Peace and Economic Development in the Age of Globalization

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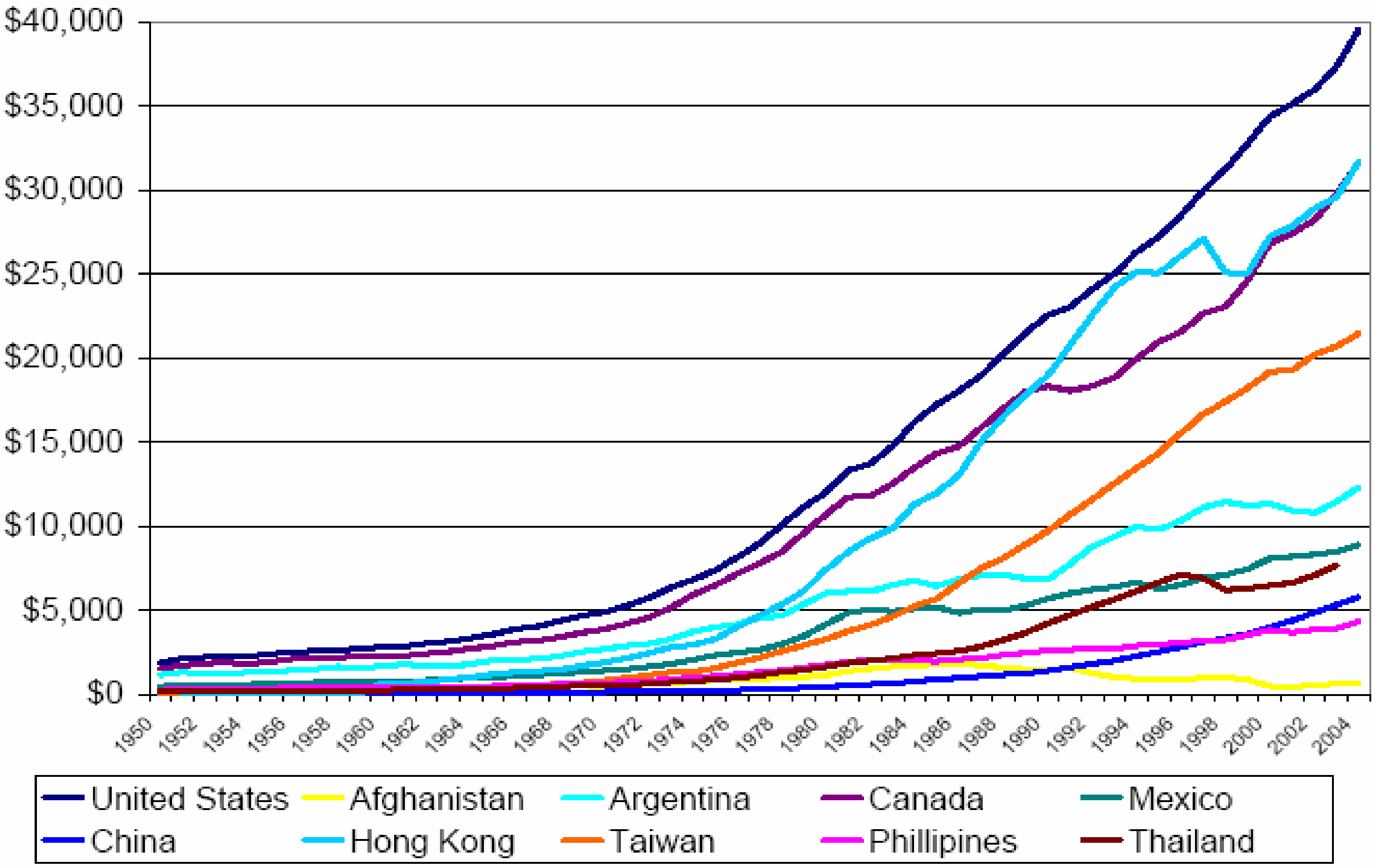
- Deficient economic development often comes in the way of peace

