Economic Policies of a Small Open Economy in a Polarizing Global Economy

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Major changes in development thinking in the last fifteen years

- Broader goals
  - Not just growth, but sustainable, inclusive, and democratic growth
- More instruments and policy frameworks
  - Industrial policies can work
  - New instruments in old areas: macro-prudential regulation
  - New tools: Conditional Cash Transfers; Micro-credit
  - Better management of natural resources: better auctions, better contracts

Major changes in development thinking in the last fifteen years

- New actors
  - Now recognize importance of civil society
  - The provision of the public good is a public good, and will normally be "undersupplied"
  - New development banks
- A variety of institutional arrangements
  - Not just for-profit institutions and government
    - In US, some of the most successful institutions are not-for-profit foundations (e.g. universities)
  - Many examples of successful cooperatives

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Major changes in development thinking in the last fifteen years

- New thinking
  - The only sustainable growth is inclusive growth: Equality and growth are complements
  - Rents are pervasive in the economy—the competitive model does not describe well a modern economy
    - Who captures rents, what limits rents, how the rents are used becomes critical
- Neoliberalism has become thoroughly discredited
  - Led to more instability, lower growth, and more inequality
    - Structural adjustment programs in Africa led to lower growth and deindustrialization
  - Even the IMF has argued for the importance of equality
  - Even the IMF has argued for the use, at times, of capital controls
  - Privatizations have often failed

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Major changes in development thinking in the last fifteen years

- But the legacies are still with us
  - Trade and investment agreements
  - Eurozone constructed on its principles is a failure, and is dragging down global growth

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Major changes in development thinking in the last fifteen years

- New challenges and opportunities
  - Slowdown in global growth in 2015 is likely to continue
  - Slowdown in China is central
  - Contributing to end of commodity price boom
  - Most countries have not been able to offset forces leading to more inequality

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Major changes in development thinking in the last fifteen years

- In US, recovery likely to continue to be anemic
  - Capping a third of a century of neoliberal policies—leading to median income lower than a quarter century ago, median income of a full time male worker lower than four decades ago, and wages at the bottom the same as sixty years ago—a failed economy
- Eurozone stagnation likely to continue
  - Crisis is not over
  - Flawed at birth—based on flawed economic models

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Major changes in development thinking in the last fifteen years

- Export led growth model may be over
  - Global manufacturing employment in decline
  - Fight for share of that declining employment
  - Will have to be shift to services
  - Services are less traded
- New technologies have opened up new opportunities
  - Especially important in communication

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Explaining shift in development thinking

- Influenced by major successes and failures of the last 30 years
  - Which have also led to reshaping our understanding of development
- Development/growth beyond anything that had been thought possible
  - And contrary to what others (Myrdal) had thought would occur
- The success of East Asia, including China
  - Hundreds of millions moved out of poverty
- Based on government assuming a major role in the economy
  - But using markets

Explaining shift in development thinking

- Major debate about what it was that the government did that led to success
  - Different countries did different things, policies changed over time
- Also influenced by successes and failures elsewhere
  - Success of micro-credit schemes
  - Failures of most of transitions to market economy
  - 2008 crisis showed dangers of excessive deregulation

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Explaining shift in development thinking

- Benefits of growth do not automatically get shared
  - Trickle down economics doesn’t work
    - US prime example
- Similarly situated countries can have markedly different outcomes
  - Inequality in US much larger than in other advanced countries
    - Without any offsetting benefits, e.g. in growth
  - In some countries, inequality is even going down—inequality is not just a matter of economics

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Explaining shift in development thinking

- Inequality is a choice
  - A result of our policies, our rules, how we design institutions, what we spend money on, etc.
- That means politics matters—economics and politics inseparable
- Economic inequality gets translated into political inequality, which leads to more economic inequality in a vicious circle

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Explaining shift in development thinking

- Influenced by major changes in economic theory and research
  - New insights into failures of markets
  - Theories of imperfect and asymmetric information
  - Game theory/imperfect information
- Behavioral economics
  - Model of "rationality" underlying most economics flawed
  - Important implications
  - Policies can change beliefs, perceptions (central message of World Development Report of 2015)

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Metrics

- Metrics have become increasingly important, but wrong to focus narrowly on GDP
- The International Commission on The Measurement of Economic Performance and Social Progress emphasized deficiencies in measure
  - (a) what we measure affects what we do and the design of policy: Metrics are important;
  - (b) no single number can capture something as complex as our society;
  - (c) accordingly, there will have to be a "dashboard of indicators;"
  - (d) the dashboard which is appropriate for one country may be different from that of another;
  - (e) but among the metrics that should be included are those that reflect distribution and environmental sustainability;
  - (f) there needs to be improvements in the way we measure the value of government and other services;
  - (g) median income adjusted for inflation almost certainly reflects a better measure of what is happening to the typical individual, and therefore it should be among the numbers

Role of government

- Government policies need to pursue wider range of objectives, using a wider range of instruments
  - Government has both a regulatory role, a catalytic role, and a coordinating role
  - In the most successful developing countries in both East Asia and Africa, the government has assumed the role of a *development state*
  - Even in most successful advanced countries, government has played an important role in promoting technology—the *entrepreneurial state*
- We now know more about how government can successfully pursue these objectives, incl. to reduce the risk of "government failure"
- We need to broaden our analysis to go beyond thinking about the role of the state vs. the role of the market
  - More complex interactions
  - More actors, more institutional arrangements

