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WAVING OR DROWNING: DEVELOPING COUNTRIES AFTER THE FINANCIAL CRISIS

Yılmaz Akyüz

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SOUTH CENTRE

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ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
AEs	Advanced Economies
AFL-CIO	American Federation of Labor and Congress of Industrial Organizations
BIS	Bank for International Settlements
bp	basis points
BRICS	Brazil, Russia, India, China, South Africa
BWIs	Bretton Woods Institutions
CA	Current Account
CB	Central Bank
CACs	Collective Action Clauses
DCs	Developing Countries
DESA	(United Nations) Department of Economic and Social Affairs
ECB	European Central Bank
ECFIN	Economic and Financial Affairs
EFSF	European Financial Stability Facility
ESCAP	(United Nations) Economic and Social Commission for Asia and the Pacific
ESM	European Stability Mechanism
EU	European Union
EZ	Eurozone
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HAMP	Home Affordable Modification Program
HARP	Home Affordable Refinance Program
IADB	Inter-American Development Bank
IIF	Institute of International Finance
ILO	International Labour Organization
IMF	International Monetary Fund
IMK	Macroeconomic Policy Institute
IPD	Initiative for Policy Dialogue

IT	Information Technology
LTRO	Long-Term Refinancing Operations
MSCI	Morgan Stanley Capital International
NBER	National Bureau of Economic Research
NIEs	Newly Industrializing Economies
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
PERI	Political Economy Research Institute
PPP	Purchasing Power Parity
QE	Quantitative Easing
RMF	Research on Money and Finance
RR	Reserve Requirements
S&P 500	Standard and Poor’s 500
TARP	Trouble Asset Relief Programme
TDR	Trade and Development Report
TWN	Third World Network
UK	United Kingdom
UN	United Nations
UN COMTRADE	United Nations Commodity Trade Statistics Database
UNCTAD	United Nations Conference on Trade and Development
UNEP	United Nations Environment Programme
URR	Unremunerated Reserve Requirements
US	United States
WEO	World Economic Outlook
WESP	World Economic Situation and Prospects

I. INTRODUCTION AND SUMMARY

More than five years since the outbreak of the global financial crisis, the world economy has little signs of stabilizing and moving towards strong and sustained growth. Following a mediocre growth of 2.2 per cent in 2012, lowest since the height of the crisis in 2009, the growth forecast for the world economy in 2013 is no more than 2.4 per cent. In advanced economies (AEs) output and employment gaps still remain high. For the Organisation for Economic Co-operation and Development (OECD) countries as a whole, at the end of 2012 the employment rate − the share of people of working age who are employed − was 1.4 percentage points below its pre-crisis level.[1] With the exception of the US, all major advanced economies, the Eurozone (EZ), Japan and UK have gone into second dips.

Because of policy shortcomings in removing the debt overhang and providing strong fiscal stimulus to make up for private sector retrenchment, the crisis in the US and Europe has been taking too long to resolve. While deleveraging continues to stifle private demand, economic activity is further restrained by fiscal drag in these two epicentres of the crisis as governments have turned to fiscal orthodoxy after an initial reflation. There has been excessive reliance on monetary policy, especially in the US, through provision of large amounts of liquidity to financial markets and institutions at close-to-zero interest rates, using unconventional means. This has been largely ineffective in reigniting bank lending and private spending, but has given rise to a search for yield in high-risk investments, increased leverage and boom in equity markets. It has also generated financial fragility and exchange rate instability in major developing countries (DCs). The implications of an extended period of ultra-easy monetary policy in several reserve-currency issuers for future international financial stability remain highly uncertain since these are largely uncharted waters.

There have been strong spillovers from the crisis in AEs to DCs. The combination of rapid acceleration of growth in DCs and relatively weak performance of AEs before the onset of the crisis was widely interpreted as decoupling of the South from the North. Although growth in DCs fell sharply in 2009 due to contraction of exports to AEs and sudden stop of capital inflows, this was followed by a rapid recovery in 2010 thanks to a strong countercyclical policy response made possible by their improved macroeconomic conditions during the earlier expansion, while growth in AEs continued to falter. This did not only revive the decoupling hypothesis, but also several major DCs, notably China and to a lesser extent India and Brazil, came to be seen as engines of growth for the world economy, notably for smaller DCs. In the event this happened to a certain degree when a massive countercyclical investment package introduced by China in 2008-09 in response to fallouts from the crisis gave a major boost to commodity-dependent DCs. However, with continued instability and weaknesses in AEs, the structural shortcomings of developing economies, including the major DCs are exposed.

[1] Growth numbers are from UN WESP (2013) in market exchange rates, not the Purchasing Power Parity (PPP); employment numbers from OECD (2013b).

Although conditions in international financial and commodity markets have generally remained favourable since 2009, the strong upward trends in capital flows and commodity prices that had started in the first half of the 2000s have come to an end and exports of DCs to AEs have slowed considerably. Furthermore, the one-off effects of countercyclical policies in DCs have started fading and the policy space for further expansionary action has narrowed considerably. Thus, growth in most major DCs has now decelerated significantly compared to the rates achieved before the onset of the crisis. In Asia, the most dynamic developing region, growth in 2012 was some 5 percentage points below the rate achieved before the onset of the crisis; in Latin America it was almost half of the pre-crisis rate.

The longer-term growth prospects of DCs are clouded by persistent global structural imbalances and fragilities that culminated in the current crisis. The world economy is facing underconsumption because of low and declining share of wages in national income in all major AEs including the US, Germany and Japan, as well as China − countries that have a disproportionately large impact on global economic conditions (Akyüz, 2011b; Stockhammer, 2012). There has also been an increased concentration of wealth and growing inequality in the distribution of income earned on real and financial assets. Financialization, welfare state retrenchment and globalisation are the most important factors accounting for these trends. Still, until the Great Recession the threat of global deflation was avoided thanks to consumption binges and property booms driven by credit and asset bubbles in the US and a number of other AEs, particularly in Europe. Several Asian DCs, notably China, also experienced investment and property bubbles while private consumption grew strongly in many DCs elsewhere, often supported by the surge in capital flows and asset and credit bubbles (Akyüz, 2008 and 2012). This process of debt-driven expansion, in its turn, led to mounting financial fragility in the US and the EU and growing global trade imbalances, with the US acting as a locomotive to major surplus countries, Germany, Japan and China, as well as to imbalances within the EZ, culminating in the most serious post-war economic crisis with which the world is still grappling.

In none of the major AEs and China is there a tendency for a significant reversal of the downward trend in the share of wages in national income and a more equitable allocation of wealth so as to allow rapid economic expansion based on income-supported, as opposed to debt-driven, household spending. On the contrary the crisis has widened inequality in AEs as well as several DCs (OECD, 2013c).

In the US where the downward trend in wage share started in the 1980s, in the past two decades consumption and property booms and economic expansions were driven primarily by asset and credit bubbles − first the dot-com bubble in the 1990s and then the subprime bubble in the 2000s. The current crisis has led to a greater concentration of income and wealth. On current policies the US cannot move to wage-led or export-led growth.[2] Rather, it may succumb to the temptation of letting the current ultra-easy monetary policy degenerate into credit and asset bubbles in order to achieve a rapid expansion, very much in the same way as its policy response to the bursting of the dot-com bubble gave rise to the sub-prime boom, while exploiting the "exorbitant privilege" it enjoys as the issuer of the dominant reserve currency and running growing external deficits.

[2] On wage-led growth see Lavoie and Stockhammer (2012). Export-led growth, as used here, refers to a process of expansion whereby exports grow faster than domestic demand.

Whether or not it might help generate a strong expansion, such a return to business-as-usual could produce yet another boom-bust cycle. It could be more damaging than the present crisis, not only for the US but the world economy at large. If, on the other hand, asset and credit bubbles are not allowed to develop and boost aggregate spending, the outcome could be sluggish growth, sharply increased interest rates and a stronger dollar − a combination that often breeds problems for DCs.

The EZ appears to be mired in economic weakness for an indefinite period. The resolution of the underlying problems of debt overhang in the periphery and intra-EZ imbalances in trade and competitiveness requires, *inter alia*, a wage-led growth in Germany, but this is quite unlikely under its current policy approach. In all likelihood, the structural reforms that are now being advocated would extend wage suppression from the core to the periphery and widen the deflationary gap. The periphery may find it necessary to join Germany in the search for export-led growth. Thus, the region cannot be expected to generate expansionary impulses for the rest of the world even if it manages to restore stability in the crisis-hit periphery.

China has moved to investment-led growth as its exports slowed sharply as a result of the crisis and contraction in AEs, and this has added to credit and property bubbles already under way. This pattern of growth cannot be sustained indefinitely. Despite the recognition of the need to raise the share of the household income in GDP and move to a consumption-led growth, the distributional rebalancing is progressing very slowly. Whether or not China can avoid the bursting of the bubbles and a hard-landing, over the medium-term it is likely to settle on a lower growth path with a gradual rebalancing of external and domestic sources of demand and domestic investment and consumption. Given the central role it has played in the commodity boom in the 2000s, and as a new source of investment in resource-rich DCs, notably after the onset of the global crisis, a permanent slowdown in China, together with a strong dollar, would not bode well for commodity-dependent DCs.

All these imply that there will be no more Southern tail winds. Even if the crisis in the North is fully resolved, DCs are likely to encounter a much less favourable global economic environment in the coming years than they did before the onset of the Great Recession, including weaker and/or unstable growth in major AEs and China, higher US interest rates, stronger dollar and weaker commodity prices. Indeed, they may even face less favourable conditions than those prevailing since the onset of the crisis, notably with respect to interest rates, capital flows and commodity prices. Consequently, in order to repeat the spectacular growth they had enjoyed in the run-up to the crisis and catch up with the industrial world, DCs need to improve their own growth fundamentals, rebalance domestic and external sources of growth and reduce dependence on foreign markets and capital. This requires, *inter alia*, abandoning the Washington Consensus in practice, not just in rhetoric, and seeking strategic rather than full integration into the global economy.

This paper examines the crisis from a development perspective. It has three main sections. The following section makes a critical assessment of the policy response of major AEs to the crisis and their economic performance over the past five years. This is followed by a discussion of spillovers from the crisis and the policy response in AEs to DCs, updating and extending the analysis in Akyüz (2012). Downside risks and longer-term growth prospects in major AEs and China are discussed in Section IV with a view to their possible impact on DCs. The paper concludes with a brief discussion of key policy challenges facing DCs in achieving and sustaining catch-up growth.

II. POLICY RESPONSE AND RECOVERY IN ADVANCED ECONOMIES

II.1. Current economic landscape

Even though the US economy was at the origin of the crisis, it has fared much better than other AEs, the EZ, Japan and the UK, since the outbreak of the crisis. First, the 2009 recession was less severe in the US than in the latter economies (Table 1). Second, the US economy has enjoyed continued, albeit moderate, recovery at an average annual rate of 2 per cent, growing 15 straight quarters since the end of the recession in mid-2009. However, the output gap (that is, the difference between what the economy could and does produce) has diminished only a little. At the end of 2012, it was around $800 billion with the cumulative loss since 2008 reaching some $3 trillion. Although the unemployment rate has declined from its peak of 10 per cent in October 2009 to 7.5 per cent in April 2013, part of the decline is due to the exclusion of discouraged workers; the labour force participation rate dropped from 66 per cent at the beginning of the crisis to less than 64 per cent in April 2013 (US Department of Labor, 2013). Furthermore, total non-farm employment is still 2.5 million less than what it was at the beginning of 2008.

Table 1: Real GDP Growth in Selected Advanced Economies

(Per cent change)

	2008	2009	2010	2011	2012	2013
United States	-0.3	-3.1	2.4	1.8	2.3	1.9
Eurozone (EZ)	0.4	-4.4	2.0	1.4	-0.6	-0.3
Germany	0.8	-5.1	4.0	3.1	0.9	0.6
Japan	-1.0	-5.5	4.7	-0.6	2.0	1.6
United Kingdom	-1.0	-4.0	1.8	0.9	-0.2	0.7

Source: IMF WEO (April 2013).

All other major AEs have contracted again since 2009. Following a severe recession in 2009 the EZ as a whole registered positive growth in the subsequent two years despite continued output and employment losses in its periphery, thanks to strong recovery in Germany driven primarily by exports. However, as the impact of the crisis spread in the region through trade linkages, the core and Germany in particular could not maintain strong recovery. In the first quarter of 2013 the region had its 6th consecutive quarter of negative growth. 9 of the 17 EZ countries were in recession with France as a notable addition to the list. Projections for the year as a whole are quite dismal. Germany is effectively stalled and none of the periphery countries in crisis are expected to return to rigorous growth for some years to come. Unemployment has reached 12 per cent for the total labour force and 24 per cent for the youth. In Spain and Greece, at some 25 per cent, the unemployment rate is higher than the levels seen during the Great Depression of the 1930s; for the youth it exceeds 55 per cent.

Neither Japan, nor the UK could sustain positive growth after recovering from the 2009 recession and both went into a second dip. In the last quarter of 2012 Japan experienced its 7th quarterly contraction since the collapse of Lehman Brothers in September 2008. Its income now is below the pre-crisis level. Again, from 2009 until the end of 2012, the UK had negative growth rates in 10 out of 20 quarters and has lost 3.7 million jobs. 2013 growth is expected to be less than 1 per cent, but still the best among the EU's big 5 – Germany, France, the UK, Italy and Spain.

II.2. Why is the crisis taking too long to resolve?

In his remarks on the state of the world economy, the International Monetary Fund (IMF)'s chief economist, Olivier Blanchard is reported to have said that "It's not yet a lost decade… But it will surely take at least a decade from the beginning of the crisis for the world economy to get back to decent shape" (Reuters, 2012). Presumably, this remark must reflect a judgment not only on the nature and depth of the crisis, but also on the effectiveness of public interventions to resolve it.

There can be little doubt that recoveries from recessions brought about by financial crises are weak and protracted because it takes time to repair balance sheets – to remove debt overhang and unwind excessive and unviable investments generated during the bubbles that culminate in such crises. Recoveries from such crises also tend to be jobless and yield little investment. This was the case in US recoveries during the early 1990s and particularly the early 2000s from recessions brought about by the bursting of credit and asset bubbles – that is, savings and loans and dot-com bubbles, respectively. In the current recovery, the pre-crisis income in the US had been restored by the second quarter of 2011, but employment was lower by some 6.5 million. Sluggish job and investment growth is also a common feature of recoveries of DCs from recessions triggered by financial crises (Akyüz, 2006).

However, the pace of recovery also depends on government interventions and management of the crisis. In this respect, there are two major policy shortcomings in the policy response both in the US and Europe. First, governments have been unwilling to remove the debt overhang through timely, orderly and comprehensive debt restructuring and cleaning-up of bad loans. Instead they have resorted to extensive creditor bailouts and, in the case of the EZ, to *ad hoc*, politically motivated and disorderly mechanisms to involve private creditors in debt resolution, subject to highly procyclical policy conditionality. Comparing with interventions in earlier crises in emerging economies of Latin America and Asia, an IMF Staff Discussion Note argued that in the current crisis "*the diagnosis and repair of financial institutions and overall asset restructuring are much less advanced than they should be at this stage and that moral hazard has increased. Consequently, vulnerabilities in the global financial system remain considerable and continue to threaten the sustainability of the recovery.*" (Claessens *et al*., 2011; italics in original).

