SPEECH

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■ Is there reason for confidence in the future of the economy?

Thank you for the invitation to take part in the KEPA day and share my thoughts regarding confidence in the future of the economy. I will speak about economic growth and internationalisation, draw a parallel between current events and historical events and then look ahead to the challenges and opportunities that an increasingly interlaced world economy will bring.

Since the Second World War, international growth has been higher than during previous centuries, while it has spread to a larger number of countries – never before have so many had it so good. During the industrial revolution in the 19th century, the growth rate in leading countries like Britain amounted to an average of 1.5 per cent a year. Since the middle of the 20th century, many countries have managed to achieve growth rates of between 5 and 8 per cent a year. These unparalleled successes of course have several explanations, some of the most important being extensive liberalisation of trade and capital flows, major technological advances and changes in economic policy. Assuming that the trend towards increased global integration continues, there is every reason to expect continuing substantial increases in economic wealth.

Although many people have experienced considerable improvement in their living conditions in recent decades, there are still far too many who have not yet been given the opportunity to benefit from the increase in wealth. In addition, there are still substantial environmental problems in many areas. However, the good results we have achieved since the Second World War show that we are on the right track - we need more and better globalisation, not less! I therefore consider that there is good reason for confidence in our economic future, but also that it is important for us to safeguard what we have already achieved, to make use of future opportunities that arise and to tackle the challenges that come in the wake of globalisation. As I see it, a strong multilateral framework is necessary to enable us to manage these challenges effectively.

The driving forces behind the increased wealth in the world

After the end of the Second World War, the architects behind the new multilateral economic system were determined to avoid a repeat of the fiascos during the 1930s, when countries introduced tariff barriers, made competitive devaluations and set up obstacles for payments. These measures halved world trade and led to falling GDP figures and declining real wages, mass unemployment and political chaos in large parts of Europe. The deliberate work on liberalising trade and capital flows, as well as payments for these transactions, within a strong multilateral framework began almost sixty years ago and is an important explanatory factor behind the increased economic growth we have experienced since then. The strategy was mainly based, within the framework of the GATT, on a gradual removal of trade barriers and the building up of a multilateral trade system via regular negotiating rounds and, within the framework of the IMF, to jointly promote financial stability and free payments, initially for current account transactions and later for an increasing number of capital account transactions. Moreover, the World Bank was established, whose primary purpose is now to reduce poverty in the world.

The endeavours towards liberalisation have been, and still are, very successful. With regard to trade, this can be illustrated by the fact that average tariffs on manufactured goods have fallen from over 40 per cent at the end of the Second World War to under 5 per cent today. Trade liberalisation has led, through increasing specialisation and competition, to a more efficient distribution of labour between countries, which has contributed to higher growth, and also to greater options and lower prices for consumers. However, the adjustments have not been easy, as we know from our experiences of the changes in the Swedish shipyard and textile industries. It is necessary that the people affected by them receive support to enable them to make a living in other industries and in other regions. However, despite the difficulties experienced by some people, these changes have on the whole led to improvements.

A lot of work remains to be done to liberalise world trade, which is indicated by the fact that the potential increases in wealth from continued liberalisation are substantial. Calculations made by the World Bank indicate that welfare gains of between USD 400 and 900 billion could be made if all of the current trade barriers were removed. More than half of these gains would fall to poor countries. The agricultural and pharmaceutical industries, where the poorest countries have their largest comparative advantages, would account for 70 per cent of the profits, that is to say, USD 230 billion. For comparison purposes, it can be mentioned that total foreign aid amounts to USD 60 billion a year, while the OECD countries' total agricultural subsidies are USD 330 billion a year. Increased trade liberalisation is therefore a better means of achieving wealth than foreign aid could ever be, because, to paraphrase the Chinese proverb, "if you give your friend a fish you will feed him for a day, but if you allow him to fish he will be able to feed himself for a lifetime".

The other major wave of liberalisation – the deregulation of the international capital markets – has enabled savings to be channelled to a greater extent to where they will provide the highest yield. When we Swedes were poor at the end of the 19th century, we borrowed money abroad, for instance to build the railways and the mine at Kiruna. Now we can invest our savings in emerging markets and obtain a better yield than we would at home, while we are contributing to the development of these countries. The free movement of capital has also enabled savings capital to be spread more widely and thereby reduced the risks entailed. This provides financial security both for the investor and the user of the borrowed capital. The effects of liberalisation are clearly reflected in the statistics: the Overseas Development Council has calculated that foreign parties invested around USD 1,000 billion in developing countries in the 1990s alone. In total, foreign direct investment increased by 400 per cent during the same period, and the corresponding figure for developing countries was more than 800 per cent. Recently published figures from UNCTAD show that the services sector now accounts for around 60 per cent of total foreign direct investment, compared with just under 50 per cent only ten years ago. If utilised properly, this development can improve export potential for poor countries, while also providing wealth gains for the countries importing the services.

