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POLICY BRIEF

Development Policy Revisited: Implications of the New Normal or Worse?

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Introduction

Debates on development policy in the new millennium usefully moved from the Washington Consensus to a more generally held view that connecting to the global economy was the route for economic advance. This view, supported by the findings of the Commission on Growth and Development (2008), has been broadly endorsed by the policies of most emerging market and developing economies (EMDEs). Export-oriented strategies were clearly bolstered by strong global demand in the pre-2008 period, which provided ample opportunity for countries with strong macroeconomic policies and an outward orientation to flourish. The strong progress made by many low-income developing countries, such as Bangladesh, Cambodia, Ethiopia, Vietnam and others, also seemed to support outward orientation as the key to progress, and there were relatively few debates about the direction of policy. Of course, there were always exceptions, as seen in the policies followed in Argentina or Venezuela, but they were outliers. This positive feedback loop between policies and outcomes was helped immensely by the worldwide commodity boom, fueled by China's demand for raw materials, and indeed by China's super-charged growth dynamics. But these those days are over, and policy stances are under review in many countries.

The "new-normal" state of the world economy (El-Erian 2014), in which we see slow growth and higher indebtedness, has given way to a global malaise or low-growth equilibrium that has both demand and supply factors at its core (Growth Dialogue 2015). Persistent output gaps, higher public indebtedness combined with lower investments in the capital stock, and weak total factor productivity have lead us into uncharted territory. Public policy instruments appear to be wanting and global confidence is skittish. Even more worrisome for EMDEs is the combination of low commodity prices, weak world trade growth, and volatile exchange rates. The question now is how the changes in global economic circumstances might affect national policy decisions for development.

Some Background Is Useful

The current situation of collapsing commodity prices has focused attention once again on primary exports. Since the time of Raul Prebisch (1950), primary exports have been seen as the nemesis of developing-country prospects, but in recent years they have provided a motor for growth. Indeed, the commodity boom led some major primary commodity exporters, including Brazil, Nigeria, Peru, South Africa, and Uganda, and to ignore the warning signs that their manufacturing sectors, in particular for exports, were shrinking. As Rodrik (2014)

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has convincingly shown, premature movement into services deprives countries of productivity gains needed for development progress. Moreover, many primary exporters have ignored their manufacturing sectors during commodity booms, only to be stunned by price and volume reversals. With hindsight, it is easy to say that unless gains from commodity exports are wisely reinvested in the domestic economy, the gains will be dissipated and the economy left less able to protect itself when commodity prices inevitably decline. And this is exactly what is happening to many EMDEs.

It is not difficult to see where countries have miscalculated, especially in wasting the golden opportunity of above-trend prices for raw materials. Often this has taken the form of boosting public expenditure in the social sectors or on wasteful projects rather than investing in basic infrastructure. Miscalculation is clearly seen in the case of Brazil, where public investment in energy, transport, and basic infrastructure has languished at 2 percent of GDP despite glaring gaps. Infrastructure gaps that raise the costs of logistics also deter the advancement of new productive industries. This trend has been exacerbated in Brazil by high borrowing costs and misguided policies of the Brazilian National Development Bank (BNDES). BNDES has concentrated lending on the deep-sea oil exploration of Brazil-based integrated energy company Petrobras, and focused its industrial policy on trying to create larger world-class firms. Brazil's current recession and political instability explain the poor short-term outlook; however, the structural deficits in the economy are the product of past policies that misdirected the economy during the better growth years (see Leipziger 2013).

A second strand of global developments that sent confusing signals to EMDEs revolves around volatile capital flows and consequent exchange rate movements. With the unprecedented expansion of central bank balance sheets in the United States and Japan, and to a lesser extent Europe, yields collapsed and capital flowed to more remunerative markets, largely EMDEs. This caused concerns for some economies where exchange rate appreciations hurt noncommodity exports. But it also provided governments with unprecedented access to dollar financing as well as temporary boosts in reserves if they intervened to deter appreciation of national currencies. Some national authorities, such as in Peru, handled this inflow better than others and set more rigorous banking regulations to limit the creation of financial bubbles. Other authorities did less well and left their economies more vulnerable to the inevitable shift in sentiment that prompts capital flow reversals.