Second, there have been serious shortcomings in policy measures adopted in support of aggregate demand, growth and employment. The failure to intervene directly to remove the debt overhang in a timely and orderly way has meant slow deleveraging and protracted retrenchment in private spending. As a result, monetary policy has become largely ineffective in expanding credit and lifting private spending even though policy interest rates were cut down drastically and central bank balance sheets expanded rapidly through quantitative easing (QE) to pump liquidity into the economy and lower long-term rates. Thus, fiscal policy has gained added importance, but both the US and Europe have shifted to austerity after an initial reflation because of growing concerns about public deficits and debt. In the EZ, the core has also joined in the austerity imposed on the crisis-hit periphery.

The case for fiscal austerity is premised on two propositions. First, budget deficits add more to public debt than to GDP so that they would raise the debt-to-GDP ratio. Second, high ratios of public debt to GDP are detrimental to growth. It is thus believed that fiscal austerity would not undermine growth and could even stimulate it by lowering the ratio of public debt to GDP − hence the so-called "expansionary fiscal consolidation" or "expansionary austerity".

The first proposition implies that fiscal multipliers are small. This is often attributed to two different mechanisms. First, there is the crowding-out hypothesis – that is, higher public spending leads to lower private spending. The main reason is that increased public spending financed by borrowing would raise interest rates, thereby reducing private investment (and other interest-sensitive expenditures). However, this need not happen if monetary policy is accommodating or when the economy is in the so-called liquidity trap and there is considerable slack. Indeed, despite rising budget deficits and debt, US long-term rates have remained at exceptionally low levels since 2009.

The second mechanism derives from a highly controversial theorem based on a highly unrealistic assumption of rational behavior − that is, as government spending and debt increase, the private sector starts spending less and saving more in order to provide for future tax increases needed to meet debt servicing. In the same vein tax cuts financed by borrowing will be saved by rational individuals in anticipation of future taxes.[3] However, when income is falling and living conditions are deteriorating, it is highly unlikely that households would save a greater proportion of their income as public sector deficits and debt increase.

In the early years of the crisis, the fiscal policy advice of the IMF in Article IV consultations was premised on extremely low multipliers and was invariably pro-cyclical. Because of the underestimation of fiscal multipliers, IMF growth projections turned to be more optimistic than growth outcomes in several European countries such as Greece undergoing fiscal consolidation with IMF agreements.[4] However, as a result of mounting evidence on fiscal drag, the IMF has finally admitted that fiscal multipliers are much greater than was previously believed and that they are state-dependent, particularly large under recessions, with the implication that fiscal austerity could in fact raise the debt ratio by depressing income (IMF WEO October 2012: Box 1.1.; Blanchard and Leigh, 2013).

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[3] This is the so-called Ricardian equivalence theorem which maintains that the effect of an increase in public spending on aggregate demand and income is independent of whether it is financed by increased taxation or new debt. It states that there is no connection between fiscal deficits and real interest rates since rational behaviour implies that private savings would increase by the same amount as the decrease in public savings. Although crowding-out and Ricardian equivalence are competing theories regarding the impact of public deficits on interest rates, they both imply that deficit spending is ineffective in raising aggregate demand and income, though through different mechanisms.

[4] See Weisbrot and Jorgensen (2013). Studying the policy advice given by the IMF to European Union countries in 67 Article IV agreements for 2008-11, the authors show that fiscal consolidation is recommended for all 27 EU countries, and expenditure cuts are generally preferred to tax increases.

The second proposition that high debt ratios could deter growth is supported by a well-known empirical study by Reinhart and Rogoff (2010) which has provided some intellectual ammunition to the advocates of fiscal austerity in the US and the EU. The study found that economic growth slows sharply when the ratio of government debt to GDP exceeds 90 per cent, as has been the case in the US and most EZ countries hit by the crisis. However, it is generally agreed that such an association says effectively nothing about causality – indeed slow growth could cause high debt rather than high debt leading to slower growth. More importantly, subsequent research by Herndon *et al.* (2013) has found that several critical findings advanced in Reinhart and Rogoff (2010) are wrong and the corrected evidence shows that a 90 per cent debt ratio is associated with a much higher rate of growth than was found by these authors.

Supported by such dubious theories and shaky empirical evidence, fiscal austerity has gone unabated both in the US and Europe, dragging growth. The reluctance to use public spending to expand aggregate demand has meant growing reliance on monetary policy, particularly as fiscal austerity has become self-defeating by lowering growth. Not only have interest rates been kept at exceptionally low levels for an extended period, but unconventional means have been used including long-term central bank lending to banks and purchases of asset-backed securities in order to expand liquidity and lower long-term interest rates.

Rapid expansion of liquidity and historically low interest rates, notably in the US, has led to a non-negligible build-up of financial fragility and vulnerability by triggering a search for yield and excessive risk taking, both in the US and globally, very much in the same way as during the subprime bubble. Inflows into high-yielding assets in emerging economies have placed strong pressures on their exchange rates. Exceptionally low interest rates have encouraged corporate borrowing in reserve currencies, which has risen by 50 per cent over the past five years, resulting in increased exposure to interest rate and exchange rate risks (IMF, 2013a: 33-34; Oprita, 2013b). A rapid exit of the Fed from the exceptional monetary policy could thus trigger widespread corporate bankruptcies through sharp increases in interest rates and declines in the currencies of emerging economies.

There are also increased signs of excessive risk taking in the US in various forms including "reaching for yield," increased corporate leverage and maturity transformation – developments that seem to be causing concern at the Fed.[5] The equity markets have already reached historical highs and may undergo a sharp correction if real economic growth lags. Furthermore, credit as well as asset bubbles could start to form and reach dangerous levels if the exit from exceptional monetary policy is too slow, as under the sub-prime boom (Roubini, 2013). There is considerable uncertainty regarding the implications of an extended period of ultra-easy money for future financial stability, since these are largely uncharted waters (White, 2012). Although the Fed and the IMF appear to be taking note of risks to financial stability that may be entailed by exceptional monetary easing, they may not be able to identify them correctly and/or act in a timely and effective manner to prevent instability better than they did during the subprime build-up.

While central banks in the US and the EU have provided ample liquidity to banks and financial markets and purchased government debt in secondary markets in order to lower interest rates and payments on public debt, they have not been willing to abandon the

[5] See Bernanke (2013) who has warned that these may delink asset prices from fundamentals and lead to mispricing. See also IMF (2013a) and (Yellen, 2013b).

obsession against direct financing of budget deficits and permanent monetization of government debt. However, as recognized by several mainstream analysts, under present circumstances these need be no riskier for monetary and financial stability than ultra-easy monetary policy. For instance, former chairman of the UK Financial Services Authority, Lord Turner, has argued that the attempt to escape from the deleveraging trap by excessive monetary accommodation could lead to severe future vulnerabilities and the idea that overt money finance of fiscal deficits is inherently any more inflationary than the other policy levers used to stimulate demand is without any technical foundation. He concludes that the main challenge is how to "design institutional constraints and rules that would guard against the misuse of this powerful medicine."[6] However, none of the governments in the AEs in crisis have been willing to go in that direction even though some central banks are reported to have given considerations to such a solution.[7]

II.3. Bailouts, debt overhang and fiscal drag in the US

The US intervention in the sub-prime crisis has taken two main forms. First, through its $700 billion Trouble Asset Relief Programme (TARP) of 2008-09, the Treasury injected capital into banks whose net worth was moving into red as a result of loss of asset values as well as some large corporations in the auto sector to prevent bankruptcy. Second, after cutting its policy rate sharply, the Fed started relying heavily on QE implemented in several rounds, buying US government bonds and mortgage-backed securities to boost their prices and lower long-term rates. QE1 started in 2008 for purchases of mortgage-backed securities; QE2 was introduced at the end of 2010 for a purchase of $600 billion of Treasury securities and supplemented by the so-called Operation Twist whereby the Fed replaced expiring short-term Treasury bills with long-term notes and securities; QE3 came in September 2012 followed by an announcement by the Fed in December that it would keep buying $85 billion in Treasuries and asset-backed securities until unemployment fell below 6.5 per cent or inflation rose above 2.5 per cent.

These interventions have no doubt helped contain the crisis. However, they have not just averted banks' net worth moving into negative territory, but created ample profit opportunities for financial markets and institutions. At the end of 2012, US banks had restored their pre-crisis level of profits, reaching the best position since 2006. The crisis has also resulted in an increased concentration in the US banking system. The so-called "too-big-to-fail" banks are now bigger than they were on the eve of the crisis; the assets of the top 5 banks now reach 55 per cent of GDP in the US, compared to 43 per cent 5 years earlier. In the same vein, the stock market boomed while unemployment soared. The benchmark US equity index the Dow Jones Industrial Average (Dow) closed at all-time highs in early March 2013, crossing the earlier high recorded in the year 2007 while S&P 500 inched towards an all-time intraday high in early April 2013.

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[6] Turner (2013: 24). See also Wolf (2013a).

[7] Financial Times (2012) reported that direct monetization of public spending was being discussed at the Bank of England and urged that instead of ideological opposition, it behoved the Bank of England to offer pragmatic and rigorous analyses of what benefits and drawbacks such policies might bring.

However, these interventions have done little to reduce the debt overhang, prevent foreclosures or increase lending. TARP was conducted without any condition such as requiring banks to expand lending. The US Treasury also approved large bonuses for executives at firms that received bailouts. But it has not been willing to bring down household mortgages in line with their ability to pay by forcing the banks to write down debt and bondholders to take haircuts. The two voluntary schemes introduced to alleviate the debt burden of mortgage holders have had only little impact: the Home Affordable Modification Program (HAMP) to encourage the lenders to lower monthly mortgage payments of homeowners facing the risk of foreclosure; and Home Affordable Refinance Program (HARP) designed to help homeowners with negative equity to refinance their mortgages.

It is true that household debt dropped from 100 per cent of GDP at the beginning of the crisis to less than 90 per cent at the end of 2012, but much of this improvement has been due to foreclosures and hence reflects a corresponding reduction in household wealth. Homes of many households are worth less than the principal balances on their mortgages. Many of those who continue to own and live in their homes acquired during the subprime bubble are still grappling with large debt and retrenching, and this is still an important impediment to strong growth in consumer demand.

This pattern of recovery has widened the income gap between the rich and the poor. According to a recent estimate, from 2009 to 2011, average US real income per family grew by 1.7 per cent but the gains were very uneven. The top 1 per cent incomes grew by 11.2 per cent while the bottom 99 per cent incomes shrunk by 0.4 per cent (Saez, 2012). Moreover, "gains in household net worth have been concentrated among wealthier households, while many households in the middle or lower parts of the distribution have experienced declines in wealth since the crisis" (Bernanke, 2013). The households in the middle have now lower real incomes than they did in 1996. This is slowing the recovery by holding back aggregate spending since the middle class has a higher propensity to spend than the top 1 per cent and is the "true job creator". It is also holding back tax receipts badly needed for vital public investment for "long-term economic strength" (Stiglitz, 2013).

The US recovery is also hindered by fiscal orthodoxy. The initial fiscal response to consumer deleveraging and retrenchment through one-off transfers (cash for clunkers, food stamps, extended unemployment benefits, etc.) and tax cuts designed to increase spending no doubt played an important role in restraining the downturn and initiating recovery. For instance it is estimated that the fiscal stimulus raised 2010 real GDP by as much as 3.4 per cent, held the unemployment rate about 1½ percentage points lower and added almost 2.7 million jobs to U.S. payrolls (Blinder and Zandi, 2010). However, as soon as the economy started to show signs of life, fiscal orthodoxy has returned. Government employment fell to 21.8 million in 2013 after reaching a peak of almost 23 million in May 2010 (US Department of Labor, 2013). Cuts in public sector jobs and other government spending reduced GDP growth by 0.6-0.8 percentage points during 2011-12.

As pointed out by a Vice Chair of the Board of Governors of the Federal Reserve System, "discretionary fiscal policy hasn't been much of a tailwind during this recovery. In the year following the end of the recession, discretionary fiscal policy at the federal, state, and local levels boosted growth at roughly the same pace as in past recoveries… But instead of contributing to growth thereafter, discretionary fiscal policy this time has actually acted to restrain the recovery. Negotiations continue over the extent of spending cuts now due to take effect beginning in March, and I expect that discretionary fiscal policy will continue to be a headwind for the recovery for some time, instead of the tailwind it has been in the past" (Yellen 2013a: 4).

Indeed, fiscal retrenchment has continued into 2013. The legislation passed in 2011 as part of a deal on debt-ceiling required termination of certain tax cuts and unemployment insurance benefits as well as a $1.2 billion cut in defence and non-defence discretionary spending over 10 years (the so-called sequestration), to take effect at the beginning of 2013. According to estimates by the US Congressional Budget Office, the implementation of this agreement would have reduced GDP by 4 percentage points in 2013, pushing the economy into recession. This so-called fiscal cliff was partly avoided with an agreement reached at the end of 2012 which secured a smaller fiscal retrenchment than had been planned. The expiry of the payroll tax cut, increases in marginal tax rates and spending cuts through sequestration are now estimated to result in a 2.1 percentage point drag on GDP growth (Conference Board, 2013). Moreover, further fiscal tightening may be introduced when negotiations start on the budget and public debt ceiling in coming months, slowing down an already slow recovery (Goldman Sachs, 2013).

II.4. The Eurozone crisis: wrong diagnosis, harmful recipes

While the US recovery has been held back by inadequate policy measures, in the EZ the policy response has been premised on a wrong diagnosis, thereby deepening the recession. The EZ periphery is, in effect, facing a balance-of-payments-cum-external-debt crisis resulting from excessive domestic spending and foreign borrowing of the kind experienced by several DCs in the past few decades. Contrary to the mainstream diagnosis, the rapid increase in payments deficits and external debt that took place in the run-up to the crisis had little to do with fiscal profligacy (Lapavitsas *et al*., 2010; De Grauwe, 2010). With the exception of Greece, in all crisis-hit countries fiscal policy was tightened after 1999. During 2000-07 Spain and Ireland adhered to the Maastricht Treaty much better than Germany – they were both running fiscal surpluses and their debt ratios were lower (Table 2). In fact, Spanish and Irish fiscal balances were better than all other members of EZ except Luxemburg and Finland. Portugal had a relatively high deficit, but its debt ratio was not much higher than that of Germany.

As noted by Gros (2011), external debt is the key to the EZ crisis and the focus on total public debt is misleading. Belgium had a much higher public debt ratio than Portugal, Spain and Ireland, but did not face any pressure and in fact enjoyed a relatively low risk premium because it has run a sustained current account surplus and a positive net external asset position. Again, Italy is less affected than other periphery countries because it has had a much smaller current account deficit and a large proportion of its public debt is held domestically.