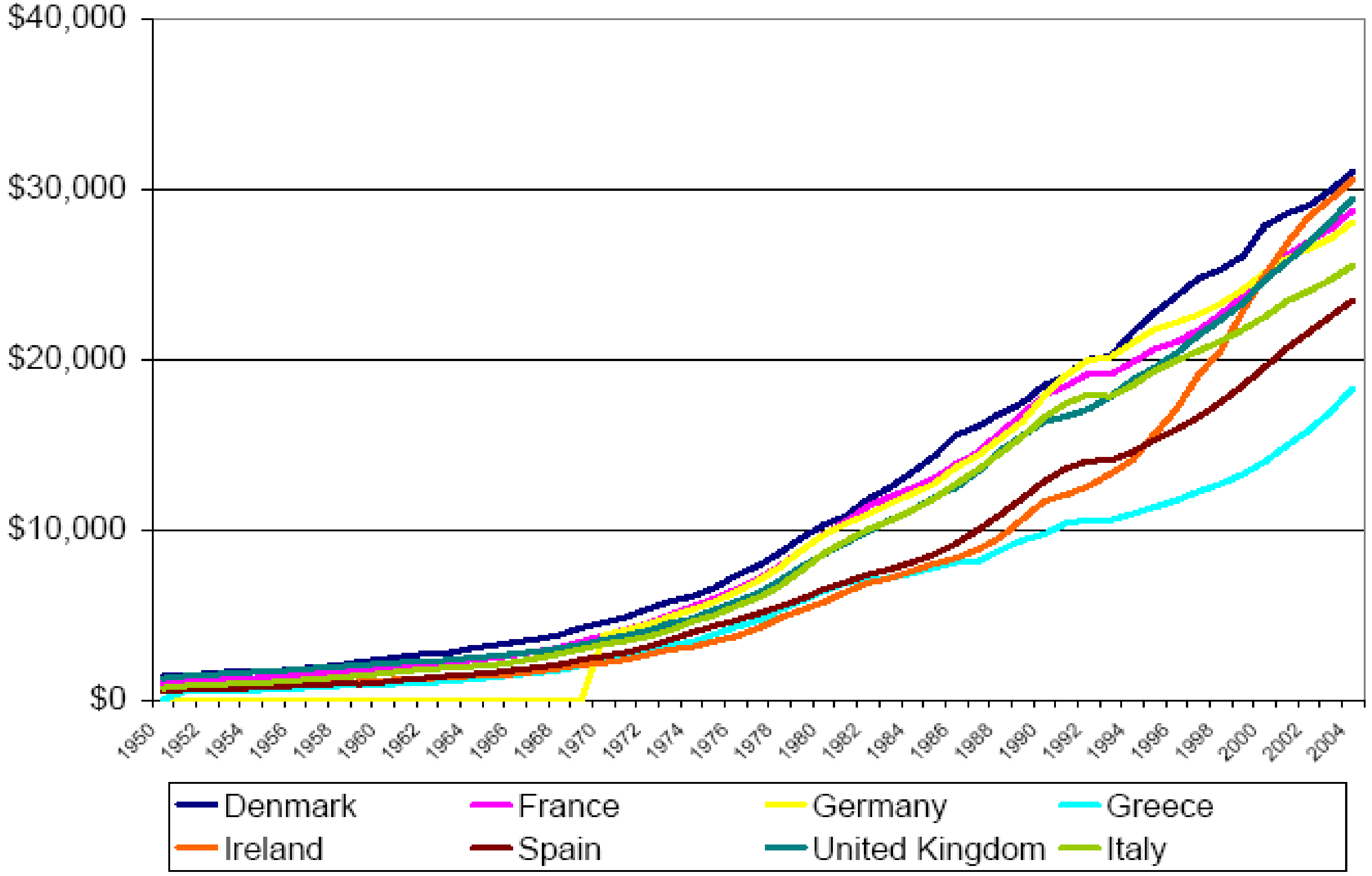
This fact is recognized by many.

Example: Emphasis placed on the topic of development at the annual Conference of Nobel Laureates, *Building a Better World*, arranged in Petra, Jordan, by the Elie Wiesel Foundation for Humanity and the King Abdullah II Fund for Development.

