Achieving Maximum Long-Run Growth– An Introduction to the 2011 Economic Policy Symposium

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The recovery from the global financial crisis and recession has been uneven around the world. Growth has rebounded sharply in many countries, especially emerging market economies that quickly resumed robust expansions. But a number of advanced economies have not been as fortunate. Some, including the United States, have experienced subdued growth and elevated unemployment. Other countries have fared worse, pushed back to the brink of crisis as investors have fled the threat of sovereign default, and austerity measures to rein in fiscal deficits have weighed on domestic economies.

This bifurcated state of the global economy highlights the central role of achieving maximum economic growth and sustaining it in the long run. To identify some of the challenges related to growth and present potential policy solutions, the Federal Reserve Bank of Kansas City sponsored the symposium, "Achieving Maximum Long-Run Growth." The symposium gathered a distinguished group of policymakers, academic economists, and financial market experts on Aug. 25-27, 2011, in Jackson Hole, Wyoming. Three key themes emerged through the course of the symposium's papers, discussions, and remarks.

First, the advanced economies face considerable challenges to resuming maximum growth, which is needed to reduce both high unemployment and large fiscal deficits. Unfortunately, the typical policy levers already have been pushed, leaving less room to maneuver to stimulate growth: Monetary policy rates are near zero, and fiscal policymakers have expanded borrowing greatly to combat the crisis and recession. In addition, even larger fiscal obligations loom on the horizon due to demographic trends and health-care entitlements. These factors make achieving maximum long-run growth all the more necessary—and difficult to obtain.

Second, while many emerging market economies have been more successful in escaping from the global recession and resuming rapid growth than the advanced economies, their longer term challenges are no less daunting. Part of the recent strong growth in emerging economies is a result of being far from the advanced economy frontier. But convergence to that frontier is not guaranteed: These countries must find ways to sustain maximum growth over the course of decades to dramatically reduce poverty and improve living standards, a process complicated by the need to rebalance away from export-led models. This is especially true for many of the least-developed countries that have benefitted from commodity price booms, as they seek ways to invest those riches for maximum long-run growth.

The third key theme of the symposium focused on the crucial role of finance in connecting advanced and emerging economies and contributing to growth. In the run-up to the crisis, capital flowed from emerging economies to advanced economies. These flows simultaneously helped generate real estate bubbles in advanced economies and helped shield the emerging economies from the subsequent crisis. Thus, how to harness the power of financial flows and financial markets for achieving maximum sustainable growth remains an unresolved issue.

Advanced Economies: Dealing with Debt

More than two years after the end of the financial crisis and global recession, many advanced economies continue to struggle with sluggish growth. Fiscal policies have been stretched by the combination of lower revenues during the recession and increased expenditures on countercyclical stabilization measures and financial rescues. Sovereign debt woes continue to flare in the European periphery, threatening the recovery and creating the impetus in other nations for fiscal consolidation. And with persistently high unemployment and a long period of deleveraging ahead, a number of economists have questioned whether economies' long-term growth paths have been permanently downgraded in the wake of the recession.

While the United States shares many of these attributes and has undergone a modest recovery by historical standards, Federal Reserve Chairman Ben S. Bernanke's opening remarks struck an optimistic tone over a longer time horizon. Even though the recovery may take some time, he expected the long-run potential of the U.S. economy would not be materially affected by the crisis and recession—*if* the country takes the steps to secure that outcome. In particular, he noted the need for housing policies to speed adjustments in that sector, greater access to high-quality education and affordable health care, and a better process for fiscal decision-making. In addition, Bernanke noted the urgency of policies aimed at tackling the high level of long-term unemployment in the economy. Monetary or fiscal policies to achieve this outcome—especially if the latter are coupled with a credible plan to place fiscal policy on a sustainable path in the future—could reduce some of the deleterious effects of long-term unemployment on workers' skills.

