I have some good news and some bad news.

The bad news is that the business cycle is not dead.

- The “new economy” turned out to be not less susceptible to vicious downturns but more so – the technology downturn has been especially hard on East Asian economies which have a large exposure to this sector.

- Improved inventory practices, aided by just-in-time delivery, did not stop inventory cycles from amplifying cyclical dynamics: the inventory cycle in the 2001 downturn was one of the sharpest ever – especially in the United States.

- Improved fiscal and monetary management removed the traditional causes of downturns – at least in the major OECD economies – but did not prevent irrational exuberance in the private sector from inflating one of the most spectacular bubbles ever – leading to the dot.com meltdown that proved to be the leading edge of the downturn in the industrialized countries.

The good news is that the business cycle is not dead – downturns continue to be followed by upturns. The global economy is again showing its ability to bounce back. North America, which led the downturn, is now leading the upturn with a comparatively powerful V-shaped recovery in swing. In Canada, the rebound has been sufficiently strong that the Bank of Canada has already raised interest rates. There have also been encouraging signs that a turnaround in continental Europe and Japan is not far off. China, which escaped a downturn but saw growth slow to 6.6 percent in the 4th quarter of 2001, posted stronger growth in the 1st quarter at 7.6 percent.
Looking back, the record shows that countries that had followed prudent policies in the 1990s had flexibility to take aggressive counter-cyclical action during the downturn. This was certainly the case in Canada as our economy slowed sharply but avoided an outright recession. Other countries were not so fortunate. So the lessons learned from preceding cycles were not without reward. At the same time, we have to admit that there is much about the global economy that we do not understand. Economic risk is real and must carefully be taken into account – and this lesson is of course one that the organizations represented here are acutely sensitive to.

Looking forward, if the rhythm of past cycles is any guide, we can reasonably expect a period of economic expansion of some several years. Trade growth, which went into reverse in 2001, should outpace overall economic activity, as it did throughout the post-WWII period. We are already feeling this dynamic in Canada, where the trade numbers picked up sharply in the first months of this year. Global trade will also receive a boost from two developments:

- First, liberalization to meet WTO accession commitments by China and other recently joined WTO members; in China, I note that exports were up 9.9 percent in the 1st quarter but imports only advanced 5.2 percent. We can anticipate more stimulus to trade from this source.
- Second, the Doha Round of multilateral trade negotiations will provide a window of opportunity to further liberal trade and investment, adding to the existing dynamic.

Lest I be accused of being a starry-eyed optimist, I must acknowledge that the global economic expansion faces a daunting array of risks. But I do want to emphasize that here we are in familiar territory. Every expansion has been considered fragile in its early phase. Every expansion has been contingent on overcoming known obstacles to sustained growth. Let me highlight four issues that are important in the context of the emerging expansion:

- We need to inject hope into the Middle East. Because without hope there will be no peace and without peace there will be an ever present risk of instability spilling over into the rest of

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1 In 2001, world exports fell by 4 percent in value to US$ 6 trillion, according to the WTO’s latest report on international trade, released on 2 May 2002. The decline was smaller in volume terms (1 percent) as prices of traded goods fell by about 3 percent. For 2002, the WTO predicts a moderate recovery of around 1%.
the world. We need solidarity within the community of nations to win the war on terrorism, and to do so without dividing the world into hostile camps.

- Global macroeconomic imbalances need to be dealt with. In particular, the continued deterioration of the US current account deficit has to be of concern to all of that country’s trading partners. In previous US recessions, the current account swung into surplus. In this past recession, it remained in deep deficit at about US$ 400 billion. What is more, as the US economy turned the corner and started to grow, the already large deficit began to expand again. It flies in the face of reason that this deficit can continue to widen without serious repercussions in the global economy and capital markets.

- Japan needs to find a way out of its macroeconomic dilemma. Japan has not been a normal economy, capable of sustaining growth without fiscal and monetary stimulus for at least a decade and probably not since the Plaza Accord of 1985 which marked the beginning of a sustained and at times extreme exchange rate rise. Japan’s problems from the bubble of the late 1980s and non-performing loans are well known. But the fact is that Japan’s economy was being sustained by policy stimulus before either of those developments. Until Japan’s economy is restored to health, the global economy will not be firing on all cylinders.

- Finally, and of particular importance given the theme of this conference, we need to create a global economic context which is more conducive to success by emerging markets than has been the case in the last while.

I want to dwell on this last point. In 1996, the IMF identified 21 economies that were “forging ahead” and leaving other developing economies behind. These included of course the “Asian Miracle” economies – China, Korea, Hong Kong, Chinese Taipei and the Southeast Asian emerging Tigers. But it also included Argentina, Turkey, South Africa and other developing countries with superior performance. As it turned out, the large majority of these economies experienced one or more financial and economic crises in the next half decade – China was of course one of the notable exceptions.

