Anne O. Krueger

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The World Economy at the Start of the 21st Century

Remarks by Anne O. Krueger
First Deputy Managing Director, IMF
At the Annual Gilbert Lecture, Rochester University
New York
April 6, 2006

Good evening and thank you for that kind introduction, Ron. I'm pleased to be back in Rochester after a longer absence than I would have liked.

A hundred years ago, the international economy was entering the 20th century with the freest flow of goods, services and capital in human history. The previous century had witnessed expansion of global output and trade, and rising living standards in Europe and North America at a pace never before seen in human history. The 20th century then saw just over a decade of continued expansion, followed by the abrupt disruption of trading and financial ties during the First World War. After some steps toward a restoration of the prewar situation, the international economy collapsed during the decade of the Great Depression, and continued to be fragmented during the Second World War. The century-long trend toward globalization had been reversed and, as of 1950, or even 1960, globalization and the degree of integration of the world economy was considerably less than it had been fifty years before.

Since then, of course, there has been an unprecedented revival and intensification of global integration, supported by technical change, and by international economic policies resulting from multilateral cooperation. These phenomena combined to result in greatly reduced barriers to international flows; further acceleration in the growth rate of world output; the spread of living standards that we associate with advanced industrialization to additional parts of the world and the reduction of poverty and improved living standards in most other parts of the globe; and the emergence of a number of new key players in the international economy.

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My purpose in this lecture is to present a broad outline of the evolution of the world economy in the 20th century, with a view to examining where we stand today. I shall argue that international economic policies have been phenomenally successful to date, and have in many ways changed the contour of the world economy itself, mainly for the better. At the same time, however, there are a number of challenges which, without appropriate and timely responses, could undermine progress to date and undo many of the benefits so far achieved.

In both the 19th and 20th centuries, technical change played an important role. But, paradoxically, in the 19th century it was the dramatic decline in transport costs that enabled the rapid expansion of global trade and real incomes, whereas in the second half of the 20th century, it was a dramatic decline in policy-induced trade barriers that had the same effect. And whereas the reversal of globalization in the early 20th century resulted from political hostilities, the major threat to continued economic success at the beginning of the 21st century appears to be economic nationalism.

I shall first outline the key features of the global economy around the turn of the 20th century, and trace its evolution to the l950s. I then turn to the structure of the international economy and the policy framework that permitted the highly successful evolution of the subsequent fifty years, focusing first on trade relations, then on international financial relations, and, thirdly, on the differential evolution of industrial and poorer countries during that period. On the basis of that analysis, I will note the tremendous improvements in economic well-being in most of the world that globalization has enabled and then, in conclusion, identify the challenges confronting the global economy today.

The Background

One hundred years ago, observers of the international scene would have described the phenomenal globalization of the preceding century, especially in the period 1870-1914.

Until the 19th century, transport costs had been sufficiently high to discourage all but high value—low volume trade, while policy-imposed trade barriers (tariffs and other taxes or restrictions on international transactions) had further impeded trade flows. For most commodities, transport costs exceeded the price of goods in the country of origin, often by a substantial margin.

In the early l9th century, the United Kingdom provided leadership in reducing tariffs, and many other European countries followed suit in the middle of the century. Transport costs also fell dramatically, even in the first half of the century. Douglas North, for example, cites evidence that ocean shipping costs by around 1850 were only about a third of what they had been barely thirty years earlier—when shipping under sail was still the order of the day. While international trade and economic growth picked up as a result of these phenomena, it was really in the late l9th century, especially in response to the "amazing" decline in transport costs (the phrase used by O'Rourke and Williamson), that trade volumes and growth rates accelerated. The last decades of the 19th century were described as the "gilded age" on this continent, as per capita incomes are estimated to have doubled between l870 and l900. The late Victorian era was likewise regarded as a boom period in Europe as European per capita incomes and wage rates rose at even faster rates, albeit from a lower base.

The late nineteenth century boom was encouraged by technical change and by policy changes in industrial countries. Technical change was especially apparent with the introduction of electricity and its applications, and included communications (the telephone and telegraph), transport, and much more. The introduction of the railroad led to a steep decline in the costs of moving freight, and there were further dramatic drops in the costs of ocean shipping following the introduction of steamships. Data from O'Rourke and Williamson imply a drop in costs of transport between the U.S. and Europe from about 80 per cent of the price of the commodity to less than 20 percent during that period.

The sharp decline in transport costs came at a time when most European countries had lower tariff levels than earlier in the 19th century. The U.K. had zero tariffs on agriculture and manufacturing until l914, and Dutch and Scandinavian tariffs were also low.[1] [2] The impact of rapidly falling transport costs, combined with the reduced levels of protection, undoubtedly led to a major net reduction in barriers—both natural and artificial—to trade.

As a consequence, world trade grew rapidly—at an annual rate of 3.4 percent between 1870 and 1914, with growth not only in industrial goods but also in raw materials. In many instances, the primary commodity exporters were colonies, whose manufacturing bases did not achieve sustained development.[3]

Simultaneously, integration of world capital markets proceeded rapidly. By the early 20th century, it is estimated that foreign-owned assets were about equal in value to about 20 percent of world GDP.[4] The United Kingdom was, as is well known, the world's banker and at its peak, owned 80 percent of foreign assets globally. Its capital outflows were as much as 10 percent of GDP in some years, and averaged 4.5 percent of GDP per year between l870 and l914.[5]

The growth of real incomes, the growth of world trade, and the integration of the world economy—both through the removal of artificial barriers to trade such as tariffs and through reduced costs of transport—were causally linked. The drop in costs of

international transactions was itself a function, in significant part, of technological change.[6] But while real wages and living standards rose throughout the world, the rate of increase was much faster in the industrial countries. Until the early l700s, it is estimated that living standards were not significantly different between different geographic regions of the world. But by the end of the nineteenth century, economic growth had been sufficiently rapid in the "industrial countries" that the world had bifurcated in terms of living standards and rates of economic growth.[7]

The First World War, however, led to an abrupt reversal in the degree of globalization. As transport routes were disrupted and countries experienced different degrees of inflation in response to the differential strains of their wartime expenditures, the earlier integration of the international economy was largely reversed.