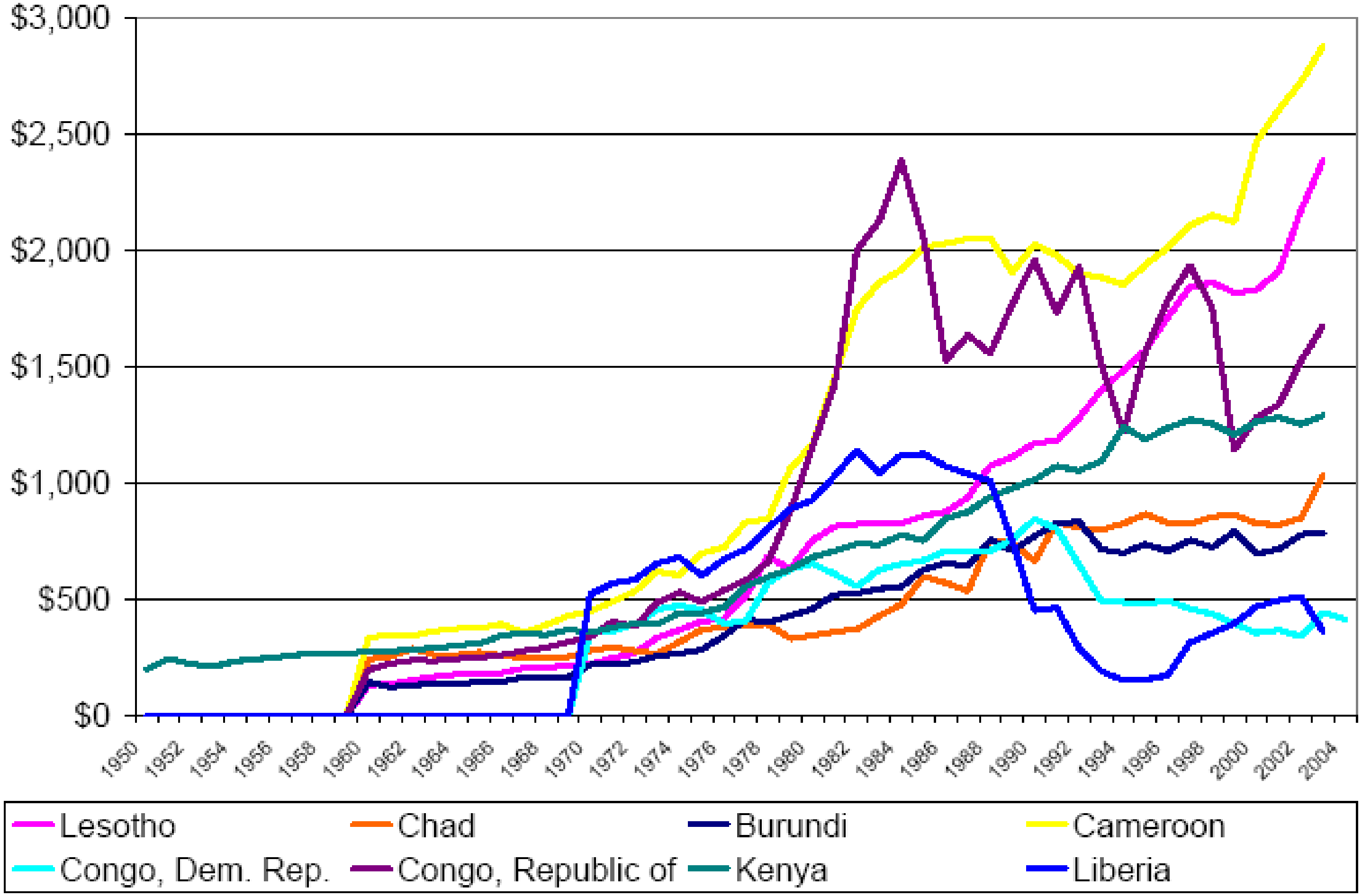
Real GDP per capita



Real GDP per capita: Europe



Real GDP per capita: Africa



Overview of Talk

- Framework of modern macroeconomics
- Rules vs discretion; fundamental reason for policy inconsistency over time
- Acute examples
- Lessons from Argentina and Ireland
- What fosters/hampers economic development?

- Models inhabited by millions of people

  Characterized by preferences over goods and leisure into the indefinite future

  Budget (resource) constraints

  Model economies are explicit about people’s dynamic decision problems

- Models contain thousands of businesses

  Aggregate production function

  Technology for converting inputs of capital and labour into output of goods and services

  Technological change

- Calibration

  Model is a measuring device; needs to be calibrated

  Part of making the quantitative answer as reliable as possible

  Computational experiment

- Introduce government

Government has an objective
and a budget constraint

Theoretical result:

The optimal government policy generally is
inconsistent over time and requires a
commitment mechanism to be implemented.
Alternative outcomes can be very bad.

- Fundamental reason for inconsistency:

  Planning for today and the future,
  the optimal government policy takes into account current and future private decisions, which in turn depend on current and anticipated future government policy.
  When the future arrives, private decisions up until then have already been made, implying a temptation, even for a benign government, to change its policy from then on.

- Where is that temptation the greatest?

  Increasing tax on physical and human capital

  Partially renege (default) on government debt through surprise inflation

Examples of mechanisms used in practice by governments to attempt to tie their own hands (not necessarily successfully!)

(i) Gold Standard

(ii) Currency Board

(iii) Independent Central Banks

- Inflation targeting

  How likely to work in the long run?

  Equivalent to price-level targeting? No.

- Main driving force for economic growth:

  Innovative activity and technological change

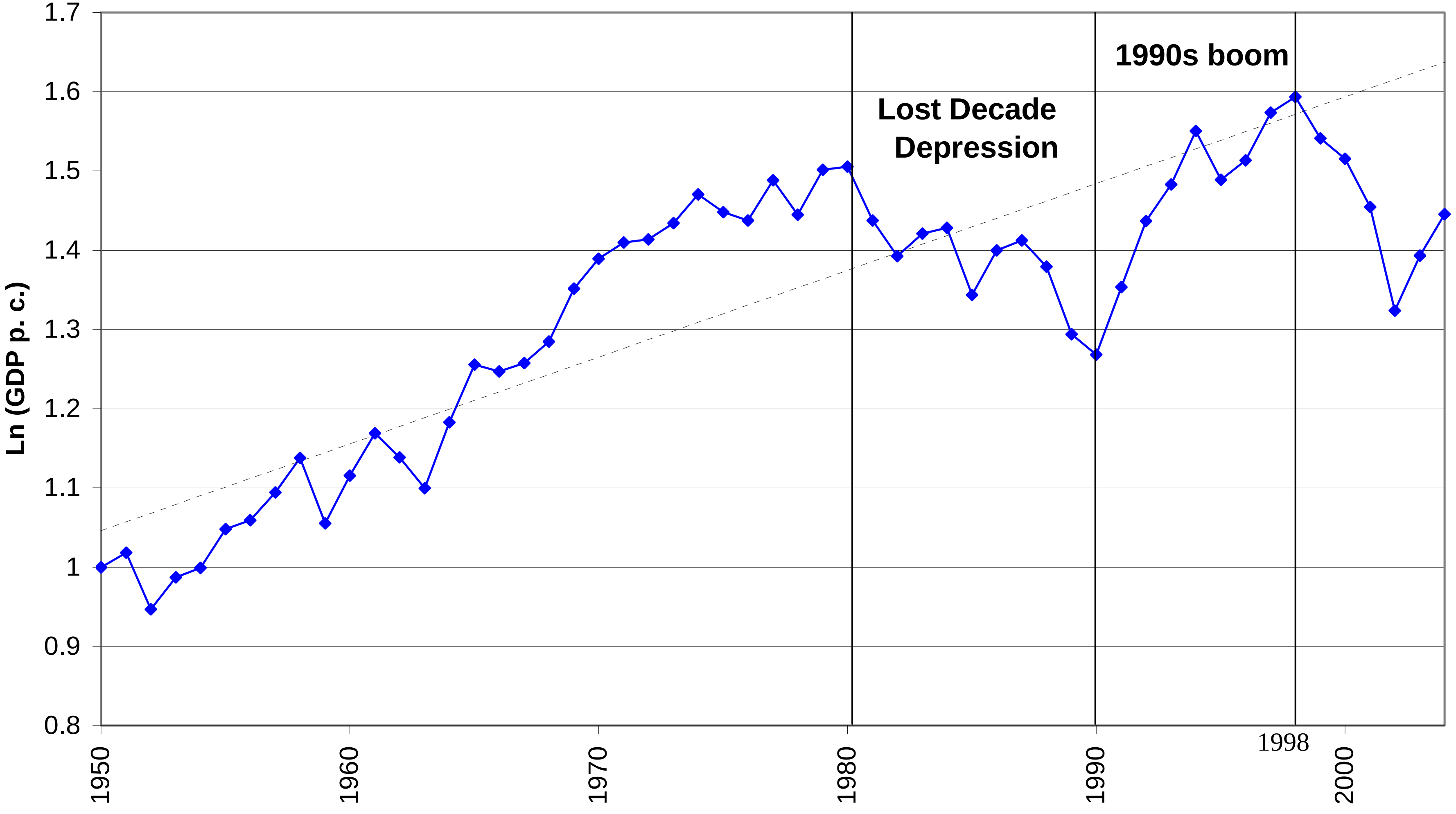
- But cannot live by technological change alone

  Need incentives to invest in new capital
  (factories, machines, office buildings…)

