



# Economic Premise

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## Ascent After Decline: Challenges of Growth

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*This note examines one of the most fundamental questions to emerge from the Great Recession of 2007–9: how to regrow global economic growth going forward? Although all are painfully aware that it may be 2013 or 2014 before the global economy returns to normalcy, no one is sanguine about medium- to long-term growth prospects. For this reason, the challenging task of “regrowing growth” will take center stage for politicians and policy makers alike. One point is clear: without a resurrection of strong economic growth in major economies, the likelihood of rapid economic development in poor developing countries is diminished.<sup>1</sup> How various elements will affect growth prospects is less clear, but vitally important. In the terminology of Hausmann and Rodrik (2003), this is a process of discovery and we are in somewhat uncharted territory.*

A sharp cleavage has become evident between the prospects and challenges facing advanced economies and those facing emerging and developing economies. Attention in the advanced economies has focused on the financial sector, where the global crisis originated, and on government balance sheets, which have been affected by the economic downturn, bailout costs, and the need for massive fiscal stimulus. At the same time, to avert another Great Depression, monetary policy has been pressed into service in an unprecedented manner—from a coordinated cut in policy interest rates in October 2008 to operations aimed at increasing liquidity in the nonfinancial corporate sector and rounds of quantitative easing (QE) in advanced economies.

The euro area faces serious difficulty from its dependence upon bank credit and a sovereign debt problem in vulnerable euro area countries that has compounded the problems of banks holding government securities. These problems began with the bailout of Greece in April 2010 and spread to Ireland, Portugal, and Spain, despite the creation of a €750 billion stabilization fund and substantial purchases of government bonds

by the European Central Bank. The Greek debt restructuring has done little to calm markets and a Euro-recession is happening. Added wrinkles include the urgent need for fiscal consolidation in some countries and proposals to revamp prudential regulations and capital adequacy requirements, which could adversely affect loans extended by banks in the short run even as they reduce volatility and bolster the health of the financial system over the long run.

In contrast, with a few exceptions, emerging and developing economies remained robust sources of growth (Canuto, Garcia-Kilroy, and Silva 2011). In most, the recovery moved beyond the replenishment of inventories and toward consumption and investment, with large increases in industrial production using up excess capacity. Capital flows resumed and credit growth increased, to the point of leading most emerging economies to apply anti-inflation policies last year. However, as highlighted by Canuto and Leipziger (2012), the relatively weak growth prospects in advanced economies and the interdependence between the two sets of economies pose serious coordination challenges, and emerging markets, in-

cluding China, are no longer immune to the prolonged global low-growth scenario.

## Obstacles to Global Recovery

The main obstacles to recovery include uncertainty in financial markets, mounting sovereign indebtedness, growing solvency concerns in the euro area periphery, a huge amount of maturing bank debt, and exposure of both households and banks to stagnation in the real estate sector. The real estate sector will pose a drag on the recovery and will continue to be a source of risk to the financial sector for a while (Roubini 2010; Shiller 2010). Damaged balance sheets and lack of confidence have conspired to limit economic recovery in the United States, while Euro-skepticism has hurt European growth prospects.

Against this background, limited room remains for monetary and fiscal policy maneuvering in advanced countries. A delicate balancing act is called for—in particular, how to manage the handoff to private demand as fiscal stimulus fades, while ensuring that fiscal consolidation itself does not worsen recovery prospects to the point where sustaining public finances slows growth and reduces fiscal revenues.

In the medium term, the return to strong growth is threatened by:

- *Rising debt levels.* According to the IMF (2010), if growth is 1 percent less than in the IMF *World Economic Outlook* baseline between 2010 and 2015, gross government debt in the advanced economies will exceed 120 percent of gross domestic product (GDP), compared to less than 110 percent in the baseline. For individual countries, the baseline versus slow-growth scenario in 2015 is eye opening: 250 percent versus 269 percent of GDP for Japan; 110 percent versus 122 percent for the United States; and 86 percent versus 99 percent for the United Kingdom.<sup>2</sup>
- *Reduced trade prospects.* Whether the movement of nominal and real effective exchange rates is enough in magnitude and direction to achieve a global rebalancing of demand has become a controversial topic. In the absence of coordinated actions to facilitate global adjustment, pressures for protectionist measures could arise.
- *Global imbalances.* A related concern is that, after initially shrinking, trade deficits restarted widening in external-deficit countries where significant output gaps exist; that is, these economies have excess capacity, with GDP in some cases significantly below potential. The opposite was then happening in external-surplus countries, and if this situation persists, it could end up derailing global recovery. Doubts remain on whether exchange rate moves and differential growth rates will be enough to correct imbalances at an appropriate speed.

