Keynote Address

Development Prospects in Light of the Global Financial Crisis

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The world economy has been experiencing its worst shock since the Second World War. In both depth and breadth, the world has not experienced anything even close to this severity. All countries have been affected except those entirely cut off from the international financial system, and those are the countries whose per capita incomes are low and stagnant.

Unlike earlier crises, industrial countries are fully part of it. Developing countries are experiencing a downturn not of their making (but that was also true of earlier recessions). There are a number of questions about how developing countries may need to adapt their policies to foster economic growth in light of the crisis. Various prognosticators have argued that the financial crisis shows that outward-oriented development strategies are a thing of the past, that the crisis proves that market-based economic policies are misguided, and that new development strategies are needed.

But these conclusions are, in my judgment, in error. In the future, more attention will certainly need to be paid to the financial system and an appropriate regulatory framework, capital will likely become more expensive, and these factors alone will reduce the latitude for misguided policies in the future. However, that is not a prescription for changing economic policy more generally.

To develop the argument, several issues need to be addressed: (1) the role of the financial system, (2) the outlook for the international economy in the near, intermediate, and long term, (3) the way in which different countries and groups of countries have been affected, and (4) on the basis of considerations for 1 and 2 and 3, the lessons for the future.

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Annual World Bank Conference on Development Economics 2010, Global

The Role of the Financial System

In assessing policy options and prospects, a first point to remember is that a well-functioning financial system is essential for economic growth and that the more advanced the economy, the more important it is to have a deep and well-functioning system. The vital economic function played by the financial system is to evaluate the risk-reward trade-offs of alternative investment opportunities, selecting those that have the highest risk-adjusted payoffs and enabling different groups of savers to allocate their resources to those investments closest to their own risk-reward preferences.

Any economic history of the industrial countries must include a record of the development of the financial system alongside the real economy. Starting from a world in which virtually all investments were owner or family financed (with a consequent failure of highly profitable firms to grow as rapidly as they might and less profitable firms to grow more rapidly than they should), short-term finance developed in a variety of ways, among them sharing among guild members and early bank financing of commercial paper. Longer-term lending, equity finance (which enabled the development of large-scale enterprises, today's modern corporations), start-up investors (venture capitalists and angels), and so on all became part of the financial intermediation industry. None of these could have happened without the development of a commercial code and an appropriate set of institutions to enforce contracts and settle disputes.

Numerous studies have documented the strong relationship between level of per capita income and extent of development of the financial system. In considering how national or international financial architecture might be altered, it is important to remember that the risks in the financial system can often be diminished, but they cannot be negated entirely without negative consequences for economic growth. Regulation is needed, but the wrong sorts of regulation or overregulation may lead to stagnation or relatively slow growth. The art is to find the happy medium.

However, it has long been recognized that financial intermediaries are "special" in various ways. An important one of those ways is that many financial institutions, and especially banks, are lending long and borrowing short. There is an inherent mismatch in maturities between their assets and their liabilities. Because the future is inherently uncertain, lenders will not lend without receiving an adequate reward for the risk they are taking. This gives rise to the "risk premium," which borrowers pay to compensate lenders for accepting the risk.

This can lead to perverse incentives in difficult situations. If a bank recognizes, for example, that its equity is or will be greatly eroded, there is a strong incentive to "gamble for resurrection" by making highly risky loans. Such loans naturally bear higher interest rates because of the risk. If the borrowers are able to repay, the bank is "saved." If the borrowers are unable to repay, the bank owners are no worse off, because the bank would have failed anyway.

Thus, there never was a strong case for totally free financial intermediation, unless incentives could be found that would induce bank owners and managers to avoid taking on too much risk, especially if they encountered adverse fortunes. The requirement that banks (and other financial institutions) maintain adequate equity relative to the riskiness of their loans is set precisely in order to avoid the perverse behavior that might otherwise arise if banks face difficulties.

