The Bellagio Symposium on New Growth Paradigms

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Where Are We?

The advanced economies of the world are out of money, out of growth and out of trust. That is the principal challenge now facing the global economy. The response has been a paralysis of sorts with governments both uncertain about the right course of action and also incapable of executing new policies. As a result, a "hold-the-course" approach is the prevailing order of the day. It is a pattern that is repeating itself at global, national and local levels where policy and its implementation are no longer seen as effective given the structural challenges of low and jobless growth, unfavorable demographics that drive expenditures, and a pattern of excessive public debt. There appears to be a vacuum of leadership, greater uncertainly about the sustainability of exiting growth paths, and weak political support. At the same time, citizens are expecting more from the state and the state is not delivering. Magnified at the global level, this is a cause for concern. The Bellagio Symposium was organized by the Growth Dialogue to discuss possible ways forward.

The Big Picture

Global economic management and coordination is sputtering. After coming together in a significant way in 2009, the G20 has proven itself unable to generate a political momentum to enable national governments to pursue successful economic policies. Across the board, policymakers are complaining about the exchange-rate implications of uncoordinated national monetary policies (or in the case of some emerging economies of explicit nominal exchange rate targeting). The crisis period since 2008 has been characterized by very large fluctuations of the $/Euro exchange rate, with a volatility that suggested that currencies were not reflecting underlying fundamentals. Global currency and debt markets, in turn, seemed to have lost confidence in the ability of governments to manage economies in an orderly way, and without any anchoring of expectations, volatility has continued to be high. This has heightened risk and hindered investment.

The G20 is perceived to be the only body that could re-establish greater confidence in coherent international policymaking, but its framework of strong, sustainable and balanced growth has not proven to be effective in restoring confidence. Major issues, such as the consistency of the international monetary system with long-term, stable growth, have remained unaddressed. Equally, the ability of the

G20 to deliver on global public goods and reduce global bads has been limited, with some success in fighting protectionism, but failures in dealing with global food and energy price shocks, and, in a longer-term perspective, addressing the issue of climate change.

Calls for a strengthening of international institutions are offset by a sense that the political window for closer global cooperation may well have closed and no country today is really driving change in the international system, each concentrating instead on national self-interest. One might well characterize the current global system as one akin to an “absentee landlord.” The advanced economies are under stress and the emerging economies are not yet able or willing perhaps to take up the gauntlet of helping to manage the global system. There is no global decision-making process that appears up to the task at hand of restoring short-term confidence and stability, medium-term growth, and longer-term fiscal sustainability. Global policymaking is still struggling to find a governance system that balances legitimacy and inclusion with effectiveness and action.

National Challenges to Growth

At the national level, there are many countries that need to de-lever and adjust to establish a new sustainable pattern of growth and employment. There was considerable concern expressed over the loss of confidence in governments in the advanced economies to manage themselves and ensure growth. The dilemma of regaining fiscal control and rekindling growth has been formidable. In the case of emerging economies and some advanced economies, structural reform at the national level has for many years taken the shape of freeing the private sector from government controls—governments largely stopped doing things they should not be doing. But in the process, the broader discourse has evolved in a way that has weakened governments’ ability to do things it should be doing, what is now referred to as “smart” or “strategic” government, especially as it relates to regulation and market oversight as well as investment and coordination to enhance competitiveness.

In 2009, fiscal policy was overwhelmingly driven by aggregate demand management concerns; however, the voices in favor of a stronger supply-side role for government have become increasingly vocal. Of course, fiscal policy still needs to address the current depressed stage of the global business cycle, but the ratio of potentially long-term unemployed in total unemployment has risen, suggesting a large structural component to labor market problems in many advanced economies.

A magic triangle of budget discipline, growth-supporting investments, and expenditures that promote social cohesion was proposed, with the implication being that governments would need to rebalance spending towards investment (especially infrastructure), restructure how they spend to achieve greater accountability and results (for example, on universities that deliver results or competitive grants for innovation), and rebalance regulations on protected sectors such as retail trade and re-invigorate those in finance(to promote real competition).

