Challenges to Development in Our Globalizing World

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We expect two sets of challenges will retain prominence over the next decade, differentiated with the respect to the timeframe one has in mind. In the short run, conflict over trade and exchange rate policy and the associated imbalances in global flows of goods and capital will remain as a basic threat to the resumption of growth and global macroeconomic stability. The interesting question here seems to be whether the G-20 has the capacity to play any role in the resolution of this conflict. Over the medium to long term, however, the main challenge that the developing world will continue to address will be the quality of economic governance. In particular, there will be a strong need to prioritize; given the complex way in which institutions come about and change over time, are there any policy actions or reforms that can accelerate the emergence of good institutions of economic governance? We elaborate on these two sets of issues in this article.

The Prospect of Currency Wars

Where is the world economy heading? This is a question on everyone's mind. While the threat of global depression was averted thanks to enormous fiscal stimulus programs and unforeseen monetary expansion, the recovery in industrialized countries has been rather slow. This is not very unusual. It is similar to what happens in systemic crises—crises that threaten and shake up a country's economic system. A typical recovery after a systemic crisis has two characteristics. First, to the extent that the country's debt burden is high—be it public, private or external—the recovery will be slowed down by worries about the debt sustainability or what is called the debt overhang. Second, the recovery is almost always jobless. That is, even after the economy starts growing, the unemployment rate is stuck in its new plateau for some time.

What differentiates the current recovery from previous recoveries in advanced countries is the epicenter of the crisis. The financial crisis basically originated in an advanced economy, the United States, and has significantly shaken the financial markets of another advanced economy, the European Union. During the recent emerging market crises, the capital outflows from these countries led to substantial depreciation of the domestic currency. While capital outflow made things worse during the climax of the crisis, it also made the recovery faster. The rapid currency depreciation would have eventually led to recovery through its expenditure switching effect. As the domestic currency declines in value, the country's exports mostly to advanced economies gain momentum while its imports decline. Both lead to an increase in demand for domestic products and hence lift the whole economy with it.

The 2008-09 global crisis did not lead to a substantial devaluation of the dollar. To the contrary, during the climax of the crisis, as the major global vehicle currency, the U.S. dollar appreciated against other major currencies as all financial players were scrambling to stay liquid in the face of increased financial risk. As the global depression was averted, the U.S. dollar started to lose against other currencies. This trend was reversed at least against the euro when the Greek sovereign debt problem was allowed to turn into a euro crisis.

Recent developments in the currency policy area show that the slow recovering industrialized countries are trying to find ways to grow again. Once

the crisis was averted, they start thinking more about what they could do to accelerate growth in the recovery stage. The fact that China continues to keep its currency undervalued pits three advanced economies (the U.S., the EU and Japan) against each other. When domestic demand starts to increase slightly, most of this extra demand spills over to China as Chinese goods continue to be more competitive. As the expected appreciation of the yuan against the dollar, the euro and the yen does not take place, these countries are pressed hard to follow policies that will at least turn their bilateral trade in their own favor.

As the euro debt crisis reached its climax in May through July, the euro depreciated substantially against other currencies. This definitely helped those European countries that rely heavily on exports, particularly Germany. As the euro depreciated, Germany's exports increased substantially, whereas U.S. exports stalled and the trade deficit expanded rapidly to reach $130 billion in the second quarter. As the upward tendency in the trade deficit continues, the U.S. Congress and the Obama administration increased pressure on China to revalue its currency.

Chinese officials continue to protest U.S. pressure, arguing that if China were to slow down there would be domestic backlash. In order to fulfill existing high expectations, the Chinese government claims that China must grow at a 10+ percent rate a year. While China looks at binding domestic constraints, it is completely ignoring external constraints that will also soon become binding. If the current exchange rate policy continues while U.S. imports surge, U.S. exports will slow down and unemployment will continue to increase or at least not decrease. Consequently, Americans will ask for retaliation against China in the form of trade restrictions.

As a result, the EU, Japan and many emerging market economies will also have to rely on restrictive trade policies. If China continues to rely on its undervalued yuan for the long term, its trading partners will have to use policy measures that will curtail this. Such a policy response in the end may to lead currency and trade wars between the significant players in the world markets. All countries have to do their best to avoid such an outcome. When South Korea used an undervalued currency policy, it was not as harmful to other countries, especially at a time of growth. China is different from South Korea and other emerging market economies. Through its exchange rate policy, it inflicts substantial job losses in many industrialized and emerging market economies. In the "new normal" age of global economic relations, macroeconomic imbalances either through exchange rate policy or through loose monetary policy or excessive private consumption cannot be tolerated for a long time.

