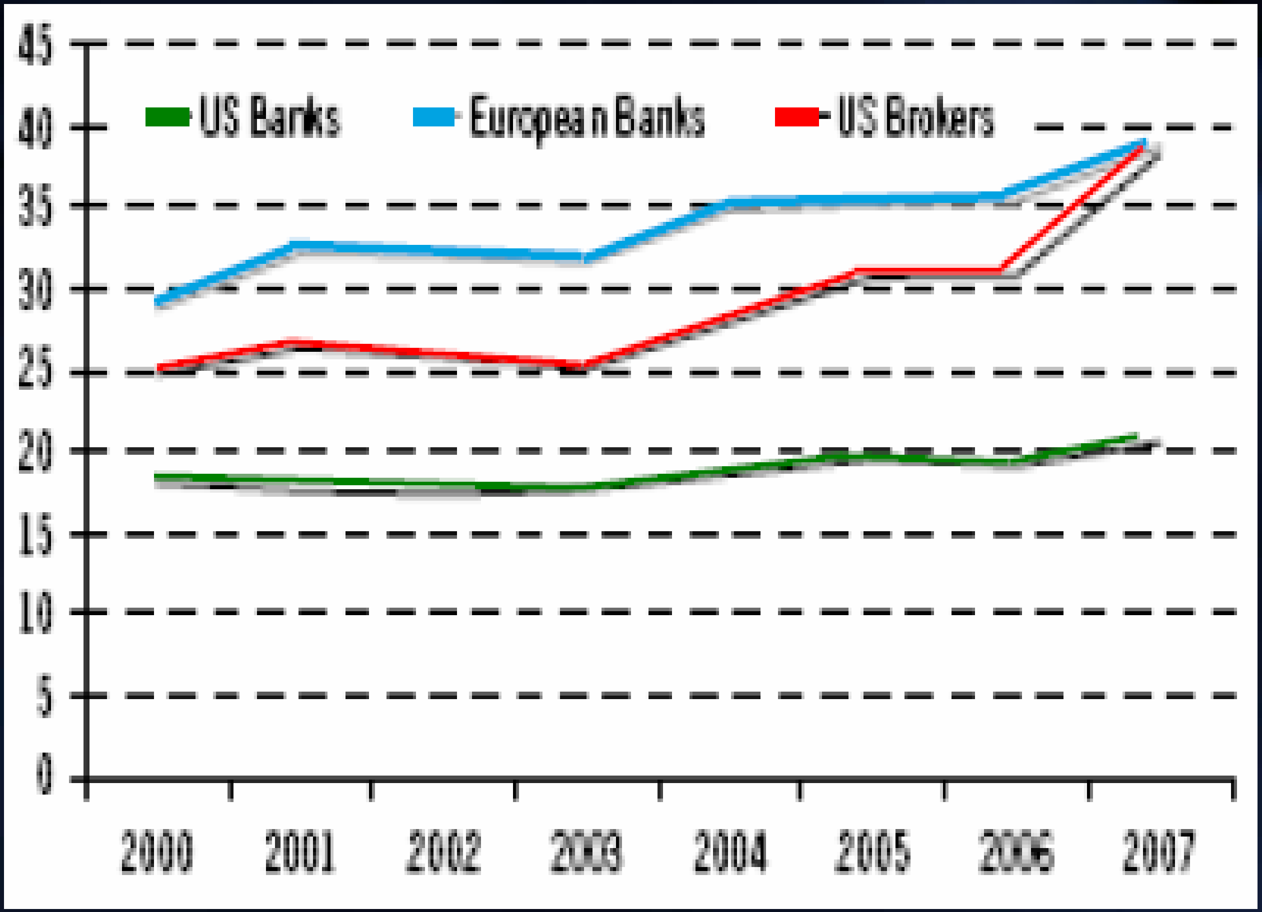
Securitization



Evidence of Low Credit Quality

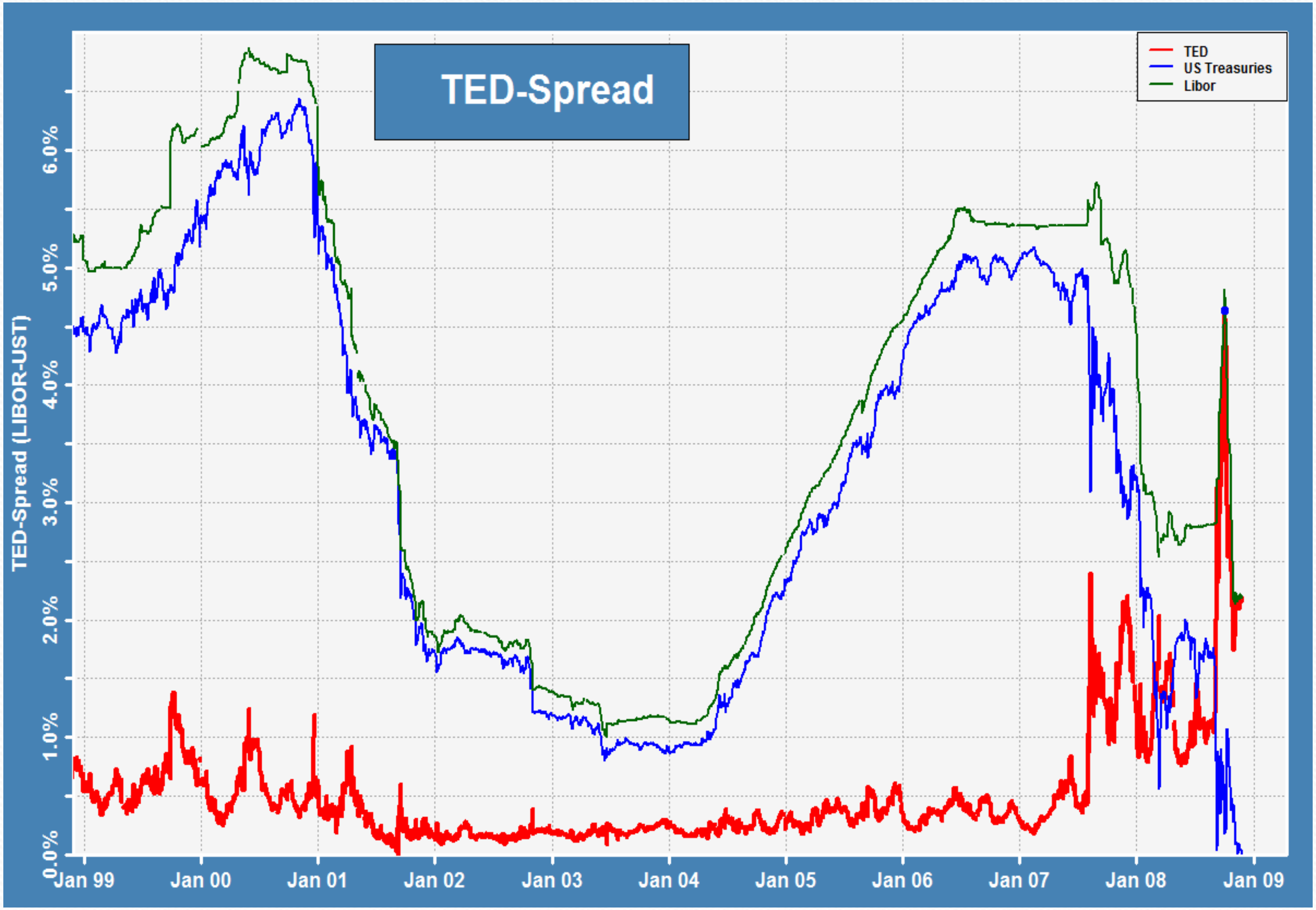


Bank & Broker Leverage Levels (Assets/Equity)



(1) Source: Citigroup. September, 17 2008.

Low Interest Rates Followed by Rapid Increase



Upward Dynamics

- **Center of story is risk, perceptions and risk models**
- **Risk**
  - **1. Exogenous, stationary, uncorrelated**
  - **2. Endogenous, non-stationary (rising), correlated (systemic)**
- **Relevant data depends on the model underlying the beliefs**
- **If beliefs are closer to 1., then system does not produce disconfirming data until it breaks and the dynamics shift**

September Inflexion Point

- **In Sept of 2008, the beliefs, expectations and dynamics changed sharply**
  - **as a result of a sequence of failures, emergency merger and seizures.**
  - **Lehman failure as tipping point**
- **Private capital ceased to enter the financial system**
- **Governments were left as the only source of capital to restore balance sheets.**