Despite efforts to restore the status quo ante after the war, disequilibria associated with the overvaluation of the pound sterling following the British return to the Gold Standard in 1925, German reparations, and other imbalances led to slow progress in the l920s. At the end of that decade, markets were not as integrated as they had been prewar.

But the Great Depression reversed even that progress. As is well known, real incomes dropped dramatically in most countries, unemployment rates rose sharply, and prices of goods and services fell abruptly. The policy response intensified the difficulties: the l930s were characterized by rising trade barriers (both tariffs and non-tariff restrictions) and competitive devaluations, often referred to as "beggar they neighbor policies", and by rapidly falling volumes of trade and prices of traded goods. As each country attempted to reverse its own downward spiral by imposing ever-higher tariffs, devaluing its currency, and other measures, they in effect exported part of their own deflationary pressures, only to be hit by deflationary pressures resulting from similar actions in other countries. Britain was forced off the gold standard in l931, while the United States followed suit in l933 and simultaneously experienced a "banking holiday" as banks were hard hit by nonperforming loans in their portfolios. Worse still, the American Congress had enacted the Hawley-Smoot tariff in the early l930s, giving an **average** tariff level of 59 percent in 1932 in the United States: the highest level since the 19th century. As it became evident with hindsight that the Hawley-Smoot Tariff Act had greatly intensified the Great Depression, rather than offsetting it, the name became synonymous with unilateral policies of individual countries that harmed themselves and other countries, so called "beggar-thy-neighbor" policies.

By the late l930s, recovery was underway, but then the Second World War began and rapid expansion ensued in response to wartime demand. Of course, output and trade patterns were once again disrupted, as production of consumer and investment goods demanded in peacetime were replaced in significant part by production related to the war effort.

The Situation at the End of the War

The world economy as of 1945-46 was far less integrated than it had been at the end of the First World War, both because of the war itself and because of the protectionist and isolationist measures of the l930s. The United States, Canada, Australia, and a few other industrial countries not devastated by wartime destruction were producing at levels much higher than they had been in the late l930s: but most of Europe, the Soviet Union, China, and Japan were hard hit. While many economies in the areas that had not experienced the industrial expansion of the earlier era were not similarly affected, it was evident that they were "different". So with the decision of the Soviet Union and China to insulate their economies, the global economy was effectively split into three. There were the industrial countries: these were themselves divided between those where production had fallen significantly during the war, and those where the structure of production had shifted but output increased. The second group were the—as they were then called—"underdeveloped" economies. Many of these had been able to export primary commodities at high prices to the combatants during the Second World War, and had built up large reserves of foreign exchange (because there was little to import). But these economies were all heavily concentrated on producing raw materials, both agricultural and mineral, with a relatively small manufacturing industry producing primarily small-scale labor-intensive consumer goods, with very low standards of living by contrast with the industrial countries. The third group was the centrally planned economies; until the l990s, their evolution was almost entirely independent of that of the rest of the world, and so I leave their story aside for now.

When planning for the postwar era began during the latter years of the war, it was based on several premises: l) that the United States would emerge from the war economically strengthened and the preeminent economy; 2) that Europe and Japan were economically devastated and would need time and resources to recover; 3) that a repetition of the mistakes of the l930s should be avoided through multilateral cooperation within an appropriate institutional framework; and 4) that the supply of long-term private capital would not resume after the experience of the 1930s.

The postwar planners proposed a framework for international economic cooperation (as well as the United Nations for political cooperation) in which there would be international organizations for l) international monetary cooperation; 2) reconstruction and development; and 3) international trade in goods and services. International monetary cooperation was intended to facilitate international trade by inducing currency convertibility, preventing competitive devaluations, and enabling coordinated international financial policies. To that purpose, the Articles of Agreement for the International Monetary Fund were drawn up, and subsequently ratified by 38 countries by the time the Fund's Board of Governors held its inaugural meeting in March l946. Crucially, countries with "balance of payments" difficulties were expected to consult with the IMF, and to adjust their domestic policies, altering exchange rates only in circumstances where it was agreed with the IMF that there was "fundamental disequilibrium". Signatories to the Articles also agreed to Article VIII—convertibility of their currencies for current account transactions. As will be seen, achieving this among IMF members was a significant achievement, but it required more than 15 years before even the major industrial countries had removed exchange control regulations to the extent necessary to comply with Article VIII.

Given the presumed absence of private sources of capital, the postwar planners concluded that longer term financing would have to come from official sources, both to provide capital to accelerate the reconstruction of the war-devastated countries and to enable higher rates of investment, and therefore of growth, of the "underdeveloped" economies than would otherwise materialize. As a source of longer-term official finance, the International Bank for Reconstruction and Development, now generally known as the World Bank, was founded.[8]

The third leg of the envisaged arrangements was for multilateral cooperation for an open international trading system. The General Agreement on Tariffs and Trade, signed in 1947, was seen as a interim arrangement pending the establishment of the proposed International Trade Organization (ITO), but proved remarkably durable in the absence of ratification of the ITO charter. The GATT arrangements provided for nondiscriminatory treatment of all trading partners, for elimination of quantitative restrictions on trade, and for fora in which countries could reciprocally negotiate tariff reductions and in which trade disputes between countries could be settled.