In her first speech as Managing Director of the International Monetary Fund, Christine Lagarde echoed Bernanke's suggestions for the United States regarding housing policies and long-term fiscal consolidation combined with near-term policies supportive of growth, but she also took a broader perspective on issues facing economies worldwide. In general, she declared that with growth tepid and risks rising, "there are no *easy* solutions, but that does not mean there are *no* solutions." Beyond the United States, she identified in Europe the need for sustainable fiscal policies, bank recapitalization, and a clear vision for the future of the euro zone. Lagarde also argued for a faster pace of rebalancing in the global economy, which would improve prospects for achieving maximum long-run growth.

High debt levels are one of the central challenges facing advanced economies, and the effects of debt on growth were the focus of the symposium paper written by Stephen Cecchetti and co-authors. At low levels, debt can promote growth by transferring scarce resources to their most productive uses. But beyond a certain point, high debt can make economies less stable and reduce growth. Cecchetti found that such a threshold exists for government debt in the range of 80 percent to 100 percent of gross domestic product (GDP). Beyond that point, a 10-percentage-point increase in the debt-GDP ratio can reduce trend growth by more than 10 basis points. Moreover, merely reducing government debt levels to the threshold may not be enough; governments should strive to reduce their debts below the thresholds, to give themselves latitude for countercyclical stabilization policies as needed.

In addition to large debts incurred during the crisis and recession, demographic trends and health-care entitlement spending are expected to stress many advanced economies' fiscal budgets for the foreseeable future. Health-care spending is especially problematic because much of it is publicly financed and it is also growing much faster than GDP. Thus, the key issue is how to rein in health-care costs in advanced economies. On this score, the symposium paper by Katherine Baicker and Amitabh Chandra offered some hope. Baicker argued that much U.S. health-care spending is highly inefficient: inexpensive options such as aspirin are underused, while highly expensive but unproven treatments like proton beam therapy are generously reimbursed. Reforming the health-care system offers the potential to reduce these inefficiencies, lower the costs of health care, and provide better health outcomes. These reforms likely will take a variety of forms, from Medicare-reimbursement reforms on the provider side, to reforms that better align patients' expenditures to the value of the treatments they receive, to the broader diffusion of information on the comparative effectiveness of drugs, procedures, and delivery systems.

In discussing these two papers, Maya MacGuineas noted that the fiscal challenge now is twofold: to implement deficit reduction plans, and to do so when many other countries are doing likewise.

As a starting point, she sketched out what credible multiyear debt reduction plans may look like. To make the plan credible, she argued for bipartisan statutes that would include triggers if the policies fall short. Such credibility is important to reassure markets while allowing the pain of consolidation to take place gradually. To achieve the desired goal of reducing debt, she pointed to the need for wide-ranging reforms: tax reforms that increase revenues for deficit reduction, entitlement reforms, policies to promote longer working lives, and targeting budget cuts to protect productive public investments.

While high debt levels and scars from the crisis are likely to weigh down growth in advanced economies, Pier Carlo Padoan pointed out reasons for optimism about the ability to push the frontier forward. Notably, the crisis itself may spur the need for structural reforms in advanced economies to improve the quantity and quality of education, stimulate competition in product markets, and make labor markets more flexible. Padoan argued that the benefits to these reforms actually may accrue faster than often thought, and he urged countries to undertake reforms when they can rather than being forced to do them. In addition, he noted that structural reforms can support moving the frontier forward through innovation, and that the emerging field of "green growth" could yield growth dividends for advanced economies in the near term while helping conserve natural assets for the long run.

In his remarks on the closing panel, European Central Bank President Jean-Claude Trichet set out several priorities for creating strong, sustainable, balanced, noninflationary long-run growth. In his first priority, he echoed Padoan's remarks regarding structural reforms, especially in Europe, for which he cited the need for a more integrated single European market and more flexible labor markets. But he also pointed out that Europe is not an outlier: the differences across countries in the euro zone are similar to the differences across states within the United States. Trichet's second priority was maintaining vigilance against imbalances—whether global trade or financial imbalances, private or public debt imbalances, or income imbalances within a country. Regardless of the case, growth must be sustainable and balanced to truly benefit society in the long run. Finally, Trichet pointed to the need for "credible alertness" among policy institutions, as an ever-changing landscape may require the implementation of both standard and nonstandard policies, depending on the circumstance.