- **Viability/solvency issues for all major financial institutions caused inter-bank lending to dry up, and the payments system started to malfunction**
- **THE CHANNELS by which short term credit is delivered to businesses and municipalities locked up**
- **Triggered a variety of emergency responses that limited immediate large scale damage to the rest of the economy**

TED Spread

- **Source: Bloomberg**

Chart 12

Sovereign Wealth Fund Investment in Wall Street

Country	Date of Deal	Amount	Company	Price of Stock on Deal Date	Price on 8/28/08	% Change
Kuwait	1/25/08	$3 billion	Citigroup	$26.00	$19.08	-26.6%
Kuwait	1/25/08	$2 billion	Merrill Lynch	$54.22	$27.52	-49.2%
Singapore	1/16/08	$6.88 billion	Citigroup	$29.52	$19.08	-35.4%
Singapore	12/24/07	$4.4 billion	Merrill Lynch	$53.90	$27.52	-48.9%
China	12/20/07	$5 billion	Morgan Stanley	$51.37	$40.60	-21.0%
Singapore	12/7/07	$9.75 billion	UBS	$50.48	$22.16	-56.1%
United Arab Emirates	11/26/07	$7.5 billion	Citigroup	$30.70	$19.08	-37.9%
Singapore	7/23/07	$2 billion	Barclays	$735.00	$326.75	-55.5%
China	7/23/07	$3 billion	Barclays	$735.00	$326.75	-55.5%

