THE YEAR IN REVIEW:

A Turning Point ?

By

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Introduction

There was a golden age of globalization in the last part of the nineteenth century. However, the push for globalization weakened over time and tariffs and restrictions were enacted, which created barriers to international trade and investment. During the last decades of the twentieth century, there was another golden age of globalization and market liberalization. But there has been a new backlash against this trend, stimulated by a set of economic problems that have become evident in the past couple of years. The responses to these problems threaten once again to send globalization into reverse. Are we seeing in the current economic situation a parallel to the end of the first golden age of globalization?

This review begins by describing the cycle of enthusiasm and then disillusion associated with globalization and market liberalization. It then offers an evaluation of the causes and implications of four of the economic problems that have contributed to the backlash--the nature of the global slowdown and what is needed to restore growth; the decline of the "new economy" and the implications for policy; the reasons for continuing financial crises, particularly those in Latin America; and finally, the nature of the barriers to economic development that have prevented many poor countries from growing. Out of necessity, this review will leave out much that is important, and it draws freely on the work of others.[1]

The review concludes that some of the problems have been the result of market failures, exacerbated by institutional failures and inadequate policy responses. Other problems, however, were the direct result of bad policies, at either the macroeconomic or the microeconomic level, or both. Forceful use of stabilization policies is vital to economic success, while failure to control government budgets is eventually a recipe for disaster in developing economies. The appropriate extent and nature of regulation is a key issue. For corporate governance, for banks, and in many individual product markets, smart regulation is better than no regulation. In practice, however, there is no guarantee that actual regulation will be so smart and it can, and often does, cause more problems

[1] I am particularly indebted to my colleagues at the Institute for International Economics and at the McKinsey Global Institute, which has studied many developed and developing countries in detail. Pavel Trcala provided helpful research assistance.

than it solves. Because many markets have unique properties, it may be better to think about policies to promote competition and flexibility in markets, rather than pushing for deregulation or even market liberalization as goals in their own right. Finally, some "problems" are the result of changes in technology and productivity and cannot be "solved" without hurting economic growth. They are part of the process of economic evolution and the playing out of competition at the national and global levels.

It is possible that countries will pull back from the path of globalization and competition. This review concludes that if this were to happen, it would be a setback for global growth.

Enthusiasm for Globalization and Competitive Markets

Large steps have been taken towards a world economy based on competitive and flexible markets, in which goods, services, and capital are traded freely. Most dramatic have been the shifts in China, Russia, and Eastern Europe away from central planning towards market-based economic systems. But the change did not just come among the former communist countries. In Asia, Latin America, and through much of the rest of the world as well, a prevailing view developed in the last decade of the twentieth century that market liberalization was the key to economic growth. The World Economic Forum has played its own part in this, by stressing the desirability of competitiveness and measuring each country's performance in achieving favorable economic conditions.

Many Europeans have reservations about freer and more flexible markets and stress that they should not come at the expense of social welfare concerns. Education and worker training have long been the favored tool for generating equal opportunity, while income support programs for the disadvantaged and the elderly were preserved as part of the European "third way" between pure laissez faire capitalism and socialism. Support for free-market capitalism has always been stronger and less ambivalent in the United States, and maybe in Britain, but even in the United States, the administration in the 1990s stressed government support for worker training and the importance of social welfare programs such as the Earned Income Tax Credit that supplements the incomes of low-wage workers.

The last two decades of the twentieth century provided perhaps a high point in enthusiasm for a liberal, competitive, global world economy. Europe moved further towards its goal of creating a single market, including the adoption of a common currency. In the United States, innovation and competition were perceived as fostering much faster rates of productivity growth and an unparalleled stock market boom (although of course the perceptions got ahead of the reality). World trade and investment flows expanded rapidly. China and India, the world's two most populous countries, grew rapidly and liberalized their markets. They gave promise that the scourge of endless poverty and underdevelopment around the developing world could be lifted by the adoption of a market system.

Of course there were reasons to question the optimistic view of globalization even during the boom of the 1990s. In developing and transition countries there were recurrent economic crises. In a majority of countries the gap between rich and poor widened as the majority of low-income countries failed to achieve sustained growth, most notably the countries of Africa. In Russia and other countries of the former Soviet Union, the road to a market economy was very rocky and chaotic. The Russian economy experienced a sharp decline in its GDP after the fall of communism, a rise in unemployment and underemployment and created a system where a few lucky or unscrupulous individuals prospered while the bulk of the population suffered sustained economic hardship.

And there were problems in the United States, Europe, and Japan too. In the United States, the distribution of wages and family incomes started to widen in the 1980s, with more-educated and higher-wage individuals faring far better than lower-skilled, lower-wage workers. There has been a huge increase in the number of people incarcerated in the United States, disproportionately young African-American males. In Europe there has been chronic unemployment since 1973. Measured unemployment has been high. And in addition, a variety of programs such as youth training, early retirement, work sharing, disability and general income support have disguised an even greater employment problem than is revealed by the unemployment statistics. The Japanese economy was the envy of the world for many years, but has now become the sickest of the major economies. By 1989, per capita GDP in Japan had reached around 85 percent of the US level in the same year. Since then, the US economy has continued to grow strongly, but the Japanese economy has all but stagnated, falling to around 74 percent of the US level of GDP per capita in 2000. Reported unemployment is low, but underemployment is reportedly widespread and problems in the financial sector are extreme.

These difficulties, however, did not weaken the support for globalization and market liberalization among the majority of policymakers and economists in the 1990s. On the contrary, the problems were seen as a confirmation of the basic value of open markets. It was argued that financial crises occurred, for example in Asia, because of incomplete liberalization. The poorest countries in Africa had too little globalization as they had largely insulated themselves from the global trading system. Europe needed a more flexible market system, while Japan's economy was seen as rigid and sclerotic and its financial institutions had failed to use rational lending criteria.

Disillusion

The mood is very different today. A slowdown in global economic growth started in 2000 and became more severe in 2001. Then came the terrorist attacks on New York and Washington. Last year's issue of *The Global Competitiveness Report* warned that these "attacks will have a lasting negative impact if the policy responses trigger a reversal of the global economic integration that has characterized the past twenty years." It went on to note the dangers of political backlash and market uncertainty that could follow and their potential to "derail the benefits of global business" (page 8).

The benefits of globalization are now being questioned by business, by policymakers, and by the public. The economic difficulties in Asia and Latin America have resulted in a reassessment by multinational companies of the benefits of the strategy of full-tilt globalization. Many companies' efforts at direct investment in Asia or in Latin America have failed to pay off and the imperative of global expansion seemed less compelling to many CEOs. The terrorist attacks reinforced in the minds of business executives the importance of a review of the successes and failures of their global strategies and left companies even more aware than before of the political risks of cross-border activities.

In Latin America there is a severe public backlash against globalization and the liberalization of markets. Brazil and Argentina privatized their state-owned companies and liberalized their markets to a significant extent. In the early or mid-1990s they linked their exchange rates to the dollar in order to give credibility to their anti-inflation policies. And yet today Argentina is in a terrible crisis in which the exchange rate of the peso has now collapsed and the banks are insolvent. Brazil faces the threat of partial default on its debt, having already faced crisis and devaluation in 1999. Globalization has been under attack from Genoa to Seattle.

Nobel economist Joseph Stiglitz (2002) has provided an intellectual framework for opponents of globalization. He argues that while globalization does provide potential benefits, the way it has taken place in practice has imposed substantial costs on developing countries and on the poor. The existence of market failures, notably the lack of perfect information, and the fragility of industries in developing economies, undermine the case for rapid market opening and liberalization, in his view. Stiglitz argues the International Monetary Fund (IMF), a major proponent and architect of globalization, has failed to recognize the implications of market failures and has abandoned the use of Keynesian policies to preserve full employment.

There are of course political and military dimensions to globalization, and these too may have experienced a turning point. With the fall of the Iron Curtain it seemed possible that there would be an end to global political and military tensions. No one expected an end to local and regional conflicts, which often cause terrible bloodshed. But with cooperation among Russia, Europe, and the United States, the framework for a more peaceful world seemed to be in place.

Although the threat of nuclear annihilation remains much lower than it was in the Cold War, the attacks of September 11, the endless Middle East conflict, and the prospect of a US war with Iraq that is opposed by many other countries, remind us of the difficulty of achieving real global consensus and cooperation. I have neither the space here nor the ability to assess this dimension adequately, but it does affect the economic situation and cannot be ignored. Political and military uncertainty weaken stock markets and increase risk premiums, and sharp increases in oil prices have been triggers to global recession or barriers to recovery.

A major reassessment of economic returns has also taken place within the advanced economies. This started with the bursting of the bubble in equity prices for technology stocks. Then the broader equity market declined in the United States, Europe, and Japan. Many small investors had been caught up in the idea of easy gains from stock price increases. They bought into the market near the peak and have lost money, sometimes a large portion of their savings.