The IMF and World Bank Articles were negotiated at Bretton Woods in l944, and the two organizations began functioning in 1946. The GATT began functioning in l947 with a first round of tariff reductions negotiated at that time. The GATT, and later the World Trade Organization (WTO) included two key provisions: l) that member countries would not impose and/or would eliminate nontariff barriers to trade[9]; 2) that member countries would grant "most favored nation" status to their GATT/WTO trading partners so that all trading partners would face the same trade barriers unless there was a preferential trade arrangement (the conditions for which including coverage of all trade items, zero tariffs between the PTA countries, and a certain timetable for achieving zero tariffs).

When the war ended, however, it became evident that the degree of European/Japanese devastation was much greater than anticipated, and the United States emerged even more dominant than expected: as late as 1950, Maddison estimates that the United States produced 27 percent of global real output and accounted for over 14 percent of global exports. The U.S. also held 54 percent of international reserves.

Although, as stated, the GATT achieved its first major round of tariff reductions in l947, the postwar reconstruction needs, especially of Europe, were far greater than had been anticipated. It fell primarily to the United States to support the European and other countries in their reconstruction efforts (although the World Bank did extend some loans), first through "Point Four" aid, and then through the Marshall Plan.

European and Japanese economic recovery was stunningly successful after the first two very difficult postwar years. Prewar output levels were generally attained by the early l950s, and were only the start of a period of sustained rapid growth. From a situation in the late l940s when most European economies traded through bilateral payments arrangements with each other (or used Marshall Plan aid), they moved to

multilateral clearing arrangements. Simultaneously, tariff reductions were taking place and quantitative restrictions were being removed.

With the groundwork laid by the Marshall Plan, increasingly free exchange regimes and tariff reductions (spurred both by the GATT multilateral tariff reductions and intra-European liberalization undertaken in the context of the Marshall Plan), the world economy embarked upon a quarter century of sustained and unprecedentedly rapid economic growth. While developing countries—as they came to be called—grew, they generally did so without integrating with the world economy, and I shall return to their story later.

The changing postwar world

The most rapidly growing countries were in Europe and Japan. While the rest of the industrialized world grew rapidly, and at rates well above those achieved in the first half of the twentieth century, it was the phenomenal growth of Europe and Japan which led to the biggest changes in the world economy. In l950, it could fairly be said that the United States dominated; by the early l970s, Europe and Japan were also major players in the world economy.

During the golden quarter century, tariff reductions continued. The rate of growth of world trade averaged almost 8 percent per year from l950 to l973. Quite clearly, trade was an "engine of growth", just as it had been in the late l9th century, growing at about twice the rate of growth of world output. But whereas in the late l9th century, it was primarily reductions in transport costs that facilitated that growth, it was reductions in tariff and nontariff barriers to trade were the major stimulus to the growth of trade in the postwar years.

The very rapid economic growth of that era took place in a relatively non-inflationary environment. Most industrial countries had single digit rates of inflation. To be sure, individual countries did experience "balance of payments crises", and rates of growth fluctuated through recession and boom periods. Nonetheless, the world economy as a whole was relatively stable. Through the provision of financial assistance to countries in balance of payments crises, the IMF played an important role in enabling adjustment to take place without the disruption to the international system that had characterized the inter-war period. Many of the industrial countries—and many developing countries—took advantage of the IMF's lending facilities. Britain, in 1977, was the last major industrial country to borrow on a large scale from the Fund.

Part of that stability derived from the relative size and dominance of the American economy. From l950, when 79 percent of foreign exchange reserves of the industrial countries were held in gold, the American dollar assumed increasing importance. By l973, more than 90 percent of the foreign exchange reserves holdings of those industrial countries that reported such data were held in U.S. dollars. International prices, and settlements of accounts even between other countries, were predominantly denominated in U.S. dollars. But the underpinning of the Bretton Woods system, and the continuing downward movement of trade barriers were also major factors.

The World in the Early 1970s

By l973, then, the industrial countries were still preeminent in the world economy: they are estimated to have produced 59 percent of world GDP and to have accounted for 64 percent of world exports, contrasted with 60 percent of world GDP and 61 percent of world exports in l950. Within the developed countries, though, the U.S. share had diminished as other countries had experienced more rapid growth.

But developing countries had also achieved growth rates (in part benefiting from the rapid growth of industrial country markets for their goods) higher than those experienced in the l9th and early 20th century. Many of them had been former colonies; but whether former colony or previously independent, most of their governments put the goal of raising real incomes and rapid growth as their foremost objective. To achieve this, however, they adopted policies that insulated them to a major degree from the international economy. While the industrial countries were reducing trade barriers and freeing financial transactions, most developing countries were protecting (infant) domestic industries and restricting international transactions. Nonetheless, per capita incomes rose in most countries, and life expectancies, literacy rates, nutritional statuses, and other indicators of well-being improved significantly.

As contrasted with the immediate postwar period, then, by 1973 the global economy was characterized by the increased relative and absolute importance of international trade. Among industrial countries, there was much greater freedom of financial flows and, during the l960s, private capital flows between Europe and the United States began increasing rapidly. For developing countries, foreign aid—both bilateral and multilateral—and other official flows had increased, but their own payments regimes were still highly restrictive. Moreover, in many developing countries, growth rates were beginning to decline, as the costs of continuing to pursue inward looking "import substitution" policies increased.[10] Hence, they remained primary commodity exporters: although many had experienced growth of manufacturing, and the manufacturing share in GDP, almost all the increased output was destined for the sheltered domestic market. Even in primary commodities, the share of developing countries had dropped.