Source: A. Gary Shilling & Co. and Yahoo Finance

Global Asset Deflation

- **Global asset deflation with near certainty of overshoot**
  - **Asset prices are increasingly disconnected from intrinsic or longer term values**
  - **Intrinsic values (PV of free cash flows) are endogenous**
  - **Balance sheet / income statement interaction**
- **Interacting with and accelerating global economic slowdown**
- **Driven by deleveraging process and technical factors associated with the unwinding**
- **Threatens a very deep recession globally and much longer term loss of trust in global economy and financial system**
- **What is required is a coordinated and simultaneous asset buying process combined with fiscal stimulus that arrests the overshoot.**

The Housing Markets and Mortgages

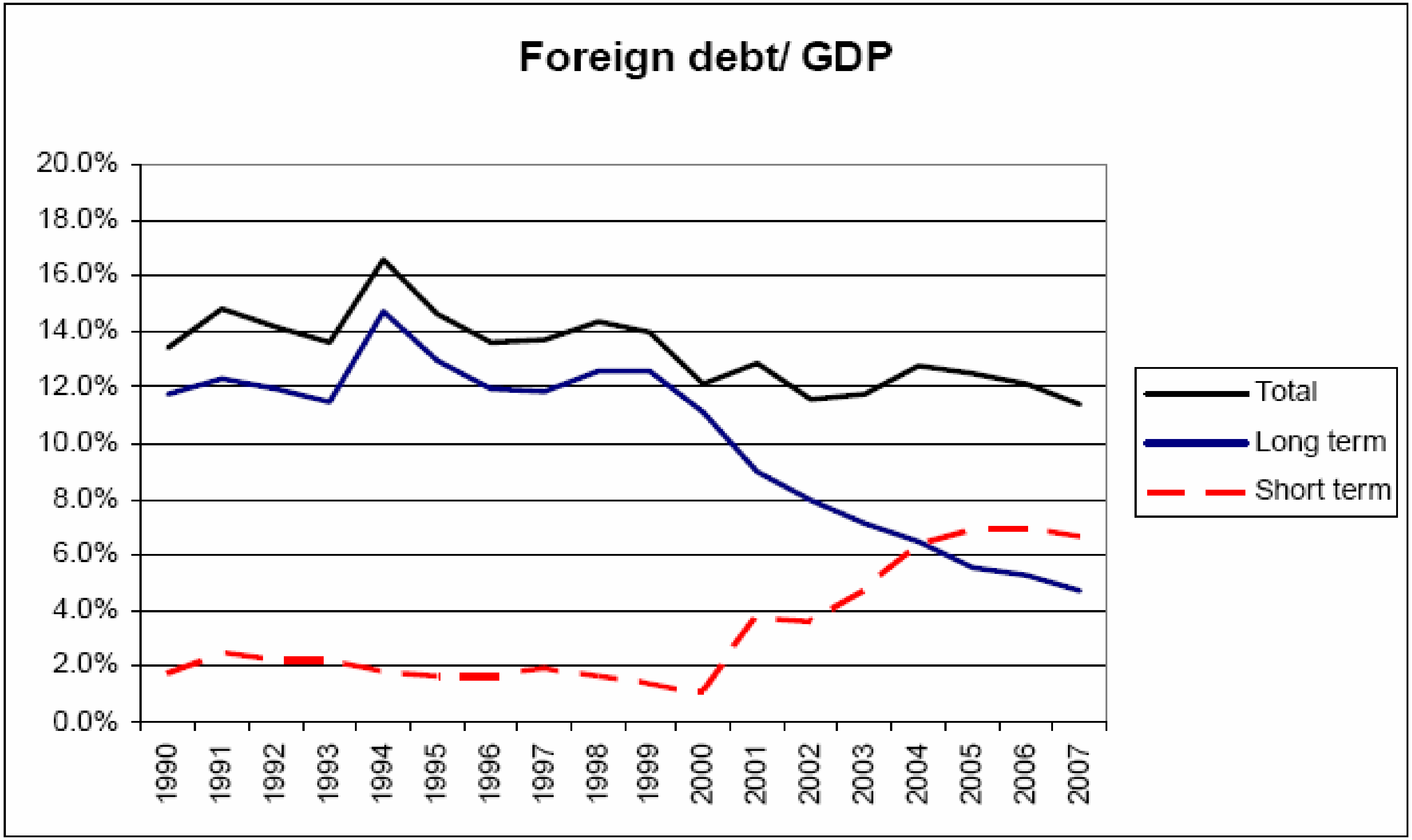
- **The bottom has not been found**
  - **And won't be until the toxic assets are cleaned out**
  - **Huge transparency problem**
- **TARP (the bill Congress passed is still important economically and politically) has been set aside for now**
  - **Remove damaged assets, inject capital, reset mortgages, prevent excessive foreclosures into a falling housing market**
- **Did not act fast enough – Gordon Brown**

