Untapped Resource

World Bank President Robert Zoellick knows more about international governmental institutional arrangements than anyone in the world. He should lead the effort for a new global growth agenda. An exclusive interview.

Robert Zoellick

TIE: **Is the developed world becoming like Japan—in other words, mired in debt and unable to grow at more than mediocre levels? For 2012, Japan is expected to grow at a higher rate than the rate achieved by both the eurozone and the United States. Do you agree with this "We're all becoming Japan" scenario?**

Zoellick: The core issue for growth is to go back to the fundamentals. I'm not sure how much more can be done with monetary policy one way or the other. Federal Reserve Chairman Bernanke's Jackson Hole speech did a service because he pointed out that most fundamental decisions now lie with Congress and the executive branch.

Beyond fiscal policy, the real answer to your question about Japan is whether countries are willing to address the structural elements of growth to free private sector potential. When I talk about growth, I'm not talking about Keynesian macroeconomic management. I'm talking about the fundamentals of growth and productivity, for example the work of Robert Solow. At the World Bank, I see many developing countries working in this structural growth framework. As a striking example, when early in the crisis I attended a G-20 finance ministers meeting in Scotland, the mood was as dour as the sky. Then I flew to Singapore for an APEC session, and the Asian countries were more upbeat, saying, "We've seen versions of this movie before, and we're going to have to focus more on how we deregulate, expand opportunities for private-sector dynamism such as in services, and invest to create fundamentals of growth."

TIE: **How would you improve the fundamentals of growth in the industrialized world?**

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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Zoellick: The moods and coalitions of democratic politics matter, so one needs to look beyond textbook economics. For example, one can sense that across constituencies and political groups, there's a movement for broad-based tax reform: broadening the base and cutting the rates, as in the tax reform enacted when I was at Treasury in 1986. Discussions and interest—like earlier in the 1980s—is a long way from enacting major legislation. But tax reform could be a very good signal to drive investment and productivity growth. That would be high on my agenda.

Social Security reform would send one heck of a confidence signal.

Second, you can't ignore spending, debt, and deficits, but so far the United States government has been focused on discretionary spending. That's a start, but not fundamentally where the real bucks are. The challenge for policymakers is entitlements. Social Security is one area where by now people know the variables quite clearly. Social Security reform would send one heck of a confidence signal to businesses that are sitting on cash and to the world that the United States can fix its problems.

An odd political dynamic has been created by both parties. Democrats don't want to see so-called "cuts" in Social Security—it's part of their political base strategy. Republicans want to show that they're disciplined on spending so they want to emphasize the size of "cuts." People in a fast-paced media world will turn off very quickly if one talks about "cuts."

But you can start by saying you'll protect people who retire by guaranteeing what they're getting from Social Security today plus cost of living increases. That's not a cut. That's a respectable way to secure Social Security. The government would use the CPI for increases as opposed to a wage index. Then add a year or two to the retirement age. That just reflects the changed demographics and years of life. If you want to make Social Security more progressive, add means testing to limit increases. Social Security is just sitting there on the table waiting to get done.

First, we should do broad-based tax reform for growth, then Social Security reform. The third element—one of the best drivers of structural change—is free trade in an open economy. Our trade policy has been stagnant.

***TIE:* Is that it?**

Zoellick: There are other good possibilities out there. Take infrastructure. Depending on the wage rate and how Davis-Bacon is handled, improving our infrastructure could lead to employment and productivity growth. From what we've seen in emerging markets, infrastructure enhancement offers a triple benefit: not only jobs today and productivity growth tomorrow, but it also draws exports of machinery and services from the developed world.