Many countries, notably in Africa, followed an even more dangerous strategy of borrowing in dollar-denominated bond markets. Some of this borrowing comprised long-duration bonds for investment purposes; other borrowing served current financing needs. Ethiopia, Ghana, Kenya, Rwanda, Senegal, Côte d'Ivoire, and Zambia have all issued foreign currency bonds in recent years, following the "original sin" path described previously by Eichengreen, Hausmann, and Panizza (2002) for Latin America. These debt burdens are reminiscent of past episodes of unwise borrowing, in light of the collapse of commodity prices (a prime engine of economic growth for many) and the appreciating U.S. dollar. An unfortunate negative cycle can be seen in low global growth, reduced export earnings, and greater fiscal stress on already strapped lower middle-income economies. The outlook, as seen by the IMF and the OECD, is not much improved for the medium term. Policy makers now must figure out how to respond.

The IMF's *World Economic Outlook* (IMF 2015) reports sizeable output gaps, low investment in the global capital stock, and a weaker outlook for economic growth. China is experiencing growth hiccups; Japan's Abenomics is facing headwinds; Europe is still managing internal strains; Brazil, Nigeria, and South Africa are mired in recessions or low-growth traps; and there are few positives on the horizon. Constrained global economic growth poses serious dilemmas for many EMDEs. Should development strategies change? How do governments deal with the aspirations of newly emerging middle classes when economic activity weakens? How do EMDEs prevent retrogression from the modest progress made in addressing inequality concerns that have plagued many for decades? How do governments respond to slow growth environments? And finally, will this policy conundrum inevitably lead to a revisiting of industrial policies?

Current Dilemmas

There is little doubt that this is bad time to be a policy maker. Global malaise creates fiscal problems as tax revenues are reduced. For example, the Ministry of Finance in Brazil is facing a huge challenge; the economy has slipped into recession and attempts to cut spending are limited by reduced tax takes. Of course, buffers should have been set up by stashing away surpluses during the good times, but in the absence of strong fiscal rules that force government's hand (as in the case in Chile and Colombia), this option usually eludes policy makers. In most countries there is a political preference for short-term gains associated with current expenditures—some for beneficial social purposes, others less so. At the same time, there is no pipeline of infrastructure investments to fall back on and little fiscal space to finance them. In this ambit, of course, China has an enormous advantage. Nevertheless, even there the returns to public investment have declined, implementation has faltered in some provinces, and the mode of financing is worrisome, as seen in shadow banking and borrowing by state-owned enterprises.

In a world of weak global demand, the option of "rebalancing" aggregate demand to favor domestic sources of growth is an intriguing one, although only a few countries have the fiscal resources to consider this path. If one takes as a given that global demand will be limited for a substantial period of time, then boosting domestic demand makes sense, provided that the projects are well designed and not mere consumption fillips. Again, Brazil's boost to consumption through tax incentives and the like in the years preceding the last presidential election is instructive of a flawed policy that should not be emulated. Still, the larger, long-term question remains—whether globalization is still the correct approach to underpin development strategies.

Looking at past experience, including the cases of China, Indonesia, Malaysia, the Republic of Korea, Thailand, and Vietnam to name a few, the answer seems clear. Yet it can be argued that the world has changed and with it so should development strategies. While there is a clear argument that the gains to globalization—namely, connecting to global supply chains and larger global markets—have declined, there is no evidence that points to an alternative development path. Withdrawal from global markets, either voluntarily or through policy mistakes as seen in the case of Argentina or Venezuela, will not work, in part because the price signals that global markets provide are then ignored. Furthermore, state interference in markets inevitably leads to corruption and misallocation of resources. Recent policy announcements in Nigeria that seemed to be aimed at maintaining an

unrealistic exchange rate through import controls and support for domestic industries are backward-looking. Experience from Latin America clearly shows that import substitution is a failed policy prescription.

Another approach is seen in aggressive industrial policies. These policies are often selective and unconnected from coordinated national and private sector actions that can in some cases make industrial policies effective. In the latter case, to quote Haussman et al. (2008), "Industrial Policy assists firms in their search and discovery processes for new lines of comparative advantage." To be potentially successful, however, this approach involves a host of complementary and reinforcing policies that few economies can effectively muster. Even in developed countries, we see ample examples of failed industrial policies as well as empty announcements of actions to gain competitive advantage in new industries.

