CHAPTER 1
Globalization Revisited

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Since the May 2008 release of *The Growth Report*, the world economy has been hit by an extraordinary series of shocks. These shocks have threatened the economic security of many poor countries and imperiled the strong macroeconomic progress recorded by others. Among other things, these shocks will provide an important test for the recommendations of *The Growth Report*. At the time of its writing, the connection between the report’s recommendations and the twin crises was apparent, but not the extent to which long-term, sustainable growth would be imperiled. A mere few months later, however, with the advent of the housing, banking, and stock market crises, the situation changed radically. As Claessens, Kose, and Terrones (2008) note, although the combination of distress in these three segments of the financial system is rare, it is associated with deeper and longer recessions.¹

¹ Claessens, Kose, and Terrones (2008) examine evidence of 122 recessions in 21 industrial countries in the period 1960–2007. Reinhart and Rogoff (2009) catalogue severe crises and quantify the depth and duration of the following slump. See also Freund (2009) for data on the increase in trade elasticity to gross domestic product (GDP) over the last 50 years.

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New in this equation are the extent of globalization, which is much wider than in earlier crises, and the extent to which increased integration will magnify the losses.2

Globalization as an economic phenomenon has been the dominant force for economic integration and the main driver of growth worldwide for many decades, although the speed of globalization—taken to include trade, finance, flows of information and technology, and offshoring—is unprecedented in modern economic history. The increased economic interconnections between countries are widely credited as one of the driving forces that significantly reduced poverty in China and Vietnam, enabled the poorer nations of Europe to ride the European Union train to higher incomes, and gave hope to some African countries that Collier’s prognosis that globalization is biased against latecomers might be too pessimistic (Collier 2007). The extent of financial flows, reaching 8.6 percent of the combined GDP of emerging and developing market economies (EDMEs) in 2007, seemed to supplement national shortages of capital and to promote domestic investment in some cases.3 The export drive of the EDMEs in the period 2000–07 contributed about two-thirds of the growth in total world trade and 60 percent of the growth in total world output. This is remarkable when compared even to the decade of the 1990s, when the EDMEs accounted for only a quarter of the growth in world trade and about 40 percent of the growth in world output (World Bank 2008b, 2009a).

The 2009 collapse of the bubble changed the landscape considerably. Talk of decoupling disappeared, and discussion centered on the future, not only of globalization, but also of capitalism as we know it (Wolf 2009). The startling fact that global output shrank in 2009 for the first time in modern postwar history is reinforced by the size of the decline—now variously estimated by institutional pundits to be between negative 2.5 and negative 2.9 percent. Using the steeper decline would mean that world income in 2009 has been set back at least to the level of 2007, a two-year loss. World trade has fallen by at least 10 percent in volume, and prospects for 2010 portend an anemic recovery (IMF 2009; OECD 2009b; World Bank 2009a).

Average changes in world incomes are illuminating, but, as is usually the case, the distribution of these welfare losses is asymmetric. The early concerns raised by Stiglitz (2002) and others about the unequal gains and losses from globalization become more starkly relevant when the losses begin to mount. The argument pre-crisis was that public policy was at fault for not dealing sufficiently with the losers from globalization, whereas the issue now is how much of the loss should be allocated to which segment of society. Given the expansion of national indebtedness in the United States,

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2 Freund (2009) calculates that the elasticity of world trade to GDP rose from under 2.0 in the 1960s to a high of 3.5 before the crisis. She also finds that the decline in the growth rate of trade following a decline in GDP is sudden and, on average, more than four times as large as the growth of income.

3 See Rodrik and Subramanian (2008b) for an explanation of why foreign capital failed to be channeled to productive investment in other cases. See Bresser-Pereira and Gala (2007) for a similar argument.
for example, the fiscal incidence burden becomes increasingly intergenerational as well (Barr and Diamond 2009; Burman 2009; OECD 2009a). Recent work on fiscal incidence policy by Estache and Leipziger (2009) and their collaborators points to the importance of measuring the beneficiaries for all types of expenditures, in particular, because middle-class interests may not be appropriately protected, with adverse consequences for the conduct of economic policy (Estache and Leipziger 2009; Leipziger and Spence 2007; Stiglitz 2002).

For emerging and developing countries, the question becomes one of whether the landscape has changed so fundamentally that economic policy needs to be redesigned. In Post-Crisis Growth in Developing Countries: A Special Report of the Commission on Growth and Development on the Implications of the 2008 Financial Crisis (hereinafter, the special report), the Commission argues that the basic direction of policy that aims to achieve long-term growth remains unaltered, but that the gains from leveraging the international trading system may be smaller than in recent decades and that past reliance on foreign flows may need to be rethought (Commission on Growth and Development 2009). Issues surrounding globalization are here to stay, and this volume of papers, prepared for Commission workshops held from 2007 to 2009, is intended to help us to navigate various elements of the globalization debate.

There has been no dearth of commentary about what the crisis may mean, but in reality, until the bottom has been reached and the path to recovery is clear, it will be difficult to draw general lessons for the future. This collection of essays encompasses a variety of viewpoints and covers both medium- and long-term policy issues. It is said that more textbooks have become obsolete in 2009 than in any year since the Great Depression. As a corollary, much has been written that is worth reviewing in a volume on globalization. The papers look at the issue of globalization from diverse points of view and add insights and perspective to the recommendations of the The Growth Report.

The State of the Current Debate

There is no shortage of commentary on the implications of the current crisis for the future. Some see it as a temporary setback to the open and integrated system of both trade and finance that has ushered in two decades of spectacular world growth and monumental gains for those most integrated in the global system. To the globalizers—and here I would put prominently Bhagwati, Cooper, and Mishkin—there is much work to be done to restore the system’s health, and governments need to show statesmanship in resisting nationalistic solutions that are globally welfare reducing. Globalization still offers the best outcome for the most people, even though some distributional questions remain. The efficiency arguments of globalization and the political necessity of pulling together to keep the system functioning are seen to be of paramount importance (Bhagwati 2004; Mishkin 2006; see Cooper in chapter 5 of this volume).
For others, like Stiglitz, Rodrik, and Subramanian, the system is broken
to some degree, and the future should not and cannot resemble the past in
many fundamental ways. Stiglitz focuses on the governance requirements
of the system and its basic inequities as well as the market failures that are
not easily remedied. In fact, Stiglitz would argue that “market fundamen-
talism” is dead, and his view that urgent reform is needed certainly has
more adherents than before. Others would rely more on markets to fix
themselves, stressing incentives and incentive-compatible regulation (Barth,
Caprio, and Levine 2006; Calomiris in chapter 3 of this volume). Rodrik
has argued that the goal should no longer be maximum openness in trade
and finance, but levels that leave sufficient room for the pursuit of domestic
social and economic aims. With Subramanian, he argues that the days of
unquestionably open capital markets in EDMEs, and the accompanying
volume of cross-border flows, are gone and that this is, on balance, a good
thing (Rodrik and Subramanian 2008a; Barth, Caprio, and Levine 2006;

Where we will emerge from these debates remains to be seen; however, a
strict return to the status quo ante is unlikely. For one, the regulatory envi-
ronment will not allow it, and, as has been noted by Rajan and others, the
shape of corporate finance will change and with it the nature of international
flows (Dell’Ariccia, Detragiache, and Rajan 2005; Rajan 2009). Second, the
tradeoff between domestic job losses and industry profits that has driven
offshoring, at least in the United States, will need reexamination. We refer
below to the thinking of Blinder (2007, 2009) on this important issue. Third,
the future of the open, globalized system will depend a lot on how the new
economic powers (NEPs) manage themselves and how they influence the
system going forward (Leipziger and O’Boyle 2009).

