Effective Economic Growth for People:
The Role of the United States[1]

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It is a pleasure to speak once again before the Society for International Development. The title of this conference, "Effective Economic Growth for People," suggests the importance of achieving sustainable growth with benefits that reach the poor. In view of the title of this panel, "US Role in the World," I will outline what I believe are the key policies the United States needs to pursue to contribute to effective global development and poverty reduction.

***Growth* –** First, however, it is important to recall that there are grounds for hope for global development. It is sometimes said that there has been growth "divergence" instead of "convergence," and that the developing countries have been left further and further behind the rich countries. The record is actually to the contrary (Figure 1). In the past four decades, the countries that comprised the poorest 60 percent of the world's population in 1960 have experienced real per capita growth of 4 percent annually, which is almost twice the rate for the countries with the richest 20 percent. The success stories of Korea, China, now India, and many others should remind us that development is indeed possible. Political stability and sound domestic economic policies are the main ingredients. The figure also shows that sub-Saharan Africa has indeed lagged behind the rest of the world, with per capita growth barely above zero. The broad message should be one of hope, but clearly special efforts must be made for (and perhaps more importantly, *by*) Africa.

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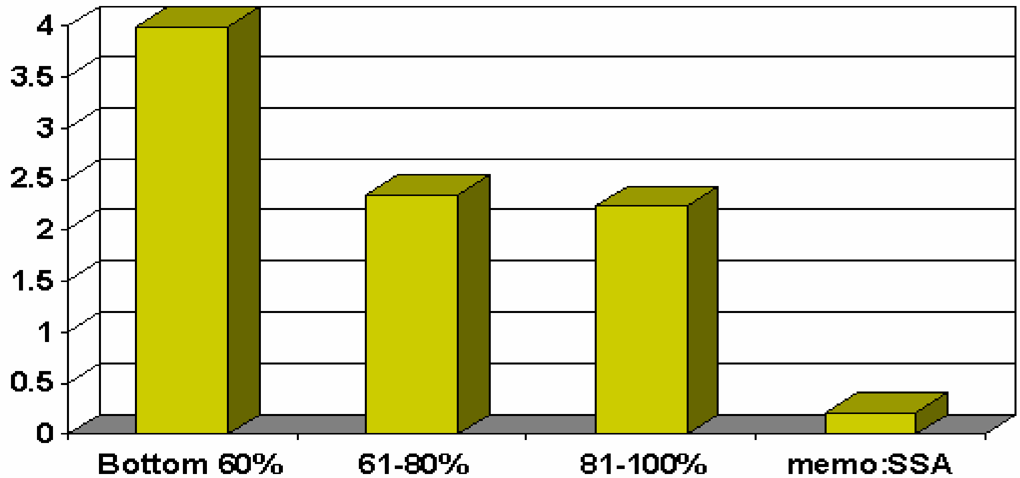
[1] Presentation to the Annual Meetings of the Society for International Development, Washington DC, December 1, 2004.

Figure 1. Real per capita growth 1960-99 by initial country income.