  Government policy may be detrimental
  to such growth

  Example: Argentina in the 1990s

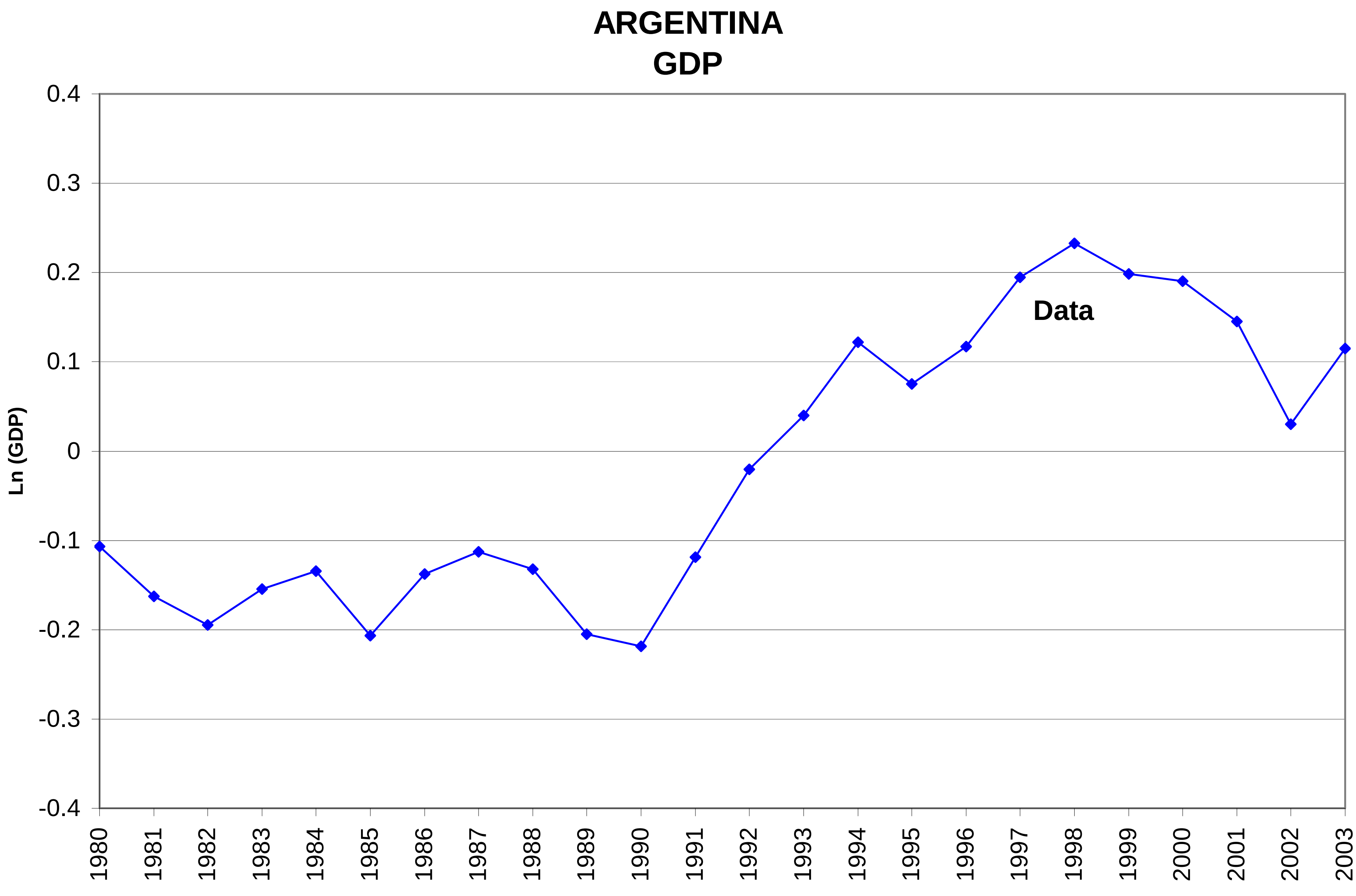
ARGENTINA
GDP per working age person (Index)



- Lost Decade in the 1980s. But especially interesting: the 1990s boom

  Argentina grew fast from 1990 to 1998

  Surprise: In light of the high rate of productivity growth, the standard model implies investment should have been much larger in the 1990s, and the capital stock therefore much bigger by the end of the decade


ARGENTINA
GDP
Ln (GDP)
Data
0.4
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
1980
1981
1982
1983
1984
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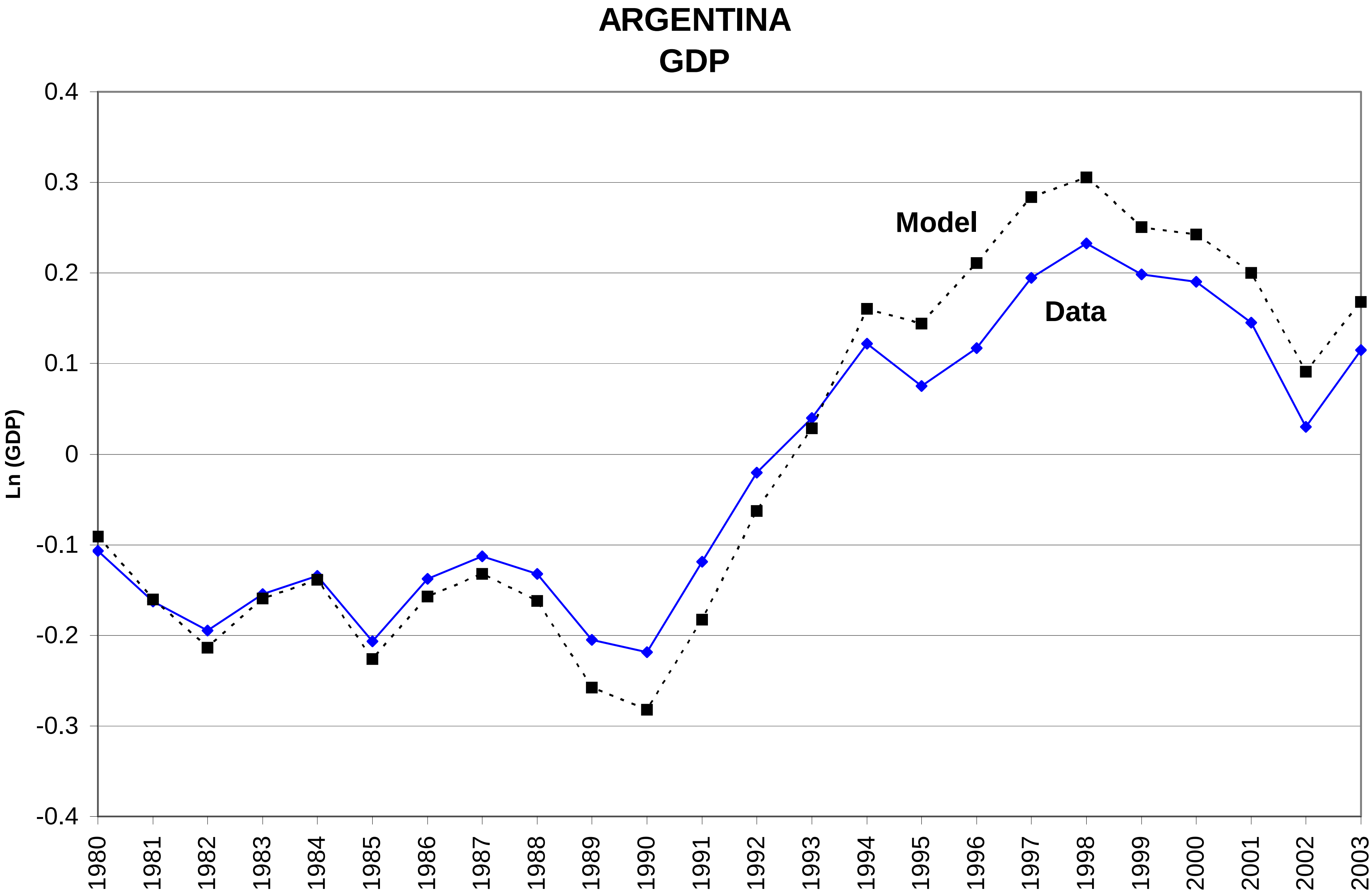

