Alan Greenspan: The wealth of nations revisited

Speech by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at Banco de Mexico's Second International Conference "Macroeconomic Stability, Financial Markets, and Economic Development", Mexico City, Mexico, 12 November 2002.

The references can be found on the website of the Board of Governors of the US Federal Reserve System.

* * *

More than two hundred years ago, Adam Smith offered the first comprehensive examination of why some countries are able to grow and have high standards of living while others make little progress. In *The Wealth of Nations*, Smith put forward a number of explanations for the different paths that countries follow. He accurately identified capital accumulation, free trade, an appropriate--but circumscribed--role for government, and good "institutional infrastructure" as key drivers of national prosperity. Perhaps most important, he emphasized the role of personal initiative:

> The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is . . . capable of carrying on the society to wealth and prosperity . . .[1]

In his writings, Smith gave us an invaluable start in our efforts to answer what is probably the most important macroeconomic question, that is, "What makes an economy grow?" In this very real sense, we are Adam Smith's intellectual descendants. We are still endeavoring to craft answers to questions similar to the ones he asked and, we hope, learning what policies and institutions are best able to create wealth and so enable nations to prosper.

The debate regarding the sources of economic growth has markedly twisted and turned in recent decades. Following World War II, some countries seemed to pull back from the free-market paradigm articulated by Adam Smith. Many observers interpreted the economic turmoil of the Great Depression as a sign that free markets were flawed, and they increasingly looked to the apparently successful efforts of wartime planned economies. They thought that perhaps governments could also coordinate the far more complex activities of civilian economies.

These more interventionist attitudes toward economic policy implied increased regulation of industry, greater government ownership of productive assets, higher tax rates to fund broadened social welfare initiatives, and in some instances controls on wages and prices. These policies were believed to improve the functioning of markets and to maintain economic stability and growth. Not until the 1970s--and the economic difficulties of that decade--did the realization finally take hold that market incentives had been reduced and that we were losing the dividend of efficient uses of resources that such incentives provide. Even those observers who derided the more unbridled forms of capitalism became increasingly aware that attempts to tame the market could be costly in terms of economic growth and the average living standards of a nation.

Over the past thirty years, as many countries have struggled to liberalize their economies and improve the quality of their policies, global per capita income has steadily risen.[2] I recognize that poverty rates are notoriously hard to quantify, but according to a recent study, the share of the world's population living on less than $1 per day, a commonly used poverty threshold, has fallen dramatically over the past three decades--from 17 percent in 1970 to 7 percent in 1998, representing a decline of 200 million people.[3] In addition since 1970, the infant mortality rate has declined by more than half, school enrollment rates have risen steadily over the past thirty years, and literacy rates are up.[4]

---

[1] Smith (1776), Vol II, book IV, chapter V, p 43.

[2] World Bank (2002)--GDP per capita (constant 1995 dollars).

[3] Sala-i-Martin (2002). The $1 per day threshold is measured in 1985 dollars on a Purchasing Power Parity basis.

[4] World Bank (2002).

While, from a global perspective, wealth and the overall quality of life have risen, that success has not been evenly distributed across regions or countries. The economies of East Asia are often-repeated success stories. Some, including China, Malaysia, South Korea, and Thailand, stand out not only as growing very strongly, but also as having seen the greatest declines in poverty rates. Overall, over the past three decades, Asia's $1 per day poverty rate fell by one measure from 22 percent in 1970 to just 2 percent in 1998.[5] Moreover, Asia was not alone. Per capita incomes in Latin America also expanded during the period, and poverty rates fell, although progress was somewhat slower.[6]

But, sadly, the story in Africa has been quite different. Levels of per capita income in that continent have actually fallen.[7] The poverty rate, which in 1970 matched the rate in Asia at the time, is estimated to have doubled to 40 percent by 1998.[8] While Africa's performance has clearly been subpar, some African countries have had some success. For example, Botswana, Lesotho, and more recently Uganda have made some progress in raising per capita income growth and reducing poverty rates.[9]

Modern economic analysis has confirmed much of what Adam Smith inferred from a far less impressive set of data. Today's economists generally point to three important characteristics influencing growth: (1) the extent of a country's openness to trade and its integration with the rest of the world, (2) the quality of a country's institutional infrastructure, and (3) the success of its policymakers in implementing the measures necessary for macroeconomic stability.

By openness and integration we generally mean the ability for goods and services, capital, and more broadly, the flow of information, people, technology, and ideas to move across the borders of a country. This freedom of movement may enhance growth by intensifying competitive pressures, increasing specialization, and allowing access to larger markets.

