

CURRENT ECONOMIC ISSUES AND THEIR IMPACT ON DEVELOPING COUNTRIES

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OUTLINE

- Changes in thinking about development
- Changes in the international environment
- Trade related issues
- Other important issues
- Conclusions

I. CHANGES IN THE WORLD OF IDEAS

- Last 50 years has shown that development is possible
 - Remarkable success of the countries of East Asia
- But not inevitable
 - Failures in much of the rest of the world
 - Especially in Africa
 - And in Latin America

INTERPRETING THESE EXPERIENCES

- Latin America is the region that followed most closely the prescriptions of the Washington consensus (IMF)
 - Focusing on stabilization, privatization, and liberalization
 - Growth was just over half of what it was in earlier decades
 - Last half decade has seen declining per capita income
 - And benefits, of whatever little growth they had, has gone mostly to the people at the top
- East Asia followed markedly different model
 - Government has an important role
 - Key is getting the balance right (both in direct activities and regulation) and improving the efficiency and efficacy of public sector
 - Emphasis on social justice, not just economic efficiency

ELEMENTS OF SUCCESS

- Closing the knowledge gap
 - Education
 - Industrial policies
- Promoting savings
- Good financial institutions to ensure savings were invested well
- Emphasis on ensuring that benefits of growth were shared equitably

INDUSTRIAL POLICIES

- Highly controversial
- Often abused
- But have played a role in all successful countries
- Not just picking winners
 - But identifying areas with 'spillovers' (externalities), long run potential
- Key is finding right way
 - Export promotion
 - Rules based approaches

SUCCESSFUL COUNTRIES

- Managed to sustain growth over long period of time
- By changing and adapting policies to changing circumstances
- Controversial interpretations of East Asia crisis and rapid recovery
 - Pushed liberalization (especially capital market liberalization) too fast,
 - Without adequate adaptation of the rest of the economic system

EXPERIENCES LED TO NEW THINKING IN DEVELOPMENT

- End of Washington Consensus
 - Or even Washington Consensus “plus”
 - Though one still gets some W.C. Advice from international financial institutions
- Today, there is no consensus
 - Except that the Washington Consensus is neither necessary nor sufficient for successful development
 - Even if each of its policies made sense for particular countries at particular times
 - That any future consensus cannot be *made just in Washington*
 - And will have to allow for greater adaptation to unique circumstances of the countries

CHANGED VIEWS ON KEY POLICY ISSUES

- Recognition that capital market liberalization has not led to faster growth, but has led to more instability (poverty)
- Recognition that financial service liberalization may have adverse effect on economic growth
 - Lack of capital for small and medium sized domestic enterprises
 - Based on information asymmetries

CHANGED VIEWS

- **Trade liberalization has had ambiguous effects**
 - No systematic relationship between trade liberalization and economic growth
 - At the very least, trade liberalization does not ensure growth
 - Mexico after NAFTA has grown slowly, real wages have fallen
 - Partly because of NAFTA
 - Partly because, in spite of name, NAFTA was not really free trade agreement (agriculture, non-tariff barriers)
 - Partly because Mexico did not make necessary complementary investments
- **Key is how trade liberalization is done**
 - Depends on whether job growth has matched job loss from liberalization
 - Depends critically on pace and pattern of liberalization

ELEMENTS OF POST WASHINGTON CONSENSUS

- **IMPORTANT WARNING:** do not confuse means and ends
 - Liberalization, privatization, and stability were viewed as ends in themselves
 - And often undermined ultimate objective

BROADER OBJECTIVES

- Not just increases in GDP
 - Though that is important
 - And common measures may be highly misleading
- Sustainable, democratic, equitable development
 - Economically sustainable
 - Environmentally sustainable
 - Socially sustainable

MORE INSTRUMENTS

- To achieve macro-stability, one must use more than macro-instruments
 - Banking regulation
- Poorly designed macro-policies can harm long term growth
 - High interest rates
 - Insufficient attention to credit flows

PRIVATIZATION

- Without regulation can lead to higher prices lowering consumer welfare
- Need strong anti-trust laws
- And regulatory authorities for 'natural' monopolies
- Widespread corruption in privatization process can undermine gains from privatization