There is considerable uncertainty about the nature of globalization post-
crisis. If, for example, the switch in demand in the NEPs from exports to
nontradables is permanent, then poorer developing (for example, African)
countries may be able to assume the mantle of cheap manufacturer to the
world. Whether this will be enough to offset the overall decline in exports
to advanced countries remains to be seen. If, however, a new kind of indus-
trial policy begins to permeate, and national industries and banks are given
government preferences in countries of the Organisation for Economic
Co-operation and Development (OECD) as well as the NEPs, then the sys-

One of the drivers of growth in world trade in recent decades has
been the demand for offshore services in the United States, arguably the
growth engine for much of global demand. This offshoring, which has
all the efficiency-enhancing characteristics of trade that are eloquently
noted by Bhagwati, Panagariya, and Srinivasan (2004), also comes with
strings attached. Blinder (2007) persuasively argues that the expansion of
offshoring by U.S. firms has dramatically altered the employment landscape and will do so even more in the future. This observation was rendered before the current crisis and therefore has potentially even greater significance now for the future of globalization. Blinder sees the offshoring trend as a large, potentially disruptive force in the United States, equivalent to an industrial revolution in its impact on jobs. He argues that it is significant because it could affect between 20 and 30 percent of jobs in the United States, particularly those that are “impersonal,” not requiring either face-to-face or customized interactions.4

This is not good news for the future of world commerce because we have now seen a conflagration of all three developments that Blinder predicts for the American labor market, namely (a) an increase in frictional unemployment due to job churning, which is unprecedented because of firm closings in the current crisis; (b) an increase in structural unemployment because of a mismatch of skills caused by the export of impersonal jobs, which, according to Blinder, is a continuing trend;5 and (c) an increase in unemployment during cyclical downturns, which has reached historic proportions because of the sharp drop in personal income, spending, and confidence in the U.S. economy in 2009. While these phenomena are not new, they have gained considerable traction at a time of rapidly increasing unemployment. Taken as a package, the political economy consequences are inevitably going to be on the side of creating and preserving (through whatever means) domestic jobs. Even more important to the future is that, whether this will be seen as formal protectionism or not, globalization will no doubt be put at odds with national economic goals in a highly politicized fashion.

**Trends and Inflection Points**

A useful starting point for discussing whether or not we can expect a paradigm shift in the globalization model of recent decades is to review where we are with respect to economic integration and then to overlay both the recent unprecedented crisis and the longer-term trends that are fairly certain. The World Bank’s 2007 *Global Economic Prospects* (World Bank 2007) serves as a useful guide, since it correctly portrayed a world of increasing interdependence in which trade outpaced economic growth and in which, as a result, the average trade to GDP ratio rose from 13 percent in 1970 to 25 percent in 2005. The report predicted a trebling of world trade to $27 trillion by 2030, including both rapid gains by EDMEs and

4 Blinder (2007) sees offshoring going far beyond billing, booking, and information technology support and observes that, even in a field such as medicine, radiology is more likely to be offshored, subject to regulatory issues, than is pediatrics.

5 Blinder (2009) posits two big shocks that will allow this phenomenon to continue: (a) adding labor previously outside the global economy will put downward pressure on wages and upward pressure on returns to capital, and (b) increases in technology will make previously personal services impersonal.
major increases in trade in services. Will these trends, which were so pronounced over the 2000–07 period, in which developing country exports more than doubled (an increase of 127 percent) and South-South trade grew at an even faster clip (150 percent), continue despite the current setbacks (WTO 2008)?

The unprecedentedly high unemployment rates in the advanced countries, particularly in the United States where social safety nets are weaker than those in much of Europe, will put enormous political pressure on policymakers to deal with job losses. Of course, a key driver of the increase in trade in services is offshoring—between 1994 and 2003 in India alone, trade in services grew more than 700 percent! We already have witnessed several protectionist measures in the context of stimulus packages in many countries, not least in the U.S. “buy American” and Chinese “buy Chinese” provisions. The future trajectory of growth with its consequences for world trade is closely connected to the issue of jobs and public policy to protect or create domestic employment (Anderlini 2009; World Bank 2007).

Taking a step back, the Pew Global Attitudes Survey of 2008, conducted prior to the crisis, found a sharp decline in positive views among Americans toward international trade. Compared to five years earlier, only 53 percent of respondents thought trade was a good thing, a drop of 25 percentage points (Pew Global Attitudes Project 2008). This reflects the increasing polarization of the globalization issue between advanced economies and emerging markets, which still largely view globalization as a positive force. Much of the disenchantment with free trade stems from the perception that it is the main cause of job losses in industrialized countries. Whether this is true or not is debatable, as is the question of what is driving job losses: lack of education, wage differentials, or technological innovation (Blinder 2009; Goldin and Katz 2007; IMF 2007; Lawrence 2008). However, one point is quite clear: in the public perception, jobs in the United States are being exported, a phenomenon that is politically untenable when combined with housing foreclosures, impaired stock market assets, and record high unemployment. Since it can be argued that the United States set the bar for globalization efforts, the current state of the economy may presage a return to economic nationalism, a trend seen worldwide these days. Recent evidence shows that 17 of the 19 individual members of the G-20 instituted some form of protection in 2009 and also that the frequency of antidumping suits increased (Gamberoni and Newfarmer 2009). Antidumping actions are frequently seen as a tactic to slow down imports and protect domestic industries under stress (Leipziger and Shin 1991). Despite general admonitions to avoid protectionism, such as those contained in G-20 and G-8 communiqués, domestic political pressures are fiercely protectionist, especially during downturns.

This brings the issue of distribution front and center. In the United States, still the largest trading nation, we see a disturbing trend regarding inequality, and it is probably connected to the finding that America’s middle class reports the lowest satisfaction with international trade as a positive
phenomenon (Pew Global Attitudes Project 2008). The overall Gini coefficient for the United States, flat during the 1960s and 1970s, began to rise in the 1980s and continued to climb between 1990 and 2005 to about 0.47. This places it not only among the more unequal ex ante (that is, before redistribution) of OECD countries, but, which is more important, among the most unequal ex post as well. More important, however, according to the U.S. Census Bureau (2009), most of the increase in inequality has come from the unevenness between the top 5 percent and the median income earner. Most dramatically, only the top 7.5 percent of U.S. households increased their real earnings in the 2001–05 period. The coincidence of very rapid growth in incomes, a highly skewed sharing of these gains, and the high point in globalization reached in the period between 2001 and the current crisis gives rise to a great deal of cynicism in the United States toward globalization (Subramanian 2009a).

Andre Sapir observed that, among European social models, increased use of employment protection legislation is associated with lower rates of employment. He noted that the continent’s most efficient and equitable social model, the Nordic model, has achieved this result through a high degree of labor market flexibility combined with a robust social safety net, although the long-term sustainability of this model and the degree to which it can be transplanted to other countries is in doubt. In a synchronized collapse such as the one experienced in 2008–09, however, these tradeoffs may recede in importance, and employment-protecting policies may well emerge across-the-board when faced with the possibility of a slow recovery.

