

THE HAMILTON PROJECT & THE COMMISSION ON
GROWTH AND DEVELOPMENT

ECONOMIC GROWTH STRATEGIES FOR DEVELOPING COUNTRIES
IN AN ERA OF GLOBAL UNCERTAINTY

Monday, April 14, 2008

Washington, D.C.

Welcome:

ROBERT E. RUBIN
Citigroup Inc.; former U.S. Treasury Secretary

Opening Remarks:

A. MICHAEL SPENCE
Growth Commission Chair; Nobel Laureate and Professor Emeritus,
Stanford University

Roundtable Discussion:

Moderator:

LAEL BRAINARD
Vice President and Director, Global Economy and Development,
The Brookings Institution

Discussants:

ROBERT E. RUBIN
Citigroup Inc.; former U.S. Treasury Secretary

HAN DUCK-SOO
Former Prime Minister of South Korea

DANNY LEIPZIGER
Growth Commission Vice-Chair; Vice President, World Bank

A. MICHAEL SPENCE
Growth Commission Chair; Nobel Laureate and Professor Emeritus,
Stanford University

LAWRENCE H. SUMMERS
Harvard University; former U.S. Treasury Secretary

* * * * *

PROCEEDINGS

MR. RUBIN: Good morning! I'm Bob Rubin. On behalf of all of us at the Hamilton Project and at the Commission on Growth & Development, let me welcome you to our discussion this morning.

The Hamilton Project began in 2006. Our initial objective was to put together a broad-based economic strategy for this country aimed at growth, broad participation in growth, and increased security. Then pursuant to that, we've had a series of events, panels, and papers with regard to policy issues relating to pursuing those objectives. Universal healthcare, healthcare costs, energy, technology, dealing with current financial market issues, tax policy education, and much else. The Hamilton Project itself is a really most unusual group of members. We have policy analysts, we have academics, and we have financial market participants. And that combination, I think, has really brought a very special quality to the work that we've done. And all of this work has been done with the utmost seriousness of purpose.

The Commission on Growth & Development was founded by Michael Spence, former Dean of the Faculty of Arts & Sciences, which is where I first met Michael, and now Nobel Laureate in Economics. The Commission is aimed at improving strategies for growth and development

in developing countries. It consists of leading academic and policy analysts from around the world.

The Hamilton Project and the Growth Commission share a common view, and that view is that more effectively promoting growth and reducing poverty in developing countries is a moral imperative and also powerfully in the self interest of the industrial nations. With today's global interconnection due to trade, transportation, modern technology, travel, and migration, the inability of developing countries to deal with a whole host of issues because of lack of resources can also powerfully affect the industrial countries. Transnational environmental issues like global warming, spread of disease, illegal immigration, crime, and much else make this point. In addition, developing countries that are successful economically can provide additional markets and additional sources of effective supply in the industrial countries' economies. So, the Hamilton Project and the Growth Commission, for all these reasons, decided to come together to conduct today's discussion, both to promote a better understanding of the issues around growth of developing countries, and to try to help raise the profile of this critical area that, unfortunately, receives far too little attention in the policy and political debates in this country.

Our program will begin with a presentation by Michael Spence. Then we'll have a panel, led by Lael Brainard, the Vice President

and Director of Global Economy and Development for the Brookings Institution. The panel that we have, as you know, is truly outstanding. You have their résumés in your materials, so I will just briefly introduce them now. They are Han Duck-soo, Former Prime Minister of South Korea and a Ph.D. in Economics from Harvard; Danny Leipziger, Growth Commission Vice Chair and Vice President of the World Bank; Michael Spence, who I've already identified and, who in addition to being a Nobel Laureate and Former Dean at Harvard, is also Professor Emeritus at Stanford; Larry Summers, Larry is the Charles W. Eliot University Professor at Harvard University, former President of Harvard University, and former Secretary of the United States Treasury; and then finally, me. With that, I will turn the panel – turn the podium over to Michael Spence, who will be a one-person panel, and then we'll have the panel discussion.

DR. SPENCE: Thank you very much, Bob, and good morning ladies and gentlemen. I am the Chairman, as Bob said, of the Commission on Growth & Development. It will finish its work and produce a report and a set of supporting working papers in about a month from now, May 21st. I'm not going to talk about the content of that report. It will focus very much on the policy and investment supporting surround of sustaining high growth. I'm going to try to focus a little bit more on the

complexity of policy decision-making in a developing country. So, let me begin.

The subject -- the Commission members rather, just for your information, are here. Let me introduce one other member of the Commission who's in the audience. Sir Dwight Venner is here, and he is the head of the Central Bank of the Eastern Caribbean. The focus of my talk and the intention of the Commission is focused on what we call "sustained high inclusive growth" and the policies and investments and leadership and political underpinnings of that. "Sustained" means over several decades because that is the kind of growth that turns out to produce dramatic reductions in poverty and improvements in the lives of people. "Inclusive" means the intent and the result of not leaving people out in this process. That's important for poverty reduction. We understand and are explicit that people don't ultimately care about growth. They care about working and being productive and being creative and being healthy, and they care about their children's and grandchildren's opportunities. But we think that growth is an important means to that end, in fact, an essential means. We looked at cases of sustained high growth in the post-war period. There are 12 of them. If you set the standard at 7% or more a year for 25 years or more, and I've listed them here, I don't intend to talk about them in detail. They have many, many differences

among them, but they have some common characteristics that I intend to address in just a minute. I think it's a very reasonable bet that India and Viet Nam, both of whom are experiencing growth accelerations, will join this group in the relatively near future, and there may very well be others. The global growth and growth in many parts of the developing world has up-ticked, but I think it's also fair to say that the jury's out on that and wouldn't want to place a bet. The common characteristics of these sustained high-growth cases -- forgive the brevity of this summary -- are listed on this slide. Probably the single most important one is "engagement and leveraging the assets in the global economy," and the two most important of those are "knowledge" -- this is the so-called catch-up effect -- and "demand." Demand meaning very large global demand so that when you find an area of comparative advantage, or competitive advantage in more ordinary language, you can grow at very high rates without having the demand truncate itself. They're all systems that use market incentives, decentralization price signals. Intrusive government or centrally planned systems simply failed, and I think we can be confident about that. They are high-saving and investment paths, including high-public saving and investment, as well, with the investment going to education and infrastructure. If you look at these at a more microeconomic level, they are not adequately described as water rising in

a bathtub. The economy is diversifying in the direction of the global economy and structurally transforming itself, and at these growth rates, it happens at very high speed. It's a difficult, somewhat chaotic, process to manage and it produces anxiety among people, so they need a protection and it's an important part of the growth process. They all are characterized by dramatic examples of resource mobility. Labor moves across sectors and moves at relatively high speed into urban environments. There's been a lot of talk about urbanization, which you have heard about. It's true, and this urbanization is not an ancillary consequence of growth, it's the essence of it. It takes a long time to grow from relatively poor to relatively advanced, even at high growth rates. This slide is just arithmetic, but even at very high growth rates, 7% plus, you're talking about five or six decades to make the full transition from relatively poor to more or less advanced income status. Let me just illustrate these things very quickly. These numbers are relatively well known. This is China, on the left-hand side the growth in per capita GDP and output per worker. And on the right-hand side the dramatic reduction in poverty that went along with that growth. This is the largest and fastest example so far of sustained high-speed growth. The glitch in 1989 was Tiananmen Square, and the aftermath is strikingly quick recovery. This is India coming along behind. India's acceleration has been slower, but is now up

around the Chinese growth rate. So I think it's reasonable to say that India's approximately 13 years behind. But if it follows the China path, it'll just follow the China bar graph with a 13-year lag. These are the saving and investment rates. The India one is fairly normal at 25+% of GDP, public and private together. The China one is an outlier. This has not been done before at these levels. They're extraordinary numbers. They don't look very extraordinary now, but if you imagine a country whose per capita income is \$400, saving a third of the GDP, which means not consuming and spending it, you realize what an extraordinary set of intertemporal choices have been made in this context. This is the trade exposure openness to the global economy, and you can see that there's a pattern, not monotone, but a pattern of rising exposure to the global economy measured as we normally do by exports and imports. It's not a perfect measure. In India, at lower levels, but clearly accelerating in the direction of the Chinese rates. And finally, these dynamics: This rapid movement of people into new and much more productive employment carries with it a fairly natural tendency to produce rising income inequality. That is, it produces both poverty reduction, that is improvements in the absolute well-being of people, but it also produces in varying forms across these countries, a rising pattern of income inequality and if it gets out of hand, it's a problem because people don't like it and don't think it's fair.

And this is the Chinese case, which is dramatic. The Chinese Gini coefficient is now around .45, about the same as ours in the United States, and well above global averages outside of Africa and Latin America.

Now I want to talk about why it's hard to get this done. It's easy to say this is what should happen, and it's much harder to say how to do it. This is Bob Solow, they had a sort of party to celebrate the 50th anniversary of the publication of his famous paper on growth a couple of years ago, and it was published in the *Oxford Review of Economic Papers*. I'll just let you read it, but I think it adequately summarizes the feelings of many people about our understanding of how to produce permanent shifts in the growth rate, both in advanced and developing countries.