There had, however, been a few economies where economic policies had shifted away from the earlier "import substitution" policies toward a much more open economy. Some had gone so far as to rely on exports as an "engine of growth". Those economies, in East Asia, experienced sustained increased rates of growth unlike anything earlier witnessed in the global economy. The 4 "Asian tigers" were the most notable. South Korea, the largest of them, was typical, increasing exports at over 40 percent a year in the l960s, with rates of increase of real per capita incomes of 7-9 percent a year. By 1982, South Korea was one of the world's top 15 exporters, and it today ranks 11th in exports in the global economy.

But, as of l973, high growth rates among the East Asian economies had not made a significant difference to the structure of the world economy, as these rates had been experienced from a very low base. From a global perspective, the world was still divided into rich industrial countries and poor developing countries.

1973, however, marked a watershed in the global economy. Inflationary pressures had been rising, especially in the United States, and there was a commodity price boom in l972-3. By that time, the United States had been incurring a current account deficit for more than a decade spurred by a faster rate of American inflation (at a fixed exchange rate) and U.S. demand resulting from the Vietnam war expenditures. In l971, the United States announced that it was suspending the gold convertibility of the dollar. Hence, the Bretton Woods system, as founded (as a fixed, but adjustable, standard) and which had become a de facto dollar standard, was abandoned, and by 1973 floating exchange rates between the U.S., Japan and the major European currencies had become the order of the day.

But at that same time the "oil price shock" of l973-74 quadrupled nominal oil prices in a very short period of time. Many oil importing countries found their import costs greatly increased; some (mainly industrial) went into recession, while others (mainly developing) borrowed from private financial sources. It was the first large-scale access of developing countries to private capital markets and permitted the recycling (through banks in industrial countries) of oil exporters' current account surpluses to oil importers' current account deficits. That there were already floating exchange rates between major currencies certainly facilitated the adjustment.

After a recession following on the oil price shock, economic growth resumed in most industrial countries, and in oil importing countries. Indeed, for the rest of the decade after the l973-74 oil price increase, oil importing developing countries grew more rapidly than oil exporting developing countries. And, among developing countries, those—mostly in East Asia—that had switched to outer oriented economic policies experienced much more satisfactory rates of economic growth than those still relying on inner-oriented policies. It is also worth noting that this more rapid growth took place against a background of relatively low income inequality; and there was rapid progress in reducing poverty in these countries.

But by the early l980s, after the second major oil price increase, the world economy went into recession as the United States altered its monetary policy to contain, and subsequently permanently lower, its inflation. The resulting high nominal and real interest rates, combined with falling commodity prices (attributable to the recession) resulted in debt-servicing difficulties for many of the developing countries that had earlier borrowed to finance their increased oil import bills. Indeed, for heavily indebted developing countries, the l980s were a "lost decade" as debt-servicing difficulties and continuing adherence to inward looking policy stances resulted in negligible increases in per capita incomes, and declines in some cases.

By the late l980s, inflation was contained in most industrial countries, and debt was being restructured (the Brady Plan) in the heavily indebted developing countries. The oil price had peaked in real terms in l979, and fell sharply in l986. The stimulus from lower real oil prices and stable price levels resulted in a period of sustained growth of the industrial countries. Trade barriers among industrial countries continued to drop, as quantitative restrictions had been almost entirely eliminated and tariffs were being further reduced under the influence of successive rounds of trade negotiations under

the GATT.

A new round of trade negotiations under the GATT was proposed in the late l990s, but not agreed upon until the Doha Round was inaugurated in November 2001. The new round faced several significant challenges, to which I shall return later.

The start of the final decade of the twentieth century coincided with another major shift, as the world adapted to the collapse of the Soviet Union, and the emergence of formerly centrally planned economies into the global economy. For most of the l990s, the "transition" economies were adjusting to their new economic structure, and adapting their economic policies for greater integration into the international economy. For present purposes, it is also important to note that the examples set by the East Asian countries seem to have had a significant influence on policy makers in other Asian countries, most notably China and India, as they, too, began reforming their policies.

The "lost decade" of the l980s, in turn, led a number of other countries to begin reducing their barriers to trade and other impediments to growth. Mexico, for example, embarked on a series of major economic policy reforms in the latter half of the l980s, anchoring them in the North American Free Trade Agreement, which permanently assured outward looking economic policies.

As reforms took place in country after country, and investment became more profitable, private capital flows—especially to "emerging markets", as the successful developing countries came to be known—increased enormously, eclipsing official capital flows in their magnitude.

But, as that happened, the vulnerability of some of the emerging markets to changes in investment flows increased dramatically. The first country to be affected by this was Mexico; its exchange rate policy did not adequately accommodate domestic credit expansion or the altered outer oriented trade stance, and in late l994, investors became reluctant to finance further current account deficits (the l994 deficit had been 7.6 percent of GDP). The ensuing capital outflow forced Mexican officials to take swift action, adjusting monetary and fiscal policy in the context of a large loan from the International Monetary Fund. Within three months there had been an effective nominal devaluation of 65 percent.

The l990s witnessed a number of other "capital account" crises. These differed from earlier "balance of payments" crises in which the IMF had supported adjustment in its member countries both in the fact that the immediate origin of the difficulty was a major change in the willingness of foreigners and domestic residents to hold domestic assets and in the fact that there was little time in which to decide on policy changes.