At the local level, the concern was that broad national policies often failed to relate to the specific needs of disadvantaged groups and were neither sufficiently tailored nor effectively implemented to make a

difference. For example, in India, urbanization rates had slowed down because of a lack of urban services and the inability to deal with land problems. South Africa's unemployment problems seem intractable, and Ghana's educational achievement level was inadequate. Other examples pertain to labor market policies, which may need to be more focused on lagging regions, young people, women and migrants, who all operate in segments of the labor market that may not be affected significantly by broad-brush interventions. The conclusion: very specific, well-crafted policy interventions are needed with constant monitoring and feedback during implementation. Relatively few governments these days seem to have the capacity to deliver well on this metric.

Politics and Policymaking

One strongly held view was that the economic prescriptions for overcoming current challenges were broadly known, but that political will and institutional capacity for action were lacking. "It's the politics, stupid" was a recurring sentiment, both in terms of making appropriate policy choices (including clearly distinguishing between long-term and short-term growth dynamics) and in terms of sustained implementation. The fact that the losses of the economic downturn have been so concentrated on particular groups, while the uncertainty created has so rattled the middle class, also means that the politics of economic policymaking has become more complicated than before; traditional macro-economic tools seem not well-suited to address the political concern to not only target the poor, but also the middle class that seems to have lost income, wealth and, most of all, confidence.

There was also an alternative view that policymakers were still fighting last year's wars in thinking that the recession was simply a very pronounced cyclical downturn, and that riding it through and stressing fundamentals was the right course. This view of the world was largely rejected as not fully internalizing the seismic shifts in investment and consumption behaviors, risk tolerances, and the limits of government policy that have emerged. When added up on a global scale, these uncertainties that envelop policymaking at present make it all the more difficult to coordinate and find superior global outcomes. Put theoretically, the result is that every government acts in its own self-interest, creating a low-level Nash equilibrium outcome, instead of cooperating to create a Pareto-superior result. In a world of multiple equilibria, confidence in the trajectory of policymaking is vital in steering investment decisions so as to reach better global outcomes.

In these political circumstances, there has been a dangerous tendency to be selective in the interpretation of the effectiveness of different approaches and institutions coupled with what many consider the erroneous path of picking a few of a wide-range of policies that seemed to work, in East Asia, for example, and expecting economic miracles. Moreover, the hegemony of ideas by some elements of the economics profession has been broken by the unexpected course of the global crisis, and, while this opens the door for new ideas and productive discussions, it also creates opportunities for a variety of bad ideas to flourish. Former policymakers commented on having to spend 70 percent of their time on combating bad ideas and only 30 percent on developing and championing good ideas. In

this open debate, a strong recommendation for maintaining a focus on long-term growth, employment, and productivity emerged.

While it may seem obvious that growth should be the primary preoccupation for politicians, there is increased concern that this may not be the case in practice. Given that the benefits from growth in advanced countries have become narrowly concentrated in the elite, and jobless growth is a common phenomenon, the mass appeal of growth-oriented policies has declined. This is unfortunate since there is virtually no escape from fiscal imbalances that does not require a restoration of economic growth. At the same time, the elderly, those disadvantaged by market competition, environmentalists and others have become skeptical that long-term growth policies will advance their aspirations. While much of the world is experiencing unparalleled prosperity in historical context, mal-distribution of gains and a greater focus on relative welfare measures has reduced trust in the system and the likelihood that growth will benefit the many at the expense of the few. The pro-growth coalition in advanced economies is shrinking. If the middle class joins the anti-growth bandwagon in the belief that capture and money politics has rigged the system and the erosion of trust in government continues, some economic policies that are detrimental will be hard to reverse.

The Model

Growth is stronger in developing countries and the growth model there seems less affected. It seems apparent that convergence between countries will continue, with low income and middle -income countries able to sustain faster growth thanks to the diffusion of catch-up technology. While broadly speaking there was an agreement that this would be good for global growth, there was some unease that globalization combined with powerful trends in technology may be having a greater impact on jobs in advanced countries than commonly thought. The prevailing wisdom is that skills-biased technological change is responsible for a large majority of job losses, with global competition playing a secondary role. But this may be too sanguine. With industry level productivity data, globalization and technology are hard to separate. If low-wage jobs are out-sourced, the data may appear to show a skills-biased technology improvement in those jobs that remain, but in reality what has taken place is a shift of the supply chain due to globalization. There are further complications with interpreting productivity data (with the import price index, most significantly) so many academic studies could be flawed and indeed newer studies with alternative data suggest a considerable adverse impact of foreign competition on US jobs. This would support the rapidly falling preference for globalization in recent surveys. Nevertheless, when trade, investment and innovation are taken together, the view that global growth and globalization go hand-in-hand remained unquestioned.

