Long-Run Policy Consistency and the Growth of Nations

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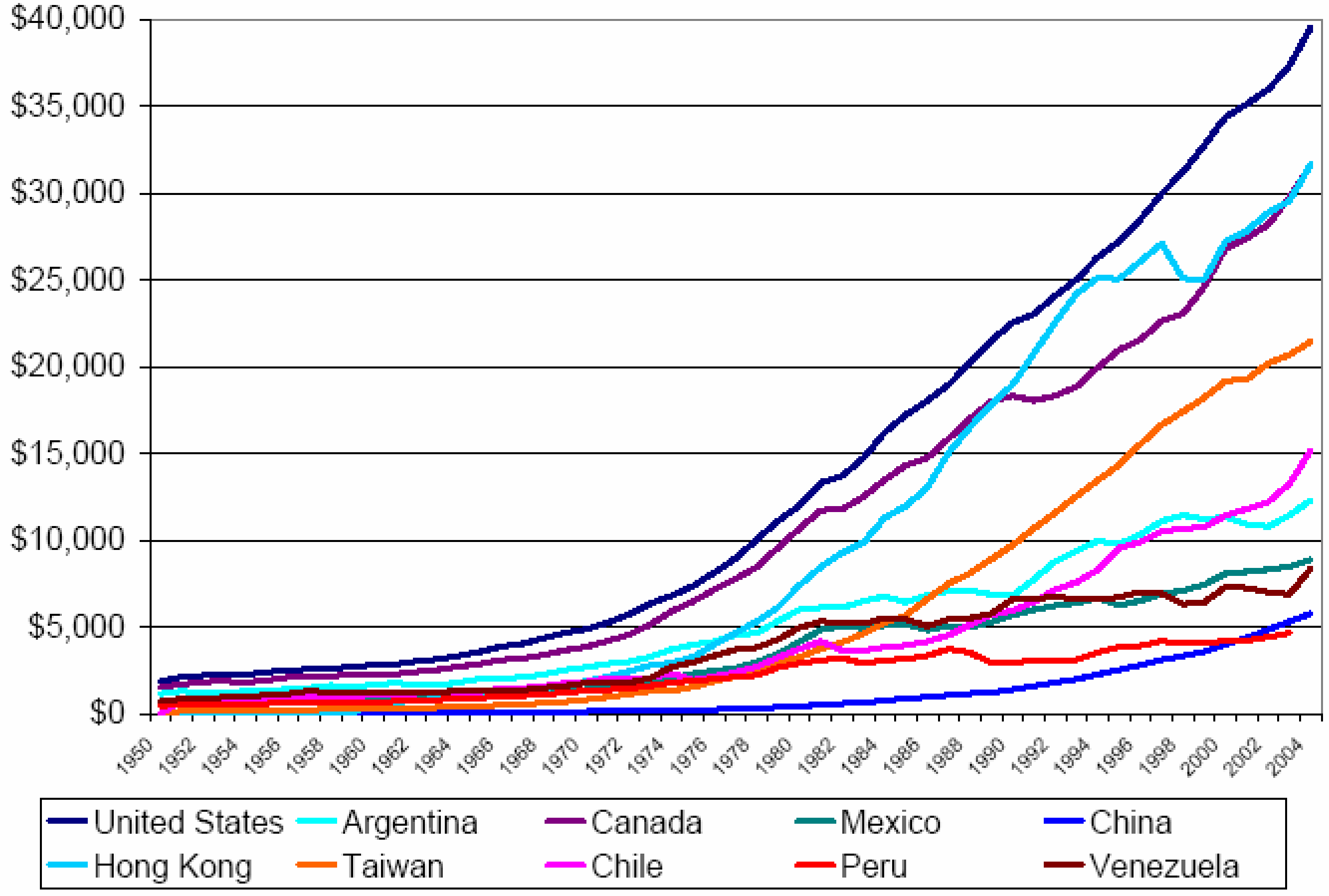
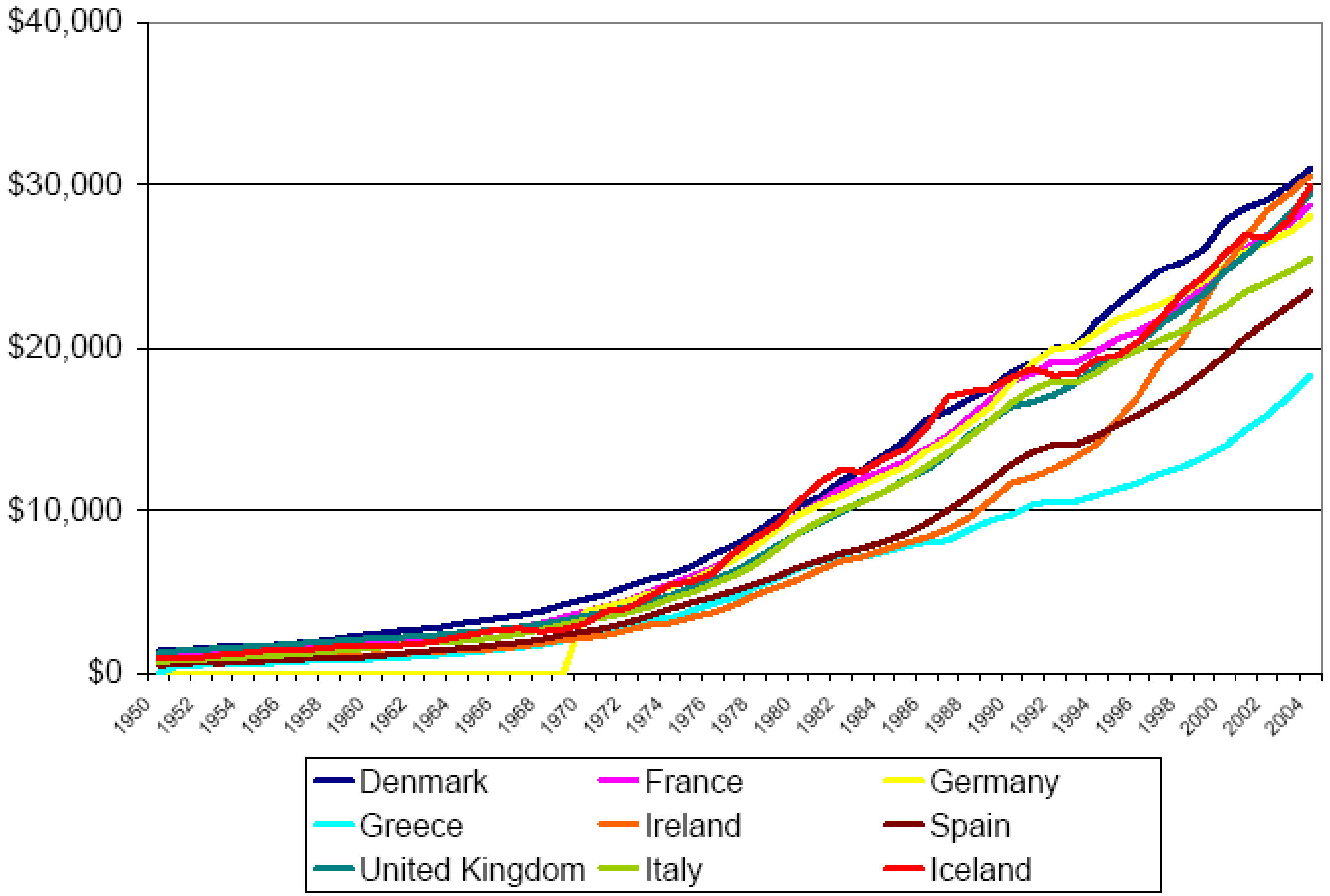
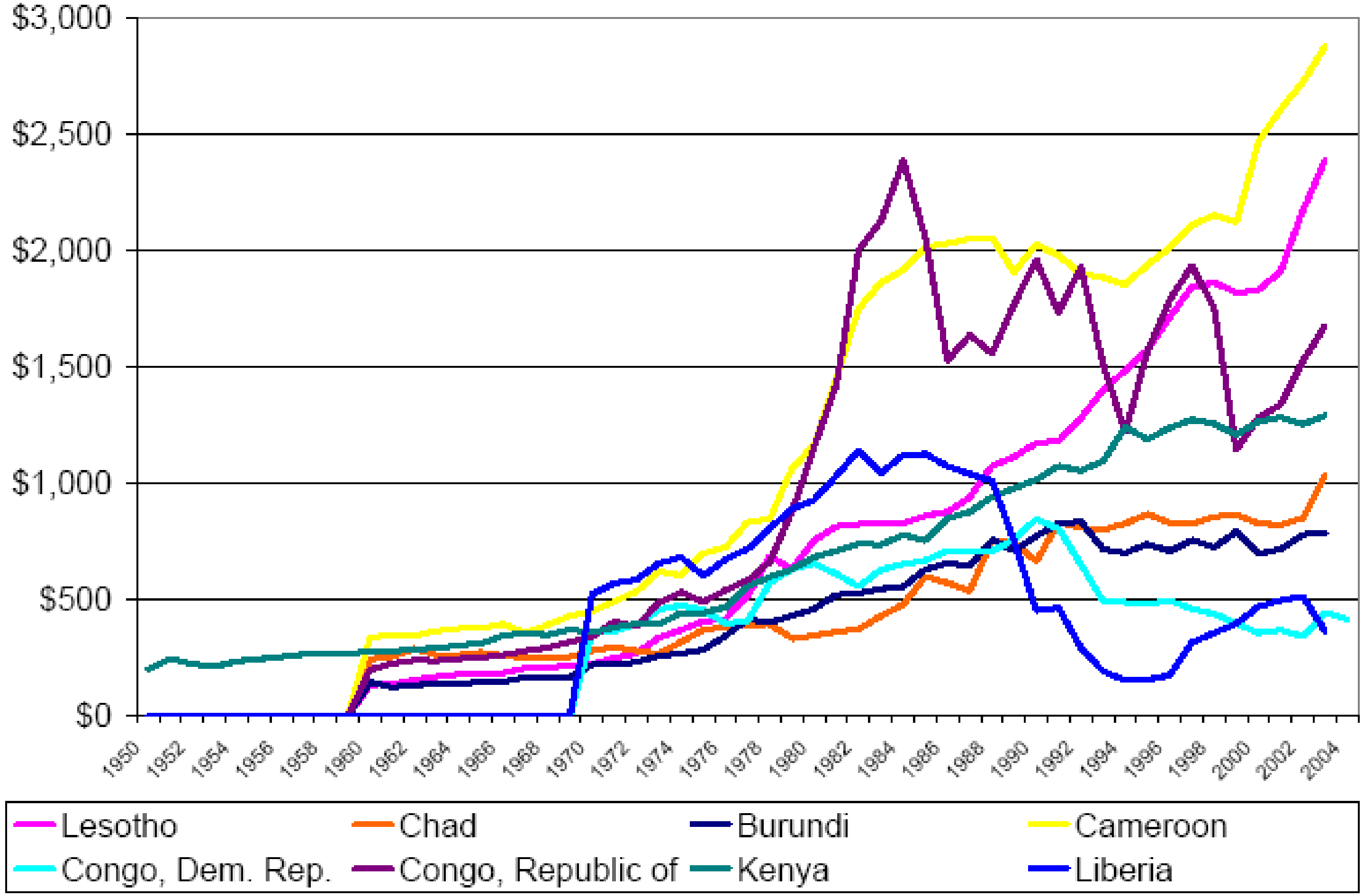
Real GDP per capita