China Likely to Weather the Storm

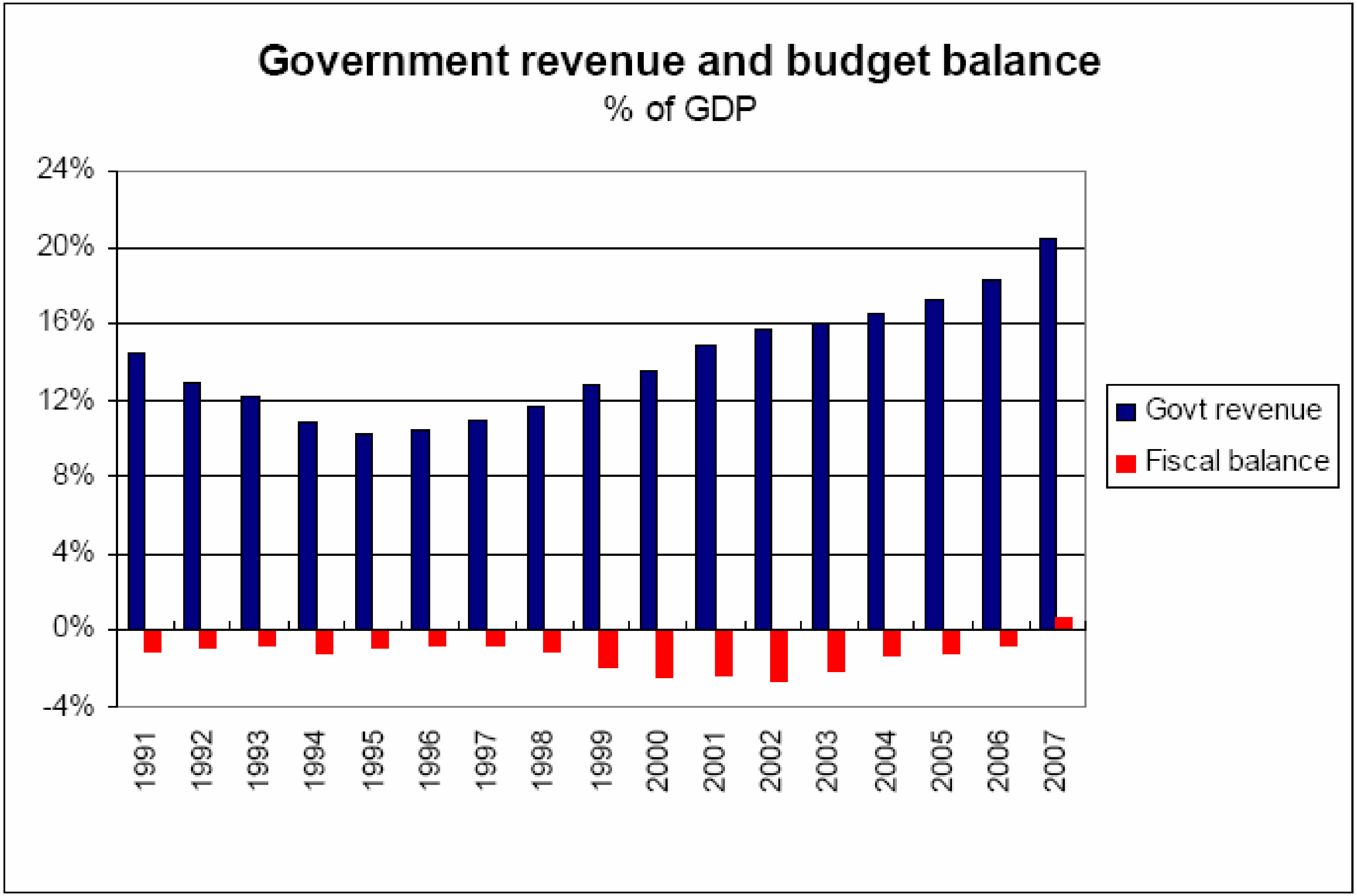
- **GDP $3.5 trillion – a big domestic market**
- **Growth going forward 8% to 8.5% in 2009 down from 11% plus in 2007**
- **Huge reserves: 1.9 trillion dollars**
- **Another 500 billion in SWF and Banks**
- **Fiscal capacity (see graphs)**
- **Very high savings and investment rates**
  - **I = 45% of GDP S=55% of GDP**
- **Less export dependent than most think**
- **Structural Transition versus Global Slowdown**

China

Figure 4.