The reassessment of US economic performance has taken place, in part because official economic data have been substantially revised. At the end of 2000 it looked as if productivity in the United States (output per hour in the non-farm business sector) was actually accelerating, with growth getting faster and faster each year. Based on data available a year ago, it looked as if GDP growth from mid-1999 to mid-2000 would be at a 6 percent annual rate, driven by the rapid increase in productivity combined with a buoyant labor market. Even the recession of 2001 seemed to be barely recognizable, with only one quarter of the year showing a decline in GDP based on preliminary data.

Revised data are very different, with productivity estimates scaled back (2.9 percent in 2000 and 1.1 percent in 2001) and overall growth noticeably slower. Revised GDP growth in 2000 was 3.8 percent—still strong but no longer a blockbuster—and the latest data show three consecutive quarters of GDP declines in 2001. An important reason for these revisions is that new surveys suggested there had been less investment in both information technology hardware and software than originally thought. The "new economy" lost a lot of its shine after the data were revised.

For the government data, the restatement of economic performance reflected the availability of new data. For corporations, the restatement of performance reflected, in many cases, the fact that the books were being cooked. Profits had been overstated through a variety of accounting tricks and outright falsification. There were signs that this was happening even in the late 1990s, as reported corporate profits weakened even as the economy continued to grow strongly. Creative accounting can often move profits forward to exaggerate growth for a while, but then there are no new tricks and reality sets in. The collapse of Enron revealed wholesale distortions of the company's financial position, sanctioned by auditors from Arthur Anderson, which had been one of the most respected firms of accountants. These revelations were followed by earnings restatements at

Worldcom, Tyco, Adelphia, Global Crossing, and others. One hundred and fifty seven US public companies restated profits following the collapse of Enron. Although the United States led the way in this bout of corporate excess, Europe and Japan have faced similar problems. The telecom industry around the world has gone through a massive boom and bust cycle. Corporate scandals have affected Europe, while in Japan hiding bad news is almost a way of life, both in business and government.

A Synchronous Global Slowdown

Europe, Japan, and the United States (the Triad) have all experienced a slowing in economic growth, or outright recession, at about the same time. Figure 1 shows the growth of real GDP in France, Germany, Italy, Japan, the UK, and the United States for 1999 to 2002. The figures for 2002 are IMF forecasts released in September 2002. All of the countries show a growth slowdown in 2001. The United States had the sharpest decline in growth, but also seems to be the economy that is recovering most quickly. The slowdown in the UK appears to be very mild, while Germany and Japan are the hardest hit.

These synchronous movements of GDP are matched in equity markets. Figure 2 shows the similarity of movements in equity prices among the same group of countries. Indexed to 100 in January 1999, they all rose strongly through that year and into early 2000 and then slumped through mid-2002. The stock indexes did not move exactly together, but the correlation is very strong. According to Consensus Economics (2002), the 52-week correlation between the US stock market and stocks in Europe has increased from 40 to 60 percent in the early 1990s, to around 80 percent more recently. The Japanese stock market has certainly moved on its own separate path since their bubble burst in the late 1980s. But even in Japan, stock prices have tracked a similar pattern of rise and fall over the past 2½ years.

The weakness in equity markets has been an important trigger for overall economic weakness. An early sign of trouble in equities came in the United States with the collapse in the prices of technology stocks. The NASDAQ stock index peaked in March of 2000, having doubled over the previous year and risen by a factor of around 10 over the previous decade. It lost more than half its value by the spring of 2001, recovered modestly and then fell again. As of the fall of 2002, the NASDAQ index is down to its level of the mid 90s. The Dow Jones, the S&P and other broader stock indexes did not go through the same massive bubble as the NASDAQ, which is so heavily dominated by technology stocks. But the overall market clearly had reached unsustainable levels at the end of the boom. Overall stock market valuation in the United States had declined by $7 trillion from its peak by the spring of 2002, and it has fallen more since then.

The weakness in equities adversely affected US consumer and business confidence, which dropped sharply in the fall of 2000. The US manufacturing sector had been under pressure from a strong dollar even in the late 1990s, and when the strong dollar was combined with a slowdown in the growth of domestic demand, layoffs in manufacturing increased rapidly. Over two million jobs were lost in this sector from its peak through August of 2002. For the US economy as a whole, the sharp growth slowdown of 2000 turned into a mild recession by the spring of 2001.

The Federal Reserve started to raise short-term interest rates in early 1999 and continued to increase them through mid-2000. Inflation had not yet increased significantly but there were signs that it might. Wages were rising faster, oil prices were up substantially and the Fed wanted to cool off the economy before it overheated. In particular, the rise in equity prices had encouraged a buying spree among American consumers and businesses.

In some respects the US slowdown and recession that followed the interest rate increases was unexceptional. The growth slowdown of 2000 was at first largely an inventory correction. Production was greater than sales, and inventories needed to be reduced. This was followed by a drop in investment, with a large drop off in purchases of high-tech equipment. This pattern of inventory and investment adjustment is pretty normal for recessions. And after all, the US economy had been expanding for nearly ten years, so a slowdown or recession was hardly surprising.

Europe's growth had not been quite as rapid as that in the United States, and the expectation was that it could avoid a recession. Historically, there has been some correlation of the business cycle among the major economies, but it is far from exact. The direct link between the United States and Europe, in terms of bilateral trade does not seem large enough to drive synchronous downturns. The United States is the destination of only 9½ percent of EU exports. There seemed no clear reason why a cyclical decline in the United States should trigger a similar decline in Europe. And yet that seems to have happened. There is some diversity of outcomes within Europe, but the euro area as a whole has slipped into a downturn, especially its largest economy, Germany.

Japan's economy lacked the resiliency to absorb the growth decline in the United States and it too fell into recession, prolonging the long agony of slow GDP growth and deterioration in the financial sector. Japan's GDP declined by 0.7 percent for the four quarters ending mid-2002.

One possible explanation of the synchronous cycle is that it is the result of the attacks of September 11, 2001. But that is not a perfect or even a very good explanation. US real GDP grew in the fourth quarter of 2001, so the US recession may have ended in the fourth quarter of 2001, rather than beginning then! Real GDP rose at a 2.8 percent annual rate over the three quarters starting with the fourth quarter of 2001, so it is pretty hard to say the US economy was knocked down by the attacks. In Japan, when consumers are nervous they save more. In the United States, when consumers are nervous they go out and buy houses and Sports Utility Vehicles—ready for all emergencies. In the United States, equity markets were weak prior to the attack and there was a very sharp drop in prices after the attack, when Wall Street reopened. But prices bounced back fairly quickly over subsequent weeks.

In Europe, the growth slowdown occurred a bit later than in the United States, so arguably the attacks were a contributory factor. Europe is more vulnerable to a disruption of oil supplies than is the United States. But overall, it is hard to see why Europe should have been more affected than the United States by attacks on New York and Washington by terrorists whose enmity is focused on the United States.

Perhaps it is just coincidence that the business cycles and equity markets in the Triad have moved so closely together. But a more likely explanation is that globalization has created stronger links among the economies than are visible in the bilateral trade flows among them. Globalization has created a network of multilateral trade flows, so that, for example, when the United States went into a downturn, this negatively affected East Asia, which supplies it with high-tech and low-tech products. This reduced the demand for capital goods and hurt Germany as a major supplier of capital goods to the world. Many industries, especially in the high-tech sector, are global industries with global sourcing. Weakness in the United States, which has been the great consuming engine of the world economy, has a contagion effect that ripples round the global economy.

Allowing for multilateral trade linkages is still not enough, though. Beyond trade flows, there is a confidence factor that also spreads through the global economy. And in this case, weakness that starts in the United States, flows overseas and then comes back to affect the United States again. As this is written, in October of 2002, it seems likely that the United States is on the path of economic recovery, but the strength of that recovery remains quite uncertain and the recovery in Europe is yet to show itself. The US stock market, having weathered the terrorist attacks, has been overwhelmed by the blizzard of corporate scandals and profit warnings. And as Figure 2 showed, other markets have fallen as much or even more. The collapse of the high-tech sector, the fall of Enron and a raft of telecom companies, quintessential new economy companies, have done what the fall of the World Trade Center towers did not do—shake the faith of investors around the world. As equity markets weakened, the recovery of business and consumer spending has been threatened.

While some aspects of the recession in the United States were very typical of past recessions, others were not. This business cycle was driven in large part by an excessive rise and then sharp drop in asset prices. In contrast, most previous recessions were the result of an excessive rise in overall goods and services price inflation. The stock market boom of the 1990s created a "wealth effect", encouraging consumers and businesses to increase their spending which then led to an overheated economy. In the downturn, the negative effect of the loss of stock market wealth is holding back the recovery.

The volatility of asset markets, therefore, can be an important source of economic instability. Why does it occur? Purists argue that markets are always rational and absorb efficiently any available information. If you do not believe that, they say, there is clearly an opportunity for you to make money by outguessing the market. Market critics reply that Wall Street is a gambling hall that is subject to herd behavior. Investors get caught up in optimism or pessimism and drive the market above or below the level that is consistent with the underlying profit fundamentals.