NEW ISSUES

- Key to success of economy is getting balance between role of government right
 - Both in regulation and in the provision of goods and services
 - “Third way”
 - Not minimal role of government as envisaged in Washington Consensus

IMPROVING GOVERNMENT

- Improving the efficiency and efficacy of government is central
 - Transparency/reducing corruption one important dimension
 - Effective freedom of information act
 - Specific techniques (use of computer technology, rotating tax collectors)
 - Reinventing government initiative
 - Importing business practices
 - Including competition
 - Recognizing limitations of markets

II. CHANGING ECONOMIC ENVIRONMENT

- One of key factors in East Asia's success was adapting to changing global environment
 - New international rules
 - New international competition

KEY CHALLENGES: ADAPTING TO CHANGING GLOBAL TRADE ENVIRONMENT

- China is becoming dominant manufacturing economy
 - Other economies must find distinct product niches
 - And develop ways of interacting with China
- End of MFA agreement (textile quotas)
 - Market will be more competitive
 - No inevitable comparative or absolute advantage for China (not high technology, not large returns to scale, etc.)

GENERAL PRINCIPLES FOR RESPONDING TO CHANGING GLOBAL ENVIRONMENT

- Diversification
- Thinking about *dynamic* comparative advantage, not just static comparative advantage
- Finding Niches
 - Especially quality
 - Looking for stages in production process
 - Recognizing that most trade occurs between countries with similar economic endowments
- Sensitive to anomalies in tariff structures
 - Quotas on sugar; but not on candy
- Think about strategy
 - Trade with Mexico as a channel for entering into U.S. market

GLOBAL POLICY DEBATE: TRADE

- Recognition of hypocrisy of advanced industrial countries
 - Symbolized by position on agriculture
 - But going well beyond
 - Uruguay Round actually made poorest countries of world worse off

GLOBAL POLICY DEBATE: TRADE

- Must recognize that position of advanced industrial countries and especially U.S. is not based on principles, but on advancing its own commercial and financial interests—in spite of rhetoric
 - Reflected in unbalanced agenda and outcomes of Uruguay Round
 - Reflected in unbalanced agenda of so-called Development Round
 - Commonwealth/IPD Report: Does not even deserve to be called a Development Round
 - A True Development Round would look markedly different

GLOBAL POLICY DEBATE: TRADE

- Recognize that free trade agreements only provide bargaining framework, not true free trade agreements
 - Non-tariff barriers, agriculture
 - Inequities exacerbated by lending conditionality

GLOBAL POLICY DEBATE: TRADE

- More recently, proliferation of bilateral free trade agreements
- Of questionable value to developing countries
- Have imposed additional conditions which impair development
 - Intellectual property agreements
 - Making access to drugs more difficult
 - And possibly impeding development itself
 - Forcing capital market liberalization
 - Disadvantages terms in telecommunications
 - Other intrusions into national sovereignty

GLOBAL POLICY DEBATE: EMERGING CONSENSUS

- Proceed cautiously
- No agreement is better than a bad agreement

INTELLECTUAL PROPERTY RIGHTS

- Important issue in many trade agreements
- Recent call by WIPO for a development oriented intellectual property regime
- Recognition that Uruguay Round TRIPS agreement was not balanced
 - U.S. Pharmaceutical and Media interests dominated
 - At the expense of developing countries
 - Health needs
 - Development objectives
 - And even research community in U.S. and elsewhere
 - Knowledge most important input into research
 - Makes access to knowledge more difficult
- Important to formulate and implement right intellectual property regime
 - And not sign new agreements that further tilt the balance in the wrong direction

OTHER IMPORTANT ISSUES

- Growing inequality and social sustainability
- Finance
- Global fragility

INEQUALITY AND SOCIAL SUSTAINABILITY

- The process of trade liberalization/globalization is typically accompanied by increasing inequality
 - Both in developed and less developed countries
 - Contrary to what had been expected; standard theory had predicted that demand for 'unskilled workers' in developing countries would increase
 - Scarcity value of skills increases with globalization
 - Especially as it is accompanied by upgrading of product quality

INEQUALITY: NEED FOR REDISTRIBUTION

- Globalization increases need for redistributive programs
- But often lead to less scope for redistributive programs
 - Demand for development funds makes opportunity cost of social safety net expenditures very high
 - And pressure from international financial institutions for privatization, individual accounts discourages creation of effective redistributive safety net
- But often lead to less scope for redistributive programs
- Unless policies are put into place to address problems of growing inequality, social tensions may rise, and growth may not be socially sustainable

FINANCIAL MARKETS

- Importance
 - Brains of economy
 - Allocate scarce capital
 - Successful countries have managed to allocate scarce capital well
 - And provide capital to new enterprises
 - Including SMEs
- But....

