Opening Address

Learning from the Past to Reinvent the Future

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It is a great pleasure to be in Seoul today, to address this very timely conference, and to open up our discussions on lessons from East Asia and the global financial crisis. Before sharing a few initial thoughts on the topic of the conference, let me thank our host, the government of the Republic of Korea, and our partners in this initiative for their extraordinary generosity. I also wish to thank the participants, many of whom have traveled across the globe to share their experience and ideas on how to deal with the current global crisis, which is the most serious crisis since the Great Depression.

There have been signs that the global downturn might be bottoming out: a recovery of stock markets, a decline in interest rate spreads, and improved business and consumer confidence. It is probably too early to know if some of these positive signs simply reflect the mechanic effect of the expansionary monetary policies adopted by almost all central banks and the fiscal stimulus packages under implementation around the world.

Moreover, there are also many worrisome signs on the global economic horizon. Unemployment is still rising in most economies, and capacity utilization rates are low. In most of the Western world, housing prices are still on the decline, as the oversupply of homes, tight credit conditions, and foreclosures continue to hamper the market. While mortgage rates are low and houses are, in principle, more affordable than at any time since 1980, rising unemployment is pushing more and more people to default on their home loans and foreclosures will continue to rise. The risks of a double-dip recession or a "W"-shaped recovery are still present in many parts of the world.

Even after global output growth begins to pick up, unemployment may continue to rise as capacity utilization rates remain low across the world. The International Labour Organization projects that unemployment will rise by 30 million worldwide

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Annual World Bank Conference on Development Economics 2010, Global

in 2009, of which 27 million will be in developing countries. Absent assistance, households may be forced to sell additional assets on which their livelihoods depend, withdraw their children from school, forgo necessary health care, and cut back on food, which could risk malnutrition. The effects of falling real wages and joblessness impede the ability of households to provide adequate food and necessities to their members.

Prior to the current crisis, World Bank research estimated that about 1.4 billion people were living below the poverty line worldwide. Preliminary studies of the impact of the global downturn indicate that an additional 53 million people will fall below the poverty line in 2009. The long-run consequences of the crisis may be more severe than those observed in the short run, possibly turning a short-run macroeconomic adjustment into a long-term development problem. When poor households pull their children out of school, there is a significant risk that they will not return once the crisis is over or that they will not be able to recover from the learning gaps resulting from lack of attendance. And the decline in nutritional and health status among children who suffer from reduced (or lower-quality) food consumption can be irreversible. The middle class will also be hit hard by soaring joblessness, losses in equity markets, possible currency depreciation, and anxiety over the safety of local banks.

Constrained by the erosion of fiscal space and foreign exchange reserves, many developing countries will be unable to implement countercyclical policies on their own. Moreover, the crisis is reducing their income, hereby worsening public finances, threatening existing levels of spending, and further reducing services to the poor. We may be facing nothing short of a development emergency.

In my remarks this morning, I reflect briefly on lessons learned from the East Asian experience, in terms of both economic development strategies and recovery from major macroeconomic crises. I then highlight a few issues for discussion at this conference.

Lessons from the East Asian Experience

With worsening global poverty, economists and policy makers around the world agree on at least one thing: sustainable recovery and economic development are the only solutions to the problems facing the global economy. East Asia is well placed to shed light on effective development strategies and the appropriate paths to recovery, with its long and rich history, the enormous amount of knowledge accumulated over millennia, its painful or exciting experience of booms and busts, its vibrant and diverse intellectual community, and the infinite processes of learning constantly at work.

The Recipe for Effective Development Strategies

The economic record of Asian countries over the past half-century is impressive by any measure. In 2007, the average per capita income was 3.5 times higher in South Asia than in 1960 and about 12 times higher in East Asia. In these economies in the early 1950s, per capita gross domestic product (GDP) was less than 2,000 international Geary-Khamis dollars—as measured by 1990 purchasing power parity—and the same as in China and less than in Eastern Europe and Latin America at that time. Japan was the first success, followed by Korea; Taiwan, China; Hong Kong, China; and Singapore—the four East Asian newly industrialized economies (NIEs)—and, recently, by Thailand, Malaysia, and Indonesia. Since the 1960s, the economies of the four East Asian NIEs have maintained an annual growth rate of 10 percent for two to three decades. Such growth completely changed the poor and backward state of their economies.