Free trade allows the more efficient use of resources which, in turn, raises both the productivity of the domestic workforce and the level of national income. Adam Smith cited comparative advantage. He observed:

> If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.[10]

One recent study of the effects of openness on growth demonstrated that when countries are divided into two groups--those with generally open economies and those with generally closed economies--open economies have experienced average growth that is 2 ½ percentage points higher than the growth of closed economies.[11] Furthermore, when developing economies are ranked according to their historical record of openness, economies such as Hong Kong, Malaysia, Singapore, and Thailand are near the top of the list.[12] These Asian economies are some of the same ones that participated in the region's so-called growth miracle.

For another example of a country that has benefited from free trade, we need look no further than Mexico--our host today. During the early 1980s, Mexico's non-oil merchandise exports were running a bit below $10 billion a year, or about 5 percent of its gross domestic product. By 2001, however, Mexico's exports of such goods had soared to more than $145 billion, or nearly 24 percent of GDP. The strength of exports has contributed importantly to the ongoing transformation of Mexico's economy. A good portion of this export growth has occurred in the context of the North American Free Trade Agreement, but the most important effects of NAFTA may be the increased openness of Mexico's domestic economy and the associated policy reforms.

---

5 Sala-i-Martin (2002).

6 World Bank (2002)--GDP per capita (constant 1995 dollars) for the per capita income data and Sala-i-Martin (2002) for the poverty data.

7 World Bank (2002)--GDP per capita (constant 1995 dollars).

8 Sala-i-Martin (2002).

9 Sala-i-Martin (2002) and World Bank (2002)--GDP per capita (constant 1995 dollars).

10 Smith (1776), Vol I, book IV, chapter II, p 422.

11 Sachs and Warner (1995).

12 Sachs and Warner (1995).

A second characteristic that economists have identified as influencing a country's ability to grow is termed its "institutional infrastructure." By this we mean the institutions that help make an economy work, such as a functioning legal system, which ensures the rule of law and protects property rights. These institutions are responsible for setting the "rules of the game" and ensuring that those rules are observed.

Sound institutions provide the backdrop against which markets operate. They foster confidence that contracts will be honored, that debts will be paid, and that the gains from sound investments will not be stolen or expropriated.

Researchers in recent years have found that the rule of law--defined as a system that emphasizes creditor rights and rigorously enforces contracts--facilitates the development of an efficient banking system and financial markets more generally; this development, in turn, supports growth.[13] The quality of the institutions in a country--such as a sound regulatory environment, political stability, and the control of corruption--have important effects on growth.[14] Economies with a high quality of governance, relative to other economies in their regions, including Hong Kong and Singapore in Asia, Chile in South America, and Botswana in Africa, have had some of the fastest growth rates in their respective regions in recent decades.[15]

The quality of a country's educational system is clearly a significant part of its broader institutional infrastructure. Policies that foster the human resources of a country improve growth. Many studies exhibit a link between education and growth, with some showing that even a small increase in average education can lead to a sustained rise in the rate of economic expansion.[16]

Finally, an undeniable determinant of economic growth is macroeconomic stability--having fiscal, monetary, and exchange rate policies that are sound and predictable. A prudent government sets, among other things, the long-run course of policy variables such as inflation, the government budget deficit, and debt at levels that are conducive to, or at least do not impede, growth. For developing countries, the management of debt denominated in foreign currencies has been especially nettlesome.

In all economies, political constituencies seek to employ the powers of the state to increase their share of limited national resources. While the record of developed economies is far from unblemished, they have had greater success in fending off such demands. One indication of that success is that exchange-rate regimes have not often been upended by domestic political pressures in these economies.

Although the range of outcomes has been wide, many emerging-market nations have had less success in insulating their international financial positions from domestic political pressures. Those pressures, at times, have become exceptionally difficult to deal with. To close the gap between the financial demands of political constituencies and the limited real resources available to their governments, many countries too often have bridged the difference by borrowing from foreign investors. In effect, the path of least resistance has been external borrowing, usually at the lower interest rates of internationally tradable currencies, rather than confronting politically difficult tradeoffs.

Periodically, as an economy borrows its way to the edge of insolvency with debt denominated in foreign currency, government debt-raising capacity appears to vanish virtually overnight. This vanishing capacity characterizes almost all financial crises. Lending institutions will provide funds beyond the immediate visible short-term cash flow of a borrower only if they perceive that maturing debt will be rolled over. The first whiff of inadequacy in debt-raising capacity induces a run to the exits--not unlike a bank run. Thus, an economy's necessary condition for solvency--indeed, a necessary condition for economic growth--is the maintenance of significant unused financing capacity. Too often governments have endeavored to contain impending debt crises with inflationary policies that inhibit growth.