Necessary and sufficient conditions: We live in a world in which there's a huge amount of progress in economics and other fields, political economy, and understanding these processes, but I think it's fair to say that, at this stage, most people would agree that we do not understand or know with confidence the necessary and sufficient conditions for growth in developing countries. It would be nice if it were otherwise, but what it implies is that policymakers and political leaders are making decisions essentially with an incomplete model of the process that they're trying to influence. And as the economy develops and its

institutions mature, which is an inherently important part of the process of growth and development, that model uncertainty declines because then they become more like advanced-country models where we do have a pretty good fix on how they work and how they will respond to policy shifts. So the central question, I think, is what do leaders and governments do or need to do to increase the likelihood of accelerating and then staying in one of these desirable high-growth modes. Leadership and politics, I think, are underestimated in terms of importance and are tremendously important. There has to be some sort of understanding of the process that one's entering. A strategy or a vision, sometimes a kind of blurry description of where this is all leading, that people can accept and think is plausible. The time horizons point, I think, is very obvious. Communication is essential. You can't just do it; you have to tell people where you're going. As I mentioned before, there are important intertemporal sacrifices to be made in the early stages of this, and people will go along with it if they believe the growth is inclusive, meaning it includes their children and grandchildren, and if they think it will actually work. Otherwise, there are lots of political processes that will cause the process to be unsustainable. We have not found -- there are lots of different forms of political organizations across these sustained high-growth cases, ranging from a dominant party to a single party to a

democratic structure. So it seems pretty clear that you can't make any definitive statements about that, but what does seem clear is that governments that aren't trying to act in the interest of most of the citizens don't succeed in this. That is, if they're acting in their own interest or a subset, something goes wrong with the sustainability of the process.

And now let me turn to what is the essential part of this paper. I got going on this because I realized that there were important areas of policy in which there's an ongoing debate and no resolution yet, as far as I could tell, that relate to growth and development. So I think what I tried to capture with Mohamed in this is some notion of what it is that these leaders and policy people are wrestling with. And the first thing I think I would note is that in the early stages of a developing economy, one needs to recognize -- and they tend to recognize -- that the advanced-country model isn't useless. It makes accurate predictions in many cases, especially at the microeconomic level, but it's an incomplete guide. So that makes them somewhat skeptical of theory and orthodoxies, and a little bit more sort of pragmatic. They're kind of interested in case studies, similar examples, and so on, as a partial guide to how to go about formulating policy. It also produces a kind of gradualism, or a step-by-step approach, rather than doing everything at once or in the next year. There's a tendency to try things out and see if they work. It's a risk-

mitigation strategy, and it shouldn't be confused with just being too timid to move. The Chinese case is a particularly striking example of caution as a result of not knowing what the impact of some of the changes would be in the early stages when they were emerging from a centrally planned economy to very rapid and effective implementation once a decision has been taken. It produces a kind of experimental approach to policy and reform, and it's effective provided that the failed experiments are truncated really promptly and the successful ones are expanded. It does seem to require unwavering attention to the goal, which is growth. That is, it isn't apparently enough to do sort of reforms in the abstract. You have to worry about whether you've actually found the sufficient conditions, and if you don't know what they are, you keep trying until you get it right. There are lots of countries in the world that have not yet successfully found the path into sort of export diversification, which is the initial phase of this sort of high-speed dynamics I was describing before.

Government effectiveness is very important and so I won't stay on this for very long except to say it's not just policy formulation and priority setting, although that is very important and is country specific, you need very good talent not always present in developing countries to do this job, and you need -- the leaders need to have an environment in which they allow a vigorous policy debate. Now that will strike some of

you as odd because these countries differ dramatically in the extent to which the policy debate is visible from the outside, and to the extent to which think tanks, the press, and others are participants in it. But it does seem to be true that vigorous policy debate is important, and then there has to be an end, just as there is in a corporation, and somebody makes the decision and then acts and implements. It's important -- and I take this from the experience of the members of the Growth Commission, many of whom are political and policy leaders in developing countries -- it's important to recognize that in this kind of environment, you're going to make mistakes viewed ex post. They may not be mistakes viewed from the starting point, but they will ex post be viewed as mistakes. And it seems important to admit the mistakes, be clear about that, be clear that they're going to be made, and then fix them promptly.

Now, I thought I'd just -- I'm not going to get into any of these, but I thought I might mention some of the policy areas in which there's ongoing debate in the academic and policy community. These are things where we have an incomplete guide to policy formation. There are lots of disagreements in this area, and I wouldn't try to arbitrate them, but they're important parts of the growth and development process. There's a general consensus that the right answer to opening up on the current account, which means trade and goods and services, and on the capital

account, which means capital flows, best answer might not be to do it in a very sudden fashion. But when one comes to the question of the speed and sequencing of the opening up, there's much less wide-ranging agreement. From a developing country point of view, and recognizing that the structural dynamics is a process that Jim Pater described many years ago, its creative destruction, and in particular, its destruction and creation of jobs, where the destruction is the destruction of low-productivity jobs. And its central challenge for developing country policymakers is to not let the job destruction process get out of balance or out of line with the job creation process. If there were a single guide on how to do that, other than to tell you what to do, but it tells you what you're shooting at. There's considerable debate about what the financial sector openness pattern ought to be and how it depends on the maturity of the financial sector itself. Again, the level of agreement right now is financial sector maturity matters, but we don't get very precise. A very contentious area is the area of industrial policy and export promotion, ranging from "the private sector will take care of that" to "you need to be a little proactive," there are informational and other market problems of a transitory kind that need to be dealt with and, hopefully, some of these will come up in the discussion. I simply flag them as things that are issues, but the point I want to make about this is that in academia, we can debate these things and disagree.

For a decision maker, you have to actually make choices. This is decision making under uncertainty with an incomplete guide, and you have to balance the benefits and the risks. One of the things I've discovered is there's a very strong tendency to find a successful formula, you know, promotion of the labor-intensive manufacturing sector, and then do it for too long. The point I want to make is that part of the challenge in this world is to understand that the structural transformation is continuous. There really isn't anything permanent in this process.

And finally, a central role of government in order to maintain the support for the policies, and I think this applies to advanced countries, too, is you have to find a way of protecting people through the transitions that are associated with this creation and destruction and structural dynamics process. And that's not an ancillary kind of additional task; that's centrally important, you can't keep this going if people think it's too risky. The mistake that usually gets made is to protect specific sectors, specific companies, and specific jobs, as opposed to attempting the harder challenge of protecting people and families in these transitions through both income and access to basic services.

I'm going to conclude by saying this is a little bit analogous, for those of you who thought a lot about this, to the climate change problem. That is, the time horizon is similar, and it really is sequential

decision making under uncertainty with a high degree of initial uncertainty, an enormous amount of learning along the way, and, if you believe the technology will lower mitigation costs over time, then it's a moving target as it is in a developing country case. In the global climate change case, we have enormous uncertainty with respect to the science; that is, what the temperature increases will be associated with specific stocks of CO₂ in the atmosphere. But we also have considerable knowledge to acquire about the costs of mitigation by source, about the efficient pattern of mitigation across countries, and the time path of the cost reductions. So this is, in some ways, not identical but similar to the kinds of challenge you face in the early phases of growth. And the response Howard Rafer taught us, when we were studying decision making under uncertainty with a sequence in learning, is that you take actions that reduce, in the global warming context, the mitigation costs -- that's technology -- and that produce the maximum amount of useful information or learning so that in the next round, you're much better informed about setting targets and so on.

And so I'll just close with this -- this is a picture of the CO₂ emissions per capita. It's on a list of about five or six trends that we think are dramatically important for developing country prospects in the future. Many of you know this data. The so-called agreed-on safe level is on the

order of 2.3 tons per person. The world is at about double that, and these are the per capita data. So, if you froze the world in terms of growth and development and asked “how big is this problem?,” the answer is “it’s a factor of 2.” We have to reduce per capita emissions globally by a factor of 2 to move into what this slightly fuzzy safe zone is. But, China and India account for 40% of the world’s population, and they’re growing in the 9% to 10% range. So if you imagine that they’ll keep that up, then they’re certainly going to increase their energy consumption, and their carbon footprint is going to get bigger. And if you just do the calculations and assume that they’ll hit European-kind of standards in the sort of 8 to 10 tons per capita range, then this 2 times problem that we have now would, absent activity, turn into a problem of roughly 3½ to 4 times, meaning per capita emissions would be on the order of 3½ to 4 times the safe level. And in that context, it seems pretty clear that the only solution that works, both for developing countries and for the rest of us, is to dramatically reduce the costs of mitigation. Because absent such a dramatic reduction, there’s no way, I think, to grow at high speed. With that, I just put this up not to talk about it, but if you ask “what do the developing countries need from the rest of us and from the global context in order to succeed?” in what I’ve been talking about, which is essentially the internal decision—making process, these would surely be on the list. So I throw

them up as potential subjects of discussion in the panel to follow. Thank you very much for your time.