## Rebalancing Global Demand

The “strong, sustained, and balanced growth” sought by the G-20 (2010) rests on two feats of rebalancing: (a) *internal rebal-*

*ancing* in advanced countries, with private demand stepping into the breach as fiscal consolidation occurs, and (b) *external rebalancing*, involving a reduction in current account deficits in countries like the United States and a corresponding reduction in current account surpluses, particularly in emerging Asia and in China.

The big questions are, first, to what extent will uncertainty in financial markets, problems in the real estate sector and on private balance sheets, and the end of restocking impede private demand from firing in the advanced economies, and second, whether the domestic demand in emerging economies, while robust in many, will compensate for weaker aggregate demand in the advanced economies.<sup>3</sup>

A crucial consideration, as noted above, is that the room for fiscal and monetary policy maneuvering in the advanced countries is now limited. The second round of QE in the United States ignited a fierce debate about a return to currency wars and the perceived negative collateral damage to emerging economies as the money created spills over via the carry trade. One view is that such easing and other subsequent monetary policy decisions have been more of attempts to avoid a slide into deflation than to surreptitiously engineer a devaluation of the dollar; with monetary policy rates close to zero and a political impasse over further fiscal stimulus, those easing policies have been the only available option (Dudley 2010; Brahmabhatt, Canuto, and Ghosh 2010).

The trend of decreasing output growth rates in advanced economies will have significant negative repercussions for fiscal revenues relative to the precrisis situation, with adverse consequences for public debt dynamics unless eventually public expenditures are cut or taxes increased. Capital and labor will need to be reallocated from declining to expanding sectors, posing major social challenges. This shift also means that the demand for consumer durables and investment-goods imports by advanced economies will be below precrisis trends during the transition. Emerging economies that rely heavily on such demand will have little choice but to augment domestic sources of demand to achieve growth rates similar to those that prevailed before the crisis.

All of these trends mean that, globally speaking, emerging economies will have a difficult time compensating fully for the fall in potential output and demand in the advanced economies. Growth in emerging markets and developing countries in general has exhibited some resilience, but the global economic growth may remain subpar for longer than it would be the case if smart national policies and multilateral coordination were in place.

## The Changing Landscape for Growth

Many developing countries were mercifully spared the worst of the initial shock because their financial sectors are too poorly developed to take on high-risk transactions. In addition, the

normally precarious external environment was such that those countries tended to manage their macroeconomic policy more cautiously. In the case of emerging economies, the previously acquired fiscal space for anti-cyclical policies, combined with accumulated foreign reserves and a margin to maneuver and ease monetary policies allowed them to respond well to the formidable shocks from advanced economies in 2008–9 (Canuto and Lin 2010).

What can the changing landscape mean for medium-term growth in developing- and emerging-market economies? And can the talk of delinking, multipolarity of growth, and the rise of Asia fundamentally alter their policy options? At one basic level, the domestic policy imperatives remain the same—namely, to save more, invest better, and derive more value added from exports, while increasing human and physical capital to raise long-term productivity. Those challenges remain, as ever, the basic task of development.

Still, although the Growth Commission's Supplemental Report (CGD 2009) left the essential recommendations of its 2008 Growth Report (CGD 2008) unchanged, the returns once expected from the export-oriented, outward-looking strategy may have declined. This is an important finding. It is revealing because countries have increasingly found that the standard prescriptions attached to the basic growth paradigm do entail variations, especially concerning the role of government in the development process. Moreover, if the landscape has fundamentally changed, policies need to adapt further as well (box 1).