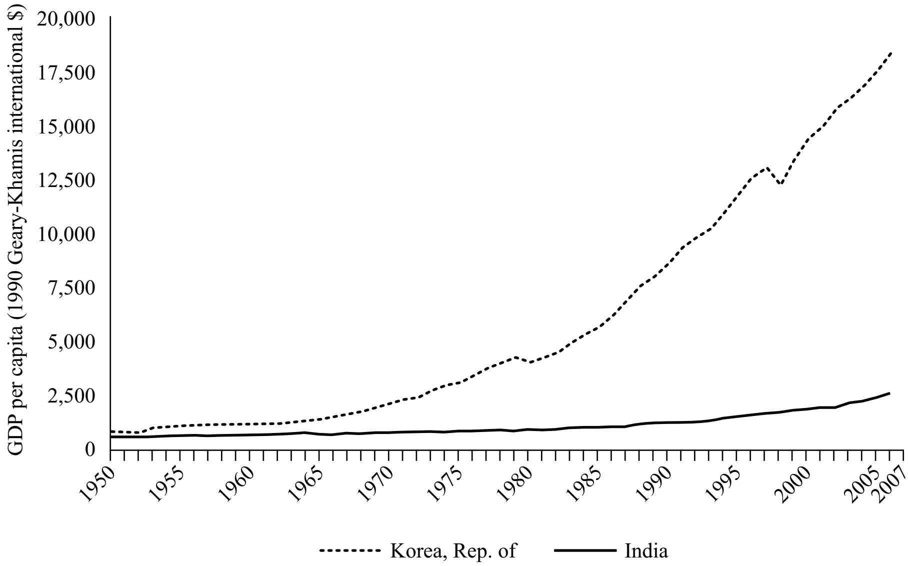
However, regulation itself is difficult and imperfect. The risk classifications in Basel I turned out to be ill-advised in several ways, including the categorization of various forms of loans into risk categories. And Basel II seems to be undergoing great scrutiny. The art of regulation is to thwart the perverse incentives that might arise, but simultaneously to permit the development of an effective and efficient financial system for evaluating risk-return trade-offs and appropriately allocating loanable funds. Since a considerable fraction of loanable funds is devoted to increasing the nation's capital stock, the efficiency of the financial system is an important determinant of the rate of economic growth.

That said, there will always be financial crises. Perhaps the first lesson of this (as well as past) financial crisis is that it would be foolhardy to expect that it would never happen again. Even so, the timing, proximate causes, and nature of any future crisis will be different from those of the past. The best that individual countries can do is to develop their own financial system in accordance with good regulatory practice, while supporting the development of international norms, regulations, or cooperative regimes to address some of the international aspects of financial regulation.

While financial crises are painful, and we must seek to understand their causes and implement policies that will reduce, if not eliminate, their negative impact, it should also be remembered that there are worse things than crises. Researchers have shown that countries that have had financial crises have, on average, grown more rapidly than countries that have not; the reason is that the financial systems in the crisis countries, although imperfect, generated more credit and a higher rate of return than those in countries where there was financial stability through heavy regulation, with resulting lower growth rates (Rancière, Tornell, and Westermann 2008).

The point is dramatically illustrated by the comparative experience of the Republic of Korea and India. Figure 1 shows the income per capita of Korea and India in the period since 1960. The two countries started at about the same level of income per capita, but economic growth was considerably faster in Korea than in India. Korea, however, had the major crisis of 1997, which shows clearly on the figure. India did not have such a crisis, as shown by the continuous (but slower at least until the 1990s) upward slope of the line for Indian income per capita. Forced to choose between the Korean growth rate cum crisis and the Indian growth rate sans crisis for the next half century, most people would choose the Korean experience for their countries. Thus, while measures to reduce the magnitude of crisis are urgently needed, care must be taken so that those measures do not so stifle the financial system and greatly reduce growth rates.

FIGURE 1.
GDP Per Capita in Korea and India, 1950–2007



Source: Maddison 2003.

In this regard, one additional lesson, which is valid for all countries, is worth noting. Until this crisis, the tendency among policy makers and academics had been to regard finance as a field separate from macroeconomics. One of the fundamental lessons of the crisis is that finance is an integral part of macroeconomics and vice versa (how else could the real economy have been so affected by the financial system?). It seems virtually certain that over the next few years, many economists and finance specialists will be trying to understand better the interrelations between finance and macroeconomics.

Causes of the Crisis

A first question pertains to the causes of the crisis. There will surely be analyses and studies for a long time to come, as researchers seek a better understanding of what happened and why. At present, there is broad understanding of the following features.

First of all, there are several levels of analysis. While there is little doubt that the crisis was financial, it was, and is, "real." The first apparent difficulties took place in the housing sector, and concerns about the degree to which home loans would become nonperforming in various portfolios marked the beginning of the crisis (concerns really covered the actual rate of nonperforming loans and the uncertainty about who held how many). But the factors that immediately led to crisis—the housing bubble (in some countries), then the mortgage crisis, then the financial crash—themselves had causes.