The experience of the past two years makes the market purist view hard to accept. In principle, the volatility of markets does imply a profit opportunity, but in practice it would take a lot of patience, a lot of wealth and a strong appetite for risk to take advantage of that opportunity. Alan Greenspan warned in 1996 that the US stock market was experiencing irrational exuberance, and he was surely correct. But someone betting on his view would have lost money for four years before being proven correct. Investors who are right about the market fundamentals can still lose money if everyone else believes something else. That said, the message of the market should not be dismissed completely. As will be explored later, there were new opportunities that opened in the United States and the world economy in the 1990s and these raised potential economic growth and profits. Some exuberance was called for; it is just that the market went way too far.

Restoring Growth in the Triad

It appears that asset markets can over-react to economic news and be subject to speculative swings, the question is how serious a problem this is for overall economic instability and how quickly will growth be restored in the Triad. Some previous examples of recessions linked to asset price bubbles are not encouraging. The Great Depression of the 1930s followed the end of the stock market boom of 1929, and full economic recovery did not occur until 1941. Japan has gone through economic ups and downs since its stock market and real estate bubbles ended in 1989, but has failed to generate sustained economic growth for over ten years. Many in Japan have warned that the United States is destined to suffer a long period of weak or negative growth following the end of the 1990s boom.

Recovery and Uncertainty in the United States. The chances that the United States will slip into a prolonged Japan-style period of very slow or negative growth are very low indeed; it is almost impossible. The Great Depression was the only time the US economy ever experienced a long period of very high unemployment and there have been tremendous institutional and policy regime changes since then. In contrast to the 1930s, the US financial system today is in generally good shape, better than in the early-1990s recession, and with adequate reserves. It has lost money on bad loans, but not enough to imperil the system. Deposit insurance adds great stability to the system. Moreover, the growth of securitized markets means banks no longer carry as much risk as they used to.

In a world with well-developed securities markets the consequences of economic shocks or changes fall heavily on asset holders. Assets are repriced, and the impact is spread widely to people and institutions that (should) hold widely diversified sets of assets. Asset repricing in response to changes in the fundamentals reduces the incidence of bank failures or other more costly alternatives. Of course for this to work well, the risks associated with asset price variations have to be borne by those who can understand and accept them, and recently this has not always been the case.

Another precondition for a securitized market system to work well is that there has to be honest reporting of financial information and this condition has not been met either. There can be a market failure caused by asymmetric information. Company managers may have an incentive to mislead investors about how well their company is doing in an attempt to raise the share price of their companies. Because of this lack of information, or lack of trust in the market, even good companies will trade at discounted prices because investors do not know whether or not to believe the managers. The current weakness in equity markets reflects a necessary correction to an overvalued market earlier. But it also reflects investors' concerns that some companies that look good on the surface are overstating their profits.

This problem in financial markets is mitigated by the presence of independent auditing companies that certify a company's economic performance using generally accepted accounting principles (GAAP). This process broke down because the auditors were receiving large accounting and consulting fees, and allegedly turned a blind eye to false or misleading reporting. The research departments of investment banks were another way in which investors could be informed about companies, but in some cases this source of guidance seems to have been biased because the researchers were told to give favorable reports on companies generating large underwriting fees to the investment banks. Finally there is the problem of stock options granted to managers as a large part of their company remuneration. These options were reported in the footnotes of company statements, but were not accounted for in the profit and loss statements. In the 1990s, the amounts of employee stock options were very large and affected reported profits substantially. Some shareholders may not have realized how large these options were and, hence the likely impact on future reported profits. The existence of these options often provided a major incentive for CEOs to inflate their stock prices with false or misleading information, and then cash out the options before the profit inflation was revealed to the public.

Clearly the problem of incomplete information was not being solved by the regulatory system that was in place. There was a need for US and world markets to restore investor confidence in the information they have available as they decide what securities to buy. At the same time, not too much should be done. Over-regulation would discourage risk taking and new ventures.

It looks as if the right steps are currently being taken to restore confidence in corporate accounts. The US Congress passed a bill (Sarbanes-Oxley) whose provisions should improve accounting practices. There are also negotiations taking place on rules that would separate investment banking and research. Changes are also being made at the Securities and Exchange Commission to improve enforcement. And the market itself is responding as investors, notably large institutional investors, are demanding that companies meet higher standards—in reporting stock options for example. It will take some time before investors regain their confidence.

Another threat hanging over the US and world economies as this is written is the impending war with Iraq. Thus far, the conflict with Iraq and the uncertainty about the outcome have been a negative for growth. Financial markets do not like uncertainty, oil prices have risen, and consumer confidence has fallen again. There is the possibility that US consumers will finally lose their appetite for houses and SUVs.

A short successful war with Iraq in which Saddam Hussein was replaced by a new government that was less hostile to the West, would certainly be a positive for the US and world economies. It would lift some of the clouds currently hanging over markets. I realize that opinions differ as to the appropriateness of US Iraq policy, and I am not commenting on that, merely the likely economic outcome. The uncertainty would be reduced, oil prices would likely fall and the expenses of the war would actually provide a boost to total demand in the United States. A more protracted or a wider war, in which the United States was faced with street-to-street fighting in Baghdad and heavy casualties, would have negative effects. Oil supplies could be disrupted by terrorist attacks on tankers or other facilities. A new wave of terrorist attacks against the United States or others could be initiated.

Barring an adverse outcome in Iraq, the weight of the evidence suggests the US economy will make a normal recovery from the mild recession of 2001. GDP growth will likely be uneven but should average over 3 percent a year going forward. A big reason why solid recovery is likely is that the correct macroeconomic policies were followed. Monetary policy moved quickly and aggressively to counteract the downturn. Fiscal policy became expansionary also, as the tax cuts kicked in, followed by increased federal spending in the aftermath of the terrorist attacks. Down the road, the United States will have to confront the possibility of a return to chronic budget deficits, but that is another story and is not an issue that will derail the current recovery.

As well as the right policies, there is also the overall resilience of the US economy. The microeconomic and labor market policies favor growth also. Many Europeans dislike the harshness of the US economic system, and I understand and share some of their concerns. But the current US economic system does have distinct advantages by creating very strong incentives for people to work and by making it very easy for new businesses to start and existing businesses to grow—easy access to land being an important reason for this.

It is certainly possible that the prediction of a continuing US economic recovery will not pan out in the short run. The fragility of business and consumer confidence and the economic weakness in the rest of the world could pull the United States into a second downturn. This would be costly for the United States and for other countries that rely on US growth. However, it would not derail longer run US growth prospects. Within a year or so there would be a return to solid economic growth in the United States. Forceful and appropriate use of macro policies, a sound financial system, and growth-friendly micro policies are the three-part foundation for this prediction.

The Need for Faster Growth in Europe. Europe does not have all three of these parts in place (Japan has none of them). Europe has a sound, if somewhat fragile, financial system, but it has used macroeconomic policies less forcefully than it should have. The European Central Bank does have a mandate to consider both inflation and growth, but in practice the inflation target has dominated its decision-making. This imparts an unfortunate degree of caution to its actions in response to a weak European and global economy. Although it has been argued that the ECB has acted sufficiently to the downturn[2], many economists, myself included, judge that this is not the case. Current short-term interest rates are higher in Europe than in the United States even though the euro has appreciated against the dollar. The ECB should have lowered interest rates more than it did in 2001. It did not do so then and is reluctant to cut interest rates now because core inflation in the euro area is holding around 2½ percent. In addition, there is a fairly widespread impression in Europe that the introduction of the euro provided an excuse for companies to raise prices. The ECB argues that the data do not support this view, but it still makes them anxious to be perceived as tough on inflation. If the economic weakness in Europe continues or worsens, as seems quite likely, the ECB should reconsider and provide further monetary easing. In the current world economic environment, the threat of inflation is much less than the threat of recession.

Having tied one hand behind its back in limiting monetary policy, the EU has tied the other hand also through the fiscal stability pact. Some restraint on excessive deficit spending is appropriate, but such a limitation must be carefully designed. When economies are weak, tax revenues fall and budget deficits worsen. Trying to observe the stability pact can force countries to raise taxes or cut spending in response to cyclically induced deficits. This is folly, hitting the economy when it is already down. Following such a policy is another reason that the US recession of 1929 turned into the Great Depression of the 1930s—it is Herbert Hoover economics. Fortunately it appears the stability pact is being reassessed, although there is no consensus on what should be done.

Europe has made progress in increasing competition and in privatizing previously sluggish state-owned monopolies. For example, the road freight industry in Europe is also improving its performance as restrictions are eased. But overall, Europe's micro policies are not yet sufficiently growth friendly. Its social protections discourage employers from hiring and discourage many people from working, including those who are given large financial inducements to retire. The intensity of competition in many industries, especially domestic services industries, is too low and restrictions impede business

[2] See for example, the Bank for International Settlements (2002).

expansion. Europe is crowded and has to be concerned about preserving the environment, but environmental concerns can become an excuse to restrict new competitors from entering an industry, often because land is not available at all, or only at very high cost. Regulations whose avowed purpose is to protect jobs in existing establishments end up costing jobs and growth in new or expanding establishments.[3]

Provided the United States recovers well, the chances are good that the core countries of Europe will also resume a pace of sustained, if sluggish, growth. But that is not enough. Europe is not doing its part in helping the global economy to recover. For its own sake, and for the sake of other countries, it should be an engine of world growth and not be waiting on a US recovery.