China

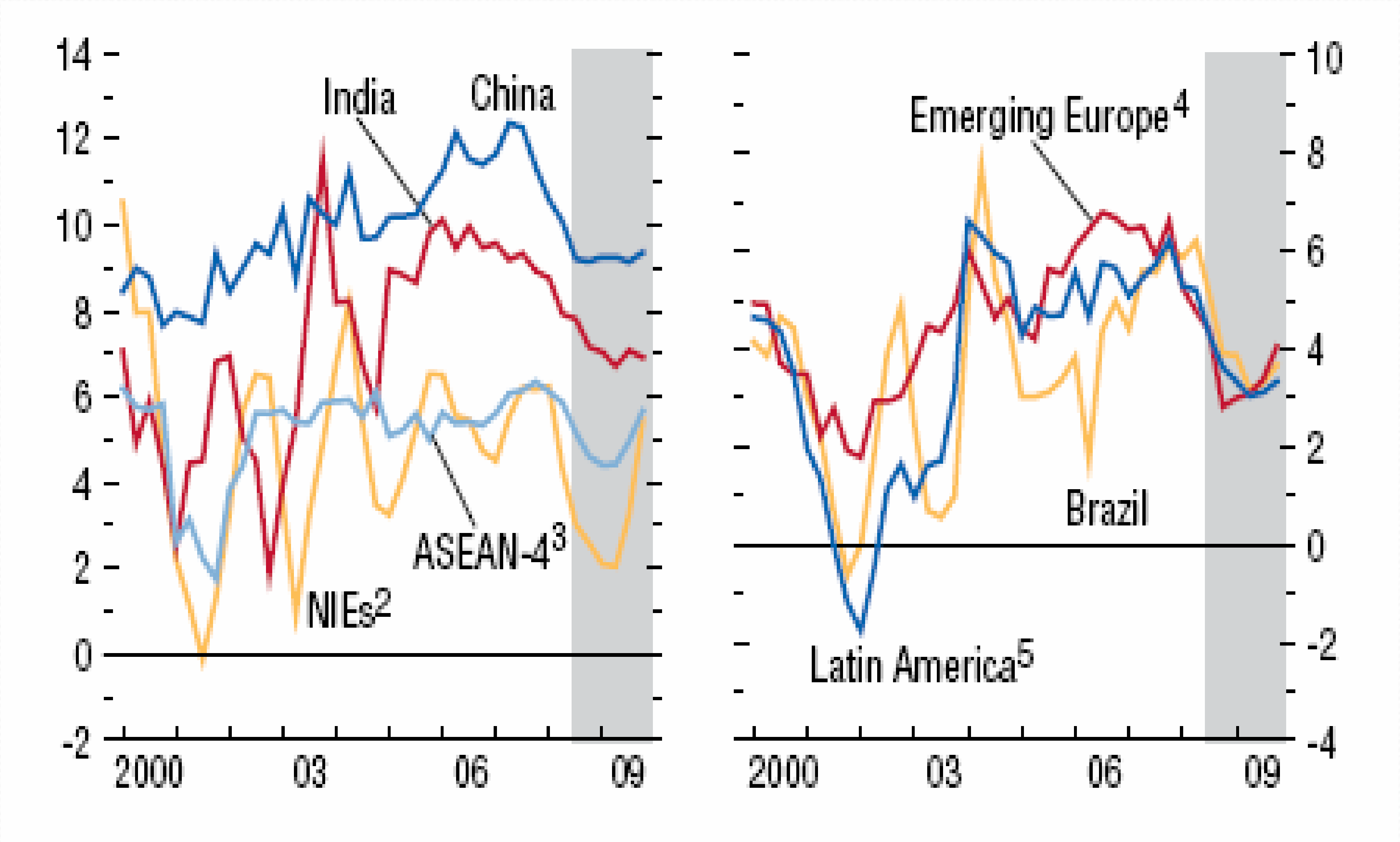

Government revenue and budget balance
% of GDP
24%
20%
16%
12%
8%
4%
0%
-4%
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Govt revenue
Fiscal balance