[13] Levine (1998) and Levine and Zervos (1998).

[14] Kaufmann, Kraay, and Zoido-Lobaton (1999).

[15] Kaufmann, Kraay, and Zoido-Lobaton (1999).

[16] Barro (1997).

Controlling inflation is essential to creating an environment of sustained growth. Once inflation gets above a certain point, it has a large negative effect on growth, according to most research. Stanley Fischer, for example, concluded that if a country with inflation of 10 percent becomes a country with inflation of 110 percent, its annual growth rate would fall 4 percentage points; the consequences of this for standards of living can hardly be overemphasized.[17] This effect may help to explain why East Asia, where inflation has been relatively low on average, has been more successful than Latin America, where many countries have suffered bouts of hyperinflation.

More generally, Latin America provides a good example of both the deleterious effects of macroeconomic instability and the benefits of putting sound policies in place. Between 1975 and 1990, when many Latin American countries struggled with large budget deficits and high inflation, average per capita income in these countries expanded at a pace of just ½ percent per year.[18] Economic performance in the region improved markedly in the early 1990s, as these countries reduced inflation, liberalized their foreign exchange regime, increased their openness to trade, and developed their financial markets.[19] More recently, while Argentina, Brazil, and several other countries in the region have experienced economic disruptions, Mexico and Chile have remained relatively insulated, apparently reflecting market confidence that these countries are committed to sound policies.

Mexico is a particularly interesting case. In the two decades before 1995, the Mexican economy suffered several severe crises. Yet in recent years, with the implementation of NAFTA, a floating exchange rate regime, relatively stable fiscal policies, and much lower inflation, Mexico's vulnerability appears to have declined markedly. This country now seems to be viewed by international investors as a relative "safe haven" within the region.

As Easterly and Levine indicate, much of Africa's plight can also be linked to macroeconomic instability. Empirical evidence suggests that Africa's large government budget deficits, underdeveloped financial markets, and black-market foreign-exchange premiums (which likely proxy for a host of deficiencies in the financial and legal system) apparently explain roughly half the growth divergence between East Asia and Africa over the past several decades. In other words, these results suggest to Easterly and Levine that growth of per capita annual income in Africa would have been about 2-1/2 percentage points a year higher had countries in Africa followed policies adopted by the East Asian economies.[20]

Central bank independence has not received a great deal of attention in the recent literature on growth. Given the importance of keeping inflation under control, the policies of the central bank--and the freedom of the central bank to set those policies without political intervention--can play a key role in creating an environment conducive to growth.

Empirical evidence for industrial countries indicates that countries with a higher degree of central bank independence are also generally countries with lower rates of inflation.[21] In emerging markets and transition economies, the evidence of an association between measured central bank independence and inflation rates is not well-established, although a couple of very recent studies do find a negative relationship.[22]

To sum up, none of today's recognized fundamental determinants of growth--openness, institutional infrastructure, and macroeconomic stability--are recent insights. Adam Smith and his colleagues proffered them more than two centuries ago. Yet assuming that Smith's complex insights into what creates the wealth of nations are accurate, why have they been embraced and largely implemented by some societies and not others? As history amply demonstrates, unless a broad majority of a population implicitly or otherwise believes that a competitive free market paradigm advances their welfare, it cannot for long be imposed on them by an authoritarian or even a democratically elected government.

---

17 Fischer (1993).

18 World Bank (2002)--GDP per capita (constant 1995 dollars).

19 Easterly (2001).

20 Easterly and Levine (1997) cited in Easterly (2001).

21 Alesina and Summers (1993).

22 Gutierrez (2002) and Cukierman, Miller, and Neyapti (2002).

That an "invisible hand" converts self-centered behavior into a greater good is a profoundly abstract notion that--while largely, but by no means fully, embraced by developed nations--has been held only tentatively, even recently, by many developing nations. If not in some sense seen as generally equitable and fair, the distribution of income that emerges from competitive free-market capitalism will not have the support in law that is a necessary condition for markets to produce wealth. Now that the central planning paradigm of earlier decades has been largely discarded, the differential rewards of competitive markets based on skill do seem to be accepted though rewards from what is perceived as monopolistic or corrupt are not.

It is hence incumbent on those of us who see broader and market-based globalization as fundamental to the creation of wealth to defend and advocate the tenets of Adam Smith.