

The Crisis and Beyond

Dani Rodrik

Forum Istanbul

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What I shall talk about

- What have we learned from the crisis
- What kind of a world economy will emerge in the aftermath of the crisis
- What are the main implications for economic policy in Turkey

Weaknesses revealed by crisis

1. Financial innovation has run ahead of ability of regulators to keep track
 - The financial system has been driven to excessively high leverage and risk-taking, due to
 - Agency problems
 - i.e., managers are inadequately disciplined by shareholders and award themselves compensation deals that reward one-way bets
 - Misaligned incentives
 - i.e., credit-rating agencies get paid by the same firms whose securities they rate
 - Moral hazard
 - i.e., firms that are too big too fail exploit implicit bail-out guarantees
 - Asymmetric information
 - i.e., securitization (CDOs) leads, in practice, to information loss

Weaknesses revealed by crisis

2. Global macro imbalances are a source of instability
 - Epitomized by the U.S-China trade relationship
 - China's growth model has come to rely increasingly on its trade surplus with the U.S.
 - Which, however, was unsustainable both for economic and political reasons
 - And by huge build-up of reserves in EMEs
 - Motivated by self-insurance against financial whiplash
 - Result is a “liquidity glut”
 - Leading to bubble in asset prices
 - And search for high-yield, but riskier investments

Weaknesses revealed by crisis

3. There are no adequate mechanisms to respond to financial crises at the global level
 - Regulatory response fragmented, despite clear spillovers
 - Fiscal stimulus not coordinated, despite clear spillovers
 - No lender-of-last resort to counter the “sudden stop” experienced by emerging and developing countries, which were innocent by-standers
 - Large build-up of reserves has provided at best partial cushion

Fixing the problems of financial globalization

- Tougher domestic regulations
 - Expand and deepen the scope of financial regulations
- Greater oversight and discipline over currency undervaluation and trade surpluses
- Improved global governance
 - Improved international guidelines
 - Financial Stability Board (the old FSF, with enlarged membership and responsibilities)
 - A revamped IMF with larger resources

Will these remedies work?

Several questions

- Do they go far enough?
- Do they recognize the need for national diversity?
- Do they rely too much on willingness and ability of major countries to provide leadership and surrender sovereignty?

(probably not, not really, and most definitely)

The post-crisis global setting

- Financial stability will be restored in the advanced countries eventually
- But developed countries (esp. U.S.) are unlikely to resume rapid growth soon
 - sizable wealth destruction + burden of public debt => slow consumption growth
- Plus, political constituency for “openness” in the advanced countries will (at best) remain weak
- So the world economy will be characterized by some degree of **de-globalization** in the medium-term

What kind of de-globalization?

- Not of the 1930s kind, but more like a return to the 1960s and 1970s
 - A retreat from the gung-ho globalization of the post-1990 years, but not from globalization per se
- Where will this show up?
 - Slower growth of import demand from advanced countries
 - Reduced appetite for cross-border lending
 - Less tolerance for large current account imbalances
- For developing countries, this will be a world in which
 - Penetrating export markets is even more difficult
 - Commodity prices are relatively low
 - International finance remains scarce
 - Maintaining undervalued currencies and running large trade surpluses (e.g., China) is no longer a viable strategy

What does this imply for growth prospects in developing nations?

- A closer look suggests there is more room for optimism than might appear at first sight
- Rapid economic growth in countries such as Turkey remains quite possible and feasible in a *partially* de-globalized world
 - Provided the fundamental sources of growth are well understood
 - And these countries follow the appropriate growth strategies
- In some ways, the new global context may prove even more conducive to longer-term growth, because it is going to rule out some “bad” models of growth

Where does growth come from?