Real GDP per capita: Europe



Real GDP per capita: Africa



Overview of Talk

- Framework of modern macroeconomics: Models with people

- Fundamental economic reason policy may be inconsistency over time

- Examples of where it may hit badly

- Lessons from Argentina and Ireland

- What fosters/hampers economic growth and 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

$$GDP_t = Z_t F(K_t, L_t)$$

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

Technological change

- Government in such an economy: Recent examples

  Monetary changes not potent to jumpstart the economy

  Fiscal policy: Temporary tax cuts have little effect. Investment in infrastructure better

- Focus on government with its budget constraint

  Suppose the government has an objective, say, to maximize some measure of welfare over time

  Theoretical result:

  The optimal government policy generally is inconsistent over time; requires a **commitment mechanism** in order 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:

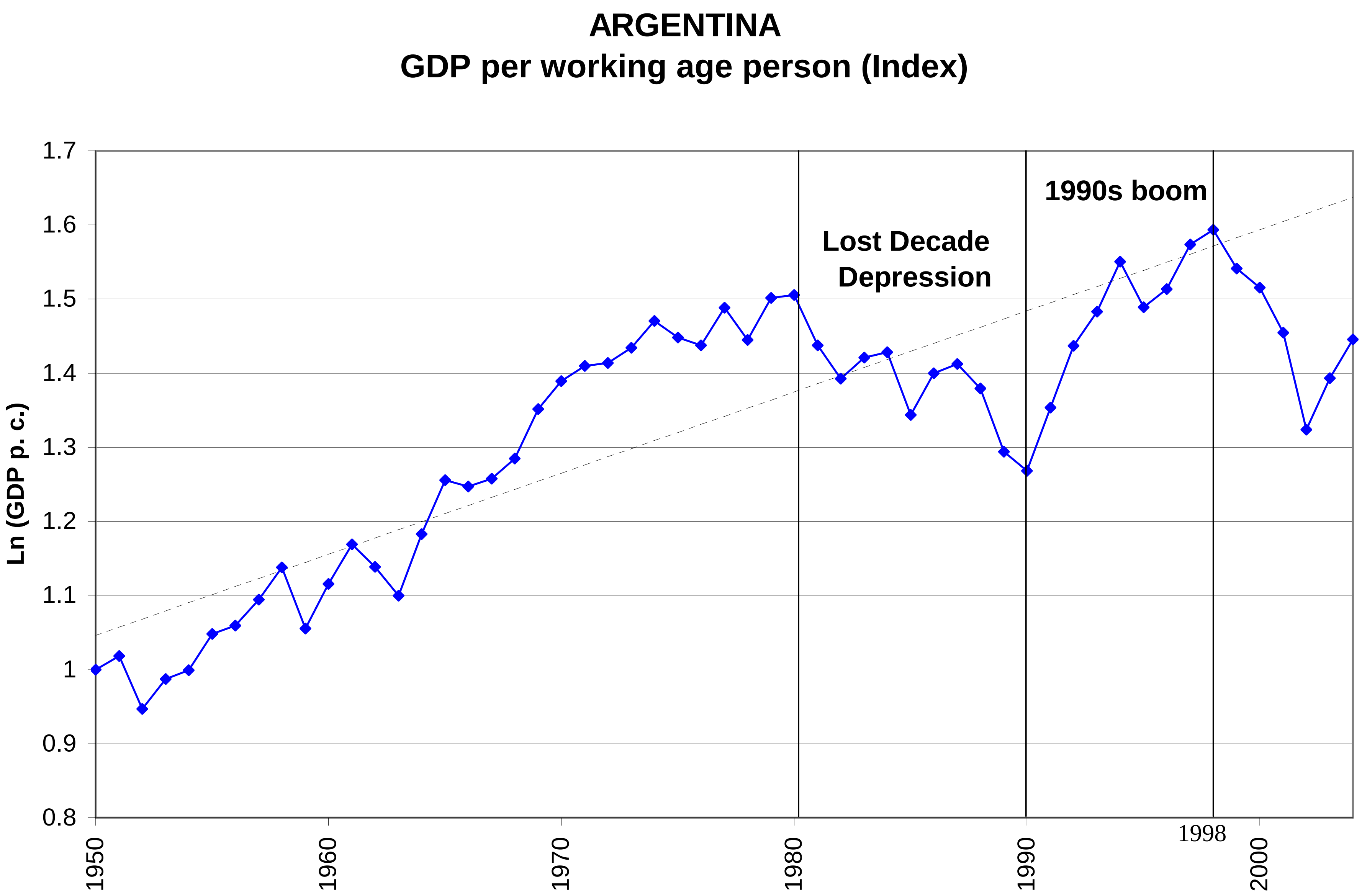
  Innovative activity and technological change; much knowledge available all over the world

- But cannot live by technological change alone

  Need incentives to invest in new capital, physical (structures and equipment) and human

  Government policy may be a crucial factor, positive or negative, for such growth

  Examples:
  Argentina in the 1990s
  Ireland in 1990s and 2000s



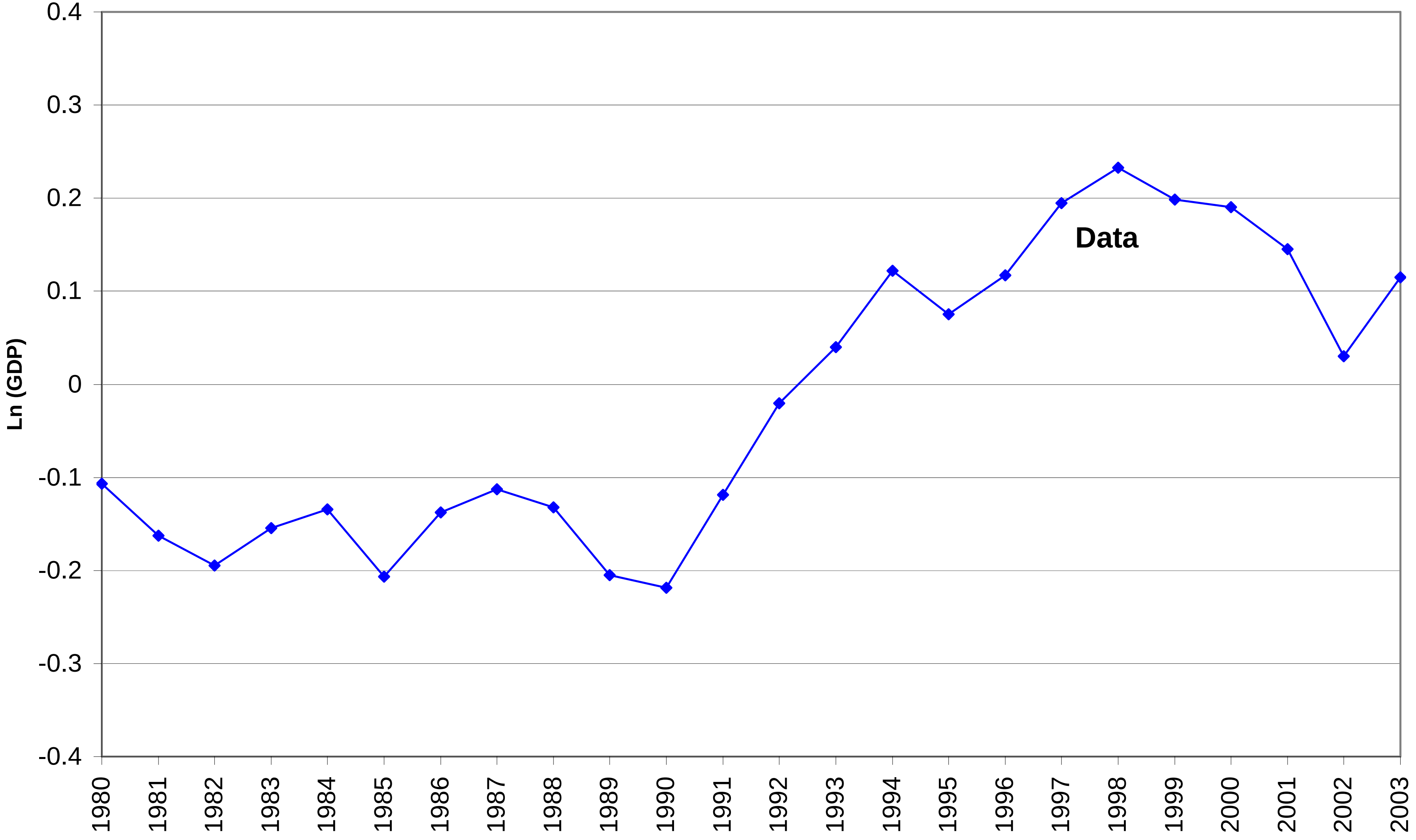
ARGENTINA
GDP per working age person (Index)
Ln (GDP p. c.)
1.7
1.6
1.5
1.4
1.3
1.2
1.1
1
0.9
0.8
1950
1960
1970
1980
1990
1998
2000
Lost Decade
Depression
1990s boom