A common feature of the periphery countries in Table 2 is that they were all running larger current account deficits than all other EZ members in the run-up to the crisis. In Spain and Ireland, deficits were entirely due to a private savings gap. Even in Greece the current account deficit rose faster than the budget deficit because of a private spending boom. In 2007, the Greek current account deficit was over 14 per cent of GDP while the budget deficit was 6 per cent. Before the outbreak of the crisis, public debt in the periphery, except in Greece, was on a downward trend while private debt was rising. A growing part of the external debt was incurred by the private sector. In Greece only half of the external debt was sovereign and the proportion was even smaller for Portugal and Spain.

Table 2: Pre-Crisis Debt and Deficits in the Eurozone

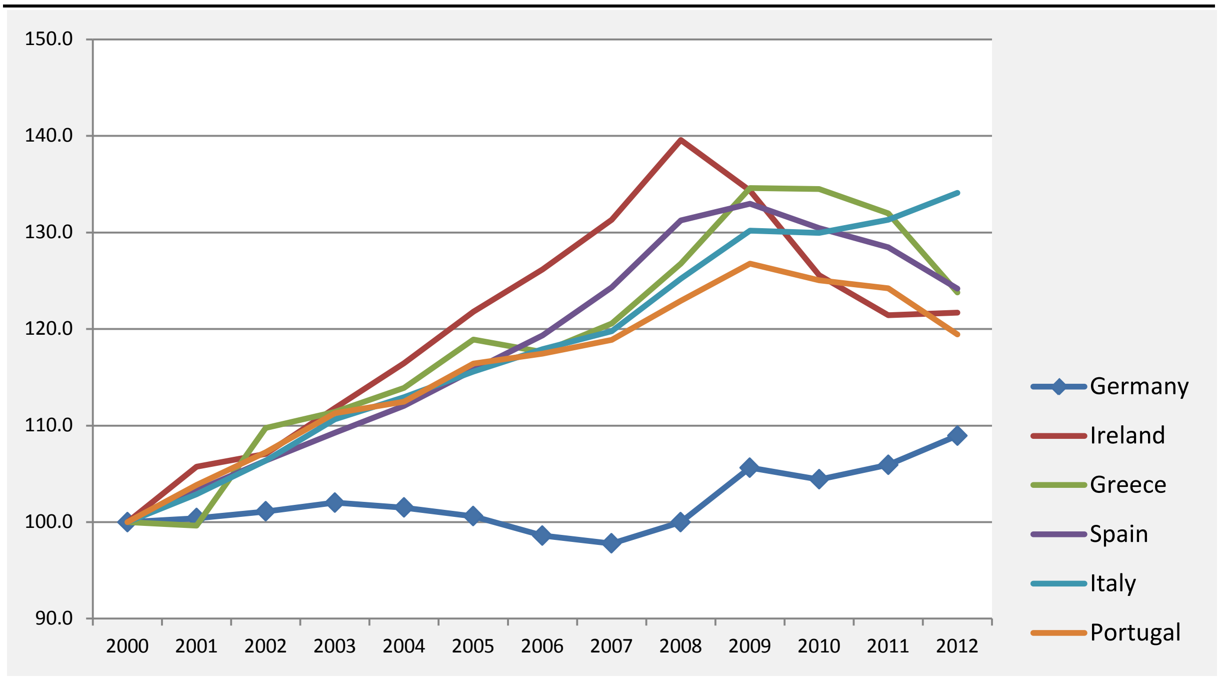
(Per Cent of GDP)

	Fiscal Bal. (2000-07)	Public Debt (2007)	Priv. Bal. (2000-07)	CA Balance (2000-07)
Greece	–5.6	107.3	–2.8	–8.4
Italy	–3.0	103.3	+2.4	–0.6
Portugal	–4.1	68.3	–5.2	–9.3
Spain	+0.4	36.3	–6.2	–5.8
Ireland	+1.4	25.0	–3.3	–1.9
Germany	–2.3	65.4	+5.5	+3.2

Source: IMF WEO (April 2013) and IMF (2013b).

Chart 1: Unit Labour Costs in the Eurozone

(2000=100)

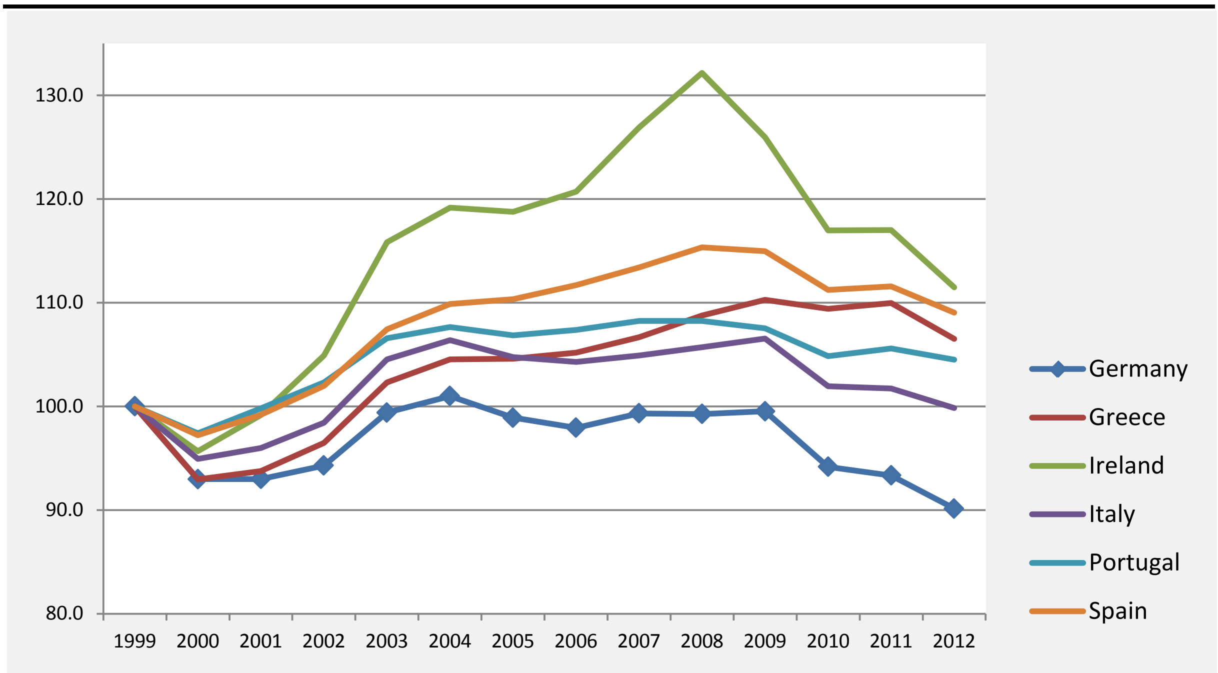


Source: Eurostat.

Two interrelated factors played an important role in rapid increases in current account deficits and raising external debt in the periphery. First, after the monetary union, wage and price movements diverged sharply between the periphery and the core. During 2000-07 Germany undershot the inflation target and its unit labour costs fell while the peripheral countries overshot the inflation target and their unit labour costs increased (Chart 1). Improved German competitiveness was not always due to a superior productivity growth and wage suppression played a central role. For instance, between 2000 and 2007 German real labour productivity per hour worked grew, on average, by 1.6 per cent per annum compared to 2.3 in Ireland and 2.6 in Greece.[8] From early 2000 Germany was engaged in a process of "competitive disinflation", keeping real wages and private consumption virtually stagnant and increasingly relying on exports for growth (Akyüz, 2011b; Palley, 2013). By contrast, in the periphery wages went ahead of productivity, leading to an appreciation of the real effective exchange rate and loss of competitiveness (Chart 2). This created a surge in imports, mainly from other EU countries, but also from the rest of the world, notably China (Chen *et al.*, 2012).

Chart 2: Real Effective Exchange Rates in Eurozone

(1999=100)



Source: BIS.

This process was greatly helped by a surge in capital flows from the core to the periphery, including loans from German banks, triggered by the common currency and abundant international liquidity (Sinn, 2011). They fuelled the boom in domestic demand, reduced private savings and widened the current account deficits in the periphery.[9] They also helped Germany to increase exports and hence maintain a higher level of activity than was possible on the basis of domestic demand. As in Latin America in the early 1980s, this process of debt accumulation also ended with an external shock from the US, this time the

[8] Data from Eurostat, Labour Productivity Annual Data. Last update 7 March 2013.

[9] On the role of private savings and investment in the build-up of current account imbalances and adjustment in the periphery, see Atoyan *et al.* (2013).

subprime crisis, which caused a panic turnaround in creditor sentiments and a sharp cutback in lending.

Monetary policy interventions in response to the EZ crisis have followed broadly the same course as in the US although it has been less intense. Alongside the sharp cuts in policy rates, the European Central Bank (ECB) has undertaken several rounds of QE, providing liquidity to banks and purchasing sovereign bonds in order to boost their prices and lower borrowing costs to troubled debtors. In March 2010 it eased collateral requirements in lending to banks, thus accepting low-grade sovereign bonds as well as asset-backed securities. This was followed by the Securities Market Programme in May of the same year with the ECB buying sovereign bonds in secondary markets – an initiative that created controversy regarding the no-bail-out provision of the 2007 Lisbon Treaty. The Long-Term Refinancing Operations (LTRO) were introduced at the end of 2011 for the ECB to provide three-year loans to banks at low interest rates, enabling them to buy high-yield sovereign bonds and earn large spreads, notably in Spain and Italy. In summer 2012, soon after its head reaffirmed the pledge to "do whatever it takes" to save the single currency, the ECB announced that it would undertake Outright Monetary Transactions (OMT) in secondary sovereign bond markets subject to certain conditions. Although this is yet to be implemented, it has created a wave of optimism in financial markets.

Several bailout facilities have also been introduced in response to the crisis. The first one was the European Financial Stability Facility (EFSF) of May 2010, designed to issue government guaranteed bonds to raise €440 billion to lend to crisis-hit countries in the context of a €750 billion program with the IMF. These bonds were downgraded by Standard and Poor’s when France and Austria, two large guarantors, lost their triple-A ratings. The EFSF operated alongside European Financial Stabilization Mechanism (EFSM), an emergency fund authorized to borrow up to €60 billion, backed by the EU budget. In March 2011 agreement was reached to establish the European Stability Mechanism (ESM), a permanent bail-out fund to replace both the EFSF and EFSM.

These facilities have been used to keep debtors current on their payments to creditors and avoid default and to lower borrowing costs through bond purchases in secondary markets. The biggest rescue operation so far has been in Greece (some €170 billion), followed by Portugal (€78 billion), Ireland (€68 billion) and Spain (€42 billion), and some €17– €23 billion for Cyprus yet to be finalized (Fidler, 2013). Despite occasional references to the need to involve the creditors in the resolution of the crisis, the initiatives taken in this respect have brought limited relief to debtors. In early 2012 Greece was lent for debt buy-back to convert high-rate short-term bonds to low-rate long-term bonds and to reduce its stock of debt through a voluntary debt restructuring, presented as a one-off measure by the EU. The latter involved a buy-back of privately-held debt at a discount of 53.5 per cent, using the Collective Action Clauses (CACs) in internationally issued bonds and retroactively introduced CACs for local-law bonds.

However, these have not removed the Greek debt overhang. As one-third of the discounted debt was held by Greek banks, the operation necessitated recapitalization with new borrowing, thereby raising public debt. It also inflicted large losses on Greek bondholders in Cyprus, notably banks, in the order of €4.5 billion, thus inflating the subsequent bailout package in the latter country. It is generally recognized that Greece needs a deeper debt write-off. However, around 70 per cent of its sovereign debt is now held by the official sector, including the EFSF, ECB, IMF, national central banks and other EZ governments, and the write-down of this debt is resisted by the ECB and Germany. The agreement reached in November 2012 with Greece is a stop-gap measure to prevent default, providing little relief from austerity.

While the need to involve private creditors in the resolution of debt crises is generally recognized, notably in Germany, a coherent approach has not been followed in bailing in creditors and depositors in crisis-hit countries and politics has often interfered with decisions in this regard. In Ireland and Spain where the crisis originated in the banking system, creditors and depositors of troubled banks have largely escaped without a haircut.[10] Ireland gave a blanket guarantee to its bank depositors (as well as holders of other bank debt) which, incidentally, led to a diversion of deposits from other EU members, notably Britain, but also triggered a run on public debt. Greek workouts also spared the depositors, both at home and abroad. In most of these cases rescue operations involved large amounts of money to prop up and recapitalize banks.

By contrast, for Cyprus the initial bailout package prepared by the EU and the IMF in early 2013 envisaged a levy on all deposits, including insured deposits of under €100.000, in order to generate some €7 billion of an estimated €17 billion needed to recapitalize banks and to finance the public sector. When this was rejected by the Cypriot parliament a new plan was agreed at the end of March 2013 to scrap the tax on deposits but to close the second largest bank. Insured deposits have been protected but those above €100.000 were moved to another bank and frozen, to be tapped to raise funds for the bailout. Holders of such deposits, mostly Russians, are estimated to lose as much as 50 per cent of their balance. Senior as well as junior bondholders are expected to suffer large losses. Restrictions are imposed on deposit withdrawals and capital movements. In mid-April 2013, the estimated cost of the bailout was raised to €23 billion from an earlier estimate of €17 billion, for a country with a GDP of some €18 billion. More than half of this would be paid by the Cypriots themselves and the foreign depositors of their banks. Austerity demanded by the Troika has gone beyond the measures imposed on Greece. The IMF WEO (April 2013) gives no figures for growth projections for Cyprus for 2013-14, but economic contraction is widely expected to reach double-digit figures.

While the deal has averted a total collapse of the banking sector in Cyprus and the consequent exit of the country from the euro, it has damaged the confidence in the capacity of the EZ authorities to handle the crisis and the deposit insurance guarantees across Europe. It has also widened the North-South divide. The crisis is far from being resolved as austerity measures are likely to push the country into a deep and protracted recession. The deal brings the debt ratio to 140 per cent of GDP and is likely to be followed by further bailouts. Without a significant debt write-off it would be difficult for the country to avoid default.