One important issue not mentioned so far is the large and persistent US trade and current account deficits. Other countries complain about this problem and indeed the United States should and likely will reduce this deficit over time. But in some respects the complaining countries are themselves a cause of the US deficit, because they send so much of their capital to the United States and keep the dollar high. And they take advantage of the fact that the United States is a great market for everyone else to sell in. Both the United States and other countries have benefited in certain ways from the US deficit and are reluctant to pay the cost of reducing it. If the US trade deficit is to come down, the dollar will need to fall. The United States can contribute to solving its current account deficit by its own policies (long-run fiscal discipline in particular), but a rebalancing of world trade inevitably will require the rest of the world to generate additional domestic demand, including new investment opportunities. Europe has to be a prime mover in that rebalancing, using its macro and micro policies to become a source of world economic growth.

Dealing with the Problems in Japan. Japan is a hard case. One can look back twenty years and see how Japan could have made the transition from an export-oriented, but otherwise closed, economy to a more competitive flexible economy, with a functioning labor market and a modern consolidated financial system, relying less on bank loans and more on securities markets. One can look back ten years and see how

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[3] McKinsey Global Institute (1997). See also a new report from the Institute updating and extending this work, forthcoming October 2002.

Japanese macro policy could have responded more forcefully to the downturn, and, through early action, avoided a crippling deflation. Looking at Japan today, one is frustrated that the problems have only become worse over time. One is frustrated by the political weakness of the government and its inability to deal with either the non-performing loan problem or the vested interests that prevent structural microeconomic reform. Dealing with the non-performing loans requires closing many bad banks, foreclosing many bad loans and putting the non-performing assets on the market. The remaining banks will have to be re-capitalized to restore a functioning financial system. Currently, the number of existing loans that are becoming bad loans exceeds the rate at which old bad loans are being disposed of, so the situation is in danger of escalating into a full-blown financial crisis.[4]

Monetary and fiscal policies can lose their power if the economic situation gets bad enough. Monetary policy can face a liquidity trap, in which nominal risk-free interest rates fall to zero, or close to it, so the central bank has no more room to cut rates. If prices are falling, real interest rates remain positive even with zero nominal interest rates. The United States may or may not have been in a liquidity trap in the Great Depression, but it sure looks as if Japan is in one now. On the fiscal policy side, budget deficits in Japan have become huge. In part these deficits have been the result of past unsuccessful expansionary policies, in part the consequence of the economic weakness itself, which has reduced tax revenues. Further expansionary fiscal policies are being restrained because outstanding government debt is already high relative to GDP and is rising fast. If the debt reached too high a level, default risk would become a more serious issue and longer-term interest rates would rise. The expansionary effect of any further fiscal expansion would be offset by the rise in medium- and long-term interest rates. Japan, arguably, faces a fiscal policy trap as well as a liquidity trap.

What is to be done? It is easy to be very gloomy about Japan's economic prospects. While some modest cyclical recovery from the current recession is likely in Japan, I do not count on sustained solid growth any time soon. Muddling through is a more likely outcome than a crippling financial crisis in the next few months, but something has to be done eventually and a crisis is certainly possible.

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[4] Adam Posen (2002).

Most economists argue that the most important policy step that could be taken is to deal with the bad loan/bad asset problem. And they argue that the government is capable of doing this, along the lines stated earlier, if it has the political will[5] and is willing to tell Japanese voters and taxpayers how much it will cost them. A sound financial system would improve the access of companies to capital and make it easier for those that have growth potential to exploit it. The financial system could also encourage consumer spending by making credit more available.

Macroeconomic policy may not be as powerless as suggested earlier. Since prices are falling, inflation is hardly a threat; in fact some positive inflation would be helpful. There is no reason for the Bank of Japan to limit monetary expansion. Even though short-term interest rates are near zero, expanding the money supply would increase household wealth and, in combination with an announced goal of achieving a modest but positive rate of inflation, might be able to change expectations and encourage spending. An expansionary fiscal policy, such as tax cuts, could also be used in combination with an expansionary monetary policy. The Bank of Japan could purchase (monetize) the increase in government debt in order to reduce the threat of default. Alternatively, since there is a great deal of wasteful government spending in Japan, tax cuts, offset by spending cuts, might stimulate consumer spending without worsening the budget deficit.

It is uncertain, however, whether macro or financial sector policies will work, or work for very long, unless more is done at the micro or industry level to restructure the business and agricultural sectors. One face of Japan consists of companies like Toyota or Sony that have very high productivity and compete strongly in the global market. The other face of Japan consists of farmers, retailers, food processors, and so on that have been protected from global competition or from intense domestic competition. This second, and larger part of the economy has low productivity because of inefficient operations, and in many cases because industries have never been restructured and consolidated to take advantage of modern technology and business practices. Japan has not allowed enough failing businesses to fail, and that has made it harder for new or thriving businesses to expand. If reforms are not carried out at the sector and industry

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[5] Adam Posen (2002) and R. Glen Hubbard (2002), Chair of the Council of Economic Advisers, have suggested such an approach.

level, it is possible that the increased availability of loans will not increase investment sufficiently and encourage new businesses given the maze of protections for existing businesses. Macroeconomic policies can have only a limited or temporary effect if the business sector is in a straightjacket. [6]

A drastic economic restructuring faces huge political obstacles, because the voting base of the ruling party in Japan is precisely among the groups that are protected by the existing system. The short-term employment losses in traditional industries might come more quickly than the employment gains in new activities. One sign of hope for Japan is that Heizo Takenaka has been appointed as the new financial czar and is talking about an aggressive program of financial sector reform that will include allowing more companies to fail. Time will tell if he can follow through with this program.

Lessons from the downturn. The growth slowdowns or recessions in Europe, Japan, and the United States demonstrate, on the one hand, the advantages of flexible competitive markets and, on the other, the advantages of sound policy actions to improve the functioning of those markets. Market forces generate jobs, economic growth and wealth, but can also result in speculative asset bubbles, corporate fraud and excess and macroeconomic instability. There is a set of policies that can mitigate these failures.

The economies of Europe and Japan demonstrate how hard it is to undo restrictive and misdirected microeconomic policies, once they are in place. The companies and jobs that are never created lack a voice in the political debate.

Lessons from the Rise and Fall of the New Economy

Productivity growth in the United States increased after 1995. The combination of strong productivity growth, heavy investment in information technology, a booming stock market and a very favorable combination of unemployment and inflation led many observers, myself included, to describe the arrival of a new economy in the United States after 1995. This very strong economic performance suggested that a US-style market system was more innovative and dynamic than any alternative economic model. Companies based in the United States had been the leaders in developing IT and the US economy seemed to be ahead in the use of IT.

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[6] McKinsey Global Institute (2000).

Given the economic downturn, the stock market declines and the collapse of IT investment since 2000, what should we make of the US new economy today and what implications does it carry for other countries that are trying to improve their own growth rates?

Despite the data revisions, the trend of productivity growth in the United States does appear to be continuing at a higher rate, than in the 1970s and 1980s. Output per hour in the non-farm business sector of the United States is rising at about 2.4 percent a year. This is not as fast as the postwar period, but a sharp improvement over the record of the prior twenty years (see figure 3). In addition, the improvement in productivity growth has occurred not just within high-tech manufacturing, but also within services industries.[7] Faster productivity growth, the most important element of the new economy, remains in place, if a little attenuated.

The slowing of overall productivity growth in the United States in the early 1970s had been associated with a collapse of productivity growth in the services sector. Explanations of this phenomenon ranged from skepticism about the data for services industries, to a belief that the services sector was intrinsically unable to raise productivity. The resurgence of productivity growth in services after 1995, therefore, was an important sign that there might be a new economy. If there is a new economy it cannot be based just on the ability of the high-tech sector to make faster and faster computers. There has to be evidence the rest of the economy is able to make productive use of the new technologies. Since the services industries are heavy IT users, the productivity improvement in services seemed to suggest that IT had allowed the sector to overcome whatever intrinsic problems it had with improving productivity.

These same ideas seemed to carry strong implications for Europe and Japan. Real GDP per hour worked is not an ideal measure of productivity in the market economy, but it is available on a timely basis across countries. According to The Conference Board, real GDP per hour worked grew at 2.0 percent a year in the United States, 1995-2000, compared to 1.4 percent a year in the EU and 1.8 percent a year in Japan.[8] This meant that the United States has had the most rapid productivity growth among the three regions

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[7] Martin Neil Baily (2002) and Jack Triplett and Barry Bosworth (2002).
[8] The Conference Board (2002).

after 1995. In earlier periods, Europe and Japan had experienced much faster rates of productivity growth than did the United States.[9] On the basis of this turnaround in relative productivity performance, international organizations and many academics said the key to raising productivity growth in Europe and other countries was to increase or improve the use of IT.

Australia was seen as a pure test case of the benefits of using IT. Productivity growth has increased in Australia, and yet it produces almost no IT hardware. It has billed itself as a country that was a successful user of IT.