The latter part of the decade saw more capital account crises, including most notably South Korea, but other countries in east Asia and elsewhere. The South Korean situation was particularly shocking, as by that time the country was seen as a "newly industrializing country"; the crisis had been unanticipated, and was dramatic. As in Mexico and other cases, substantial borrowing (mostly from the International

Monetary Fund) and policy adjustments stemmed the crisis. In the South Korean case, the l997 level of real per capita income had been re-attained within 6 quarters and by 2004, real GDP was almost 40 percent above its l997 pre-crisis level.

But to the world, it was clear that, to the earlier, current-account based, balance of payments difficulties, were now added capital account crises. At the turn of the 21st century, one major challenge was seen as learning the appropriate lessons going forward as to the prevention of such crises, and, when they did occur, the appropriate policy responses for the country involved and for the international community.

While headlines were captured by the dramatic events in the former centrally planned economies and capital account crises, other events were going on that would, if trends persisted, alter the global economic landscape at the beginning of the 21st century. The American economy experienced rapid growth, with more rapid rates of productivity increase than had earlier occurred. Moreover, those rates were achieved in the context of a prolonged period of sustained growth and price stability, minus the recessions that had accompanied growth in earlier decades.

Europe had begun a process of increasing integration with the opening of trade and financial flows under the Marshall Plan. The Treaty of Rome had started the process of movement toward an integrated internal market, undertaken within the context of lowered trade barriers from the multilateral trading rounds under the GATT. As additional countries joined the European enterprise, and policy harmonization deepened, the European Union emerged as a major force in the global economy with 38 percent of world trade and 26 percent of world GDP as of 2000. By contrast, after four decades of growth and rapidly rising living standards, the Japanese economy had entered a period of stagnation by around 1990, and Japanese growth remained sluggish a decade later, primarily as a consequence of the asset bubble of the late 1980s and the policy challenges posed both by the need for reform of the financial sector.

Despite the difficulties of countries such as South Korea, growth in developing countries accelerated during the l990s as a result of their policy changes and the supportive global environment. By 2000, developing countries as a group accounted for about 47 per cent of world GDP and a third of world trade. And, of course, the East Asian economies, in addition to Japan, were by 2000 large enough to be significant. Japan, as already noted, was a major economic entity by the l970s, but by the year 2000, South Korea, the ASEAN countries, and China, were also gaining share. India had embarked upon reforms and, in consequence, growth rates were beginning to accelerate.

The Global Economy at the Turn of the Century

With the power of compound interest, many of the growth rates and changes that had occurred during the preceding several decades had, by 2000, basically altered the landscape of the international economy. Moreover, the experience of the years since the Second World War had taught a number of lessons which seem to be fairly

widely accepted today. In this section, I review these changes and lessons, as a basis on which the challenges going forward can be assessed.

The Altered International Economy. What were the basic changes? The world was a much more open place. The internet, and access to it, had grown rapidly. There were further significant drops in transport and communications costs: in 2001, two economists from the Chicago Fed noted that in constant 1998 prices the cost of a three minute phone call from New York to London had been $293 in 1931 and had (by 2001) fallen to around $1 for a much better quality connection. In 2006 that same call costs just a few cents. Other technical changes, and above all the reduction in tariff and other barriers to trade, had played a role in opening up the global economy.

As mentioned at the outset, in the l9th century, reductions in costs of international trade had also spurred growth, the difference being that it had been the reduction in transport costs in the 19th century, and the reduction in policy-related tariff and non-tariff barriers in the second half of the 20th century that had enabled closer integration. For manufactured goods, at least, average tariff rates among industrial countries are now less than 5 percent; within areas such as the European Union, they are zero. With airfreight, the internet, and other changes, goods can be ordered from one part of the world and received elsewhere in a matter of hours, contrasted with the months the same transaction would have taken two hundred years ago. But while it would be difficult, if not impossible, to reverse technical change and the drop in costs of transport and communications, the same cannot be said for policy-induced trade barriers. I return to this in the next section, as a significant threat to continued strong global growth lies in risks that the trend toward trade and financial integration that has spurred growth may end or even reverse.

Increasing openness during the late 20th century had, of course, resulted in greatly intensified international economic activity. Consequently, the relative importance of international trade in the world economy had greatly increased: from 5.5 percent in l950 to 17.2 percent in 2000, according to Maddison. Much more trade was in intermediate goods, as producers were able to locate each stage of the production process in the country or countries where costs of production were lower. And, whereas in l950 45 percent of merchandise exports were agricultural and 37 percent were manufactures, the composition of trade was radically altered, and trade in services grew in importance. By 1980, services trade constituted 15 percent of all goods and services trade, agriculture accounted for 12 percent and manufactures for 45 percent. The comparable numbers for 2004 show agriculture down to 7 percent, services up to almost 20 percent, and manufactures to 59 percent. In addition to trade flows, other international transactions had increased in importance: tourism, other services items, and capital flows. The fifty years had seen enormous improvements in living standards, not only in the developing countries, but even among the richest. The United States is estimated to have had a per capita income of just $13,000 in 2005 dollars in l950; by l975, that figure was $22,200; and in 2005, it was $41,900.

But just as the structure of the international economy had changed, so, too, had domestic economic policies. Increased macroeconomic stability within the industrial countries has already been highlighted; the global reduction in inflation rates has been a significant contributor to accelerated world growth. But, in addition, the shift toward more market-friendly policies (in developing countries and in some industrial countries) together with the transition from central planning has enabled more resilient economies and stronger responses of output and employment to changes in incentives, further accelerating growth.