Development policies that were adopted after World War II by some of these countries and led to success were inappropriate in the context of the prevailing theories at that time. Those developing countries that followed prevailing development theories in formulating their policies failed to narrow the gap between them and the industrial countries. Similarly, China's transition to a market economy, begun 30 years ago, was thought doubtful in the light of prevailing theories. But the path taken led to sustained growth, while countries that followed standard approaches in their transitions encountered various difficulties. This contrast in economic development and transition is intriguing to economists.

According to Adam Smith and many classical and neoclassical economists, the free market is the mechanism for bringing prosperity to a nation. After World War II, and under the influence of Keynes, economists of the structuralist school challenged the free market principle. They believed that markets cannot serve as the foundation for development, because they send the wrong signals (in the presence of monopolies) or because factors of production are not fully mobile. Their ideas became the foundation of the newly established field of development economics. They believed that governments in developing countries should intervene in the allocation of resources for industrial development. This contributed to the adoption of import substitution strategies in many developing countries. The consequent debt crisis in Latin America in the 1980s and the collapse of the socialist planning system once again led to the domination of free market thinking in development economics.

The failure of the old structuralist model can be explained by the fact that many countries attempted to implement strategies that defied their comparative advantage. Their governments had to protect numerous nonviable enterprises; however, because these governments usually had limited tax collection capacities, such large-scale protection and subsidies could not be sustained with their limited fiscal resources. They had to resort to administrative measures—granting a market monopoly to the nonviable enterprises in prioritized industries, suppressing interest rates, overvaluing domestic currency, and controlling prices for raw materials—to reduce the costs of investment and operation of the nonviable enterprises. Such intervention caused widespread shortages in funds, foreign exchange, and raw materials. The government, therefore, needed to allocate resources directly to these enterprises through administrative channels, including national planning in the socialist countries and credit rationing, investment, and entry licensing in nonsocialist developing countries.

A close look at successful growth experiences of several developing countries in East Asia and other parts of the world reveals that the market was the dominant allocative mechanism in their economies; however, the state also played an active role. Moreover, the majority of industrial upgrading took place not only in exporting sectors, but also in import substitution activities (that is, import substitution that was compatible with each country's comparative advantage). Therefore, both the structuralist and the neoclassical views may reflect important insights about the process of economic development in developing countries.

Successful Asian countries have followed economic development strategies that are consistent with their comparative advantage. In each stage of development, the market has been the best mechanism for effective resource allocation. However, economic development is a dynamic process that involves shifting from one stage to the next, which requires industrial upgrading and corresponding infrastructure improvements. Infrastructure has the character of a public good and has large externalities to firms' transaction costs and returns to capital investment. Thus, the government should play an active, facilitating role in infrastructure improvements. The firms engaging in industrial upgrading also provide externalities to other firms in the economy. Therefore, it is desirable for the government to provide support for innovation. In developed countries, public funding for basic research and the patent system are examples of such support.

Continuous technological innovation and upgrading of industrial structures—as well as corresponding institutional changes—are the driving forces of long-term economic growth in modern times. First, the optimal structure of the economy is different for each country at different stages of development. This applies to a country's industrial, financial, legal, and other institutional structures. Second, each stage of economic development is a point on a spectrum, not a dichotomy of economic development stages. Third, markets play a fundamental role irrespective of the stage of development. The state needs to play a facilitating role by helping to upgrade the economy from one stage of development to the next. The endowment structure, including natural resources, labor, human, and physical capital, as well as hard and soft infrastructure, is different in each stage of development and from country to country. (Hard infrastructure includes power, transport, and telecommunications systems; soft infrastructure includes the financial system and regulation, the legal framework, and social networking.)

The experience of Asia therefore suggests the need to conceptualize a new structuralist approach to development, with the government facilitating industrial upgrading by (a) providing information about new industries of comparative advantage, (b) coordinating improvements in infrastructure, (c) subsidizing activities with externalities, and (d) promoting new industries by incubation or foreign direct investment.