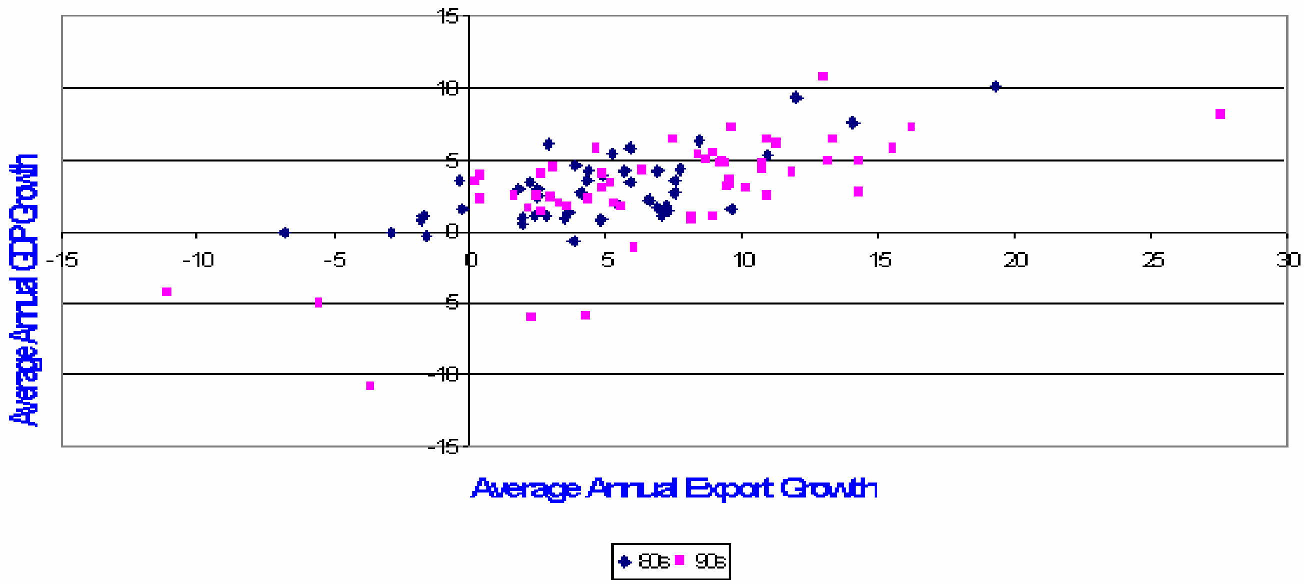
There is another encouraging part of the big picture as well. Economic growth tends to provide leveraged poverty reduction (Table 1). For each rise in per capita income by 1 percent, the number of people in poverty (for example, living on less than $2 per day) declines by typically about 1-1/2 to 2-1/2 percent. The response is larger where incomes are more equally distributed, and where the median income is higher relative to the poverty line.

Table 1. Percent reduction in poverty for 1% per capita GDP growth

Bangladesh	2.3	Brazil	1.5
China	2.9	Mexico	2.1
India	2.5	Turkey	3.5
Indonesia	3	Mozambique	1
Pakistan	3.2	South Africa	1.7
Philippines	2.2	Tanzania	1
Thailand	3.5	Uganda	1.4
Argentina	2.9		

Trade -- The second major fact to recognize about the development record is that international trade has played a vital and positive role (Figure 2). In the past two decades, countries that have achieved higher export growth have systematically achieved higher GDP growth as well. An extra percentage point in export growth has been associated with an extra 0.15 percent growth in GDP. This is no surprise. Exports provide scarce foreign exchange to pay for imports of capital equipment needed for growth. Strong exports make the economy less vulnerable to debt crises. Exports provide a way for small countries to reach a large market and achieve economies of scale.

Figure 2. Average GDP and export growth.



Integration with the world market has also been shown to increase long-term productivity growth (Table 2). The average finding in numerous statistical studies is that a rise of trade (exports plus imports) relative to GDP by 1 percent has been associated with a 0.5 percent increase in the long-term level of output per worker. This also makes sense, because the international market is a key source of new ideas, new technology, and improved quality standards, especially for developing countries that are not at the technology frontier.

Table 2. Change in long-term productivity for 1% in trade/GDP (%).

Levine-Renelt '92	0.14
Frankel-Rose '00	0.33
Alcala-Ciccone '01	1.44
Dollar-Kraay '01	0.25-0.48
Easterly '03	0.14-0.96
Chaudri-Hakura '00 (mid-tech industry)	0.18
World Bank GEP '02	0.8
OECD '03	0.2

Trade policy – Now let me turn to what the United States can do to contribute to global development and poverty reduction. The most important thing the United States can do is to provide forceful leadership for deep reduction in trade barriers in the current Doha Round of negotiations in the World Trade Organization. There is still substantial protection in industrial country markets, especially in agriculture (Table 3). After the G20 of developing countries confronted the United States and Europe over agricultural subsidies in Cancun in 2003, this past July the WTO negotiators reached an important framework agreement that sets the stage for a successful Doha Round. The industrial countries have already agreed to eliminate agricultural export subsidies, but much more remains to be done.

Table 3. Aggregate measure of protection (AMP, %).

