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MAKING GROWTH WORK FOR THE POOR
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The Great Stabilization

The world economy is recovering from an unprecedentedly deep and synchronized recession provoked by the bursting of a global financial bubble. For the first time since World War II, the global economy as a whole contracted by a bit over 2 percent. But what could have become known as the second Great Depression turned into the Great Stabilization, thanks to unprecedented policy efforts and policy coordination around the world from all the major economies, supported by international financial organizations, and by a reversal of the inventory drawdown during the height of the crisis. The immediate impact of the financial crisis, including the slashing of equity prices by half, a sharp drop in housing prices and the practically drying up of credit is already starting to become a fading memory, and the green shoots of the recovery that became apparent mid-last year, are gradually gaining firmer roots, and world trade and industrial production are on the rebound, while unemployment seems to have seen its peaks in most economies around the globe.

Although the financial crisis started in the developed world, and with the exception of Eastern Europe, developing countries avoided a direct impact of the financial crisis, the developing world as a whole fared hardly better than developed countries. While on aggregate, GDP growth in developing countries in 2009 remained positive at 2.5 percent, this was largely due to China and India. Excluding these rapidly growing giants, output in developing countries fell by 2.2 percent—a sharp contrast with the record 8 percent growth accrued only two years before. Developing East Asia did far better, largely due to the outstanding performance of China, which, on the back of an early and forcefully implemented stimulus program raked up 8.4 percent growth—still rapid, but far short of the 13 percent growth achieved in 2007. The region as a whole grew a little under 7 percent, but excluding China, growth only inched forward with 1.3 percent, and countries such as Malaysia, Thailand and Cambodia saw negative growth. In contrast, Indonesia and Vietnam saw their growth holding up relatively well. For the Philippines, performance fell in between these two groups of countries: thanks to higher than expected growth in remittances, a timely fiscal stimulus, and avoidance of the direct impact of the financial crisis, growth remained positive, albeit at less than 1 percent, a far cry from the record 7.1 percent posted in 2007. Growth would have been higher were it not for Ondoy and Pepeng, which in our view shaved off some 0.4 percent off the country's growth, a loss that can be reversed this year, if spending on recovery materializes.

Modest Expectations

For 2010, the World Bank expects a modest recovery for the world economy, led by East Asia, and supported by other emerging economies. As the positive contribution from fiscal and monetary stimulus and inventory buildup wanes, growth is likely to slow in the second half of the year. In the medium term, growth is likely to remain less buoyant than it was before the financial crisis for a number of reasons. First, households, banks and enterprises alike will continue rebuilding their balance sheets that were affected by the crisis, and as a result little growth impetus is likely to come from investments and consumption demand in developed economies. Second, although the direction and speed of reforms remain uncertain for now, it is clear that there is a growing consensus that the financial sector requires additional regulations that require financial institutions to better price risk and realign incentives so as to avoid excessively risky credit growth in the future. In simple terms, this means that credit will be tighter. Third, although for most countries

exit from stimulus measures is premature for now, a time will come when fiscal policies will need to become less expansionary so as to maintain sustainable debt levels, and the extraordinary monetary measures that kept the banking system alive during the crisis will have to be phased out so as to limit the risk for inflationary expectations to rise. "Exit strategies" will therefore be the talk of the town in the year to come.

East Asia, which led the recovery last year, will in our view again be the leading region in terms of growth. Because of the lackluster external demand from developed countries, though, growth will not rebound to pre-crisis levels. We estimate developing East Asia will grow by 8.1 percent—well short of the 11.4 percent growth of the region in the year before the financial crisis. The Philippines, with continued strong remittance growth, a continued fiscal stimulus already planned, including spending on recovery from Ondoy and Pepeng, and possibly some effect from election-related spending, could rake up growth in the order of 3.5 percent.