DR. BRAINARD: Well, thank you very much. That was a lot of material to potentially focus on. I wanted to start over to my left with Larry. The presentation ranged over a large number of factors, some of which are squarely in the kind of body of mainstream economic theory, some of which are very focused on policy processes, a little bit on institutions. Can you talk a little bit about where you find common ground, and where maybe you would look to different factors as a kind of driver of growth?

DR. SUMMERS: It is with considerable trepidation that I discuss so thoughtful a paper by my former teacher, Department Chairman, and Dean, but somehow I will find the courage to proceed. The paper contains two sets of propositions, one controversial and the other, I think, less controversial with which I entirely agree. Highly consequentially for the development community, the paper urges the centrality of growth in achieving poverty reduction and suggests that rapid rates of growth are necessary, and while not quite sufficient, very substantially contributing to poverty reduction. At a moment when important parts of the development community have lost sight of that central fact and that crucial lesson of the Asian experience, Mike Spence and his colleagues do a great service by

highlighting that critical fact which needs to be carefully considered by aid agencies around the world. The paper also contains a wide range of observations to the general effect that this is an extraordinarily difficult subject, that there are no silver bullets, that one needs to proceed carefully with caution, that there are a variety of aspects of a country context, and so forth. I find those observations less controversial, but am entirely in agreement with them. I have trouble with what in a sense is, I think, the implicit message of the paper, and my difficulty starts in a way with the methodology and then moves a bit to the policy recommendations. If you wanted to study the keys to getting wealthy, one approach would be to interview the members of the Forbes 400 and see how they did it. And you would find that they all dismissed the precepts of conventional finance, that none of them believed in diversification, that all of them believed in a strong-willed, nondiversified, make-a-single-big-bet approach, and you might well on the basis of your research be led to counsel very considerable skepticism about conventional financial theory as an approach. That would probably be bad advice for the vast majority of investors. And I have the concern that picking out the characteristics of recent successes may also be problematic as an approach to thinking about growth. It is a somewhat cheap shot, but reading the report, I am reminded of the World Bank's celebrated 1979 economic report entitled

“The Remaining Economic Miracle” which also extolled a set of dirigist activists’ promotion of government policies on the basis of a really strong prior economic record and did not prove entirely prescient in its predictions for Central Europe. There are in a sense two orientations to -- I’m going to draw, to save time, I’m going to draw the contrast I would make in criticizing the paper in an overly sharp way. But there are essentially two broad views of countries’ growth through engagement with the international economy. One is I would call the “standard economic” view, which holds that trade is good, that countries benefit from trade, that that’s well described by the theory of comparative advantage that allowing markets to work with appropriate property rights, prices that reflect true costs, and the like, will tend to be an availing strategy. There’s an alternative approach, which is found in the rhetoric of quite a number of Asian countries that have succeeded, which I would call a modern mercantilist approach, that has somewhat the character of the international economic competition is like a basketball game and exporting is being on offense. And when you export more, you score more, and you succeed because export industries are really good industries. They’re good industries because they draw labor from places where the labor’s very unproductive because you learn and develop technologies, and that a substantial tilt of the playing field towards exports is the key to economic success, and

figuring out how to achieve that tilt is central to development strategy. The paper, in a very significant way, reveals a bias towards the second view, significantly based on a reading of the Chinese experience. And while I think there is something to be said for that view, I think there are three important problems with it as a guide to development policy that I'm not sure Mike addressed in a way that was at least fully convincing to me.

The first is: How clear is it that some industries are really better than other industries, that you can decide which ones are better? Mike didn't talk about much, if at all, but the paper spends a certain amount of time on what's called the labor surplus theory of development, which is basically the idea that there are all these people on the farms. That they could move to the cities, but for not entirely clear reasons, they don't. But if you subsidize more great stuff in the cities, people will go from earning \$1 a day to earning \$5 a day and all you need to do is make there be more jobs in the cities and then they'll go and do it. That view is rejected by about -- I don't know what the exact number is, but I think it's fair to say the very substantial majority of modern development economists think that view is wrong. They think that more or less people make the right rational economic decisions in terms of moving from the rural areas to urban areas, and that there's no strong presumption that somehow some industries are better than others and that you should tilt the playing field

substantially in that direction. And in deed, if one looks at the examples, many of the examples that are characterized in that way, when people look carefully, they decide the economic growth has in a sense only been produced through very heavy capital accumulation, not through real genuine economic progress. For example, people compare Hong Kong and Singapore and note that Hong Kong's growth is deemed to be of substantially higher character than Singapore's, reflecting the lack of a dirigist strategy. The second problem is the adding-up problem.

Whatever the merits of the views Mike expresses, as in explanatory theory of past-growth successes, there's a question if there's going to be all this subsidized exporting, subsidized exporting through a financial system that's oriented to getting credit to the exporters through an undervalued real exchange rate, through special tax breaks, through all the various policy mechanisms, through until the tilt is going to take place. The question arises "who are going to be importers, are they going to stand for it, is there going to be enough import demand?" At a moment when China's current surplus is 12% of GNP and not fully acceptable to the rest of the world, and in a moment where a 10% growth in China means twice as much exports that the rest of the world has to receive, as it meant just seven years ago, the idea that China can recommit itself to this strategy and be followed by dozens of other countries, and that there is enough

import demand, and that there is enough political tolerance in the rest of the world to accept all of these imports, makes me rather skeptical that this is a viable strategy going forward. I also suspect that the right economic strategy -- the paper is very dismissive, very cheering of manufacturing exports, it's really quite dismissive of raw material exports. At a time when raw material prices have risen threefold relative to manufactured prices, I'm not sure that's right. My instinct is that if Africa was successful in harnessing its natural resources to a substantial degree without a lot of industrial policies directed at getting into an already overcrowded apparel market, that might well be the better strategy. So there's a serious adding-up problem. And the third problem is: The capacity of governments to execute these strategies well and successfully. And here you'd get the question "Should Larry Summers, investor, diversify or should he try to imitate Warren Buffet?" And probably the better strategy for Larry Summers, investor, is to diversify rather than to imitate Warren Buffet. Even if one accepts the view that these countries have all succeeded, with the success coming from the heterodox elements, it's far from clear how many others can successfully follow. And the paper rather overstates the role of heterodoxy and understates the role of international pressure to conform to market dictates. Perhaps the most striking omission from the paper is what I would have regarded as a

highly salient episode in Indian economic history. The moment in 1990, when India was on the verge of bankruptcy, had to move, had to send its gold to London in secret as collateral in order to avoid bankruptcy, accepted an IMF program with substantial conditionality, conditionality that was in many ways designed by the Indian technocrats in the Finance Ministry who very much wanted to see IMF style changes, and now had their opportunity to bring them about. That had a great deal to do with the progress that India made and the substantial acceleration between the 1980s and 1990s. And so to hold that out as a reflection of an indigenous local strategy without the international financial institutions, from which the international institutions can learn, seem to me to be rather disingenuous. So I applaud in some the tremendous emphasis on growth. I think rather more skepticism about local heterodoxy, based on learning the lessons of China, should be present than is contained in the paper. And I think the paper is a little quick to take on some of the fashionable Joe Stiglitz-type criticisms of the international financial institutions. It bears emphasis -- and the paper doesn't quite say this, but it comes close -- it bears emphasis that in roughly all the cases when countries were heavily influenced by the international institutions, it's because the path they were on was completely unsustainable in the sense that they could no longer borrow any money and pay back their debts. And in the event that they

received significant support, the idea that that support was conditioned on policy changes continues to seem to me rather reasonable. And in its enthusiasm for local heterodoxy, I think the paper slightly fails to recognize the many moments that would have led to rather severe difficulties in important countries.

DR. BRAINARD: Rather than coming back to you, let's go around the panel and collect some more thoughts. Han Duck-soo, you are I would say somebody who was at the helm of one of those Fortune 400 countries that Larry was describing, so I'd be interested in your reaction to his critique. In particular, can you talk a little bit -- I think South Korea is arguably the model that China most closely followed. Talk a little bit about the role of mercantilism, the role of industrial policy -- has it been overstated? And in particular, this issue of -- if you have a China that is following a manufacturing export-led growth strategy, does that suck the oxygen out of similar kinds of strategies for countries like Mexico?

DR. DUCK-SOO: Well, of course, as Mike indicated in the paper, there's a lot of contextual implications for what was said in his presentation. So it may be first of all somewhat hard to say that his presentation is just exactly following one predetermined direction and logic of growth, which cautions one's mind. I'd like to say that some of the policies that were actually -- on which some caution was put by Professor

Summers as someone more inclined on heterodox theories and experiences. From the countries of success, which was indicated here, not concentrating on China and India, certainly there are a lot of actual policies that were implemented for growth, which I think somewhat quite in line with the market mechanisms as we said that more reliance on markets were one of the very important features of the successful countries that were actually discussed. One for export, mostly it's good for any countries who are starting development to engage with the global economy because the demand is rather small, the domestic demand is small. They should go to the global world for very elastic demands. When we are competitive, there are a lot of potential for export and growth. And also -- but when we follow this kind of engagement with the global economy policy, the starting point was not that we put a lot of subsidies and protections on the part of the industry for the export. What we are -- the starting point from where we generally start is that already there are a lot of distortions existing in the economy school I just would like to develop. That means a lot of the government interventions, tariff distortions, and tax distortions, and so on. So the starting point for this kind of economy with very good political leadership and effective government is to make the level of competitiveness of the sector in question which will carry a lot of shares of the exports of that country by

eliminating a lot of distortions first. For example, resources that I used by that exporting sector of a particular economy are certainly subject to reforms and should be gone so that globally they can compete on equal terms. From an overall perspective, still there are a lot of distortions there. But for the exporting sector who will gain competitiveness to be exported to the large markets of the global economy, certainly are subject to someone, they have been approached from the other side of the reforms. That means putting them on the level playing field with the competitiveness on the global markets by removing a lot of distortions that are existing on the economy.

