

## **Panel Discussion 1: Failure of economic growth models: varying responses and results**

### **Opening Address**

(Peter Bekx Director, International Economic and Financial Affairs, DG ECFIN, European Commission)

I would like to address a different kind of growth model, namely, the one that emerged from the two oil shocks and the end of the Bretton Woods system.

#### Slide 3

The growth model that we have there, following the fall of the Berlin Wall and the collapse of the communist bloc; strengthened the global and overarching nature of this model. It was conjugated in different ways in different countries or regions. The US was probably the closest country to the model I am describing here. EU countries kept a strong social dimension and also developed an environmental dimension, and Japan and Asian countries embraced only partially the six elements of the growth model.

#### Slide 4

Now, since the 1990s, growth accelerated and in the mid-2000, the world economy experienced the highest growth rates in a decade. Growth inequality declined so we have found paradise. To speak with Thomas Friedman, the world had become flat, and Fukuyama could credibly argue that history had reached its end.

The new economy in the US, and to sort of a lesser extent in the EU, also led to strong and sustained growth in emerging market economies. There was an increase in the frequency of financial crisis, but they could be managed. Most of the productivity gains of the new economy goes to the top quintile of the US population, with the top 1% making most of the gain, so these are clear winners in this growth model. Also women gained.

Losers, in this growth model, were unskilled workers and poor countries since they did not profit from the productivity revival in advanced country, in the case of workers, and from the rapid expansion of emerging market economies in the case of poorer countries.

One other drawback of the model is that it had high environmental costs.

#### Slide 10

I am going to turn to the end of this growth model, "Paradise Lost."

This pre-crisis growth model did indeed produce impressive results but in the end, it was inherently imbalanced and unstable. The frequent currency and financial crises should have rung a bell but too

much trust was put on the efficiency and the capability of financial markets to self-regulate, as well as on the ability of policymakers to address the bursting of real estate or financial bubbles exposed. As a result, the model produced unsustainable domestic and external imbalances, large and unsustainable current account deficit in the US, for example, mirroring large and unsustainable current account surplus in some emerging market economies, and an over-reliance on poorly regulated and supervised financial markets. The sub-prime crisis was the iceberg that sank the model but like the Titanic, it was because it had some major safety flaws.

#### Slide 11

Let me then look at the European growth model. There are a variety of pre-crisis EU growth models. We have the Scandinavian model. We have what we call the neo-corporatist model, the Anglo-Saxon one, the Southern European one, but all of them incorporated the key six elements, in the sense that the part of the six elements in the respective growth models was growing. However, all these models also had common features that differentiate them, for instance, from the pure model that was existing in the US. Common features are economic stability, low inflation, small external imbalances, relatively low growth, unfortunately but significantly smaller inequalities, more attention to the environment, and a better balance to work and leisure.

#### Slide 12

Now, despite having temporarily stopped to catch up with the US in GDP terms, the EU growth model presents some important strength, in particular when social welfare and environmental issues are taken into account. In this respect, the EU growth model outperformed that of the United States. First, there are of course limits to GDP as an indicator of economic performance and social progress, as it has been very recently emphasized in the Stiglitz and the Sen Report. Also the EU pre-crisis economy is characterized by a strong manufacturing basis, by a sound household's balance sheet, by again, I remind you of environmentally friendly infrastructure networks, a better and less costly healthcare system than in the US, although that may be changed now, a lower poverty rate than in the US, better protection of workers' rights, and a more energy efficient, low carbon economy than in other advanced countries.

#### Slide 13

Of course, there are also important weaknesses in the pre-crisis EU growth model. For instance, productivity growth did not accelerate, and in particular the productivity performance in the services sector was poor because lack of competition was there, because there were organizational rigidities that hampered the optimal use of the new IT technologies. Then we had the problem of aging population that increased the cost of the welfare state, taking out resources that could have been put

to a more productive use. High labor protection had, of course, positive social benefits, but it also hampered mobility and, therefore, led to a less efficient allocation of resources. Finally, labor force participation was too low, in particular in the Mediterranean countries.

#### Slide 14

So after the collapse of the old growth model, we are now looking for a new one. To be more precise, at this stage we are just trying to identify and put in place some of the pillars that will support the new growth model. In this respect, I see five pillars that will differentiate the new growth model from the old one: A more balanced growth is necessary. There is a need for more and better regulation and supervision in financial markets, less inequalities. We want to have flexicurity, which is the European buzzword for a social system in which you have both flexibility in labor markets and security for the workers; and again a more sustainable, environmental-friendly growth.