Emerging Economies: Sustaining Growth

While advanced economies struggle in the aftermath of the financial crisis and global recession, many emerging economies have experienced strong growth. This has been especially true in the "BRIC" countries—Brazil, Russia, India, and China—but also throughout much of the world. Unfortunately, many emerging economies are starting from a very low base; their per capita incomes are a fraction of those in the advanced economies. Because they are so far from the advanced economy frontier, catch-up alone should predict rapid growth rates.

Thus, the central question is: Can these emerging market economies continue to grow at a rapid pace and eventually converge to the advanced economy frontier, or will their growth eventually slow and their economies plateau at a lower level? The first symposium paper, by Dani Rodrik, offered mixed news. Rodrik found that there is convergence—but it is in manufacturing industries, not in entire economies. Getting an entire economy to converge by reallocating resources to the most productive industries is a difficult and rare feat that defies simple policy prescriptions. Instead, Rodrik noted that many of the countries recently experiencing the fastest growth have "flouted the rules" by adopting undervalued exchange rates, restrictions on capital flows, and industrial policies. But with the advanced economies experiencing slow growth and the least-developed economies trying to emulate these paths, there is less ability for the successful emerging market economies to continue their rapid growth rates using the same techniques. Rebalancing to more domestic-demand oriented policies may be a bumpy process that inhibits the path to convergence.

Barry Eichengreen offered a similar cautionary tale about the ability of emerging economies to continue their rapid growth through the "middle-income trap"—the tendency for rapid growth in emerging countries to slow once they became middle-income countries, largely from a slowdown in total factor productivity growth. He identified several common features of countries that fell into the middle-income trap, such as per capita incomes around $16,700, persistently high investment rates and low consumption rates, and chronically undervalued real exchange rates. Retrospectively, South Korea fell into the middle-income trap in the 1990s, culminating in the financial crisis in 1997-98. Looking into the future, Eichengreen noted that China will soon fit these criteria as well. While many economists predict that China's growth will slow in the future, largely due to the one-child policy, Eichengreen's analysis suggested that a sharper slowdown is possible if the Chinese economy fails to rebalance toward consumption and normalize its real exchange rate.

Sustaining growth is not only a challenge for the successful, fast-growing emerging economies. Many of the poorest countries have recently been enjoying high prices for their natural resources along with new discoveries. However, resource riches usually are depleted quickly and price booms often trigger their own demise due to innovation, hence this resource boom may only last for a generation. In his luncheon address, Paul Collier proposed that low-income countries could benefit by establishing Sovereign Development Funds (SDFs) and Sovereign Liquidity Funds (SLFs) to invest resource revenues for the future and to smooth through resource cycles, respectively. While bearing some similarities to a sovereign wealth fund, SDFs would allow for an "investing-in-investing" approach that would buy countries time before eventually investing funds domestically; SLFs would provide a mechanism to hedge commodity price swings. To protect these resource riches, Collier argued that African central banks should take a central role in administering and promoting SDFs and SLFs.

Ensuring that the benefits of growth are distributed throughout an economy was a key theme in the paper by Esther Duflo. Unfortunately, market failures–including financial market failures that impose high borrowing rates and prevent widespread access to saving accounts, limited access to insurance, weak land rights, and segmented labor markets–are especially pronounced in developing countries and fall disproportionately on the poor. In the presence of market failures, there is not necessarily a simple relationship between growth and inequality;

that is, faster growth is not guaranteed to alleviate poverty. Instead, Duflo argued that policies to mitigate market failures can improve the ability of the poor to benefit from growth regardless of its source. Policies to improve the functioning of credit markets for medium and large firms would push up wages and employment broadly. Land reforms and stronger property rights could boost productivity. And education policies that broaden access to education would deepen the pool of human capital in developing countries.

