Closing Summary

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For two and a half days (June 22–24), the participants in the twentieth Annual Bank Conference on Development Economics engaged in a series of high-quality discussions and debates on the most pressing economic and development policy issues of our times. The World Bank's Development Economics Group is grateful to the Republic of Korea's Ministry of Strategy and Finance and the Korea Development Institute for their generous hosting of this annual international conference on development policy and research.

The timing and place of this conference were especially appropriate. As outlined at the start of the conference by Jeung-Hyun Yoon (Korea's minister for strategy and finance), Justin Yifu Lin (chief economist of the World Bank), and Il SaKong (chairman and chief executive officer of Korea's International Trade Association), we face great development challenges. In the short term, of course, policy makers worldwide and the international financial institutions have focused their attention on the financial and global economic crisis. This effort has already led to important institutional innovations, such as the rise of the G-20 as perhaps the premier economic grouping, huge debate on the strengthening of existing global institutions and perhaps on the need for new ones, and thinking on effective fiscal stimulus, including the opportunities for a "green" stimulus. We are in the midst of the crisis and need to increase our understanding of its causes, its impacts, how to exit, and how to change financial regulation to reduce the risk of recurrence.

However, we also face longer-run development challenges. Even before the crisis some 1.4 billion people were living in absolute poverty. Can countries implement industrial policy effectively and, if so, how? How can they accelerate technological upgrading needed for sustained growth? Can we better understand social capital and how it affects development and how it can be harnessed for favorable, rather than

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negative, effects? How can slowly growing regions learn from the rapidly developing "miracle" countries of East Asia, like Korea? How do countries "take off"?

These issues and more, including climate change and the challenge of Korean unification, have been the focus of this conference, and, in the discussion of both the crisis and longer-run development issues, the focus has been on the role of the state, its interaction with market processes, and the institutional underpinnings of effective policy.

Since it is impossible to summarize a two-and-a-half-day conference in a few pages, we will therefore only highlight a few takeaways in this note.

Industrial Policy

When can industrial policy be successful? One view emphasizes the nature of the underlying political economy equilibrium—it is successful only when those implementing it have an incentive for it to succeed rather than to redistribute rents to supporters, as addressed in the papers by Jim Robinson (Harvard University) and Ha-Joon Chang (Cambridge University). Another view sees some forms of targeted policy as inevitable and indeed—as shown by Asian experience—essential for rapid sustained development, given market failures. With "good enough" political conditions, countries can implement such policies if they go about it in the right, pragmatic way. Past experience provides many lessons. Monitoring effectiveness is crucial, and export performance is less easily manipulated. There need to be strategies for exiting from failed policies, strategies that take into account the fact that the policies will themselves create new pressure groups seeking favored treatment.

Social Capital

The discussions in the papers by Partha Dasgupta (Cambridge University) and Masahiko Aoki (Stanford University) focused on the micro-foundations of social capital. The basis was seen as "trust," which itself is rooted in reciprocity—repeated engagements in a multiple-period game. One essential parameter is the discount rate: if it is too high, future exchanges are discounted, leading to a tipping point—a breakdown in mutual enforcement and a disintegration of trust. The combination of a series of interlinked social and economic games can sustain equilibrium outcomes that are impossible with just one or the other alone. This is a useful advance in thinking about the micro-foundations of social capital. More research is needed in this area, and a better understanding of the roles of dense social networks—for example, among elites and the implications of ethnicity for such networks—is important when trying to understand the institutional basis of economic decision making. The subject has a "warm glow," but certain types of social capital can also be harmful.

Globalization and Economic Success

In the 1960s Korea was at the level of income of Africa and often considered a hopeless case. However, Korea evolved a coherent and cohesive development policy, and incomes rose more than tenfold in about 40 years. Korea exploited the opportunities afforded by globalization; exports were 3 percent of gross domestic product (GDP) in 1960 but 38 percent by 1980. These opportunities are still there, even if in somewhat modified form. Africa differs from Korea in several respects, but there are many lessons, including the importance of nurturing small firms to provide a basis for growth and reducing the level of inefficiencies in the business climate.

Even if global growth may be slowed as households adjust demand in an effort to reconstitute their balance sheets after huge losses, the postcrisis world economy still provides opportunities for growth. Indeed, because capital is likely to be more costly for an extended period, there is a special premium on the effective use of labor and an opportunity for well-managed labor-abundant countries, including in Africa. But it is vital to secure free trade, and developing countries, which have much to gain, should be more vocal in advocacy, as discussed in the paper by Anne Krueger (Johns Hopkins University).

The themes of globalization and development were echoed in several discussions in this conference:

- *Innovation.* Innovation is greater in countries that are more open to equity-type capital inflows, especially if they have greater capability, and the development effect could be magnified after reaching a certain threshold of development per capita, as covered in the papers by Philip Lane (Trinity College, Dublin) and Sunchul Chung (Science and Technology Policy Institute, Seoul). The remarkable record of Korean innovation and its positive effects on the supply side should be required reading for other developing countries. The Korean strategy favored export-oriented firms, which were more exposed to global competition. These firms in turn benefited from government expenditure on research and development (R&D), initially absorbing almost all of the country's R&D expenditures and now accounting for only 20 percent.

