Growth After the Storm: A Longer-Run Perspective

Kemal Derviş

Istanbul, Turkey

Sunday, October 4, 2009

Banks Association of Turkey
Per Jacobsson Foundation

THE PER JACOBSSON LECTURE

Growth After the Storm?
A Longer-Run Perspective

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Per Jacobsson Foundation
2009

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ISSN 0252-3108

Editor: Michael Harrup
Composition: Alicia Etchebarne-Bourdin
Cover design and production: IMF Multimedia Services Division

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Foreword

The 2009 Per Jacobsson Foundation Lecture, "Growth After the Storm: A Longer-Run Perspective," was delivered by Dr. Kemal Derviş, who is the Vice-President for Global Economy and Development at the Brookings Institution in Washington, D.C., and Senior Advisor to Sabanci University in Istanbul, Turkey. The lecture was held, as is customary, in conjunction with the Annual Meetings of the Boards of Governors of the International Monetary Fund and the World Bank, on October 4; the venue was the Conrad Ballroom of the Conrad Hotel in Istanbul, Turkey. Sir Andrew Crockett, Chairman of the Board of Directors of the Per Jacobsson Foundation, moderated the event. The Banks Association of Turkey cosponsored this year's lecture.

The Per Jacobsson Foundation was established in 1964 to commemorate the work of Per Jacobsson (1894–1963) as a statesman in international monetary affairs. Per Jacobsson was the third Managing Director of the IMF (1956–63) and had earlier served as the Economic Adviser of the Bank for International Settlements (1931–56). Per Jacobsson Foundation lectures and contributions to symposia are expressions of personal views and intended to be substantial contributions to the field in which Per Jacobsson worked. They are distributed free of charge by the Foundation. Further information about the Foundation may be obtained from the Secretary of the Foundation or may be found on the Foundation's website (www.perjacobsson.org).

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Opening Remarks

ANDREW CROCKETT

Good afternoon and thank you very much for coming. I would like to thank the Banks Association of Turkey for their generous sponsorship of this occasion. The Per Jacobsson Foundation has been a feature of World Bank and IMF Annual Meetings for about 20 years now. I have had the pleasure as its Chairman to introduce a wide number of very distinguished speakers.

Today, it is my great pleasure to introduce somebody who clearly needs no introduction in this city and probably most cities in the world, Kemal Derviş. Kemal and I have been friends and colleagues for more than 30 years now, and it has been a great pleasure for me to watch his career progress from his beginnings at the World Bank and the distinct contribution he made there to policy analysis and recommendations for many countries.

Subsequently, as is well known, Kemal became the Finance Minister and Deputy Prime Minister in this country and contributed very significantly to the economic policies that have helped revive the Turkish economy and stabilized it in the years during his stewardship of the economy.

He subsequently became Administrator of the United Nations Development Programme, and he's now at the Brookings Institution and also Overseer on the Board of Sabanci University.

There are many other things I could say about Kemal, but I don't want to detract from the time available for his speech. So without further ado, let me ask Kemal to give us his lecture.

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Growth after the Storm? A Longer-Run Perspective

KEMAL DERVIŞ

A year ago this time, in early October of 2008, the world was on the edge of a financial and economic abyss. Those very close to the events in the financial sector were terrified. The world at large had not yet fully comprehended the magnitude of the disaster. The October 2008 *World Economic Outlook* had predicted that global GDP growth would have attained 2.7 percent in 2008 and would be 1.9 percent in 2009. Compare that to the 2.1 percent realized in 2008 and the most recent projection of –2.3 percent for 2009. Projections have been revised upward over the last few weeks, but the loss of output in 2009 will still be much greater than what was projected a year ago. The real point, however, is that it could have been much worse. What happened on Wall Street in September of 2008 was the financial equivalent of the Cuban missile crisis of 1962. We came very close to a complete meltdown . . . as the world had come very close to nuclear war in 1962. But the meltdown did not take place—a very vigorous policy response in the major economies and concerted action by the major central banks forestalled a much worse disaster.[1]

The topic today, however, is not the past but the future. Will the world return to the kind of growth we had in the 2002–07

[1]There is currently an attempt in the United States, which appears largely politically driven, to argue that the fiscal stimulus was ineffective. I will not get into that debate here, except to stress that a key fact to consider when evaluating the effectiveness of fiscal expansion should be the interest rate. If fiscal expansion leads to a substantial rise in interest rates, it is not effective and instead crowds out private spending. If interest rates remain low, as they have so far, there is a good case for saying that it is indeed effective. It is not only fiscal policy that helped, of course. Direct intervention in the financial sector, as well as aggressive monetary easing, were at least as important.