- Growth comes from convergence with the productivity levels (the “technology”) that prevail in the rich countries
 - “Technology” is the name for the stock of *ideas* and *knowledge* that is available for developing countries to absorb (and disseminate throughout their economies)
- This stock does not disappear or dissipate when rich countries grow more slowly or when world trade is less buoyant.
- Therefore the potential growth rate in the developing world need not be affected by partial de-globalization
- The question we need to ask is how partial de-globalization affects the incentives:
 - Of firms to engage in productivity catch-up
 - And of governments to follow appropriate policies

Models of growth (1)

There is “bad” growth ...

1. Commodity boom-led growth

- Examples: 19th century, many African (and Latin American) countries in the last decade
- Not sustainable in the longer term, because of both cyclical and long-term downwards trend in the commodity terms of trade
- Also associated with the booming of the “wrong” kinds of economic activities
- And produces bad politics on top
 - Resource rents and the rentier state
 - Chile a rare example of a country that has (so far) managed resource rents well

Models of growth (2)

There is “bad” growth ...

2. Foreign borrowing-led growth

- Examples: countries in the periphery of EU in 1990s, Latin America in 1970s, Turkey
- Good to the extent that it eases the financing constraint of firms
- Inevitably comes to an end when capital flows dry up
- This pattern of growth is associated with current account deficits and the overvaluation of the currency
- and the booming of the “wrong” kinds of economic activities, which do not promote long-term growth
 - non-tradables such as construction and real estate

Models of growth (3)

... and then there is “good” growth:

3. Structural transformation-led growth

- From low-productivity traditional products
 - traditional agriculture and informality
- to modern, non-traditional activities
 - manufacturing, non-traditional export crops, and tradable services
- Examples: Japan, S. Korea, China, India
- Based not on (static) comparative advantage, but on producing what countries richer than you produce
- Associated with “productivist” policies
 - policies that *explicitly* promote structural change, through removal of constraints on investments in modern activities
 - and also through industrial policies, undervalued currencies, financial controls
- This is the only model that generates reliably sustained convergence with income levels in the advanced countries

