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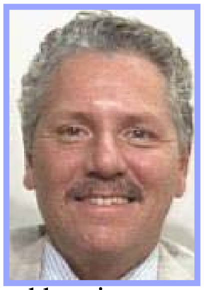
THE NEW FACE OF GLOBALISATION: A POST-CRISIS ASSESSMENT



It is indeed a great honor to be here with you today and to be asked to share some thoughts with you in honor of Sir Arthur Lewis, who did so much to increase our understanding of development economics and the challenges of poverty reduction.

I can think of very few reasons why I should have been given the honor of addressing you tonight other than the fact that I am married to a Lewis, and perhaps there was some weight given to genealogy in the selection process. That said, it's a great pleasure to join you all in the presence of Sir Dwight Venner, with whom I have served on the Spence Commission on Growth and Development over the past three years and whose friendship I hold dear.

Ladies and gentlemen, I have just completed 28 years of work in the field of development economics at the World Bank, and I must say that just as we began to think that we understood things better, we were confronted, as were all of you, by the current economic and financial crisis that has served to humble us.

Arthur Lewis might not have been so surprised, since he dealt with real development problems stemming from low productivity in agricultural economies rather than derivatives and speculation. But make no mistake, the effects of this confluence of shocks are real and will be with us for quite a while.

My themes today will be three: the contrast between sophistication and progress; the new role of government post crisis; and the inevitable tradeoffs between good national policy and healthy global policies.

Let me begin in a more philosophical vein, namely the distinction between economic sophistication and economic progress.

Those studying economics or finance in recent decades will all have been inculcated with certain models of economic behavior. We learn to formulate models based on predictable and efficient behaviors. This allows us to aggregate individuals and firms and to mathematically find optimal solutions. The greater the degree of behavioral certainty underlying these models, the easier the modeling becomes, the greater the sophistication, and yet the further from reality we move. I recall in graduate school hearing a fellow PhD student present a thesis on optimal spatial use in urban economics assuming the city was a straight line! Good for modelling, not so useful in real life.

In the world of policymaking this meant that governments were asked to get out of the way so markets could do their magic.

In the aftermath of the fiasco of the combined housing, stock market and real economy collapse, we now can see more clearly a whole set of facts that make this fascination with financial sophistication and efficient markets rather flawed.

Let's start with the assumption of the rational consumer.

Behavioral economists like Cornell's Robert Frank frequently point out that when individuals are offered a choice of a 4,000 sq. ft house in a neighborhood of houses averaging 3,000 sq ft. or a 6,000 sq ft. house in a neighborhood of 8,000 sq. ft. average, the majority of those polled prefer the smaller house that bests their neighbour's. Is this rational?

Was it rational for homeowners to take mortgages they couldn't afford? Yes, perhaps they were duped and perhaps they were uninformed, but similar to borrowing money on credit cards, this is not the rational economic agent that micro textbooks depict. And these are not the rational actors assumed in our regulatory regimes.

So we have a disconnect between the theory of markets and the marketplace itself.

Behavior towards and risk tolerances are similarly distorted because how else can we explain sub-prime mortgages or banks not calculating the interaction effects of poor economic outcomes. Perhaps the thought of government bailouts is comforting in a perversion of moral hazard, but perhaps it is an irrational discounting of future risks. After all, in many circumstances, once the problems arise, it's usually someone else's problem to clean up the mess. That's how it often was in the World Bank and we tend to think accountability there exceeds that on Wall Street!

One thing is clear however, and that is that the school of thought built on rational expectations in which individuals act with perfect foresight cannot be the guide to policy. We can all agree that this lesson has been learned the hard way.

