

Asian Society Hong Kong Center 2011 Spring Gala Dinner

**Global Solutions to the Global Crisis:
Beyond Keynesianism and the “New New Normal”**

Justin Yifu Lin
Chief Economist and Senior Vice President
The World Bank

March 23, 2011

Good evening ladies and gentlemen. Before starting my speech, I would like to express my condolences to the citizens of Japan for the triple tragedy— earthquake, tsunami, and nuclear disaster—that is impacting on them. I hope the economic impact of this disaster on Japan and East Asia be fairly short-lived, though the human toll in Japan is heartbreaking and enormous.

Now for my remarks.

Over the past two and half years, the global economy has witnessed its most tumultuous times since the Great Depression. The impressive coordinated policy response of the G-20 nations has helped the world avoid the worst possible scenario. Economic activity is now recovering around the World. Global GDP increased from negative 2.2 percent in 2009 to positive growth of 3.9 percent in 2010 and is projected to grow 3.3 percent in 2011.¹

But, we are observing a recovery at two different paces. On the one hand, there are the high-income countries whose growth rates in 2010 and 2011 are estimated 1.7 percent and 1.4 percent, far below the historical average following other crises. On the other hand, developing countries have been growing at 7.0 percent in 2010 and likely to be at 6.0 percent in 2011, much faster than advanced countries and returning to their pre-crisis rates. Developing countries, especially China, India, but others too, have increasingly become engines of growth of the world economy.

Challenges of global recovery and large excess capacities

While the recovery is on its way, many challenges remain.

¹ World Bank, *Global Economic Prospects*, vol. 2, January 2011, p. 4.
(<http://siteresources.worldbank.org/INTGEP/Resources/335315-1294842452675/GEPJanuary2011FullReport.pdf>)

First, and most importantly, the high-income countries are still beset with high unemployment rates and large excess capacities in housing and manufacturing sectors, which repress private consumption and investment and slow growth. The combination of low returns and high risks on financial investment caused by low growth and high unemployment in high-income countries has been referred to as the “new normal”.²

Second, sovereign debt in a number of European countries and government debts in some states in the U.S. may require restructuring and threaten the stability of global financial markets.

Third, the large short-term capital inflows to a number of middle-income countries create appreciation pressures and may damage their external competitiveness and stymie their growth prospects. The capital influx may also lead to the emergence of unsustainable bubbles in their equity and real estate markets.

Fourth, the surge of food, commodity and fuel prices in the past few months is hurting the poor, and poses a threat to social stability, as demonstrated by events that have unfolded in Tunisia and Egypt.

The above risks to a sustained recovery are directly or indirectly related to the simultaneous existence of large excess capacity in the high-income countries. In spite of the recovery, industrial production in high-income countries is estimated to be more than 10 percent below the peak in 2008.³ The high unemployment rates in high-income countries are a reflection of their large underutilization of capacity. The need for increasing social spending and undertaking stimulus efforts to counter high unemployment and underutilization of capacity at the same time that public revenue is under stress presents a dilemma. Fiscal deterioration is a looming concern and has led to state and sovereign debt problems in the US and several European countries. The adoption of low-interest rates in high-income countries as a countercyclical measure at the same time that investment opportunities are constrained by the underutilization of capacity encourages investors to seek high-yields, resulting in large short-term capital outflows to emerging markets and contributing to the spikes of food, fuel, and commodity prices.

So, what can the world do to mitigate the challenge of “new normal” or even the risk of a return of a global crisis?

Beyond Keynesianism and global recovery

In my view, a global push for investment along the lines of a Keynesian stimulus is the key for a sustained global recovery; however, the stimulus needs to go beyond the traditional Keynesian investment. The products of high-income countries’ manufacturing sectors are mainly capital goods. A push for investment will increase the demand for capital goods and reduce the underutilization of capacity in manufacturing sectors in high-income countries, which in turn will increase the high-income countries’ employment, consumption,

² Clarida, R. (2010), “The Mean of the New Normal Is an Observation Rarely Realized: Focus Also on the Tails,” *Global Perspectives*, PIMCO, July.