The view that IT is the key to improving productivity growth was a plausible one that seemed to fit the facts of relative growth performance across countries. However, it now seems incomplete and even misleading, both as a description of the US productivity resurgence, and as a prescription for faster European growth. Using the standard tool of growth accounting, Jack Triplett and Barry Bosworth (2002) look at the US services industries where productivity growth increased, and they find that most of the resurgence in these industries came not from the contribution of IT capital, but instead from multifactor productivity growth (also called total factor productivity growth). Multifactor productivity growth is computed as a residual. It is the fraction of growth that cannot be explained by the standard quantifiable inputs. So this exercise does not reveal an alternative reason for the speedup in growth. It could be the result of innovations enabled by IT or it could be from changes in business practices that were largely unrelated to IT.

Another approach to understanding the role of IT in growth was provided by the McKinsey Global Institute (2001). This research goes behind the mystery of multifactor productivity growth to determine what companies were actually doing. It looked at case studies of specific industries, concentrating on those that had contributed heavily to the overall productivity increase. Among the services sector case studies, retail and wholesale trade and securities were important in this regard. In turned out that a variety of changes and innovations were at work, including the increased use of so-called "big

[9] After World War II, the US economy achieved sustained and rapid economic growth but the European economies and Japan achieved even faster growth, allowing their economies to close the productivity gap to the United States. There was strong "convergence" among this group of countries. In the early 1970s there was a sharp slowdown in the rate of productivity growth among almost all the advanced economies, although the rates of productivity growth remained faster in Europe and Japan than in the United States--until the mid-1990s.

box" stores in retailing and the shift to higher value-added products and services. IT did play a direct role in improving productivity, in the securities industry, for example. In other situations, IT was an enabling technology, for example large retailers would find it impossible to operate their current business systems without a strong IT backbone. In these cases it was often the IT that was installed prior to 1995 that was most important in boosting productivity after 1995.

The most important conclusion of the study is that productivity had increased only when companies made successful business innovations. Those companies that simply invested in IT systems with the vague promise that this would help their performance, were generally disappointed. High-powered PCs do not do much if the users cannot take advantage of them. Advanced data management systems do not help performance if the data comes from different and incompatible sources or if the company has not figured out how to take advantage of the new information it gains. The case studies of the banking and hotel industries revealed clear examples of IT investments that had failed.

These findings about the productivity impact of IT investment, combined with the fact that IT capital spending slumped so badly in the downturn, suggest that companies in the United States over-invested in IT capital during the boom years. This is surely true of investment in communications equipment and fiber optic cables, an area where over-investment also occurred in other countries. Once again, therefore, with the benefit of hindsight, one can point to a "market failure." Irrational enthusiasm for the hoped-for benefits of IT contributed to the boom and bust cycle and wasted resources. This is not a situation that calls for policy intervention, however. The new technologies held out considerable promise, and sometimes delivered on that promise. Policymakers were often cheerleaders for the new economy and would not have directed the economy in a better direction with more interventionist policies. Businesses have now learned and become more discriminating in their choices. Grand successes and failures are to be expected with a new technology.

If IT was only a part of the explanation of faster productivity growth in the United States in the 1990s, what else was at work, and will the faster growth continue? Definitive evidence is not available to answer that question, but the most likely explanation is that strong competitive intensity, driven in part by the increase in globalization, started to pay off in the 1990s. In autos, for example, strong competition from Japanese transplants as well as from imports, put pressure on the US domestic industry. The deregulation movement has been accompanied by mistakes (California power, for example) but on balance it encouraged competition and fostered innovation. Even in domestic US industries, competitive intensity increased as the strongest competitors in retailing expanded nationwide, and forced adjustments from the rest of the industry (a sign of the potential for Europe from the single market).

Going forward, competitive intensity in the US economy remains high, and the potential for productive use of IT is still strong. This makes me cautiously optimistic about a continuation of strong productivity growth in the United States. From the second quarter of 2000 through the second quarter of 2002, labor productivity in the United States rose at an annual rate of 2.5 percent a year, a pretty solid performance during a period of economic weakness, one that is consistent with the trend growth of 2.4 percent from 1995 on. So far so good in terms of the new productivity trend surviving the recession. One reason for caution is because of uncertainty about the data--further revisions are possible. Another reason is that business cycle fluctuations have a short-term effect on productivity and make it hard to estimate the underlying trend.[10] Despite these reservations, figure 3 makes a pretty convincing case that there was a shift to faster trend growth after 1995 that has continued through the downturn.

What are the implications of the new economy for Europe? Many Europeans are comfortable with the way things are and see no case for change. After all, productivity growth in Europe was much faster than in the United States for many years, and the level of productivity is pretty high in France and West Germany. Companies in Europe are making use of IT and may have avoided the over-investment of the US boom years.

Not all Europeans agree, however. They recognize the need for better productivity growth performance now, particularly since the number of retirees will be rising so rapidly in the future. The Centre for European Studies points out that not only has productivity growth in Europe been slower than in the United States since 1995, lately it

[10] Robert J. Gordon, who writes in this issue of the *Report,* has argued that the business cycle explains some of the strong productivity growth of the 1990s.

has been slowing down even more.[11] Growth in GDP per employee has come in well below its predicted growth rate in 1999-2001, even after adjusting for the impact of the business cycle. They see a threat of stagnation and even stagflation. Moreover, concerns about productivity growth come on top of existing concerns about employment that were mentioned earlier. In 2001, GDP per capita in the euro area was 67 percent of the US level, with 69 percent in France and Germany.[12] Given that they choose to work so few hours, Europeans need to make sure each hour counts. They need to create an economic environment in which productivity grows.

With hindsight, perhaps talking about a "new economy" in the United States was an overstatement. But it would be a mistake to see the pendulum of opinion swing too far in the other direction. Economic performance did improve sharply in the United States in the 1990s and IT did play an important enabling role for business innovation. The surge in US productivity growth suggests that the pace of business innovation is enhanced by competitive, flexible markets, by land-use policies that encourage business expansion, by a sophisticated financial market that can fund risky investments, encourage entrepreneurship and weather storms, and by a labor market that encourages people to try new jobs. The single market in Europe provides an important way in which competitive intensity can increase as best practice companies spread region-wide. But this is only a potential that could be thwarted by restrictive regulation. With an economic environment that fosters business innovation, Europe could ensure it leverages the full benefits of IT use. A policy that tries to force-feed technology to the economy would likely result in wasted investments.

The lessons for the rest of the world from the new economy experience in the United States are similar. Create a good economy and let companies use IT in ways they find best. A certain amount of infrastructure development or standard setting may be needed, but this should not be an excuse to direct or control an industry. One useful lesson of the past couple of years is that being a producer of IT hardware is not as valuable as it looked. The number of jobs in the IT hardware sector was never all that large. At one time, the wealth creation in that sector was stupendous, but much of that

[11] Centre for European Studies (2002).
[12] The Conference Board (2002).

wealth has collapsed as the technology bubble burst. Industrial policies that fostered high-tech manufacturing in developing countries are not good investments.

Financial Crises: Market Failures or Policy Failures

Repeated and costly economic crises are a terrible failure of the global economic system. The dynamics of crises vary by country, so there is no single cause or cure. Since the focus of this paper is on the past year or so, I will look mostly at the lessons from Brazil and Argentina, but a preamble on the crisis in Korea is helpful to illustrate that not all crises are alike.

The Korean economy has been one of the greatest success stories of economic development. It quintupled its GDP between 1970 and 1995, transforming itself into a major economic power. Korea did a lot of things right, but Korea's rapid path of industrialization also contained some pitfalls. It never developed a modern banking system or financial markets that were able to assess risk and deal with company failures. It funneled a huge amount of capital into industries that were the chosen favorites of industrial policy, even though they could not use it productively. The close relationship between government and industry gave rise to favoritism and corruption. Corporate governance problems are not confined to Korea, but theirs were extreme, with unwieldy and opaque chaebol relationships. Investment decisions were not based on reasonable expectations of future profits.

The consequence of these difficulties was that very highly leveraged companies started to have trouble servicing their debts in the 1990s. The rate of return to capital had been driven down, not because Korea had too much capital overall, but because the capital was concentrated in industries that had over-expanded and over-invested. Rather than face up to the bad assets and bad loans, the banks borrowed from overseas, often with loans denominated in US dollars, to make up the shortfall. This made them highly vulnerable to crisis when contagion spread from Thailand and other Asian countries in 1997.