On the issue of false sophistication, let me give you a very practical example on the use of financial markets for better or for worse. I was involved in the bailout of Korea in 1997 and one of the damning critiques of the Korean system of finance, which had its share of flaws, was that the Chaebol, the Korean conglomerates that had been encouraged in order to create corporations large enough to matter in exports markets (the Hyundais, LGS, and Samsungs) were highly leveraged). They had debt that normally exceeded equity by 3 to 1 and in the crisis this leverage rose even higher. This model was excoriated by the IMF, the US treasury and others as being excessively risky and government inspired. But what did these companies do with this leverage? They created jobs. They produced cars. They produced cell phones. They produced TV sets. In other words, they supported economic development and the progress of Korea in raising its living standards. They used leverage to improve national welfare.

Contrast this with the actions of hedge funds, where the leverage ratios were often 20 to 1 and the motives were to bet that the hedge fund manager could anticipate market sentiment correctly. What is the economic benefit that society derives from these actions? More efficient markets? Not really, since you will recall that the word hedging is supposedly synonymous with reducing not increasing risk.

When the Germans raised this in 2006 at the G8, they were ignored by so-called market purists, led by John Taylor at the US treasury. When some academics like Joe Stiglitz rang alarm bells, they were ignored. In fact, one wanted to turn people away from the punchbowl as William McChesney Martin said decades ago.

So let's not confuse financial sophistication with economic progress.

Allow me now to turn to a second critical topic, namely the role of government in economic policy.

In the growth report issued in May 2008 by a distinguished commission led by nobel laureate, Mike Spence and including Sir Dwight, we came to the view that it was not the size of government that mattered, but rather its effectiveness. This contrasted with the views of another Nobel Prize winner, Bob Lucas, who advised the commission that the trilogy of "stabilise, liberalise, and privatise" was a sufficient policy admonition for policymakers.

We didn't believe it before the crisis and we certainly don't believe it today.

Government plays an indispensable role in the development process and its role continues to evolve as the economy advances. There is no one model that dominates, even in advanced economies, since the German corporate model wouldn't work in Brazil, and the British post Thatcher model wouldn't work in India, and the Chinese model only works in China. So what do we expect of governments, especially these days?

First we can expect governments to intervene when markets cease to function well. When fear creates ill-liquidity and panic sales and when the economy is in free fall, governments must act. That was the central admonition of Keynes and it rang true again in 2009 as Paul Krugman wrote in the N.Y. times in September: " Ben Bernanke understood this well. Pity that his predecessor at the Fed read too much Ayn Rand and not enough Hyman Minsky or else we might have well avoided the catastrophe of 2009 when world output shrank for the first time in 70 years." So government needs to act in emergencies. Of course they need to act wisely but also quickly.

Governments also need to regulate markets to limit the cost of crises and to protect the average citizen when economic actors take on too much risk and imperil the system. The list of regulatory failures is indeed long, especially in the U.S. but elsewhere as well. Too big to fail has always been a problem, but systemic risks based on excessive leverage in highly inter-connected markets add further peril. Interestingly, less sophisticated financial markets and better regulated markets like that in Canada survived the crisis well.

As Akerlof and Shiller describe in their recent book, *Animal Spirits*, greed is a driver of economic activity but we need to place limits on the actions of the greedy. The Shiller-case housing index and comparisons of earnings to housing prices should have set off alarm bells but they did not. Charles Calomiris of Columbia University sees politics as well as bad economics as culprits, as everyone pushed increasing home ownership in a world of unbelievably low interest rates. And here one can say something nice about John Taylor, namely the massive divergence from the Taylor rule in the conduct of US monetary policy bordered on the criminal.

Government needs to exercise regulatory oversight impartially and aggressively, more in the spirit of Singapore than China or the US or the UK.

And finally governments as providers of a level playing field need to be concerned about the fairness of the system.

If the distribution of income becomes progressively more skewed, then not only will the social consensus for good policy disappear, (and in some parts of Latin America this has led to populist outcomes,) but also the incentives become skewed, to the detriment of competition and equality of opportunity.

Interestingly, the pre-tax and transfer distribution of income of the US and France in 2005 was quite similar. The big difference is that the Gini coefficient drops from around .44 to around .34 after transfers in France, while is stays about the same in the US. The fact that between 2000 and 2008, 95 percent of Americans saw their real incomes either stagnate or fall should have set off political economy alarm bells, but it did not.