However, experiences over the past twenty years indicate that we in many respects have had difficulty in liberalising the capital markets in the right way, which has led to capital balance and exchange rate crises in several countries. Much work has therefore been put into creating international agreements, norms and standards – with regard to, for instance, accounting principles, capital adequacy rules, bankruptcy legislation and collateral – with the aim of promoting stability and balance in the corporate and banking sectors. This work has progressed fairly well, and the main focus is now on promoting the observance of these standards. At the same time, it is important to remember that the basis for a successful liberalisation of capital markets is a stable macroeconomic framework aimed at price stability and sound public finances.

Up to the end of the 1980s it was only the free world that experienced the liberalisation in trade and in the capital markets and benefited from the ensuing growth in wealth. The spread of wealth is therefore closely linked to the change in economic policy that has swept through large areas of the world over the past fifteen years. After the economic implosion of the Communist states and the ensuing collapse of the Soviet bloc, it became clear to most people that it was impossible to achieve wealth or freedom in a planned economy. The fact that the failure of the planned economy finally became blindingly evident meant that not only the Soviet bloc, but also most of the developing countries that had experimented with planned economies abandoned these ideas in favour of a market economy approach. This led to the old Comecon, China, India and several other countries in Asia, Latin America and, unfortunately to a much lesser extent, Africa, becoming integrated into world trade and the global financial system.

The fact that many more countries are now participating in the world economy has been a contributory factor to the increasing economic integration over the past twenty years, when world trade has increased at twice the rate of GDP growth, direct investment has increased three times as much and both foreign exchange trading and share trading have been around ten times faster than GDP growth. This most recent "globalisation wave" has benefited more than three billion people and led to the doubling of annual GDP growth per capita in many developing countries; in China GDP growth per capita has even increased fivefold. The conclusion that increased openness contributes to higher growth is also supported by research; for instance, Sachs and Warner found in a study published in 1995 that open economies, all else being equal, grow at an average of 2 percentage points a year faster than closed economies. Although openness alone cannot provide growth, one fact is clear – there are no countries that have achieved wealth through autarchy and isolation from the rest of the world.

Openness is thus a necessary condition, but not sufficient in itself, for achieving wealth. Many other policy elements are required, including macroeconomic stability, a good standard of education, legal security, efficient bureaucracy and protection of private property, to create good conditions for broad growth in a market economy. The Peruvian economist Hernando de Soto was a pioneer in the study of practical bureaucracy in some developing countries. His view was that it was not primarily a lack of property that made people poor, but rather a lack of *legal* property. The problem is that many poor people have no paper to prove ownership of their property, because it is so expensive and complicated to obtain in most developing countries. De Soto showed that, for instance, in Lima, Peru, it took six years and eleven months going through 207 legal stages among 52 different public authority offices to obtain permission to build a house. Obtaining legal permission to start a small company required six hours work a day for 289 days to follow the various bureaucratic steps, and it cost 31 times as much as the monthly minimum wage applying at the time. The fact that poor people therefore cannot formally own their houses or businesses means that they can have them stolen from them at any time, without the guilty parties being punished. It is also impossible for these people to use their assets as collateral to take out loans and perhaps even to sell them. It is therefore crucial, according to de Soto, for developing countries to reduce bureaucracy and thereby release a mass of capital with the aid of the law.

The World Bank has extended the studies made by de Soto to include more countries. The recently-published report *Doing Business in 2005: Removing Obstacles to Growth* shows, for instance, that it takes on average more than twice as long to register a new company in poor countries than in wealthy countries and that it is also much more expensive, in relation to income. Most companies in developing countries therefore operate in the informal sector. Despite this, wealthy countries implemented more than three times as many reforms to improve their investment climate last year than were made by poor countries. Developing countries can thus, often using fairly simple means, ensure that more job opportunities are created by improving the opportunities for entrepreneurs in the formal sector and thereby promoting economic growth.

