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In the Wake of the Crisis

Leading Economists Reassess Economic Policy

Edited by: Olivier Blanchard, David Romer, Michael Spence, Joseph E. Stiglitz

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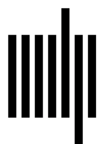

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Growth in the Postcrisis World

Michael Spence

Macroeconomic Stability

Before the crisis of 2008, 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 thinking on its head.

Postcrisis, 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 principal 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. Policy in several categories is important and needs to be rethought, but it is a mistake to focus exclusively on policy. A critical ingredient in creating the recent crisis was the inability of the participants, both regulators and private-sector participants, to perceive risk accurately. 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 to the crisis. One conclusion is clear. As part of the effort to improve the system, we need to recognize that the models

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of risk in the financial system are incomplete. It is a challenge and an opportunity for those in the academic community, among others.

I do not agree that the self-regulatory properties should always be presumed to be missing and that the burden falls on regulation. 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 Robert Solow's work showed. Emerging economies have the following principal ingredients of sustained high growth:

- Macroeconomic stability
- Engagement with the global economy
- Inbound knowledge transfer
- Export diversification and structural change
- Capital deepening (Investment rates are in the range of 25 to 35 percent of gross domestic product, including public-sector investment rates in the range of 5 to 7 percent of GDP. With capital to output ratios in the range of 2.5 to 3.3, these investment rates support growth in the 7 to 10 percent range.)
- High rates of public-sector investment (These raise the return to private-sector investment, including foreign direct investment, and hence the level of the latter.)
- Inclusiveness in employment opportunities and access to education
- Policy setting that involves decisions made under uncertainty with incomplete models and that has a pragmatic and experimental component

This is a short summary. A fuller treatment can be found in the Commission on Growth and Development's *The Growth Report: Strategies for Sustained Growth and Inclusive Development* (December 2010) (see also my 2011 book, *The Next Convergence: The Future of Economic Growth in a Multispeed World*).

In the future, there will be additional longer-term issues. They can be thought of as a collection of problems that represent a challenge to the

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replicability and sustainability of the model that focused on an individual developing economy and that presumed that the global economy was large in relation to it.

An interesting and recent development is a growing recognition in the large emerging economies that the growth paths of their predecessors and the advanced countries will not work because they put too much strain on natural resources and the environment. They are at the beginning 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 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 China and India, which will lead the shift, 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 that began in 2008, 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. The financial system, at least, is less stable than most thought. But by and large, this shifting of strategy and direction has not happened, perhaps because the recovery in the major emerging markets was rapid. 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, lessons have been learned, but they are 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 in 1997 and 1998) 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 households and businesses. More attention is now being paid to prebuilt mechanisms that can be rapidly deployed to counter the adverse income, employment, and credit effects of crises.

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In the past twenty years, some areas of policies have generated a diversity of views and practice. There has been some convergence of views, but it is certainly incomplete. The major areas that have 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 World Trade Organization's rules and negotiations), and (3) the capital account, particularly the use and misuse of capital controls on various types of cross-border capital flows and reserve accumulation. On one level, the crisis has not substantially changed the positioning, 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 crisis of 1997 and 1998 and then modified somewhat in the aftermath) was further reduced by unexpected instability in the advanced-country financial systems and by the need to take defensive action against rapid capital outflows and to offset the effects of large inflows (particularly 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 negating the risks of extended over- or undervaluation. The risks of these two are asymmetric and quite different with respect to timing. Valuation is less well understood. Eventually, it achieves its negative effect by damaging the incentives for structural transformation of the economy and hence the underpinnings of growth.

The current 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 was no place to hide. Countries varied in their capacity for fiscal stimulus and used whatever 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, which probably are manageable. With the help of a rapid bounce

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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, India, and Brazil, in that order. This rapid recovery has given the emerging economies a greater sense of resilience and confidence, and rightly so.

The effectiveness of the crisis response does not guarantee a return to precrisis 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 emerging markets 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 emerging markets. This has to do with composition as well as the size of emerging-market demand. It now appears that they have reached an aggregate size, a level of income (which shifts the composition of demand), and a pattern of direct intra-emerging-market trade that is capable of sustaining this growth.

However, decoupling is not an either/or matter. A major downturn in Europe or North America would subtract enough demand to slow growth in the emerging markets. 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 affect trade and growth. Thus far, that has not happened. Finally, China's growth is a large and growing part of the emerging-market total, so 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 most of its smaller Asian neighbors. It is the largest trading partner (share of imports plus exports) for six of the Group of Twenty countries.

The rising systemic importance of the emerging markets has created new challenges. For China and prospectively for India, it has caused their

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global effects 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. No one—these countries, their predecessors, or the global system as a whole—has figured out 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 postwar global system involved a hybrid in which the advanced countries adopted policies that were designed to promote growth and keep the system stable. The developing countries had relatively little systemic impact on the system as a whole (because of small size) and therefore were free to focus on policies that promoted growth. With the increasing size of the latter, this convenient hybrid cannot 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 emerging markets. A case in point is the expansion of interventions in capital flows in the postcrisis period to manage and limit the adverse effects of large capital inflows that stem in part from the accommodative monetary policies in advanced countries. From a longer-term perspective, emerging markets 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 emerging-market growth, it is worth devoting a few words to the challenges on that front. As noted above, China is entering the middle-income transition, a passage that has slowed many of its predecessors. The known high-speed middle-income

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transitions have thus far been confined to the economies of Japan, Korea, Taiwan Province of China, Singapore, and Hong Kong SAR.

At least five linked transitions are embedded in the next phase of China's growth, and they have been envisaged in the country's twelfth five-year plan:

- Change the country's growth model or supply-side structure as its labor costs rise, its global market shares get large enough to limit expansion, and advanced countries' growth momentum and tailwind decline for an unknown period of time;
- Rebalance demand from investment and exports to domestic consumption;
- Accommodate a rapidly urbanizing population, and structure incentives so that the process is as orderly as possible;
- Build the social infrastructure necessary for achieving a harmonious society with special emphasis on opportunity; and
- Take on international responsibilities for stability, growth, and sustainability (including tackling climate change) in a way that is 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 a portion of the investment portfolio tends toward low private and social-return investments that seem to be driven 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.

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

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Some recent work on the changing structure of the U.S. economy can help begin to bring the issues into focus. Here I can only hint at the analysis. In the U.S. economy in the eighteen 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 nontradable 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—finance, computer design and engineering, management of enterprises, consulting—grew. The remainder, consisting of manufacturing sectors that 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 U.S. 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 was not an obvious employment problem.

The unbalanced and unsustainable pattern of growth leading up to the crisis, with excess consumption as a key component, appears to have allowed the nontradable 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 precrisis employment patterns will continue in the postcrisis period. One view is that this is a long, difficult recovery by historical standards but not much more than that. I believe that the United States cannot return to the precrisis 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. The precrisis trends in income distribution certainly included

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relatively rapid increases in incomes at the upper end of the spectrum and low to flat incomes in the midrange.

Much more remains 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. For several decades, the distributional effects of the evolution of the postwar global economy were largely benign, with a successful postwar 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 that market forces and growth dynamics work, it seems likely that we are entering a more challenging period from the standpoint of distributional issues and that it is relatively uncharted territory.

Looking forward, the major new policy challenges related to growth, both domestically and internationally, seem to fall into two categories—sustainability 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.

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