FINANCIAL SERVICES

- Particularly important because credit is essential for growth of private sector
- Local banks Major source of funding for new investment in all countries
 - But especially important in developing countries (where security markets are weak)
- Local banks have local information and are more subject to guidance in development objectives
 - U.S. growth was based on local banks
 - Financial services liberalization may put local banks at a disadvantage unless CRA requirements are imposed
- Liberalization of financial services:
 - International banks may have advantages in terms of providing sense of security
 - Will present especial problem in countries where domestic banking sector has problem (e.g. non-performing loans)

FINANCIAL MARKET LIBERALIZATION

- Fear that foreign financial firms will not lend sufficiently to small and medium size domestic enterprises
 - Foreign banks are in an informational disadvantaged position
- Response: “CRA” (Community Reinvestment Act) requirements, requiring all banks to lend certain fraction of portfolio to SMEs
 - Creates a more level playing field
 - Promotes development
- Response: require all banks to open up branches in rural and other underserved areas
 - Requirement helped promote development in India

SECURITY MARKETS

- Have distinct advantages in risk spreading
 - But suffer from problems of asymmetric information even in developed countries
 - Exemplified by corporate scandals in U.S. during the 90s
 - Problems worse in developing countries
- Important to put into place good security and corporate governance laws
 - But also important to recognize that security markets are likely to play limited role going forward

GLOBAL POLICY DEBATE: REFORMING THE GLOBAL FINANCIAL SYSTEM

- After East Asia crisis, recognized need for reform in global financial system
 - But there were no real incentives for reform, no real interests
 - Lack of Transparency (hedge funds, secret bank accounts) serves interests of financial markets and US (at least until 9/11)

POLICY DEBATE: A FEW POSITIVE SIGNS

- Recognition by IMF that capital market liberalization not associated with stability or growth
- No major crisis since Argentina
- After the Argentinean crisis, widespread recognition of need for sovereign debt restructuring mechanism

POLICY DEBATE: BUT MANY DISTURBING SIGNS

- Has new understanding of risks of IMF been translated into policy?
 - U.S. insistence on bilateral trade agreements
- IMF SDRM plan was badly flawed
 - But U.S. opposed any meaningful alternative
- Continuing, if not increasing, global instability

GLOBAL FRAGILITY

- The richest country continues to live well beyond its means
- Contributing to increasing level of global instability
- In spite of great advances in capital markets in slicing and dicing risk, developing countries bear the brunt
 - With huge consequences—Latin America, Moldova, etc.

GLOBAL FRAGILITY: UNDERLYING PROBLEM

- Global reserve system
 - Inequitable
 - Not sustainable
- Dollar as reserve currency implies poor countries provide low interest loans to the richest
 - But with large net imports, full employment only attained through large deficit spending
- Increasing indebtedness of the richest makes reserves increasing less secure
- And burying several hundred billion dollars of purchasing power in ground contributes to global insufficiency of aggregate demand

GLOBAL RESERVE SYSTEM

- Sum of trade deficits has to equal surpluses
- So if some countries insist on having surpluses, others must have deficits
- Deficits are like hot potato
- Large deficits lead to crises
- System only works as well as it does because U.S. willing to be deficit and consumer of last resort
 - But is the system sustainable?
- Reform is difficult because U.S. thinks it benefits—but everyone loses from unstable system
- Principle of reform: Annual issues of SDRs

CONCLUSIONS

- Developing countries must fight for an international economic (trade, finance, intellectual property) environment that advances their interests
- But in the meanwhile have to learn to live with the inequities of the current system

CONCLUSIONS

- It will require taking to heart some of the lessons of success and failure in other developing countries
 - Including the failure of the Washington consensus policies
- What is at stake is not only the ability to sustain rapid economic growth
- But also the nature of Indonesian society for generations to come