The challenge ahead for think tanks from G-20 countries is to discuss the possible mechanisms to coordinate exchange rate policies across industrialized and emerging market economies. One conclusion we can reach from the recent great recession is that keeping the value of some currencies artificially low for a long period while others are freely floating will lead to imbalances that cannot be sustained in the long run. Those countries with fixed exchange rate policies should be asked to undertake periodic adjustments in their exchange rates to partially reflect their balance of payments position. As the currencies that are already in a free float regime automatically adjust in response to developments in the balance of payments accounts, a coordination in exchange rate policies will help the long-term orderly growth of the world economy. As the U.S. and other hard-pressed industrialized countries undertake expansionary monetary policy, depreciation of their respective currencies will allow them to recover from recession. In the medium-term, as the U.S. economy starts to recover and the monetary policy is tightened, the pendulum will swing back and the dollar will start to appreciate.

Can Reforms Accelerate Institutional Change?

In the long-term, we view institutional reforms as a major pillar for achieving development goals. Many economists and political scientists believe

that institutions of economic governance—that is protection of property rights, enforcement of voluntary contracts, and provision of public infrastructure and services that support private economic activity—are important determinants of long-term growth. Institutions themselves are the consequences of the distribution of political power, which itself is largely determined by political institutions. From a policy perspective, the problem is that institutions have a lot of inertia and change is slow. In many formally democratic developing countries, political institutions do not favor the creation of institutions of good economic governance but of patronage and clientelism and not of a merit -based bureaucracy but of politicization and political favoritism.

The question then is: are there a subset of reforms and measures that would facilitate the transition to better institutions of economic governance?

In this regard, the Turkish experience suggests a number of potential areas of reform. It shows that despite democratization attempts and market-oriented reforms that have been taking place since the 2001 economic crisis, the rather weak internal democracy of political parties and the politicized bureaucracy of market regulatory institutions continue to form a serious blockade to the sustainability of long-run growth.

To start with the structure of political parties, the current constitution, the political party and election laws make it almost impossible for the rank and file to rise within a party and form a serious opposition to the incumbent party leader and his cadres. The charismatic leaders can take the whole party apparatus under control and govern the party single-handedly. Once the party forms a single-party government, then the whole country will be governed by the decisions of a single person. Such a set up has very damaging consequences for governance in general and economic governance in particular, and obviously is not sustainable in the long run. This structure inhibits contestability at the level of political parties. It implies that acquisition of power within the party occurs not on the basis of competence to do good public policy, but on the basis of affinity to the leader. More generally, it creates mechanisms of adverse selection whereby competent politicians may indeed not be allowed to reach above a certain level in the party hierarchy for fear that they may one day pose a challenge to the power of the incumbent leader. Further, it creates incentives for political competition to be carried out on the basis of patronage and clientelism rather than good economic governance.

The Turkish experience also suggests that the questions of the quality of the bureaucracy in general and of regulatory agencies in particular are closely linked to the political structure described above. Since the 2001 economic crisis, Turkey established several market regulatory institutions. The objective was ostensibly to delegate regulatory authority from the ministries to the agencies so that regulatory interventions would not be distorted by day-to-day political favoritism. However, most, if not all, of these regulatory institutions are heavily controlled by the party/parties in power. Bureaucrats are not necessarily appointed on the basis of merit, but rather on the basis of political loyalty. When political loyalty becomes the critical factor influencing the appointments, the bureaucratic apparatus becomes completely under the tutelage of the politicians. Such a system carries the risk of making the whole bureaucratic apparatus inefficient. This is so for two reasons: first, appointments not based on merit reduce the average quality of bureaucrats, which in turn reduces regulatory quality and competence. This is called the selection effect. Second, in a non-merit based system of public management, appointed bureaucrats have lower incentives to produce good public policy and higher incentives to please their political patrons; this is called the incentive effect.

In the Turkish case, both effects are visible in regulated industries such as electricity and telecommunications. In these sectors, the regulatory agencies should function effectively on a daily basis to have a real impact on competition in service markets, which in turn have significant implications for the competitiveness of the manufacturing industry

and the long-run growth prospects of the whole economy. It is, therefore, critical to depoliticize at least the bureaucratic apparatus of the regulatory institutions. However, one should also be careful in making sure that the de-politicization of bureaucracy does not lead to the other extreme case of creating technocratic/bureaucratic elites that have complete autonomy. Hence, encouraging the merit system should be reinforced by mechanisms that increase transparency, accountability and allow citizens to express their voice.

This is already a tough list of reforms. Further, there may be potential conflicts between the need for reform and short-term political interests of governments. This raises a number of questions: are any of these reforms "more binding" than others? Can they be prioritized? Is there a sequencing aspect? Would some initial success facilitate success in others? Addressing such questions may provide significant benefits in the quest for better institutions of economic governance.