That leads to the second major change: whereas in 1950 the United States was THE economic power, and by the mid 1970s Europe and Japan were clearly established as major global players, by 2000, emerging Asia—especially China and India, but also a number of other countries—had become a significant economic force in the international economy. Much of Europe, of course, is now in the European Union and has achieved an even higher degree of internal integration than that realized externally. And the emerging Asian economies are already so large as to have global significance and impact. Assuming that their relatively high rates of economic growth persist, they will become increasingly important in the years to come.

For India and China and many other developing countries, living standards—while still low contrasted with developed countries—have increased remarkably. This is reflected not only in per capita income numbers, but in other indicators of well-being. Over the past half century or so, infant mortality rates have fallen sharply in most developing countries. In China, for example, the infant mortality rate fell from 150 deaths per 1000 births in 1960, to 30 in 2003.

Perhaps the most telling statistic is life expectancy. In general, life expectancy in developing countries has risen at an astonishing pace.

Since 1960 life expectancy in the developing countries has risen at roughly double the rate in the richest. The gap between life expectancy in industrial and developing countries has narrowed from around 30 years in 1950, to around 10 years today.

For a few countries—most notably those in East Asia—living standards have risen so markedly that they are now beginning to close the absolute, as well as the relative, gap in income levels.

And, significantly, most of the transition economies of the former Soviet Union and Eastern Europe are realizing above-average rates of economic growth and integrating into the world economy.

At the same time, however, some other countries are still extremely poor and, indeed, their relative (and in some cases, absolute) position has even worsened. The poor economic performances of many Sub-Saharan African countries are well known. It is frequently forgotten that, after the Second World War, observers and all systematic estimates placed Sub-Saharan Africa real per capita incomes well above those of most Asian countries other than Japan. The juxtaposition is remarkable. Ghana, for example, was estimated to have a per capita income of around US$ 1,874

(in 2000 prices at purchasing power parity rates) in l956 whereas Korea's was US $1,347. In 2003, Ghana per capita income level was $2,114, only 13 percent above the level in l956. By contrast, Korea's per capita GDP was nearly 13 times its 1956 level, at $16,977. And the same holds true for many other Sub-Saharan African countries relative to Asian countries.

Thus, while many—in East Asia, South Asia, the Middle East and Latin America—have seen major progress with regard to living standards and poverty reduction (while still having a considerable distance to go if they are to "converge" with the developed countries), there remains an important challenge with regard to the poorest countries, to which attention returns below. No longer can the "developing countries" be seen as a homogeneous group: some have become "newly industrial", some have "emerged", and many more have significantly better standards of health and nutrition than they did fifty years ago; but a few have been left, or even fallen further, behind.

A third major change has been the rapid increase in integration of global financial markets. In 1952, only seven countries (U.S., Canada, and five Latin American countries) had free exchange rate regimes for current account transactions as set out in Article VIII. Today, 164 countries have accepted Article VIII obligations, while capital account transactions are much freer than they were.

Lessons. We have learned a lot over the past half century, much of it emanating out of experience. Perhaps the most important lesson—at least in terms of the degree to which thinking has had to change—has been the importance of economic policies in affecting relative and absolute economic performance. The relative roles of markets (via incentives and within an appropriate legal framework) and the private sector is better understood and appreciated than was the case fifty years ago. The importance of institutions, infrastructure, and other governmental functions is also increasingly recognized.

Out of all this has come increased appreciation of the importance of open markets—for promoting competition and technical change with consequent increases in productivity and in enabling higher rates of economic growth than is feasible in relatively more closed economies. And it has been recognized that growth rates can be much more rapid under appropriate policies than had earlier been thought. [In his review of the twenty five years from 1950, David Morawetz noted that per capita income growth in developing countries as a whole had "exceeded both official goals and private expectations." . The most rapidly growing countries have grown at rates that were regarded as unthinkable fifty years ago.] Thus, governments desirous of rapid economic growth can undertake changes that can enable significant acceleration of growth. But, at the same time, it has also been seen that growth is not inevitable, and, indeed, that retrogression is possible, not only in the event of dire external circumstances, but more often because of domestic economic policies inimical to a well functioning economy.

A second lesson, or perhaps a corollary of the first, is the importance of macroeconomic stability. In the early postwar years, it was generally thought that some degree of inflation would be the inevitable cost of full employment in the

industrial countries (the Phillips curve), and that inflation might even accelerate development in developing countries. Inflation at moderate levels was thought to be manageable. It was regarded by governments and many academics as a useful tool to circumvent budgetary constraints.

It is perhaps only with hindsight that we can truly appreciate the costs of the worldwide inflationary surge that we experienced from the 1970s onwards. In the 1970s and 1980s, governments in both industrial and emerging market countries discovered that the more tolerant of inflation they were, the more likely inflation was to trend upwards, and the smaller the trade-off, if any, perceived between more unemployment and more inflation. It is those countries that have pursued policies aimed at reducing and controlling inflation that have experienced more rapid—and sustained—growth.

Earlier efforts to document negative effects of inflation on growth proved unsuccessful. But, as inflation has been overcome in country after country, there is mounting evidence that price stability itself enables better resource allocation and investment decisions, and, in so doing, is conducive to more rapid economic growth.. The Fund has worked with its member countries to advance the process of lowering inflation, especially through our surveillance work. Through annual Article IV consultations with members, the Fund to identify policy weaknesses and successes. Where governments are seeking to implement appropriate polices we can be supportive; where we identify policy shortcomings we can try to persuade the authorities of the need for reforms.