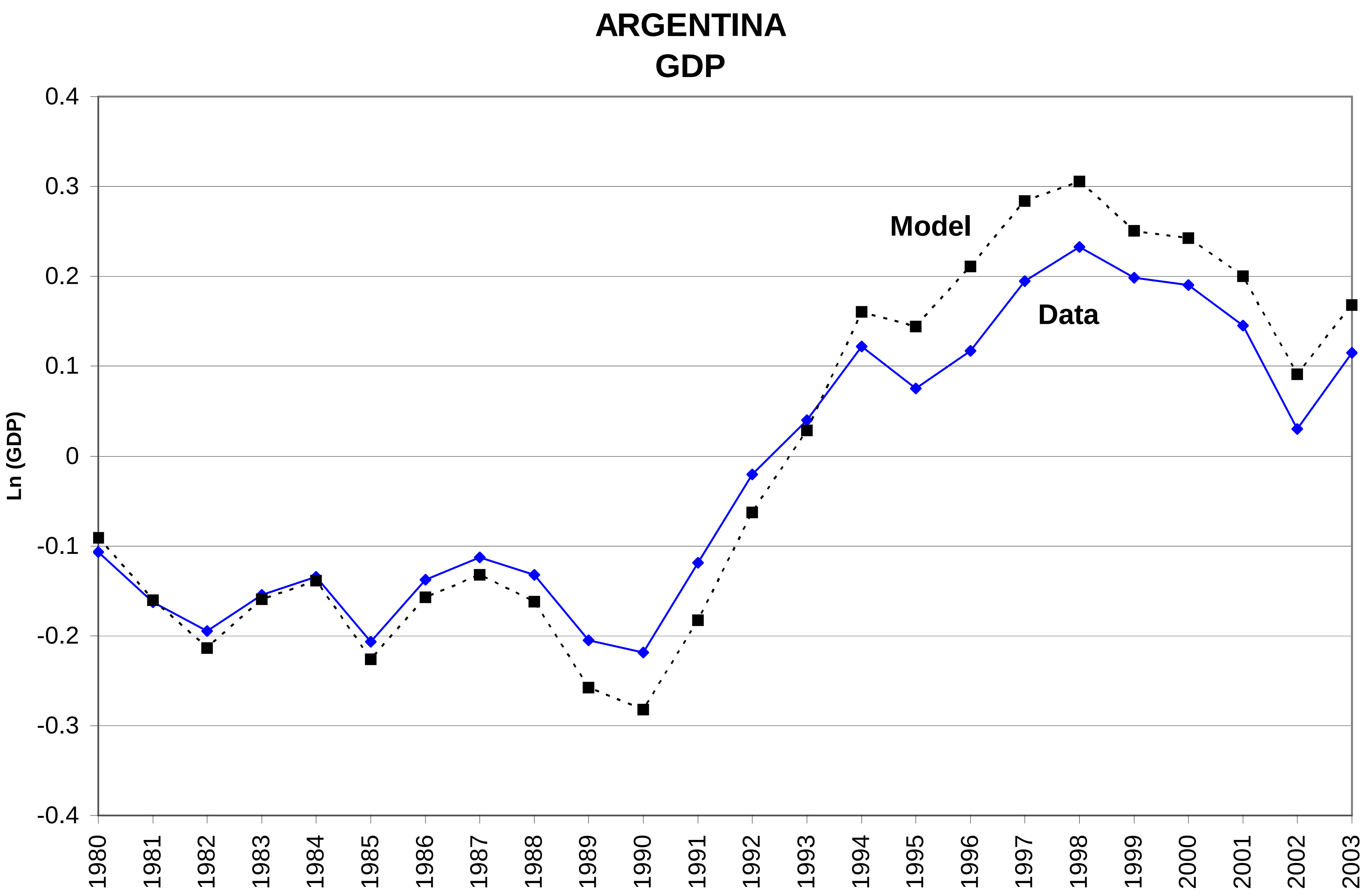
- Argentina's Lost Decade in the 1980s.
  But especially interesting: The 1990s boom