And on industrial policy is sometimes for the countries some kind of newly established -- you know, distortions were put in place. But, also there, they are always being compared with other economy sectors who are competing with countries in question, so, I would like to emphasize that most of the policies that are making these sectors of the export and the sectors of potential growth are gaining some of the policy focus from the moving of some of the distortions that are already existing in this economy.

On the possibility of other countries following the strategy of the countries of success, yes, I think there's still a lot of potential for them to follow them in the sense that good leadership and effective

governments are making a clear vision where the economy can go, and where the economy can be competitive and the reforms are made in accordance with the experiences that have been conducted in the past by removing the distortions on a particular sector or the overall economy so that they can compete on an equal basis with sectors of the economies with which they are competing.

The problem is that the ingredients of growth, which are explained in this paper presented by Mike, are not always there in a good combination. That means certainly in the engagements with the global economy of the economies who'd like to develop and grow should start with very good policy packages which will remove the distortions which make these dissectors of the economies who'd like to pursue growth in competitive in the past, and also they have the good policy implementation so that the merits of global economy can be fully taken advantage of, for the outside investors can come in seeing that effective government is there and the corruption is being deduced and their engagements with global economy will certainly guarantee some of the good friendships with the outside investors and foreign investments and that technology transfer will certainly -- can be compatible.

So, this kind of ingredients of growth are still there and good packaging of those policies will certainly, I think, will generate very good potential for the countries who'd like to develop in the past.

Thank you.

DR. BRAINARD: Bob, you can react to any of those things, but I wanted to get your view. In particular, in Mike's paper, the trade channel was just so critical. I think it's been emphasized by both Larry and Han Duck-soo.

At a time when in some of the wealthy economies, and, clearly, the U.S. chief among them, there's a real questioning going on really about the aggregate benefits of trade, but even when it's acknowledged there may be some aggregate benefits, looking at a country like China, really asking whether it makes sense to engage in this kind of development strategy for China when there are distributive consequences in the U.S. that are uncompensated.

And, so, is this a sustainable model for China and for other countries to follow if you don't have the political will in countries like the U.S. to support it?

MR. RUBIN: No, I think it's a good question, Lael.

I was reading something the other day, it was a speech by Dwight Eisenhower, and he talked about how difficult it was to get the American people to understand the benefits of trade.

Well, however difficult it may have been for Dwight David Eisenhower, we are in a multiple more difficult world today, and I think maybe Larry made the point about market-less policies. I think we really are into a new and different and I at least find very troubling environment with respect to trade liberalization in this country, and I think it's probably true in some measure -- at least it's my impression -- some measure in continental Europe, as well.

So, I think that the opportunity to try to create real strategies that are based on an export-oriented trade regime for low-wage countries is going to run into increasingly difficult headwinds in terms of policies in our country.

Well, it's obviously not a subject for this panel, but I do think in this country we need to find a way forward. I think it's probably some combination of trade liberalization plus domestic policies that really do address the distribution holdings, security, and other issues, as well as prepare people to deal with trade.

So, I think that is a question, Lael.

I'd like to add one more thing, if I may. I read Mike's paper, and then I obviously listened to Mr. Han's subject. All of us have spent a lot of years involved with it one way or the other.

It is striking to me that when you look at the countries that have been successful -- the poor countries that have been successful in promoting growth and achieving sustained high rates of growth over long periods of time, in the post World War II period, effective government, it seems to me, has been the essential ingredient, and then everything else builds around that. If you don't have effective government, then you can have all the good policy process in the world; the policy will never get put in place. And if you do have effective government, then, as Michael said, you can experiment with this and experiment with that and work your way forward.

It doesn't mean policy understanding isn't important; it's critically important, but it seems to me the essential ingredient, the threshold ingredient, the fundamental ingredient is effective government, and I think, Michael, I'm right in saying that in post World War II development economics, almost all the countries that have had these sustained high rates of growth have had relatively authoritarian governments at the times that they made the really critical policy decision.

Now, South Korea today is a democracy, but in the days when many of the most difficult intertemporal, if you will, intergenerational decisions were made that are so difficult, it was a more authoritarian government. And with the exception of India, and I guess you can debate Chile a little bit, whether it was or wasn't when these decisions were made, I am enormously in favor of living in a democracy. I think a democracy has tremendous advantages, but I think the question of how to promote effective governance in a democratic structure is a very serious one, and it should be an integral part of all of this, and that relates not only to the developing countries, but, I must say, to the industrial countries, as well.

DR. BRAINARD: I'll turn over here to Danny Leipziger on that issue.

World Bank has done a lot of work trying to understand what makes for an effective government and done a lot of measuring of institutions.

To what extent does this commission, do you feel, have the kind of underlying research to support conclusions on what effective government constitutes?

DR. LEIPZIGER: Well, it's true we've done a lot of work, particularly lately, in governance areas. I think the way the commission

will come out is that we are somewhat agnostic with respect to the size of government, but we're not agnostic with respect to effectiveness, and I think we look at effectiveness from a variety of angles, not only setting out long-term strategy, but also dealing with issues of inclusion and equity and who wins and who loses.

So, I think the role of government is central to the report.

If I could say a word or two, I think what we think we can get out of this in terms of the Bank is putting the growth agenda back front and center, and I think that's what Larry was referring to, and, as he knows, it's ebbed and flowed inside the World Bank as a major objective, but it turns out that it's very hard to actually get real poverty reduction over long periods of time without sustaining high growth, so, I think that's one of the merits of the report.

I think in terms of the kinds of policies and how heterodox the report is, I think it's interesting to look at how developing countries have done in the last 5 or 10 years.

In terms of fiscal performance, inflation, a number of other areas, actual developing country performance is much, much better, so, I don't think there's this big debate that we have to re-enforce fiscal probity, et cetera, et cetera. There are always going to be some outliers, so, the heterodox nature of it, if you want to put it that way, is more about what it

means to achieve the growth goal, and I think we're talking about different approaches that may work in different countries.

It's sort of like there's this book out there in defense of food which talks about dieting, and it says, you know, everyone's looking for that one magic diet that's going to help them lose weight, and it turns out then that people look at the impact of individual foods on their diet, et cetera, and the author says, well, look, it's a function, first of all, of a combination of foods, and they'll have different impacts depending on what other policies or what other foods accompany them.

And, second, it depends on the context. If Americans started drinking a lot of red wine and eating garlic, they're not going to get French longevity rates because of the context is a bit different.

So, perhaps, a bit of a stretch, but the point is that we're looking at a range of policies that might work.

If I could just answer very quickly. At least, I mean, Michael defend himself against his former pupil, but I think that it's not really a mercantilist report; it does say that countries need to leverage the international -- the global economy. I think to put in an industrial policy is not an area where the commissioners are uniform, and, so, I think we recognize that.

On the adding up problem, I think it certainly is a question. Bill Kline wrote this paper, I think, in the early 80s pointing out this adding up problem, but I don't think that if we went back to his models, he would have predicted the growth of China and the generation of additional demand, and, perhaps, growth that comes out of developing countries, so, obviously not every country can be a China, but I think we're try to lay out some parameters for what better policy choices might be.

But, so coming back on the role of government, I think that's the key, however, and I think that's a message we take from the report.

MR. RUBIN: I'd like to go back to one thing. I think -- this is my view, and I'm sorry if it's wrong. But if you take a look at the international integration of a lot of these countries that are growing, they really have done it through an export-oriented strategy and then gradually have opened themselves to imports. I think in today's political environment, that really may not be a viable approach. That would be my impression.

So, it seems to me what's going to have to happen somehow the international system, in a sense, is working now. So, somehow or other, what's going to have to happen is that the large emerging market countries are going to have to come part of finding a solution that involves (inaudible) for growth, and that's partly a question of trade, and that's

partly a question for financial balances. They need to be brought into -- they need to become part of the solution, and part of that means the industrial countries have to welcome them into that.

Paul Martin, the former prime minister of Canada, thinks the G-8 ought to become a G-15 or 20 or whatever his number is, and that's one way to go it. There are probably a lot of different ways to go at this, but I think we're going to have to really rethink sort of the way the whole growth system works.

SPEAKER: Agreed.

DR. BRAINARD: On that point, hold on one second, let me come back, just broaden that out a little bit, and I wanted to come back to you, Michael.