Other economists have described the Korean crisis, and the crises elsewhere in Asia, in somewhat different terms, focusing on the problems of fixed exchange rates, contagion, and short-run liquidity. And indeed those things were important, especially for the timing and short-run dynamics of the crisis. When the value of the Korean won fell, this left banks with a mismatch between their assets, in the form of won-denominated loans, and their liabilities, in the form of dollar borrowing from the global capital market. But the underlying structural problems that created the vulnerability to crisis in the first place are also important.[13]

Argentina did not achieve the stunning sustained growth that occurred in Korea. However, it did grow strongly in the 1990s, with real GDP growth averaging 4.4 percent in the years 1993-98 and inflation at only about 3 percent a year.[14] The relative price stability was in marked contrast to earlier periods of very high inflation. Argentina had taken the powerful but dangerous medicine of fixing its exchange rate to the US dollar in order to establish credibility for its monetary policy and reduce inflation. It had also taken major steps to establish a sound financial system, encouraging international banks to take over Argentine banks and ensuring these banks had adequate reserves and were well regulated. Given that growth was strong over this period, it should have been possible for government deficits to remain low and for the debt to GDP ratio to grow modestly or even decline. That was not the case. The debt to GDP ratio rose from 29 percent in 1993 to 41 percent in 1998, despite the fact that reported government deficits were rather small.[15]

A serious problem in Argentina, paralleled until recently in Brazil and Russia, is that spending decisions are made at the regional or local level, but the central or federal government is responsible for the resulting debts. This undermines fiscal discipline. It also undermines the confidence of investors, who see the instability in the budget process. As the debt to GDP ratio rises, they begin to doubt the government's ability to pay back its obligations. This problem is intensified if a significant fraction of the debt is held internationally and denominated in dollars, as was the case in Argentina. As confidence erodes, interest rates rise and the problem of debt service increases, even if the level of the debt to GDP ratio is not high by the standards of developed countries.

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[13] Structural problems are often dismissed, on the basis that: "how can they be important when Korea grew so fast for 25 years?" That is a false argument and I will return to it later in this paper.
[14] Michael Mussa (2002).
[15] Mussa (2002).

Argentina became vulnerable to crisis because of its fixed exchange rate and its fiscal problems.

In early 1999 the Brazilian real was allowed to float and the exchange rate dropped sharply. Brazil is a major trading partner of Argentina so the crisis in Brazil put heavy pressure on Argentina, increasing the likelihood of a devaluation of its currency, a breakdown of the one-to-one relation with the dollar. With the US dollar itself being very strong against other world currencies and the Brazilian currency depreciated, the Argentine peso had become unsustainably overvalued. Interest rates increased, and the economy went into a recession as GDP contracted by 4 percent between 1998 and 2000. The debt to GDP ratio rose to 50 percent in 2000 and the debt service rose even faster. With a currency that was way out of line and worsening fiscal problems, it was only a matter of time before the crisis took place. And in the course of responding to the crisis, the government has managed to bankrupt its previously sound banking system. It will take some time for Argentina to recover.

Turning to Brazil itself: After the devaluation of the real in 1999, Brazil managed to avoid the serious threat of runaway inflation. The fact that Brazil was able to end its fixed exchange rate and yet maintain reasonable stability was an achievement, and credit goes to the policies of the central bank under Arminio Fraga. However, the Brazilian government was not able to deal adequately with its fiscal problem, and it is now in danger of another crisis, involving restructuring (partial default) on its government debt. Some of the same ingredients that were at play in Argentina have also been at work in Brazil, notably the failure (until recently) of the national government to control the fiscal situation in the regions. One issue that is worth stressing in the Brazil context is the instability of the debt dynamics in a country threatened by crisis.

Take a hypothetical example to illustrate. Suppose a country has a government debt to GDP ratio of 50 percent and the interest rate paid on that debt is 10 percent. This means that total interest payments on the debt are equal to 5 percent of GDP. Suppose government revenues less government spending on everything except interest (the “primary surplus”) amounts to 3 percent of GDP. This means the overall budget deficit is 2 percent of GDP. Provided nominal GDP grows at even a moderate rate (anything over 4 percent a year), the government debt to GDP ratio will be falling. The country is a model of fiscal rectitude and investor confidence remains high.

Consider now a situation that differs from the above example only with respect to the interest rate the government must pay on its obligations. The debt to GDP ratio is the same, at 50 percent, the primary budget surplus is the same at 3 percent of GDP and real growth and inflation are the same. What is different, however, is that investors no longer have confidence in the government's ability to service its debt. There is a large risk premium imposed and in order to roll over its debt, the government must offer an interest rate of 25 percent. The debt service is now a massive 12.5 percent of GDP and the overall budget deficit is 9.5 percent of GDP. Nominal GDP would have to rise 19 percent a year to keep the debt to GDP ratio constant. Lower rates of growth will result in an upward spiral of rising debt to GDP, leading to even lower investor confidence and a rising interest rate, until a crisis occurs.

A high rate of nominal GDP increase is certainly possible with a large enough rate of inflation. There are many historical examples of countries using an increase in inflation as a way to get out of debt problems. But faster inflation creates its own difficulties and, in the case of countries like Brazil, will not even solve the problem. The government debt often carries floating interest rates (tied to the overnight rate for some bonds) and may be indexed to the exchange rate. This means the debt service costs will increase about as fast as any increase in the rate of inflation. Investors are well aware of the inflation risk and will not hold long-term bonds at fixed interest rates.

The particulars of Brazil's situation obviously differ in detail and are more complex than the example. Its net public net to GDP ratio in June 2002 was 59 percent, having risen from 30 percent in 1994 (using more conservative numbers on government assets the net debt in 2002 is as high as 66 percent).[16] It has recently been paying an interest premium of 20 percentage points over the rate on US Treasuries in order to borrow. Some of the debt is international, denominated in dollars. This means that devaluation immediately raises the ratio of public (and private) debt to GDP. It also adds additional concerns about the availability of foreign exchange to service the foreign debt. There is an election coming soon and the likely winner is Lula, the candidate of the

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[16] John Williamson (2002).

Workers' Party. But despite these additional elements, Brazil's overall situation does reflect in a central way the problem shown in the above example. It has made major fiscal reforms, including bringing discipline to the regions, and is running a primary budget surplus of 3.75 percent of GDP. But Brazil is paying very high interest rates and is in imminent danger of default and a debt restructuring.

The numerical example given earlier illustrates a phenomenon in economics of broader application—the existence of multiple equilibria. If everyone believes a country will be able to contain inflation and repay its debts, then interest rates will be low and the expectation is fulfilled. If expectations turn sour and interest rates rise, then the chances of default rise also and the expectations may be fulfilled. Economists often insist that expectations are rational and based on the underlying economic fundamentals. But the above example argues that there are actually two (or more) possible outcomes for which expectations turn out to be correct.

Interpreting this model is tricky, however. Investor expectations are not formed out of nothing. Whether a country ends up with a high-interest-rate equilibrium or a low-interest-rate equilibrium depend on the policies it followed along the way. Brazil has a long history of borrowing to cover an excess of government outlays over revenues. The government chose to borrow in dollars (or with bonds indexed to the exchange rate) as a way of reducing the cost of borrowing. But this strategy made the risks of borrowing much greater, and when the exchange rate slumped, the debt obligations jumped in value. Even in the past few years when there has been greater budget discipline, new government obligations have been uncovered that have pushed up the debt to GDP ratio.[17] A different policy path in the past would have prevented Brazil from moving to the bad equilibrium.

Lessons from the Crises. The crises in Korea, Argentina, and Brazil were not the result of the liberalization of domestic markets in these countries, or of trade liberalization. In fact if Korea had moved sooner to liberalize its domestic economy and reform its corporate governance structure and its banks, it might well have avoided a crisis. Argentina and Brazil did derive some benefit from the deregulation and market

[17] Morris Goldstein (2002b) provides a critical assessment of Brazil's budget situation and how it developed.

reforms they followed and Argentina developed a strong banking system by bringing in multinational banks. None of the three countries fully liberalized or opened their economies.

Further liberalization in Brazil and Argentina would not have been enough because the problems at the macro level limited the benefits of microeconomic liberalization. In Brazil, for example, it was hard for companies to invest and expand when real interest rates of 30 to 100 percent prevailed on loans for working capital or for purchases of consumer durables. Korea regained macroeconomic stability more quickly after its crisis and resumed solid growth. It has made substantial strides towards liberalization after the crisis, although it does still have to go further.

All three countries had problems resulting from fixed exchange rates. Possibly there are occasions when fixing the exchange rate will help overcome a history of exchange rate instability or of hyperinflation. But it is very hard to preserve a fixed exchange rate in the long run, without subordinating domestic monetary policy completely to this goal, which can create its own problems. In particular, if the currency does not adjust, then wages and prices in the domestic economy have to adjust, and that may come only with a severe recession or with chronically high unemployment. Exchange rate intervention may be helpful, if currencies are prone to instability, but some flexibility is needed to avoid crises.[18] Inflation targeting is not a policy I support for developed economies, but it may well be a good option for countries with a history of hyperinflation—a better alternative than trying to fix the exchange rate.

A lesson that is hard to draw clearly is the extent to which the crisis countries suffered purely from self-inflicted wounds, or were hurt by the workings of the global capital market. The promise of integration into the global capital market is that it offers countries access to funds for development and access to financial skills to provide better allocation of capital. These are important benefits. But the global capital market is a harsh taskmaster. A country that has sinned in the past (by running unsustainable budget deficits, for example) may find it very hard to recover. Investors, both domestic and foreign, are suspicious of promises to maintain fiscal discipline and avoid excessive inflation in the future. This is particularly the case when such policies will worsen a

[18] Morris Goldstein (2002a).

domestic recession. So interest rates remain high and the country is stuck in a high-interest-rate equilibrium. If a country's economic institutions are not ready to operate in the global environment, or if governments use the global market to finance unwise policies, then the costs of integration into the global capital market may outweigh the benefits.