India

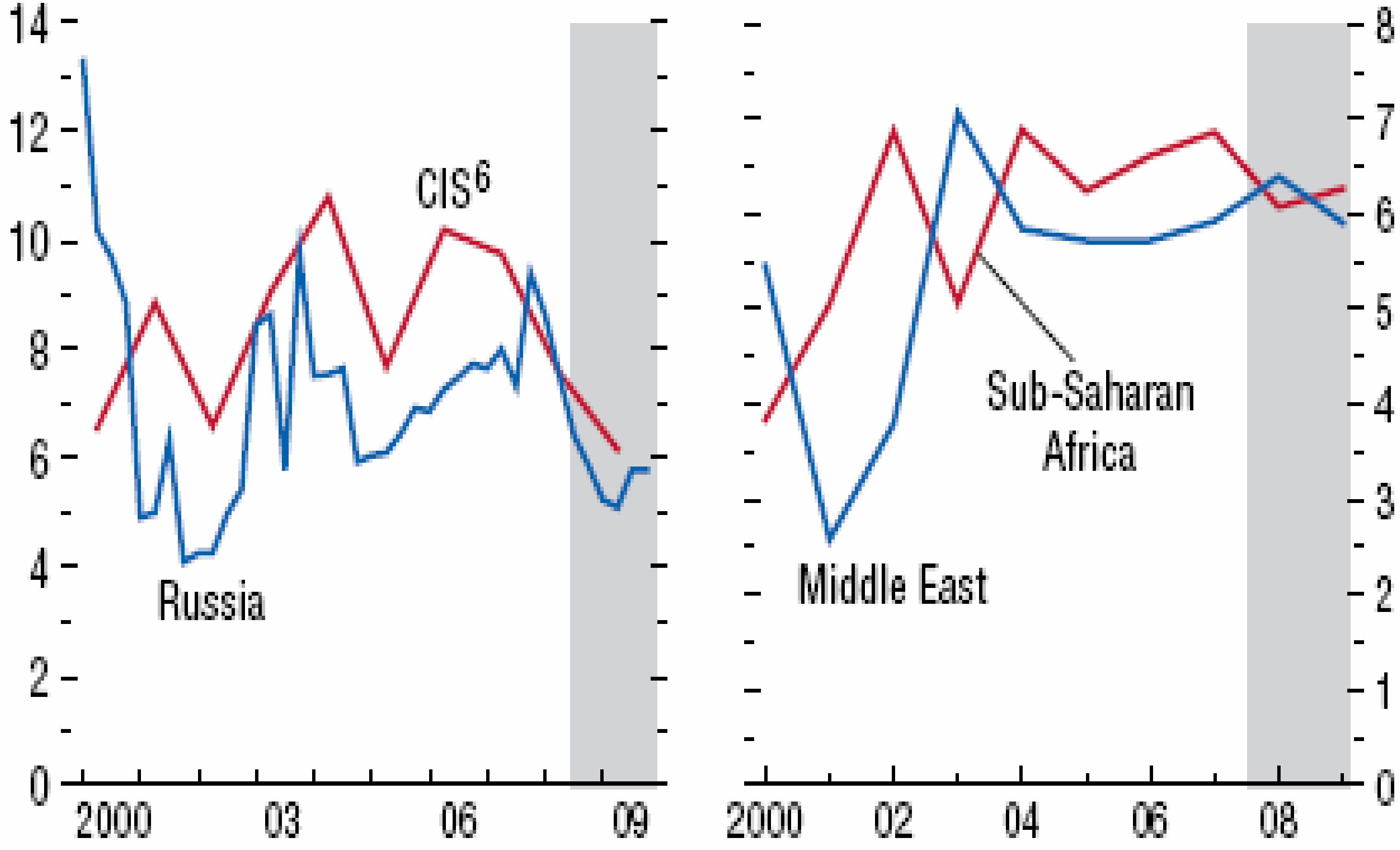
- **Challenge to hold 7% growth – was 9% in 2007**
- **First priority: stabilize financial system and restore credit**
- **Reserves used to partially reverse capital outflows rupee leveled off at 50 to the dollar**
- **Lowered interest rates**
- **Fiscal stimulus**
- **But large fiscal deficit**
- **Reliance on private and external capital for infrastructure**

Capital Outflows and Rapid Depreciation of the Rupee

Growth Around the World



Growth Around the World



Longer Term Challenges

- **Rising income inequality, rising risk and resistance to globalization**
- **Impact of China and India – relative prices of manufacturing and labor intensive services**
- **Commodity price levels and volatility**
- **Energy efficiency, sufficiency and sustaining global growth**
- **Demographics – aging, anti-aging and labor demand/supply**
- **Climate Change**
- **Interdependence, risk and the management of the global economy**