That was not taken to imply that governments should be passive viewers of globalization--quite the reverse. Governments need to actively consider globalization's implications. One hot debate was on the degree of spill-overs from manufacturing. The importance of the manufacturing sector for providing "good" jobs and hence helping promote broadly shared income gains and aiding social cohesion, as well as prodding innovation, was stressed. In the United States, manufacturing employment collapsed after 2001 due to plant closures (not lay-offs) in labor-intensive, tradable sectors. But manufacturing firms account for two-thirds of all research and development in the United States, and almost all R&D is done

within the United States, so manufacturing becomes an important component both of the broad social compact and as a source of continuous innovation. Manufacturing had been helped in the past by a supportive university system and by public investment in infrastructure, but the opportunities to use these levers for the promotion of long-term growth seems be under-exploited in some advanced economies. What is more, the policy concern has shifted to trying to keep the lower wage manufacturing jobs on-shore, not just the higher-skills jobs which have been relatively protected.

The competitiveness of the manufacturing sector in a globalized world inevitably depends on exchange rates and there was considerable interest in how exchange rate management should be viewed in this context. At one level, there was concern that the absence of a formal international monetary system introduced significant global risks that were rising as the dominance of the US dollar as an international safe asset of choice declines. Despite the importance of exchange rates to the real economy, monetary authorities appear to be willing to permit large fluctuations. The hoped-for emergence of a stable international monetary order with all central banks targeting inflation around a common level of 2 percent has disappointed, as many important international players have simply not been willing to adopt the same ground rules, some exploiting the advantages of global currencies, others promoting exports, and still others concerned about regional stability. Recent events in Europe also cast doubt on the balance of objectives between inflation and growth.

Indeed, monetary and financial systems seem to be overly influenced by national self-interest and are not globally coherent. Financial innovation was broadly seen as a major part of the growth problem, rather than a driver of more rapid, long-term growth. There was a consensus appreciation of the in-built long-run boom-bust cycle that appears to be an inevitable result of rapid financial innovation, even though the period of the Great Moderation tantalizingly promised the opposite. The underlying growth model of this period was clearly flawed, based as it was on the build-up of high debt to support demand growth. Moreover, as one outside observer, iconic in the study of growth, noted: financial innovation has passed the point of usefulness for the global economy. But there was less consensus on what to do about this--regulation, in and of itself, was also not perceived as the right answer for renewed growth. It could simply encourage a shift into the unregulated segments of the market. Indeed, there are many concerns over the large and still unregulated shadow banking system that some believe continues to pose serious systemic risks. The political economy of captured regulators and cozy rent-seekers making monopoly profits were also presented as a threat to growth, not just in finance, but in other sectors as well. In Europe and several middle-income countries, excessive regulation is also visible in the retail and other services sectors, where competition is thwarted and growth is stymied.

Regulations need to permit creative destruction and flexibility if they are to be supportive of growth and there was considerable interest in the German approach. There, an apprenticeship system has some of the properties of a low entry-wage level, coupled with organized skill development that permits future wage gains. The tripartite system in conducting a national dialogue on a social compact has proven to be effective in providing flexibility in wage costs, saving employment and shifting resources into worker education and training. Perhaps just as pertinently, Germany has been actively responding to a perceived reduction in the tolerance in society for inequality. It has been doing something about inclusion and the success of this system in permitting Germany to navigate successfully through the

Great Recession has led some to argue that the design of social policies would be more important to growth and productivity than the design of industrial policy, although the notion of absolute government “ neutrality” was largely discarded as unrealistic.