  Grew at fairly high rates in the 1990s

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

ARGENTINA
GDP





ARGENTINA
GDP
Ln (GDP)
0.4
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
Model
Data
1980
1981
1982
1983
1984
1985
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1994
1995
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1999
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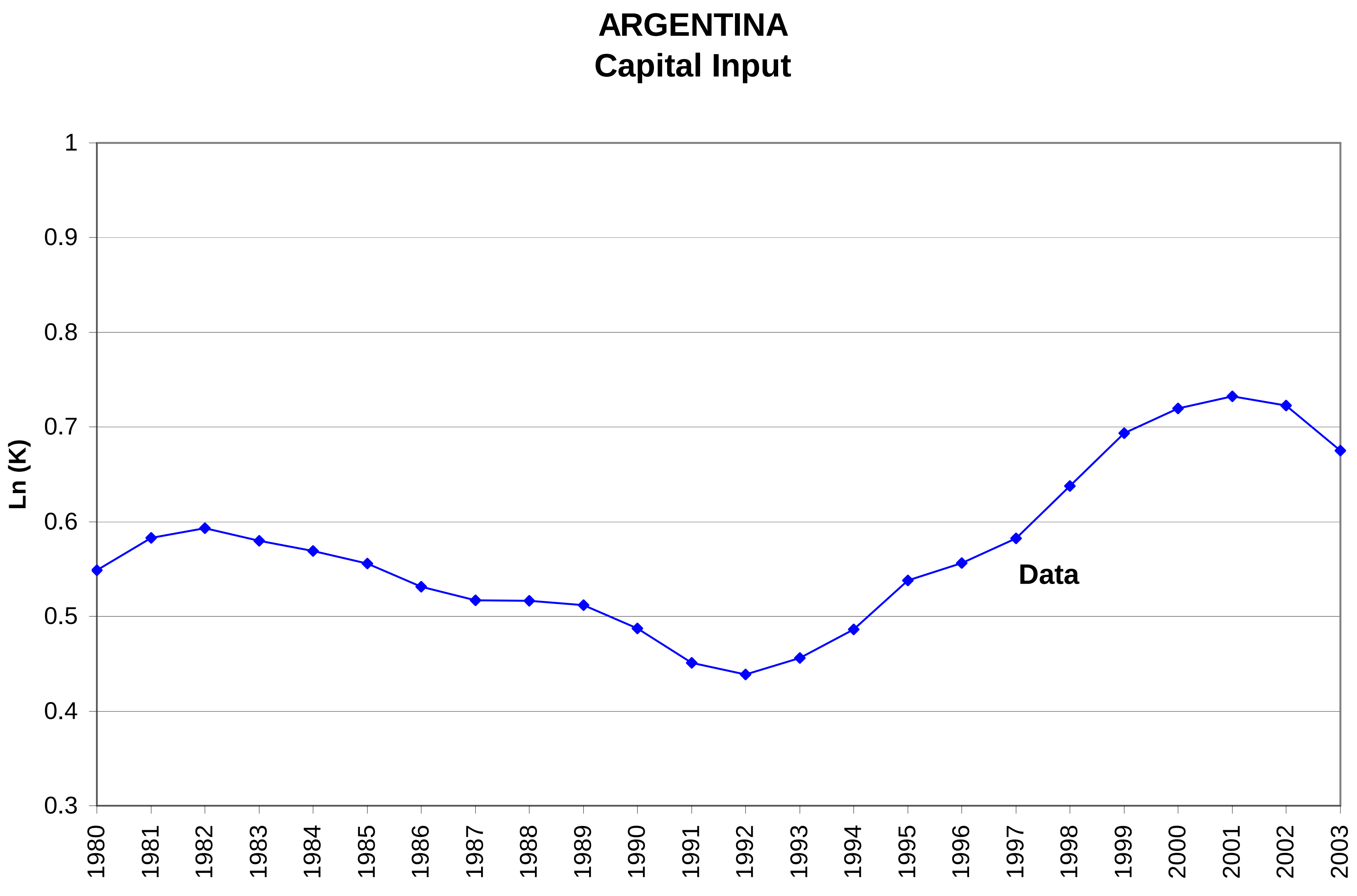
2002
2003