But here's the big difference. Most of the discussions on infrastructure I've heard in the United States are still focused heavily on public-sector models. Yet I cannot go to a developing country where people aren't interested in public-private partnerships for infrastructure. This is significant. In the middle-income countries, they want public-private partnerships not because of the capital, but because the projects are better designed, better maintained, and operated more cost-effectively. The World Bank Group has created an Infrastructure Finance Center of Excellence in Singapore to foster projects and also help countries develop the legal and regulatory frameworks and pipeline capacity for private financing and management of infrastructure. One of the projects that we've done is to monetize a toll road in Chongqing, China. It's ironic that in Communist China, they're very interested in privatizing the toll roads, but in the state of Pennsylvania the legislature rejected the idea.

When I learned accounting, there were two sides of the balance sheet: liabilities and assets. A lot of the states have liabilities, but they're also sitting on assets. The case of Indiana Governor Mitch Daniels offers a good example. In 2006, the Indiana Toll Road was leased for seventy-five years in exchange for a one-time payment of $3.85 billion. With this revenue, the state financed a backlog of public transportation projects and created a $500 million trust fund for maintenance of the state highway system. At first this move was politically unpopular, but it managed to work out quite nicely for the governor and for Indiana.

And afterwards, Macquarie, an Australian firm that was one of the leasing companies, analyzed some of Indiana's roadways and found, for example, that in one part of the state it cost more to pay people at the toll booths to collect the tolls than the state was getting from tolls. The state switched to smart cards.

***TIE:* Any other thoughts?**

Zoellick: The World Bank has just completed some very interesting work on gender equality. It starts from the logic that if countries are not fully drawing on the talents of 50 percent of their populations, they're not going to be as productive. Some of the statistics about increased productivity are amazing—remember, growth's about productivity. Not all changes require money. In Ethiopia, the World Bank worked with the government to change the land title forms so that there's room for two names. All of a sudden, women have ownership as well as men, and now they can borrow against property and get credit for inputs. Giving women rights and making them full members of a society can also boost productivity. That's another area of opportunity for the United States. In emerging markets, people are thinking about how to connect education to training to jobs to productivity. How do we build infrastructure for productivity? How do we help women be more productive and lead fuller lives? I'd also examine the regulatory impediments to entrepreneurial innovation, including to initial public offerings.

***TIE:* On another subject, is the export-dependent nature of the developing economies sustainable?**

Zoellick: Twenty years ago, I was part of the structural impediments initiative discussions between the United States and Japan. The idea was to help shift Japan from its traditional export-led model while opening up business opportunities, especially in the unproductive service sector. The Japanese treated the structural impediments initiative as a negotiation. They did a few things such as open up retail stores, but they didn't really take advantage of the opportunity. The World Bank is now engaged in a much fuller exercise with the Chinese about their future structure of growth. The Chinese have been growing 10 percent a year for thirty years. But the Chinese themselves recognize that the export-led, investment-led growth model just can't keep producing this way. If China continues to grow at about the same rate, by 2030 it would be like adding fifteen South Koreas to the world economy. That's not going to work.

The Chinese know they're going to need to change their growth model. So for a year we've been working with the Development Research Council of the State Council and with the Ministry of Finance, with the blessing of the top leaders, to examine what China needs to do to avoid the "middle income trap." China has outlined the objectives of a shift to greater domestic demand and increased consumption in its twelfth five-year plan. But the question is "how" to do it. Our work with China on the "how" is quite detailed—urban versus rural development; natural resource prices; reforms in land, labor, and financial markets; service sector liberalization; open innovation; expanding the private sector; more and better quality public services; bringing all public resources "on budget"; mobilizing more resources, including from state-owned enterprise profits; promoting competition and the rule of law—it's extensive.

The devil will be in the details—whether China actually can take the steps to implement the ideas. But the timing is useful for the next generation of leaders in 2012. I'm struck that a country that's grown at 10 percent for thirty years could easily try to keep doing what it has been doing. But the Chinese are willing, even during a period of strong growth, to think about structural change. Maybe it's time for the United States and Europe to think about structural change, too.