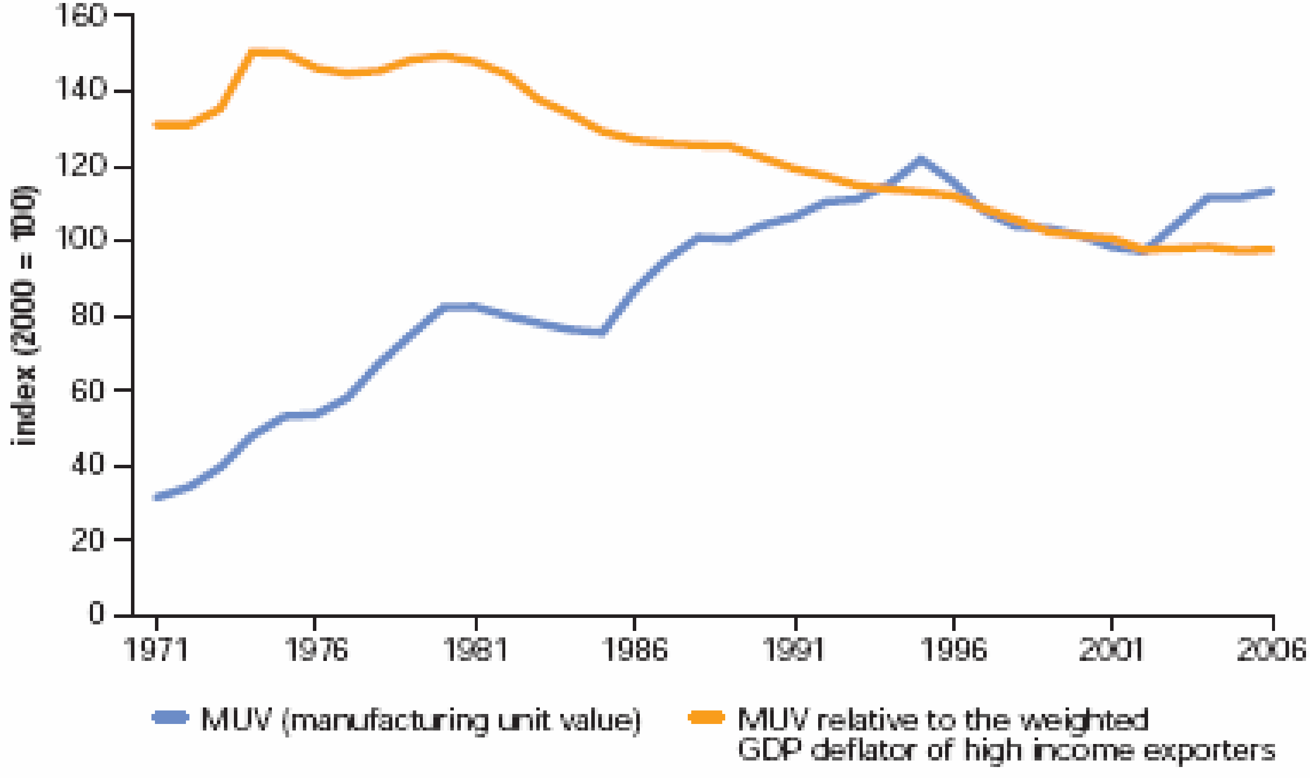
Longer Term Challenges Detail

- **Rising income inequality and perceived risk and resistance to globalization**
  - **Resistance to globalization is rising**
    - **Pew Survey of attitudes**
    - **Rising food and energy prices driven by rising demand**
  - **But it is what enables rapid growth and poverty reduction**
  - **Insufficient attention and response to distributional consequences (in advanced and developing countries)**
  - **The aggregate benefits are large, but it is hard work to make the distributional side come out fairly**

- **The Impact of the Growth of China and India**
  - **Large long-term shifts in relative prices: labor intensive manufactured goods**
  - **Can late arrivals compete, and will the growth strategies work**
  - **The adding-up problem or the fallacy of composition**
  - **Decline in relative price – absorptive capacity of global demand or protectionist response**
  - **Global imbalances one new version of the adding up problem**

Relative Price of Manufacturing Declined
The China Effect

Figure 11 Chinese-Led Decline in Manufacturing Prices



Source: Development Economics Prospects Group, World Bank.

Commodity Prices, Relative Price Volatility and Growth

- **Food prices**
  - **Emergency response**
  - **Balkanization**
  - **Opportunity for many countries**
  - **Supply response likely to be large (demand elasticity is low)**
- **Energy prices**
  - **Have the capacity to slow global growth**
  - **Demand response likely to be very high**
  - **Need for unified global market**
- **Relative price volatility likely to be a recurring feature of the global economy – it means additional risk**
- **Inflation**