#### Slide 15

So, what does this post-crisis EU growth model look like? The EU is trying to move in that direction through a new strategy which will actually be adopted today by the European Council, and which we have called the Europe 2020. The strategy is based on three mutually reinforcing priorities. We want to go towards a smarter way of growing, developing an economy that is based on knowledge and innovation. We want to go to a sustainable growth model, which provides a more resource-efficient, greener, and a more competitive economy. And we want to go for more inclusive growth that fosters high employment and delivers social and territorial cohesion.

#### Slide 16

In this EU 2020 program, we have identified a number of headline targets. We want to increase the employment rate from the current 69% to 75%. We want to increase the percentage of GDP that is invested in R&D. We want to have the so-called 20/20/20 energy targets, which means, that we reduce greenhouse gas emissions by at least 20% compared to 1990 levels. We increase the share of renewable energy to 20%, and achieve a 20% increase also in energy efficiency. We want to improve education and reduce the poverty rate by 25%.

#### Slide 18

I would like to bear in mind that no growth model, no growth strategy can succeed in isolation. We have learned from the crisis in the 1930s that protectionism and isolationism delayed the recovery, and of course is very bad for democracy, so it is very important to respond to the crisis in a coordinated way, and the G20, as the premier forum for economic policy coordination, will play a very important role in that.

## Comment

(Sahoko Kaji Professor, Faculty of Economics, Keio University)

As a private sector economist, I can afford to be shocking and probably provocative to the general voting public.

The question is: Which part of the model failed? Dr. Bekx's answers are summed up here. One is the unsustainable current account imbalances and levels of leverage. Behind this are two of his keywords, I think, globalization and competition. Then poor financial regulation, behind which were also a lot of his keywords: deregulation, privatization, competition, innovation, and finance.

The question I would like to ask after his excellent presentation is: Is it enough to aim at smart growth, sustainable growth, and inclusive growth? As someone who has studied The Lisbon Strategy to a certain extent, I think I can say that aside from the emphasis on sustainable growth, this is not very much different from The Lisbon Strategy so I am reminded of the French saying, "Plus Elle Change, Plus Elle Reste La Môme Chose" which is, "The more you change, the more it remains the same."

I personally have more fundamental questions that I would like to ask. Should we try to shrink current account imbalances, in order to shrink external borrowing and lending? After all, if global imbalance was one of the key sources of this present crisis, we have got to get rid of it somehow. The second question I ask is: Would we be better off necessarily with "better" financial regulation?

So there are two cold facts here. Each related to the two fundamental questions I am asking. One cold fact is: Private sector balance plus government balance is equal to external balance, which happens to equal current account balance, which means we cannot change external balances without changing private balances and/or public net saving domestically. In other words, unless the private sector changes its savings-investment balance and/or the government budget balance changes, we cannot change our external borrowing and lending status. Zero external balance means, for that period, when external borrowing and external lending is equal, which means you are not in danger of not being able to pay what you owe to foreigners. That means that the current account is in balance. So to be perfectly sure that you are not owing dangerous money to foreigners, your current account has to balance.

Finally, financial markets are inherently unstable. There is nothing we can do about it. The new financial instruments, which turned out to be dangerous, were developed exactly to get rid of those dangers, to cover for this instability. So, it is a bit like pushing a beanbag, which probably translates nicely into Japanese as "Otedama." You press it and one part goes in but the other part sticks out. So, you cannot get rid of this inherent instability in financial markets. We have to deal with it.

On top of that, it is very convenient to bash the bankers but nonfinancial firms have benefited from such instruments such as derivatives as well. We need to keep that in mind.

The final point that comes out of all of this is: Can we optimize the two roles of money; store of

value and medium of exchange, at the same time. We need to grow our savings in order to pay for old age but that means we have to play dangerous games. That has the possibility of hurting the function of money as a medium of exchange.

(Martin Schulz Research Fellow, Fujitsu Research Institute)

I come from a private industry think tank, so for us the world looks a little bit different. We have not been living through a paradise throughout the last decade. We have been living through a decade of extremely hard work, lots of frustration in many ways, and many changes. We are now in a situation, which is certainly not paradise, but we are basically heading in two directions.

Thinking about new growth models, what could be changed, what could be good for the future? How can we regain paradise but we have to leave this to the government and to universities?

What we are doing at the private industry research think tank is we look at why our people, markets, behave in the way they are behaving. How come that we were running into these imbalances? We are not asking the question: Is it really good or bad. It is just what can we do about it? How can we work with it?

The main point here is that the last boom produced something really remarkable in Asia. This is the first major crisis where Asia is not falling apart, where Asia is still growing. It should have fallen apart when demand in the US is going down. But China is growing, Thailand is growing, and most of Asia is growing. We have production networks throughout Asia, including Japan, that are working, that are producing again and that are producing demand again. This is the result of the last boom, which is extremely positive. It is integration from the market side bottom up. You should not forget about this.