	US	EU	JPN
Agriculture	19.9	46.4	82
Textiles, Apparel	10.9	11.6	9.2
Other Manufactures	2.1	3.2	1.5
Oil, other	0.9	0.6	0.3
All (AMP)	4	9.5	16.6

In a book published by the Center for Global Development and Institute for International Economics this past June, I developed model-based estimates of the potential impact of global free trade on global poverty (Table 4).[2] I identified three major impacts: the traditional "static" gains from trade, including higher real wages for the abundant factor in developing countries – unskilled labor; dynamic investment gains as new capital enters to take advantage of new opportunities; and dynamic productivity gains associated with greater integration with the world economy. I calculated that about 500 million people would be lifted out of poverty over 10-15 years as a consequence of global free trade. That would reduce the number of poor globally by about one-fourth from its baseline level in 2015. So the stakes are enormous, and the key question is how far Doha can go in realizing this opportunity for global poverty reduction. The US role will be crucial in providing the answer.

Table 4. Combined long-term static and dynamic effects of free trade on poverty (millions, change from baseline).

Country	Static:		Dynamic:		Total:	
	central	high	productivity effect	1/2 add'l net steady state effect	central	high
Asia	-63.5	-201.9	-150.1	-145.0	-358.7	-496.9
Bangladesh	-2.7	-12.0	-23.9	-2.4	-29.1	-38.3
China	-20.3	-82.7	-38.6	0.0	-58.9	-121.3
India	-20.1	-66.5	-52.9	-77.3	-150.3	-196.7
Indonesia	-5.2	-14.2	-7.6	-6.3	-19.1	-28.1
Pakistan	-7.2	-12.3	-21.0	-42.3	-70.5	-75.6
Philippines	-1.7	-1.4	-2.2	-1.1	-5.0	-4.7
Thailand	-4.1	-4.0	-0.7	-9.1	-13.9	-13.8
Latin America	-8.4	-5.5	-1.3	-5.5	-15.2	-12.3
Argentina	-0.7	0.2	-0.1	-0.1	-0.9	0.0
Brazil	-1.5	-0.9	0.0	-0.4	-1.9	-1.3
Cen. Am.& Carib.	-3.2	-2.9	-1.1	-1.6	-5.9	-5.6
Mexico	-0.4	0.4	-0.2	-0.1	-0.8	0.0
Europe	-2.4	-1.0	-0.7	-0.2	-3.3	-1.9
Central & E. Eur.	-2.4	-1.0	-0.7	-0.2	-3.3	-1.9
Middle E., N. Africa	-5.1	-4.4	-2.7	-7.5	-15.4	-14.7

[2] *Trade Policy and Global Poverty*.

Sub-Saharan Africa	-18.8	-31.6	-0.9	-26.8	-46.0	-58.6
Mozambique	-0.5	-0.1	-0.2	-0.5	-1.2	-0.8
South Africa	-0.8	-1.3	0.1	-0.2	-0.9	-1.4
Tanzania	-1.4	-3.1	0.0	-0.5	-2.0	-3.6
Uganda	-0.4	-2.3	0.0	-0.4	-0.9	-2.7
Other	-15.6	-24.8	-0.8	-24.6	-41.0	-50.1
Total	**- 98.2**	**- 244.4**	**- 155.8**	**- 184.3**	**- 438.6**	**- 584.5**

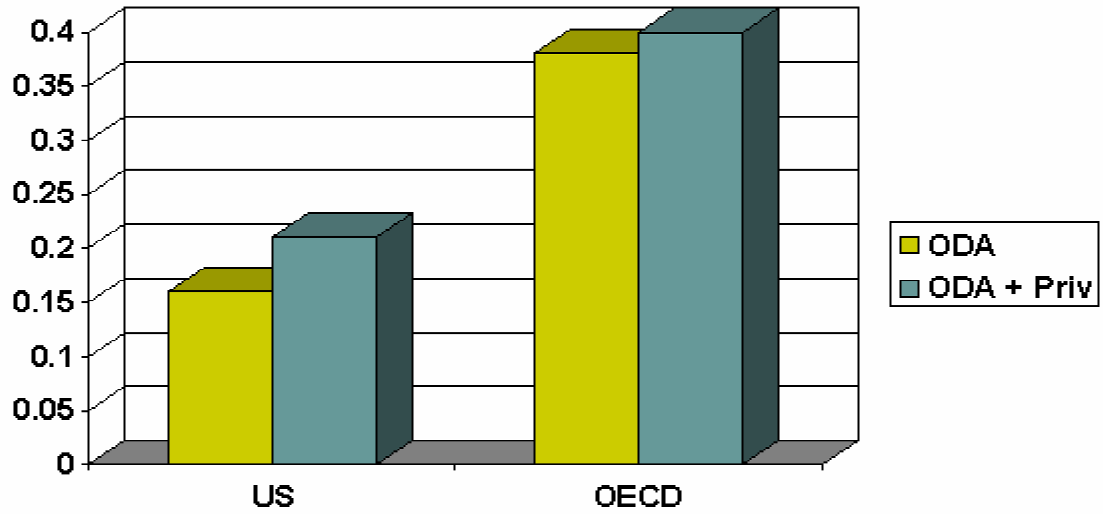
My study also estimated that the long-term income gains from global free trade would amount to about $200 billion annually for developing countries, and that at least half of this amount would come as a result of the removal of protection in industrial country markets (Box 1). The $100 billion or more from industrial country liberalization amounts to about twice what the rich countries are currently providing in aid, and moreover would come as a benefit to industrial country consumers through lower prices, rather than as a cost to their taxpayers. My study found that half of the gains would be in agriculture, where protection is the highest.