That immediately raises the question, Why was there a housing bubble? One factor, certainly, was low real interest rates. The years 2002–07 saw the most rapid period of inflation-free economic growth in human history (except, perhaps, in postwar reconstruction or recovery from natural disaster). One of the reasons for that growth was that the world had experienced very low real interest rates. The demand for housing ownership is highly sensitive to the real interest rate, and low real interest rates were a major factor in the housing boom.

In addition, low real interest rates led to a "search for yield," as investors sought a higher return than was available with safe assets. That led many portfolio managers and individual investors to increase the share of their assets invested in emerging markets (where spreads were inordinately low) and other risky ventures, which also contributed to the financial crisis.

The fact that low real interest rates were a major factor encouraging the housing bubble and investment in risky assets more generally raises the next question, Why were real interest rates so low? At that deeper level, much of the blame must, in my judgment, go to global imbalances. As everyone knows, the United States ran large current account deficits during the years prior to the crisis, while China had large current account surpluses (to be sure, oil exporters and a few others contributed significantly to the surpluses, but China and the United States were the major players). While focus has been on the American deficits, it seems clear that if the United States had not run large current account deficits, either there would have been a global recession earlier or some other countries would have had to make their economic policies more expansionary. In the longer term, unless the world adopts a system, probably rules based, for the resolution of unsustainable global imbalances, the same sort of difficulties will arise again at some (reasonably distant) future date. But for the next decade, at least, it is unlikely that a buildup will occur again (although there may be other problems that I will discuss).

Outlook for the International Economy

It is obvious that the prospects for developing countries and emerging markets will be better the healthier is the growth of the international economy. Here, there are two questions. First, what sort of economic growth will emerge over the medium and longer term? Second, and not totally unrelated, to what extent will the trend toward increasing openness and deeper integration of national economies continue?

Turning to the first question, many observers have questioned whether the industrial economies can resume the rates of economic growth that they enjoyed in the two decades prior to the crisis. There are several reasons for skepticism: (1) concern that consumers and firms will want to restore their balance sheets by saving much of any increase in income when recovery does start; (2) belief that part of earlier growth was unsustainable and cannot be repeated; and (3) belief that the focus on fiscal deficits and buildup of government debt in the industrial countries may "crowd out" private investment and therefore impair growth prospects.

The first concern is essentially one for the short and intermediate term, say, the next five years. It posits that, after the bottom is reached (which, it is hoped, will happen soon), the upturn will be slow because of balance sheet considerations. Offsetting that is the rapid increase in aggregate demand that can be expected in some countries where large fiscal stimuli have been applied and are beginning to take effect. Whether balance sheet or aggregate demand effects will dominate is difficult to say, but even if balance sheet effects do constitute a drag on the rate of economic growth in the industrial countries, the outlook will be for a gradual acceleration of the growth rate over time. Some countries with very high savings rates, most notably China, will almost certainly realize that it is in their self-interest to encourage the expansion of domestic consumption relative to gross domestic product (GDP), which would and should take up some of the slack as those in the previously low-saving countries save more.

The second concern arises from the observation that earlier growth was spurred in significant part by the increase in indebtedness of households and corporations in the industrial countries. While that is certainly true, it is also true that China, India, and others grew rapidly while accumulating assets, and as they continue to grow rapidly in the future, they will become more important as a source of international demand. While some of the industrial countries may grow more slowly than they did in the middle of this decade, other countries may accelerate their growth, and there seems little basis for pessimism over the medium or longer term about world growth prospects because much of that growth was financed by unsustainable borrowing. It will, of course, require a rebalancing of sources of demand, with China and other surplus countries spurring their own domestic consumption and reducing their current account surpluses, but that is in those countries' interests and probably would have happened even without the crisis.

The third consideration—crowding out by the public sector—is the one to which most attention needs to be given. The International Monetary Fund (IMF) estimates that the public debt of the industrial countries will increase by about 85 percentage points over the period between now and 2015. As recovery progresses, it is likely that higher real interest rates will be needed to induce investors to hold public debt. Moreover, the aging of populations in the industrial countries and some others is certain to place a heavier fiscal burden on governments, even beyond those resulting from the current crisis. Both intermediate and longer-run considerations suggest that real interest rates and the cost of capital will be higher than in earlier years.

Policy makers in developing countries will face scarcer capital, either in the form of reduced capital inflows altogether or in the form of higher real interest rates to induce the desired inflows. In terms of the economic environment going forward, higher real capital costs are likely to be a significant factor once the upturn has become entrenched.