The IMF can and has played a valuable role in helping countries get back on track. And it has made mistakes also. There is a contentious debate at present about the role of the IMF, which I do not wish to enter. I note only that the IMF is in a tough situation as it responds to crises. It may not have enough funds to shift an economy from a high-interest-rate equilibrium to a low-interest-rate equilibrium. And even if it did, like private investors, it may be suspicious of the promises that governments make about the future. Frequent large support packages by the IMF would tempt countries to avoid dealing with the problems in their fundamentals.

The clearest lesson from the experience of crisis countries is that it is vital to avoid trouble in the first place. As the famous Watergate saying notes, once the toothpaste is out of the tube it is very hard to get it back in again. Once a country has lost credibility for its monetary or fiscal policy it is very hard to regain it. [19] And the credibility with its own citizens is just as important as the credibility of the global market. Lacking that credibility, policymakers may be faced with either making drastic cuts in government spending or going into default.[20] Argentina has chosen to default and has bankrupted its banks in the process. Brazil faces very tough choices.

Development Failures and the Market Development Path

Views about the desirability of alternative paths to economic development have shifted in the last couple of years. As noted earlier, there is a profound backlash in Latin America against the market approach to economic development. Even in the transition economies, some policymakers are looking to the Asian model of growth instead of the

[19] This is another example of asymmetric information in markets and the problems it creates. A government may have a genuine commitment to sound policies, but investors do not know this.
[20] Cuts in government spending have been deplored on the grounds that such spending provides support for the poor. Some does, but the spending often goes to pay the salaries or pensions of bloated government bureaucracies or overstaffed government enterprises. That does not make the cuts any easier politically, however.

market model.[21] In this section I argue that the failures of economic development do not represent a failure of the market model.

William Easterly, a long-time World Bank economist, argues that past development efforts have been based on the belief that increases in capital and education, combined with control over population would lead to economic growth.[22] The World Bank has had an input-driven view of growth, he says. Standard economics assumes output in an industry or at the economy-wide level depends upon the inputs of capital, labor, skills and technology. Increases in output depend upon increasing the inputs, and so if output grows faster than population, the country is developing. And of course there is a simple legitimacy to this view, since after all no one can operate a factory or office or retail establishment without these inputs. But as a development strategy this input-based approach is flawed. Education, in particular, has been a development favorite, but there are many examples of countries that have invested heavily in education, but failed badly in their efforts to develop. Easterly says that development policy failed to account for people's response to incentives. If the economic incentives are wrong, educated workers take jobs in large government bureaucracies or move to the United States. Capital investment projects create gleaming new highways, but there is no economic activity to take advantage of them.

One can question the assumption here that economic development really has failed. India and China contain a large proportion of the world's population and they have been growing strongly for two decades. Based on the number of people in poverty, the economic situation has been improving for two decades according to a study by Surjit Bhalla.[23] Neither India nor China is a model of market forces, but both have been moving towards rather than away from the market model. Easterly's focus on economic incentives is the correct one, however. Many developing economies fail to get the economic incentives right for development.

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[21] Economic development also appears to have failed in Africa, when per capita incomes have actually been falling for twenty years. I have no knowledge base for discussing the situation in this continent.
[22] William Easterly (2001).
[23] Surjit S. Bhalla (2002) explains the difference between his findings and earlier more pessimistic reports from the World Bank. Africa is a notable exception to the general rule of poverty reduction.

The series of developing country studies by the McKinsey Global Institute, several of which I participated in, have documented, industry by industry, the institutional failures and policy interventions that have distorted incentives and created barriers to growth in a wide range of countries. The body of information in these studies is very large, but a few examples can illustrate the conclusions drawn. India placed restrictions on apparel producers, limiting the amount of capital (machinery) that could be used by any single company. The idea of this restriction was to protect employment. The result was that apparel companies could not achieve optimal scale and their productivity was low. The level of productivity *and employment* in the industry in India is far lower than in China where there were no such restrictions. India placed restrictions on foreign direct investment and its auto industry remained very small and with low productivity. Licensing requirements were abolished and foreign investment permitted in the early 1990s. From 1992-93 to 1999-2000, labor productivity in this industry increased 256 percent, output rose 280 percent and employment increased 11 percent. In Korea, industrial policy favored investment to expand capacity at the expense of profitability. The semiconductor, confectionary, and auto industries in 1995 all had capital per worker that was about the same as the United States, but productivity was only half the US level. There was widespread excess capacity even before the crisis in 1998. In the confectionary industry there were brand new production lines standing idle, which had been built without adequate market research as to whether people would buy the products.

In Brazil and Russia high productivity supermarkets must pay taxes. Their expansion has been slowed because they have trouble competing against low productivity retailers that evade taxes and do not abide by safety and sanitary rules. A playing field that is tilted against high-productivity companies, or small companies with the potential to grow, often showed up in these studies as a barrier to growth.

There is a crazy quilt of restrictions, distortions, and regulations in Brazil, Argentina, India, Russia, Turkey, and probably most developing countries. They do not solve any market failures, and they create an environment that often breeds corruption as well. A large and even growing share of employment is in the informal sector, held there by restrictive policies, the difficulty of getting clear title to land and problems of contract enforcement. It is not surprising that many economists and policymakers have suggested sweeping market reforms. There is something to be said for this approach to development, and it could work in any country that could maintain a reasonable level of inflation and avoid an unstable fiscal situation. Market reforms, accompanied by a sound legal system, would likely get incentives a lot straighter than they are now, even if there were some market failures along the way.

In other countries, however, such shock therapy might cause more dislocation in the short run than the political process can stand. And perhaps it is a dangerous approach in countries that lack adequate institutions, a sound legal system, or a sound financial sector. The right sequencing of market liberalization is a tough issue that goes beyond the scope of this paper.

The important point is that it is possible to look directly at the workings of a developing country economy and see why its industries are not growing and why productivity is low. It is information that is not available from official statistics and does not come from short visits to a country. It is essential information to an understanding of the barriers to development and how to create the right microeconomic environment for growth.

Finally, there is the question of whether the Asian development model refutes the argument made here. Japan, Korea, Taiwan, and Singapore all grew very rapidly in periods when they had a lot of government intervention in the economy.

Developing countries would do well to copy many of the features of the successful Asian economies. They achieved moderate inflation and fiscal discipline. They educated their workforces and, while education is no magic bullet for development, the availability of an educated workforce was helpful to growth. They exposed many of their industries to competition with the world's best practice companies with export incentives. They provided incentives for saving and directed the flow of funds into industrialization, which was appropriate at their level of development. Corruption existed but was kept under control.

The specific industrial policies that favored some industries over others were not the basis for success in Asia. A careful review of industrial policy by Marcus Noland and Howard Pack (2002) concludes that it accounts for very little of the strong growth in Japan, Korea, and Taiwan. In fact, the industrial policies followed by these Asian countries have costs that have grown larger over time. The period of rapid economic growth in each country was achieved with extraordinary rates of saving and investment, levels that squeezed consumption among households at a time when they had very low standards of living. If these economies had been more open and their domestic industries competitive, they could have relied more on productivity growth and less on input growth. Singapore, a very rich country, encouraged the inflow of foreign direct investment, bringing capital, skills, and technology with it.

Korea's industrial policy made it vulnerable to crisis, in the manner described earlier, while the example of Japan suggests that the Asian growth model can run into a brick wall at some point. Making the transition to a more open flexible market economy at that point is hard. There are many virtues to the Asian development model, but industrial policy is not one of them.

Conclusion

Some of the economic dislocations of the past year or so can be linked to market problems. Examples include the equity market boom and bust cycle in the United States and elsewhere, and the corporate greed and corruption. And policymakers in Brazil and Argentina who were trying to solve their economic crises can be forgiven for thinking the global capital market is a tough master.

But at the end of the day, getting the incentives right is the answer to economic growth and, generally, getting the incentives right means using competitive markets. For all its problems it is the best system available. It is made much better with good stabilization policies and with legal and regulatory systems that provide accurate information to market participants. It works better when it encourages competition and regulates monopolies (sensibly), if these are the only workable structure for an industry. It can be combined with redistribution policies without eroding the incentives unduly. The market system works worse when screwball restrictions are put in place with an incoherent rationale behind them. It works worse when regulation becomes an excuse to protect one set of jobs in the economy at the expense of potential new jobs elsewhere. It works worse when policies prevent industries from evolving and old firms from dying. It works much worse if fiscal and monetary policies follow paths that are unsustainable over the long run.