Box 1. Global Free Trade Impact

- Lift 500 million out of poverty in 15 years
- $200 billion annual long-term income gain for developing countries
- At least half from removing industrial country protection
- This is twice annual aid, and it benefits industrial country consumers
- Half of gains are in agriculture

Aid Policy -- Aid also remains crucial to achieving development, however, and is much more concentrated on the poorest countries than the trade liberalization benefits. US development assistance policy continues to need to move closer to the burden-sharing targets of the international community. US Official Development Assistance in 2000 was 0.16 percent of GDP, far below the OECD median of 0.38 percent (Figure 3). Although the United States tends to have more private charity to developing countries, even if that is added in, the US figure at 0.20 percent of GDP is only half the OECD median of 0.40 percent. The US commitment to raise aid by 50 percent is therefore welcome and must be implemented. The Millennium Challenge Account is also welcome as a means of reinforcing growth by linking aid to country performance, and it is essential that the MCA move ahead expeditiously with its lending program.

Figure 3. Aid as percent of GDP.



There is also encouraging recent research showing that aid works (Box 2). Numerous statistical articles in recent years have debated whether aid helps countries grow or not, but for the first time this new study gets the data right to test this question. It omits from the aid data the flows that no one would expect to result in growth in the first few years. For example, aid flows to help out in disasters are likely to be the highest when the economy is in crisis, so statistical tests can show a false negative impact of aid on growth. My colleagues Michael Clemens, Steve Radelet, and Rikhil Bhavnani have shown that when the aid data are limited to the types of aid that one would expect to have an impact on growth over the next few years, there is a strong positive effect. Each dollar in aid flows induces a cumulative $1.64 in extra future output.[3] The public needs to know this message, because public skepticism about the effectiveness of aid has contributed to relatively low US aid flows in the past.

Box 2. Measured Properly, Aid Works

Clemens, Radelet, Bhavnani (2004):

- Exclude humanitarian, disaster, long-term aid (education, health, environment)
- The rest is 54%: balance of payments support, infrastructure, agriculture, industry
- For this core aid, $1 additional aid generates $1.64 present-value increase in output

Let me also call to your attention another new study showing that aid can work. My colleague Ruth Levine has compiled a survey of successful health projects in developing countries.[4] A prime example is the international effort that effectively eliminated river blindness in West Africa.