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period—averaging about 3.2 percent at market prices and 4.3 percent at purchasing power parity prices? Those five years were a period of very rapid growth, close in pace to the growth experienced during the post–World War II reconstruction period. Or are we likely to experience much slower growth for a number of years? I am not talking about 2010—I am trying to look forward to the next five to ten years. What kind of economic growth can the world expect over the next decade? Predictions diverge widely, in line with the disagreements in the economic literature on trend reversion of GDP.[2] Until recently many observers have stressed that we should not expect world growth to resume at precrisis pace in the near future. The majority view has been that not only will we not experience the kind of accelerated post-depression growth observed, for example, in the U.S. economy in the 1930s, but there will be several years of below-trend growth after the great crisis of 2008–09. The process of deleveraging will take time. The U.S. consumer will no longer be able to play the locomotive role of the past. A more-regulated financial sector facing higher capital requirements will be unable to provide financing as easily as in the past. These are some of the arguments most often cited to express caution and a subdued view on future growth. More recently, as the data point to a stronger recovery of output in the second and third quarters of 2009 than what was expected in most countries, many observers now see a "good snapback" in the second half of 2009, but then a "slow crawl" in the coming years, at least in the advanced economies.[3] In terms of the literature on trend reversion, most observers probably agree that the crisis of 2008–09 qualifies as a candidate to be one of the "structural breaks," different from more minor recessions for which there is some evidence of trend reversion,

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[2]See, for example, Charles R. Nelson and Charles R. Plosser, "Trends and Random Walks in Macroeconomic Time Series: Some Evidence and Implications," *Journal of Monetary Economics*, Vol. 10, No. 2 (1982), pp. 139–62; Robert E. Lucas, "Macroeconomic Priorities" (2003 AEA Presidential Address), *American Economic Review*, Vol. 93, No. 1 (2003), pp. 1–14; Valerie Cerra and Sweta C. Saxena, "Growth Dynamics: The Myth of Economic Recovery," Working Paper No. 226 (Basel: Bank for International Settlements, 2007); and Valerie Cerra, Ugo Panizza, and Sweta C. Saxena, "International Evidence on Recovery from Recessions," Working Paper No. 09-183 (Washington, D.C.: International Monetary Fund, 2009).

[3]These are the words used by Federal Reserve Bank of Dallas President Richard Fisher in a speech at the University of California, as reported by Reuters on September 4.

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at least in some countries. What I would like to do today is to share my perspective on this question of medium-term growth prospects. Clearly a great deal of modesty is in order. As Michael Spence, Chairman of the World Bank–sponsored Commission on Growth and Development in which I participated, has written in the postscript report that will be discussed later today, here in Istanbul: "the crisis was a humbling experience for anyone who seeks to understand and explain the world economy."[4] Let me stress that not everyone got it equally wrong. There were warnings about excess leverage, unsustainable housing prices, bubble features in many classes of asset markets, and global imbalances. But very few predicted the nature and extent of the crisis. When it comes to predictions, modesty is in order for economists. All I aspire to do is to review some of the arguments and make some tentative suggestions. Let me also add, here at the outset, that GDP growth is a very imperfect measure of human progress, as has most recently been explained again, and with updated detail, by a commission led by Joseph Stiglitz and Jean-Paul Fitoussi. The fact that this lecture focuses on the traditional GDP growth measures should not be interpreted as implying that GDP is a sufficient measure of economic and social progress. That very important issue is not, however, discussed in this lecture. Another very important issue not discussed is the issue of climate change. If there is no global collective action to reduce carbon emissions, world growth over the next decades will increasingly be facing a climate challenge and climate constraint. When growth prospects over the next few decades are discussed, climate has to be part of the discussion. In this lecture, we focus on the next five to ten years. While preventive action is needed starting in this coming decade, and while the relationship between climate policy and growth is already important, I have not addressed it in this lecture. A longer-term discussion of global growth prospects would have to include serious analysis of climate-related issues, including the need to drastically reduce the carbon intensity of GDP.

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[4]Commisssion on Growth and Development, *Post-Crisis Growth in Developing Countries: A Special Report of the Commission on Growth and Development on the Implications of the 2008 Financial Crisis* (Washington, D.C.: World Bank, 2009), p. 2.

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The Recent Debate about Growth Has Focused Only on Demand-Side Factors

The worldwide economic debate over the last 18 months has been conducted almost entirely from an aggregate demand perspective. This is of course understandable, as the financial crisis of 2008 led to an unprecedented worldwide collapse of private demand. High oil and commodity prices did add a supply-side element to the making of the crisis in mid-2008, but the dominant initial cause of the downturn was the decline in demand in the advanced economies caused by the steep fall in asset prices and the credit crunch in the United States and Europe. The second wave of demand declines quickly came through the trade channel, amplifying the first and reaching the emerging market and developing economies. Steep declines in aggregate demand led to contractions in the demand for exports, with multiplier effects throughout supply chains and across borders. The most export-oriented economies, except those with large current account surpluses and reserves acting as buffers, suffered the most. This experience of the crisis with its devastating effects should not make us forget, however, that considered from the supply side, the recent history of the world economy had been one of rapid and indeed accelerating growth. As mentioned before, growth during the 2002–07 five-year period averaged to one of the highest levels ever experienced.