Middle Income Countries and Middle Class Issues

In fact, a consensus emerged that, regardless of the specifics, growth strategies needed to be constantly adapted to changing country and global circumstances. Many developing countries, where change is more rapid, have felt this for some time. Commodity exporters must figure out how to translate their riches from higher prices into sustainable growth. Middle-income countries need to avoid the middle income trap and manage the expectations of a new middle class. Contrary to conventional wisdom that views the middle class as a major driver of growth through consumer spending, there was a concern that the middle class can also retard growth. If the middle class becomes unhappy despite rising incomes, because of excessive debt or disappointment with low-wage jobs, they can create political tensions and foment policies that are damaging toward growth and the quality of life. Protectionism, lower taxes, general public expenditures and fossil fuel subsidies are some of the growth-reducing policies that have been adopted in response to middle class pressures. The new middle class in emerging economies is still vulnerable to shocks and has little by way of safety nets in the event of an accident or a health-related absence from work.

The difficulties experienced by middle-income countries are a concern in growth economics. The reasons why some states fail at low income levels are increasingly well understood in terms of their institutions and governance, but failure to grow at middle income levels is as prevalent and much less well understood. It may be that governments, supported by vested interests, do not adapt growth strategies rapidly enough to match the evolving structure of the economy. One basic issue relates to labor markets and jobs. In fact, a large part of the growth/jobs puzzle is why employment rates in so many middle income and advanced countries are so low. For those families that are outside the labor market, familiar prescriptions from the left (unions, collective bargaining) or right (liberalize labor legislation, right-to-work) are both irrelevant. Finely targeted policies that address the specific barriers that prevent people from working are needed, some of them related to gender-specific policies that encourage female labor force participation. Unless such barriers are identified and dealt with, and lead to higher employment rates, it will be hard for economies to achieve the social cohesion needed to support long-term growth strategies and valuable human capital will continue to be wasted.

A disillusioned middle class can emerge when there is a sense that economic policies favor those at the top (socialization of large financial sector losses and privatization of large, often non-welfare improving gains), while government efforts at distribution are oriented to those at the bottom of the income distribution. In the case of the former, opportunities for middle class economic advancement are lost. In the case of the latter, personal responsibility that is the bedrock of middle class values may be ignored. A healthy middle class, therefore, arises in environments where both opportunity and responsibility are

taken seriously. Competition (in services), anti-discrimination (in education), transparency (in tax expenditures) and accountability (in teacher evaluations) are policies that can favor the middle class. Capture of a disproportionate share of gains by the uppermost income groups and ineffective redistribution efforts towards the middle class can be seen as drags on future growth generation.

Growth Drivers

One source of optimism about future growth comes from the recognition that technology is the main driver of productivity, and that technological effort is continuing largely unabated, despite macro-economic problems. Of course technology needs to be marshaled and managed, and this does not happen automatically. On the one hand, developing countries face a special problem in trying to manage sophisticated technological systems, and capture major benefits of innovation. When they cannot do this effectively (because of weaknesses in public sector capabilities), it reinforces the advantages of operating in advanced countries. On the other hand, supply chains are evolving rapidly into new areas and new countries, underlining the spread of globalization. It is therefore unclear who benefits and who loses most from globalization. Firms may be indifferent to location, but national governments cannot afford to be.

To make technology work for growth can require public management systems that drive systemic national changes. Doing this effectively requires bringing together well-designed incentives for individual behavior along with competition into an accountability framework for growth. With large portions of any economy now dependent on public sector performance, improving public management is a priority. Incentives and governance systems are quite different from those of the private sector. One conundrum is that Finance Ministers often keep new pilots small to manage governance problems, but then find themselves unable to scale up successes. Bringing technological change into the public sector may be a key component of ensuring that the benefits of technical change are felt throughout the economy.

In all countries, technology and globalization are equalizing wages at higher skilled levels. It is at lower skills where big differences remain. The entry into the global force of many lower skilled workers in China may have accelerated an existing trend that has depressed wages for workers with basic skills in advanced economies. That is bringing into question the impact of university education as a route through which individuals or countries can gain a competitive edge. If the costs of tertiary education in advanced countries rise (as more students choose to go to college), while the benefits fall due to competition from overseas, then rates of return can quickly plummet. The higher end of the income distribution, which has benefited most from globalization in the past, may also be vulnerable to globalization in the future. In the end, regardless of the division of responsibility for lower wages and fewer jobs between technological advances and off-shoring, the politics of lower real incomes is an undeniable challenge.