A key problem faced in the EZ is destabilizing interfaces between private and public debt. In countries like Spain and Ireland governments have had to act to rescue heavily indebted banks and this has added significantly to public debt, increasing its financing needs. However, the very same banks are also expected to play an important role in financing heavily-indebted governments. Being unable to print national currency, governments have limited capacity to bail out banks or monetize their own debt. This problem is further

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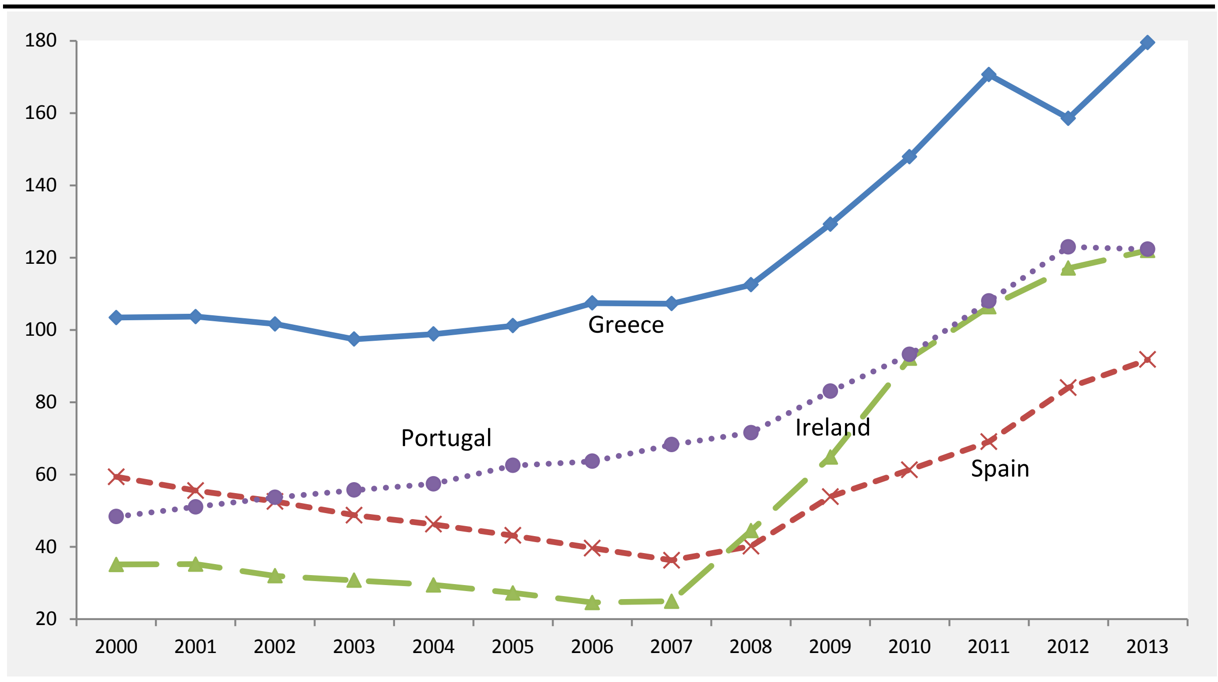
[10] But holders of hybrid debt (securities with elements of both debt and equity) took haircut; see Hay and Unmack (2012).

aggravated by the tendency of international (intra-EZ) lenders to withdraw from crisis-hit countries. A solution to this dilemma could have been to decouple public from private debt by stopping bank bailouts by national governments and by introducing an EZ-wide bank resolution mechanism including bailing-in private creditors, recapitalization and liquidation.[11]

Chart 3: Public Debt as Per Cent of GDP



Source: IMF (2013b).

Public debt ratios have been rising in all four periphery countries because of severe recessions and continued high interest rates (Chart 3). In Spain and Ireland the downward trend in debt ratios has been reversed whereas in Portugal the increase has accelerated after 2008. The Greek debt ratio has started to rise again after the decline brought about by the partial write-off. A fundamental dilemma is that when the ratio of debt to GDP is high and the real interest rate on debt exceeds the growth rate of GDP by a significant margin, the amount of primary surplus needed to stabilize the debt ratio would be quite high. Cuts made in the primary (non-interest) budget to achieve this would create a sizeable contraction in output because of relatively large fiscal multipliers noted above, making the task even more difficult.[12] Thus, debt ratios of Spain and Ireland, which were both well below the 60 per

[11] For a proposal for such a unified banking framework see, Burda *et al.* (2012).

[12] The primary budget surplus needed to stabilize the debt ratio is given by: $p = [(r - g)/(1 + g)]d$ where p is the ratio of primary surplus to GDP; r is the real interest rate; g the growth rate of GDP and d the ratio of debt to GDP (Akyüz, 2007). With a debt ratio of 100 per cent, a negative growth rate and a real interest rate of more than 5 per cent, Spain would need to generate a primary surplus of at least some 5 per cent of GDP in order to stabilize the debt ratio, even in the absence of any negative feedback from fiscal retrenchment to growth. With a much higher debt ratio and greater gap between the real interest rate and the growth rate, Greece faces an even more daunting task – none of these countries have come close to such rates in recent years – see, IMF (2012b: statistical table 2).

cent threshold on the eve of the crisis, have now reached 100 per cent and 120 per cent, respectively. For the same reason, the intensification of fiscal consolidation has not always resulted in lower deficits as a per cent of GDP. In Greece deficits increased from 9.5 per cent of GDP in 2011 to 10 per cent in 2012 and in Portugal from 4.4 per cent to 6.4 per cent.

A strategy of adding to external debt and cutting growth by retrenchment cannot succeed when existing debt is not fully payable. This is the main reason why the Baker Plan, premised on maturity extension and concerted lending by banks and provision of fresh financing by the Bretton Woods Institutions (BWIs), subject to retrenchment and counter-cyclical market-oriented reforms in 15 heavily indebted countries, failed to resolve the Latin American debt crisis in the 1980s (UNCTAD TDR 1988: chap. 4).

In view of the key role played by external debt and deficits in the EZ crisis, payments adjustment as well as debt restructuring is essential for the periphery to achieve a sustainable external position based on the expansion of exports. In this respect the periphery faces the additional problem of having been locked in a currency whose nominal exchange rate is beyond their control. Consequently, the only way to restore competitiveness is through cuts in wages. This problem was encountered by Argentina in the 1990s when it had fixed the peso against the dollar with the Convertibility Plan. In commenting on its prospects, UNCTAD TDR (1995: 90) noted that “the main question for Argentina is how much unemployment will be needed to improve competitiveness, given that it has excluded the possibility of using what is normally the most potent instrument of policy to that end, namely the exchange rate, and whether such unemployment will be politically acceptable.”

So far the periphery countries with overvalued currencies have achieved a certain amount of internal devaluation and adjustment in their unit labour costs through wage suppression (Charts 1 and 2). They also achieved significant improvements in their current accounts between 2007 and 2012: Spain and Portugal reduced deficits from around 10 per cent to 1-2 per cent of GDP, Greece from 15 per cent to 3 per cent while Ireland moved from a deficit of 6 per cent to a surplus of 5 per cent. However, much of these improvements have come from economic contraction, cuts in private investment and imports (Atoyan *et al.,* 2013). Unemployment would need to remain high in order for wages to be kept under control and for unit labour costs and real exchange rates to continue declining. This may face serious social and political obstacles, and could eventually lead to default and exit, as was the case in Argentina.[13]

A growth-oriented adjustment in external debt and deficits in the periphery depends to a large extent on adjustment in surplus EZ countries. Germany needs faster wage growth and higher, albeit moderate, inflation to appreciate its real exchange rate. It should abandon fiscal austerity and create demand to help export-oriented adjustment in the periphery. The latter should try to restore competitiveness not so much by creating unemployment and cutting wages as by investment-led productivity growth. However, none of these are likely to come by easily under the current policy approach. Consequently, under continued austerity, the adjustment fatigue could bring back the spectre of default and exit from the euro to haunt the guardians of the EZ.

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[13] Technically the Argentinian exit from the Convertibility Plan was easy in comparison with an exit of a periphery country from the euro because Argentina had a national currency in circulation.

II.5. Does the Eurozone need others to resolve the crisis?

The EZ has sought international support to resolve the crisis, effectively asking major emerging economies, to invest, *inter alia*, in the debt of crisis-hit countries directly or through special-purpose vehicles to be created by the EFSF. There is no doubt that DCs have a strong interest in a quick resolution of the EZ crisis in view of its adverse spillovers. However, the EZ has no moral grounds to call on DCs to invest their hard-earned or borrowed reserves in euro-denominated bonds, when it has all the means to resolve this crisis between intra-EZ debtors and intra-EZ creditors, having the ability to issue an international reserve currency. Such an investment would carry significant risks for DCs in view of uncertainties surrounding the solvency of some of the heavily indebted members of the EZ. It could also raise the currency risk for DCs by increasing the proportion of euro-denominated assets held as reserves.

The IMF has become deeply involved in the resolution of the EZ crisis. Europe already accounts for a large proportion of total IMF exposure. At the end of 2011 the member states of the EU decided to make bilateral loans to the IMF as much as €200 billion. In its April 2012 meeting, the Fund secured pledges for $430 billion from several of its members, including some major DCs, raising its lending capacity to almost $1 trillion, matching the size of Europe's own rescue fund. Although the new money is said to be available to all members, this increase is triggered primarily by the spread of the EZ crisis to its larger members and the need to respond to a possible financial meltdown in the region and to create a global firewall.

The overextension of the IMF to the EZ is problematic for several reasons. The EZ does not need an international lender-of-last-resort because it is capable of issuing international liquidity. The euro is not an external reserve currency commonly adopted by a number of countries, but the creation of a highly integrated economic union as a reserve currency, rivalling the dollar. The euro is not under pressure because the EZ faces external financing problems of the kind that typically necessitate IMF support. On the contrary, the EZ runs a payments surplus and is a creditor vis-à-vis the rest of the world whose support it requests to resolve its internal crisis.

The moral hazard argument used against intra-EZ bailouts also applies to IMF bailouts. More importantly, the financial integrity of the IMF may be put at risk by large scale lending under unrealistic adjustment programs that are unable to secure debt-sustainability – a *sine qua non* for IMF loans. In the event of a default by its borrowers, the IMF has no *de jure* preferential creditor status. The EZ has in effect been shifting the risks associated with bailouts to the IMF, including its poorest shareholders, by lending to the IMF to enable it to lend to troubled EZ members, rather than lending to the latter directly. The risk to the IMF is compounded by the fact that the Fund is becoming highly leveraged – its borrowing has been increasing rapidly relative to quota subscriptions. Furthermore, lending by the IMF to keep EZ periphery current on their debt to private creditors would make it difficult to achieve the much needed debt write-offs if *de facto* seniority of IMF lending were to be preserved. All these may explain why the IMF has been hardening its stance vis-à-vis the EZ in joining the bailouts, as seen during the Cyprus quandary.

III. SPILLOVERS TO DEVELOPING COUNTRIES

III.1. The decoupling debate

Developing countries experienced exceptional GDP growth before the outbreak of the crisis, averaging at an unprecedented 7.5 per cent per annum during 2000-08 while growth in AEs remained relatively weak. This was widely interpreted as decoupling of the South from the North, including by the IMF. Presumably, decoupling in this sense does not imply that the South has become economically independent of the North−something that would be far-fetched given closer global integration of DCs. Rather, it should mean increased ability of DCs to sustain growth independent of cyclical positions of AEs by pursuing appropriate domestic policies and adjusting them to neutralize any shocks from the North.

Decoupling was discussed in Akyüz (2012). As shown by several authors cited in that paper, business cycles understood as deviations from trend or potential output continue to be highly correlated. Regarding a more fundamental question of whether there was an upward shift in the trend (potential) growth of DCs relative to AEs, it was concluded that the pre-crisis acceleration of growth in DCs was due not so much to improvements in their underlying fundamentals as to exceptionally favourable but unsustainable global economic conditions including a surge in their exports to AEs, booms in capital flows, remittances and commodity prices, largely resulting from property and consumption bubbles in the US and Europe, rapid growth of international liquidity and historically low interest rates.

In the early months of the crisis, DCs were again expected to decouple from the difficulties facing AEs. The IMF underestimated not only the depth of the crisis, but also its impact on DCs, maintaining that the dependence of growth in the South on the North had significantly weakened (IMF WEO April 2007 and WEO April 2008). After the collapse of Lehman Brothers in September 2008, the global economic environment deteriorated in all aspects that had previously supported growth in the developing world, resulting in a sharp downturn in several DCs. However, this was soon followed by rapid recovery, starting in 2009, thanks to a strong countercyclical policy response in DCs, made possible by their improved fiscal and balance-of-payments positions during the earlier expansion. Monetary policy response to the crisis by the US and Europe also helped recovery in DCs by directing capital flows back to them after a sudden stop and sharp reversal triggered by the Lehman collapse.

The combination of the downturn in AEs and strong recovery in the South was once again interpreted as decoupling. However, the initial momentum in DCs could not be maintained. Although since 2009 conditions in global financial and commodity markets have generally remained favourable, the strong upward trend in capital flows and commodity prices has come to an end and exports to AEs have slowed considerably. Furthermore, the one-off effects of countercyclical policies in DCs have started fading and the policy space for further expansionary action has narrowed considerably. Outside China, fiscal and payments constraints started biting in most major DCs as a result of the shift to domestic-demand-led-growth, leading to fiscal tightening.[14] Consequently, growth in DCs declined in both 2011

[14] Ortiz and Cummins (2013) show that many DCs joined fiscal austerity after 2010 and premature expenditure cuts became widespread. Fiscal consolidation is expected to intensify significantly in 2013.

and 2012 after a strong recovery in 2010. In Asia, the most dynamic developing region, in 2012 it was some 5 percentage points lower than the rate achieved before the onset of the crisis; in Latin America it was almost half of the pre-crisis rate.

The IMF has now "refined" its position on the question of decoupling, revisiting the issue in IMF WEO (October 2012: chapter 4) under "Resilience in Emerging Market and Developing Economies: Will it last?" In a quantitative analysis, lumping together more than 100 emerging market and developing economies (with per capita incomes ranging from $200 to over $20.000) and examining their evolution over the past 60 years, it has concluded that "[*t*]*hese economies did so well during the past decade that for the first time, [they] spent more time in expansion and had smaller downturns than advanced economies. Their improved performance is explained by both good policies and a lower incidence of external and domestic shocks: better policies account for about three-fifths of their improved performance, and less-frequent shocks account for the rest.*" (IMF WEO, October 2012: 129. Italics in original.)

"Good policies" that the IMF has found to have improved performance in DCs include "greater policy space (characterized by low inflation, and favourable fiscal and external positions)" created by "improved policy frameworks (countercyclical policy, inflation targeting and flexible exchange rate regimes)." No robust link could be found between structural factors including trade patterns, financial openness, capital flows and income distribution on the one hand, and the "resilience" of DCs on the other.

The Fund ignores the role of *positive* external shocks in stimulating growth and creating policy space in DCs, but focuses on the absence of strong adverse shocks. There is ample evidence, cited in Akyüz (2012), that improved performance of commodity-exporting DCs which account for much of the acceleration in the South after 2002 was the result of the twin booms in commodity prices and capital flows which also created space for subsequent counter-cyclical policies in response to fallouts from the global crisis. These *positive* shocks provide a better explanation of the exceptional performance of many DCs in the past decade than "good" orthodox policies such as inflation targeting, single-digit inflation and flexible exchange rates.