What Are the Key Sources of Growth from the Supply Side?

It will be useful to briefly recall the main longer-term drivers of growth in potential output. First there is technical progress or the outward *shift of the production possibility frontier* due to innovation and new knowledge, mostly taking place in the most-advanced economies operating close to the knowledge frontier. Technical progress had been very rapid, particularly in the United States during the second half of the 1990s. There has been some slowing of the pace of productivity growth in the United States in the early years of this decade, probably reflecting less investment, but the underlying shift of the technological frontier is unlikely to slow down as new advances in knowledge are taking place. These range from new waves of progress in information and

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communication technology and digital production techniques to advances in biotechnology and energy efficiency.

Second, there is the *speed of diffusion of knowledge and technology.* There is little doubt that globalization—which we can here define as the increase in trade, investment, and information flows—accelerated the diffusion of technology. Globalization reached a new dimension after the fall of the Berlin Wall and the much greater integration of China into the world economy. The emergence also of India as a significant participant in the world economy, after the early 1990s, has now added hundreds of millions of workers and consumers to a much more integrated and interdependent world economy. Over the past two decades old barriers disappeared, information traveled faster than ever, and new technologies could be diffused at unprecedented speed across the globe. Because of the enlarged world market, and because of the nature of new Internet-based modes of production, the potential for exploiting economies of scale has also increased in the case of many economic activities.

The availability of knowledge and new technology can generally translate into increased labor productivity and production only if there is sufficient investment to make it happen and if physical investment is complemented by appropriate human capital formation. The need to embody technology and traditional capital deepening make capital accumulation the third major source of supply-side growth. Human capital indicators are overall improving rapidly, although unevenly across the world. The progress in Chinese secondary and tertiary enrollment rates is particularly impressive. Moreover, the aggregate world *savings and investment rate* had recently been on an increasing trend primarily because of the increasing weight in the world economy of the East Asian high-saving nations, but with some oil exporters also a strong contributing factor. And this increase took place despite a low and declining American savings rate. If the savings rate in the United States had not declined from about 16 percent to about 13 percent—I am here referring to total gross savings as reported in the national accounts, not to the much lower household savings rate—the increase in world savings over the 2002–07 period would have been even more remarkable. In Asia, plentiful savings made "catch-up" growth all the more rapid, as the great potential for technological diffusion could be translated into unprecedented

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output expansion through high investment rates. New techniques came embodied in new capital goods, and the high Asian investment rates facilitated diffusion of knowledge. There is every reason to believe that this process will continue for many years, even if we should see a slow decline in the extraordinarily high Chinese savings rate. Most Asian countries as well as the oil exporters of the Gulf will continue to have high savings rates, and their weight in the world economy will increase. The Chinese savings rate will probably come down a little, but in relative terms it will remain huge. In the advanced countries, savings are unlikely to decline. They may even increase in the United States. So in the aggregate the world savings rate will probably continue to increase, at least moderately.

A rapidly shifting technological frontier, rapid worldwide diffusion of knowledge, and plenty of investment, including in human capital, translate into rapid growth of potential output worldwide. This process can produce particularly good results in terms of output, while there is still a lot of *underutilized labor* in the rural sectors of emerging and developing economies, constituting a fourth source of supply-side growth. Even without appealing to a shifting production function or to technology with economies of scale, it would still be possible to view part of the growth of potential output in many emerging market economies through the lens of a classical Lewis growth model where there are no diminishing returns to investment, as more rural labor can be drawn into the modern sector with low opportunity cost. Economies of scale and technical progress only add to the prospect of accelerating growth in potential output.

There are, therefore, powerful factors supportive of growth in potential output in the world economy, and there is no reason for any one of the main elements causing this trend to weaken in the medium term, if we define the medium term to be about a decade or so. The accumulation of knowledge does not appear to slow down. On the contrary, all indications are that further impressive advances can be expected not only in informatics and digital production, but also in other sectors such as biotechnology, and the field of potential applications is wide. The rate of diffusion of knowledge will also continue to be rapid, as there is continued progress in education and language skills, as well as communication technology. With the increasing economic weight

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of the nations with high savings rates, the overall potential investment rate will be high. Finally, for the next decade at least, there are still large amounts of "reserve labor" to be deployed in the higher-productivity modern sectors in the developing economies, or indeed through migration, in the advanced economies. Supply-side growth models for the world economy as a whole factoring in all these elements will tend to produce an average annual global growth in potential output close to 4 percent for the coming decade, with GDP measured at market prices, close to or a little higher than what was achieved in the best years of the past two decades.