The second main concern surrounding the future of globalization centers on the capital market, where wholesale deleveraging and unprecedented actions on the part of central banks and governments have ushered in a period of extreme volatility and uncertainty (Kashyap, Rajan, and Stein 2008; Rajan 2005). Flows have dried up in response to the deleveraging of the financial sector; however, the concern is a medium-term one. As pointed out by the International Monetary Fund (IMF), the refinancing needs of the corporate sectors in EDMEs will total about $1.5 trillion for 2010, and the sources of finance are not apparent (IIF 2009; IMF 2009; World Bank 2009a). Does this imply that countries will need to be more self-sufficient in providing credit? In 2009 we have already seen that governments in the major NEPs, such as Brazil and India, have relied on state development banks to provide credit that normally would be accessed abroad. Such a reversal in financing sources can bring with it concerns about government

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6 Jesuit and Mahler (2004) show that, after fiscal redistribution, the picture changes entirely, and most OECD countries have Gini coefficients below 0.30, while only the United States (0.345) and the United Kingdom (0.323) exceed that level.

7 Sapir (2005) observes that the Anglo-Saxon model is efficient, but lacks equity. The continental and Mediterranean models are not efficient and are therefore unsustainable in the long term. He finds an inverse relationship between the strictness of employment protection legislation (used more in continental and Mediterranean models) and the employment rate. See Aghion and others (2008) for the implications of trust on labor market regulation. See also Algan and Cahuc (2006) for an analysis of the adaptability of social models.
intervention in sectors and can revive old debates about industrial policy (Exman 2009).

More generally, the debate has shifted recently to discussions about not only the regulatory failures but also the appropriate role of foreign capital in the development process. Subramanian has argued that the “fetish” of relying on foreign capital may have ended. Past debates about controlling the quality of capital inflows (for example, the Chilean reserve tax, which discouraged short-term inflows, and even the Malaysian response to the East Asia crisis) are being reopened as commentators wonder about the advisability of open capital accounts and the inherent riskiness of reliance on external capital (Demirgüç-Kunt and Serven 2009; SAIS 2009; Subramanian 2009a). While some, like Cooper in chapter 5 of this volume, are not swayed in their confidence in markets, others like Rodrik and Subramanian see the end of an era of open capital accounts and the advent of much greater management of exchange rates, imbalances, and, by implication, other policy variables. There is a consensus on the need for financial reform, if not on the schemes to be chosen. Of course, the nature of the chosen regulatory path will have major implications for the future of capital flows and, therefore, for the future of globalization.

With a smaller pool of available capital—a consequence of smaller imbalances in the medium term—the cost of capital will be higher, especially if risk premia are more pronounced in the future and more conservative capital adequacy becomes the norm. One wild card is the existing stock of international reserves, prominently in China, which has no attractive alternative use other than to purchase U.S.-denominated assets. Despite talk of the emergence of SDRs (special drawing rights), a unit of account available in very limited quantities since the 1970s, there is as yet no practical proposal that would diminish greatly the role of the dollar (Eichengreen 2009). That said, in many countries, there are significant savings, but much of it rests offshore because of governance concerns. In the case of Argentina, for example, at least $45 billion in domestic savings has left the country in the past two years alone (Leipziger 2009). The implication of less plentiful external flows is that domestic capital markets can be given a boost; however, this requires not only technical market development, but also assurances of greater governance in some cases (Rodrik and Subramanian 2008a).

One thing for certain is that the crisis will accelerate a rethinking of the merits of increased globalization. In this context, Stiglitz was prescient in drawing attention to the question of winners and losers and to the necessity of using the instruments of public policy to deal with the consequences of globalization and also the concentration of economic power (Stiglitz 2006). Moreover, those such as Eichengreen, who pointed to the unsustainability of the large imbalances run by China and the United States, were also correct (Eichengreen and Park 2008). The paradigm of a consumer in the United States who does not save but instead consumes cheap goods that are

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8 Commission of Experts (2009). See also G-20 (2009) for the joint declaration on strengthening the financial system.
produced in China by low-wage workers and sold at Wal-Mart, aided by a favorable exchange rate, only works in a growing economy with abundant credit. But when the bubble, fueled by an abundant supply of money and abnormally low interest rates, bursts and global demand falters, this model fails. This raises interesting questions about the role of monetary policy, an issue seized upon by politicians on both sides of the Atlantic.

A related and interesting emerging debate concerns the nature of capitalism and markets and the respective roles to be played by government and the private sector. Many in Europe lay blame on Anglo-Saxon capitalism and put forward a supposedly superior model of state capitalism (Davies 2009). It is clear that markets in the United States and the United Kingdom were underregulated, causing extreme consequences and large public bailouts—the balance sheets of both the U.S. Fed and the Bank of England have more than doubled in the 2008–09 crisis. Whether state capitalism is the answer is not at all clear in light of concerns about both efficiency and governance. Continental European banks have also suffered huge subprime losses and are expected to be hard-hit by impending losses in their Central and Eastern European portfolios (Gros 2009). What is manifest, however, is that developing countries with neither the regulatory structures nor the institutions face a difficult dilemma regarding the role of government going forward.

Governments in all countries have been thrust back onto center stage as markets have either failed to function or gyrated greatly, making it difficult for businesses to operate. Policy responses to the crisis have varied considerably, although in most countries with fiscal space, some supplementation of aggregate demand has been adopted. Exactly what has been done and what government’s role has been exert an important influence on the future conduct of economic policy. In this context, some economic policy decisions taken in the crisis will constrain future public choices and will affect future growth policies. It is worth taking a look, even in a speculative fashion, at the implications of the crisis and its management for the future.

How Crisis Management Will Shape Future Growth

Although The Growth Report placed governments at the center of the growth and development process, the report brought together experience and judgment applicable to sustain long-term levels of high economic growth rather than advice on crisis management. Nevertheless, it is crisis management that preoccupies policy makers at present, and it is no exaggeration to claim that the conduct of these short-term measures will have lasting implications. This is true in both the advanced and the emerging market economies.

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9 IMF (2009) shows that the actual Fed funds rate was 4.6 percent below Taylor rule guidance in the second quarter of 2004.
One worry is that the boosts to aggregate demand may not be transitory. Reductions in tax rates are difficult to reverse, and supplements and extensions of coverage in social safety nets, although well advised, are equally hard to retract. Somewhat easier to manage may be the pure expenditure side of fiscal stimulus packages, although even here multiyear infrastructure plans, such as those being implemented in the Republic of Korea, or shifts to domestic construction, as in China, will be around for many years. For countries expected to experience renewed high growth in coming years, these shifts in fiscal stances may be sustainable. In others, particularly the more advanced economies, the fiscal burden of bailouts and increased spending will exact a future price, and that price is a lower growth trajectory.

Related to the conduct of fiscal policy is, of course, the conduct of monetary policy. The custodians of monetary policy in the United States and the United Kingdom have taken a different approach from the European Central Bank, with the latter focusing on inflation and resisting demands to prime the pump. This is a conscious tradeoff. In the so-called Anglo-Saxon economies, a sobriquet not used in an endearing fashion by critics, central banks have taken on the Herculean task of bailing out the financial sector and attempting to restore confidence and liquidity to scared and, in some cases, dysfunctional capital markets. This has led some commentators, such as El-Erian, to speak of the “new normal.” He refers to a financial system laid low by deleveraging, deglobalization, and reregulation, in which price formation in many markets will be influenced by the legacy and, in some cases, the continuation of direct government involvement (El-Erian 2009). Concretely, this can be seen as diverting the U.S. Fed from one of its two roles—the price stability role—with effects on intertemporal fiscal decisions that raise debt levels in the United States and therefore constrain future growth.