You mentioned the issue of carbon, and this is not unrelated. The numbers that you cited I think are stunning, troubling, and the kind of growth paths that you are reviewing and talking about in the commission are very carbon-intensive growth paths, just as they are manufacturing and export-intensive growth paths.

How does a China and an India take it upon itself to become part of the solution, and what are the appropriate international kind of burden-sharing mechanisms?

DR. SPENCE: That's a very important question. There's a number of things that developing countries need to do that are responsive and that reduce the time path of their carbon footprint. There's a very widespread pattern of energy subsidies, very large energy subsidies in a huge collection of developing countries and they need to accept and move as promptly as is kind of politically possible to get rid of those.

Second, there are imperfect across the border provisions in the Kyoto protocol, and they need to be kind of improved, but, in the short run, across the border mitigation initiated from the advance countries but undertaken for reasons of efficiency and lower costs in the developing countries is an important part of a kind of transition until we have a global system based on either carbon taxes or trade credits or something like that, and that has a cost sharing aspect to it, as well as promoting efficiency, and the developing countries can't be standoffish about that.

The negotiating position, which sounds like you caused the problem, so, you fix it, it simply will not work. If you reduce the advance country admissions to zero and then let them others grow on the trajectory they're on, then that'll swamp the system. We can't solve the problem, and I think that's understood.

The thing that's going on now that isn't productive is to ask developing countries that still have per capita incomes that are barely over

\$2 a day in the case of India, you know, on a carbon footprint that on a per capita basis is only barely visible and only gets to be visible because of the enormous size of the population, to make a 50-year commitment to a target that just looks so incredibly risky in the absence of knowledge of what costs are going to be undertaken in the absence of a system for understanding how their portion of the cost will evolve as their wealth increases and so on, and I just think a more aggressive short run assault on both technology and therefore mitigation costs and advance country kind of short-term targets with these cross border provisions and the other things I mentioned, particularly the energy subsidies are likely to be a more productive way to get everybody in the game. With luck, that's the path we're on, it's just rocky at the moment.

DR. BRAINARD: Larry, you wanted to comment on Bob's point earlier.

DR. SUMMERS: If I could, I wanted to make three points quickly.

First, on effective government, I agree with Bob, but only to a point. I think there's a strong tendency to get a little tautologies in this area when we see countries succeed in having grown rapidly, we deem them to have effective governments, and then we say that we need effective government.

So, take a country like Indonesia between 1966 and 1996. We tend to call them a somewhat totalitarian country that had an extremely effective government. If economic growth had been poor in Indonesia, we would have confidently stated that pervasive and extensive and massive corruption rendered government ineffective.

So, I think there is an easy tendency to label it as effective government when there was growth.

There is a quite large literature on the question of the relationship between democracy versus less democracy and economic outcomes, and I think it fairly consistently says three things. It says that there is no strong relationship on average between democracy and/or lack of democracy and economic growth.

Second, it says that, in the presence of democracy, the variance is lower. That is, when you have less democracy, you get more terrific outcomes and more terrible incomes.

And, third, it says that if you look at indicators other than G and P growth, like life expectancy, mortality, literacy, rights of women, democracies tend to perform somewhat better.

So, I think the overall balance sheet on democracy, most people who've studied this would come to a slightly more favorable conclusion.

The other thing I would say is our discussion of the adding up problem has focused on what I think is a crucial issue, which is how much is the rest of the world prepared to take, protectionism in the rest of the world, and all of that.

Even if one assumed that that was a non-issue, there is still an issue that the world has only so much demand for textiles, has only so much demand for manufactured goods that are early in the process, and that if everybody grows substantially in their capacity to produce them and everybody increases their price, you're going to push down the relative price, and it may not be in the interest of the countries that are going to do them, so, the adding up problem is not just a political problem, but is a substantive economic problem.

And the last thing I would say is I think there's universal agreement that there are a vast number of distortions in almost all countries, and certainly in many developing countries, that create biases against market exports, and I don't think there's any disagreement on this panel and probably in a wide range of places that removing those distortions is a good idea. I think where there is controversy and I think where the report does go further is in saying that maybe you shouldn't have central bank independence so that the Treasury can manage a weak exchange rate to subsidize exports and saying that the tax system should

be non-neutral and favor export industries in a variety of ways, in saying that a capital control regime should be managed in ways that enable credit to flow on a favored basis to export sectors, and the controversy is about those kinds of heterodoxy.

And I would ask you if you think about the countries where this is still at an issue, in Africa and all of that, it is far from clear to me that the focus should be on an industrial-lead development strategy rather than on making agricultural, which is the activity which employs the vast majority of Africans, work in a stronger and more effective way, and, so, is a broad guide to governmental policy.

I think one at least has to pause over where one thinks Africa's likely to find its greatest success over the next quarter century and moving into competing with China and manufacturers strikes me as a non-obvious direction for government to tilt the playing field.

DR. BRAINARD: Let me just pick up slightly on one of those points and just throw a question out to the Panel.

When we see sovereign wealth funds from poor countries purchasing assets and very wealthy countries, is that a sign that these are increasingly sophisticated financial markets and that theories are working well, or is that a sign of some kind of distortion in the financial market and the export market development?

DR. SPENCE: For the most part, I don't think of the sovereign wealth funds as evidence of the distortion. Many of them come from either resource wealth, where it's perfectly natural to invest the proceeds abroad, and a number of others come from a long period of sort of successful economic management, as in the case of Singapore.

I guess if China expands its sovereign wealth funds, then we'd get back into this debate; maybe I can come back to that later.

But I think the fundamental imbalance is not related to the sovereign wealth funds; it's related to this question that was raised before, which is low savings in the United States, powerful continuing export promotion policies in reserve accumulations in China and other places, and, so, I would separate it personally from the sovereign wealth funds.

DR. BRAINARD: All right.

DR. SUMMERS: I think if you broaden it to say large scale public investments by developing countries, whether you call them sovereign wealth funds or not, there are two categories. Many are resource countries that aren't going to have the resources forever, and, in that case, it's natural to take the resources out of the ground, sell them, and invest the money so you have forever.

Another very large portion of them are the accumulations of large amount of reserves because you intervened in the markets to

maintain your exchange rate at an artificially low level in order to promote your exports, and then you chose to invest them in U.S. Treasury bills, earning a zero real rate of return in dollars.

I think it is far from clear that that's a good economic strategy, given what's happened to the dollar exchange rate over time and given the quality of investment opportunities in those countries. It's far from clear that it's a good strategy for those countries, and I think it's far from clear that it's a good strategy for the global system.

And, so, the reason why I'm resisting it as strongly as I am, the pro-export bias, particularly in the exchange rate area implication of this report, it seems to me it has as its corollary, the desirability of building up those kinds of financial imbalances, because that's the only way in which the countries can have the substantial bias towards export-led growth.

To put this in a salient way, Mike's graph on China went through 2004. If you look at the IMF statistics of six months ago, China consumed 39 percent of G and P, according to the then most recent statistics. It's hard to believe that a country at 39 percent of G and P shouldn't be focusing on a domestic demand-led growth strategy that emphasizes consumption more heavily, which is, in many ways, the opposite of the direction that's somewhat implicit in this report.

DR. BRAINARD: (Off mike) and come back to Mike at the end.

MR. RUBIN: Well, it does strike me, as I'm listening to all of this, this county's next administration, whoever gets elected, whichever party gets elected, I think really does need to face the question of whether the whole architecture of this global economy that we have doesn't need to be changed. It was created, most of it, in the post World War II period (inaudible) later, and now you've got this enormous change in circumstances where you have India, China, et al, growing enormous economies. You have these very large trade imbalances, you have financial imbalances, you have very high oil prices. You more recently have very high food prices, and I don't think it works. You have these large accumulations of capital, and I don't have a view as to what the system ought to be or how it ought to work, but it just strikes me as this doesn't all work.

And it needs to be rethought and probably needs to be an architecture, and I know Larry's focused on this a little bit. An architecture that reflects modern circumstance, and I would think that, for a new administration, that was not something you would ever hear debated in a political campaign. This ought to be probably a very serious issue.

Secondly, all this discussion we're having right now about poor countries and developing countries, they're going to face a different set of headwinds in the environment I just described, and that, too, it seems to me, and that's, of course, what Michael's paper is doing, is to try to think about that, but that, too, is not part of our political or policy date in this country at all, even though we have a tremendous practical interest in seeing these countries, the poor countries and the developing countries of the world succeed.

DR. SPENCE: I want to thank Larry for commenting on the paper I was trying not to write a little bit. But I think the best way to get at this is to say a couple of things about China.

Up until 2005, China was running a trade surplus in the range of 3 to 3.5 percent of GDP, and then it skyrocketed up. They were accumulating reserves. That's a different variable, and that was part of the exchange rate management system. I haven't ran into anybody who thinks a 12 percent of GDP surplus for a country of that size is a sensible policy, and, furthermore, I think I can say with some confidence that a significant range of the senior policy people in China agree with that, and actually think the rate of appreciation of the currency should be accelerated fairly promptly and fairly dramatically, but I do want to draw your attention, as most people -- this problem is relatively recent, and the

criticism that China was out of balance, you know, running a 2.5 to 3.5 percent surplus, seems to me, at least takes some argument.