The confluence of policy dilemmas now facing many EMDEs gives further credence to the old adage that it's never a good time to undertake structural reforms because "it doesn't seem necessary during good times and it's too difficult to do during bad times." Nevertheless, the reality is that structural reforms, some long overdue, and many binding more on the micro than the macro side, need urgent attention, even if the timing is bad. Further delay will short-circuit recoveries and more importantly will deter capital inflows, such as much-coveted FDI, from countries with poor records on governance, regulation, and logistics. So, are we back to the future—namely, an environment where economic fundamentals are crucial?

The Way Out

Economic growth can be characterized or modeled in a variety of ways (for a new perspective, see Kanbur and Stiglitz 2015). Clearly taking sustainability and inequality measures into account provides a more reasonable framework for growth discussions. Rodrik (2014) chooses to divide economic activity in a dualistic fashion and to assume that institutional factors and skill capacities help drive productivity gains in both the traditional and modern sectors. However, Rodrick also notes that that the returns from institutional reform and human capital investments are a long time in coming. In addition, few countries have made the requisite investments to significantly improve institutions broadly defined. Most indices that measure these gains among low- and middle-income countries show little movement decade upon decade. Whether looking at tax collection rates, the quality of regulation, or real educational attainment, we see relatively little movement. Fast-growing economies are an exception, but in these cases there are problems identifying the direction of causation. Thus, Rodrik focuses on the paths of unconditional convergence of productivity in sectors, and the speed with which countries can shift resources into these more productive activities.

In this process—call it industrialization for short—Rodrik shows that countries are peaking in their degree of industrialization at much earlier levels of per capita income in the past 20 years than in the previous 20. Hence most EMDEs are experiencing a decline in manufacturing as a proportion of GDP before they become higher middle-income countries, and they are hitting a wall in terms of enhancing productivity. In the case of African, we see declines in nascent manufacturing combining with rapid urbanization, employment in low-productivity services (largely informal), and a lack of sustainable growth engines to propel income growth. The flood of outward-

bound migrants throughout the continent is a stark demonstration that there are few opportunities in Africa's cities. The commodity boom ameliorated this trend somewhat as governments had more resources to allocate; however, few used these resources effectively enough to attract manufacturing FDI or move up the commodity value chain. The problem is compounded by bad "neighborhood effects," which make logistics costs high, energy supply unreliable, and cross-border transport difficult.

For low-income EMDEs, the answer to the growth problem includes basic reforms to improve the efficiency of investment, better coordination between government and business, and consistency of policy only seen in a few countries, such as Ethiopia and Rwanda. Other countries have had policy setbacks, such as Ghana and Nigeria, and yet others have experienced policy paralysis, such as South Africa. In a nutshell, none of the avenues for improved productivity gains seems to be working. This is evident despite improved growth performance between 1998 and 2008, which was a result of better overall short-term macro management, higher commodity prices, and prodigious Chinese FDI. Without the latter two factors, we now see economic policy management weakening as policy making becomes even more difficult. With resources more limited, using existing public revenue more efficiently is crucial. Unfortunately, Africa's record of fiscal management and implementation is still weak. Access to investible capital could draw on stocks of liquidity accumulated in other parts of the world, but to do so requires more effective channels for financial recycling. Some helpful new mechanisms, such as the BRICS Bank and the Asian Infrastructure Investment Bank (AIIB), have been introduced. But more concerted multilateral effort is needed, including more aggressive use of the balance sheets of multilateral lenders.

Many middle-income countries find themselves stuck, a phenomenon identified by Eichengreen, Park, and Shin (2013) even before the global slowdown. In many of these countries, the rapid changes affecting manufacturing and the digitalization of many services are causing disruptions. Moreover, even success stories are encountering headwinds and need policy reinforcement. Two successes are Vietnam and Peru, countries that were able to capitalize on the good years to make rapid advancement. Vietnam's per capita income doubled between 1998 and 2008, while Peru's tripled between 2000 and 2014. The result was a rapid drop in absolute poverty in both countries, and continued movement up the ladder to lower middle-income status in the case of Vietnam and middle-income status for Peru. Both countries have excelled in their own ways, but both would immensely benefit from a renewal of structural reforms.

These cases are the exception unfortunately rather than the rule, and we are witnessing regression in economic fundamentals in many countries. Regression coincides with elevated public expectations and tectonic shifts in the nature of manufacturing that threaten employment of low-skilled workers in many countries, both advanced and developing. This situation has led some, like Kanbur and Stiglitz (2015), to argue for a new growth paradigm. Such a model will likely elude us, and in any event, low global growth outlooks will limit the potential of new approaches.