DEMAND-SIDE THREATS

The problem is, of course, that the death of the business cycle and of Keynesian economics had been announced very prematurely. The presidential address of Robert Lucas to the American Economic Association in 2003 is often quoted as such an announcement, although, to be fair, he announced the end of depressions—not the end of recessions.[5] Be that as it may, macroeconomics is not just about aggregate supply. Supply still does not necessarily create its own demand. We have been living through massive output losses because of problems unrelated to the factors determining long-run supply, which I tried to summarize above. The massive decline in asset prices between the summer of 2008 and the spring of 2009, the huge rise in uncertainty, the collapse of "animal spirits," and the disorganization of the financial sector with accompanying declines in credit led to a worldwide fall in private consumption and investment demand and to the emergence of an output gap of a size the world had not experienced in decades.

"Ex post" supply of course always equals demand, and the adjustment had to take place through a contraction of output. Public policies have limited the decline in output by substituting public demand for private demand on an unprecedented scale. The expansion of fiscal deficits in G-20 countries is likely to average

[5]"[M]acroeconomics . . . has succeeded: its central problem of depression prevention has been solved." Robert E. Lucas, "Macroeconomic Priorities" (2003 AEA Presidential Address), *American Economic Review*, Vol. 93, No. 1 (2003), pp. 1–14.

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more than 5 percentage points of GDP in 2009, with about 2 percentage points due to discretionary fiscal stimulus. A "hyper-Keynesian" combination of fiscal and monetary policy response helped the world avoid a much bigger disaster. It is true that ascribing recent output increases primarily to fiscal stimulus spending per se is difficult, particularly in the United States, because only part of the stimulus has actually been spent. Monetary policy, including the unconventional part, and the direct interventions in the financial sector also deserve much credit. Moreover, the effect of the decisive and large overall policy response on "animal spirits" should not be underestimated. The "hyper-Keynesian" message was strong, particularly in the United States and China, but also in large parts of Europe and Japan, and it affected animal spirits. The London meeting of the G-20 and the decisions to triple the lending capacity of the IMF, as well as the measures the IMF itself took to expedite lending and make financing available through its new Flexible Credit Line, contributed to this reversal of animal spirits also in emerging markets. The fall and winter panic was overcome, and that, in itself, was probably as important as the actual amounts of government spending or the level of interest rates. Some parts of Europe appeared not to have responded as vigorously, but taking into account the strong automatic stabilizers existing in Europe, the fiscal impulse was actually quite strong even in countries openly worried about the hyper-Keynesian nature of the response. To some degree the countries having done a little less are also enjoying a bit of a free ride from the demand spillovers coming from the countries having done a lot.

Exit Strategies

There is, now, the issue of when it will be appropriate, in aggregate terms, to start to reduce public demand and wind down the fiscal stimulus as well as to start thinking about some tightening in monetary policy. I think the message from the G-20 meeting in Pittsburgh is, overall, an appropriate one. It is not a message that fiscal stimulus will now start to be withdrawn. The indicators of recovery are far too weak at this point. Unemployment worldwide, in particular, is still increasing. The appropriate interpretation of the message is that policymakers, worldwide, are preparing exit strategies and will be ready to tighten fiscal

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and monetary policy in appropriate doses *if and when economic indicators warrant such action*. Such a message is needed, both because it is what should happen, and because here again it is what is needed from the point of view of animal spirits. There is a justified worry that some of the fiscal expansion could be hard to rein in and that there could be pressures in the government debt markets of the largest economies leading to substantial increases in interest rates that would slow down or kill the recovery. A strong message that policymakers are aware of this danger and are, already now, working on preparing exit strategies is a positive one for animal spirits and will be supportive of the recovery, if it is credible. The Istanbul meetings of the IMF and the World Bank can reinforce this message and make it more credible by showing common resolve.

I would like to add two points in this context. The first one is that the dosage and timing of the policy response remains very important and perhaps more difficult than in the winter of 2009. Then, the danger of a world depression was so great that it was necessary to mount essentially as large as possible a response, as quickly as the legislative processes allowed. Now, fine tuning becomes more important, in terms both of timing and of amounts. The second point relates to the inflation unemployment trade-off. I believe, with Akerlof and Schiller,[6] that there is indeed such a trade-off, even in the medium term, although it is not a very stable trade-off. The fine tuning of the exit strategies will have to be based on political choices regarding that trade-off. The inflation targets governments and central banks choose should depend on the amount of unemployment projected over the next two to three years. A *totally necessary* commitment to *low inflation* need not and should not imply that the inflation target chosen over a two- to three-year period should not at all depend on where we are with regard to employment. Long-run steady-state inflation targets are a different matter. It may indeed be desirable that they be fixed more or less forever . . . but that should not be the case in the immediate aftermath of a huge crisis.