How the global context affects these models of growth

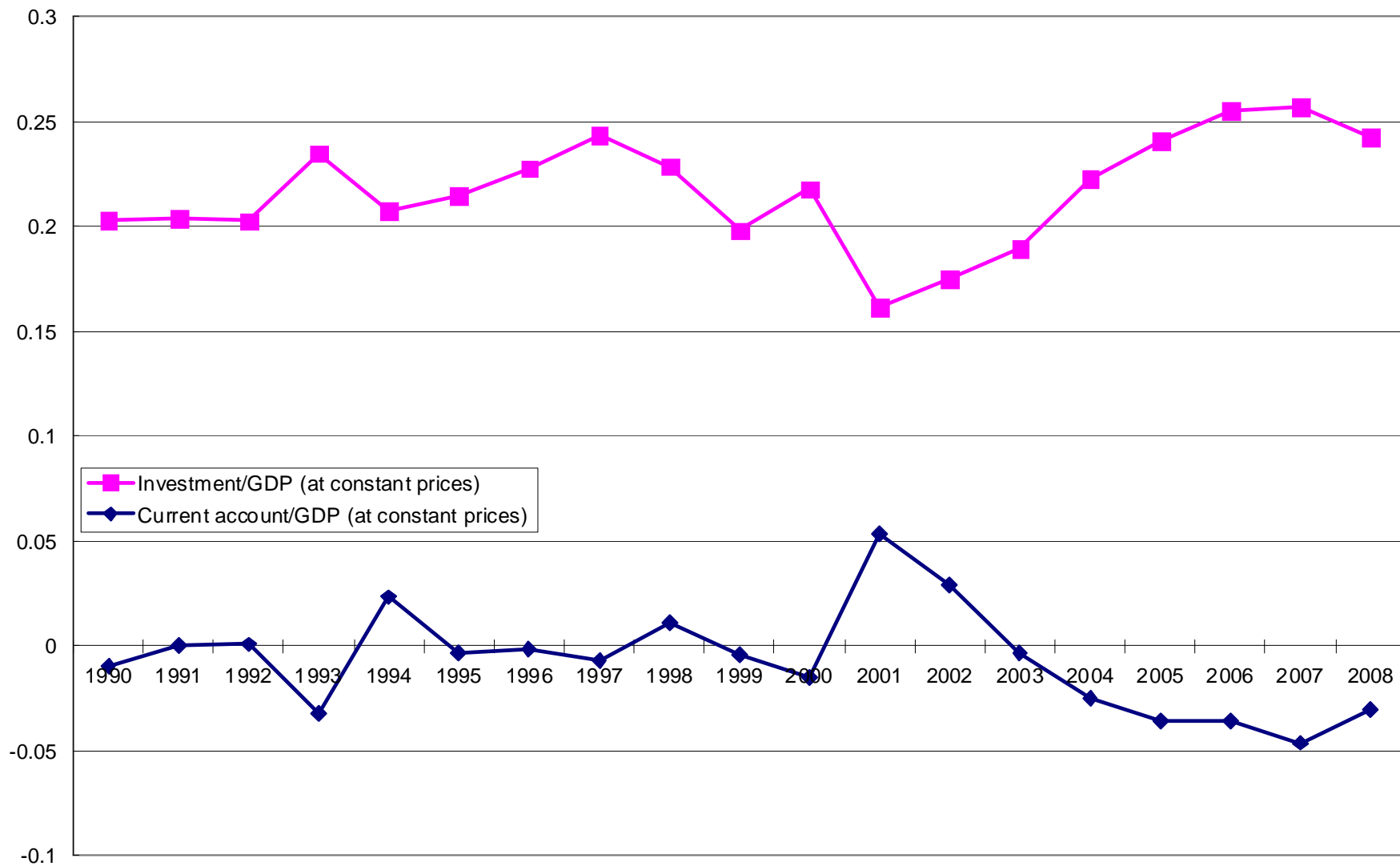
- Models 1 and 2 become less viable
 - Low commodity prices => no commodity-led boom
 - Less cross-border finance => fewer opportunities for running up large current account deficits
 - But no reason to lose much sleep over the demise of either model
- Model 3 remains viable
 - Unlike 1 and 2, it is based on a *domestic dynamic*, and does not rely on trade or finance links other than those needed to keep channels of technology transfer open
 - Although its practice may require some adjustments
 - In particular, promoting structural change through trade surpluses (and highly undervalued currencies) becomes much less feasible for large or middle income countries

What is the Turkish experience?

- Investment and growth have become highly dependent on foreign borrowing
- Problematic because
 - External finance is volatile and subject to “sudden stops”
 - In the new global environment, international finance is likely to remain scarce
 - Capital inflows result in overvaluation, which discourages the right kind of structural change