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***TIE:* A lot of analysts believe the European situation is significantly worse than that of the United States. Do you agree?**

Zoellick: In the near term, the problems in the United States are commensurate in seriousness with those in Europe, but not as imminent to the markets. I operate in the international world, dealing with both developing and developed countries. Americans have to realize how quickly emerging markets are rising. If America wants to remain the power that it has been—and I certainly want it to do so—these questions are fundamental. Other than the supercommittee—the Congressional joint committee charged with recommending at least $1.5 trillion in additional deficit reductions by November—I don't know how much is going to get done before 2012. But Americans really need to be taking up these issues. Asians and others who admire American openness and innovation say another decade of problems could lead to a very different United States in terms of influence and global standing.

For Europe, my focus has been two-fold. So far, the Europeans have provided liquidity. I'm not against buying time, but I believe you have to use the time. They're going to have to figure out exactly what they do with Greece, and the ramifications of that action for others. They're dealing with each piece of the problem separately. But sovereign debt, the banks, and competitiveness are all interrelated. Some banks need more capital, but the amounts depend in part on how sovereign debts are handled. With Greece it's not just a question of the debt, but also competitiveness.

The time for muddling through has passed. The real issue the Europeans face is deciding the future of the European economic system. This has to be decided by Europeans, because it is fundamentally a political decision. But the eurozone really has to choose one of two paths. One

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path is to create a political and fiscal union that's complementary to the monetary union.

That's not just a question of euro bonds. Should they pursue a Hamiltonian assumption of past debts? What about future debts? What incentives are there for markets versus institutional disciplines? People talk about a European finance ministry—what does that mean in terms of control? And what is the target for competitiveness? Does everyone become like Germany or does Germany become like everyone else?

The alternative path is not to become a fiscal union. But then Europe must face the consequences of dealing with some countries that are too indebted and some countries that are uncompetitive. The current system cannot be sustained.

Ultimately, the European Union will have to face these decisions. At a minimum, leaders had better know where they want to go. Sometimes crises offer opportunities for reform, but Europeans need to decide where they wish to go.

***TIE:* Some Germans suggest that in the end, the eurozone won't end up with a liquidity problem or even a solvency problem; they will face a credibility problem for monetary union itself because of soaring debt-to-GDP ratios, even for Germany.**

Zoellick: There's discussion about the size of the European Financial Stability Facility, and ideas to multiply its effectiveness. Understandably, the Germans value fiscal prudence and said, "Well, somebody's going to have to stand behind the EFSF, and what will it do to our credit rating?" The Germans don't want to have to bail everybody out. I believe the EFSF could be used as a first loss or guarantee facility to counter market worries about larger EU economies. The key objective is to offer enough assurance so that Italy and Spain can roll over debt even after Greece.

There's an opportunity to design a union that would have market disciplines in addition to bureaucratic checks. One idea would be to combine a European assumption of past states' debts while retaining state responsibilities for future debt. That is what Hamilton designed for a new federal U.S. government in its relations with the states. In the nineteenth century, some U.S. states defaulted. This approach still enables market discipline to take its course. Greece is still going to be a big challenge because how the Europeans manage Greece will affect the perceptions of how they would manage other crises.

***TIE:* The Europeans have a new favorite word. They want to "ringfence" Greece, the banks, and sovereign debt. What does that mean? Something like controlled default?**

Zoellick: When people start to use metaphorical terms, I get nervous. I want to know what's the machinery behind the metaphor.

***TIE:* How confident are you that the emerging markets will save the global economy?**

Zoellick: Coming into August, the emerging markets—which now represent about half of global growth—were the economic bright spot.Their biggest worry was overheating. But after the August shock, developing country bond spreads started going up, their equity markets tumbled, and a number of currencies fell. Trade financing is starting to tighten.

Exports from developing economies to developed economies have never fully recovered in this crisis, but there's been a healthy growth of south-south trade. We're watching very closely now to see whether the loss of confidence that hit Europe and the United States extends to emerging markets. If developing market consumers and businesses retreat for lack of confidence, suddenly we are in a very different environment. Their growth would slow.