Since 2011 the IMF has been constantly over-projecting growth in emerging and developing economies. The IMF WEO (April 2011) projected 6.5 per cent growth for 2012, revised it downward to 6.1 in September 2011, to 5.7 per cent in April 2012 and 5.3 in October 2012. IMF WEO (April 2013) estimates the growth outcome for these countries at 5.1 per cent, almost 1.5 points below its original projection, and recognizes the possibility that "recent forecast disappointments are symptomatic of deeper, structural problems" (p.19), revising downward the medium-term prospects of these economies (pp. 22-23). Another IMF report estimates the average potential growth rate of DCs in the Western Hemisphere at slightly over 3 per cent, far below what is required for a genuine "rise of the South" and catch-up with AEs,[15] and recognizes that the above-potential growth achieved during 2003-12 is not sustainable without fundamental changes (IMF, 2013c).

[15] Pre-crisis potential growth of the US economy was estimated at 2.5 per cent, but the Great Recession is expected to have reduced it to 2.2 per cent; Bernanke (2012) and Wessel (2012).

III.2. Private capital flows and financial spillovers

The financial crisis in AEs has led to considerable instability of private capital inflows, yield spreads, equity prices and exchange rates in DCs. The surge in capital inflows to DCs that had begun in the early years of the 2000s with sharp cuts in interest rates and rapid expansion of liquidity in AEs continued unabated in the early months of the crisis. However, the flight to safety triggered by the Lehman collapse led to a sudden stop and reversal, resulting in strong downward pressures on exchange rates and asset prices.[16] Closer and deeper integration with major financial centres and rapidly growing gross asset and liabilities positions of DCs with the AEs intensified the transmission of financial stress to asset, banking and currency markets. The crisis also led to a contraction of credit in DCs due to cut-back in international bank lending and local lending by foreign banks' affiliates in DCs as well as declines in inter-bank cross-border lending for funding by domestic banks (Cetorelli and Goldberg, 2010).

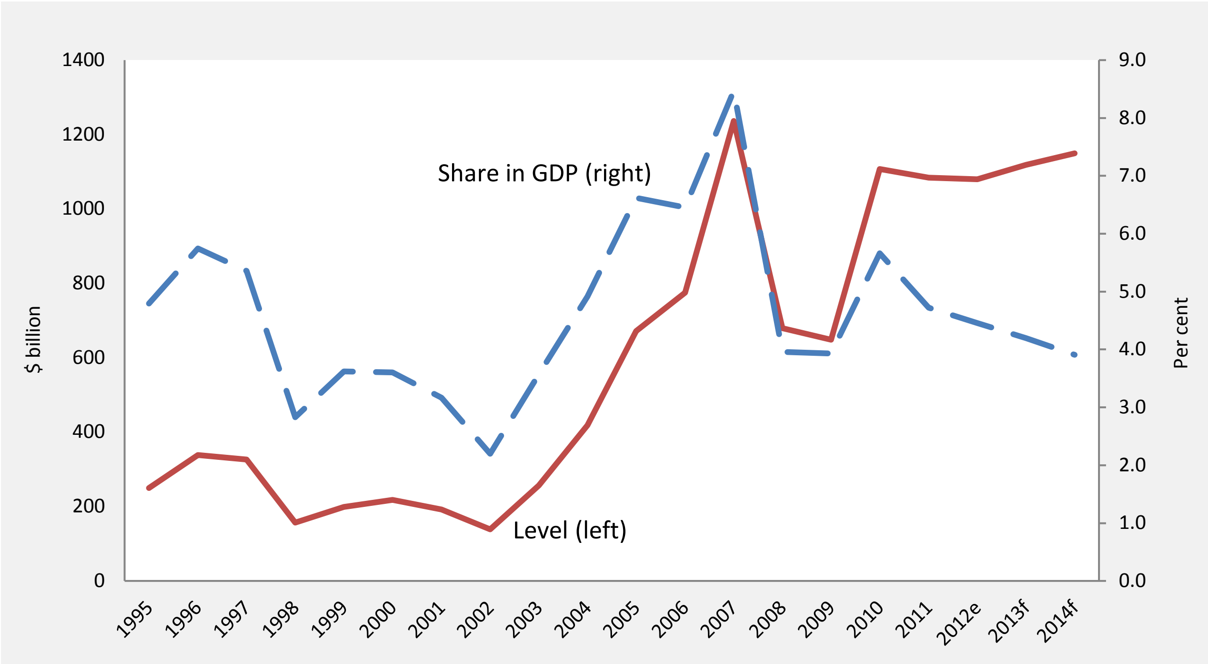
Although private capital inflows recovered quickly from early 2009, helped by sharp cuts in interest rates and QEs in AEs and shifts in risk perceptions against them, they have lost their pre-crisis momentum and have become unstable and uneven. At the end of 2012, in nominal terms they were below the peak reached in 2007. As a percentage of GDP of the recipient countries, the decline was much steeper, from 8.5 per cent in 2007 to 4 per cent, a level not much different from those seen in the 1990s (Chart 4). Net flows available for current account financing and reserve accumulation in DCs are much lower, less than 1 per cent of GDP, because of resident outflows from DCs through direct and portfolio investment abroad. Institute of International Finance (IIF, January 2013) projections are for a moderate increase in 2013-14; but in absolute terms they are not expected to reach the 2007 peak and as a percentage of GDP they could continue to fall.

While the pre-Lehman boom in capital inflows was broad-based, pull factors have become more important in the post-Lehman recovery with lenders and investors increasingly differentiating among DCs. In absolute nominal terms net inflows to Asia and Latin America have exceeded the peaks reached on the eve of the global crisis even though the slowdown in China after 2010 has led to some deceleration in direct investment (Chart 5). By contrast, despite some recovery, inflows to European emerging economies have remained well below the peak reached before the crisis, largely due to strong fallouts from the EZ crisis. This is also true for Africa and the Middle East.

The EZ crisis has played a central role in the overall weakness of private capital inflows to DCs. On the one hand, it has led to increased global risk aversion and greater preference for relatively safe assets. On the other hand, it has impinged directly on the volume of global capital flows. Before the outbreak of the global crisis, Europe was the main source of (gross) capital flows to the rest of the world, with $1600 billion per annum during 2004-07, higher than total outflows from the US and Japan taken together. With the outbreak

[16] According to Dadush *et al.* (2009) Argentina, Jamaica, Ghana and Mexico are among the most affected by the immediate financial impact of the crisis during September 2008-May 2009 in terms of currency depreciations, equity market declines and increases in bond spreads. By contrast, several DCs including China, South Africa, Malaysia, Peru and Colombia are among the least affected countries. In a study of debt and equity markets over February 2007-March 2009, Dooley and Hutchinson (2009) found that markets of emerging economies were decoupled from the US for a period of time, but linkages dramatically re-emerged by late summer or early fall 2008 with a remarkably uniform timing across most emerging economies.

Chart 4: Private Capital Inflows to Emerging Economies, 1995-2014

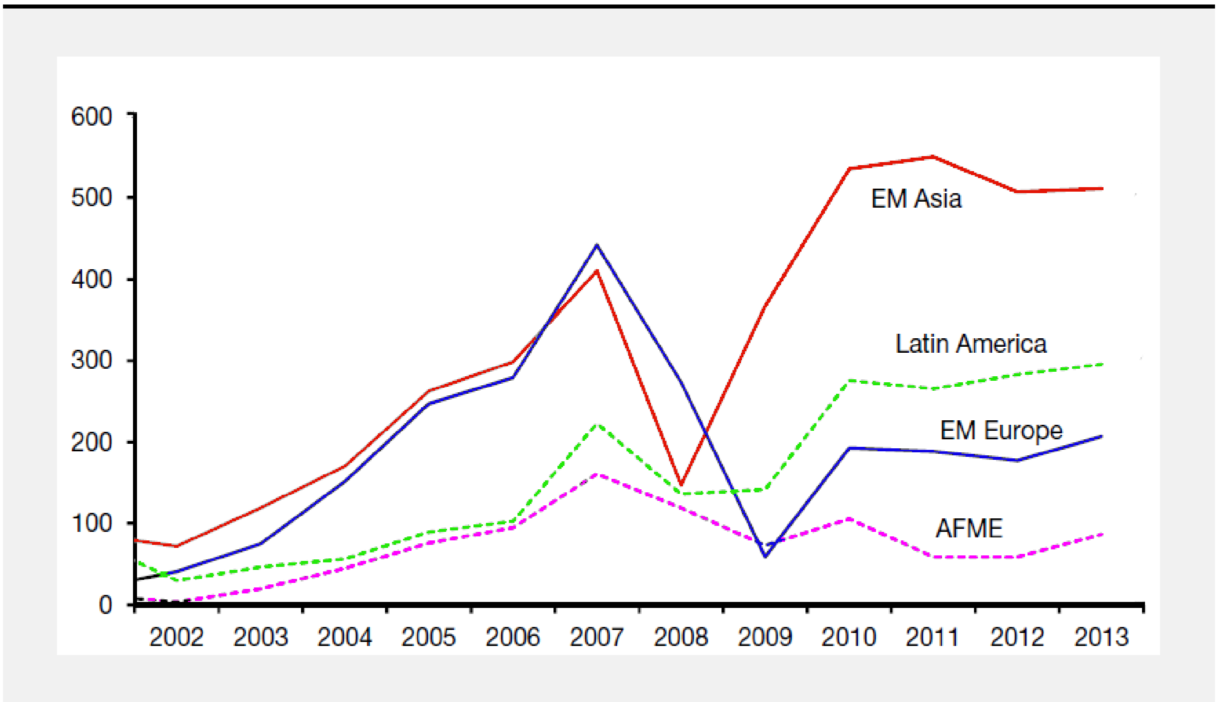


Source: IIF (January 2013).

Note: f = IIF forecast, e = estimate.

Chart 5: Private Capital Inflows to Emerging Economies

(Billions of U.S. dollars)



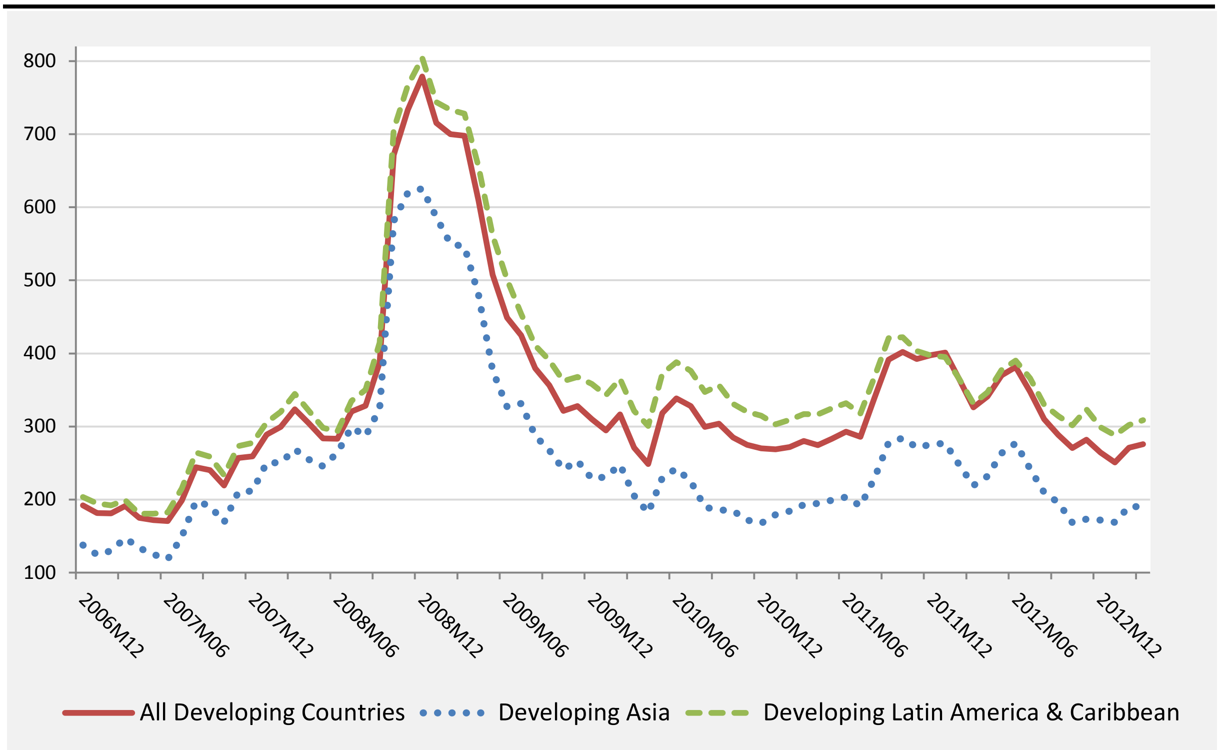
Source: IIF (January 2013).

of the crisis and the consequent bank deleveraging, total outflows from Europe fell sharply, registering a bare $300 billion a year during 2008-11.[17]

The EZ crisis has also led to considerable short-term, month-to-month volatility in capital inflows to DCs as they have become increasingly sensitive to news coming from the region, leading to difficulties in macroeconomic management in DCs. From mid-2011, market sentiments turned sour with the deepening of the Greek crisis, strikes and political turmoil in the periphery and credit downgradings, leading to a drop in estimated capital inflows to DCs and significant downward revisions in forecasts.[18] Global risk appetite improved in the early months of 2012 with the agreement on ESM and austerity packages in Greece and Spain, the implementation of the LTRO, the signing of the Fiscal Compact and increased lending limits from EFSF and ESM. However, markets became bearish again after spring 2012 when Spain requested assistance for bank capitalization, was downgraded by rating agencies and its yield spreads mounted, and concerns grew over Greece. As already noted, this was followed by renewed optimism after mid-2012 with the commitment of the ECB to save the euro. However, the mood changed again with the confusion created by the Cypriot bailout plan in March 2013.

Chart 6: Sovereign Bond Interest Rate Spreads

(Basis points over US Treasuries)



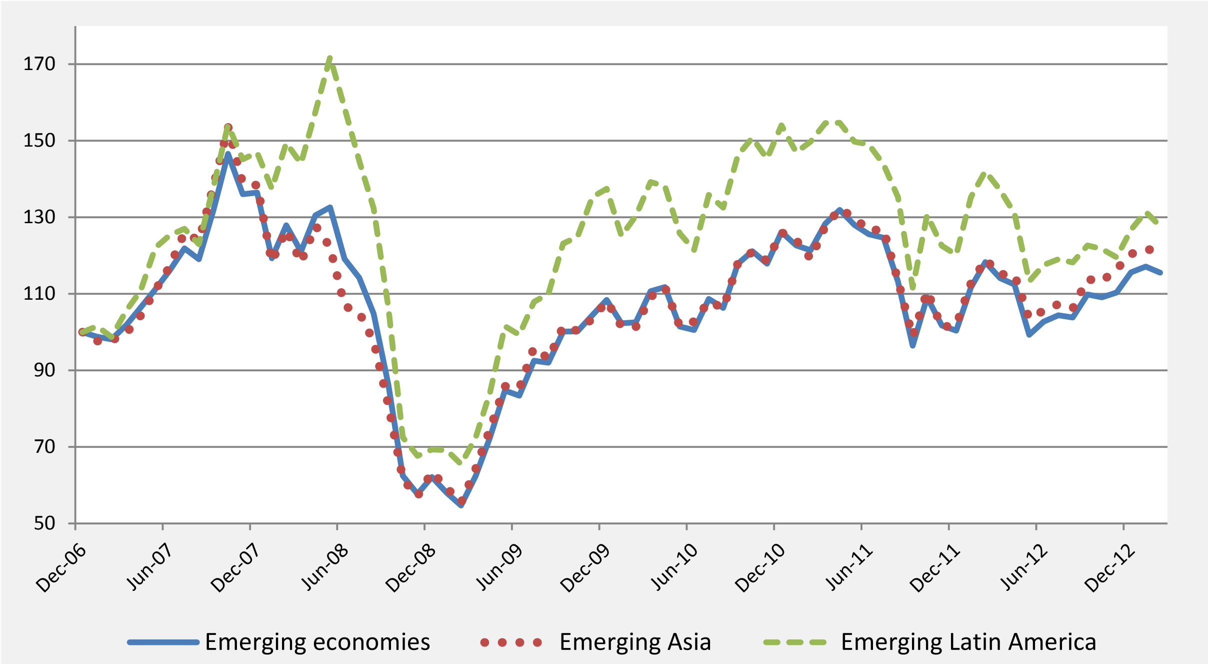
Source: World Bank (Datastream).