Our surveillance work is greatly strengthened by the Fund's unique cross-country insight. Our ability to monitor closely the economies of all 184 members enables us to identify what works and what doesn't. It helps inform our research as we seek to improve our understanding. Our membership gains directly from that: they can benefit from experience elsewhere when shaping their own policy framework to their national concerns and priorities.

There is plenty of evidence that overly expansionary policies are equally damaging. A good recent example is the case of Peru when Alain Garcia became President in 1985 and ran a highly expansionary fiscal and monetary policy. Real GDP expanded by 12 and 7 per cent in the following two years. But by that time, there was a large current account deficit (which reached 5 percent of GDP in 1990, the year Garcia left office); Peru had incurred huge foreign debts (foreign debt as a percentage of GDP had risen from 73 in l985 to l65 three years later); and the party had to end. At that point, real GDP fell by 9 and 13 percent in the next two years. While Peru had experienced an expansion of real output in l986-87, there was no sense in which it was "growth": four years later, per capita incomes were lower than they had been at the beginning of the boom.

Yet another lesson has to do with the recognition that relative sizes and importances of different trading countries will change in the future. We can no more take today's relative importances in world trade and in world GDP as indicative of the future than were the l950s relativities. The immediate challenge is twofold. First, more needs to

be done to recognize the increased roles of the rapidly growing economies—especially in Asia—and to adjust the international economic and financial framework accordingly. But, second, we must also ensure that any adjustments to the international economic framework also make it more flexible, able to adapt easily to future changes in relative economic performance and influence.

Challenges going Forward

In l964, Harry Johnson gave a series of lectures at Sir George Williams University in Montreal on the international economy. He entitled it The World Economy at the Crossroads. His theme, then, was the necessity and desirability of further liberalization of trade and payments systems, and the need to incorporate developing countries into the global system (interestingly, he said nothing about the centrally planned economies). In light of subsequent events, he was prescient.

Much the same strictures could be made today. The enormous success of the global economy in delivering higher living standards to most cannot be questioned. But , as is evident from the past, we cannot rest on our laurels. On one hand, retrogression is possible. And, on the other, failing to address remaining challenges could also undo a considerable amount of the progress that has been made.

The open international trading and financial system is clearly a key to future global economic growth. Aided by falling costs of long distance transactions and trade liberalization, trade has served as an engine of growth for the past half century, just as it did in the 19th century. The integration of financial markets has furthered the process. And the benefits are there for all to see.

But the current Doha Round of trade negotiations has encountered serious resistance. Instead of recognizing that economic growth has not solved all ills but has created an environment that can make it easier to address remaining problems, some have come to see so-called globalization as the source of difficulties, rather than as the enabler that it has been for today's prosperity. Narrow sectoral interests respond defensively to threats while policymakers fail to take account of the benefits that flow from a more open trading system.

The Doha Round has faced formidable challenges that weren't present to the same extent in earlier rounds of trade negotiations. Some of these are a direct result of the rapid integration of the global economy. The WTO now has 149 members, all with their own priorities and interests that have to be reconciled in the final agreement: the first round of trade negotiations under the auspices of the GATT in 1947 had only 23 signatories. Moreover, the Doha negotiations are far more complex, encompassing agricultural trade and services: until the 1990s, agriculture had been excluded from multilateral trade negotiations.

But the complexity can make it easy to lose sight of the fact all countries have much to gain from an agreement. A successful outcome to the Doha Round will ensure the continued expansion of trade and so underpin future global growth. Of course, developing economies are anxious to safeguard their interests, as are all participants

in the negotiations. But it is developing countries that have most to gain from further trade liberalization, in part because their remaining trade barriers are highest.

We need to see a successful Doha outcome because of the great benefits it will bring to the global economy. We also need an agreement because without one there is justifiable concern that protectionist pressures will be strengthened and so begin to unravel progress made in the past. Standing still is not a practicable option: the choice is between moving forward with further trade liberalization, which will further boost world trade growth; and moving back as strengthened protectionist pressures bring the risk of slower growth in world trade, and consequently slower growth in world GDP than would otherwise be the case.

One consequence of the complex challenges now facing multilateral trade negotiations has been an increase in the number of preferential trading arrangements that are being negotiated. It can be tempting to see a bilateral approach as an easier substitute for complex multilateral negotiations. And bilateral free trade agreements, and the development of regional trading blocs, can be a useful boost to international trade if undertaken in the context of multilateral trade liberalization. But they are not an alternative to multilateral liberalization and if seen as such will hinder progress on the multilateral front.

The second challenge as we look forward is for the international financial system. Here, two issues are crucial at the current juncture. The first is the need to give Asia appropriate weight in the international financial system, including in the IMF itself. The Fund management's position on this issue is clear. We recognize that Asia has a powerful and legitimate claim to greater weight in the Fund than allowed for under the current rules. Asia has a voice, of course: it wields considerable influence in Fund discussions. But it is clearly under-represented. This issue is firmly on the agenda of the Fund's shareholders ahead of the next Annual Meetings, in Singapore next year.

At the same time, there is a pressing need to strengthen the mechanisms for resolving global imbalances. This is more than just a case of tackling the U.S. current account deficit, or structural reform in Europe and Japan, or addressing low domestic consumption in Asia. The current imbalances in the global economy are complex in their origins and require action on several fronts at once if they are to be resolved without undermining global economic stability and growth. There is a clear opportunity for strengthened multilateral surveillance by the IMF to play a central role in this process.

Applying many of the lessons from the financial crises of the 1990s has already strengthened the global economy. It is now generally recognized, for example, that flexible exchange rate regimes have an important role in enabling smooth adjustment to changing domestic and international circumstances. It is also clear that foreign direct investment and strengthened financial sectors can both help to reduce the vulnerabilities associated with private capital flows.