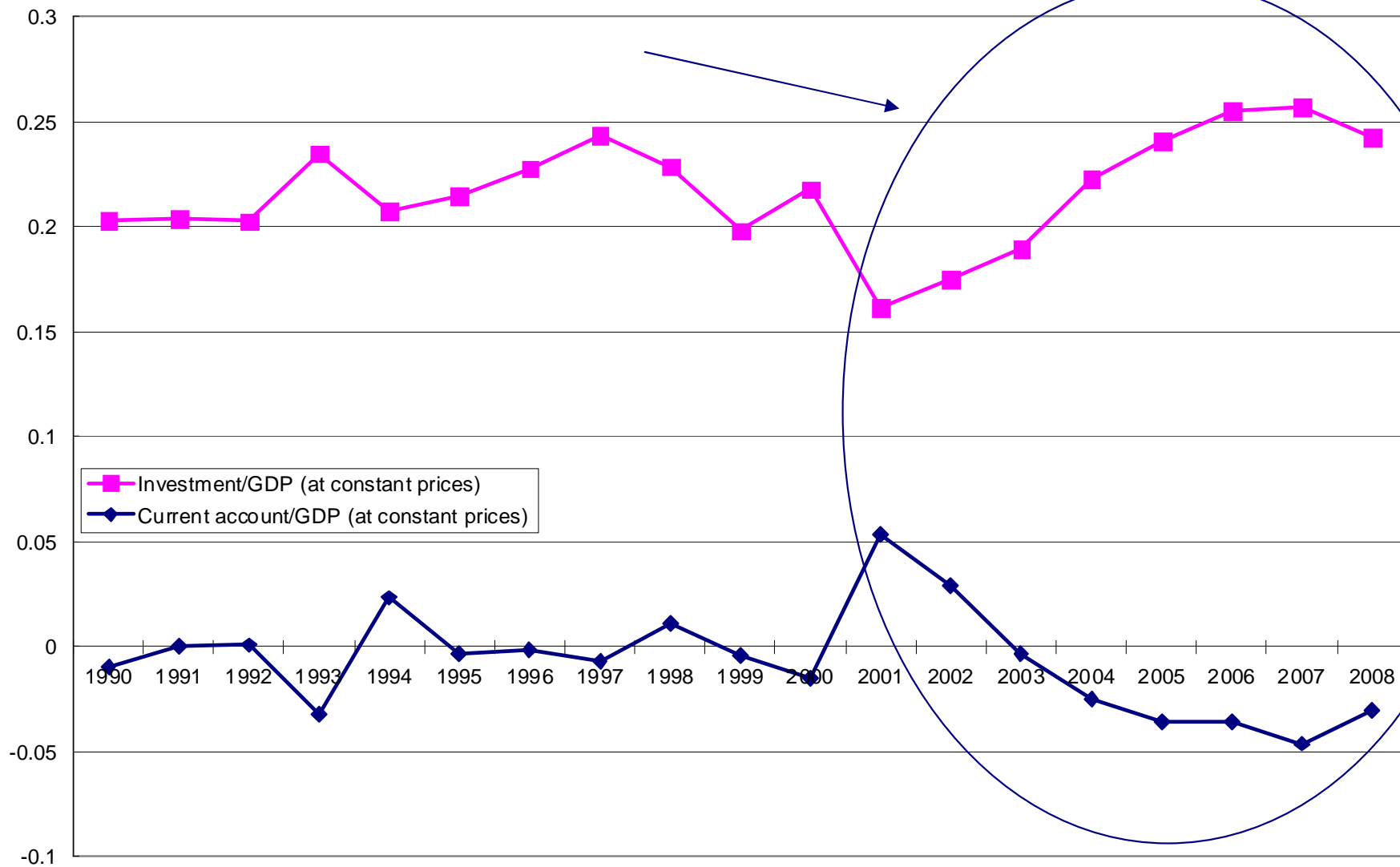
Domestic investment is very sensitive to availability of external finance