Most important for EDMEs, as the role of government has changed in the advanced economies, the emerging market policy makers have taken on a revised role as well. Much in the spirit of The Growth Report, policy makers now see themselves as much more empowered to manage growth, to create stronger ties between business and government, to direct credit to corporates who are shut out of international markets, and, by implication, to articulate a stronger trade policy, especially in light of rising protectionist sentiment. Rodrik, in chapter 7 of this volume, points to the need for governments to be much more hands-on with respect to management of post-crisis growth, and the counterargument that this should be left to markets is clearly resonating less. Whether governments are well equipped to undertake this expanded role is a separate question, but ideology has shifted as a result of the meltdown of markets and the necessity of public sector action.

As a result of faltering demand and slower growth, attention is also shifting to the need for large-scale reallocation of resources and new forms of innovation. Schumpeterian economics, now coming back into the debate, is seen as a positive force when churning of firms and ensuing
job losses can be more than compensated for (at least in the aggregate) by the creation of new firms and new jobs (Schumpeter 1942). Romer has written persuasively about this churning in his contributions to The Growth Report, and Romer and Aghion independently have pointed to the great benefit of innovation as a driver of growth (Aghion and Howitt 1992; Romer 1990). In recent work, Aghion has stressed the differing policy choices facing imitators and innovators as well as the complementarities among growth policies, technological innovation, and institutions (Acemoglu, Aghion, and Zilibotti 2002; Aghion and others 2009). This has been the story in the United States throughout the twentieth century; however, current political economy realities in most of the advanced countries no longer are able to accept creative destruction on a large scale. This is because of the sizable job losses associated with the current slowdown as well as the unavailability of credit at a time when lenders are conserving capital and are extremely risk averse. The former creates tremendous pressure to preserve firms with government bailouts, while the latter makes it difficult for new firms to get started or expand. It can be argued that Schumpeterian economics works less well in a global meltdown, the alternative being to protect current industries to the detriment of innovation and change. Inevitably, however, less creative destruction means less innovation and, ultimately, slower long-term growth.

Many commentators have opined on policy lessons due to the crisis. Subramanian draws lessons for Indian policy makers, and Lin and Wang draw lessons from Chinese policy for other countries (Lin and Wang 2008; SAIS 2009; Subramanian 2009b). Krugman (2009), writing in the New York Times, sees a widening schism between the market fundamentalists and a more pragmatic new group of influential economists who see market flaws as systemically dangerous. At the United Nations, the Commission of Experts led by Joseph Stiglitz has proposed radical changes to the global financial architecture, going so far as to include a proposal for the development of a new global reserve system and entities for global financial supervision (Commission of Experts 2009). As Mike Spence notes in the special report of the Commission, this crisis has embarrassed a lot of theories and theorists, and the question is how much can be amended yet salvaged and how much needs fundamental rethinking (Commission on Growth and Development 2009).

One area of past controversy is the role of public sector banks, often the source of huge nonperforming loans and political influence. In the aftermath of the crisis, we have seen public banks in India being shored up with a major influx of capital (partly financed by World Bank loans) to increase credit and finance infrastructure; large increases in lending by the Banco Nacional de Desenvolvimento Economico e Social, Brazil’s large public development bank; and, of course, large expansions of credit through Chinese government-sponsored banks (Economist 2009; Exman 2009). Are these actions any less reasonable than the Fed’s bailouts? Only time will tell, but the resurgence of public sector banks and the public takeover of
private banks are realities and cannot be seen as benign for the future of globalization as we have come to know it.

The basic connection with globalization is that the reemergence of national policies—in the areas of credit for the private sector, public infrastructure investment, and use of tax credits and other means to foster demand in a particular sector (for example, autos in Brazil)—has wide-reaching implications for the international economy. Whereas the past couple of decades saw national governments taking major cues from global markets, that epoch appears to be over, at least for the largest EDMEs. For the poorer and smaller economies, the paradigm shift may be of smaller magnitude (Brahmbhatt 2008); however, the ideological shift is palpable, and international financial institutions will have a more difficult time arguing for pure market solutions.

There are some final implications to be drawn regarding the exigencies of crisis management and the attainment of longer-term goals. The debate around “decoupling” has taken an interesting turn, with a greater reliance on the positive growers for 2009 (Economist 2009; Kose, Otrok, and Prasad 2008). With this has come a shift in perceptions as to which countries are responsible custodians of the global system, and the G-20 has emerged as an important new forum, highlighting the future economic importance of the NEPs (Leipziger and O’Boyle 2009). As large emerging economies are increasingly regarded as the growth engines that will lead the world out of recession, a long overdue debate is taking place about their representation in financial and economic decision-making bodies. Over the long term, large emerging and developing economies will be more involved in systemic initiatives and will have the opportunity to take leadership roles in the international system.

In the wake of slowing growth as a result of the crisis, preserving and promoting trade will be a critically important challenge to the world economic system. Despite global rhetoric in opposition to increased protectionism, recent evidence has shown that protectionist measures have increased among the world’s largest trading nations (Bown 2009 for countries for which data were available). The revival of the Doha Round is an important step, in no small part due to its symbolic importance as a test of the world’s commitment to a multilateral trading system (Commission on Growth and Development 2008). However, this current wave of protectionism is occurring both within the legal bounds of World Trade Organization (WTO) rules and outside the scope of the Doha agreement. This post-crisis period presents a unique opportunity for the major trading nations, both developed and developing, to resist protectionism and strengthen the trading system from which they have greatly benefited (Mattoo and Subramanian 2009). Reform of the global financial architecture is another issue that is being reshaped as a result of the crisis, with major developing countries playing a larger role. Given the historic debate over the opportunities versus the threats of financial globalization, this crisis has precipitated yet another reevaluation of its merits. Economists doubting the positive effects
of external finance on growth have been at the forefront of this debate (Rodrik and Subramanian 2008b), and political action has led to increased regulatory scrutiny over cross-border financial flows and multinational financial institutions. The transformation of the Financial Stability Forum to include large emerging market countries has been a concrete step toward more effective cross-border regulation. The new group, the Financial Stability Board, will work closely with the IMF on identifying and addressing transnational macroeconomic and financial risks (Economist 2009) and expanding its mandate to include assessment, oversight, coordination, and information exchange capabilities (G-20 2009).

In addition to posing immediate challenges, the crisis has major implications for long-term trends, many of them correctly identified in The Growth Report. Urbanization is an easily identified secular trend. We have also seen governments trying to marry the need for immediate fiscal stimulus with a longer-term desire to foster “green investment,” and in some cases, such as Korea, the linkage has been strongly visible in the government’s stimulus program (Watts 2009). One arena in which the needs of short-term policy and longer-term trends do not necessarily coincide is in labor market issues, perhaps one of the thorniest aspects of globalization, made more complex by shifts in demographics and income inequality.

The Implications of Longer-Term Trends

Changing demographics will be an important feature of the global environment in the next few decades—one that will have impacts on saving behavior, pension systems, and fiscal stability. As The Growth Report documents, we will witness a continuous increase in world population, although more than 90 percent of the increase will be in EDME cities. At the same time, in the richest countries, populations will age (World Bank 2007). In fact, the proportion of the world’s population above the age of 60 in 2050 compared to 100 years earlier will more than double, to 22 percent. This has major implications for the financing of safety nets and for the dependency pyramid, as Bloom, Canning, and Fink describe in chapter 13 of this volume.