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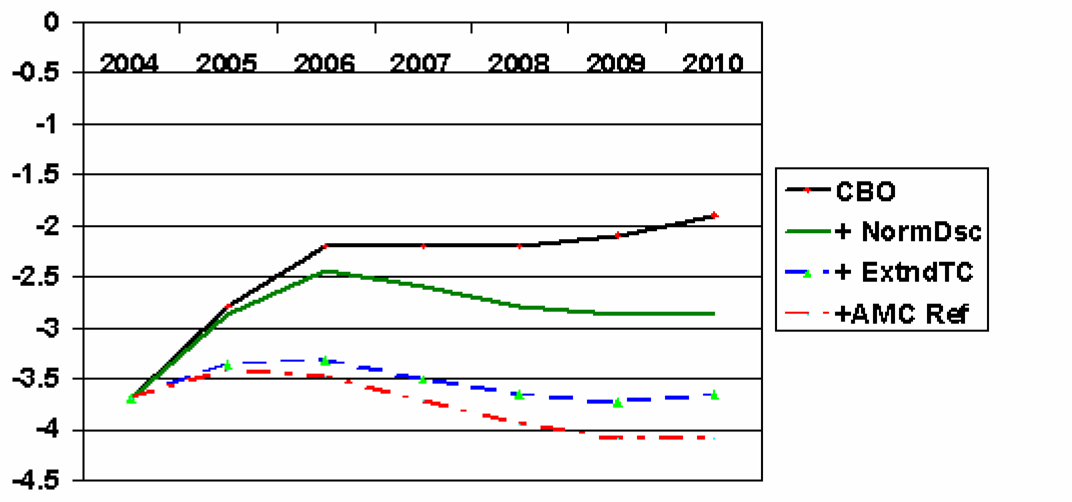
[3] Even this high figure is probably understated, because it uses a high rate of 15 percent to discount future output gains to arrive at this present value. Michael Clemens, Steven Radelet, and Rikhil Bhavnani, "Counting Chickens When They Hatch: the Short-term Effect of Aid on Growth." Working Paper No. 44 (Washington: Center for Global Development, 2004).

[4] Ruth Levine with Molly Kinder, *Millions Saved: Proven Successes in Global Health* (Washington: Center for Global Development, 2004).

US Economic Adjustment **--** Beyond emphasizing trade and aid policy, I would single out US fiscal policy and external sector adjustment as crucial areas where the United States needs to improve in order to ensure that there is a healthy global environment for growth and poverty reduction. In the 1990s the United States eliminated its fiscal deficit, but with the collapse of the stock market bubble and capital gains revenues, the 2001 recession, and the tax cuts, the United States once again has a large fiscal deficit, at 3.6 percent of GDP this year. About two-thirds of this deficit is now attributable to the tax cuts in 2001-2003. Although official policy is to cut the deficit in half by 2008, projections by the Congressional Budget Office suggest that a more likely outcome is a continued deficit of 3 to 4 percent of GDP, especially if the tax cuts are made permanent, the alternative minimum tax is reformed, and more normal growth occurs in discretionary spending such that it keeps pace with GDP instead of falling (Figure 4).

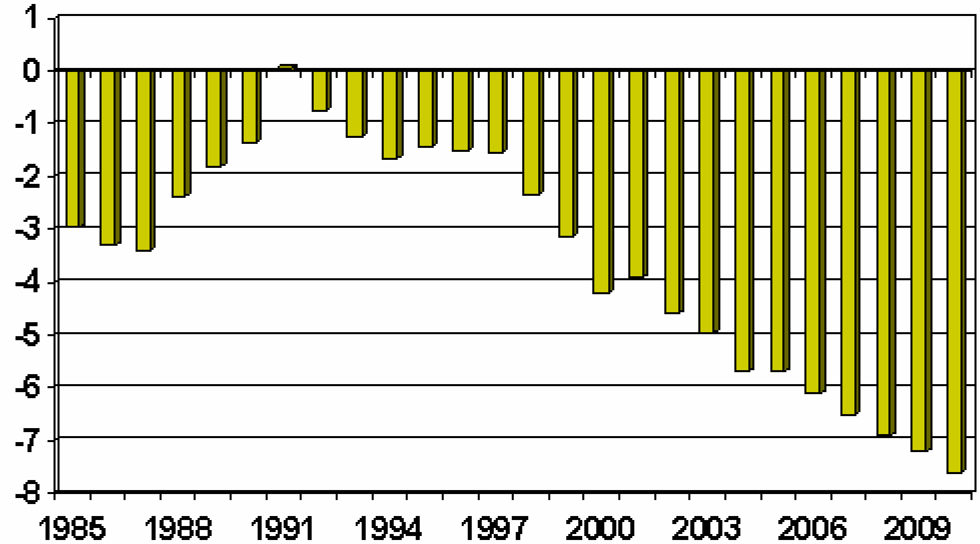
Figure 4. US fiscal balance (% of GDP).