Like Germany, France, and other countries in Western Europe in the nineteenth century and Japan and the NIEs in East Asia after World War II, any developing country can learn from the experiences of developed countries in technology and institutions. They can undertake rapid technological improvements, upgrade their industry, and adapt institutions at a relatively low cost and with less risk. Such a strategy could allow them to maintain rapid economic growth for several decades, narrow the gap with developed countries, and even overtake some of them.

How to Recover from Economic Crises

There are some similarities and some differences between the 1997–98 East Asian crisis and the current global crisis. In terms of similarities, both crises were made possible because the volume and patterns of international financial flows have increased considerably in recent decades. This evolution was underpinned by many factors: the deregulation of markets, which lifted capital controls in many developing countries, de facto or de jure; the high returns to portfolio investment in East Asian financial markets; and the improvement in the general economic outlook and the new developments in the technology of international financial transactions.

While East Asian countries benefited enormously from their integration into the global economy, they also realized that globalization and liberalization carry important risks. In Thailand, where the 1997–98 crisis was ignited, investors, who had been encouraged by high growth rates and had overlooked weaknesses in the financial and corporate sectors, suddenly lost confidence. Policy makers in these countries had difficulty addressing the problems of an overheated economy and the weakening of the current account. This created doubts in international financial markets about the compatibility of the monetary and fiscal stance with an exchange rate tightly linking the domestic currency to the U.S. dollar. Such inconsistencies in macroeconomic policies were a clear recipe for capital flight.

Another similarity with the current global situation is the fact that the East Asian crisis revealed inadequacies in the management, supervision, and regulation of financial institutions. Flooded with liquidity, these institutions had accumulated large amounts of risky assets and contingent liabilities against which they had inadequate capital and reserves. Thus, the crisis revealed the need to update regulation, improve transparency and supervision of financial institutions, and rethink existing frameworks for dealing with troubled banks. It also raised concerns about the effectiveness of rating agencies and deposit insurance schemes. It now appears that these emerging-country problems were not paid sufficient attention in industrial countries.

Just like the Asian crisis, the current downturn has had repercussions across countries, with some economies suffering from severe capital outflows and declining stock market and asset prices because of contagion. As was the case about a decade ago, economic contraction is reflected in the decline in exports, which heightens risks of the loss of creditworthiness.

But the current global crisis, which Alan Greenspan recently called a "once-in-a-century credit tsunami," differs from the East Asian crisis in several respects. First, it originated in the U.S. and European financial systems. The bursting of the U.S. tech-stock bubble in 2000–01, which had a substantial effect on the wealth of American households, forced the U.S. Federal Reserve to aggressively ease monetary policy. It lowered either the federal funds rate or the discount rate 27 times between January 2001 and June 2003, with the funds rate falling from 6.5 to 1.0 percent over that period. This expansionary monetary policy averted a deeper recession by stimulating a boom in the housing market, which soon turned into a housing bubble. Higher housing prices fueled a consumption boom, and the Fed's continued expansionary monetary policy kept the U.S. economy awash in excess liquidity. Another essential ingredient behind the persistently low U.S. (and global) real interest rates was the shift of developing countries toward accumulating large volumes of U.S. assets, motivated by their experience in previous crises and made possible by their current account surpluses. This made it possible for the United States to finance its massive current account deficit over a prolonged period without abrupt changes in real interest rates or real exchange rates.

Second, the high levels of financial innovation in major financial markets, driven by a search for higher yields in a low-interest-rate environment, compounded the levels of indebtedness in risky assets of major financial and nonfinancial institutions. Much of this innovation was carried out through excessive leveraging by firms whose activities were not regulated and other new instruments that were too complex to be regulated effectively. As a result, policies tended to advocate for deregulation of financial markets and were sometimes accompanied by lax supervision.

Third, contrary to the Asian crisis, policy responses were bold, comprehensive, and countercyclical. Their goal was not only to strengthen aggregate demand but also to maintain the availability of credit to households and businesses. This was in sharp contrast to what occurred in Asia in 1998, where the high domestic interest rate policies adopted to encourage the retention of resources in national economies initially attracted further capital inflows and external borrowing by domestic residents. As a consequence, financial institutions and the private sector assumed growing levels of foreign currency risk, which eventually made East Asian economies more vulnerable to external shocks. This was not the case this time. Fiscal policy and monetary policy, as well as government guarantees and safety nets, such as deposit insurance, have been used quickly in almost all industrial countries to improve conditions in the financial sector. Moreover, most East Asian economies have had strong fundamentals and vibrant exports in the years preceding the current crisis.