A number of developing economies had rapid credit expansion. High growth often hides problems with asset values, so with slowing growth one would expect to start to see more non-performing loans. The message that I have been conveying to the Europeans is that only they can make the decisions for the eurozone. But we all have a stake in what they decide, and Europe needs to understand the effects of its decisions on developing markets.

***TIE:* Our sense is that the Germans still do not have an endgame. Do you agree?**

Zoellick: Some people—the arch protectors of the European Central Bank and the Bundesbank—face a serious question: until they get the other instruments, who's going to hold the eurozone together? Some may be making a point of intellectual protest. They know the European Central Bank's going to supply liquidity through innovative steps, but they're making a point for the institutional future of the ECB. I understand and even appreciate that.

TIE: **Well, that's correct. The Germans, even though they protest various actions by the European Central Bank, are really not in complete control anymore. That brings up a curious question—whether the Germans allowed a situation to develop in which the central bank, which was supposed to be "as good as the Bundesbank," now has an executive board where Germany and France are in a distinct minority. Five of the six members will be new. Debtor countries will have a strong voting majority within the all-important executive board. Have the Germans set up a situation in which the ECB becomes the whipping boy for all that's wrong with the eurozone?**

Zoellick: I think the Germans are putting down a policy marker. Jens Weidmann, the new head of the Bundesbank, is saying he's not against financing to support the eurozone but it needs to be done through the proper institutions. He's making points about the future structure of the European system.

At the recent IMF/World Bank meetings, German Finance Minister Wolfgang Schäuble said they were committed to creating a political union. That is the basis for a fiscal union. I don't know whether France and others will take these steps.

There are different voices in Germany. The German taxpayer is saying, "Look, don't expect us to bail everybody out forever." But the Germans by and large are still very committed to Europe and European institutions. They don't want to just throw away money, and they don't want to be told again and again they have to bail others out. They don't want to have to work hard while others are having vacations and hiding their income. But if Germans are told their financial contributions are part of creating a new European structure with much more fiscal and market discipline, I think they could be persuaded and supportive.

TIE: **The sensitive point is the way it's phrased. If it's stated as, "We need to bail out the banks," then the public reacts in the negative. And if it's stated as, "We are going to bail out the French banks," then for sure the proposed changes are not going to happen. If the line is, "You have to save monetary union and the euro so that we don't have a third world war in less than a century," the proposal might have a chance of being accepted.**

Zoellick: As I said, Europe needs its own structural growth reforms, too. I was talking with a German visitor recently about Google and Facebook, and we realized SAP is the only main European software company left. German manufacturers are innovative. But Europeans face the risk of stifling some innovative sectors.

My main point on banking regulation is beware of unintended consequences.

TIE: **And does the United States need its own new structure?**

Zoellick: A non-American recently asked me whether there could be any positive surprise for the United States. The only one I see on the near horizon is the supercommittee on deficit reduction. It will be interesting to see whether the supercommittee can start to move on some structural growth issues—such as tax reform—while exceeding estimates on spending reductions, which really means just slowing the rate of spending growth. Congress established a voting procedure that enables the supercommittee to ensure votes on these recommendations even if they propose hard decisions.

TIE: **Let's go back to the big picture. When the history of this period is written, we may conclude that what really happened was as follows: Bubbles burst—a real estate bubble in the United States and a sovereign debt bubble in Europe—and then the elite powers on Wall Street and in and around the European banks forced their governments and their central banks to try to prop up the asset values on bank balance sheets at levels that were simply unsustainable. Values continued to drop. With QEII, we discovered that people don't become confident consumers, even with a stock rally, when they know that the value of their homes could drop further. It's a similar situation in Europe. People have known that the banks have been in deeper trouble than government officials have admitted. This is one reason the public is so pessimistic. The bailouts are attempting to do the impossible. Do you buy this assessment?**

Zoellick: The officials who have faced crises have been trying to do the best they can to stop the financial system from further unraveling. Whether Rogoff and Reinhart are right and an over-leveraged system needs to deleverage, or whether we should be looking at problems from the asset side of the balance sheet, real estate is certainly a big piece of the bleak picture. Government and legal actions could exacerbate the problem, lessen it, or not affect it at all. But we will still need markets to clear.