ARGENTINA
GDP
Ln (GDP)
0.4
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
Model
Data
1980
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1982
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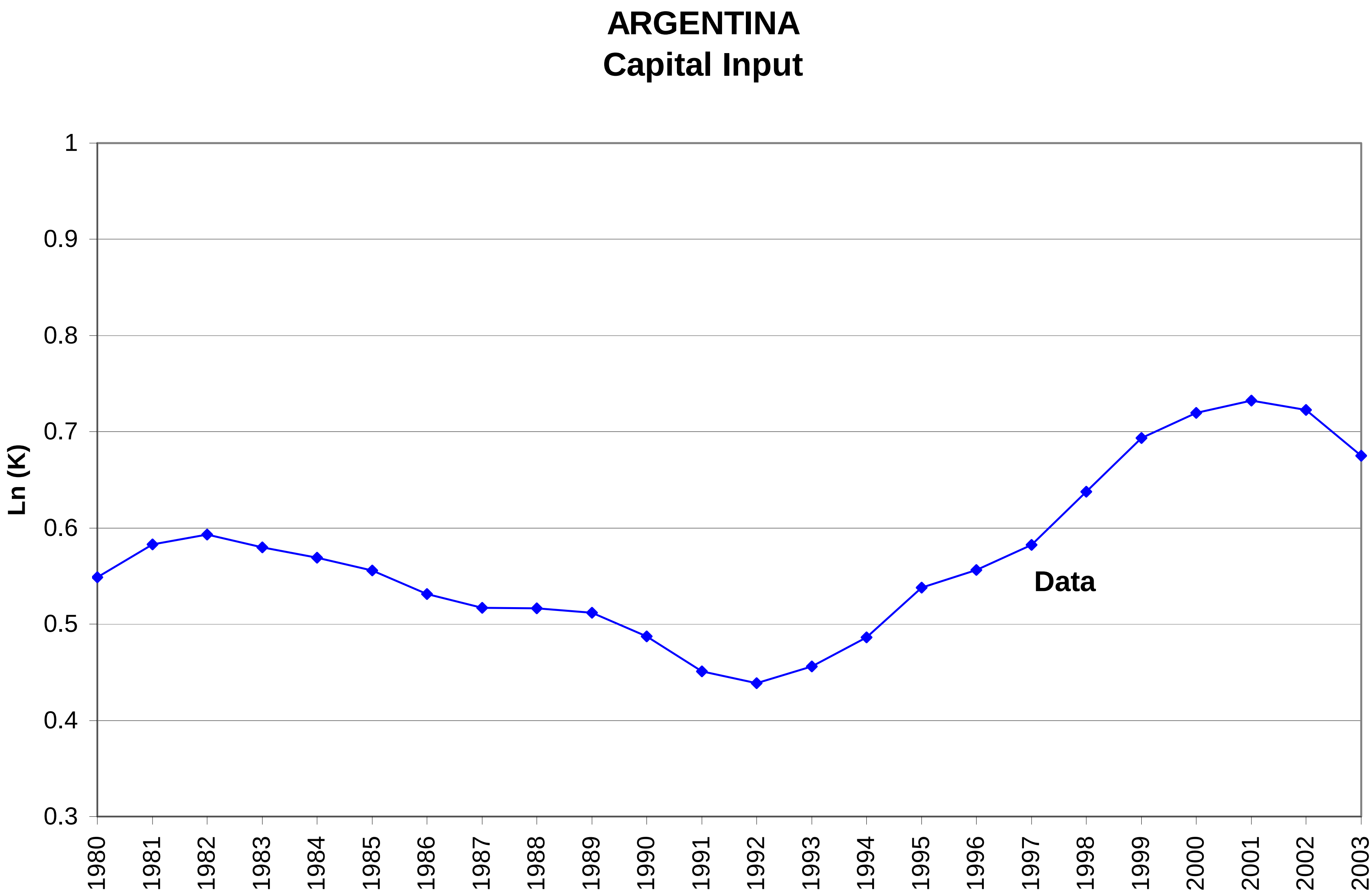
ARGENTINA
Capital Input
Ln (K)
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
Data
1980
1981
1982
1983
1984
1985