- *Crisis.* Some rethinking is required about countries' growth strategies in a global context, as covered in the presentations by Simon Johnson (Massachusetts Institute of Technology), Olivier Blanchard (International Monetary Fund), Anne Krueger (Johns Hopkins University), and Jong-Wha Lee (Asian Development Bank). The challenges include increased vulnerability to massive and sudden capital outflows (some think some forms of controls on inflows may be necessary, but others disagree); the need to find a better reserve currency than the U.S. dollar, which may take a long time to emerge; and the need to rebalance the surplus of some countries and the deficit of the United States. However, as private consumption declines in the United States (as private saving increases), other countries will need to consume more. A big question confronting policy makers is, who will pick up the slack?

- *Exit strategy.* Some very difficult balancing acts are needed for countries to exit from the crisis. A transition from the massive fiscal stimulus is needed. This will require significant (and often politically difficult) structural fiscal reforms. Also, there is a need to rethink monetary policy and inflationary goals, with some arguing that somewhat higher inflation targets are needed.

Financial Markets

Regulation of the financial markets clearly needs a major overhaul, as discussed in the paper by Stijn Claessens (International Monetary Fund) and the keynote speech by Simon Johnson (Massachusetts Institute of Technology). Markets are prone to crises and regulatory cycles. This can reflect reasons of political economy, as an extended period of calm reduces the perceived need for tough regulation, as those who will lose from a potential crisis (taxpayers) become complacent. Conversely, crisis periods are prone to induce overregulation, as those who will benefit in the future from less regulated and more entrepreneurial finance will not be heard, as demonstrated in the paper by Joshua Aizenman (University of California, Santa Cruz, and National Bureau of Economic Research). More regulatory independence is needed together with more disclosure to reduce information asymmetries. However, there are also operational reasons for procyclicality, for example, in market risk management, regulation itself (capital adequacy), as well as macrofinancial regulation; we still look at institutions individually.

Crises are not all bad, however: it was observed that countries that had experienced financial crises grew on average more than those that had not, a paradox resulting from their more entrepreneurial and less overregulated financial sectors. This somewhat comforting conclusion confronts two particular features of the current situation, however.

First, globalized finance has outstripped the patchwork of national regulation. There is no system of global financial governance, neither regulation and supervision nor lender of last resort nor global fiscal authority. Neither is there at present a clear alternative to the U.S. dollar reserve currency system, despite the tendency for such a system to be unstable in the long run. Neither is there a clear policy to deal with large systemic macroeconomic imbalances. Far deeper reforms are needed of the international system, especially to head off the most damaging types of recessions, those that, in part, are widely synchronized and accompanied by financial crises. The conference participants discussed these reforms in some detail, including enhanced liquidity support (reserves, International Monetary Fund enhancements, currency swaps by the central bank of the reserve currency) and the need to adapt global regulation to the conditions of developing countries. A better global system is needed to make it safer for developing countries to open up.

Second, nothing has been done to reverse the state capture by the financial sector that has taken place since the 1980s. It was argued that "finance on steroids" has outstripped its usefulness to the productive sectors and to consumers. Its power and wealth, which were increased by deregulation, has driven an ideology that "finance is good" and resulted in institutions that are too big to fail. Nothing has been done to reverse this trend; on the contrary, with consolidation, the largest institutions post-crisis will be even larger, exacerbating the problem of moral hazard and powerful oligarchies, with enormous current and future claims on taxpayers. The answer, as in previous oligarchic cycles, is to break up the largest banks.

But no such fundamental steps have yet been taken, and the outlook is not promising, especially as many of the current features of the crisis, including outrage at bankers, had been features of previous crises. As illustrated in the paper by Giovanni Zanalda (Duke University), societies have the opportunities to draw the right conclusions from crises, but they often fail to do so.

Other topics were covered in a range of interesting papers and discussed at parallel sessions:

- Decoupling or recoupling of East Asia (change from unidirectional—North-South—dynamics to a bidirectional relationship)
- Relationship between exporting and productivity growth (self-selection versus "learning by doing," which is stronger for firms with some capability)
- Implications of production networks
- Household and firm responses to shocks
- Implications of adaptation of the euro
- Climate change
- Korean unification

The discussion on climate change noted the need to "turn the discussion upside down" with a shift in focus from technical and physical issues to social ones, with a strong emphasis on people and a local stress on adaptation. It also noted the gap in trust between developed and developing countries in the global architecture—the reluctance to recognize the "polluter-pays" principle and the lack of credibility that existing shortfalls from aid commitments create for promises of additional support for climate change. The apparent gap in "trust" complicates efforts to find a globally optimal solution to the lack of adequate global social capital.

On the question of Korean unification, comparisons between Korea and Germany show that the difficulties of a similar unification process—unification before transition—would be far greater in Korea; the Koreas are more divergent than the Germanys were and more equal in size. However, they also show that such a process is very unlikely given the political conditions. Far more likely is a paced transition followed by extended unification. This would be a very different process, and possibly a win-win one, but there would still be severe stresses; for example, even with "two countries, two converging systems," Korea's constitution will make it impossible to block labor flows from the North as the regime is liberalized.

Conclusions

This summary can only offer a superficial picture of some of what transpired at this very high-quality conference. The exchanges that took place led to many useful thoughts and suggestions on how to face the formidable policy and development challenges facing all developed and developing countries in the world today. Finally, many of the sessions will provide inspiration for research in future years.