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We want to encourage the clearing as quickly as possible without breaking the financial system or the society. In the U.S. housing market, I worry about all the litigation that's tying up resolutions and lowering values further. Meanwhile, the value of those houses declines as they sit uninhabited with no one taking care of the house and neighborhood. At the same time, policy needs to try to provide people with effective safety nets and support. The World Bank is doing interesting things in emerging markets. Instead of propping up the whole system, support goes to those most in need. For example, there are conditional cash transfer programs in forty countries where, for a half of 1 percent of GDP, 15 to 20 percent of their poorest people receive income support and in return must send their children to school and get health checkups.

You don't want government interventions that are costly and less effective. You do want to combine intervention with growth strategies. We haven't touched on protectionism but that could rear its head in days ahead.

So when history's written, the real question will be whether people at the appropriate point stepped in to stop the bottom from truly dropping out. There will be a whole series of Ph.D. dissertations on small steps like QEII, which people will write about until the end of time. And they'll basically conclude that these steps may have done something modest for a limited time. The bigger story is the one that relates to structural growth.

The main advice I would give on banking regulation is that it's always the problem you didn't see that gets you. I'll give you an example. The Basel Committee on Banking Supervision looked at trade finance and assumed every instrument is at least a year's term, which it isn't in trade finance. And they assumed that the credit of all the emerging market banks is weak. Peter Sands, who has a good bank, Standard Chartered, said the greatest disconnect between his capital model and Basel was on trade finance. Based on supposed reforms, many banks pulled their money out of trade finance. It didn't make sense. And all of a sudden you find trade drying up in a lot of emerging market countries. My main point on banking regulation is that people at Basel or others don't always get it right, and beware of unintended consequences. So build in feedback loops to test how new rules actually work.

The German taxpayer is saying, "Look, don't expect us to bail everybody out forever."

TIE: **In a crisis, we'd be the first to say when you're looking over the precipice, deal with the cards that you're dealt. But even in that environment, you can still haircut AIG. Former Treasury Secretary Paulson's initial instinct was correct: Don't repeat the Japan mistake. Get the toxic assets off the bank balance sheets, or else you're going to live with a sluggish economy for decades. But that never happened. We still have all this junk on bank balance sheets and the banks are not lending. They say there's no loan demand. But two years ago there was, and they weren't lending then, either. They were buying Treasuries and other government agency bonds with money they borrowed for next to nothing at the Fed's Discount Window. So in the end, isn't the problem that Washington policymakers and their European counterparts blinked—they were too passive in dealing with a restructuring of the banks?**

Zoellick: That certainly captures the mood of the moment. I'm not sure how constructive beating up on the banks is. My worry is that the "teach them a lesson" model will become very complicated and ultimately very costly and unworkable, and still probably won't catch the next problem.

A senior Fed official, talking about what's going to be done to fix the mortgage securitization process, said the originators have to hold part of the mortgages they originate. That makes economic sense. But what about the structure of the mortgage banking industry? It's very thinly capitalized. Companies go out of business at the end of a cycle, then open again somewhere else. So you can require them to hold 10 percent, 20 percent, whatever. But if they face losses that exceed the thin capital, they'll shut down, then they'll reopen. That solution won't work unless one changes the industry structure to require well-capitalized mortgage originators.