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Volatility of international capital markets took part of the blame for these crises, as did weaknesses in the international financial framework that are now being addressed (including for example an international insolvency regime for sovereigns). But much of the blame was laid at the foot of the crisis countries themselves. In sharp contrast to the relative degree of praise heaped on these economies a short 6 years ago, the ex post criticisms of their policies have often been so severe that one is left wondering how on earth they managed to grow at all let alone make it onto the IMF’s list of emerging market “stars”.

At the time, the IMF could only classify 23 of the 185 or so countries on the planet as being “industrialized”. These 21 emerging markets were thus the “B+” group of the global economy – by almost any objective standard, they had managed a sustained period of performances that was significantly better than the remainder – the “non-emerging markets” so to speak.

So we are faced with a conundrum: if most of the emerging market stars were in retrospect disasters waiting to happen, needing fundamental reform to untenable policies, then what realistic hope is there for the rest of the global community? The global community cannot comfortably go forward on the basis that, in order to develop, an emerging market must have Singaporean-like foreign currency reserves and current account surpluses, or be one of the most attractive destination for foreign direct investment in the world, as China has been. Nor is it reasonable to ask developing countries to have in place the institutional trappings of an OECD member economy as a precondition for development. That simply sets the bar too high for most countries.

This is not to diminish the importance of developing countries making their best efforts to deal with known problems as exemplified in the commitments that African countries have made in the New Partnership for Africa's Development (NEPAD). Macroeconomic prudence, sound financial practices and good governance are clearly part of the solution. Canada, as G7/8 host this year will be promoting vigorously these ideas and seeking to mobilize support for this initiative from the industrialized countries.

Nor is it to diminish the importance of market opening in the industrialized world to products from the developing countries. Without attempting to assign causality, it is clear that no country
has managed to develop without trade and investment playing an important role. Trade and investment have been central to China’s remarkable transformation and growth record since the 1980s. A successful Doha Round – including trade-related technical assistance and capacity building from the industrialized countries – is therefore also clearly part of the solution.

But the developmental failures of the past quarter century and the record of emerging market crises of the last half decade suggest that this will not be enough to generate what we would all like to see – a rising tide of vibrant economic growth and democratic development that lifts all boats in the developing world. In this world, the difference that good policies would make would not be the difference between survival and disaster but in how fast a country gets ahead. And, in this world, the growth of final demand in the developing countries would also fuel growth in the industrialized world – just as China’s growth last year, led by domestic demand, helped cushion the downturn for its trading partners. Rarely in the past few decades have we seen the three main cylinders of the global economy – the US, Japan and EU – all firing at the same time. And today, with economies leaner and meaner than they’ve ever been, with excess capacity all around, and with prices flat or falling, there is every evidence of inadequate global demand. So we need generalized growth in the developing countries for the good of the global economy.

I do not pretend to have the answers of how we get to that world. But I do think that the answers are bound up with the factors responsible for one of the puzzling stylized facts about today’s global economy. This is described by what has been called the “Mathew Principle” after a passage in the Bible: “For unto every one that hath shall be given, and he shall have abundance: but from him that hath not shall be taken away even that which he hath.” (Mathew 25:29) – this could be paraphrased as “The rich get richer and the poor get poorer”.  

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3 For a description see William Easterly, The Elusive Quest for Growth: Economists’ Adventures and Misadventures in the Tropics (MIT Press, July 2001). In his review of Easterly’s book, Berkeley economist Bradford DeLong observes: “Since World War II there have been at least six such crusades [for development]: the "building socialism" crusade, the "financing gap" crusade, the "import substitution" crusade, the "aid for education" crusade, the "oil money recycling" crusade, and the "population boom" crusade. All of them failed to spark rapid economic development.” DeLong groups the current initiatives for development into the seventh or “neoclassical crusade”. See J. Bradford DeLong, “The Last Development Crusade” http://econ161.berkeley.edu/TotW/Easterly_neoliberal.html .

In economists’ jargon, the concept is that of “increasing returns” or “agglomeration pressures”. In systems dynamics, it is described as “positive feedback”. In today’s global economy, it is reflected in the fact that skilled labour and capital are not apparently flowing to regions where they are least available but are crowding into those places where they are most abundant – into the OECD countries and, in recent years particularly, into the most capital-rich and skill-labour-rich corner of the OECD, the United States.

The “Mathew Principle” is consistent with divergence, not convergence; it is destabilizing not stabilizing. It is very much at odds with the predictions of neoclassical economics that form the main intellectual basis for today’s policy prescriptions. It is also very much at the heart of the antipathy towards globalization that has fuelled the protest movement of the last half decade.