I think the reason why I agree with Bob and Larry is that we know have developed the new architecture that we have, now what developing countries that are really big, important players in the global ecology in terms of investment, in terms of trade and so on, and that just cries out for a different sort of architecture and governance structure where they get to participate in the rebalancing process, and what I was hoping this paper would do is help, to some extent in the developed world, people understand what the challenge looks like for a developing country. And Bob implied this: Most developing countries are not big enough individually to turn the terms of trade against them to affect the relative price of either commodities or manufacturing. China by itself and China and India are.

And I guess a final comment since I can't cover the waterfront Larry was talking. There is a really serious debate about whether a labor-intensive option for growth. Nobody really disagrees that global demand is big, and part of the early stage growth has to be focused on that. I don't think that's controversial. How you get there is the subject of a lot of controversy, but there's a serious debate about what the options in the global economy are for a number of developing economies that

really aren't developing, meaning they're still stalled out, and, so, Paul Collier, who's one of the acknowledged experts on Africa, says they really can't jumpstart the structural diversification process without some help. Others disagree with that. For really poor countries, that's a terribly important debate.

I think the World Bank position -- I shouldn't speak for the World Bank, but the Collier-Bob Zoellick position is there's a huge opportunity in Africa associated with the high commodity prices, notwithstanding its impact on the poor, and there are a number of initiatives to turn those elevated rents into a pattern of investment in education and other things that at least have the chance of jumpstarting and accelerating the growth, and I think that's a useful to look at it, and being agnostic about where that growth -- particularly the high employment generating part will come from strikes me as very sensible. I don't think we need to be in the business of guessing it, but commodities by themselves are not the basis of sustained high growth.

And the last comment I'll make is agricultural is terribly important because in many of these countries most people still live there, it's productivity could increase, and investing in it in a variety of ways in the technology and infrastructure and so on is a very good idea, but I

always come back to but the dynamics are important, which is the really high speed growth comes from people moving across that boundary.

The productivity differential in all of these cases and in the not so successful ones between the agricultural sector and where people are going once they find this growth engine, whatever sector it's in, those productivity differentials are somewhere between three times to six times in favor of the new activity, so, and that's why the growth is so high. You can't get that growth from just increasing agricultural productivity, even though 70 percent of the people still live out there in the case of India and its 51 percent in the case of China.

So, it's this balancing act that I think it's hard to understand because you sort of simultaneously have to invest in something that in terms of population is going to disappear over time. I mean, the short version.

MR. RUBIN: Lael, can I ask Dr. Han a question?

DR. BRAINARD: Yes.

MR. RUBIN: If you look at world perspective of Korea, are you not going to be able to compete on the basis of labor because China has massive amounts of labor that's cheaper than yours?

DR. DUCK-SOO: At present.

MR. RUBIN: "At present." What do you mean, import a lot of people?

DR. DUCK-SOO: Not to say 1960s, you know what I mean?

MR. RUBIN: Yes, right.

DR. DUCK-SOO: Yes, right. We can compete.

MR. RUBIN: Anymore, so that -- and I guess in terms of value added, in the high knowledge industry, because there are a lot of countries now focused on those, so, if you take Korea, this is an interesting example, what is the growth strategy for Korea for the next 20 years?

DR. DUCK-SOO: Well, so here I think there is some kind of over simplification of the strategy that was suggested in the paper Mike presented. That is, whether we are commanding some kind of mechanicals approach for the developing countries who are now just wanting to develop.

There might have been some kind of elements when the case studies we did on 12 countries might have that kind of elements in early 1980s, 70s, 60s, but now, there are a whole lot of multilateral frameworks which do not allow that. But, still, we should not deny that still the engagements with the global economy is very crucial for any developing countries who'd like to start to develop.

On Bob's question, when we look at the world from Korea's point of view at this time, maybe the assertions we made in the paper Mike presented are quite different, so, the future package of strategies for Korea at present, of course, is to go toward more value-added industries and some service industries, not on manufacturing, which has already lost out to China in most cases, textiles, footwear all gone, and some of the service industries we'd like to promote.

So, the ingredients of the policy package, the emphasis on each ingredient of policy package will be totally different, so, now we discussed on some kind of literacy issue of education, but, at present in Korea when 82 percent of total high school graduates are going to college, of course the most important issue for education in Korea is not on literacy, but on how to make the good university education system to produce more people who will contribute to the more value-added industry.

So, we can say -- what I'd like to emphasize is there are continuous changes in the ingredients of strategies that each developing country should take. So, for Korea, it's for value-added industry now, so, more educations and sophisticated technology training will be necessary. When we look back at the 1960s and 70s, there may be some of the paradigms which may not be totally acceptable at present.

DR. BRAINARD: I'm going to get Danny to come in and then I want to open up to the audience, and, so, there are some roaming microphones. When you do get the mike, if you wouldn't mind identifying yourself and your affiliation, and we'll take the first question right here right after Danny intervenes.

MR. LEIPZIGER: I just wanted to come back on the sovereign wealth funds, which is an interesting problem, and I think for resource-rich countries, no issue.

I think I agree with Larry that if we take countries that are generating excess reserves either as in the case you gave, which is exchange rate issues, or because they're trying to avoid risk. I mean, I think the average reserve level is now much higher than they were a decade ago, so, even if we move to a different region -- let's take Latin American, Larry, instead of East Asia -- reserve levels are much higher, rates of return. If they put in T bills negligible.

Should a country there think about a sovereign wealth fund? My answer to that would be no, and I think you gave the reason why, which is that there are all these unmet needs inside the country in question.

I mean, infrastructure investment Latin American public is 1 to 2 of GDP. This is a bad decision for a country to make. I mean, Mike

talked about Singapore. That's sort of a special case, but I think as a general proposition, try to export and then using the proceeds to buy assets, bypassing some valuable investments at home is probably not smart for growth, but also not very good for the populace, which has a lot of needs that government needs to finance.

So, I think I'm agreeing with you on that one.

DR. BRAINARD: Larry, did you want to react to that more broadly?

MR. SUMMERS: I think we mostly agree. Just to state the issue a slightly different way, and I don't think I'm disagreeing with you, if you take a country that is managing its exchange rate, and, in the process, accumulating substantial reserves, it has three options.

Option A is to continue to do that and continue to invest the money in treasury bills and earn sort of zero after inflation in the United States, and since ultimately its currency will probably go up, a negative return from a local point of view.

B, it can invest the money externally, a portion of the money externally for the longer term, accepting more risk, and taking the position that it can function more like the Stanford endowment or the Harvard endowment since it doesn't need the immediate liquidity and can earn a higher rate of return. That's the sovereign wealth funds.

I would argue that B is almost certainly a wiser strategy than A, and then there's the question of strategy C, which is to invest it domestically in infrastructure. It needs to be understood that if you invest it domestically in infrastructure, then you're buying domestic assets with the money, not foreign assets with the money. Therefore, you're no longer intervening to prevent your currency from appreciating, and, so, the consequence of that is an appreciation of the currency, some difficulty for your export industry, some change in economic patterns.

On balance, I think more exchange rate flexibility would be a desirable thing, but I just want to stress that the choice to diversify to risky foreign assets, it seems to me, is unambiguously better if done carefully. The choice to invest it at home probably has the highest return, but also carries with it that you're no longer achieving your exchange rate objective and the merits of that can be debated. And China has moved rather slowly in the direction of some investment at home.

I think finally on this, it just bears emphasis that, because many of these countries are tied to the dollar and the dollar has depreciated relative to the rest of the world's currencies, even those countries that have some appreciation relative to the dollar, in most cases, if you look at their exchange rate relative to the world, for example, in the

case of China, it's actually changed only negligibly in the last two to three years.

DR. BRAINARD: All right. We're going to go here for the first question.

MR. PESIN: My name is Alph Pesin and I run a company called Distributed Capital Group in New York. Thank you all for coming; it's a wonderful panel.

My question has a lot to do with the new architecture bond that you began to mention, and then Larry, the belief that maybe an export-driven model isn't necessarily the way to go. And my question centers around the fact that, while the dollar may be depreciating, it stills remains the most powerful currency, and, for smaller countries, if we're going to talk about developing models for them to really control their own destiny, if exports are forced into being priced into dollars because the buying side of that model has most of the power in that relationship, then control of the domestic economies really is in Washington and New York and not in the small countries.

And I wonder whether or not this new architecture has to move toward advocating that exports be priced in local currencies. I wonder what your thoughts are about that.

DR. DUCK-SOO: Definitely if the dollar continues to depreciate permanently, the strategies for focusing on export may not be feasible. But we are talking about rather more medium to long-term strategies for the developing countries to start with, so, we think that's still the engagements with the global economy will be one very feasible strategy.

MR. PESIN: Even in the medium term, if the dollar, even at its current level, stays and exports are still priced in dollars, you're effectively importing inflation, and, so, then the central banks of these smaller countries have less and less control over the stability of their own economies.

I'm wondering what the answer to that is.

MR. RUBIN: This is not a subject I've ever understood completely, and many people say things that have the character of the things that you're saying.