In managing economic challenges, there is a significant gap between theory and practice. Traditionally, this gap has been filled by resort to pragmatism and evidence-based policy-making. But such approaches

may be harder to implement as new, and more complex, questions arise for which appropriate data is not available. The inability of economists to fully understand the impact of globalization is in part because trade data is not disaggregated into value added and intermediate components and global supply chain-related data is opaque. Without this information, the impact of trade policies on incomes (a value added concept) or even on the size of current account imbalances cannot be properly measured. Similarly, data on income distribution are unable to permit a sorting out of inequality of outcomes from inequality of opportunity. They do not quantify perceptions about social fairness and the social compact as opposed to inequality. They do not measure happiness, trust or confidence, all of which seem crucial to economic management today.

In several advanced economies, there is recognition of the inadequacy of data to provide a solid foundation for policymaking and efforts to expand national or state level accounts to incorporate natural resource use, to develop indicators of happiness, to disaggregate trade data and the like are underway. These efforts are critical in ensuring that the growth paradigm can continue to evolve as necessary to provide new generations with improvements in living standards at the same pace as that delivered by the growth paradigm outlined in the 2008 Growth Commission Report.

The call for global safe assets and global safety nets as the two most important foundations to mitigate risk in the modern global economy illustrates a paradox of modern growth. Innovation, entrepreneurship and creative destruction are needed for productivity increases, but individuals are looking for greater safety in their investments and in their lives. Economic and political forces are moving in opposing directions. The role of government thus becomes even more essential.

What Next?

There is little doubt concerning the daunting challenges ahead. Indeed there is talk these days of decelerating growth models or those with inherent limitations. These built-in limits can affect large countries that have relied excessively on consumption to drive demand as well as those who have relied too much on investment led growth. In the former case, asset bubbles, over-indebtedness, and difficulties in income adjustment make the picture cloudy for households and nations; in the latter case, diminishing returns to investment and chronic under-consumption make for a difficult transition in the composition of growth and reduction of surpluses. Whatever policy choices are selected, key considerations involve first, political implementability, and second, international acceptability. The emerging consensus was that the promotion of a more rapid long-term growth path with improvements in fiscal balances and greater fairness in distribution was possible for many.

Countries in Europe have achieved distinctly different income distributions after government actions on taxation and transfers, showing that growth and distribution combinations can be affected by policy. Some tough inter-generational issues will need to be tackled, however. The second challenge of squaring job creation with economic growth is potentially more difficult and involves the issues of middle-income countries and those affecting the middle class. These challenges require political economy solutions to be growth enhancing.

Attempting to make longer-term growth strategies compatible with sustainability objectives is costly and difficult; however, there are many green investments, for instance, that will quickly pay for themselves and be growth-promoting. The constraint is often political and economic rather than technological, and in some cases can be tackled at local levels. Moreover, effective investments in education can in the long run also improve incomes and build support for structural change, while enabling the creation of new growth engines.

The sense of the Group remains that a basic factor influencing future growth policies revolves around the role of the state. The state (i.e., government) has multiple roles as economic manager and shock absorber, regulator, redistributor, and strategic investor—all of which affect growth prospects. If the state is captured, then the benefits of growth cannot be shared in any fashion compatible with social cohesion. This is not a problem that only affects failed states—it affects all states. Moving government out of the way was not generally seen as the smart play in a world of greater uncertainty and greater inequality.

Looking internationally, for the stewardship of the global economy to function, especially during difficult times, groups of committed states need to cooperate and they require institutional support. The fabric of the international system is frayed, but not broken. Re-commitment and re-investment in that system is indispensable. The capacity of governments to act, and their willingness to do so, depends in the first instance on their ability to solve national growth challenges effectively. It is only within that calculus that globally better policies can be effectively pursued

Homi Kharas Danny Leipziger Michael Spence

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