[6]George A. Akerlof and Robert J. Schiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (Princeton, N.J.: Princeton University Press, 2009).

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GLOBAL IMBALANCES

Let me now turn from these remarks on global aggregates, to a brief analysis of problems relating to the *structure* of global demand. The stylized story has been that U.S. consumption demand was the locomotive of world demand, providing, in particular, Asia, and there, mainly China, with the necessary outlet for export-led growth, with both Asian capacity creation and some of American consumption financed through a huge Asian savings rate. A healthy recovery implies that American consumers rebuild their balance sheets, and the worry is that the implied higher American private savings rate and reduction of the U.S. current account deficit would mean that the American consumer could no longer be the "driver" of global growth. It is feared that such an interruption of what, for a long time, has been viewed as the growth engine of the world economy would lead to a lasting slowdown of world growth. In the absence of a strong expansion of consumption demand in China and other surplus countries, so the stylized story goes, there would have to be either a return to a large U.S. current account deficit and, again, a low U.S. savings rate, or lower world growth as a whole, as output has to adjust to insufficient global effective demand. As the need for deleveraging and concern about the deteriorating U.S. net debt position will not allow a return to the old global imbalances, it is argued that the only way the world can return to a sufficient amount of effective demand to allow rapid growth is through a change in the export-led growth model of China and to a lesser degree of Germany, with greater domestic consumption in these surplus countries leading to a lasting unwinding of the great global imbalances. Fred Bergsten and Arvind Subramanian put it as follows in a recent opinion piece in the *Financial Times*: "The U.S. strategy on this issue is not, at least for the moment, consistent with strategies elsewhere. Put starkly, [White House National Economics Council Director Larry] Summers stated that China can no longer behave like China because the U.S. intends to behave much more like China. The world economy cannot have two, or even one-and-a-half, Chinese growth strategies from its most important two economies."[7]

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[7]Fred Bergsten and Arvind Subramanian, "America Cannot Resolve Global Imbalances on Its Own," *Financial Times*, August 19, 2009.

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There is no question that some rebalancing of global demand would be beneficial for world growth over the next few years. The deleveraging process in the United States that is necessary to overcome what has been called a "balance sheet recession" will require a higher household savings rate. Moreover the U.S. net debt position, while still modest, has been on a rising trend, and a continuation of large U.S. current account deficits would no doubt create new vulnerabilities for the United States and the world economy. As all the major countries in the world consider their fiscal and monetary policies for the next two years, it is highly desirable that they choose these policies in a manner that would facilitate the unwinding of the global imbalances. In fact, it seems that in 2009, the sum of the absolute values of the current account surpluses and deficits, ignoring signs, of the G-20 economies will be close to half of what it was in 2008. But this sum, which we can take to measure global imbalances, could rise again in 2010 and beyond. If the macroeconomic policy mix in the United States over the coming years were to be more expansionary than the policy mix in China, Japan, and Germany, then global imbalances will rise again. International policy coordination explicitly targeting these imbalances is desirable, and the decisions taken at the Pittsburgh summit constitute a major, welcome step in formalizing a process that should be helpful in that context. If the surplus countries expand by more than the deficit countries, we can enjoy lower global imbalances and therefore greater overall medium-term stability with higher aggregate world growth. If, on the other hand, the burden of adjustment is put strongly on the deficit countries alone, then it will be possible to reach equilibrium only at lower aggregate world output levels.

I do not disagree with this line of argument, but I do think that one should not exaggerate the extent to which rapid expansion of U.S. consumer spending is a sine qua non for world growth. Let me make a few observations in this context.

First, it is something of an exaggeration to say that the American consumer has been the "driver" of world growth, in any long-run sense. The real medium-term drivers of world growth have been high rates of technical progress, rapid diffusion of technology, high Asian investment rates, the exploitation of economies of scale, and the availability of labor and resources. On the demand side, U.S. private consumption amounted to about 17 percent of

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total world demand in 2008. It grew at a rate of about 3 percent a year in the rapid-growth period preceding the crisis. Suppose that it will grow at only about 2 percent over the coming five years. Such a 1 percentage point decline, compared to the precrisis years, by itself, and holding everything else constant, would mean a 0.17 percentage point decline in the growth of aggregate world demand. If we instead project U.S. consumption to grow at only 1.5 percent a year over the next decade, the immediate decline in total world demand would be about a quarter of a percentage point. This would be significant, but hardly cataclysmic.