I think what most economics would tend to teach in their classes is that it doesn't make much difference how a price is denominated. That is to say that if you quote the price of oil in dollars, there will be a tendency when the price of oil goes down, when the dollar goes down in value for the price of oil to go up. If you quote the price in euros, they'll be a tendency when the euro goes down for the price to go

up, and the price relative to a weighted average of other currencies won't tend to behave very differently based on what the content of the invoice is, and I think that's probably the right medium run approximation.

There may be a variety of dislocation affects, and there's certainly some important issues having to do if you're Abu Dhabi, whether you should tie your currency to the dollar, tie your currency to a basket of currencies, allow your currency to float, but I think most economists would tend to tell you that the denominating price is probably not the highest order variable, though I don't doubt that in some short and medium run important changes in it might have very powerful psychological effects.

DR. BRAINARD: Other questions? Wayne?

MR. WOO: Thank you. I'm Wayne Woo with the Brookings Institution.

Mike Spence talked of the need for continual structural changes, and Bob Rubin talked about the importance of state governance.

I would like to ask, I would like to hear some more about what should be the continual change in state governance. How much of it is in the reduction in the role of the state, and how much of it in the change in the role of the state?

For example, from direct investment in export-oriented industries to the investments in education in general starting off with social safety and so forth. In particular, in the case of Korea, how much of it is reduction in the role of the state or just merely a change in the role of the state?

Thank you.

DR. DUCK-SOO: Well, to present it punitively is very, very important, very difficult, of course. But if we look at what Korea is doing recently is that there are some variances of the role of government, mainly on how to increase the welfare for the socially dislocated people. So, previous government was more concentrated on increasing the government expenditure and tax incentives for them. For example, the tax transfer and income transfer for the income of workers are now equivalent to about 4.6 percent of the income correction. The disposal income for the workers, 4.6 percent of income has changed when we look at the disposable income, taking into account the government transfer and income tax benefits for this. And, as we go into national pension going into effect to the full, that transfer of income share will increase. It may not be as 45 percent of income correction effects of Sweden, but that kind of income correction will increase and the new government, which was launched in late February, very much

emphasizing on small governments and less intervention of the governments, more reliance on market economy, but my feeling is that the end result will be some shade of difference in how this expenditure and tax support for this unprivileged and low-income class will be.

So, countries like Korea, politically, it's a very important issue whether to make governments more reduced or how should it be changed, but, in substance, I think there will not be so much difference. But, of course, in theory, there will be a lot of difference between the more strong governments and with more roles to play and the other one.

MR. RUBIN: It seems to me though that there's another set of questions. I mean, that is a set of issues as to what government should do in the context of a country like Korea where you have an effective governing system. I was actually alluding to something slight different, which is that it seems to me, as you look around the world, you have a small number of countries that have had a government that has been able to effectively pursue what it judged to be sound, economic policy, and, as Michael said, to experiment one thing or another. A lot of these involve very difficult, intergenerational, temporal issues around the costs now and benefits later, but then you have a whole host of other countries that simply have not had effective governments that pursued a growth either because the rules of those countries basically were different

to the wellbeing of their people and are interested primarily in their own enrichment and power or where you have forms of government in which the rules actually do have some real concern about pursuing public good, but the institutions simply aren't effective in making difficult decisions, and I always look at that whole other set of countries where I think a lot of the real development issues lie.

For example, a country for which I have great respect is Mexico, which has real reform over many years, and, yet, it has not had sustained high levels of growth, and I think I at least I know touch about that country, not as much as probably Mike and Larry would, but my impression is that with all that's been accomplished that's really praiseworthy, there still has been an inability to do enough of what needs to be done simply because the ruling of lead hasn't been willing to make the investment that would have enabled the government to be effective in doing enough to pursue growth, and South Africa is full of authoritarian governments in which the rule simply haven't cared about public good.

And that's the set of issues that I was more addressing rather than this question which is your very good question, what do you do when you have an effective government, and the question, what should the role of that government be?

And, Michael, I think one question your paper doesn't address is when you have governments that are not effective either because they're ineffective democracies or not effective because they're ruled by people who are different to the wellbeing of their people, how do you try to promote effective government in those kinds of regimes and conditionality on aide, which has been so often suggested? I think it doesn't really have much effect if the rulers basically don't care about the wellbeing of the people.

DR. SPENCE: Especially in high-rent, natural resource environments, which swamp the aide, and, therefore, the conditionality. That's absolutely right.

DR. BRAINARD: Danny?

MR. LEIPZIGER: Well, I was going to say on your question, I think the answer is yes to both. Obviously, the role changes as a developing country goes through various stages and you need more regulation, et cetera, and less productive involvement. Whether or not you need to -- how small you need to get is sort of interesting.

Take a case like Chile, very orthodox in its policies. There's an issue on sovereign wealth funds, which is an analogist, but that's not the point. Where actually there are certain things that the public sector probably should be doing that they're not doing perhaps on infrastructure

investment or innovation or something else because they have a presumption that the government should stay out. There's certain things, obviously, the government should stay out, but I think some of the experiences of privatization in Latin America leads you to believe that there's some things where you need the government to play some role, and it has to be a smart role and evolving role, but just saying get government out of the way is probably not the right prescription.

DR. BRAINARD: Mike?

DR. SPENCE: Just a footnote. I think the pattern as the economy develops and matures, the government, in important dimensions, withdraws. There are subsidies in some places to promote certain kinds of economic activity. There's a universal agreement that if a subsidy is required permanently, to sustain that activity, it was a mistake in the first place, so, in all kinds of dimensions, relying on market prices, removing incentives to get things started, all of those things tend to decline.

And, as Danny mentioned, in many countries, the early part of the reform process is getting the government out of things it never should have been in in the first place. It could be excessive regulation, it could be just ownership of assets that ought to reside in the private sector because they're better managed there, so, I think on all fronts, there's in

some dimensions a tendency for government's role not only to evolve, but to revolve in response to the capabilities that are being built in the private sector.

MR. RUBIN: See, I think that's a judgment that I'm less confident about, and the reason is not because I think you're entirely correct that, as societies develop, the incidents of market failure declines. I think you're entirely right about that, and, therefore, there's more scope for the government to withdraw. I think a set of points that deserve roughly equal emphasis is that in less-developed societies, the government is capable of doing much less well, and that a judgment as to what the government should do has to be based on a comparison of what will happen with the government doing it in the way it will actually do it with the way the private sector will.

If you look at the history of growth over the last century in the modern world, as economies have grown, the relative size of government has increased. If you look across countries at richer countries and poorer countries, the general tendencies for the share of government to be larger in richer countries. Perhaps, it's the case that government should, on average, withdraw, but I don't think it's something that can be assumed, and the alternative view is that in a society where there are only 73 people who graduated from college who can be in the government who are

prepared to be civil servants, you should keep it to enforcing the law and a set of minimal things and that trying to manage an industrial strategy is a problematic thing, even though there's much more imperfection in the market than there would be in a rich country.

So, in a way, I think this question of which way the government should move is really central, and I would only argue not for any absolute conclusion, but that the judgment has to be made on the basis of a comparison of the aptitude of the government versus the aptitude of the private sector and not only on the basis of a judgment of what the private sector's capacity is.

DR. BRAINARD: Yes?

DR. DUCK-SOO: But, if I'm correct, I think in most cases the basic difference is of the size of the governments in the developed countries and developing countries, the tendencies in the economic activities, the role of government is continuously decreasing, but there are other alternative roles for the government, like welfare, social safety, like in Nordic countries. Most of the developing countries have a tendency to intervene in the economic activities, but, as developments go on, the interventions in economic activities have a tendency to be reduced while other social purpose interventions actually have been increasing.

So, in most cases, the tax to GDP or expenditure to GDP, including local governments, are all increasing in that area for the developed countries.

DR. BRAINARD: There's a question right here.

MR. BJEB: I'm Venoid Bjeb from the Embassy of Mauritius. I haven't read the paper, but the presentation relied heavily on the experiences of China and India. I did hear that one of your commission members is from the Caribbean, and the question I have is many of the countries of the world are small. You take the Caribbean, you take some of the landlocked countries in Africa.

Do the prescriptions that we heard today apply to these countries, or are we are dealing with a special case here?

DR. BRAINARD: Can we perhaps go to the member of the commission who's sitting right here from the Caribbean? And if he'd be willing to comment on that.

SIR DWIGHT VENNER: I dare not refuse. No, I think the Commission tried to take in all the countries that were (inaudible) inclusive commission, and in the case studies we did of countries, we did small countries, medium-sized countries, et cetera. So then I think we are under the umbrella and the issues came up with respect to vulnerability which

were taken aboard, but I want to make a more general point which applies to something previously someone said.

The logic of the report is if you say effective government and that really you want to respond to circumstances, if you get into a world where the export issue doesn't work for you, the smaller you are, the more difficult it becomes a problem, which means that it becomes, as Mr. Rubin says, an international problem, which has to be sorted out.

One of the things we said in the report was that if India and China gobbled up everything, should countries step aside and rule that out entirely as an option or what option should we find? So, if you say effective government, in a sense, what you are saying is that, as you come across problems, government has a big problem solving them.