The final basic explanatory factor behind increased wealth that I wish to highlight here is the pioneering technological advances made, particularly in the fields of information technology, international communications and global transports. These have led to large cost savings, which in turn have enabled the rapid spread of technology around the world. This has helped, for instance, give developing countries the opportunity to diversify their exports to a greater degree. One example worth mentioning is that IT exports now account for almost 40 per cent of India's total export income. All in all, the percentage of manufactured goods in developing countries' exports has increased from 20 per cent in 1980 to just over 70 per cent in 2001 (however, in Africa the figure is less than 30 per cent). In addition, ICT developments, which have enabled more efficient production in networks and at a distance, have led to new sectors in the service industries being opened to trade and international competition. An important element in this process is the increasingly strong cooperation between ICT, trade and efficiently-functioning product markets that allows labour-intensive stages of goods and services production to be moved to low-wage countries, and that emphasises how closely linked the various components of the globalisation process actually are.

The effects of increased internationalisation on people's daily lives

I consider it particularly important to point out that although integration and technological developments entail large, and in many cases difficult, adjustments for individuals, they also have direct, positive effects on people's daily lives. The percentage of people living in extreme poverty – with a daily income of less than USD 1 – fell from 40 per cent of the world population in 1981 to 21 per cent in 2001. In absolute terms, this is a reduction from 1.5 billion to 1.1 billion people. A large part of this improvement is due to the rapid growth in China and India. Until fairly recently, it took at least two generations to double the standard of living, but in China, for instance, the standard of living is now being doubled every ten years. The average length of life in developing countries amounted to 65 years at the beginning of the 21st century, compared with just under 40 years in 1950. Even in Africa south of the Sahara the average length of life increased from 35 to 50 years before the spread of HIV/AIDS caused some decline. The ability to read has also increased dramatically since 1950, from 40 per cent to just over 70 per cent of the population. The corresponding figures for Africa south of the Sahara were from 17 per cent to 56 per cent, which is more than trebled. Another positive effect of increased wealth is that more people are expressing demands for democracy and human rights. According to Freedom House, the percentage of countries with some form of democratic government rose from 28 per cent in 1974 to 65 per cent in 2003. Another important aspect that should be highlighted is the environment. Studies show that higher growth initially leads to some deterioration in the environment, but that this phase is soon followed by clear improvements when increasingly wealthy countries can afford to safeguard their natural resources and invest in environmentally-friendly technology and production. The turning point appears to be when GDP per capita reaches approximately USD 5,000 a year.

Despite these successes, there remains a lot to be done before everyone benefits from increased wealth. Although developments are moving in the right direction, the total number of poor people is still a problem. If the fruits of globalisation do not continue to spread to more countries with a poor population and within countries, there is also a risk of more states collapsing or other political problems that could slow down growth in the poor countries, and also have negative consequences for the rest of the world. The growing discrepancy between different regions is therefore worrying. This was clearly illustrated during the 1990s, when growth in Asia averaged 7 per cent, while the figures for Latin America and Africa south of the Sahara were 3.4 per cent and 2.3 per cent respectively. There is a huge contrast between, for instance, China, which has succeeded in lifting around 400 million people out of extreme poverty over the past twenty years, and Africa south of the Sahara, where the number of poor people increased by 150 million during the same period. In addition to weak states and internal conflicts, the African continent is hard hit by HIV/AIDS, which in some countries has reduced the average length of life from 55 years in 1990 to below 40 years in 2002, and left many children and young people to their own devices, without any adult authority. One of the most important challenges in future is thus to try to integrate Africa into the global economy to a greater extent. Here, both the African countries themselves and we in the industrialised world can make important contributions.

Some historical reflections on globalisation and technological changes

Despite all the talk of the "new" global economy, the present international economic integration is actually no new phenomenon. During the fifty years prior to the First World War, there was considerable cross-border mobility for both goods and capital. Then, as now, the increased globalisation was driven by trade liberalisation and major technological advances, thanks to the development of railways, steam engines and electricity. In some respects the integration was even more extensive at the beginning of the 20th century than it is today. For instance, foreign direct investment was a much greater percentage of GDP, labour was much more mobile across national borders and even agriculture was more liberalised.

However, in other respects it can reasonably be claimed that the world economy is more interlaced now than it was a hundred years ago. The first difference is that a much larger percentage of the countries in the world now participate in the global economy, after opening up their borders to trade and investment and adopting liberal market reforms. Another aspect that should be highlighted is that although the net flows of international capital are lower than prior to the First World War, the total financial flows are much greater today. A third difference is that while the 19th century globalisation was largely driven by falling transport costs, today it is largely falling information costs, thanks to computers and the Internet, that are the driving force. This development has led to entrepreneurship becoming increasingly global, as it has become much easier to localise various parts of the production process to different countries.