Governments have to worry about basic fairness, at least in the sense that people are given a fair chance to succeed. This is central to the objective of strong investments in education in developing economies and the provision of free or subsidised opportunities even in rich countries. I, myself am a product of subsidised public university education in New York City.

Turning to the last theme, we have to be somewhat concerned with the trends towards greater economic nationalism at the expense of internationalism.

It is understandable when unemployment rates reach historic highs that politicians will veer away from global solutions. Even the consensus inside the G20 has been a fragile one, be it on stimulus packages or financial oversight or commitments to finish Doha that go beyond rhetoric. This is regrettable, and indeed dangerous.

Globalisation, despite its discontents, has been the prime driver of a lot of economic progress in the past two decades. During this time, for example, China was able to move 400 million people out of abject poverty and Vietnam was able to reduce its poverty rate from 60 to 20 percent, while others progressed as well. Even in Africa, considerable economic gains were recorded between 2000 and 2008. This would, I submit, not have been possible without the openness in trade markets - imperfect though they were - that characterised the period. Just imagine if the East Asian tigers hadn't had the US market in the 1980s and 1990s, or if China had faced EU barriers and not U.S. barriers?

The most burning question, therefore, facing the international community is what the future face of globalisation will look like. Will the fiasco of private finance lead many, including major new economic powers like Brazil, India and of course China, to use state banks in larger measure, with the specter of more active industrial policy? Or will countries do what Professor

Dani Rodrik advocates, namely, redirect demand from exports to domestic goods, since the world's appetite for imports and the imbalances underlying them has shifted? This serves to again raise questions about the viability of the export-led growth paradigm.

Will all this lead to more protection of domestic jobs, which is a euphemism for trade protection? Without a determined effort to retain internationalism, it well might happen.

A second key challenge of 2010 and beyond is in the area of international finance. Will increased regulation be effective in reducing systemic risks or will it merely increase the cost of finance? And as far as capital importing countries are concerned, should they rely less on foreign capital and generate more resources at home? How to do this? (two quick suggestions before I close: first, that governments do a better job of tax collecting and the second, that there be a greater focus on governance, so that there aren't more Argentine savings in Miami than at home).

In the special report of the growth commission, issued after the crisis, a few weeks ago actually, the point is made that when all is said and done, the basic notion that growth is best supported by open trade regimes, judicious capital flows, strong government vision, and a reliance on markets (regulated ones to be sure where the risks are high), is still the best approach.

The report notes that the crisis has embarrassed many theories. This is an accurate and severe indictment; however, that doesn't mean that we have replaced capitalism or done away with markets. What is clear is that policymakers need to be more cognisant and more cautious. And central banks and other independent institutions need to be strengthened so that they are more effective counter-weights to the avarice and short-sightedness that Akerlof and Shiller so aptly describe.

In this post-crisis world in which trade will be more complicated, finance more expensive, remittances less generous, and labor markets more scrutinised, we can expect smaller economies to fare less well.

Aid, although useful, is not the sustainable solution. So this brings us back to Arthur Lewis and the need to develop smaller and weaker economies by increasing productivity. If Singapore can do it, so can others, although I admit they lived in a good, namely, high-growth neighborhood.

Above all, however, governments need to have a human face and care about general welfare, something that Arthur Lewis took as a given but merits re-emphasising, especially lately. Good governance is not only whether elections are held and whether they are honest. It is also whether those with wealth can exercise undo power over decision-making and whether wealth accumulation becomes obscene. We see this being played out on Wall Street today.

Some say it's a difficult time to be an economist, or even worse, a banker. I disagree. It's merely a difficult time to be a citizen, especially an international citizen. Arthur Lewis was one such outstanding global citizen, contributing far beyond his home, and it is in his memory that I dedicate these humble remarks.

Thank you very much.