According to the IMF, demographic change is the major threat to long-term fiscal solvency. In addition to population aging, potential government funding obligations of pension liabilities as a result of falling asset prices will further jeopardize fiscal stability and long-term growth. The primary risks to governments arise both from the direct effects of investments in assets affected by the crisis and from explicit guarantees covering private assets. Political pressure to make up for the losses suffered by pensioners covered by private plans will also be substantial. In the United States, for example, government defined-benefit plans have lost 25 percent of their value since the end of 2009. Such a decline in equity prices triggers a requirement to close the funding gap over the following five years, a burden
that is likely to fall on government, employers, and ultimately the taxpayer. As Barr (2009) points out, there are four possible ways forward for pension systems: (a) people pay higher contributions, (b) people receive lower monthly pensions, (c) people retire later, and (d) governments find policies that increase national output (Barr 2009; Giles 2009; IMF, Fiscal Affairs Department 2009; OECD 2009a).

Such increases in age-related costs, in addition to the costs of the bailouts and stimulus packages, will have to be borne by the fiscal side, which can only be expected to be less robust. In advanced economies, the weakening in public sector accounts over 2008–09 will be the most pronounced of any in the past three decades. With no further infusions of finance from surplus countries, this implies a lower-level equilibrium growth rate for the advanced economies. Translated into demand for imports from the EDMEs, one can generally expect less momentum for externally driven growth, with a greater role for domestic demand, even once the recovery has begun. Thus the components of aggregate demand will likely shift in advanced and emerging market economies to favor government spending. This is a major shift indeed.

Governments will be challenged to spend wisely in the short term to avoid giving up gains in long-term growth. In the aftermath of a crisis, the real value of government debt tends to explode, rising by an average of 86 percent in the major post–World War II episodes (Reinhart and Rogoff 2009). For this reason, fiscal measures should be largely reversible or have clear sunset clauses contingent on economic conditions and precommitment to future corrective measures. Smoothly unwinding fiscal stimulus measures either at a specific date or on a contingent basis is important to regaining fiscal positions (IMF, Fiscal Affairs Department 2009). Tax breaks and subsidies granted during the crisis will have to be unwound eventually, which is never a politically attractive option. Once economies have stabilized, governments would do well to increase tax collection efforts, given lower government revenues and the pullback in foreign flows of private capital. While volatile, foreign flows have averaged only about 1.5 percent of recipient country GDP over the 1990–2008 period, and an increased tax effort of this size is within the realm of possibility (World Bank 2009a). Research conducted by the World Bank has shown that among a sample of 104 countries, 38 percent have the capacity to increase tax revenue collection significantly without jeopardizing medium-term growth (Le, Moreno-Dodson, and Rojchaichananinthorn 2008).

Contrary to popular belief, the main cause of rapidly expanding government debt is not the widely feared cost of bailing out and recapitalizing the banking system, but rather the collapse of future tax revenues in the wake of the crisis.

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10 IMF, Fiscal Affairs Department (2009). IMF data show that in 2007, 54.5 percent of countries for which data were available had fiscal surpluses and those that did not were in deficit by an average of 1.68 percent of GDP. In 2010 only 3 percent of these countries are projected to be in surplus, and the average balance of those that are projected to be in deficit will be negative 5.38 percent of GDP.
of deep and prolonged economic contractions. Therefore, governments will be challenged to ensure that programs promoting future growth are not cut for lack of resources (IMF, Fiscal Affairs and Research Departments 2008). Such cuts in growth-promoting spending have been shown to lower the present value of future tax revenues to a degree that more than offsets the improvement in the present cash deficit for which the cuts were made (Easterly, Irwin, and Serven 2007).

At present, the outlook for advanced economies is somber: the IMF projects a 56 percentage point increase in debt ratios by 2030. Emerging markets should fare somewhat better because of lower crisis costs, lower primary deficits, and lower expected age-related costs combined with a stronger growth outlook. Developing countries, however, have seen a significant falloff in private participations in infrastructure, and it is unclear whether the public sector will be able to fill the void. The August–November 2008 period alone witnessed a 26 percent decline in project completions due to delays and cancellations as a result of higher costs of financing and slackening demand (World Bank 2009b). Infrastructure spending, however, has been prominent in the G-20 stimulus packages to date, suggesting that advanced and large developing countries realize the importance of maintaining investments in the future. Of the roughly 50 percent of discretionary fiscal stimulus enacted through expenditure measures, approximately two-thirds has gone or will go toward infrastructure spending in 2008 and 2009. This represents 0.7 percent of 2008 GDP of G-20 countries (IMF, Fiscal Affairs Department 2009).

As mentioned, the vast majority of population growth in the coming decades will occur in developing-country cities, implying a rapidly increasing pace of urbanization across the globe. In 2008, the world reached an invisible but momentous milestone: more than half the world's population—3.3 billion people—was living in urban areas. By 2030, this number is expected to swell to almost 5 billion, an increase of more than 65 million people a year. The developing world in particular will see an unprecedented scale of urban growth, with urban populations in Africa and Asia doubling between 2000 and 2030. Despite this rapid change, urban population growth rates have actually slowed in the past 30 years, peaking at 3.7 percent a year in 1950–75. However, given the growing base of people living in cities, annual population increments in absolute numbers are very large and, to many, alarming (Spence, Clarke Annez, and Buckley 2009; United Nations Population Fund 2007).

The evidence to date clearly supports the conclusion that cities are important facilitators of economic growth, increased productivity, and rising incomes in poor and rich nations alike (Quigley 2009). In all known cases of high and sustained growth, urban manufacturing and services led the process, while increases in agricultural productivity freed up labor that moved to the cities. In the high-growth cases examined by the Commission, the average productivity of a worker in manufacturing or services is on the order of three to five times that of a worker in traditional sectors and
sometimes much more. There is also a robust relationship between urbanization and per capita income: nearly all countries become at least 50 percent urbanized before reaching middle-income status, and all high-income countries are 70–80 percent urbanized. In fact, we know of no countries that either achieved high incomes or rapid growth without substantial, and often rapid, urbanization (Spence, Clarke Annez, and Buckley 2009).

Urbanization poses major challenges to developing-country policy makers. While urbanization has some potentially major benefits in terms of agglomeration economies and innovation, it also has negative consequences in terms of congestion, lack of service delivery, and sheer unmanageability. The first challenge is to foster the growth of high-productivity activities that benefit from agglomeration and scale economies in developing-country cities. The second challenge involves managing the likely side effects of the economic success of cities—pollution, regional inequality, and high prices of land and housing—critical to mitigating the divisive impacts of successful economic growth. Empirical studies of livability and GDP per capita suggest that long-term growth is only feasible if city attributes regarding congestion, pollution, and safety are improved alongside urban economic management. Infrastructure and public services will be a key piece of the puzzle, perhaps the most important. According to some estimates, $40 trillion of infrastructure spending is required to meet the needs of cities in developing countries. Devising means of financing such vast expenditures is probably the biggest challenge for urbanization policy in the developing world (Gill and Kharas 2007; Gómez-Ibáñez 2008; Spence, Clarke Annez, and Buckley 2009; see also Estache and Fay in chapter 8 of this volume).