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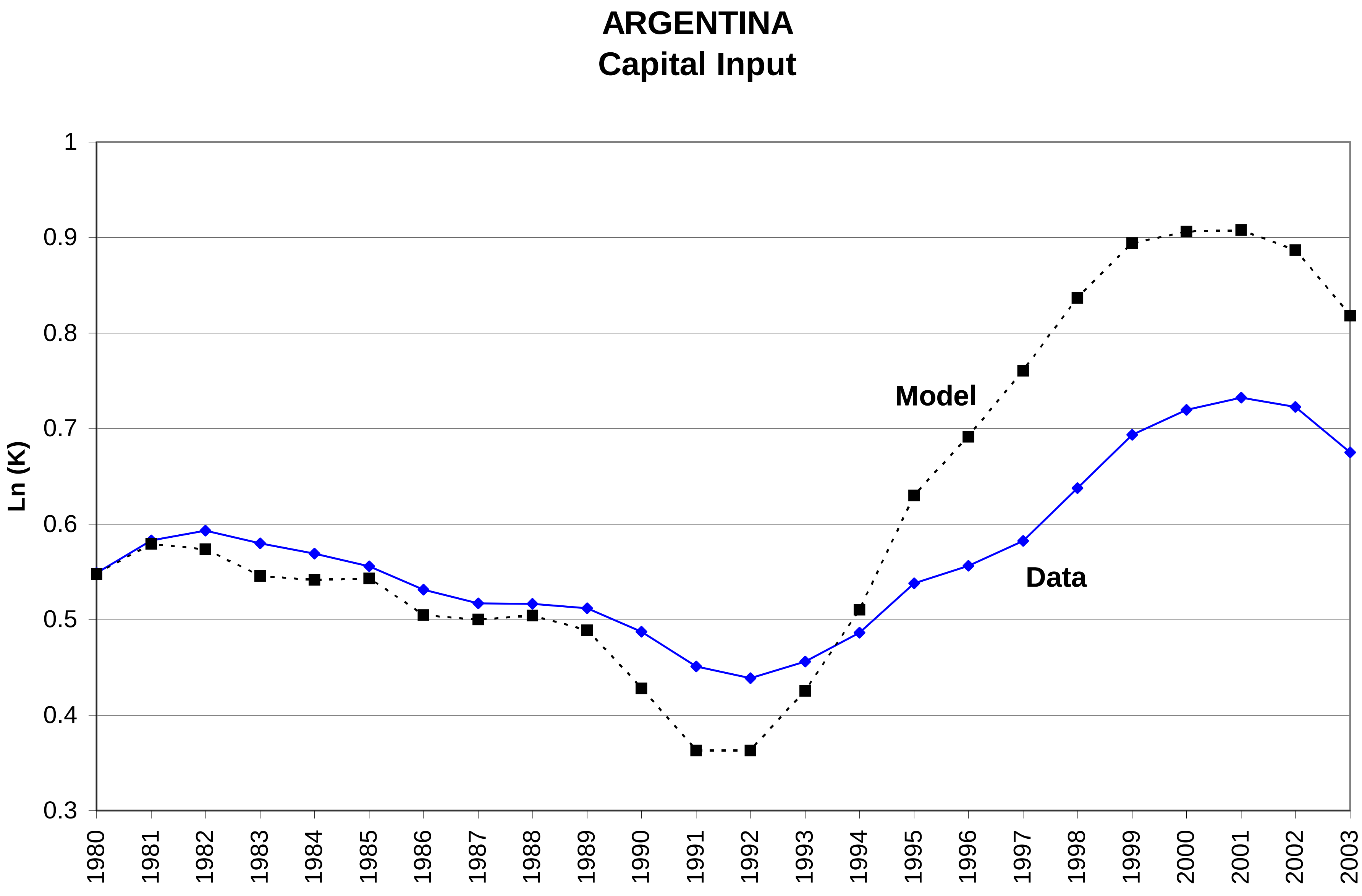
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Capital Input
Ln (K)
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0.8
0.7
0.6
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0.3
Model
Data
1980
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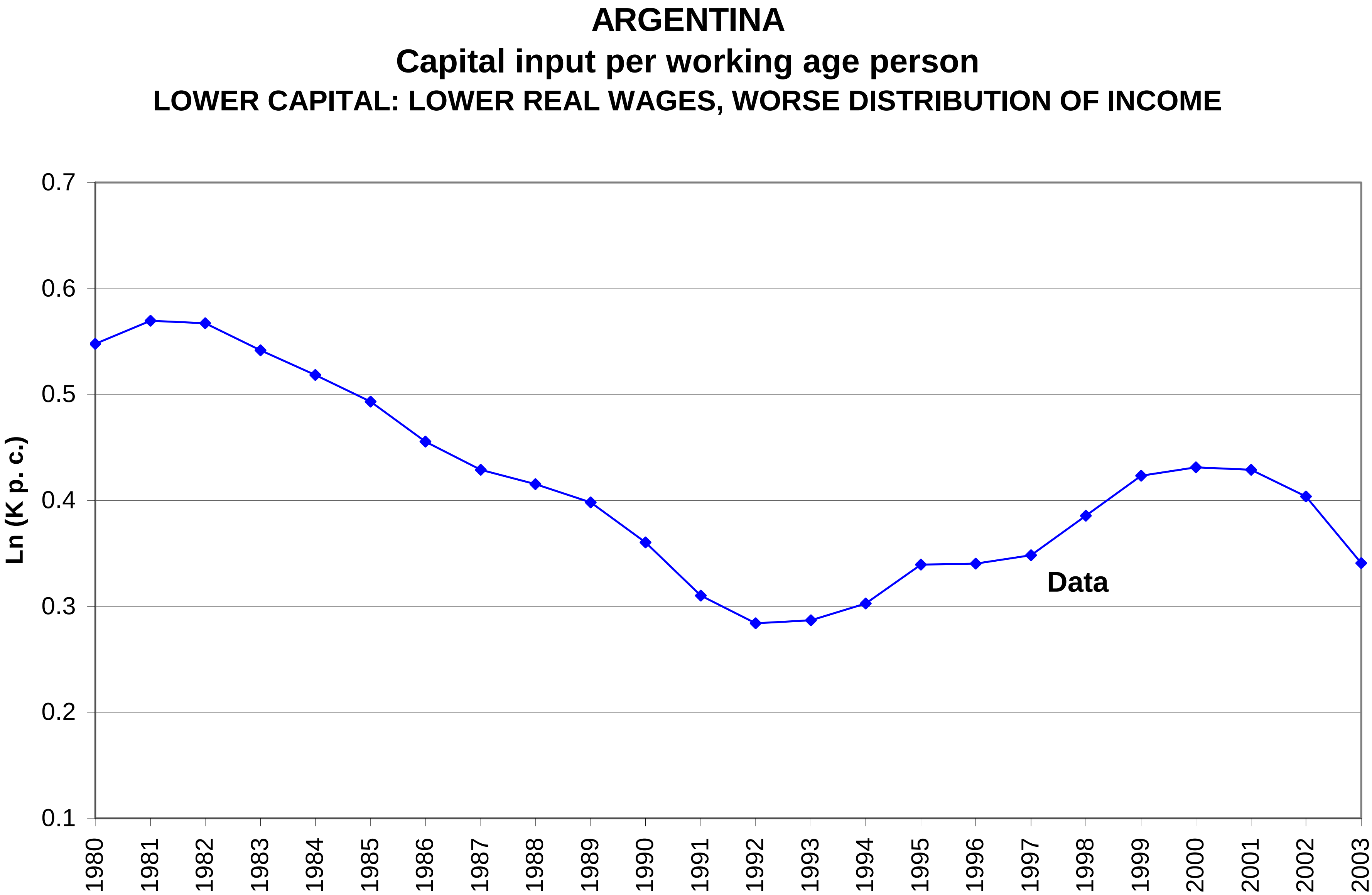
- Possible explanation