Investment and the external balance



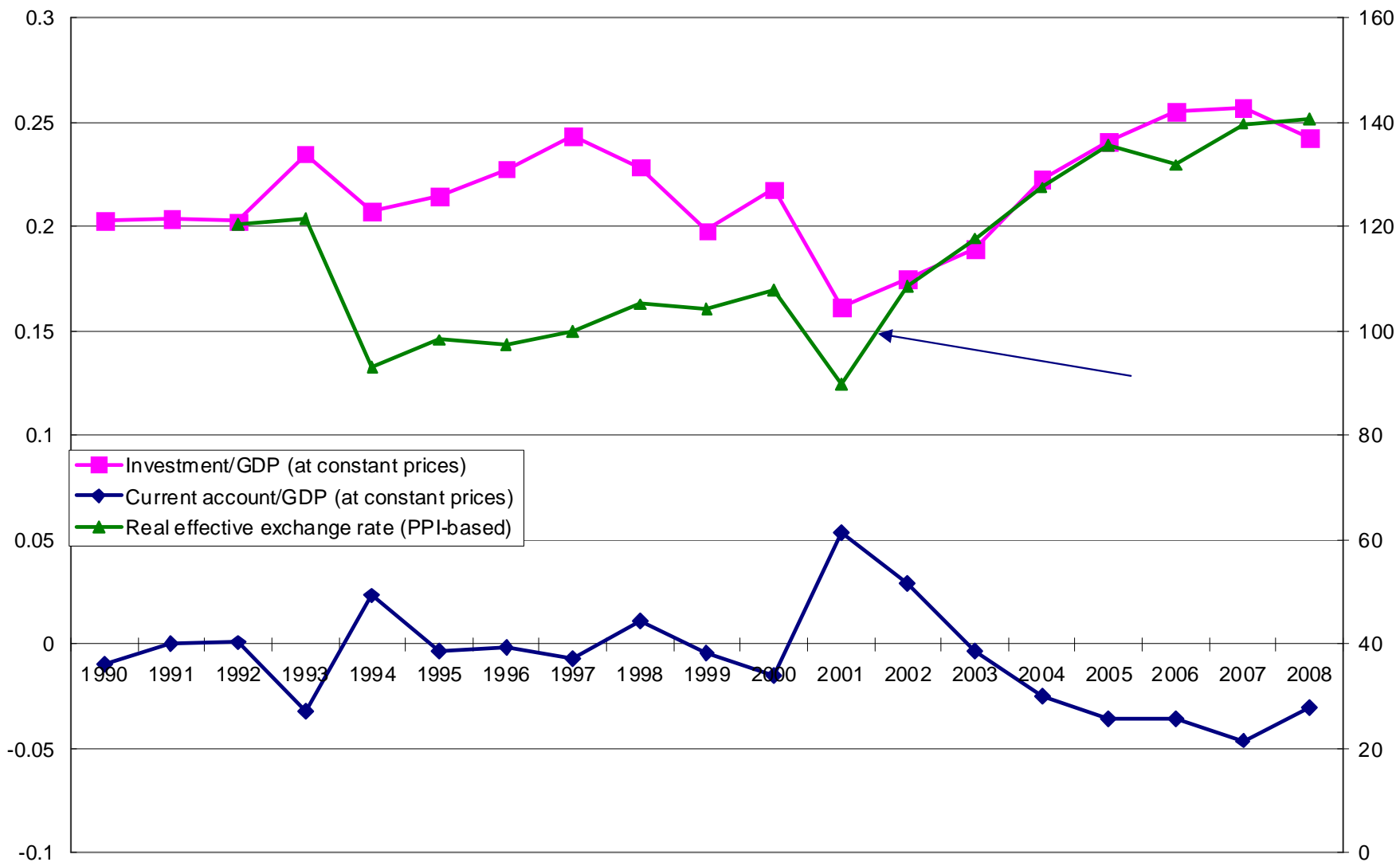
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Investment and the external balance



Domestic investment is very sensitive to availability of external finance

Investment, the external balance and the real exchange rate



Implications for economic policy

- The only way to reduce dependence on current account deficits (and prevent overvaluation of the currency) is to increase domestic saving
- There is role both for increased public saving
 - Smaller deficits/larger primary surpluses
- And for incentives to increase private saving
- The macroeconomic reform agenda will remain incomplete (and micro reforms will be ineffective) unless the domestic saving effort is raised by a few percentage points of GDP

Conclusions

- We are likely to enter a world in which trade and cross-border finance will grow at a much smaller pace than in the last quarter century
- But what matters for economic growth in developing nations is not a high level of trade/GDP or trade surpluses; nor necessarily large amounts of access to foreign finance
- Key is to facilitate the transformation within national economies from traditional agriculture and informality to high productivity manufacturing and non-traditional agricultural products
- Turkey has tremendous strengths in these non-traditional productive areas
- But needs to alleviate the domestic financing constraint by increasing domestic saving
- So the challenge remains largely the same as before the crisis
- By ruling out alternative, but unsustainable models of growth (based on foreign finance), the post-crisis environment may facilitate focus on the fundamentals that really matter