An example using telegraphy and the current information technology can illustrate the significance of costs for the spread of innovations. Telegraphy was expensive; in the 19th century people had to go to a telegraph office or hire a telegraph boy and pay significant sums if they wished to send a telegram. In today's money, it cost them around SEK 2,000 to send a long-distance message of 20 words, while the corresponding cost today is around 10 öre for 20 pages. In other words, the variable cost is negligible and the fixed cost is moderate. We can therefore now find powerful computers and Internet access in most workplaces and in many homes. The costs are so low that many people have the financial possibility to use computers and the Internet, at least in industrial nations. This spread also means that the time and the cost that lay in the telegraph boy's running from place to place have been eliminated. It is thus this spread that makes the current information technology much more important than telegraphy was a hundred years ago.

However, a historical warning may be appropriate; experiences show that confidence in integration, the market and the open society can be rapidly undermined in the event of major economic crises and political instability. This happened in the First World War, which broke off the globalisation process of the time. Later, the spread of Communism after the Second World War forced the previously successful industrial nations in central Europe out of the international community. At present, the main threat to a free exchange perhaps stems from the risk of an escalation of terrorism leading to more closed borders. It is therefore important that we constantly explain why tendencies towards increased protectionism and introversion are not good for growth. Globalisation cannot be taken for granted – it must be defended.

Future possibilities and challenges

I now intend to look ahead to the possibilities and challenges that follow in the wake of the increased integration and technological changes. I have already mentioned the importance of safeguarding and developing the advances already made, and this cannot be stressed too much. Nor should we forget that macro stability, that is to say, price stability and sound public finances, is an important condition for stable growth. The Swedish experiences over the past decade are a very good example of this. A stable economic policy framework is particularly important in the light of the demographic challenges that will soon have a major effect on the economies of many countries, particularly in Europe.

Mark Twain is supposed to have once said: "I'm all for progress; it's change I don't like." However, change lies in the nature of market liberalism, which neither can nor should be stationary. The structural changes that come in the wake of globalisation mean that less efficient production is replaced by more efficient production, and that sectors that do not hold up in competition are replaced by sectors where the country has comparative advantages, that is to say, is relatively better than its competitors. Structural changes thus consist of two parts: closing down (or moving out) and new establishment of businesses. The

Austrian economist Joseph Schumpeter called this *creative destruction*; old jobs and technologies disappear and new, more productive jobs arise as technology develops and production becomes more specialised. The major challenge in future, in both Sweden and other industrialised nations, will therefore be to create dynamic conditions in which new jobs can arise as the old ones disappear due to rationalisation or are moved abroad.

Studies regarding some industrial nations indicate that many jobs lost during the most recent economic slowdown have not yet been replaced by new jobs in the same branch when economic activity picked up again; instead productivity has been higher. However, employment has continued to increase in other sectors, which appears to increase the number of jobs regardless of economic activity. The fact that employees have to change sector leads to greater friction unemployment arising. While these structural changes are nothing new in themselves, they make substantial demands with regard to a good business climate where new jobs can be created and to a good capacity for change and flexibility in the labour market, to enable employees to seek work in other industries and regions. This can of course be a difficult process for the individual and his or her family, as if often entails a change of career and also of the area in which he or she works, and perhaps even the area where they live. It is important to facilitate this difficult adaptation process, for instance, by offering support in the form of education, retraining and reasonable compensation during the changeover period.

In recent years the allocation of jobs abroad, known as offshoring, has been the focus of debates regarding structural changes. This is not a new trend in itself; as the manufacturing industry has become increasingly internationalised during the post-war period, we have seen equivalent patterns. The new element today is that it is jobs in the services sector, which are sometimes well-paid, that are being increasingly offshored. This opportunity has arisen as a result of the major advances in the ICT sector and the steeply falling information costs. Thus, entire sectors where trade was previously impossible at long distances have been opened up to international competition. The increased trend towards offshoring is primarily driven by large cost savings, which can amount to as much as 60 per cent. For example, the labour costs in the new EU member states are between five and twelve times lower than those in Sweden and Germany, while the productivity gap has declined significantly over the past 10-15 years.

What is interesting in this context – and an important lesson for the future – is that many studies that have been published do not find any evidence for the critics' claims that offshoring will lead to a mass migration of jobs and the phenomenon of jobless growth. On the contrary, they indicate that offshoring, by promoting a better division of labour between countries, leads to cost savings and productivity gains that in turn mean that labour and investments in the industrialised nations can be transferred to more highly processed products. The consultancy firm McKinsey has estimated that each dollar invested in outsourcing to India gives the United States an economic gain of USD 1.12-1.14 and India a gain of USD 0.33. In the long term, this can even lead to a stronger development in employment. Thus, offshoring can be regarded, as President Bush's economic adviser Gregory Mankiw pointed out, but was much criticised for, as a form of trade that will make production more efficient and increase GDP growth in the world economy.