On balance, the argument that world economic growth will inevitably be slower in the future than in the past is weak. With appropriate policies, it is quite possible that growth could resume, with fewer structural weaknesses than were present in the years of "global imbalances."

Impact of the Crisis on Developing Countries to Date

Initial discussion of "delinking" emerging markets and other developing countries from the industrial countries, should they enter a recession, was predicated on the assumption that the recession would be confined largely to one or a few industrial countries and would have about the same severity and duration as earlier recessions. As both its magnitude and its breadth exceeded all predictions, the impact on developing countries and emerging markets has been greater than anticipated.

However, although there have been serious repercussions for developing countries and emerging markets, they have been far smaller than expected based on experience in earlier recessions. Not only did most countries experience rapid growth in the five years prior to the crisis, but they also managed to tame their fiscal policies to a considerable degree. As such, many entered 2008 in much better fiscal and monetary shape than they had been before entering earlier periods of downturns in world trade and capital flows.

One of the impacts on developing countries is the severe reduction in capital flows and credit from financial institutions in industrial countries. For some countries, the drying up of foreign credit has itself been a major source of difficulty, especially for those with large current account deficits.

But for most countries, the differences lie in other areas. To a first approximation, countries can be divided along two lines. On the one hand, countries can be classified as oil exporters, other commodity exporters, and exporters of manufactures. Within that classification, there are degrees of reliance on foreign trade. On the other hand, countries can be classified by their fiscal stance and level of indebtedness. Within that classification, some entered the current period in much better condition than others.

Countries worst off include those that both are heavily dependent on one or more primary commodities whose prices have fallen drastically and have relatively high fiscal deficits and high ratios of debt to GDP. Argentina is such a country: exports consist largely of primary commodities and constitute a sizable fraction of GDP. Simultaneously Argentina's debt-to-GDP ratio is high, not even counting the unrestructured external debt still outstanding. Meanwhile, Argentina's inflation rate was officially around 12 percent before the crisis, but economists regard 23–27 percent as a more realistic number, and the government was appropriating pension funds in order to finance its activities. Clearly, there is little scope in such countries for countercyclical fiscal policy (as there were deficits during good years), and the impact of commodity price declines could be large.

By contrast, Chile had a budget law requiring a surplus equal to 0.5 percent of GDP in the structural budget, had accumulated funds during the years of high copper prices, and had little debt. While still affected by the slowdown in economic activity and the sharp drop in copper prices, the Chilean government had more than enough fiscal space to adopt a stimulus package. In contrast, in most prior recessions, the Chilean government had been forced to undertake procyclical fiscal tightening because of its starting fiscal position. Most forecasts are for Chilean real GDP to be about the same in 2009 as in 2008.

Likewise, one can contrast other countries. India and China are both exporters of manufactures, but China's exports are a much larger percentage of GDP than India's. China has large reserves and huge current account surpluses. India, meanwhile, has a high (above 80 percent) debt-to-GDP ratio and a large fiscal deficit (above 5 percent in the last fiscal year). The country has sizable reserves, but very little fiscal space given the large fiscal deficit and high debt level. It is likely to be less able than China to undertake policies that sustain GDP growth, even though China's dependence on manufactured imports is considerably greater.

One can classify countries along these lines, and in general the larger the initial fiscal deficits and debt are and the more dependent countries are on exports of primary commodities whose prices have fallen sharply, the greater has been the relative severity of the impact of the current economic slowdown.

Worse, for countries with high initial debt levels and fiscal deficits, the room for offsetting fiscal action is severely restricted. Indeed, in some countries fiscal consolidation may even prove stimulative, in that the crowding out effects of the fiscal situation are sufficiently serious so that reducing the deficit may increase domestic demand.

Few developing countries, however, have thus far been able to adopt structural balance rules of the type that Chile (and several industrial countries) have. One lesson for the future is the desirability of such rules as a means of greatly reducing the impact of slowdowns in the world economy. If real interest rates in the world economy rise as anticipated, such rules will become even more important in the future than they were in the past.

Development Policies in Light of the Global Outlook

The outlook for the international economy as a whole is for growth that is no faster, and possibly slower, than the growth realized in the past very successful years. It is for an international economy with higher real interest rates and, it is hoped, smaller global imbalances.