My second point is that we should look at the overall structure of current account deficits and surpluses, not just at the United States and China. In that context it is not clear whether focusing on the German surplus makes much sense. Germany is part of the euro zone, and Spain, another part of the euro zone, has had a huge deficit. The euro zone as a whole has not had a significant surplus or deficit. Maybe Texas, in the United States, has had a large surplus and California has had a deficit, but we do not look at such numbers. It would seem to make more sense to talk of the euro zone rather than individual countries in it, when discussing global imbalances. It is true that the euro zone is not a federal country with a common fiscal policy, but it is now both a single market and a single monetary zone. From the point of view of the link between current accounts and the euro/dollar exchange rate, for example, it is the aggregate savings-investment balance of the euro zone that matters. More importantly, some of the rebalancing could and should take place in a way that involves the middle- and lower-income countries. Let us think stylistically of six economic "regions" in the world economy: the United States, the euro zone, other advanced countries, China, the Gulf oil producers, and the other emerging and developing countries. The precrisis Chinese surplus of about 10 percent of Chinese GDP has been largely seen as the counterpart of the U.S. deficit, and it has indeed contributed significantly to the financing of the U.S. deficit.

For the world to have a desirable structure of current accounts, by how much does China have to lower its surplus in the next few years? I would like to suggest that rather than trying to lower the surplus drastically, which could have a significantly negative impact on its growth, China could redirect a significant portion of its surplus savings towards developing countries, allowing them

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as a group to run somewhat higher current account deficits and finance somewhat more investment. I have done the rough arithmetic. Taking the 2010–15 period, we could have a Chinese current account surplus averaging about 6 to 7 percent of GDP, a U.S. deficit of about 2 to 3 percent of GDP, and an "other emerging and developing countries" deficit of about 3 to 4 percent of their GDP. Arithmetically, this would be consistent with a surplus of about 10 percent of GDP for the Gulf oil exporters (this implicitly assumes quite high oil prices), and a nearly balanced aggregate current account in the euro zone and other advanced countries taken as a whole. Such a scenario could constitute a good transition phase during which the world avoids very sharp swings in growth strategies and macroeconomic balances. The United States would not have to eliminate its current account deficit. China could continue with a somewhat more moderate version of its high savings, export-led growth strategy and manage the transition to a more consumer-driven growth process gradually rather than very quickly. A greater amount of savings would flow to the poorer countries, allowing them to increase their investment and rhythm of development. The average return on those investments in the developing countries would surely be higher than what China can earn in U.S. Treasury bills. The scenario involves gradual change, not sudden, large, and potentially disruptive change, in the structure of world savings and investment.

A key feature of such a scenario that I consider desirable is the larger net capital inflow into the developing countries. As policy frameworks in these countries have improved, it is desirable and should be natural for them to be net capital importers rather than run balanced or surplus current accounts, without this leading to the types of balance of payments crises that these countries experienced in the 1980s and 1990s. And given the very high Chinese savings rate, some of these flows could and should come, directly or indirectly, from China. We have seen the beginning of such a new structure of capital flows over the last two years, including bilateral agreements between China and some Latin American countries to use their own currencies in part of their trade. To reduce and pool risk, some of the suggested capital flows could also be intermediated by the multilateral development banks, which should receive capital augmentations. Some of the excess Chinese savings could contribute to "pooled reserves" for the de-

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veloping countries, including in the form of precautionary finance at the IMF.[8]

Such a global demand management scenario would allow a gentle rather than an abrupt unwinding of the global imbalances and a gradual shift in growth strategies rather than a large sudden change, which could be disruptive. If it could be realized, the problem of global imbalances would not be the key major constraint on medium-term world growth. Current accounts are of course not policy instruments, but the outcome of public and private sector spending decisions. For the scenario I have outlined to be realized, coordination of macroeconomic policies and a more active role of the international financial institutions in helping channel resources to the developing countries and in helping them manage the risks of a larger inflow of capital would be necessary. Fortunately, that is exactly what the Pittsburgh summit decisions should make possible.

INTERNAL DEMAND-SIDE CONSTRAINTS IN KEY ECONOMIES?

While current account imbalances may evolve in a direction compatible with rapid worldwide growth, what about "internal" savings and investment balances in key economies? One of the most dramatic and unsettling economic statistics in recent times is that a full two-thirds of all economic gains in the United States during the rapid precrisis growth years accrued to only 1 percent of the population.[9] In China, the share of labor income in GDP has declined to only 40 percent! It may well be that it is income-distribution-related *internal* imbalances that may be a key short- to medium-term demand-side threat to sustained rapid growth. But how come, then, there was such rapid precrisis growth despite these extreme income concentrations at the top? One answer to this question is that it was the unsustainable internal debt accumulated by U.S. households and the illusion of wealth due to the asset price bubbles that sustained consumption in the United States and other countries, despite the worsening income distribution and the lack of real income growth for most households. In

[8]For this to happen in a big way, the pace of governance reform at the IMF would have to increase.