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
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
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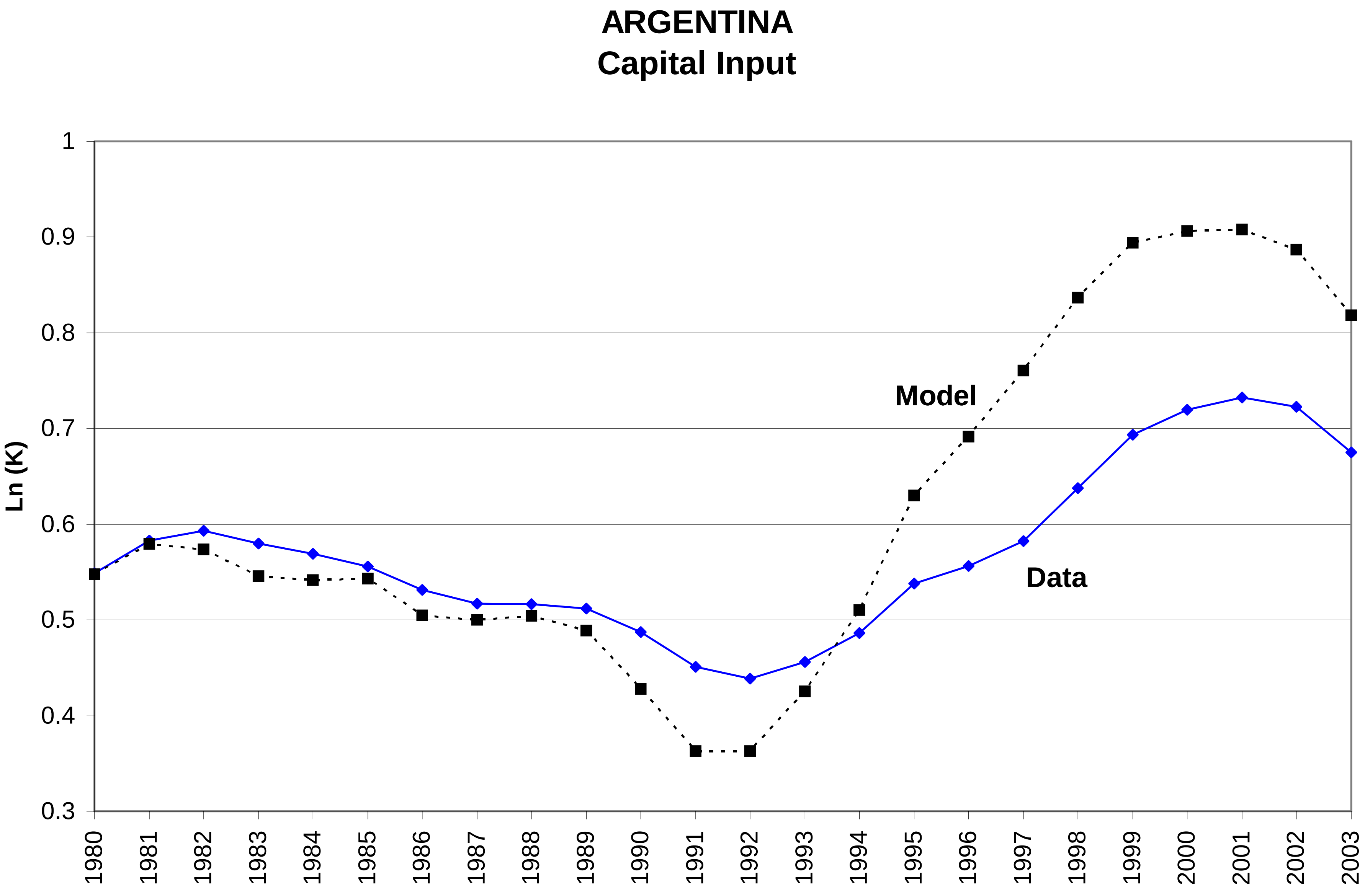
1997
1998
1999
2000
2001
2002
2003