Financial markets had a role to play in this. We have major capital flows throughout the world. We have major imbalances, of course, but they produce something, which might be a new level now we can work on. This is the question also of this workshop. What happens next?

We already had an excellent presentation, which showed that developing emerging countries are now growing even stronger than before and, more or less, rescuing the world. Again, this is not paradise found again where the emerging countries now take over and do everything. These are lots of government investment in these countries, rescuing China and many other emerging countries. They will run into trouble with this. Government investment has not become much better and smarter throughout the last year. So, there will be readjustment again. But, very importantly, we will most likely see new demand coming up. The last boom was very much driven by demand in financial industries, high equipment value-added gadgets, and whatever, because the US was booming. This was an imbalance.

Now, we believe that emerging developing countries are growing stronger for quite a few years to come. What does this mean? Demand for old industry products. Demand for the stuff Japan and

Germany are producing, for example, chemicals, steel, technologies to produce electricity, demand for raw materials. On the back of this, Africa probably will grow, which will help the world economy tremendously. This has not happened before as well. Plus, the old imbalances will probably come back. Now we can say we have to fight it. Probably old industries in Japan will be coming back over the next year. We are seeing this when we look at the sector numbers already now. We will probably see higher export numbers from Japan.

What can we do about it? Japan-Germany will most likely not stop to be manufacturers. This is because we are mature, aging societies. We have troubled, being old, going out of one industry and going into a new one. We will not become bankers or software engineers or whatever next month. We will still continue to produce the products we do, but we have to do it in a sustainable way. How can we do that?

Very easy. Demand is there for the products of these mature economies and there is demand for capital because now young developing countries are growing stronger. This is brilliant news. It helps support the demand for this structural problem in these aging economies but what we have to do is we have to bring our technology, our production facilities into the emerging markets. This is what is already happening, what Japan is doing. We are investing in Asia. We are producing in Asia, not so much at home anymore. My company is not producing that much or exporting that much anymore. We are working in emerging countries already and this is going on.

So, the new balance will be investing from mature economies into the emerging ones; transferring technology, using it there, achieving growth and income overseas and having this for our pensioners throughout and appropriately deregulated and a very effective financial industry turned into higher interest rates, into higher returns, higher dividends that will then increase demand for the products produced in emerging countries.

I think this would be the new paradise but an accessible one, a near-term goal, I think we should support this from the government side, not so much with lofty ideas but with basic deregulation, support for global trade and support for global investment.

(Tetsuro Sugiura Senior Managing Executive Officer, Chief Economist, Mizuho Research Institute)

Dr. Bekx talked about the balanced economic growth is a must and in Mr. Schulz's also referred to a well-balanced economic growth, so I understand that is a very important point. When we think of the balance between finance and economy, finance was bloated compared to the size of economy and that created bubble and might have resulted in financial crisis. If that is the case, we have to think of another optimal balance. When we think of a balance between developed countries and emerging countries, to make sure the further sustainable growth in emerging countries, we have to think of the exchange rate and economic policy, and also cooperation is indispensable to achieve this. Besides,

balance between market and the government, if there is excess in the market that that might be the background of the financial crisis we actually saw, then the optimal balance will be necessary between them.

Regarding that last point, there is some question mark in my mind. For example, before the crisis, we saw that the market has become too grown and become too powerful. During the crisis, because of the government's intervention, in other words, we increased the role of the government and we got out of the crisis and as Chairman Hatakeyama mentioned, because of the support of the government, the world economy is now enjoying recovery.

So, what sort of balance should we strike in the future? In particular in Japan, there is a school of thought, which emphasized more on the role of government compared to other countries. So, in terms of the growth strategy, some say that the government should select future potential growth industries and give support, and when Japanese companies would like to acquire overseas markets for infrastructure development projects, some say the government should give support to them. Moreover, some say that anti-monopoly law should be relaxed so that there will be a very strong and powerful company like the ones in Korea. Therefore, even if we restrict the certain competition in the market, it is said that maybe we need gigantic companies.

In terms of rectifying a disparity or having a good social security system, yes, the government can play an important role, but in terms of economic growth, I think if the government's role is too big, that will be an obstacle for the economic growth. For example, if the government nurtured certain future growth sectors, it did not result in the overall growth of the economy. That is the historical fact. If you want to allocate sufficient manpower and financial resources in future growth sectors, I think market is optimal to do so. In 1990s, there was a recovery of the US economy because market played an important role to allocate the resources to different companies and sectors and it worked.

So, we should not think that the government should play a very important role like now. Although it is true that we should have regulations and systems in which market can function well, we should place emphasis on the market role. Market liberalization, market opening and deregulation will be necessary. In other words, through the competition, there should be optimal allocation of resources, and I think the market is the one who plays that role.