The third challenge for the future is, in a sense, domestic. Whenever growth is rapid there are those left behind because they are not able, in the short term, to benefit

from the increased opportunities that growth brings. Over the medium and longer term, of course, education has a crucial role to play. Access to high quality education for all is important both at the individual level—where it enables individuals to reap the benefits associated with a rapidly growing economy—and at the national level, since without a well-educated workforce growth will eventually be restricted.

To address short-term needs, however, other measures besides improving the provision of education will be needed. Social safety nets are vital. But they need to be well-targeted, to benefit those most in need. Subsidies that mainly help the middle classes, for example, are ineffective, expensive and can undermine fiscal discipline and so, in turn, macroeconomic stability. Safety nets that distort incentives too much will undermine growth.

Putting well-targeted and affordable safety nets in place is a particular challenge for emerging market and developing countries—though many industrial countries have welfare systems that are unduly distortive. But all industrial economies and a growing number of developing countries face another challenge to domestic economic policy: demographic change. As populations age—very rapidly in some countries-public pension systems are coming under increasing strain. As the elderly dependency ratio rises, and fewer workers support an increasing number of older retired citizens, measures will be needed to ensure that fiscal policy remains on a sustainable path. In industrial countries action is needed sooner rather than later in order to avoid a fiscal crunch. In emerging market countries, there may be more time in some cases, but the challenges are greater: public pension schemes, while more limited, are already expensive and unsustainably generous. For all countries, therefore, confronting demographic challenges means ensuring more efficient government spending and, most important, means ensuring that economies are flexible and so able to respond to the challenges in a way that does not undermine growth.

The final challenge is for countries left behind or retrogressing, and is in some ways the most daunting. The Millennium Development Goals agreed by the United Nations in 2000 have highlighted the extent to which some countries have fallen behind. Experience over the past half century has taught us that ultimately it is domestic policy reform that will determine whether those countries that have yet to integrate with the global economy in any meaningful way can begin to share in the benefits of global growth. Without policies that enable these countries to integrate more successfully into the global economy, their citizens will remain poor—and, indeed, will in some cases become worse, rather than better, off. Improved governance, an end to corruption, policies aimed at achieving macroeconomic stability are essential for the sustained growth that will make poverty reduction possible. Without such policy reforms, the scope for help from the international community will be restricted.

Yet the international community—bilateral and multilateral donors alike—has a vital role to play in helping these countries. Aid transfers continue to be vital of course. But so too is capacity-building, policy advice and technical assistance. Much of the IMF's work with these countries involves assisting the reform process, for example, by enabling them to implement public expenditure management and by improving

tax administration. And countries need assistance from the international community if they are to be able to absorb increased aid flows in ways which do not further undermine economic progress.

Conclusion

Let me briefly conclude.

The past half century has been a period of extraordinary growth for the world economy. Most citizens in most countries are far better off today than could have been imagined in the early postwar years. The pace of technological change has been, and continues to be, remarkable. Globalization has brought enormous benefits. And there are strong reasons for expecting this process to continue.

But at the same time there is no room for complacency. The last great period of globalization, at the end of the 19th century, ended in disaster, with the First World War. Progress was reversed and recovery from that setback took many decades.

A reversal this time may not be likely, but it is not impossible. Much of what has been achieved is a consequence of greatly improved domestic economic policies and, above all, the strength, durability and adaptability of the multilateral economic framework put in place in 1945. There have been many challenges to this framework over the years, all of which have ultimately demonstrated its underlying strength.

But the challenges we face today are, I believe daunting, not least because their seriousness is not fully recognized. The world trading system is at a crucial juncture. A successful outcome for the Doha Round will strengthen it greatly: failure would do much to undermine it. The complex problem of global imbalances must be addressed if the risk of a disorderly unwinding is to be avoided. And the problems of those countries that have yet to share in the benefits of globalization cannot be ignored.

Tackling these problems will consolidate and increase the gains already reaped from globalization. Ignoring them would be, at best, foolhardy.

Thank you.

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[1] O'Rourke and Williamson p. l7.

[2] Tariffs in many countries reached their lowest levels around l870 or l880 as some countries responded to the reduced prices of imports due to falling transport costs with higher levels of protection. See O'Rourke and Williamson p.95.

[3] There appears to have been rapid growth of industry in some developing countries; India seems to have had a twenty year period of sustained growth of industry in the late l9th century. None of these bursts of growth seems to have been sustained, however.

[4] Obstfeld and Taylor, p.55.

[5] Obstfeld and Taylor, p. 60.

[6]

O'Rourke and Williamson p. 35 ff.

[7] Japan was always an outlier in this regard.

[8] Today, the World Bank consists of the IBRD, the International Development Association (which provides loans at concessional rates and grants to poor countries that cannot access private capital markets), and several other affiliated entities.

[9] There were two exceptions—one to enable a county to "safeguard its external financial position and its balance of payments" and one for "infant industry protection" in developing countries. Subsequently, the GATT articles were amended to permit preferential treatment for developing countries by industrial countries in their trade regimes.

[10] See Anne O. Krueger "Trade Policy and Economic Development: How We Learn", American Economic Review, Vol. 87, No. I, March 1997, Pp. 1-22.

IMF EXTERNAL RELATIONS DEPARTMENT

Public Affairs		**Media Relations**	
E-mail:	publicaffairs@imf.org	E-mail:	media@imf.org
Fax:	202-623-6220	Phone:	202-623-7100