East Asian countries were able to recover quickly from the crisis because of their generally good macroeconomic fundamentals, the result of successful development strategies implemented for several decades; the good global environment prevailing at the time, which allowed many countries to regain their growth momentum through exports; and the rapid implementation of broad-ranging financial and corporate sector reforms such as the recapitalization of banks and closure of insolvent financial institutions, with their assets transferred to a restructuring agency (Korea, Indonesia, Thailand); the strengthening of prudential regulations, including loan classification and provisioning requirements and capital adequacy standards; the introduction of more stringent conditions for official liquidity support (Indonesia, Malaysia, Thailand); the adoption of competition and governance policies and trade reforms (Indonesia, Korea); the implementation of social sector policies such as labor-intensive public works programs (Indonesia, Thailand) and expansion of the unemployment insurance system (Korea); and the provision of higher public spending for health and education (Indonesia) and the reallocation of budgetary expenditure to health programs for the poor (Thailand).

Many of the broad lessons learned from the Asian crisis are still valid: first, the importance of the credibility of macroeconomic policies, both to domestic agents and to external lenders; second, the need to ensure that financial sector liberalization goes hand in hand with the adoption of a strong framework for prudential regulation and supervision of financial institutions; and third, the necessity to monitor and manage carefully capital inflows and their potential disturbances.

However, East Asia's most valuable lessons for dealing with today's crisis may be the willingness to consider carefully designed, unorthodox policies, especially in difficult circumstances. These lessons are illustrated by the contrasting paths chosen by Japan and China to fight deflation.

Japan's story of the 1990s, often referred to in the economic literature as the "lost decade," is well known. After the financial deregulation in the late 1970s, Japanese corporations were allowed to raise capital more cheaply from the capital markets, especially the foreign bond market, and savers could invest in the equity markets. In the second half of the 1980s, Japan's monetary authorities flooded the market with liquidity in order to enable businesses to cope with the rising value of the yen. A high savings rate and strong export surplus contributed to the ease of credit. Large excess capacity built up during the decade.

Fierce competition and decline in margins forced banks to increase their risk profile. Businesses invested in new capital equipment in an effort to become more competitive in international markets, but the excess liquidity also found its way into speculation in Japan's stock market, in real estate ventures, and in foreign investments. Between 1980 and 1996, loans to the real estate and construction sector nearly doubled from 11 to 19 percent, loans to the financial sector tripled from 3 to 10 percent, and loans to the manufacturing sector dropped from 32 to 15 percent.

The disproportionate growth of loans to real estate and the financial sector resulted in a large run-up in equity and real estate prices, which led to a buildup of asset bubbles. With the burst of the asset bubble, the Nikkei declined by one-third within a year from the peak at the end of 1989 to the end of 1990. Banks suffered huge losses from nonperforming loans. The collapse of large financial institutions in the late 1990s increased the cost of finance, and the credit crunch further caused a contraction in the economy. During the "lost decade," Japan's government implemented very aggressive fiscal stimulus policies. In 1991, public debt represented 60 percent of the country's GDP. By 2002, it had increased to about 140 percent—implying a very large and very decisive stimulus of 7 percent of GDP per year. Yet Japan did not get out of the crisis. Households responded by saving more, which dampened the effects of government spending.