[9]Latest findings by Thomas Piketty and Emmanuel Saez, cited in "A Long Way Down" (editorial), *New York Times*, September 16, 2009.

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China, it was both asset prices and export demand that played a role in compensating for the negative effect of internal income concentration on consumer demand. I do believe the link between income distribution and effective demand is underresearched and not sufficiently debated, particularly when compared to the constant attention given to the global imbalances issue. It is true that in the long run, the structure of supply can adjust to any particular income distribution. In the short to medium term, however, sectoral imbalances reflecting sharp changes in income distribution can lead to macroeconomic problems. It may well be that a continued worsening of income distribution in countries such as the United States and China could be as significant a demand-side threat to global growth as the U.S. and Chinese current accounts deficits and surpluses.

CONCLUSION

I would like to conclude from all this that there is probably the potential for very rapid growth in the world economy, by historical standards, over the coming decade, because of strong supply-side factors. Whether this growth can be realized does, however, depend on demand-side management both at the national level and through improved global macroeconomic policy coordination. Macroeconomics remains highly relevant, and proactive policies, national and international, can provide large benefits. The world has actually experienced an overall highly successful macroeconomic policy response to a crisis largely due to a previous excessive confidence in self-regulating markets and a neglect of the need for careful regulation and macroeconomic management. Let us not make the mistake of thinking that because output indicators are now improving, the policy response was unnecessary or that, in the years to come, macroeconomic management can be on some kind of autopilot, rather than being responsive to ever-changing circumstances.[10]

[10]Following the delivery of his prepared remarks, Dr. Derviş answered questions from audience members, as typically happens after Per Jacobsson Lectures. Unfortunately, technical difficulties with the equipment used to record the lecture prevent the reproduction of the question-and-answer session here.

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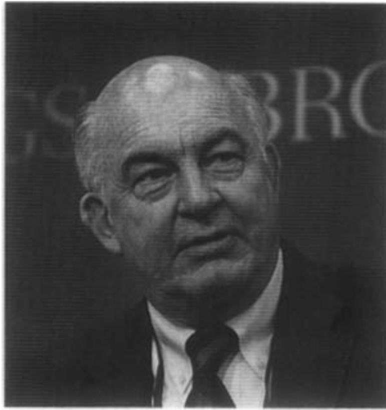

Brookings Institution/Paul Morigi

Kemal Derviş

Dr. Kemal Derviş is Vice President and Director of the Global Economy and Development Program at the Brookings Institution and a member of the Board of Overseers of Sabanci University in Istanbul. He is also Chairman of the International Advisory Board of Akbank and an Advisor to the Director-General of the International Labour Organization.

Until recently, Dr. Derviş was the Executive Head of the United Nations Development Programme and Chair of the United Nations Development Group. From 2002 to 2005, he served as a member of the Turkish Parliament, representing his native city of Istanbul. Prior to his tenure in Parliament, he served as the country's Minister of Economic Affairs and the Treasury.

Before his service in the Turkish government, Dr. Derviş had a lengthy career at the World Bank, where he became Vice President for the Middle East and North Africa in 1996 and Vice President for Poverty Reduction and Economic Management in 2000.

Dr. Derviş earned his bachelor's and master's degrees in economics from the London School of Economics and his doctorate from Princeton University. His most recent book, *A Better Globalization*, was published in 2005.

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The Approach to Macroeconomic Management: How It Has Evolved. Lecture by Lord George.

2007 *Balance of Payments Imbalances.* Lecture by Alan Greenspan.

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2004 *The U.S. Current Account Deficit and the Global Economy.* Lecture by Lawrence H. Summers.

Some New Directions for Financial Stability? Lecture by C.A.E. Goodhart, CBE (Zurich).

2003 *The Arab World: Performance and Prospects.* Lecture by Abdlatif Yousef Al-Hamad (Dubai).

2002 *The Boom-Bust Capital Spending Cycle in the United States: Lessons Learned.* Lecture by E. Gerald Corrigan.

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2001 No lecture took place due to the cancellation of the Annual Meetings of the IMF and the World Bank.

2000 *Ten Years On—Some Lessons from the Transition.* Lecture by Josef Tošovský (Prague).

Strengthening the Resilience of Financial Systems. Symposium panelists: Peter B. Kenen, Arminio Fraga, and Jacques de Larosière (Lucerne).

1999 *The Past and Future of European Integration—A Central Banker's View.* Lecture by Willem F. Duisenberg.

1998 *Managing the International Economy in the Age of Globalization.* Lecture by Peter D. Sutherland.

1997 *Asian Monetary Cooperation.* Lecture by Joseph C.K. Yam, CBE, JP (Hong Kong SAR).

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1995 *Economic Transformation: The Tasks Still Ahead.* Symposium panelists: Jan Svejnar, Oleh Havrylyshyn, and Sergei K. Dubinin.