The US fiscal deficit is important because it will affect the level of US interest rates, and US interest rates affect the level of world interest rates. Higher world interest rates impose a burden on countries with relatively high external debt, such as Brazil and Mexico. Various estimates suggest that an additional percentage point of GDP in fiscal deficit boosts the interest rate by about one-third of a percentage point. The spillover impact is probably higher for emerging market borrowing rates, because their "risk spreads" tend to be higher when international interest rates are higher. So the first major challenge for the United States is to sharply reduce its fiscal deficit.

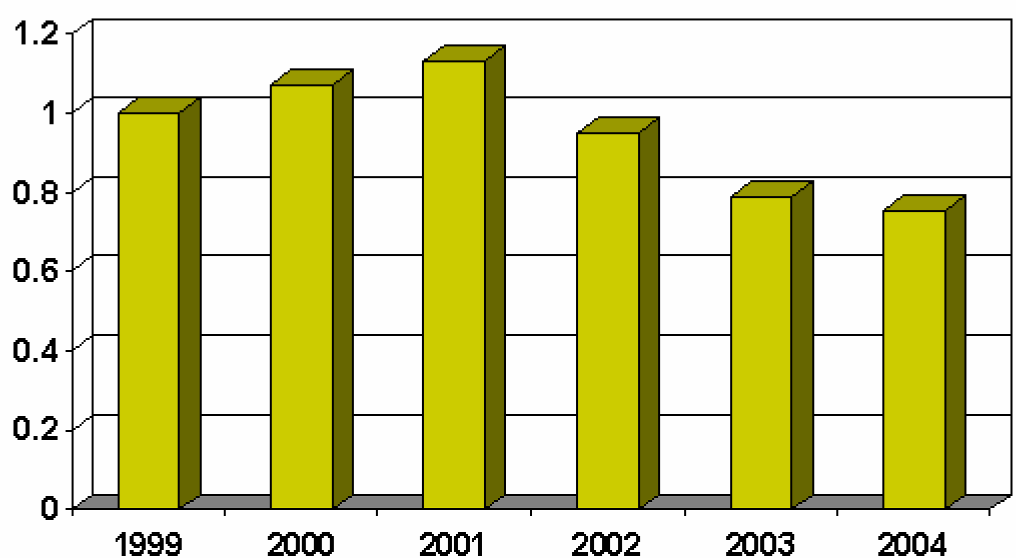
The second and related economic imbalance in the US economy is the trade (or "current account") deficit. The United States already had one period of wide external deficits and eventual correction in the 1980s (Figure 5). This time around the imbalance is even greater. This year the current account deficit will amount to almost 6 percent of GDP. The highest figure in the past was 3-1/2 percent of GDP in 1987. My projections suggest that we are presently on a path that will take the current account deficit to about 8 percent of GDP by 2010. Past experience has shown that even industrial countries begin to face difficulties when their current account deficit exceeds 4 to 5 percent of GDP.

Figure 5. US current account balance (% of GDP).



The risk for the world economy is that the United States will face a dollar crisis that will turn into a painful episode of sharply higher interest rates and slower growth, a so-called "hard landing" with adverse repercussions for the developing countries and other industrial countries. Some dollar decline is of course necessary to make US exports more competitive; the danger is that an orderly correction could turn into a disorderly rout. So far there has been a relatively well-behaved adjustment of the dollar against the euro and several other industrial-country currencies (Figure 6). There is a need for a broader adjustment of foreign currencies against the dollar, however, including especially the Chinese renminbi and other East Asian currencies.

Figure 6. Value of the dollar against the euro.



More fundamentally, the root problem now for the US external imbalance is the fiscal deficit. It is very difficult to reduce the trade deficit without reducing the "disssaving" by the public sector, unless the undesirable alternative of recession occurs. So the United States needs to bite the bullet on fiscal adjustment not only to keep its domestic debt from eventually spiraling out of control, but also to make effective external adjustment possible and thereby help ensure smooth growth both at home and in the international economy.

I will conclude, then, with a summary of the three most important things the United States can do for the global development and poverty reduction: spearhead global trade liberalization in the Doha round; implement a forceful program of increased development assistance; and carry out a domestic fiscal adjustment that, together with further broad exchange rate adjustment, will lead to moderation in the large US external deficit and thereby help avert a dollar crisis and hard landing. The United States accounts for only 5 percent of the world's population but almost one-third of global output at market exchange rates. Inevitably the United States plays a large role in the prospects for global development and poverty reduction. The challenge to US policymakers today is to ensure that this role is positive.