[17] IIF (January 2012). According to a report by McKinsey Global Institute cross border global capital flows have dropped by 60 per cent from their peak in 2007 with a $3.7 trillion decline in cross-border claims by EZ banks; see Lund *et al.* (2013).

[18] Tensions in the EZ led to a cut in projections for 2012 by $340 billion and the estimate for 2011 by $140 billion; see IIF (January 2012).

Changes in global risk appetite and private capital flows have also been mirrored by bond and equity markets of major emerging economies (Charts 6 and 7). After the Lehman collapse, sovereign bond spreads shot up and stood, at the end of 2008, above 800 basis points (bp), about three times the level in the previous year while the MSCI index fell to some 40 per cent of the level reached in 2007. With the recovery in capital flows, spreads fell and equity prices rose rapidly, but they both deteriorated after mid-2011 with the deepening of the EZ crisis. Despite some improvements in the second half of 2012, now spreads are above and the MSCI index is below the levels reached on the eve of the crisis.[19]

Chart 7: Monthly MSCI Equity Market Indices, December 2006 - February 2013



Source: MSCI.

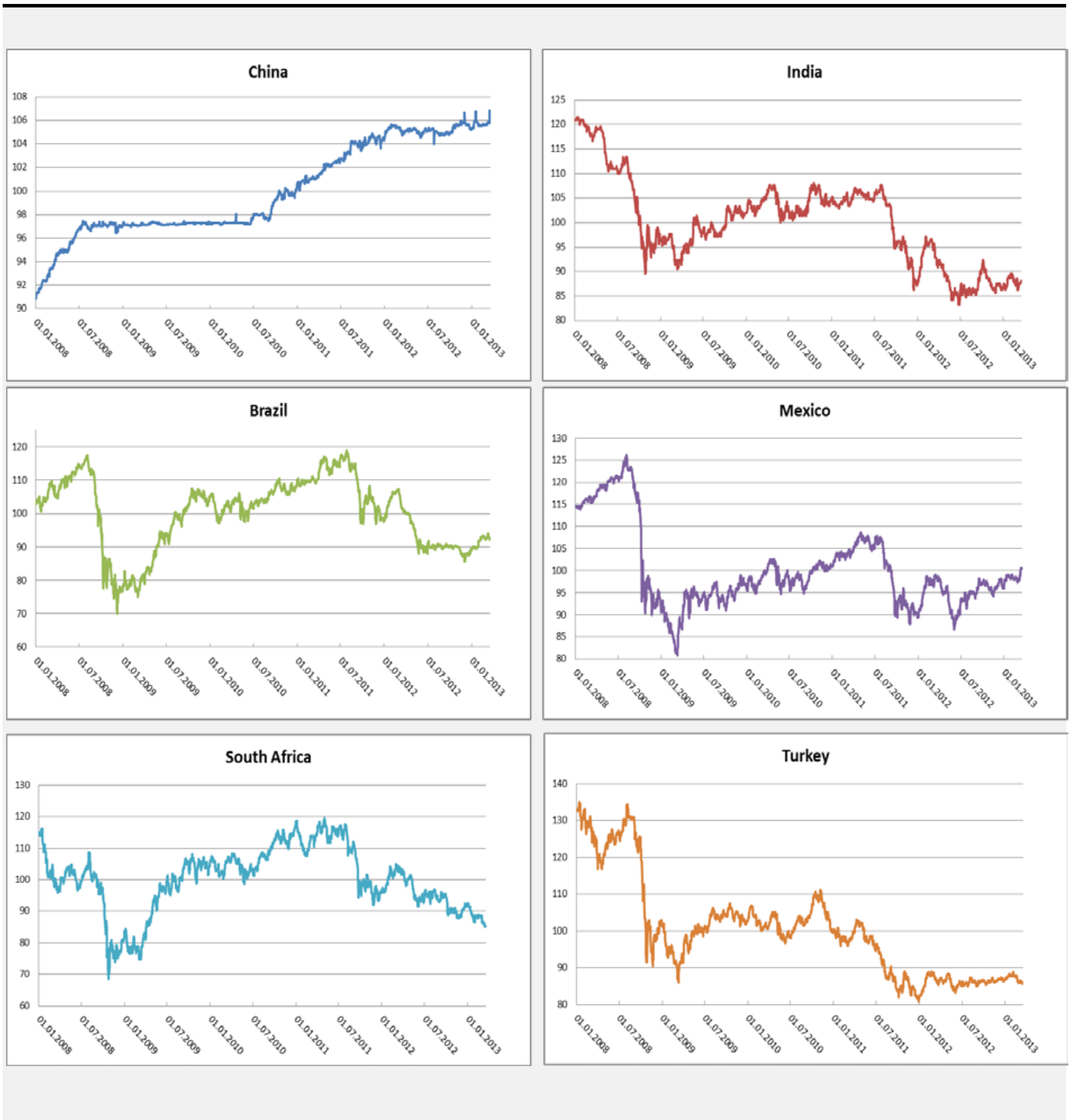
Note: December 2006=100.

The Lehman collapse and flight to safety also resulted in large drops in the currencies of most DCs against the dollar, with the notable exception of China (Chart 8). Many of them chose not to restrain the decline in view of weakened exports. Most DCs have welcomed the subsequent strong recovery in capital inflows and the boom in asset prices they helped to generate, but they have been ambivalent about their impact on exchange rates. The ultra-easy monetary policy in AEs has been widely seen as an attempt to achieve beggar-thy-neighbour competitive devaluations to boost exports to drive recovery in conditions of sluggish domestic demand. It was described as a currency war by the Brazilian Minister of Finance while the Governor of the South African Reserve Bank alluded that DCs were in effect caught in a cross fire between the ECB and the US Federal Reserve (Marcus, 2012).

[19] IMF (2012a: 20) finds that money and bond market contagion from the euro crisis was benign to moderate, but the stock market contagion was moderate to severe.

Chart 8: Nominal Exchange Rates in Selected Economies

(Period average=100)



Source*:* OANDA (http://www.oanda.com).

Note: US dollar per unit of domestic currency.

DCs have responded in various ways. Initially, almost all countries had a hands-off approach to capital inflows. Many of them, notably in Asia, intervened heavily in foreign exchange markets, absorbing them in reserves and trying to sterilize interventions by issuing government and/or central bank debt. These countries avoided sharp appreciations. The total foreign exchange reserves of developing Asia increased by some $2200 billion during 2008-12 despite the decline in their overall current account surpluses. Others, particularly those pursuing inflation targeting, including Brazil, South Africa and Turkey, abstained from extensive interventions and hence experienced considerable appreciations. There are two obvious reasons for this policy of non-intervention. First, since it is difficult to fully sterilize the impact of interventions on domestic liquidity, attempts to stabilize the currency would conflict with inflation targeting. Second, as most of these were high-interest-rate economies, sterilization would imply significant fiscal or quasi-fiscal costs, adding to government deficits and debt.

However, as upward pressures on the currencies of DCs persisted, several countries abandoned the hands-off approach to inflows and started using measures to control them. Interestingly the country that has made the most frequent recourse to such measures is Korea, a member of the OECD and hence is subject to provisions of its Code of Liberalization of Capital Movements (Singh, 2010). The Korean won has been one of the weakest currencies in the entire post-crisis period. Its effective exchange rate has never gone back to pre-crisis levels, eliciting remarks that, together with the UK, it is the most aggressive "currency warrior" of the past five and a half years (Ferguson, 2013). The measures of control used by Korea include ceilings on forex forward positions of banks, a levy on non-deposit liabilities and a withholding tax on interest income from foreign holdings of treasuries and monetary stabilization bonds. Korea is now launching a $15 billion stimulus plan in order to support exporters facing pressures from a weaker yen and to revive growth, the third largest after those introduced in response to the 1997 Asian crisis and the 2008 global crisis (Kim, 2013).

After 2009 several DCs started to control capital inflows, mainly through market-friendly measures rather than direct restrictions. These included unremunerated reserve requirements (URR) and taxes (Brazil taxes on portfolio inflows; Peru on foreign purchases of CB(Central Bank) paper; and Colombia URR of 40 per cent for 6 months); minimum stay or holding periods (Colombia for inward FDI; Indonesia for CB papers); special reserve requirements (RR) and taxes on banks' positions (Brazil RR on short positions and tax on short positions in forex derivatives; Indonesia RR for total foreign assets; Peru higher RR on non-resident local currency deposits); taxes and restrictions over borrowing abroad (India on corporate borrowing; Indonesia on bank borrowing; Peru additional capital requirements for forex credit exposure); and taxes on foreign earnings on financial assets (Thailand withholding tax on interest income and capital gains from domestic bonds). Some DCs such as South Africa liberalized outflows by residents in order to relieve the upward pressure on the currency.[20]

These measures have been designed not so much to prevent financial fragility as to avoid currency appreciations and deterioration of the current account. As noted, not only have most emerging economies welcomed the boom in asset markets, but they have also ignored the build-up of vulnerability resulting from increased corporate borrowing abroad. However, the measures have not been very effective in limiting the volume of inflows as exceptions were made in several areas. In many cases the composition of inflows changed towards longer maturities and types of investment not covered by measures. Furthermore, taxes and other restrictions imposed were too weak to match arbitrage margins. Similar measures produced different outcomes in different countries because of differences in the implementation capacity and the sanctions attached to violation.

[20] These are compiled from various publications of the IMF, including *World Economic Outlook* and *Global Financial Stability Report.*

Although ultra-easy monetary policy has continued with full force after 2010, putting pressure on the currencies of some DCs, protests from the South became much less frequent. There are basically two reasons for it. From early 2011 most developing economies started to cool and hence the pressure of capital inflows on prices eased up. Second, the shift to domestic-demand-led growth has led to a widening of current account deficits in many major emerging economies, including Brazil, India, South Africa and Turkey, and this has increased the need for foreign capital and eased the upward pressure on currencies. Indeed, as seen in Chart 8, from mid-2011 the currencies of most of these countries started to weaken.

The so-called currency war among major AEs continues unabated. The ECB's pledge to "do whatever it takes" to save the single currency, the announcement of OMT and a further interest rate cut by the ECB in May 2013 to bring it down to a record low of 0.5 per cent as well as the commitment of the US Fed to continue with the QE3 until unemployment fell below 6.5 per cent or inflation rose above 2.5 per cent suggest that the ultra-easy monetary policy in the US and the EZ are here to stay for some time to come. The Bank of Japan raised the inflation target in early 2013 and started a policy of aggressive QE, leading to a significant fall of the yen against the dollar and eliciting critical remarks, including from the Bundesbank president (Ferguson, 2013). In the UK, devaluations and exports have been seen as a way out of public and private deleveraging, with the government not ruling out abandoning inflation targeting. The pound sterling has depreciated in real effective terms more than any other major currency since August 2007. The Swiss National Bank has capped its currency against the euro and has been intervening heavily in order to prevent appreciation, despite a current account surplus of over 10 per cent of GDP.

However, liquidity expansion in AEs is not likely to lead to a generalized surge in capital inflows to DCs similar to that seen before the onset of the crisis although some countries favoured by international investors may experience strong inflows. First, in most emerging economies growth has slowed down sharply compared to the previous period. Secondly, interest rates have often been cut in response, thereby narrowing short-term arbitrage margins. In any case, a renewed surge in inflows of all types, including portfolio inflows, may be welcomed by several major DCs because of widened current account deficits.

III.3. Remittances

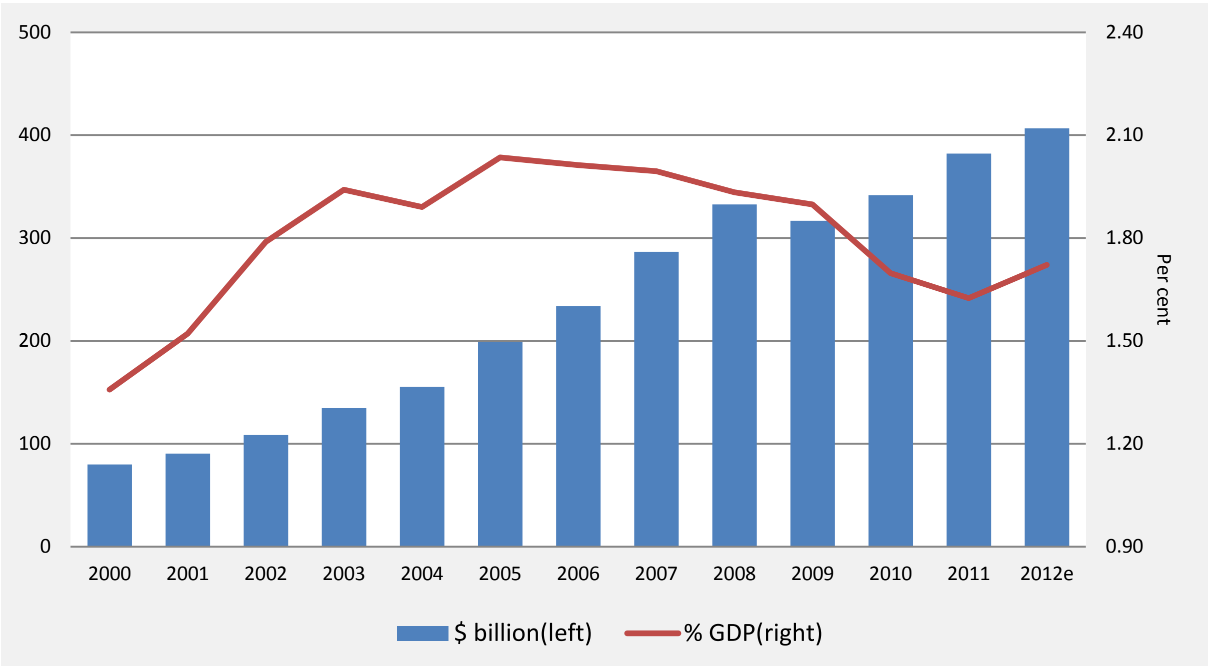
Worker's remittances have emerged as a major source of external financing for DCs in the new millennium, second only to FDI inflows. They have followed broadly the same pattern as private capital inflows, expanding at a rate of 20 per cent per annum during 2002-08. They reached the peak of some 2 per cent of GDP of DCs taken together in the middle of the decade, mostly from migrant workers in the EU, followed by the US. For several DCs, they provided an important source of current account financing, at a rate of more than 3 per cent of GDP in India and Mexico and over 10 per cent in Bangladesh and the Philippines.