³ World Bank (2011), *ibid*, p. 36.

opportunity for private investment, growth and housing demand. With more revenues from higher growth and less need for social spending, the high-income countries' fiscal position will be strengthened and sovereign and state debt issues can be solved or mitigated. The high-income countries can also tighten their monetary policy, reducing the pressure for short-term capital outflow to developing countries and commodity markets.

But how can the likely "Ricardian equilibrium trap" be avoided, i.e. a probable outcome where the government stimulus fails to boost aggregate demand because economic agents expect future tax increases to pay for larger deficits and thereby increase savings?

To avoid the likely "Ricardian equilibrium trap," it is important to go beyond conventional Keynesian stimulus of "digging a hole and paving a hole" by investing in projects which will enhance future productivity. Such investments will increase jobs and demand for capital goods now and increase the growth and government's revenues in the future. The increase in revenues can be used to pay back the cost of investment without increasing household's future tax liability.⁴

So, where could productivity-enhancing investments take place?

First, many advanced economies have considerable infrastructure gaps. Railways, airports, roads, utilities and other basic infrastructure have become dilapidated. Investment in such key infrastructure will not only help increase demand for capital goods and reduce excess capacity, but also enhance growth potential of the economy.

Second, an additional growth-enhancing investment area is clean energy, that is, green growth. Clearly, clean energy is one of the most important global priorities for reducing carbon emissions. But, current sources of clean energy are not cheap and require substantial R&D investments before the green growth can be realized globally without government subsidies.

It is unlikely that the above two areas alone will significantly improve the capacity utilization rates in high income countries. By far the greatest opportunities for productivity-enhancing investments are in developing countries. Infrastructure bottlenecks are observable in most of the developing world. The World Bank has estimated that developing countries require over \$900 billion for infrastructure investment and maintenance annually.⁵ Over the period 2012-17, India alone will require \$1 trillion.⁶ If resources can be mobilized to support infrastructure investments, it can increase the demand for capital goods, reduce excess capacity and unemployment in high-income countries, and boost the developing countries' growth potential in the future. Studies show that if the Africa region's infrastructure reaches Mauritius' level, its per capita GDP growth can increase by 2.1 percentage points and if it increases to the level of Korea, its GDP growth rate can increase by 2.7 percentage points.⁷ An

⁴ Lin, Justin Yifu (2009), "Beyond Keynesianism: The Necessity of a Globally Coordinated Solution", *Harvard International Review*, Summer 2009, pp. 14-17.

⁵<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,contentMDK:20127296~pagePK:64257043~piPK:437376~theSitePK:4607.00.html>

⁶<http://www.zawya.com/Story.cfm/sidZAWYA20110219053629/DP%20World's%20India%20foray%20to%20spur%20foreign%20fund%20flow>

⁷ World Bank, 2009, *Global Monitoring Report*.

increase in the power generation in India (with 0.7 GW per 1,000 workers at the bottom quintile of the distribution) to the levels in Israel and Hong Kong (with 2.8-2.9 GW per 1000 workers at the top quintile of the distribution) will enhance the growth rate of income per capita by 1.7 percentage points. An expansion of the road and railways system from the levels displayed in Argentina (with 0.6 km. per sq. km. of area) to levels in Korea and Taiwan (with 3 km per sq.km. of surface area at the top quintile of the distribution)—will allow growth to increase by 1.4 percentage points.⁸

Towards a “new new normal”

If the simultaneous existence of large excess capacity in high-income countries is not eliminated, the “new normal” situation is likely to persist. A number of high-income countries risk slipping into a Japanese-style “lost decade,”—i.e., a decade-long sluggish recovery with a rapid accumulation of unsustainable public debts. However, the world has a better alternative. Boosting infrastructure investment in the world, especially in the developing countries, could pave the way for a “new new normal”, by which I mean, the high-income countries return to pre-crisis norm and developing countries enjoy enhanced growth.