By contrast, China chose a completely different path when its economy entered a five-year period of deflation at the end of 1997. In the midst of the Asian financial crisis, neighbor countries all depreciated their currencies, with sharp economic slumps in Indonesia, Korea, Malaysia, the Philippines, and Thailand. There was heavy deflationary pressure on China, with many economists advocating a parallel depreciation of the renminbi. Instead, the authorities decided to hold the exchange rate steady and to orchestrate a very large (about $1 trillion) fiscal expansion in 1998–2002. The government issued an estimated ¥ 660 billion in bonds specifically to finance infrastructure, which may have induced four times more bank loans and private and local government investment. Thanks to decisive government efforts to increase public investment, the ratio of total investment to GDP remained high at 33 percent in 1998–2002. As a result, the network for land transportation increased from 1.08 million kilometers in 1990 to 1.47 million kilometers in 2000, before jumping to 3.53 million in 2006. Following the same trend, the total transportation network initially increased by two-thirds, from 1.55 million kilometers in 1990 to 2.61 million kilometers in 2000, before almost doubling to 4.85 million kilometers in 2006. That strategy allowed China to combat deflation, with uninterrupted growth at 8 percent on average during that period.

The Chinese economy emerged from deflation in 2003, and the average annual GDP growth rate reached 10.8 percent in 2003–08. Due to the higher growth rate, the government's revenue grew rapidly, and the public debt declined from about 30 percent of GDP in the 1990s to about 20 percent in 2007. The improvement in infrastructure facilities, especially in rural areas, provided a sounder basis for economic growth. The fiscal resources spent on infrastructure investment led to higher growth that was sustainable.

The success of China's economic stimulus shows not only that well-designed stimulus can enhance growth in the developing world, but also that there is room for this growth-enhancing bottleneck-releasing type of investment. In contrast to Japan, where ineffective government stimulus investment and limited investment opportunities led to a sharp increase in government debt in its lost decade, China's effective stimulus led to higher growth, higher fiscal revenue, and lower debt.

This suggests that, if the resources are used appropriately, loans can be repaid from the high return on these investments. It is therefore important for the developing world to have access to the resources needed to join a global effort at shortening this crisis. Transferring resources to the resource-constrained developing world to invest in bottleneck-releasing and growth-enhancing efforts is a positive sum game, enabling developed countries to seize the high-return investment opportunities and, at the same time, allowing developing countries to realize higher growth in the long run, while stimulating demand in the short run.

With the existence of excess capacity in the global economy, solving the problems at hand would require much more than traditional Keynesian economics. While the restructuring of credit and financial markets in developed countries was a necessary first step that also helped to avoid a currency crisis in developing countries, efforts to increase bank lending may be futile because of firms' lack of good investment opportunities and households' lack of confidence about their future job security. The consequent increase in nonperforming loans and the risk of more assets becoming toxic could jeopardize efforts to stabilize the financial sector. Even if it were possible to restore confidence within the financial markets and to unclog the channels of credit, increasing money supply by keeping interest rates low might not stimulate demand.

Excess capacity in developed economies implies limited profitable investment opportunities, pessimistic expectations, low confidence about the future, and the likelihood of a liquidity trap. When confronted with excess capacity, companies cut prices to reduce their excess inventories. This aggravates the slack in labor markets, which in turn leads to decline in wage growth and prices. Even when nominal interest rates are low, as is currently the case around the world, investment opportunities are limited by excess capacity. The ensuing fall in demand and prices is self-reinforcing: the increase in unemployment and decline in wages result in a further fall in demand and prices, and the increase in the real value of nominal debts can create severe problems of default, which may exacerbate credit losses of financial institutions and further result in a vicious cycle of debt deflation.

Dealing with this large synchronized financial crisis is beyond the capability of any single country. To overcome this synchronized financial crisis, decisive and concerted efforts are needed. High-return public infrastructure investment opportunities may be limited in mature economies. By contrast, they tend to abound in developing countries, as infrastructure is the main bottleneck to growth. Release of evident bottlenecks in developing countries would result in enhanced growth potential, higher marginal returns to private sector investment, and higher government revenues to pay for the projects. While such bottlenecks are the best investment target for effective fiscal stimulus, many developing countries are constrained by their fiscal space and availability of foreign reserves. These constraints bring into question the feasibility of the traditional Keynesian macroeconomic policies.

Loans from developed to developing countries to finance high (economic and financial) return projects can lead to a win-win situation, as they will enhance the growth potential and increase sustainable demand in the long run. By supporting investment in infrastructure bottlenecks that constrain economic growth in developing countries, the coordinated fiscal stimulus would have a large multiplier effect, raising the chances for the global economy to avoid remaining trapped in a downward deflationary spiral.