1994 *Central Banking in Transition.* Lecture by Baron Alexandre Lamfalussy (London).

Capital Flows to Emerging Countries: Are They Sustainable? Lecture by Guillermo de la Dehesa (Madrid).

1993 *Latin America: Economic and Social Transition to the Twenty-First Century.* Lecture by Enrique V. Iglesias.

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1992 *A New Monetary Order for Europe.* Lecture by Karl Otto Pöhl.

1991 *The Road to European Monetary Union: Lessons from the Bretton Woods Regime.* Lecture by Alexander K. Swoboda (Basel).

Privatization: Financial Choices and Opportunities. Lecture by Amnuay Viravan (Bangkok).

1990 *The Triumph of Central Banking?* Lecture by Paul A. Volcker.

1989 *Promoting Successful Adjustment: The Experience of Ghana.* Lecture by J.L.S. Abbey.

Economic Restructuring in New Zealand Since 1984. Lecture by David Caygill.

1988 *The International Monetary System: The Next Twenty-Five Years.* Symposium panelists: Sir Kit McMahon, Tommaso Padoa-Schioppa, and C. Fred Bergsten (Basel).

1987 *Interdependence: Vulnerability and Opportunity.* Lecture by Sylvia Ostry.

1986 *The Emergence of Global Finance.* Lecture by Yusuke Kashiwagi.

1985 *Do We Know Where We're Going?* Lecture by Sir Jeremy Morse (Seoul).

1984 *Economic Nationalism and International Interdependence: The Global Costs of National Choices.* Lecture by Peter G. Peterson.

1983 *Developing a New International Monetary System: A Long-Term View.* Lecture by H. Johannes Witteveen.

1982 *Monetary Policy: Finding a Place to Stand.* Lecture by Gerald K. Bouey (Toronto).

1981 *Central Banking with the Benefit of Hindsight.* Lecture by Jelle Zijlstra; commentary by Albert Adomakoh.

1980 *Reflections on the International Monetary System.* Lecture by Guillaume Guindey; commentary by Charles A. Coombs (Basel).

1979 *The Anguish of Central Banking.* Lecture by Arthur F. Burns; commentaries by Milutin Ćirović and Jacques J. Polak (Belgrade).

1978 *The International Capital Market and the International Monetary System.* Lecture by Gabriel Hauge and Erik Hoffmeyer; commentary by Lord Roll of Ipsden.

1977 *The International Monetary System in Operation.* Lectures by Wilfried Guth and Sir Arthur Lewis.

1976 *Why Banks Are Unpopular.* Lecture by Guido Carli; commentary by Milton Gilbert (Basel).

1975 *Emerging Arrangements in International Payments: Public and Private.* Lecture by Alfred Hayes; commentaries by Khodadad Farmanfarmaian, Carlos Massad, and Claudio Segré.

1974 *Steps to International Monetary Order.* Lectures by Conrad J. Oort and Puey Ungphakorn; commentaries by Saburo Okita and William McChesney Martin (Tokyo).

1973 *Inflation and the International Monetary System.* Lecture by Otmar Emminger; commentaries by Adolfo Diz and János Fekete (Basel).

1972 *The Monetary Crisis of 1971: The Lessons to Be Learned.* Lecture by Henry C. Wallich; commentaries by C.J. Morse and I.G. Patel.

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1971 *International Capital Movements: Past, Present, Future.* Lecture by Sir Eric Roll; commentaries by Henry H. Fowler and Wilfried Guth.

1970 *Toward a World Central Bank?* Lecture by William McChesney Martin; commentaries by Karl Blessing, Alfredo Machado Gómez, and Harry G. Johnson (Basel).

1969 *The Role of Monetary Gold over the Next Ten Years.* Lecture by Alexandre Lamfalussy; commentaries by Wilfrid Baumgartner, Guido Carli, and L.K. Jha.

1968 *Central Banking and Economic Integration.* Lecture by M.W. Holtrop; commentary by Lord Cromer (Stockholm).

1967 *Economic Development: The Banking Aspects.* Lecture by David Rockefeller; commentaries by Felipe Herrera and Shigeo Horie (Rio de Janeiro).

1966 *The Role of the Central Banker Today.* Lecture by Louis Rasminsky; commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (Rome).

1965 *The Balance Between Monetary Policy and Other Instruments of Economic Policy in a Modern Society.* Lectures by C.D. Deshmukh and Robert V. Roosa.

1964 *Economic Growth and Monetary Stability.* Lectures by Maurice Frère and Rodrigo Gómez (Basel).

The Per Jacobsson Lectures are available on the Internet at www.perjacobsson.org, which also contains further information on the Foundation. Copies of the Per Jacobsson Lectures may be acquired without charge from the Secretary. Unless otherwise indicated, the lectures were delivered in Washington, D.C.

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