While urbanization will drive the location of industry and people, particularly in the developing world, these agglomerations of economic activity will be the focal points of increasing greenhouse gas emissions. On climate change, The Growth Report stakes out a view energized by the Commission’s chairman, Nobel laureate Michael Spence, as well as that of his own mentor, Nobel laureate Thomas Schelling, namely, that growth in the developing world should not be curtailed in order to reach emissions goals (Schelling 2007; also see part 4 of World Bank 2008a). However, developing countries need to be deeply involved in the climate change conversation given their collective status as major global emitters. The realities are such that (a) even if the OECD countries curtailed all emissions tomorrow, we would still be on a collision course with respect to global temperatures; (b) the major incremental emitters will be the EDMEs; and (c) the carbon intensity of growth in some EDMEs far exceeds that in the advanced world (Energy Information Administration 2009; World Bank 2008a).

What conclusions can one draw from this evidence, and what does it imply for global growth and sustainability? First, The Growth Report makes the important point that from an economic perspective, the correct policy is to reduce emissions efficiently, namely, at the lowest cost per ton, regardless of where the pollution takes place. Of course, because of national borders, one has to distinguish among emitters, and here the second principle
kicks in—namely, that the cost of this efficient abatement needs to be distributed fairly. This means taking into account not only ability to pay, but also the record of what got us to this point. The report is careful, however, not to place an exclusive burden on the rich countries either, since much of the past growth (although not environmentally sound) is also responsible for massive income gains in the poorer parts of the world. Thus the burden-sharing formulas need to be internationally negotiated, and in these conversations, the efficiency of the global growth generation machinery also needs to be considered.

*The Growth Report* discusses decision making under extreme uncertainty; although global damage is expected from climate change, there is still major uncertainty as to the degree and the exact tipping point (Nordhaus 2006; see also Wheeler and Mendelsohn in chapters 11 and 12, respectively, of this volume). This uncertainty argues for a robust feedback loop based on the gathering of new information and, as a corollary, an option for dealing with the problem, but not in so drastic a fashion as to compromise longer-term growth that might offer better solutions. Again, if the approach is to attack the major sources of pollution, then one must do this in an economically efficient and affordable way.

The fourth major trend that is fairly evident is the increasing intranational inequality (for data on inequality trends between countries, see United Nations 2006). This is reported in a variety of country circumstances and, as expected, with different policy responses. As reported by Bourguignon for the World Bank, an increasing number of developing countries have seen positive growth in the last 10 years, but an overwhelming proportion (42 out of Bourguignon’s sample of 59) have also experienced a decline in income equality since 1990 (Bourguignon 2007). If, as in the case of Vietnam, these twin phenomena of high growth rates and rising inequality (from a low base) are combined with rapid reductions in measured poverty, this can be seen as a positive development, probably inevitable in the development process. However, in some regions like Latin America, the underlying inequality is substantial, with the top quintile capturing more than 60 percent of national income and, in Brazil, for example, outpacing the lowest 40 percent by a factor of 8 to 1 in 2003. In other regions like East Asia, the underlying inequality is less pronounced; however, the change in income shares between 1996 and 2004 are stark, with each higher quintile outearning the previous one by a significant margin (IMF 2007).

In the advanced countries, the OECD reports that the middle three quintiles of the distribution lost ground between 1995 and 2005 in terms of income shares in Canada, Denmark, Finland, France, Germany, Italy, Norway, Sweden, and the United States. The bottom quintile was either stable or lost ground in all 26 countries surveyed except Italy and Mexico. In their book on the middle class, Estache and Leipziger (2009) urge a closer look at the impact of government’s fiscal policy on the entire spectrum of income groups. Ignoring the middle class and the downsides of globalization has, in the past, threatened the political support for domestic
and internationally welfare-improving policies and could do so again. This is due to the fact that income determinants are many, and distributional concerns are a matter of local politics. This has never been more true than in the aftermath of the current crisis, which has claimed millions of jobs worldwide (Estache and Leipziger 2009; OECD 2008).

Increasing inequality is seen as a corollary of globalization in nations as diverse as China, India, and the United States. In reality there are many explanations for this rise. The IMF points to technology as the main driver, ascribing the bulk of change to this factor and very little to globalization per se (IMF 2007). And there are no doubt differences between the rise in China’s Gini coefficient from 0.28 in 1981 to 0.42 in 2004, which accompanied tremendous urbanization and new job creation, from the situation in the United States, where, according to Goldin and Katz (2007), the wage premium to education rose dramatically after 1980, exacerbating inequality. In the case of the United States, according to Lawrence (2008), wages of blue-collar occupations rose by just 4.4 percent between 1981 and 2006, while output per hour was up 70 percent. Following the views of Blinder (2009) would lead one to believe that it is no longer investment in education broadly speaking that matters, but rather investment in education that personalizes services and discourages their offshoring. The bottom line, however, is that income has become more uneven in recent decades, and the public believes that this is largely due to globalization—which is not good news for globalizers.

As ardent globalizers like Jagdish Bhagwati argue, the benefits of globalization, particularly in trade, are enormous, but there is a problem of transition and compensation. Bhagwati argues for adjustment assistance for poorer countries, while Blinder points out that adjustment assistance has never worked in the United States. Those who see fundamental flaws with the path of globalization, like Stiglitz (2002, 2006, 2009), point to the inadequacy of compensation mechanisms, the inherent asymmetry of economic power, and yes, the failure of financial regulation. As Leipziger and Spence argued in 2007, the concern about winners and losers is less about fairness than it is about the practical need to maintain political support for policies and international agreements that advance openness in the global economy (Commission of Experts 2009; Leipziger and Spence 2007; Stiglitz 2002, 2006).

The future shape of globalization is, according to some, very much in doubt. What is certain, though, is that developing countries will face new challenges to growth and must approach the current environment in anything but a business-as-usual manner. The papers assembled for this volume seek to sketch the outlines of the future growth dynamics, particularly for developing countries, as well as to stimulate debate and suggest possible ways forward.

11 Goldin and Katz (2007); Lawrence (2008). Lawrence finds that, while wage inequality did increase, a larger portion of the wage gap was due to measurement issues and education of non-blue-collar workers.
The Distinct Contributions of the Volume

In chapter 2 of this volume, Daron Acemoglu provides an ideal opening to a volume on globalization, elaborating on the intellectual errors economists have made in view of the crisis and what lessons these errors offer us moving forward. More important, he argues that key economic principles related to the most important goal of economic performance, the long-run growth of nations, are still valid and hold important lessons for intellectual and practical deliberations on policy. Acemoglu emphasizes the importance of technological innovation for the prosperity and success of the capitalist economy. However, despite their positive impacts on long-run economic growth, innovation and reallocation have been conspicuous in their absence from the political debate and have played little role in the design of crisis management responses. Acemoglu highlights why a focus on economic growth is essential. Barring a complete meltdown of the global system, the possible loss of GDP for most countries is in the range of a couple of percentage points. In contrast, modest changes in economic growth will accumulate to much larger numbers within one decade or two. Thus, from a policy and welfare perspective, sacrificing economic growth to deal with the current crisis is a bad option. Economic growth ought to be a central part of the discussion, not an afterthought.

Acemoglu also addresses the dangers posed by growing skepticism toward globalization and the political economy of growth. He reminds us that, because of the reallocation and creative destruction brought about by economic growth, there will always be parties, often strong parties, opposed to certain aspects of economic growth. Thus one of the major risks facing globalization is one of consumers and policy makers becoming pessimistic about future growth and the promise of markets. Ultimately, the crisis should be regarded as a failure not of capitalism or free markets, but, according to Acemoglu, of unregulated markets.