A Few Issues for Discussion

I now turn to the subject of this year's conference: lessons from East Asia and the global financial crisis. Beyond the painful cruelty of the crisis (loss of wealth, unemployment, and the social and political consequences), economists should welcome the fact that the crisis is likely to spark an evolution in thinking about economic development—its nature, its causes, and the choice of policies it requires. Despite the unpleasant criticism and the sometimes unfair challenges to our discipline, economists must acknowledge some mistakes—such as the naïve belief in the end of volatility and complacency—and gaps in the existing stock of knowledge. We must use the current crisis as an opportunity for new thinking on macroeconomic and development issues. Specifically, there is a need to undertake the following:

- Revisit some of the dominant analytical frameworks in macro and development economics

- Draw lessons from the past crises and the various experiences and policy responses of East Asian countries
- Undertake new theoretical and empirical investigations that may be needed to expand the stock of knowledge
- Explore alternative methodological approaches that would complement (or substitute for some of) the existing ones.

We have an exciting and wide agenda ahead of us, and a vast range of issues deserves our attention. Let me flag a few possible topics that are likely to generate a lot of discussion over the next couple of days.

The first is the reorganization of financial and capital markets. The global crisis has shaken the confidence in financial markets of investors and policy makers around the world. It has also sparked a discussion on how best to reorganize and regulate markets so that they can effectively mobilize and allocate savings among competing uses and help firms to create value. In an effort to contain the crisis, the authorities in the United States and many European governments have taken the unprecedented steps of providing extensive liquidity, giving assurances to bank depositors and creditors that include blanket guarantees, structuring bailout programs that include taking large ownership stakes in financial institutions, and establishing programs for direct provision of credit to nonfinancial institutions. Some developing countries have reintroduced capital controls to prevent capital outflows. Many old and new questions are back on the agenda:

- What is the proper role of government in the financial sector?
- What is the optimal financial structure for developing countries? Should there be different models of financial development for countries at different levels of economic development?
- What is the proper policy on capital account liberalization, and should there be different policies for different types of financial inflows (portfolio investments versus foreign direct investment)?
- When and why should government bail out or own financial institutions? Are blanket guarantees the most efficient instruments to halt a systemic crisis?
- How should prudential regulation be designed and implemented to facilitate monitoring, supervision, and innovation?
- What is the proper policy on antitrust and bankruptcy legislation?

Second is the role of government and first-order principles of good economic policy. The global crisis has not changed the basic objectives of economic policy: prosperity, equity, and stability or continuity. But it has challenged the general premise that markets tend to deliver socially superior outcomes. The boundaries and balance between markets and the state and the central role of institutions (regulations and regulatory frameworks in the case of financial markets) will be at the center of the debate in development economics in years to come. Even in the context of industrial countries, the most successful economies are not those that minimize the role of government, but those that adopt a pragmatic approach to economic policy and have the government intervene when this intervention produces superior social outcomes—even if doing so implies higher levels of taxation or management by the state of pensions, medical insurance, and so forth. This observation makes the following questions even more relevant:

- Under what conditions are the traditional broad principles of good macroeconomic management (free markets and sound money) conducive to sustained growth and poverty reduction?
- Even if these broad principles still apply to all countries in an increasingly globalized world, how should they be operationalized, especially from the perspective of developing countries?
- What new principles of economic policy can be learned from the experience of East Asian and Latin American countries that seem to have weathered the storm?
- Given that sustained growth is mostly about continuous industrial and technological upgrading, how should industrial policies be designed and implemented?
- How should the comparative advantage theory (Lin 2009) be integrated into development economics?
- What institutions really matter for growth, especially from the perspective of developing countries? What have we learned about the virtuous circle between institutions, social capital, and economic development?

Clearly, we will not be able to settle these questions—and many others on the agenda—over the next two days. Still, given the impressive collection of great minds attending this meeting, I am confident that we will make serious progress and, perhaps, enrich development thinking.

In closing, let me reiterate the World Bank's commitment to cutting-edge research that is also highly relevant to development policy. We are currently examining the future directions of our research and will welcome findings and recommendations from this conference. We will also work to improve outreach, dissemination, and access and to strengthen collaboration with local partners around the world.

References

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