Time-inconsistency “disease” due to past hyperinflations, devaluations, deposit freezes and defaults on government obligations, resulting in lack of **credibility** among investors


ARGENTINA
Capital input per working age person
LOWER CAPITAL: LOWER REAL WAGES, WORSE DISTRIBUTION OF INCOME
Ln (K p. c.)
0.7
0.6
0.5
0.4
0.3
0.2
0.1
Data
1980
1981
1982
1983
1984
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1998
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2002
2003

- Argentina’s recent recovery

Will “capital gap” be closed? If not, poor will continue to be poor for a long time

How to restore confidence?

No easy answer

Need policy geared for the long run, that is, for the next 5, 10,… years

- Lessons for policy

Focus on incentives for productivity growth (innovation) and capital accumulation

Government policy has to be **credible** and **forward-looking** (e.g., Ireland since 1990)

Institutions geared to avoiding “time-inconsistency disease”

- Income and wealth disparities across nations

Low income often the result of country-specific policies that directly or indirectly restrict the set of technologies that can be used

Bad: protection of vested interests

A lot of knowledge available. May need to be combined with nation-specific innovative activity

- Importance of good economic policy

  Paraphrasing the conclusion of Parente & Prescott’s book on *Barriers to Riches*:

  With good policy, there is potential in poor nations for, not 1-2 percent, but 1000-2000 percent income increase