Considerable Risks

These projections are surrounded by considerable uncertainties of a relatively unfamiliar kind. They are unfamiliar because they in part stem from the extraordinary measures taken during the crisis, and the possible policy and regulatory response to the crisis, which is only unfolding now. A key risk is the unduly early withdrawal from the economic stimulus worldwide, both on the monetary side as well as on the fiscal side. This withdrawal of stimulus will need to happen at some point, but moving too early may mean that the economic recovery peters out, or even turns into a "W" shaped recovery. At the same time, a number of countries face considerable constraints on the fiscal side and may be forced to reduce stimulus in order to maintain fiscal sustainability. And on the monetary side, the extraordinary monetary expansion in many countries has sparked fears ranging from future inflation to renewed asset bubbles. While East Asia faces fewer challenges on the fiscal side than most developing countries, some countries, including the Philippines, have debt levels that should be carefully managed. And on the monetary side, the region's relatively inflexible exchange rates versus the dollar may well be the channel through which excessively loose monetary policy is imported from abroad.

On the shape of financial regulations the jury is still out, but what is clear already is that there will be a tightening of rules that will reduce the probability of systemic failure in the future. The outrage on financial sector pay is currently in the headlines, but what is more important is the underlying incentives that gave rise to the high profitability in the financial sector, which, with hindsight, was really the result of excessive risk taking by a sector that enjoyed an implicit guarantee of the taxpayer. So rational behavior of individuals and individual banks led to a detrimental outcome for society. Whether tighter regulations will result in higher capital requirements, smaller banks, levies on financial sector business, regulated bonuses, the "Volker Rule,"[i] or all of the above remains to be seen, but what is clear is that the final result will be that risk will be better priced and liquidity will be tighter going forward than it was in the past. This can and likely will have consequences for long term growth. The recent Global Economic Prospects of the World Bank paints some scenarios in this regards, all pointing towards lower trend growth for the foreseeable future.

Growth in the Long Run

More important than what growth in the Philippines will be in the coming year is what growth will be in the long run. Indeed, growth in the Philippines over the last decade has been higher than that of the two decades preceding it. But average growth of almost 5 percent has not been enough to make a serious dent in poverty, which today is probably about as high as it was at the start of the last decade. Moreover, average growth of 5 percent per year in National Income means that income per capita only grows by about 3 percent per year. Again, in recent historical perspective, this is quite respectable, but as current economic managers say, this hardly meets the aspirations of the Philippines. We all like to see the country at income levels comparable to developed countries within a generation. Reaching this goal, or even moving in that direction requires higher growth.

At current growth rates, the Philippines would be as rich as today's China in 25 years. In roughly half a century from today, it would reach income levels of Malaysia today to become an upper middle income country, and seventy years from now it will reach the $12,000 per capita high income threshold that the World Bank uses for its country classification. For comparison, the average high income country currently has a per capita income of $36,000, or more than twenty times the level of the Philippines now. The blessings of compounded growth imply, however, that

higher growth more than proportionally eats into the time it takes to reach high income level. With 5 percent per capita growth, it takes a little over 4 decades to reach high income status and with 7 percent per capita income growth the same can be achieved in little over 3 decades. Moreover, international experience shows that as growth accelerates, fertility and population growth declines, so per capita growth can accelerate more rapidly than GDP growth.

Could the Philippines possibly grow at rates in the order of 7-8 percent per year for decades in a row, much like its illustrious neighbors have done? What does it take to do so, and how would a government set on achieving such a performance go about? Since 1950, 13 economies have grown at an average rate of 7 percent a year or more for 25 years or longer. The World-Bank sponsored commission on Growth and Development investigated what these countries did to grow rapidly on a consistent basis. Led by Nobel Prize winner Michael Spence, it consisted largely of policy makers from the countries that had achieved high growth. What is noteworthy is that these economies are highly diverse. Quite a few of them are in East Asia (China, Taiwan, Thailand, Hong Kong (SAR, China), Indonesia, Japan, Korea, Taiwan (China), but Botswana, Brazil, Oman and Malta also belong to the select club, and India and others are about to join this group.

According to the Commission, fast sustained growth is not a miracle; it is attainable for developing countries with the "right mix of ingredients." What the book observes is that the rapid growers did five things right: they fully exploited the world economy; they maintained macroeconomic stability; they mustered high rates of saving and investment; they let markets allocate resources; and they had committed, credible, and capable governments. Any policy action, proposal, or law that signals commitment to these elements should therefore be capable of accelerating growth. Countries need leaders who are committed to achieving growth and who can take advantage of opportunities from the global economy. They also need to know about the levels of incentives and public investments that are necessary for private investment to take off and ensure the long-term diversification of the economy and its integration in the global economy.