Offshoring is thus one means of increasing global wealth; continued multilateral trade liberalisation is another means. Unfortunately, the final negotiations in the Doha round have once again been postponed, and a final agreement will probably not be signed until 2006 or 2007 at the earliest. Although the 147 member countries of the WTO took an important decision in principle regarding goals and rules for negotiations in the field of agriculture last summer, the contents are still incomplete. In other important areas, such as trade in services, the results were even less substantial.

Europe and the United States can contribute in a very concrete way in the trade negotiations by reducing their own tariffs and subsidies, particularly in the industries where developing countries have their largest competitive advantages, such as agriculture, textiles and the steel industry. An example of the potential significance of the reforms is that a European cow receives an average of USD 2.50 a day in subsidies, while 75 per cent of Africa's population are living on less than USD 2 a day.[1] More free trade within these areas would lead to more poor people being integrated into the world economy, and would thus enable one of the major problems with the current system to be remedied. In addition, it would contribute to making the global distribution of labour more efficient, which would also benefit the industrialised world. However, when wealth reaches our levels, mobility in the labour market has tended to decline, at least in Western Europe. It is therefore probable that the increased structural changes entailed in the liberalisation of sectors such as agriculture and the textile industry would entail demands for support to manage the changes and a better business climate in many industrial nations in order to facilitate mobility between sectors.

I have previously mentioned the important work conducted with regard to creating and implementing norms and standards to prevent economic crises in different countries around the world. Despite good results, historical experiences show that crises will probably occur nevertheless. In a few cases this will lead to states experiencing payment problems. We therefore need to have a multilateral framework that can efficiently deal with any problems that arise. Both the IMF and other international forums have put a lot of work into improving crisis management in recent years. Several improvements can be noted, including collective action clauses, which are increasingly used in sovereign bond contracts and will facilitate renegotiation of sovereign bond debts in the future.[2] Some progress has also been made within the framework for cooperation between the

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[1] This example is taken from a lecture given by the World Bank's chief economist Nicholas Stern (now at HM Treasury in the UK) at Munich University in November 2002.

[2] Collective action clauses are a means of clarifying at the time the loan agreement is signed how the contract will be renegotiated if the borrower cannot pay according to the agreed amortisation and interest rate plan.

public and private sectors with regard to a voluntary code of conduct for states' payment problems. Of course these improvements are very positive. However, my impression is that we need a coherent framework for orderly renegotiations of sovereign debt in countries facing insolvency that cover *all* types of debt. The IMF worked out a proposal for debt consolidation a few years ago, entitled Sovereign Debt Restructuring Mechanism (SDRM), but the proposal has not won general approval in this form and the problem of managing sovereign states' payment problems remains. The example of Argentina showed clearly the need for a framework that could, for instance, solve the current problem of a risk of different borrower groups receiving different treatment, with various "clubs" for different types of loan. It is possible that we can get the ball rolling with a lucky name change to Framework for Orderly Restructuring of Debt (FORD). Ford owns Volvo and Volvo means "I roll".

Conclusion

There is still a lot we do not know about the growth process, but fortunately the knowledge gaps appear to be dwindling as time goes by. The research carried out over the past twenty years has taught us, for instance, that it is not only the right economic policy measures to achieve growth that we need; institution building is at least as important, and this must be adapted to local conditions and help countries to tackle new challenges. These are important lessons to take into the future with us. What we *can* say with certainty is that the path entered upon, towards greater liberalisation and market economy and the promotion of technological advances, has shown good results. Many millions of people have attained a much better standard of living over the past sixty years, both in material terms and in terms of quality of life. At the same time, all of the available data clearly indicates that the countries which have had least success are those that are least integrated into the world economy, that have not managed to create a stable macroeconomic framework, have poor protection for property, complicated and inefficient bureaucracy, a high degree of corruption and a widespread informal sector into which a large part of businesses have been forced. There thus appears to be a great deal that developing countries can do themselves to improve their situations and create the right conditions for stable growth. However, the wealthier countries also need to do their share, for instance by opening up currently protected sectors of their economies to free trade. Moreover, the multilateral institutions play an important role.

Thus, increased growth and globalisation have not solved all of the problems, far from it; there are still far too many poor people who are on the outside of the world economy and far too many countries with large environmental problems. However, existing shortcomings and defects do not mean that the present model needs to be changed; on the contrary, it needs to be defended, extended and spread further, and its weaknesses need to be managed. I believe that the positive effects of sustainable long-term growth, combined with the opportunities offered by continued internationalisation of the world economy, indicate that there are good grounds for optimism about the future.