ARGENTINA
Capital Input
Ln (K)
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
Model
Data
1980
1981
1982
1983
1984
1985
1986
1987
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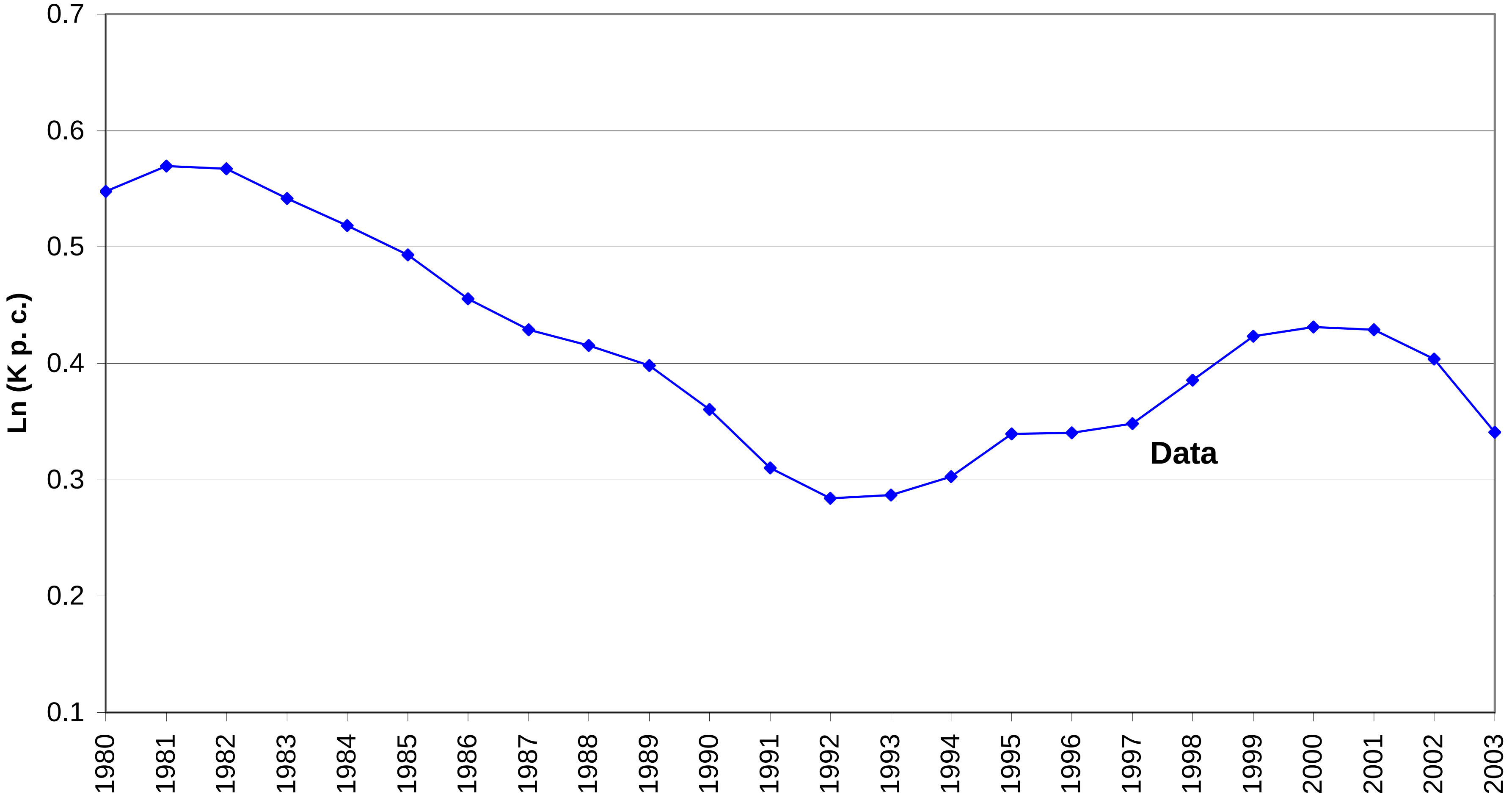
1999
2000
2001
2002
2003

- 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



- 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

- Contrast with Ireland

  We have already seen the picture:
  consistently strong growth since 1990

  But first: years of schooling had expanded since 1960s

  Then, in early 1990s:
  tax policy geared for the long-run

  Lower tax rates, with commitment
  for the next 20 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 and work practices 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

- Copenhagen Consensus Center’s Consulta de San Jose, Oct. 2007

  Question: If Latin America were willing to spend, say, $10 billion more over the next five years on improving welfare, which projects would have the greatest benefits (benefit/cost ratios)?

  Areas: democracy; education; employment/ social security; environment; fiscal problems; health, infrastructure; poverty/inequality; public administration and institutions; crime and violence

Copenhagen Consensus Priorities for Latin America

1) Early childhood development programs

2) Fiscal rules

3) Increased investment in infrastructure, including maintenance

4) Policy and program evaluation agencies

5) Conditional cash transfer programs

- Interesting proposed solution

Increase the level of political party and party system institutionalization