Surprisingly the crisis in the US and EU did not have a strong impact on total inflows of remittances to DCs even though these economies account for a very large proportion of total remittances and they have experienced sharp increases in unemployment after 2008.[21]

[21] Nevertheless, remittances from Europe, notably the periphery countries hit by the crisis have been quite weak in the past four years–World Bank (2012) and IADB (2013).

In nominal terms, remittances registered a small decline in 2009 followed by a moderate recovery afterwards, and are estimated to have reached $400 billion at the end of 2012. However, this has not been sufficient to reverse the decline in percentage of GDP of the recipient countries. At the end of 2012 they are estimated to have amounted to 1.7 per cent of GDP, compared to over 2 per cent during the pre-crisis peak (Chart 9).

Chart 9: Remittances Flows to Developing Countries, 2000-2012



Source: World Bank Migration and Development Briefs and World Development Indicators.

Traditionally, remittances to DCs have generally served to support consumption of families and relatives in the countries of origin of migrant workers and financed mainly from their current earnings. However, existing statistical recording of these flows do not allow a precise determination either of the origin or of the final use of these transfers.[22] They may actually be funded from accumulated savings of workers abroad and/or used in their countries of origin not for consumption but for investment in property or financial assets.

The continued increase in remittances to DCs after sharp rises in unemployment and declines in wages in the crisis-hit AEs suggests that a greater proportion of these may have actually come from accumulated savings rather than current earnings of migrant workers. In the same vein, these might have been increasingly used for investment rather than consumption. In other words, they may be like capital flows rather than unrequited transfers. Increased rates of return on real and financial assets in DCs relative to AEs and the change of the risk perceptions against AEs may have encouraged such transfers. This has the implication that in the event of a shift in relative risk-return profiles of investments in AEs

[22] On problems about the definition and data on remittances, see Alfieri and Havinga (2006) and Reinke (2007).

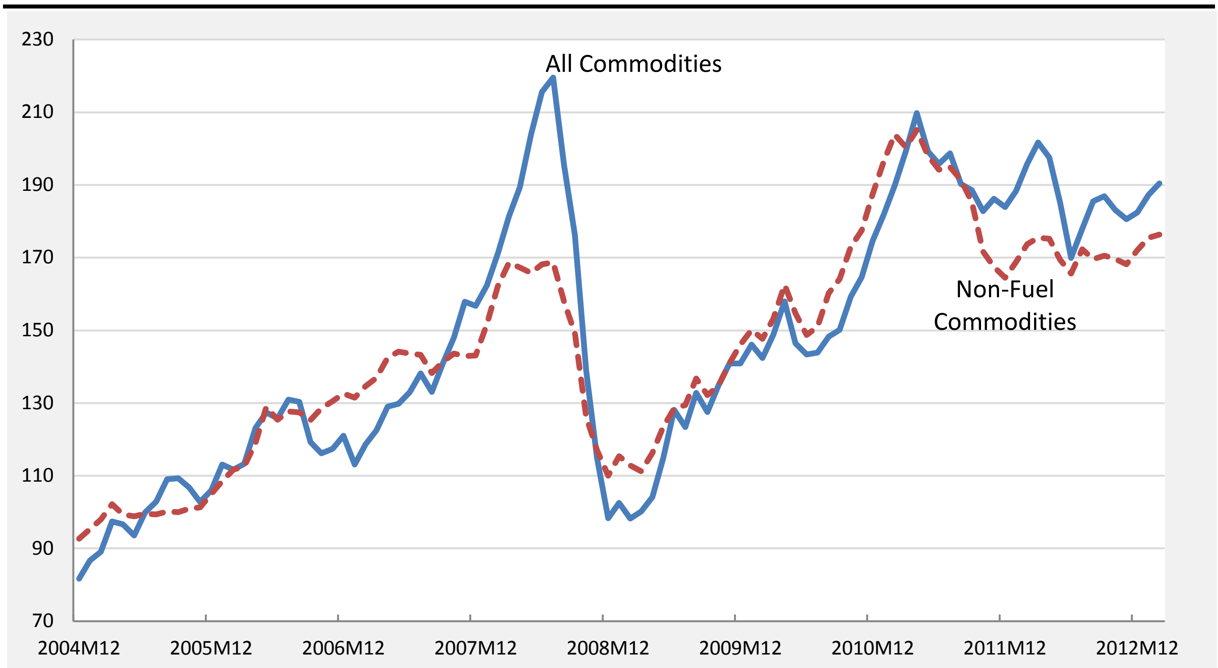
and DCs, these flows may well be reversed in the form of increased capital outflows from DCs.

III.4. Commodity Prices

The financial crisis in AEs has not depressed commodity prices to the extent seen in previous post-war recessions. The boom that had started in 2003 continued until summer 2008 with the index for all primary commodities rising by more than threefold (Chart 10). This was followed by a steep downturn in the second half of 2008, which took the index back to the level of 2004. But like capital flows and remittances, commodity prices also recovered strongly from the beginning of 2009, rising until spring 2011 when they levelled off and started to fall, manifesting increased short-term instability. In the early months of 2013, the index for all commodities was 15 per cent below the peak reached in summer 2008.

Chart 10: Monthly Primary Commodity Prices, December 2004-February 2013

(2005=100, in terms of U.S. dollars)



Source: IMF Primary Commodity Prices.

Different commodities that go into the aggregate index in Chart 10 are not only linked to economic activity in different ways, but have also important supply-side differences.[23]

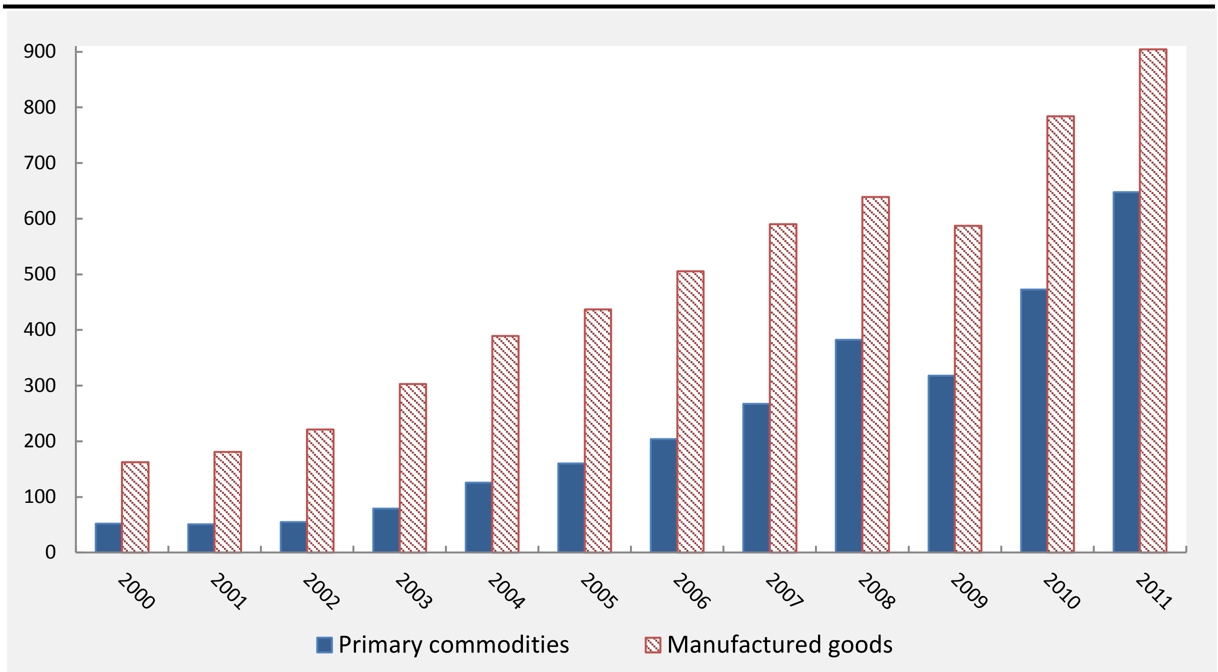
[23] Energy, which has the large weight of some 63 per cent in the overall index, is subject to geopolitical risks. Food, with a weight of some 17 per cent, is subject to supply disruptions due to weather conditions or crop infestation. Metals, the most important component of primary industrial inputs with a weight of over 10 per cent, are also subject to supply disruptions, largely due to social and political instability in the producing countries and regions. For a detailed account of the recent behaviour of the overall commodity price index and its components, see IMF WEO (October 2012, chapter 1; Special Feature: Commodity Market Review).

Still, the behaviour of prices of commodity sub-categories has been broadly similar and highly correlated with global economic activity, particularly in DCs, suggesting the dominance of common demand-side factors. Rapid growth in major commodity-importing DCs, notably China and to a lesser extent India, played a central role in the pre-crisis boom. Growth in commodity-dependent DCs also added to the momentum by creating demand for each other's primary commodities. Prices increased along with the share of DCs in world commodity consumption. Oil demand from DCs is now as high as that from AEs, with China importing as much as the EZ and twice as much as Japan. In metals, China alone accounts for more than 40 per cent of world demand.

The boom that started in 2003 and has generally continued except for a short-lived sharp downturn in 2008 is seen as the beginning of a new commodity super-cycle driven by rapid growth and urbanization in China (Farooki and Kaplinsky, 2011; Farooki, 2012). Historically such cycles are found to range between 30-40 years with amplitudes 20-40 per cent higher or lower than the long-run trend, with non-oil prices closely following world GDP (Erten and Ocampo, 2012).

Chart 11: China's Imports, 2000-2011

(Billions of U.S. dollars)



Source: UN COMTRADE.

After the outbreak of the financial crisis in AEs, the momentum in commodity prices has been kept up entirely by growth in the South, notably in China whose import composition changed rapidly from manufactures to commodities as a result of its shift from export-led to investment-led growth. As its markets in major AEs started to shrink in 2008, China introduced a large investment package, notably in infrastructure and property, pushing the ratio of investment to GDP towards 50 per cent. Since such investment is much more intensive in commodities, notably in metals, than exports of manufactures which rely heavily on imported parts and components from other East Asian economies, the shift from export-led to investment-led growth has led to a massive increase in Chinese primary commodity imports, which doubled between 2009 and 2011 compared to some 50 per cent increase in its manufactured imports (Chart 11).[24] During the same period prices of metals rose by 2.4 fold, much faster than other primary commodities.

The downturn in commodity prices that started in 2011 has coincided with the slowdown in China and India. Given the credit and property bubbles and excessive debt and capacity generated by the 2008 stimulus package, China has been hesitant to respond to the slowdown with a similar package, allowing, instead, its growth to fall below 8 per cent for the first time for several years. The slowdown in China has been reflected particularly by a sharp decline in metal prices, by some 25 per cent between the beginning of 2011 and end of 2012, considerably steeper than declines in other commodities.

Because of increased financialization of commodities and growing interdependence between financial and commodity markets, the financial crisis has also generated considerable instability in commodity prices. The severe swings seen during 2008 had an important speculative component. Within the first 6 months of that year, the overall price index rose by some 35 per cent, followed by a sharp decline of 55 per cent in the second half of the year. No change in supply conditions or demand for physical commodities in such a short span of time can explain such a sharp swing. It was largely caused by rapid, self-reinforcing shifts in trading in commodity features triggered by rapid changes in expectations and sentiments around the collapse of Lehman Brothers, about the depth of the crisis and its possible impact on commodity prices.[25]

Since 2011, the EZ crisis has had a strong influence on commodity prices not only by weighing on the demand from the region but also through financial channels. First, it has had a depressing effect on commodity prices by making the dollar stronger than it would have otherwise been. Second, it has added to commodity instability by triggering surges of entry and exits in markets for commodity derivatives. Like capital flows, commodity prices have become highly sensitive to news coming from the EZ.

The short-term outlook for commodity prices is highly uncertain not only because of possible supply-side disruptions, notably in energy and food, but also because of demand uncertainties. The latest projections by the IMF WEO (April 2013) are for continued declines in 2013-14 for both oil and non-fuel primary commodities. These are based on the

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[24] UNEP (2013) estimates that in material use (including metal ores and industrial minerals, fossil fuels, construction minerals and biomass) the Asia-Pacific region overtook the rest of the world by 2005, with China accounting for over 60 per cent of the region's total material consumption, and that during 2008, almost all of the growth in global material consumption was due to the Asia-Pacific region. It is found that material intensity, i.e., consumption of materials per dollar of GDP, is much higher in Asia-Pacific than in the rest of the world and has been increasing. While this may reflect inefficiency in the use of materials, as argued by UNEP, it is also true that material intensity depends on the composition of GDP, which has been changing in favour of material-intensive activities in China since the onset of the crisis.

[25] See Akyüz (2011b) on the change of sentiments about the depth of the crisis in the summer of 2008 and trading in commodity features. A recent paper has concluded, using highly sophisticated techniques, that price dynamics of highly-traded future commodity markets, including for corn, oil, soybean, sugar and wheat, are driven by self-reinforcing mechanisms (short-term endogeneity) rather than novel information about factors affecting supply and demand conditions. It finds that endogeneity increased in the 2000s and that about 60-70 per cent of price changes are now due to self-generated activities– see, Filimonov *et al*. (2013).

assumption of no drastic change in conditions in two main economies strongly affecting commodity prices – China and the EZ. However, in both cases risks are on the downside, raising the possibility of steeper declines than is projected.

III.5. Trade impact

International trade has been the single most important channel of transmission of contractionary impulses from the financial crisis and recession in the US and the EU. After growing at an average rate of some 7 per cent per annum, the volume of imports by AEs first decelerated sharply in 2008 and then fell by 12 per cent in 2009, largely because of the decline in imports by the US. It bounced back in 2010 due to a broad-based recovery, but lost momentum as Europe went into tailspin. Growth of total volume of imports by AEs barely reached 1 per cent in 2012. In order to avoid a sharp deceleration of growth, DCs have had to rely on their own markets or South-South trade. In fact, given the widespread economic downturn in AEs, the latter have also sought expansion in developing country markets in order to kick-start recovery.

While all DCs have been hit directly or indirectly by the contraction and slowdown in imports by AEs, the incidence varied from country to country according to their dependence on exports, the relative importance of markets in AEs and the import content of their exports.[26] In countries with very high ratio of exports to GDP, particularly in exporters of manufactures, import content of exports also tends to be high. Thus, any decline in exports entails cuts, *pari passu,* in imports used directly and indirectly for exports. Declines in exports also reduce imports through their impact on income and domestic demand, including imports from all countries. Indeed, as a result of these cumulative effects, in volume terms the world trade declined at much the same rate as the rate of decline of volume of imports by AEs. The decline in dollar terms was almost twice as large because of a sharp decline in prices, particularly for commodities.