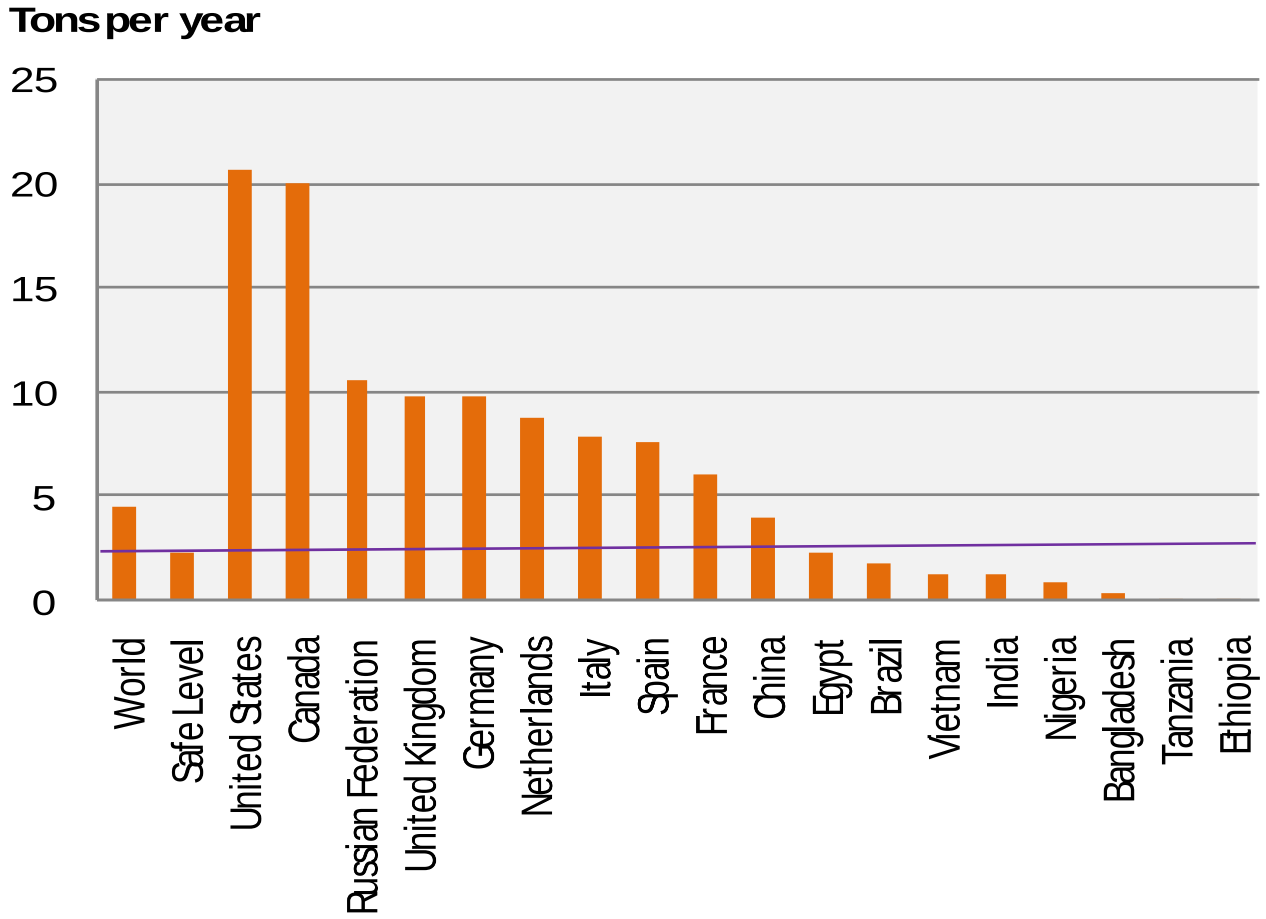
Demographics, Aging and Migration

- **Aging**
  - **In most of the advanced countries and a number of developing ones including China**
  - **That is where most of the purchasing power resides now**
- **Anti-aging**
  - **in many of the poorer developing countries**
  - **High fertility**
  - **Reduced longevity due to HIV/AIDS**
  - **Youth unemployment Challenge**
  - **Migration, migration for work, and labor mobility**

Climate Change

- Adaptation (Responding to Climate Change)
  - Major potential problem for poorer countries
  - Impact and Resources to Respond
- Mitigation (Reducing the Risk of Climate Change)
  - Tail insurance
  - Efficiency and fairness
  - The Challenge:
    - accommodating developing country growth
    - Achieving “safe “levels of CO_2 emissions by mid century
    - Complex mechanism design challenge

CO2 EMISSIONS PER CAPITA



Energy and Natural Resource Base

- **30 years ago, 1 billion people lived in advanced or rapidly growing economies**
- **Today the number is roughly 4 billion and rising**
- **Can global growth be sustained on the natural resource base that we have?**
  - **It is not clear**
  - **Not infinitely expandable**
  - **It will depend on**
    - **technology,**
    - **incentives (including shifting relative prices) being allowed to work,**
    - **human ingenuity**

Risk, Interdependence and the Management of the Global Economy

- Rising scope and magnitude of interdependence
  - Financial markets and regulatory interdependence
  - Trade shifting relative prices, movement of jobs
  - Product safety and rules governing logistics
  - Infectious diseases
  - Energy demand, pricing and growth
  - Climate Change
- Not matched by capacity to regulate and coordinate policy responses
  - Restoration of balance will take time, lots of thinking, experienced and talent people, and a measure of good will
  - The challenge of policy coordination with new important players
- In the meantime the risks are rising in the global economy and will be there for some time.