Broader understanding of market failures

- Market, on its own, will lead to excessive borrowing, especially in foreign-denominated debt
- Market on its own will lead to too big and too intertwined financial institutions
- Need for strong financial sector regulations
  - Including macro-prudential regulations
  - Including regulations on cross border flows (capital controls)

Reforming monetary policy

- Single-minded focus on inflation was worse than was realized 20 years ago—it contributed to the global financial crisis
  - Even then, inflation target should have been higher
- Single-minded focus on interest rate is wrong—many more instruments
- Simplistic rules, e.g. "monetarism" and "inflation targeting" don't work
- Central banks need to *simultaneously use* all the instruments at their disposal
  - Both conventional instruments ***and*** regulatory instruments
  - Can't and shouldn't separate the two—need to be coordinated
- Capital and financial market liberalization often lead to more instability and less growth

Institutions

- Older theories paid little attention to many things that we now know are important
  - Held that institutions don't matter: What drives the economy are underlying economic forces (supply and demand)
- But institutions *do* matter—such as sharecropping
- Sometimes, these institutions can be *explained* (e.g. responses to imperfections of information)
- But there is no presumption that these institutional responses are efficient
- And institutions often persist when circumstances change, leaving dysfunctional institutions in place
- Many institutions exist to preserve power structures

Institutions and markets

- Markets are institutions
- Markets don't exist in a vacuum
  - They are structured by norms, laws, and regulations
- The way they are structured makes a big difference for how the economy behaviors
  - Can lead to stronger or weaker economic performance
  - Can lead to more or less inequality
- The Reagan/Thatcher era and WC entailed "rewriting the rules" in ways that led to slower growth and more inequality
  - There are alternatives which can promote development and equality

Industrial policies

- Central to economic/structural transformation
  - Key failure of many resource based economies was not to diversify during commodity price boom
- Justified in terms of standard theories of market failures
  - Affecting the structure of production and the choice of technology
- Broad objectives (not just GDP: environment, equality, employment, economic diversification)
- Especially important in creating a learning society/knowledge economy—
  - Real source of wealth of economy
  - Especially important in 21st century

Industrial policies

- Focus on knowledge spillovers/learning-by-doing effects
- Many instruments
  - Competitive and Stable Real Exchange Rates
  - In many countries, development banks have played an important role
- Need a development oriented intellectual property regime
- Agenda entails strengthening the public sector and enhancing its capabilities

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Industrial policies

- Every country has an industrial policy
  - Embedded in expenditure and tax policies, and basic legal framework
  - Some countries do not realize that they have an industrial policy
    - US policy: promote dysfunctional financial sector
    - Worked: sector grew enormously

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Special opportunities and challenges of small open Economies

Challenges

- Can't avail themselves of economies of scale
  - Therefore, more exposed to risk of monopolies, imperfections of competition, less able to adequately diversify
  - Markets will underestimate macro-economic benefits of diversification
  - Companies within country may be at a disadvantage relative to large foreign companies
  - Implication: greater need for competition policies and industrial policies to promote diversification; greater need for policies to promote SME's—especially access to finance
- More subject to being buffeted by global risks—but more need to remain open
  - Implication: need to have better systems of sharing—sharing risks and benefits of openness
  - One of major insights of Scandinavian countries

Special opportunities and challenges of small open Economies

Some advantages

- One can develop a small niche and be successful
  - Finland illustrates
- One may be able to achieve broader societal consensus, without the large divides so frequently exhibited in large countries
  - May not happen automatically
- One may more easily be able to detect abuses of market and government power
  - Information asymmetries may be less
  - Again: this doesn't happen automatically, need appropriate institutions and laws

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A word about natural resource economies

Present special problems

- Have been less successful than one might have expected: the natural resource curse
- Lower growth, more inequality
  - A result of failure to manage volatility, high exchange rates that disadvantage other exports and import competing sectors, and rent-seeking
  - Not inevitable: some countries have managed resources well, investing proceeds in people, infrastructure, establishing stabilization funds, managing exchange rates, diversifying economy
  - If proceeds are not re-invested, country is poorer (wealth below ground is diminished, while wealth above ground not increased commensurately)
  - Another example where GDP is not a good measure

Managing natural resource wealth

- Wealth belongs to the country as a whole, should be managed for the benefit of the country as a whole
- Good, well-designed auctions can maximize the value of the proceeds going to nation as a whole
- Good, well-designed contracts can provide good incentives, balancing risk sharing
  - Fundamental conflict between private sector and government
    - Private sector wants to minimize what it pays government, maximize government assumption of risk
- Transparency rules help ensure that the country gets full benefit and proceeds are well spent
- Wealth of experience of bad practices

Concluding comments

- Namibia has been relatively successful in its growth
- But has not done so well in achieving shared prosperity
  - With high unemployment, high Gini coefficient
- Namibia has the potential for performing still better
  - Taking better advantage of its resources
  - Better diversifying its economy
  - And taking on board the important lessons of development of the last third of a century