And heterodox means, as I understand it, that you have to start from a position that, in the world, some things are becoming standard because there's IMF, the (inaudible) or the World Bank, what have you. Stability, clearly, is a factor which you recognize, so, fairly orthodox fiscal approaches are in vogue, but once you get stability and you want to proceed, stability doesn't become an end in itself, and the heterodoxy comes from the fact that, as you come from different situations, the world economy changes, and then you have to find solutions to those problems.

So, I don't think it's an ideological report or that we fixated on one thing or another. We affected on solutions, and that's where heterodoxy may come in.

DR. BRAINARD: Anybody on the Panel want to comment on sides?

MR. RUBIN: I think your point is a very good one. Just one small instance of it.

When I was at Treasury, it struck me as we visited smaller countries and looked at their efforts to develop financial systems, in small countries and small economies, it's going to be very difficult -- I would probably say not possible to have domestic financial institutions that can have the full range of activities that you need in a modern economy, and, so, it had struck me at the time that -- I forgotten now. It's the West African French -- what is it called?

DR. BRAINARD: The franc.

MR. RUBIN: The franc, right. They have a unit of some kind, but I don't think --

DR. BRAINARD: The monetary unit.

MR. RUBIN: The monetary unit. Precisely. It's a monetary unit. Now, I actually don't know enough to know whether they have financial institutions, but I don't think they do, that are pan country or

across country within that, but it seems to me that these small countries are going to have to find some way to develop financial institutions that go much beyond -- would have their financial systems be part of structures that go much beyond their borders.

I mean, one possibility is I'm with a large, international bank, and if the large international banks come in and be part of your financial system. Another is to develop financial institutions that cross borders and cover a region or something of that sort, but, otherwise, I don't see how these countries are going to have -- affect the financial system, and that same point may apply in other areas. I don't know.

SPEAKER: No, I think this is exactly right, and, as Dwight said, and Dwight has studied and written about small states, but the basic problem is that scale economies, government is too expensive per capita, et cetera, and, so, you are naturally led in the -- it's difficult to get it done. Pooling resources, that's why there's a central bank in the eastern Caribbean as opposed to on every single island, for example.

MR. RUBIN: Right.

DR. BRAINARD: I think we're going to wrap up.

What I wanted to do quickly, this Panel has been remarkably disciplined and focused on kind of medium-term growth strategies, but here we are in Washington, it's bank fun meetings. We just had the G-7,

thinking about bank regulation. There's big concerns about recession here and the potential spillover, continued strength, and emerging economy, so, we kind of got the usual picture flipped on its head, and given the quality of the panel, would like to get 60 seconds from each member of the Panel just to make the connection between the discussion here and kind of real-time events outside the room. So, in any order.

DR. SPENCE: Okay. You know, it's a great concern among the developing countries, but it's a healthier world. Sometimes described as multi-polar. There's, I guess, partial decoupling.

Let me put it into concrete terms. For precisely the reasons that we are unhappy with the pace of movement in China, we are likely to get what we want right now. They have an enormous capacity, fiscal capacity to stimulate the domestic economy from this starting point, and sort of sustain the growth, and that will do all kinds of good in the global economy and for their neighbors and it goes well beyond that, so, I actually think, while these are serious problems we have in the United States that kind of overall architecture from that point of view is somewhat healthier.

DR. BRAINARD: Han Duck-soo?

DR. DUCK-SOO: Well, although Korea and China and Asia are very far from here, almost at a real instant of time, our stock markets

are falling down or up, depending on what happens in New York, so, we can never evade from this kind of global phenomena. We hope that some financial multilateral institutions will be more engaging in this kind of activities, phenomena, so that the global solutions can be made which will make the countries, although far, can be much more stable.

This range and this degree of volatility and this range of crisis prone phenomena will be certainly very detrimental to the growth potentials of the countries which is too far away.

DR. BRAINARD: Bob?

MR. RUBIN: You know, it's interesting, an economist the other day was telling me he thought that there would be a large measure of decoupling because of import sensitivities or one thing or another, but I have some of Mr. Han's view, I think that even if it's so, and it's certainly so that China could stimulate a great deal of more consumption, the psychological affect of all of this and the translation of that through markets, which then, in turn, can affect internal economies, I have a feeling -- I may be wrong, but I have a feeling it ties everything together a lot more than some people who model this sort of thing might think, and, therefore, what happens in this country particularly over the next year or so is going to be more relevant to what happens elsewhere than a lot of people tend to think.

In terms of what's going to happen in this country over the next year or so, I don't have much idea, and I don't think anybody has much idea. And I personally think -- I've said this before -- I think that the risks are high enough. Hopefully, we'll muddle through in relatively short order, but I think there's enough risk that we won't, but I think policymakers should be very strongly and intensively focused, proactively focused on doing whatever makes sense to deal with the issues that we face and get us back on track as quickly as possible.

DR. BRAINARD: (Off mike).

MR. LEIPZIGER: Well, at the World Bank, obviously, we view this as what are the implications for developing countries, and I think there are some worrying aspects.

One is the linkage, obviously, through growth. The more urgent one has to do with the energy and food prices, and I think we're seeing increases that are extremely high and not just a spike, and, so, if you extrapolate these energy and food prices out two or three year, which is the forecast that our research department has, you see quite a number of countries having some serious problems, and coming back to the question as to whether or not we're now orthodox in our micromanagement. I think it's going to put a lot of countries to the test because they're going to have to probably find some fiscal means, at least

for the first year or so, to deal with a rice price or a wheat price that's essentially doubled and disposable income that used to go to food that might have been 40 percent of the family budget, you know, now being 60 percent.

So, I think we're quite worried about at the Bank, and I think we'd like to see more policy attention on that aspect, as well as on the overall global situation.

DR. BRAINARD: Larry, I'm going to give you the final word.

DR. SUMMERS: I share Bob's agnosticism about the U.S. economy. I think real economic conditions are almost certain, at least for some interval, to deteriorate from here. I think it's much less clear whether financial markets, particularly credit markets which are already discounting very serious outcomes, the direction in which they will move is, I think, much, much less clear and very consequential. I think the more likely thing is that we will muddle through, but there are real risks there.

I am inclined to put considerably more emphasis on recoupling than decoupling, in part because of the psychological impacts, in part because of a variety of the common forces that are operative everywhere.

By international standards, the United States had some very substantial distance from the largest housing bubble, and there's a lot of

that around the world still waiting to play through, and there's a strong tendency to confuse trade in tasks that leads to multiple levels of trade between countries all constructing a product which is then shipped to the United States.

To interpret that as evidenced, that there's a lot of intra-Asian trade, for example, and, therefore, that there's going to be decoupling, when, in fact, it's all being driven by the export to the United States. So, I am very pessimistic on the theory that the United States could be in real trouble and the global economy could be okay.

And, finally, I think the commodity price issues are very real. I think one aspect that -- and I don't know a lot about this, but, to my instinct, has been insufficiently explored in the discussion is the relationship between a variety of financial activity and the behavior of commodity prices. The ubiquitous decision of investors of many different kinds in light of the events of the last several years, that a portion of their portfolios should be help in commodities, I believe in a variety of ways, has probably contributed to the run-up in commodity prices and those links between financial behavior and commodity price behavior I think have not received the attention they deserve in the discussion. How large they are, I'm not in any position to judge and I'm not certain that they're significant

at all, but it seems to me that's an aspect that should be receiving more exploration that it has to date.

MR. RUBIN: In theory, Larry, if it's not natural demand, but, rather, financial demand, as you say, then shouldn't that unwind itself at some time so that what is going up should come down or no?

MR. LEIPZIGER: I don't think so. I think if CalPERS, the California pension fund, decides that, as part of an optimal configuration of risk and return, it's always going to hold an inventory either physically or through future markets of 5 percent of \$200 billion fund in commodities. That's \$10 billion that's never going to be in the commodity market, and if that's going to increase as their wealth increases, then it would tend to be a continuing one-shot increase in price, I think. And, certainly, while that process is taking place or moving to a higher inventory, you would see pressure on prices.

MR. RUBIN: And, so, they would they would hold the oil or the wheat in some sort of inventory form?

MR. LEIPZIGER: Yes, they would hold it in futures and somebody else would because they were holding --

MR. RUBIN: But they'll be held in futures and somebody else would have the -- well, I don't know. It's an interesting question.

SPEAKER: They just need to interact. There are -- people who are busy estimating what the sources of the food price increase -- the estimates I've seen so far suggest that the ethanol kind of demand and the diversion of supply in that direction accounts for well over 50 percent with other things coming from energy prices and so on, and it strikes me that one of the things the new global architecture is going to have to deal with is sort of inadvertent affects of major policy choices of that type.

DR. BRAINARD: I think the question that your financial market analysis doesn't address is his question is to the extent that it's based on structural trends, both on climate and on the very growth phenomena that we've been talking about all morning. That's I guess the question mark as to whether that's being reflected.

Let's terminate here. I think everybody will have a chance to grab some of the panelists before they have to leave. I want to thank Michael Spencer for a very interesting and provocative paper, and I want to thank all the panelists for a terrific discussion.

* * * * *