The lessons for development policy stem from these observations. Outward-oriented growth strategies and integration with the international economy will still bring benefits, although they may be somewhat smaller than in the past (although growth will still be more rapid than if countries attempt to reinstate tariff and other barriers to imports). And, as long as any slowdown in overall growth is *not* the result of, or accompanied by, increased protection in the global economy, the benefits to integration will be sizable. With the recession, there is a risk that some policy makers will increase protection, which in turn would lead to retaliation by others. Major increases in trade barriers would serve as a significant damper on world economic growth in the longer term, with the largest impact on those emerging markets dependent on trade and on poor countries whose best hopes for more rapid growth lie in opening up their economies.

But if real interest rates are higher, and capital is therefore more expensive, a key implication is that the efficient use of unskilled labor, and efforts to increase the productivity of labor, especially by investments in health and education, will become more important than ever. As capital becomes more expensive, it will generally raise the optimal labor-capital ratio for goods production, which should be to the advantage of countries with abundant unskilled labor and to the advantage of those countries accumulating productive human capital.

As industrial countries go through the demographic transition and have a much higher fraction of older people in their population, investments in developing countries with relatively abundant supplies of unskilled and skilled labor will become increasingly attractive. But investment will flow only to countries where returns are attractive, and they will be attractive primarily in countries that have business-friendly investment climates (including, especially, open trade regimes), have invested in the health and education of their population, and have flexible labor markets.

For countries meeting those criteria, the opportunities even in a slower-growth world will be substantial. It will be to the advantage of savers in developed countries (where scarce labor will dampen returns to capital) to invest abroad where labor is more abundant, and it will be in the interest of developing countries and their workers to encourage these investments.

These longer-term goals cannot, however, be achieved overnight. Especially when it comes to education and health, investments in human capital have long lead times. Countries where those investments are considerable and growing will be in the best position to take advantage of the postcrisis, longer-term economic landscape.

But, as noted, even as countries adapt their policy framework to sustain growth in the new circumstances, the growth of the international economy will affect them. The higher that growth is, the greater the payoff will be for appropriate policies. For that reason, it is incumbent on leaders in developing countries to participate in international forums far more actively than they have in the past, especially when issues surrounding the open multilateral trading system are under review. Korea, the host country for this conference, has done well in making the case for keeping trade open and should be supported by all developing (and developed) countries.

To date, developing countries have to a large extent been free riders on the open multilateral trading system, benefiting from lower tariffs and other trade barriers negotiated at the World Trade Organization primarily among developed countries, while unilaterally undertaking trade liberalization without binding tariffs. Some of the dangers of this practice for the international economy were seen in late 2008 and early 2009, as some countries took advantage of the space between bound and actual tariffs to raise their tariffs against imports. Much of the protection that resulted was by one developing country against another.

But even more important, protectionism not only hurts the country undertaking it but also invites retaliation, especially in difficult economic conditions, such as the present. Strong political leadership is needed to resist protectionism during the crisis. Trade barriers are politically much easier to raise than to lower. Raising a trade barrier meets the approval of people within the industry, and those who are adversely affected (as consumers pay more or get lower quality for some goods, as businesses pay more for their inputs and are therefore disadvantaged in competing in export markets, and as overall growth slows) usually do not recognize the extent to which they are disadvantaged, certainly not immediately.

As the Korean experience amply demonstrates, the opportunity to use international markets is vitally important for rapid economic growth, especially in the early stages of development. No country has sustained rapid growth behind high and rising walls of protection, and no developing country has sustained a successful long-term development strategy without opening up to international markets.

The reasons why liberal trade and trade opening are such a powerful stimulus to growth are not entirely understood. Some of the benefits, such as increased competition for domestic producers and access to international best practice, clearly depend more on openness than they do on the export opportunities that increase with open trade strategies. Even slower growth of the international economy would not deprive countries with outward-oriented trade strategies.

Protecting and enhancing the open multilateral trading system ought to be a top priority for the leaders of developing countries in international forums. Success would raise global growth prospects, while simultaneously supporting the economies of those developing countries.

A leaner world economy, with less scope for policy mistakes, can be expected in the future. The graying of developed-country populations can prove advantageous for developing countries that adapt their own policies appropriately. The falling labor-to-capital ratio in developed countries can lead to a shift in comparative advantage to even more labor-intensive activities in developing countries. In an appropriate economic environment, which includes the rule of law, a good commercial code, enforcement of property rights, attention to the productivity of labor through education and other social expenditures, and a flexible labor market, the rewards in terms of growth and rising living standards may be even greater than in the past. The problems arising from fiscal crowding out and the demographic shift in developed countries provide an opportunity for developing countries to use the international economy to their great benefit.

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