In chapter 3, Charles Calomiris elaborates on the regulatory failures that contributed to the onset of the financial crisis. While he, like many others, acknowledges that regulation was a primary contributor, he argues that the problem was less a lack of regulation than bad regulation. Calomiris does not agree with those who argue that the subprime crisis is mainly a story of government “errors of omission,” which allowed banks to avoid regulatory discipline due to the insufficient application of bank capital regulations. Instead, the main story of the subprime crisis, in his view, is one of government “errors of commission,” which were far more important in generating the huge risks and large losses that brought down the U.S. financial system. Government actions were the root problem, not government inaction. Calomiris references the literature to make his point that in times and places where these government interventions were absent, financial crises were relatively rare and not very severe.

However, realizing the need for appropriate regulation given the complexity of today’s system, Calomiris details six categories of policy reform
that would address the weaknesses that gave rise to the subprime crisis, including (a) smarter “micro prudential” regulation of banks, (b) new ideas for “macro prudential” regulation of bank capital and liquidity standards, (c) the creation of detailed and regularly updated prepackaged “bridge bank” plans for large, complex financial organizations, (d) reforms to eliminate the distortions in housing finance induced by government policies that encourage high risk and leveraging, (e) reforms to improve stockholder discipline of banks, and (f) initiatives to encourage greater transparency in derivatives transactions.

In chapter 4, Andrew Sheng applies network theory to the behavior of global financial markets and draws implications for supervision and governance. Sheng suggests that new insights in this area could assist theoreticians and practitioners in understanding better how markets work and how to improve current policies. Sheng begins with the premise that a system cannot be regulated unless policy makers have a complete understanding of how it works. The collapse of Lehman Brothers highlighted the nature of modern financial crises in terms of their complexity, depth, speed of contagion, and transmission. The scale of loss was unprecedented—a painful demonstration that financial regulators and policy makers did not understand the animal with which they were dealing.

Sheng highlights the need for a framework to simplify the understanding of such complex markets, in which the interaction between market participants operating under asymmetric information is dynamic, but not always stable. Such a framework needs to deal not only with a systemwide perspective, but also with vulnerabilities at the detail level—that is, the weakest link. While the network analysis does not have predictive capacity, it is useful in laying out an organizational framework to decipher current behavior, revealing our lack of appreciation of the problems of externalities, wrong incentives, weak structures, and flawed processes. The major insight of network analysis is that the process of change is not linear. In fact, it is interactive, interconnected, and the outcome of experimentation, accident, and manipulation by system participants, including financial institutions, investors, regulators, and policy makers.

In chapter 5, Richard Cooper argues that global imbalances in current account positions are a natural consequence of the globalization of financial markets and demographic trends, particularly in Europe and East Asia. Those societies are aging rapidly, with declining numbers of young adults. In both regions, savings should be high and investment weak, resulting in excess saving. With globalization of capital markets, this excess saving will naturally seek secure investment opportunities abroad. The U.S. economy, where demographic trends are markedly different (due in part to immigration of young adults), offers a good combination of yield, liquidity, and security for this excess savings, which in time will be liquidated to finance consumption in old age. Thus the large “imbalance” does not obviously reflect disequilibria in the world economy, but rather a current phase of intertemporal trade.
Speaking at the World Bank in 2009, Cooper gave positive views on the future of globalization, despite the crisis, crediting the growth and integration of the world economy in the past half century, and especially in the past two decades, for driving the biggest reduction in both relative and absolute poverty in history. However, he was careful to mention that the current crisis does pose serious dangers, foremost among them the potential popular backlash against globalization and trade in particular. A significant protectionist reaction on the part of large trading nations would have a major negative impact on long-term growth. Cooper regards financial crises as inevitable in any modern economy; the challenge to policy makers is not to prevent crises, but to limit the real damage and to be ready to take advantage of the post-crisis environment in proposing effective regulatory reforms. Cooper argues that thus far post-crisis management has failed on both these counts (Cooper 2009: 320–32).

In chapter 6, Ravi Kanbur addresses a question that is central for policy makers concerned with helping the poor during macroeconomic crises, namely, how to target scarce resources at a time of greater need. Technical arguments have suggested that finer targeting of anti-poverty initiatives, through tightening individual programs or reallocating resources toward more tightly targeted programs, leads to more efficient resource use—even when the greater information costs and the incentive effects of finer targeting are taken into account. However, political economy arguments suggest that finer targeting that results in fewer overall resources being allocated is short-sighted and that looser targeting, because it knits together the interests of the poor and the near-poor, may well be preferable. The snowballing effects associated with the near-poor being pushed into poverty by the crisis and the general desire to uphold basic consumption levels among groups in the lower part of the distribution imply that leakier programs may well be preferred in times of dramatic economic downturns.

Kanbur’s chapter is particularly appropriate in the current environment because no volume on globalization, growth, and the financial crisis would be complete without a discussion of the effects of the crisis on the poor. While the crisis has dominated headlines for bringing down some of the world’s most storied financial institutions, its effect on the poor has received less attention. According to the World Bank, 90 million more people lived in extreme poverty in 2009 as a result of the crisis. In the post-crisis environment, strategies and policies to mitigate the effects of the crisis on the poor are sorely needed. While distributional concerns always matter, they become even more relevant in periods of declining income. How one mitigates the worst consequences of crises also plays an important role in shaping the future path of recovery, and indeed, the future role of globalization in developing economies, a topic addressed in part 2.

Part 2 of the volume shifts focus from the immediate crisis to the impact of the crisis on developing-country growth. In chapter 7, Dani Rodrik examines the global environment for economic growth in the developing world as it emerges from the present financial crisis. For Rodrik, the answer
depends on how well the following tensions are managed. On the one hand, global macroeconomic stability requires that we prevent external imbalances from getting too large; on the other hand, growth in poor nations requires that the world economy be able to absorb a rapid increase in the supply of tradables they produce.

Rodrik’s views have major policy implications. He argues that it is possible to render these two requirements compatible, but that doing so will require greater use of explicit industrial policies in developing countries that have the potential for encouraging modern tradable activities without spilling over into trade surpluses. He asserts that the key to growth is the domestic output of modern tradables, not the excess supply thereof. The implication for developing nations that have gotten hooked on trade surpluses as their engine of growth should be clear: there is no need to sacrifice growth as long as domestic demand for tradables can be increased alongside domestic supply.

In chapter 8, Antonio Estache and Marianne Fay provide an overview of the major current debates on infrastructure policy given the relationship between infrastructure development and economic growth. They review the evidence on the macroeconomic significance of the sector in terms of growth and poverty alleviation and discuss the major institutional debates, including the relative comparative advantage of the public and the private sectors in the various stages of infrastructure service delivery as well as the main options for changing the role of government (that is, regulation and decentralization).