The issue of policy formation revolves around a number of questions whose answers are not yet totally clear. How fundamentally, for example, has the economic landscape changed? El-Erian (2009) describes a "new normal" in which fiscal imbalances and rising debt will take their toll and raise the cost of borrowing. According to Chinn, Eichengreen, and Ito (2012), we can expect imbalances between China and the United States to reemerge. Others point to the continuing rise of income inequality as a major threat to the open trading system and also cite the strong asymmetries between job creation and job destruction that drive global externalities of national policies (Leipziger 2012; Spence 2011; Stiglitz 2011). Aghion and Cagé (2012) examine how the role of government in the production of innovation must fundamentally change as well. How might these new trends play themselves out? Will existing multilateral institutions retain sufficient support to help restrain a new economic nationalism? And will the multilateral system be under greater stress?

On the side of fiscal imbalances, debt, and capital flows, there have been bouts of short-term enthusiasm for emerging markets because of the abnormally low yields in the United States and the precarious state of the euro. This situation has prompted some countries, like Brazil and several others, to impose capital import taxes. Still, the lure of an appreciating cur-

rency combined with excessively high domestic real interest rates makes Brazil appealing. But will this allure last when rates normalize in the Organization for Economic Co-operation and Development (OECD) countries and when domestic debt must be financed and yields rise? If not, the new steady state facing emerging-market and developing economies (EMDEs) might be capital shortage, not capital surplus. The policy conclusion is that domestic resource mobilization efforts may need to be strengthened because international flows may be more selective and less inclined toward the short term. That EMDEs should be wary of volatile short-term flows is correct, and some have been proponents of the Chilean disincentives of the 1990s toward hot flows (Perry and Leipziger 1999); however, with large infrastructure needs and high social expenditures in many countries, capital may still be in short supply.

Related to capital flows and the need to maintain a competitive exchange rate without subsidizing exports (either explicitly or implicitly), there is the issue of how far to rely on exports as the growth engine. The economic environment that faced the Republic of Korea and original East Asian Tigers served them well, and they in turn have benefited from the incredible growth performance of China. But how do new developments affect newer entrants into global markets? Specifically, what is the impact of China's thirst for raw materials and its slowly rising labor costs, which retains its manufacturing market, at a time of slow world growth?

China's rise has been unprecedented, and along with its dramatic export performance has come a new scale of demand for natural resources from poorer countries. This is beneficial overall, but when will China relinquish its dominance of low-end manufactures and allow what Cline (2010) referred to as the "adding-up problem" to absorb new producers? The answer: as soon as China can move up-market and capture further higher-value-added export markets.

This is where the problem becomes dicier, because developed economies, faced with an unprecedented combination of joblessness and offshoring (Blinder 2005, 2007, 2009), may not be politically able to maintain open markets for countries that run persistent imbalances while also subsidizing their exports. Hence emerges (a) the argument that poorer countries need open markets more than do emerging-market economies that can actively promote shifts to what Rodrik (2010) calls "modern tradables" to gain a foothold in global markets, and (b) the concern that poorer countries' turn in the queue may be jeopardized by China's ambitious export goals. If what Chinn, Eichengreen, and Ito (2012) predict is accurate about the lack of adjustment by the two great imbalancers (China and the United States), and if these persistent imbalances lead importers to push back trade openness, then the prospects for poorer developing countries may become dimmer.

## Box 1. Policy Responses as Suggested by *Ascent After Decline: Regrowing Global Economies After the Great Recession*

**Rebalancing Global Growth:** To insulate growth from the pernicious effects of slowly declining current account imbalances, combined with capital flows searching for yield, there are several venues for action:

- *Financial regulation*—regulatory reform, particularly cross-boundary coordination.
- *Central bank policy*—consider imbalances and asset prices in formulating monetary policy and minimizing threats to growth.
- *Fiscal policy*—tighten fiscal policy proactively.
- *Cross-border coordination*—countries must coordinate actions, and countries with large deficits urged to consolidate.
- *International financial architecture*—access to emergency financing through pooled reserve arrangements, bilateral swap lines, or from a special facility at the IMF would be a plus.