It is instructive to note that previous eras of globalization did not seem to be dominated by this principle. Consider the following description of globalization during the 19th Century:

“In the decades after the Napoleonic Wars, trade barriers fell dramatically, and capital and labor became exceptionally mobile. A dismantling of the byzantine tariffs, prohibitions, and regulations of the eighteenth century mercantilist empires began the process. From mid-century, the technology of iron and steam conquered distance, dramatically reducing the natural protection that transportation cost had hitherto provided. In the last quarter of the century, political reaction to imports and immigration slowed international convergence somewhat but did not eliminate it. To observers today, the globalization of factor markets seems even more striking than that of trade. Labor migrated largely free from government regulation and technological improvement made international travel swift and safe. Foreign investment faced few regulatory impediments while the new telegraph and improved stock markets made information more easily available and the international gold standard provided an international monetary standard whose stability investors today can only envy.”

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It would take only a few minor changes to transform this passage into an account of the era of globalization that followed World War II, when the trade barriers erected during the 1930s were dismantled, when the ongoing technological revolution in transportation and telecommunications further reduced the natural barriers of distance, and when global trade and investment boomed. There are differences, of course, but the essential elements of globalization are evident in both eras. Indeed, insofar as there are differences, they lie in the fact that 19th Century globalization faced fewer barriers – labour and capital mobility was greater than they are today.

What is striking in this description is that 19th Century globalization led to convergence, uneven as it was. Skilled labour and capital flowed from the core – the industrialized heart of Europe and from the London capital market – to the periphery. The Mathew Principle did not apparently apply. From this we can conclude that it is not an inherent feature of globalization. This is good news because it means there is no inevitability to globalization resulting in “the rich getting richer and the poor getting poorer”. By the same token, the recent dominance of the Mathew Principle points to problems in the structure of incentives in today’s global economy.

This is a problem for the global community as a whole. This is because, in a globalized world, distortions in one corner of the world are reflected in equal and offsetting distortions elsewhere. Consider some of the possible linkages:

- Is it a coincidence that the ballooning of the equity market bubble in the industrialized countries in the late 1990s happened at the same time as emerging markets were deflated by a massive outflow of capital?

- Is it a coincidence that the country with the main international reserve currency – the United States – has been running massive current account deficits at the same time as emerging markets around the world (and especially in East Asia) have been stocking up massive foreign currency reserves to guard against future waves of instability – and in so doing are effectively financing the treasuries of the reserve currency nations?

- Is it a coincidence that, in the context of a globalized capital market, one of the world’s major capital exporters – Japan – finds itself in the curious position of having a so-called “liquidity
“liquidity trap” while at the same time other parts of the global economy go begging for capital?\(^6\) In a world characterized by a shortage of capital and very high nominal rates of return on offer in many countries, it is curious indeed that Japanese savers keep their money in effectively zero interest rate savings vehicles in Japan instead of exporting their savings to capital-short regions where profits can be made – which would of course resolve the liquidity trap.

I think it’s well understood that, in a globalized world, we are all hostage to each other’s fortunes. Externalizing our problems – for example by competitive devaluation or trade protectionism, or allowing instability to spread abroad – eventually comes back to haunt us. As the cliché puts it, what goes around eventually comes around. There are thus collective action problems to be overcome if we are to make globalization work to the benefit of all. The happy side of this coin is that solving the problems and pressures in one area can also help solve problems elsewhere.

To summarize, the global economy is in the beginnings of a new expansion phase. As always there are challenges to overcome but in the short and medium term there is a window of opportunity opening up for developing countries to integrate themselves into the global economy, including by taking advantage of the Doha Round. At the same time, there are practical measures that can be taken by developing countries themselves and by the international community to address known weaknesses – as exemplified by the NEPAD and by efforts by Finance Ministers to mitigate the difficulty of dealing with international financial problems. And, finally, we have to go beyond these actions to examine the large-scale economic dynamics and incentive structures within the global economy that generate the effects captured by the Mathew Principle. Because we know from history that this is not a necessary or inevitable feature of globalization.

\(^6\) The theoretical description of the ineffectiveness of Japan’s monetary policy to stimulate investment is the so-called “liquidity trap”. Originally advanced as a theoretical curiosity in a closed economy model, the theory has nonetheless been unearthed to explain Japan’s problems. Not only has the theory been advanced by academics, it has been embraced by the Bank of Japan itself, which offers credible evidence of the actual existence of this effect. See “Japan’s Liquidity Trap and Monetary Policy”, Speech given by Kazuo Ueda, Member of the Policy Board, Bank of Japan, September 29, 2001. \(\text{http://www.boj.or.jp/en/press/koen072.htm}\). Ueda confirms that under-subscription in the Bank of Japan’s liquidity supply operations have been frequently observed, confirming the satiation of liquidity demand and the lack of power of expansion of the monetary base to affect credit conditions. Paul Krugman addresses the question of how a liquidity trap can emerge in the context of a open capital market. See Paul Krugman, “Japan’s Trap”, May 1998, at \(\text{http://web.mit.edu/krugman/www/japtrap.html}\)