While the heterogeneity of the infrastructure business is such that it is difficult to draw specific conclusions for any given subsector or country, Estache and Fay find that some general conclusions can be drawn. First, while the literature on infrastructure and growth teaches us that infrastructure is important, its importance varies across countries, within countries, and over time, as countries change and the binding constraints shift. Second, there is still a long way to go in meeting the infrastructure needs of the poorest countries of the world. Third, privatization has not delivered as much investment as expected, and those without access to infrastructure services are the most penalized by this failure. Estache and Fay find that one of the main reasons for a lack of clear-cut answers regarding infrastructure is the lack of objective data on the sector, which leaves it vulnerable to ideological rather than fact-based decision making. Data gaps are highlighted throughout their overview, including on basic issues such as costs and tariffs or the share of public or private resources allocated to expand or maintain the sectors. They argue that to produce substantive answers to core questions without recourse to ideology, it is essential for the international community to take the data agenda much more seriously than in the past. Furthermore, in light of the crisis and falling infrastructure finance, particularly in private sector funding, new ideas on how to move forward in the sector are needed.
William Cline in chapter 9 revisits his 1982 article on the “fallacy of composition,” reexamining it in light of the current environment. Cline’s original argument questioned the feasibility of generalizing the G-4—Hong Kong, China; Korea; Singapore; and Taiwan, China—model of growth based on the rapid growth of exports, on the grounds that if all developing economies pursued it, their combined manufactured exports would eventually trigger protection in industrial countries. His 1984 book identified a safe speed limit of about 10–15 percent annual growth of developing country exports of manufactures, well below the 25–35 percent rate of Korea and Taiwan, China in the 1960s and 1970s.

Cline’s chapter in this volume revisits this question in light of a quarter century of experience. It finds that developing countries’ aggregate manufactured exports grew at about 10 percent annually, a robust pace, but within the speed limits previously envisioned. Even so, in key sectors such as apparel, import penetration levels have exceeded thresholds that, according to earlier estimates, would provoke protection, suggesting the importance of increased WTO discipline. The base of manufactured exports from poor countries remains small relative to that of China and the original G-4, so there should be considerable room for export growth from these newcomers. Although he does not explicitly address the postcrisis world, one conclusion to draw from Cline’s argument is that the aggregate shift in demand away from exports in large emerging markets may open more export space for poorer developing countries. When combined with the rapid growth in South-South trade, this offers some renewed hope for the model of export-led growth for less developed countries.

In chapter 10, Philippe Aghion, David Hemous, and Enisse Kharroubi evaluate whether the cyclical pattern of fiscal policy can affect growth. This is a particularly important topic in light of the current efforts in developed and large developing economies to stimulate domestic demand through fiscal measures. This chapter, similar to chapter 2, questions long-standing assumptions in the study of short-term and long-term economic performance. According to the authors, macroeconomic textbooks generally impose a strict separation between the analysis of long-run growth and the short-term analysis, which focuses on the effects of macroeconomic policies (fiscal or monetary) aimed at stabilizing the economy following shocks. Yet recently this view that short-run stabilization policies do not matter for long-run growth has been challenged.

This chapter goes further, looking at the effect of countercyclical fiscal policy on industry growth, depending on industry financial constraints. Empirical evidence shows that industries with heavier financial constraints tend to grow faster in countries with more stabilizing fiscal policy. The authors’ main empirical finding is that the interaction between financial constraints in an industry and fiscal policy countercyclicality has a positive, significant, and robust impact on industry growth of comparable (or even greater) importance to that of more structural features. Practically speaking,
this has far-reaching implications for the conduct of macroeconomic policy over the business cycle, with both ex ante and ex post effects on innovation and productivity. A more countercyclical fiscal policy increases the incentives for innovation ex ante by reducing the risk that innovation will fail in the future due to adverse macroeconomic shocks; ex post it helps to reduce the proportion of firms that will have to reduce productivity-enhancing investments following a major shock.

Part 3 of this volume looks at long-term challenges to growth. In chapters 11 and 12, David Wheeler and Robert Mendelsohn, respectively, address issues of climate change in light of current debates on its regulation and impact on economic growth. Both chapters acknowledge that much uncertainty still exists on the nonscientific aspects as well as the scale, scope, and timing of certain initiatives (World Bank 2009c). While both authors agree that the science is clear that the buildup of greenhouse gases will cause the earth to warm, they have different assessments of the potential economic impacts of warming. They both agree, however, that the challenge is to develop a strategy that supports at the very least moderate measures now in order to retain the potential for more rigorous measures when the economics and politics become feasible. They are also in agreement that developing countries must be full participants because they will be most heavily affected by global warming and because the scale of their emissions is rapidly approaching parity with that of developed countries.

In chapter 11, David Wheeler addresses the implications of climate change for developing countries and public policy, arguing that efficient mitigation of emissions will require carbon pricing via market-based instruments (charges or auctioned tradable permits). To lay the foundations for confronting the global challenge, he advocates two priority actions. The first is to establish an international institution mandated to collect, verify, and publicly disclose information about emissions from all significant global carbon sources. The second is to establish four global consortia charged with (a) the reduction of greenhouse emissions, (b) the accelerated development of clean technologies, (c) the financing of their rapid diffusion in developing countries, and (d) the support for developing country adaptation to the impacts of unavoidable climate change. These consortia should be empowered to set objectives and priorities using the best available scientific, technical, and economic evidence. Their operations should be transparent and independently audited for results.

In chapter 12, Mendelsohn argues that the impact of climate change on the global economy is likely to be quite small over the next 50 years and that severe impacts even by the end of the century are unlikely, despite the grim descriptions of the consequences of climate change for long-term economic growth. In reality, according to Mendelsohn, long-term economic growth is threatened more by excessive near-term mitigation efforts than by climate change. Mendelsohn asserts that because marginal damages rise as greenhouse gases accumulate, the optimal policy is dynamic, growing stricter over time. This balanced economic approach to the problem
will address climate change with minimal reductions in economic growth. Partly, this dynamic policy reflects the fact that technical change is going to improve our ability to control greenhouse gases over time. The more aggressive the near-term mitigation program, however, the greater the risk that climate change will slow long-term growth.

Finally, in chapter 13, Bloom, Canning, and Fink examine demographic change, a field that the IMF regards as the major threat to long-term fiscal solvency (IMF, Fiscal Affairs Department 2009). They examine the impact of population aging on the labor force and the implications for long-term economic growth. Although labor force participation rates are projected to decline during the period 2000 to 2040 in most countries, due mainly to changes in their age distribution, the ratio of labor force to population will increase in most countries. This is because low fertility will cause lower youth dependency that will offset the skewing of adults toward the older ages when labor force participation is lower. The increase in labor force to population ratios will be further magnified by increases in age-specific rates of female labor force participation associated with lower fertility. These factors suggest that economic growth will continue apace, notwithstanding the phenomenon of population aging.

For the OECD countries, the declines projected to occur in both labor force participation and the ratio of labor force to population suggest modest declines in the pace of economic growth. But even these effects can be mitigated by behavioral responses to population aging—in the form of higher savings for retirement, greater labor force participation, and increased immigration from labor-surplus to labor-deficit countries. Countries that can facilitate such changes may be able to limit the adverse consequences of population aging. When seen through the lens of several mitigating considerations, there is reason to think that population aging in developed countries may have less effect than some have predicted. In addition, policy responses related to retirement incentives, pension funding methods, investments in health care of the elderly, and immigration can further ameliorate the effect of population aging on economic growth.

To conclude, this volume brings together expertise from around the world on a wide range of subjects that will affect the economic growth of developing countries in the years to come. Part 1 provides detailed analysis of the contributing factors, at both the national and global levels, that led the world economy into the morass in which it currently finds itself and proposes novel ideas for reform. Part 2 explores specific policy ideas relevant to the economic growth of developing nations in a post-crisis world. Part 3 lays out long-term trends and challenges that all countries will have to navigate in their quest for growth, made newly relevant by the pressures of the current environment. At this point in the evolution of the financial and economic crisis, it is clear that they will cast a long shadow over the development process, especially for poor countries. This volume seeks to shed light on the state of the post-crisis world and possible ways forward.
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