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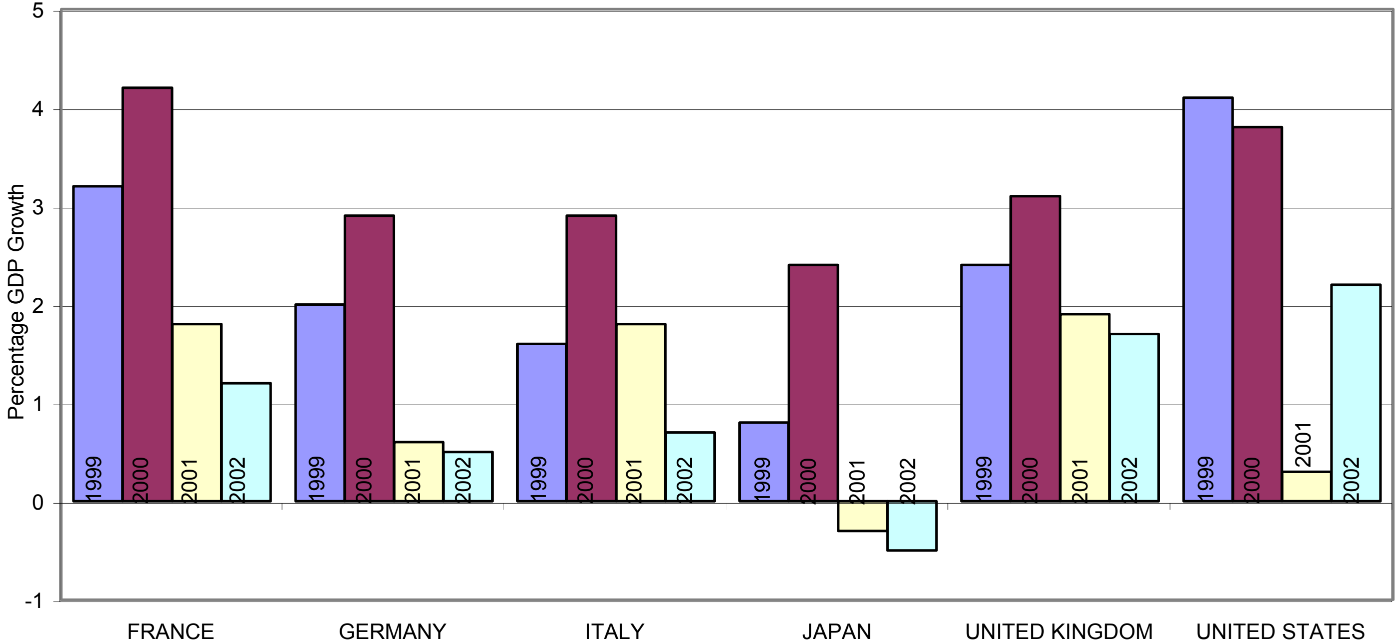
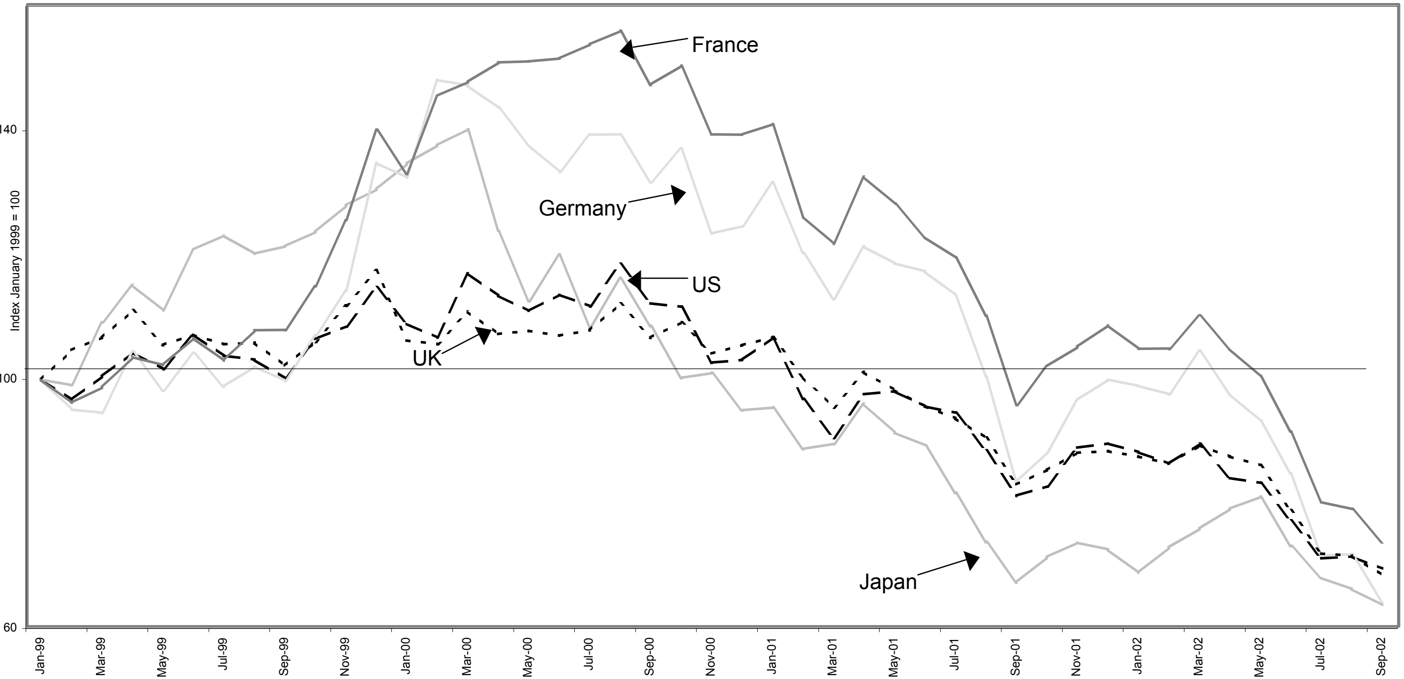
Figure 1: A Synchronized Decline in GDP Growth



Source: IMF World Economic Outlook September 2002

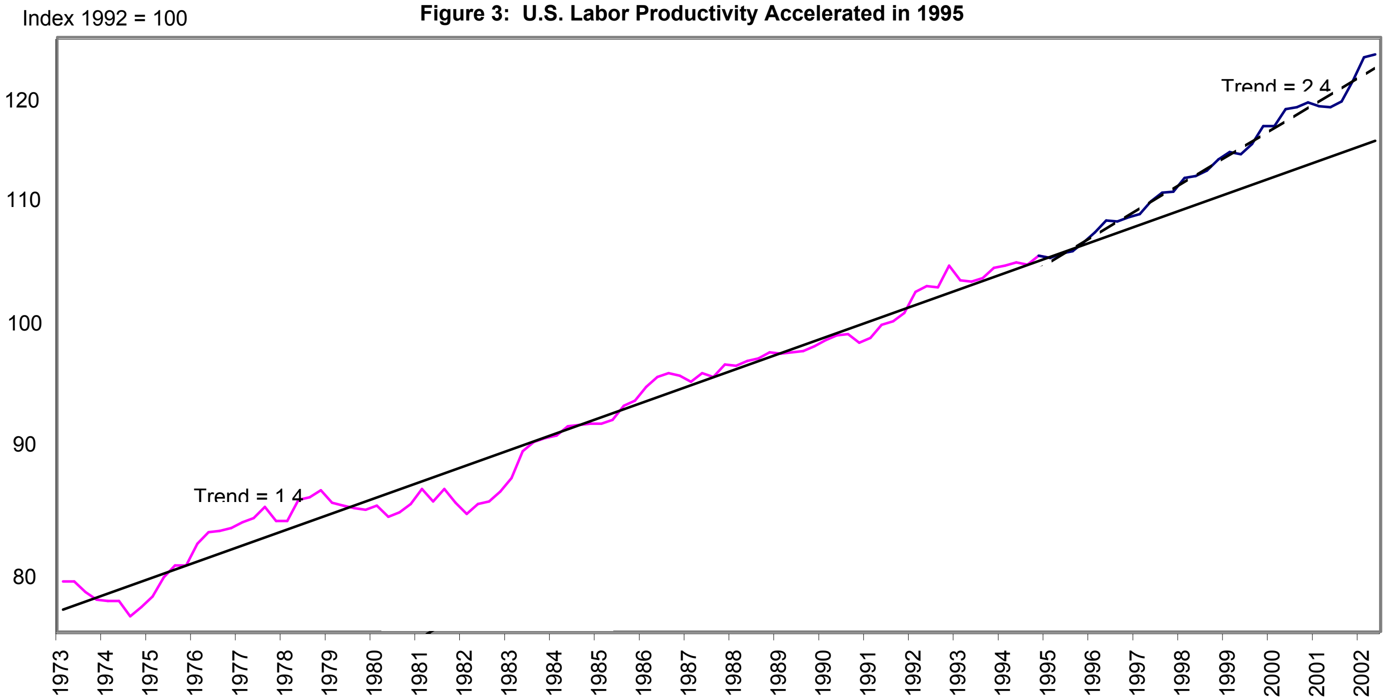
Note: IMF Forecast for 2002 Data

Figure 2: Synchronized Movements of Equity Markets



Source: Yahoo Finance. France (CAC 40), UK (FTSE 100), Germany (DAX), Japan (NIKKEI 225), US (S&P 500).

Figure 3: U.S. Labor Productivity Accelerated in 1995



Source: Bureau of Labor Statistics. Index on logarithmic