In summary, the less hospitable global environment means that reform avoidance is simply not an option for EMDEs. Advanced economies may also well be faced with tough issues like secular stagnation, as has been argued by Summers (2014) for the

United States, or as has been the case for almost two decades in Japan. For EMDEs, faced with less robust global demand, improving efficiency and raising productivity are both essential to maintaining growth performance. It's back to the basics of development.

The Multilateral Picture

Some helpful new mechanisms (the BRICS Bank, the AIIB) have been introduced, but more concerted multilateral effort is needed, including more aggressive use of the balance sheets of multilateral development banks (MDBs). One potentially promising approach is better use of the funds of existing institutions. There is room for much greater leverage in the multilaterals. Private capital can be crowded-in with greater policy assurances that MDBs can provide. With sufficient levels of risk mitigation and risk sharing, a significant amount of the US$60 trillion in investible funds can be channeled to higher-yield investments that will promote growth. The multilateral system was far more energetic on past initiatives such as debt relief than on its current challenge to promote and coordinate economic growth.

One may well conclude that the multilateral system itself is not adapting well to the changing international landscape. In the depths of the 2008–09 Great Recession the G-20 came together with coordinated stimulus packages. Since then, the G-20 has underperformed in terms of restoring confidence, promoting investment, dealing with the consequences of quantitative easing, or coordinating fiscal policies. There are lofty expectations, but rather few concrete results to show for global initiatives since 2010. The IMF is lending mostly to Europe and maintains some contingent lines, but is not

Box 1: Success Stories and Their Challenges

In the case of Vietnam, reforms would need to focus on improving the efficiency of labor markets and land markets, as well as better allocation of capital to arrest the fall in total factor productivity. The domestic private sector needs strengthening, land markets need to taken out of the hands of local government, and state-owned enterprises must be made to perform better. Vietnam's growth had been largely driven by labor-intensive FDI, but its next stage of development must rely more on technology and skills, which will require a new compact between government and the private sector. There may well be space for some forms of industrial policy (as in Malaysia), provided that issues of government influence, competition, and rule of law can be tackled.

In the case of Peru, one cannot find much fault with fiscal or monetary policy. Similarly, with exchange rate issues, authorities have rightly focused on macro-prudential tools and de-dollarization measures to lower risks. Peru ranks second only to Chile on the Lora's (2012) Structural Reform Index, indicating the degree of progress over the past two decades in a range of policy reforms. Nevertheless, Peru's export concentration as measured by a Herfindahl Index shows it to have become less diversified over time and lagging other major Latin American economies (see Santos and Werner 2015). Despite some gains in textiles, Peru has not shown great absorption of newer industries or services, and it is hard to see rapid employment gains without a major ramp-up in skills.

active enough to cushion downturns. The World Bank and the regional development banks are an increasingly smaller piece of international financial flows, a trend that should be reversed if their balance sheets can be expanded and better utilized.

Final Thoughts

There is frankly no silver bullet to cure the globe of its underperformance. Nevertheless, major EMDEs have the potential to improve their individual growth performances. Each economy must examine what constraints are impeding progress (on binding constraints, see Hausmann, Rodrik, and Velasco 2006). The worst policy stance would be an inward-looking one that catered to increasing protection and domestic interests. Even in a slower global growth track, economies will fare best if they advance their own competitiveness and learn to harness new technologies and attract investment capital. At the same time governments need to make better use of their public monies to create growth channels. Employment creation trumps safety nets as a long-term strategy. Therefore, efforts need to be devoted to raising productivity, and using the public sector to incentivize the efforts of the private sector, which in the end is the key to economic growth. Finally, institutional and governance reforms are more important than ever as fiscal resources are scare and need to optimally deployed.

The world's major economies also need to set the pace and overcome their own political and structural impediments. Labor markets are misfiring in many countries. Financial markets should also be encouraged to steer investment to the long term. Discussions of the failure of markets notwithstanding (see Akerlof and Schiller 2015), it behooves governments to work harder on fair and effective tax systems, even-handed regulations, and productivity and equality of opportunity rather than to debate the merits and demerits of capitalism. That agenda is now more urgent than ever as we see greater short-termism in both corporate and government decisions.

One thing is clear: the days of "a rising tide lifting all boats" are over. We are now in a world where each vessel needs to right itself and row faster to maintain past economic gains and set the stage for the future.

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