The Chinese experience in the East Asian financial crisis shows that a “new, new normal” is not only a theoretical possibility, but also can be a reality. Facing a situation similar to the recent global downturn during the East Asian financial crisis, China focused its fiscal stimulus investments on highways, railroads, port facilities, and electricity, areas that were bottlenecks to China’s growth at that time. As a result, for example, the highway network in China increased from 4,700 km in 1997 to 25,100 km in 2002. Such growth-enhancing and bottleneck-releasing investments resulted China’s annual growth rate increasing 1.3 percentage point from an average of 9.6 percent in 1979-2002 to 10.9 percent in 2003-2010; and prior to 2002, a 2-digit growth rate was always accompanied by a 2-digit inflation rate, whereas in 2002-2010, the inflation rate was not more than 5 percent. As a result,, public debts in China fell from over 30 percent of GDP in the early 2000s to 23 percent in 2008.⁹

Infrastructure investment represents two-thirds of the growth increase in East Asia and about half of the growth increase in Africa in the past two years.¹⁰ Infrastructure investment in the developing countries has the potential to make a further contribution to the global recovery and future growth.

A global crisis requires a global solution. The current and rather ad hoc approach to rebalancing global economy, which entails allowing currencies in high-income countries to weaken and increasing consumption while reducing savings in developing countries may merely shift growth among different countries without addressing the fundamental ongoing challenge of excess capacity in the capital goods sectors in high-income countries. What the

⁸ C. Calderon and L. Servén (2004): “The effects of infrastructure development on growth and income distribution”, World Bank Policy Research Working Paper No.3400.

⁹ National Bureau of Statistics of China, *China Statistical Yearbook 2010*, Beijing: China Statistics Press.

¹⁰ Press Conference, World Bank Group President Robert B. Zoellick, Foreign Correspondents Association (<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22760007~menuPK:34476~pagePK:34370~piPK:34424~theSitePK:4607,00.html>).

world needs is a growth-lifting solution.¹¹ Such a potential approach is increasingly recognized in global fora. At the G-20 Seoul Summit last November, members agreed on a “Development Consensus for Shared Growth,” which includes nine pillars critical to ensuring growth and resilience, with the first pillar being infrastructure.

The majority of developing countries are financially constrained. Achieving the “new, new normal” requires having new international financial arrangements along with structural reforms in both high-income and developing countries. The recent capital increases extended to multilateral development banks and the replenishment of the International Development Association, or IDA, can be part of the solution. The other option would be the creation of global, regional and bilateral infrastructure facilities similar to that envisioned for East Asia at the World Bank-Singapore Infrastructure Finance Summit last November. If realized, such infrastructure facilities could mobilize multilateral, bilateral, and private financial investments and could improve the selection and implementation of bottleneck-releasing and productivity-enhancing projects in industrialized and developing countries.¹²

Hong Kong is the world’s third largest financial center and has many leading global infrastructure companies. In the past three decades, Hong Kong’s business community made important contributions to China’s economic success and world-class infrastructure development. Hong Kong can combine its strength as a global financial center and the infrastructure development capacity of its business community in ways that will help the world overcome the current economic challenges and achieve a “new, new normal”. Such an effort will be a “win win” for Hong Kong and for the world.

¹¹ Lin, Justin Yifu (2010), “A Global Economy with Multiple Growth Poles”, in S. Fardoust, Y. Kim and C. Paz Sepulveda, eds. *Post Crisis Growth and Development: A Development Agenda for G-20*. Washington, D.C.: World Bank Press.

¹² Along the line of thinking in the paper, the EU and the European Investment Bank unveiled on Feb 28, 2011 the “Europe 2020 Project Bond Initiative”, which proposed to provide either guarantees to private investors or a direct loan at a subordinated level to mobilize €1,500bn to €2,000bn for infrastructure investments in Europe in the coming decade.