**Fiscal Policy and Growth:** The pressing question of how to adjust fiscal policy while maximizing the positive benefits for growth has no easy solution. Public indebtedness, especially in advanced economies, is already so high that merely stabilizing it may have highly negative consequences for potential growth. Lowering indebtedness to thresholds that empirical studies indicate are safe, from the growth perspective, would take a Herculean effort. Reducing public debt in advanced and emerging economies to 60 percent and 40 percent of GDP, respectively, by 2030 would involve a staggering increase in cyclically adjusted primary fiscal surpluses—by 8.25 percentage points of GDP for advanced economies and by 3 percentage points for emerging economies during 2011–20, with the primary surplus kept at this level until 2030. The big question then is whether an adjustment of this magnitude will have adverse consequences for growth because of the aggregate demand effects.

**Infrastructure Policy for Shared Growth Post-2008:** The infrastructure sector attracted attention as a quick fix during the global crisis. In G-20 countries, infrastructure accounted for 20–30 percent of the average fiscal stimulus package: policy makers and politicians believed that public infrastructure projects might be the silver bullet to create jobs and keep up demand. Although the financial sector and its regulation received most of the attention in the aftermath of the global crisis, infrastructure (which accounts for 12–18 percent of GDP) warrants a similar level of scrutiny. Policy makers tend to focus on the benefits of infrastructure, paying little heed to the rents extracted by construction firms, bankers, and operators—the burden of which ultimately falls on taxpayers. Regulation must restore balance among the key stakeholders—namely, operators, users, and taxpayers. So far, investors and operators have been the big winners, and there has been increasing political reluctance to get users to pay fully.

**Rethinking Growth and the State:** No one will seriously challenge the idea that regulation, whether in finance or infrastructure, is a fundamental government role that, if anything, needs strengthening. The issue is not so much *size* but *smarts* when it comes to defining the government's role, especially after the recent global crisis. Consider the following aspects of the state's policy role in knowledge investment:

- *Education funding*—countries will benefit from increased research funding.

- *Worker retraining*—subsidies are likely to be needed to retrain workers as part of a *liberalization* of trade or entry strategy.
- *Research and development (R&D) spending*—R&D are critical to firms' long-run growth, and could be useful for macroeconomic stabilization.
- *Climate-related innovation*—a two-pronged approach might work best: carbon pricing to discourage dirty technology, combined with subsidies to simultaneously encourage clean innovation.
- *Industrial policy*—consider a policy that targets subsidies to several firms in a given sector, spurring innovation as firms compete against each other, leading to higher productivity and stimulating new product creation.

**Financial Shocks and the Labor Markets:** Save first financial institutions or jobs? The usual answer is that saving jobs might require saving financial institutions first. But so far, despite vast sums spent to bail out and shore up the financial sector, unemployment remains high. Yet, there are still reasons to focus on financial institutions: their systemic significance, the difficulty in deciding which sectors to pick for saving jobs, and the standard moral hazard arguments, which might predispose firms to build up leverage in anticipation of being helped. Going forward, a strong focus should be on job-creating competition policies and easing barriers to entry because the lion's share of net job creation is in start-up firms.

**Information Technology, Globalization, and Growth:** How can information technology (IT) boost growth prospects? The standard channel is its positive impact on total factor productivity growth as a result of innovation. Three key variables influence economic welfare and growth: terms of trade, economies of scale, and variety. The secular fall in the quality-adjusted prices of IT products (and hence, a potential decline in the terms of trade) would tend to favor consumers and importers; at the same time, economies of scale combined with the ability to import inputs (which also benefit from scale economies) could benefit exporting countries. Incentive for businesses to do existing things better is where the real IT benefits lie. A good strategy for a developing country might be to join a global supply chain and eventually create better conditions for using IT at home, which is where the growth potential of IT lies.