## **Discussion**

First, primary concern is the achievement of the post-crisis growth model "Europe 2020," which is seen as an alternative to the Lisbon Strategy. The key issue is the employment rate in Europe. How is it possible to raise the average male and female employment rate from the current 69% to 75%? Given the productivity levels, wage cost has to be reduced in order to increase the demand for labor; however, wage cost needs to be increased in order to stimulate the supply of labor. Thus, an

inconsistent paradigm exists here.

Discussion on the characteristics of the present financial crisis elaborates on the following three points: (1) For the first time, Asia has not been at the center of a crisis; (2) This crisis has resulted in imbalances; and (3) The IMF is responsible for this crisis because of the policies it had implemented in 1997 Asian economic crisis.

After deliberating on decoupling, the early recovery of the markets in emerging economies was compared to the economies of developed countries. What are the reasons for this smooth recovery in emerging markets? One reason is that the emerging economies were less affected by the crisis directly because of their relatively unsophisticated financial sector. Another reason is that many emerging market economies, especially China, proactively adopted unprecedented stimulus measures. Moreover, capital inflows, equal opportunities for acquiring information owing to the IT revolution, and financial deregulation are seen as additional factors responsible for the growth of the emerging market economy.

However, with regard to China, its domestic consumption was still weak. The recovery of an economy mostly depends on the government's investment on infrastructure or other system facilities. Inflation is another issue related to the recovery of an economy. Sometimes, investments have to be regulated in order to tackle the difficulties involved in controlling inflation. Therefore, there is growing concern over the inevitable double-dip recession. However, the solutions for these problems are fairly straightforward. From the economic point of view, governments can implement relatively simple measures to ensure an increase in consumption and reduction in saving. For example, they could reduce education costs because people are saving funds as a precaution in order to finance their children's education. With regard to the issue of inflation, appreciating the exchange rate of the renminbi will significantly contribute to complement the weak stance of China's monetary policy and possibly reduce the risks of inflation and additional asset price bubbles. In addition, state-owned enterprises were focused upon because these enterprises are not sufficiently taxed and are allowed to retain vast amounts of profits, which are then not invested in an ideal manner for the economy. Even though a number of measures need to be adopted, a double-dip recession originating in China is virtually nonexistent.

Then, what types of countermeasures can developed countries including Japan take to avert the crisis? Although developing countries have been working extremely hard through the last decade, there has still been an enormous discrepancy in wealth and income between the developing and developed countries. However, in recent years, developed countries such as Japan and Germany, too, have been afflicted by a deflating economy. Germany has been cutting down on labor costs and contracts and improving productivity, which has now made them economically strong. Presently, Japan's economy is also extremely strong but this is not visible yet. The interest in Japanese products will be tremendous in the near future. However, if developed countries focus solely on domestic



issues, it may result in them ignoring this new development. Thus, it is necessary for them to participate in global growth summits more often.

On the other hand, another pertinent question is related to the effect on the employment rate in developed countries in case the majority of their population invests significantly in developing countries. On the basis of the projections made by *The Economist*, the so-called middle classes in developing countries have risen by 1.3 billion people, and it is considered that this is a huge potential market that can contribute to job creation in developed countries. If Japan and Europe can unleash the entrepreneurial energies of their younger population toward the developing economies, a very bright future for developed countries will be anticipated.

Regarding the influence of neoliberalism on the global economy in the last decade, it is the financial sector and its lack of supervision that has led to the present financial crisis and not deregulation and competition. Thus, liberalization has affected not only the economy of the United States but also the global economy at large, so the excesses of market forces or laissez-faire should be regulated even in industrial sectors, such as environment and food, and the financial sector would need strict supervision. However, all the countries that have been worst hit by this crisis are not necessarily had a neoliberal ideology. Therefore, simply expecting cooperation and not focusing on the global competition is as big a mistake as relying completely on the markets.

Finally, concerning the role of Europe in the post-crisis growth and its currency, the euro; since the introduction of the euro, Europe's visibility in Asia and Japan has increased by a large extent. However, it is argued that Greece and other southern countries' crises might jeopardize the euro's solidity, *raison d'être*, and continuity. It is also regarded as if European policymakers and leaders are heading in different directions when they say different things. However, there are great expectations that Europe will overcome these difficulties; and the euro will continue to play an important role in the global financial arena. If the euro had not existed, what would have been the situation of individual countries in Europe during the crisis? These countries would have probably resorted to protectionism and competitive devaluations.

Asia, too, could possibly benefit from a system to balance the exchange rates in the region, but the problem in adopting a common currency is that countries adopting it lose the opportunity of adjusting their productivity differentials. Because of the diversity in their economic power and labor productivity in East Asian countries, they prefer NAFTA-type collaborations, which open up the market, reduce the tax, customs, however, retain the exchange rate at the present levels to adjust the structural rigidities or differences between the trading countries.