In discussing Duflo's paper, Kevin Murphy stressed the central role of the labor market in lifting large numbers of people out of poverty as populations moved from less productive agrarian societies to more productive sectors. In his view, this movement was not specifically directed at the poor but it nevertheless benefitted both the poor, who earned higher wages, and society, which enjoyed a more efficient use of resources. Thus, while Murphy agreed with the important role of market failures in developing countries, he believed that expanding aggregate labor demand was perhaps the most effective way to reduce poverty within a country.

The Finance-Growth Nexus

The global financial crisis and recession have renewed interest in the linkages between finance and growth. While these linkages can take on many forms, the symposium focused on two: the connection between growth and financial institutions, and the connection between growth and financial capital flows.

Ross Levine argued that economic growth is profoundly influenced by the financial system. The financial system is not only important for transforming savings into physical capital. Rather, Levine provided evidence that financial innovation and development can also expand economic opportunities and help alleviate poverty. Achieving this outcome requires providing the right incentives and regulations for a country's particular financial system; there is not a universal "checklist" of policies, but there are regulatory strategies that are more broadly applicable. First, Levine noted that empowering regulators to achieve more sustainable growth requires enhancing the governance of the regulatory agencies as well. Second, enhancing market discipline can produce better economic outcomes, but this requires providing the right incentives, information, and legal mechanisms necessary to govern financial institutions. Third, capital regulations are not a panacea but need to be considered along with bank governance. Because financial systems vary from one country to the next, Levine concluded that Basel-like regulations may not be universally appropriate.

In discussing Levine's paper, Randall Kroszner noted the limitations on financial innovation and capital regulation. Financial innovation is Janus-faced, he noted, as it is necessary for economic growth but also capable of harm. Kroszner provided the example of credit default swaps, an innovation that can reduce risk by providing hedging opportunities but that ultimately became highly concentrated in American Insurance Group in the run-up to the crisis. Assessing the risks of new innovations thus poses a challenge for regulators. Regulators could also face challenges from rethinking capital regulation. While Kroszner agreed that one of the lessons from the crisis was the need for more and higher quality capital, he compared it with the Maginot Line: Capital is the first line of defense, but it is not necessarily a cure-all because it can disappear quickly.

Developing a country's financial system, however, is a highly complex process that depends on a country's stance on capital flows. In particular, extensive capital outflows can lead to financial market repression, which can render a country incapable of handling large capital inflows and produce asset booms and busts. Eswar Prasad noted this as one consequence of the large capital flows from emerging to advanced economies—called "role reversal" because of its contradiction with economic theory—that occurred before the crisis and that continue to the present. Historically, emerging economies faced crises related to sudden stops of capital flows, which were exacerbated by large liabilities denominated in foreign currencies. But in the most recent crisis, emerging economies were relatively insulated because they had reduced their foreign currency debts and accumulated large foreign exchange buffers. While effective in mitigating the spillovers of the financial crisis to emerging economies, Prasad argued that this self-insurance mechanism not only slowed financial market development in emerging economies but also contributed to global imbalances and puts risk on the asset side of emerging economies' balance sheets. Thus, as an alternative, Prasad proposed a market-based insurance pool that would not rely on the International Monetary Fund or major central banks.

Susan Collins pointed out that the theme of role reversal between advanced and emerging economies goes far beyond the countertheoretical notion of capital flowing from emerging to advanced economies. In the 1980s and 1990s, many emerging economies struggled to grow amid unstable financial markets, unsustainable fiscal policies, asset-liability mismatches, and recurrent crises. Today, emerging economies are drivers of the global economy and are financing the deficits of the advanced economies, which are now battling their own crises in financial markets and unsustainable fiscal policies. But Collins noted there are limitations on how far this role reversal can go given the limited financial market development in emerging economies. For this reason, she argued that capital controls—especially for capital inflows—may have some promise to assist with the allocation of capital and limit boom-bust cycles in emerging economies.