**Innovation-Driven Growth:** One thing is clear: innovation must be a key component of the new growth strategy—which in itself is not a novel idea. What is novel is that the process of innovation is undergoing radical change through open innovation, global innovation chains, and the facilitating role of new technology platforms such as the Internet. Key considerations of the new growth strategy include:

- An increase in human capital operating through technology has a bigger impact on GDP than deregulation, which operates through a positive impact on services.
- Although a decrease in regulation and an increase in harmonization have similar effects, harmonization has a bigger beneficial impact on services, while technology benefits more from deregulation.
- The ultimate driver of growth is technology accumulation, and this is strongly supported by human capital accumulation.
- Delay in implementing policy change will be costly for productivity and growth.

Source: Canuto and Leipziger 2012.

## Forging the Link between Medium- and Long-Term Growth

It is incorrect to assume that all is written in stone: if the crisis has taught one lesson, it is that when fundamental shifts occur, the outcomes will entail new elements that shape future directions and affect policy choices. Given higher debt service costs in the medium term, risk capital will be scarcer. This shortage has implications, for example, for inherently risky projects in developing countries: namely, self-financing may become a necessity rather than merely an option.

New opportunities may need nurturing, and whether in the information and communication technology (ICT) area (Mann 2012) or through technological innovation (Aghion and Cagé 2012), government policy may emerge as vitally important to move growth rates back to their previous levels. With the medium-term outlook depressed—namely, with Japan, the eurozone, and the United States considerably below their potential output levels for years—others will need to pick up the slack. And in so doing, if successful, EMDEs may, like China, become new growth drivers (Canuto and Giugale 2010). Such a positive outcome requires action not only by developing countries, but also by major emerging-market economies that need to become custodians, along with OECD countries, of global institutions and rules (Leipziger 2012).

Major new economic players may increasingly see it in their self-interest to foster more-rapid convergence, not through the decline of the existing global powers, but by growing faster in a growth-conducive environment (Leipziger and O’Boyle 2009). That environment requires greater commitment from new and old economic powers.

### Conclusion

The Great Recession of 2007–9 was not simply a severe business cycle; the global economy’s preceding boom, though unbalanced and eventually unsustainable, also revealed deep structural changes in the global economic dynamic, and these are irreversible. Thanks to improved policies in much of the developing world and the corresponding opening of avenues toward convergence with advanced economies, the former acquired increasing weight and relevance. There is ground for a reasoned optimism regarding the maintenance of such policies and thus for the continuation of those changes in the future (Canuto and Giugale 2010).

At the same time, as mentioned by Leipziger and O’Boyle (2009), the emergence of new economic powers also entails risks if they seek convergence through high growth rates without incrementally taking on new responsibilities for maintenance of the system. Canuto and Giugale (2010) and Spence (2011) argue persuasively that there is a new path of convergence between emerging and advanced countries, and if so, the path of global reform will need to accelerate and the distribution of responsibilities reexamined. Along with a reconfigura-

tion of economic powers must also come a renewed commitment to multilateralism, both by the advanced economies under stress and the emerging economic powers who are ascending (Leipziger 2012).

Perhaps there will be a bifurcation of possible scenarios ahead: in the first, advanced economies reacquire the ability to grow, with a simultaneous global rebalancing of demand and supply, and global growth can facilitate rather than hamper necessary structural change. In the second scenario, the global economy remains trapped in a suboptimal trajectory, considerably below potential output, with the attendant strains in terms of political economy that make convergence more disorderly. Hopefully *Ascent after Decline* will be convincing about the need to strive toward the first path, and avoid the second.

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This note provides a bird’s eye view on Canuto’s and Leipziger’s *Ascent after Decline: Regrowing Global Economies after the Great Recession* (2012), <http://issuu.com/world.bank/publications/docs/9780821389423>.

### Notes

1. Canuto (2010) posits several sources of “autonomous growth” in developing countries, through which many developing economies will be able to keep growing even if advanced economies remain trapped in their current doldrums. As time passes, he sees a switchover of global locomotives taking place. However, a growth differential between developing and advanced economies may still emerge with higher or lower global growth rates, depending on the growth pace of the latter.
2. Presumably, the effects would be even more adverse if interest rates rise.
3. There are limits to this phenomenon, however, given that a rebalancing of global demand and supply happens gradually, and interdependencies still exist even in a more multipolar economic world.

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