What this means specifically differs undoubtedly from country to country, and from time to time. I would hesitate to give the "menu" for the Philippines, but would be happy to discuss further what, given the Philippines' current time and place, this might mean for a program of reforms. Here, I would just like to note that in recent years, the Philippines has restored macroeconomic stability, and, as important, a reputation for macroeconomic stability, mainly on the back of rapidly growing remittances that provide a strong basis for currency stability and international reserve buildup. Further, the country now enjoys a savings rate that well exceeds investment, and the country's human resources are in high demand around the world.

The bottleneck for the Philippines seems to be in the creation of opportunities for deploying these financial and human resources at home —the investment climate. In part this is a matter of insufficient infrastructure, and our estimates are that this falls short by some 2-3 percent of GDP for the country to reach a sustainable growth rate of 6-7 percent. In addition, investment in human resources is falling short of what is required to grow faster and to lift people out of poverty. Spending on education is in the order of 2.5 percent of GDP, well short of what comparator countries in East Asia and elsewhere spend, and insufficient to provide investors with the confidence that a sufficiently large and well educated labor force will be available in the future. At the bottom end of the labor market—where the poor are—it also seems that labor regulations are too extensive for the current levels of productivity of particularly the poor. As a result, the majority of workers have no formal contract, and it is exceedingly hard for the poor, who are usually less educated, to enter the formal labor market. Better regulations that increase the employment impact of growth are key to poverty alleviation. Beyond that, it increases the inclusive nature of growth, which, according to the Growth Commission's analysis, is essential for the sustainability of growth.

Finally, governance continues to be mentioned by domestic and international investors as being a critical factor in their investment decisions. While the Philippines enjoys a reasonable quality of civil service and regulation, anti-corruption and policy consistency seems to fall short of the standards that mobile investors expect nowadays of a lower middle income country. In particular, more consistency in policies and their implementation and enforcement would benefit the Philippines' investment climate. While improvements in these areas are hard to achieve, credible commitment to more consistent policies should be high up the agenda for any government, and actions that reinforce such commitment would be much welcomed by the business community.

In my view, the modern institutional economics is a bit too negative on the prospects for growth. They basically see "institutions" as overarching determinants of incentives, and therefore

outcomes. And these institutions are results of historical processes that cannot be changed, or the result of de-facto economic power of the elites, and therefore only serving a narrow interest, not broad-based growth. True, good institutions help, and so does good luck (the Japanese car industry historically produced small cars because of land scarcity, so when the oil crisis hit, they suddenly had a huge advantage). However, I believe that good policy has a large role to play as well, and can spark rapid development while better institutions are being built. China in 1978 had few, if any, market-friendly institutions, but policies of Deng Xiaoping (and his credibility) were sufficient to substitute for the lack of institutions—even though these institutions were gradually built up. But policymakers should focus on institutions building as well--Indonesia's Soeharto's policies were largely pro-growth and worked to spark rapid development, even inclusive development, but the lack of institutional development in the end undermined this growth success, and was at least part cause of the severity with which the Asian crisis hit the country over a decade ago. Whatever the dominant factor may be, what is clear is that a change for the better—better policies and better institutions—can deliver results at fairly short notice. Consistent improvements over a number of years can create growth miracles.

Inclusive growth

What I find striking from the insights of policymakers in rapidly growing countries is their focus on inclusive or shared growth. This may of course on the one hand be human decency of those policymakers, but on the other we find that the nature of growth actually matters for the speed of growth. More inclusive growth that benefits all makes it easier for policymakers to argue for the reforms that are needed to accelerate growth. Indeed, growth is accumulation and restructuring—and restructuring is painful for those involved, for those that need to move to a new job, need to give way for infrastructure, or are otherwise affected by rapid growth. To know that they and their families will benefit from such disruption in the end is important for people to accept the type of measures that are needed. To know that there is a safety net when they become temporarily unemployed may well speed up growth, rather than slow it down. Further, providing people with better, if not equal opportunities—by having a level playing field in markets, by providing people with the education needed to succeed in life, by providing equal protection under the law could be seen as an inclusive growth agenda, but this can equally be simply considered a growth agenda, period. Of course, not all will always benefit from growth all the time, and providing a minimum safety net for those that cannot, or cannot yet participate again makes good sense economically, socially, and politically. (END)

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