Let's take mortgages one step further. Americans want thirty-year fixed-rate mortgages. The United States has tried to fund them with savings and loans, and we learned that that doesn't work very well. So Fannie and Freddie played a role, with a better asset-liability match, but the drawback of a single-industry company, by law. Policymakers and the public have to ask the question, if we want thirty-year, fixed-rate mortgages that borrowers can prepay without penalty, then who will hold that asset, how will they judge its quality, and what guarantees are available? I'm a big believer in markets and in institutions. I want to know how markets relate to institutions. I don't think we've yet reconciled supposed public preferences in the housing markets and institutions.

TIE: In the past, even though there were always imperfections, you could still get some clearing process that worked within the system of incentives roughly in place. Now we've thrown a safety net over the entire financial system. We've created an incentive system in the financial sector to run this stuff up to bubble-like levels. Aren't we where we are today because of all the subsidies to banking, and because the regulators were asleep?

Zoellick: Clearinghouses that work under stress are useful devices. In general, I believe banks need capital and liquidity requirements, but I realize there's debate about exactly how these should work. We have to come up with a manageable way to allow banks to fail. I tend to believe it's better to separate supervisory authority from monetary authority, although the two need to interact. In my experience with central bankers, the prestige is with the monetary side, and supervision takes second or third place.

TIE: Politicians want just the opposite. They want to keep piling responsibility on central banks. But central bankers regard bank supervision as sort of the plumbing—as in, "I'm worrying about the business cycle, don't bother me with the plumbing." They punted. And now we have another whole layer of banking regulation because central bankers tried to make the excuse that they didn't have the power to deal with the mortgage mess in the first place.

Zoellick: I agree.

TIE: To what extent does the entire world now prefer a weak currency for trade purposes? The normal problem of a weak currency—rising inflation—is unlikely given the huge slack in the global economy. Is the world about to see a protectionist outbreak?

Zoellick: I don't think we're there yet with weak currencies. There will be pressures, but in general I expect we'll have flexible exchange rates and independent central banks seeking to adapt in a world with monetary turmoil. This condition suggests possibly a bigger structural challenge ahead. The United States will remain the principal reserve currency, but we have to prepare for a world where there are going to be multiple reserve currencies. I wrote about this earlier in the year in the *Financial Times.* Most emerging markets are moving to rely on flexible exchange rates, and we need to help them to develop the institutional structure, the domestic currency bond markets, and the prudential tools so that the current monetary turmoil doesn't drive countries to either financial protectionism or to other types of protectionism.

The World Bank has tried to monitor trade barriers closely and helps publish the information. The World Trade Organization has also published information about whether or not barriers are permitted under the WTO rules. The number of protectionist steps has actually been down a bit until recently, in part because countries have been facing inflation, especially in food prices, so their own self-interest is to keep barriers to imports down. We need to watch whether they now take protectionist actions as their manufacturing sectors come under pressure.

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TIE: To what extent should we believe the data coming out of China? The official number for inflation is 6.5 percent, but analysts in Japan say it is probably closer to double that. Is the potential for a hard landing a lot greater than conventional wisdom suggests? You have to use proxies to really understand what's going on in China. For example, export orders to China have collapsed at Germany's Daimler. Are you worried that the China story will turn sour?

Zoellick: The good news is that the Chinese acknowledge that inflation is their major short-term issue. When you ask Chinese outside of Beijing—the mayors and the party secretaries—whether their actual inflation is a little higher than the recorded numbers, they say perhaps yes, but I'm not overwhelmingly worried. The Chinese, given the nature of their financial system, have a series of regulatory and other tools to squeeze inflation, and they are squeezing it. They're worried about food prices, and also about the social implications of inflation. With new leadership in 2012, the Chinese are keenly focused on the problem. It won't all be pretty, but I think inflation is a manageable issue.

A bigger issue is this idea that China's going to bail out the world. Forget that. The Chinese are focused on restructuring their own economy for continued and broad-based growth in years ahead. They should be. And so should others.

TIE: Thank you very much. ◆