On some estimates, trade shocks incurred by developing countries in 2009 as a result of the crisis amounted to 4.4 per cent of their GDP, of which 3.3 per cent was due to demand shocks resulting from declines in export volumes and the rest was the terms of trade shock resulting from price changes (UN WESP, 2010). Among the regions the total shock was greatest, over 12 per cent of GDP, in West Asia because of a sharp drop in oil prices, followed by Africa (5.5 per cent), East and South Asia (3.3 per cent) and Latin America and the Caribbean (2.3 per cent).

Among major DCs, the trade impact of the crisis has been particularly severe for China because of its dependence on exports to AEs. In the period 2002-07, Chinese exports grew by more than 25 per cent per annum, accounting for about one-third of GDP growth, taking into account their import contents. The dependence on exports to AEs was even higher for smaller exporters of manufactures in Asia, both directly and through supplying parts and components to China. With the outbreak of crisis in AEs, exports of Asian DCs

[26] On the eve of the crisis, the ratio of exports to GDP, as conventionally measured, was close to 52 per cent in DCs taken together. It was about 100 per cent in South East Asia and Central Africa, 80 per cent in Western Asia, 60 per cent in Eastern Asia and Western Africa around 60 per cent and some 25 per cent in Southern Asia and South America – UNCTAD (2009: table 1).

first slowed sharply in 2008 and then dropped in 2009, and became a major drag on activity, reducing growth by 5-6 percentage points (Akyüz, 2012).

Import cuts in Europe have hit Africa and Central and Eastern Europe particularly hard because of strong trade linkages; more than 50 per cent of exports of several non-EU European countries and some North African countries are destined to the EU and the figure is over 35 per cent for several countries in sub-Saharan Africa as well as Russia (IMF, 2011). The direct effects of cuts in exports to the EZ during 2011-12 are estimated to have reduced growth by some 0.8 per cent in South Africa and Russia, 0.5 per cent in China and India, and 0.3 per cent in Brazil and Indonesia (OECD 2012: Box 1.1.). Many DCs in sub-Saharan Africa relying heavily on exports to Europe were also hit hard. These include Côte d'Ivoire, Mozambique and Nigeria where exports to the EU account for between 10 and 17 per cent of GDP (Massa *et al.,* 2012).

The crisis has resulted in significant changes in the pattern of world trade. Before the crisis South-South trade was largely conditioned by trade between DCs and AEs. China's imports of manufactures from Asian DCs and commodities from all developing regions accounted for a large proportion of South-South trade and were mainly used, directly or indirectly, for its exports of manufactures to AEs (Akyüz, 2011a, 2012). With the shift of China to investment-led growth, not only has there been a shift in Chinese imports from manufactures to commodities (Chart 11), but also a larger proportion of imports have come to be used for domestic demand – over 55 per cent in 2011 compared to less than 50 per cent in 2007.

This has also meant that for many commodity exporters, China has become the single most important market. For instance, in 2007 Brazilian exports to the EU and US were four times and twice the level of its exports to China, respectively. Now the Brazilian exports to China and Europe are about the same and Brazilian exports to the US are one-half of its exports to China.

Table 3: Share of Primary Commodities in Total Exports: Brazil and Malaysia

(Per cent)

	2006	2007	2008	2009	2010	2011	2012
Brazil	47.8	50.1	54.7	60.0	63.2	65.1	63.6
Malaysia	24.4	27.4	33.9	29.5	32.1	37.0	37.2

Source: UN COMTRADE.

Furthermore, both because of the rise in commodity prices and the expansion of volume of exports, commodities have also come to account for an increasing proportion of exports of several semi-industrialized exporters of manufactures in the South. This includes not only Brazil but also some South East Asian DCs such as Malaysia. The increase in the share of primary commodities in total exports of these countries which had already started before the onset of the crisis has accelerated after 2009 (Table 3). In Brazil export earnings from commodities now exceed those from manufactures by a large margin.[27] In Malaysia, widely considered as one of the successful second-tier Newly Industrializing Economies

[27] On the export performance of Brazil, notably the slowdown of its industrial exports, see Canuto *et al.* (2013).

(NIEs), manufactures do not dominate export earnings if measured in value-added terms since they have much higher import contents than commodities. If account is taken of import contents, the share of manufactures in (value-added) exports would be about the same as, if not lower than, the share of primary commodities.[28]

III.6. Trade imbalances

The crisis has resulted in a significant shift in global trade imbalances. With the increased reliance of DCs on domestic demand for growth, current account surpluses in export-led East Asia have declined while many other DCs have moved from surpluses to deficits or started to run larger deficits. On the eve of the crisis, DCs taken together had a current account surplus of almost $700 billion and a little more than one-half of this was due to China. It fell by almost $300 billion by the end of 2012 despite a $130 billion increase in the current account surplus of the Middle East and North Africa as a result of increases in oil revenues. The surplus of developing Asia fell from $400 billion to $130 billion, China from $350 billion to $210 billion while Latin America and sub-Saharan Africa both moved from surpluses to deficits.

DCs have absorbed a large part of adjustment in global imbalances that had pervaded before the outbreak of the financial crisis. The current account deficits of AEs taken together fell from a peak of $480 billion in 2008 to less than $60 billion in 2012. The US current account deficit fell by $200 billion while the EZ moved from a deficit of $100 billion to a surplus of $220 billion. Of the three major surplus countries, the current account surplus of Germany has increased after the onset of the crisis, reaching 7 per cent of GDP at the end of 2012 (Table 4). Germany now runs trade surplus against China. By contrast, both Japanese and Chinese surpluses have fallen sharply. The decline in China's surplus has been particularly dramatic, from a peak of 10 per cent of GDP in 2007 to 2.6 per cent in 2012.

As noted, in the run-up to the crisis the share of wages and private consumption in GDP was on a downward trend in all three major surplus economies, Germany, Japan and China. In all three countries GDP growth rates exceeded the growth rates of domestic demand. Growth was much slower in Germany and Japan but more dependent on exports than in China where imports expanded by double-digit rates thanks to a very strong growth of domestic demand (Akyüz, 2011b).

After the outbreak of the crisis, Germany has continued to rely on exports. Its GDP growth exceeded growth of domestic demand in every year throughout 2010-12, thereby sucking in foreign demand and effectively exporting unemployment. It has thus continued to be a major source of imbalance not only in the EZ, but also globally. By contrast, China has provided a major demand stimulus to the rest of the world by expanding domestic demand and allowing its real effective exchange rate to appreciate by some 20 per cent since the onset of the crisis.

[28] For Malaysia the import content of total exports is estimated to be around 40 per cent (Koopman *et al.*, 2010) while the import contents of manufactures are at least twice as high as that of commodities (Akyüz, 2011a). Consequently, value-added contents would be around 75 per cent for commodity exports and 50 per cent for manufactures exports.

Table 4: GDP, Domestic Demand and Current Account in Main Surplus Countries

(Annual per cent change unless otherwise indicated)

	2004-07	2010	2011	2012
Germany				
GDP growth	2.2	4.0	3.1	0.9
Domestic demand	1.1	2.6	2.6	-0.4
Private consumption	0.5	0.9	1.7	0.6
CA (% of GDP)	5.9	6.2	6.2	7.0
Japan				
GDP	1.9	4.7	-0.6	2.0
Domestic demand	1.1	2.9	0.3	2.9
Private consumption	1.2	2.8	0.5	2.4
CA (% of GDP)	4.0	3.7	2.0	1.0
China				
GDP	12.1	10.4	9.3	7.8
Domestic demand	10.3*	10.6	10.2	9.2
Consumption (total)	8.8*	9.2	9.8	9.8
CA (% of GDP)	7.1	4.0	2.8	2.6

Source: For Germany and Japan IMF WEO (April 2013 and October 2012). For China IMF Staff Report: Article IV Consultation with the People's Republic of China (various years).

* 2005-2007 average.

IV. WHERE NEXT?

Despite adverse fallouts from the most severe post-war economic crisis and downturn in AEs, on average, DCs have so far managed to sustain an acceptable pace of economic growth for the reasons discussed above. Compared to the beginning of the crisis, total income in the developing world is now higher by almost one-third whereas AEs have barely managed to maintain their pre-crisis levels of income. Although growth in many major DCs is now considerably slower than the rates achieved before the onset of the crisis, there are widespread expectations, notably among policy makers, that prospects are brighter in the coming years, once the worst post-war crisis is fully overcome, economic activity is stabilized and employment and output gaps are reduced in AEs. These would allow DCs to go back to catch-up growth and continue to converge towards income levels of AEs, very much as in the period before the onset of the crisis.

There are, however, important question marks regarding these expectations. First, it is not clear when the crisis will be over and if DCs can sustain a reasonable pace of growth in the event of protracted instability and weakness in AEs. There are still serious downside risks, notably from the EZ and China, and global economic conditions could worsen before starting to improve. Second, the exit of AEs from the crisis may not necessarily improve global economic environment in all areas that affect the performance of DCs. AEs may not be able to move to a high and stable growth path and global financial conditions may tighten considerably with their exit from the ultra-easy monetary policy. Third, growth prospects of most DCs also depend crucially on China. Although China has withstood severe fallouts from the crisis, there is considerable uncertainty whether it can maintain strong growth over the longer term.

IV.1. Downside risks

No doubt the EZ is now the Achilles' heel of the global economy and the immediate threat to stability and growth in DCs. Although financial stress in the region has declined considerably, adjustment fatigue or political turmoil in the periphery could still deepen the crisis and even lead to a total break up. However, it is difficult not only to predict the evolution of the EZ in the coming years, but also the impact of a break-up, since past economic and financial linkages would provide little guide for estimating the consequences of such an unprecedented event. Still, even without a total break-up, an intensification of financial stress could have serious repercussions for DCs, as suggested by various downside scenarios simulated by the IMF, the UN and the OECD.[29]

Financial contagion to DCs from a major turmoil in the EZ, notably a default and exit, could be much more serious than adverse spillovers through trade because it would affect balance sheets and be more difficult to handle with standard macroeconomic policy tools.

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[29] IMF (2012a) simulations are based on increases in credit spreads. The UN WESP (2013) downside scenario is built on slippages in OMT, further fiscal tightening and increases in risk premia. The OECD (2012) downside scenario is also based on an intensification of sovereign and banking stress. Peak output losses in the EZ could exceed 5 per cent, with greater adverse impact on growth in DCs than other AEs, with the notable exception of the UK.

The main channel would be capital flows, asset prices and exchange rates, which have already become highly sensitive to news from the EZ, as noted. The impact could be similar to that triggered by the collapse of Lehman brothers in 2008 – a flight to safety, stronger dollar and sharp declines in assets and currencies in DCs. It could be longer lasting than Lehman, because of difficulties in restoring confidence and stability.

The outlook of the global economy is also clouded by downside risks surrounding China. It has been increasingly argued, including by a prominent Asian investment bank, Nomura Holdings Inc., that because of the credit and property bubbles created by its response to fallouts from the crisis, China now displays the symptoms that the US showed before the sub-prime crisis. On this view, if a loose policy stance is maintained and the risks are not brought under control, strong growth above 8 per cent could be attained in 2013, but only to be followed by a financial crisis as early as 2014 (Wall Street Journal, 2013; Frost, 2013). Again, a global survey of fund managers conducted in March 2013 has shown widespread expectations of a hard landing in China (Emerging Markets, 2013). The loss of growth momentum in the first quarter of 2013 has also renewed fears of an imminent crisis in the banking system.[30]

The impact of a financial turbulence in China on DCs could be more serious than that of a sharply increased financial stress in the EZ. It can be expected to lead to a sudden reversal of capital inflows, a sharp correction in asset markets and strong downward pressures on the currencies in the developing world. Such adverse financial spillovers would be aggravated by the impact of a sharp drop in China's demand for commodities. Consequently, DCs heavily dependent on capital flows and commodity exports are particularly vulnerable to a financial turbulence and a hard landing in China.

However, a severe financial stress in China does not have a high probability of occurrence. As argued by Anderlini (2013), even if the risks are not (or could not be) immediately brought under control, in China "a Lehman style collapse is impossible" and its "banking system is more likely to undergo slow erosion" because of extensive state ownership and guidance.

IV.2. Longer-term prospects

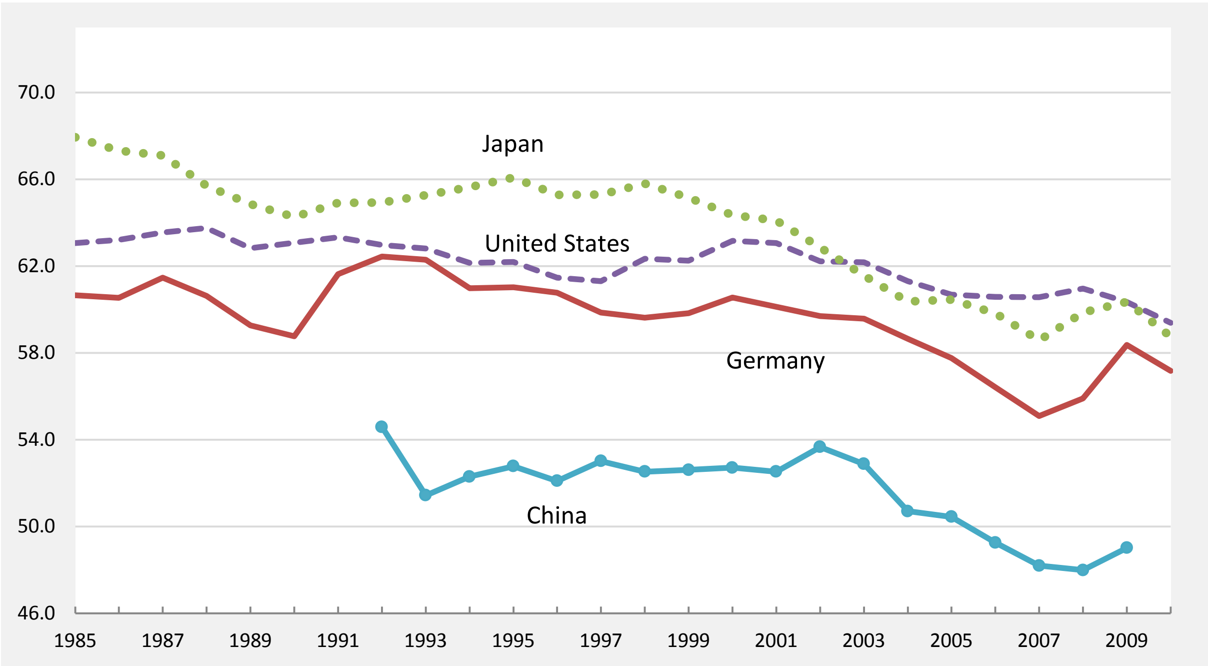
Beyond these downside risks, longer-term global growth prospects are also clouded by persistent structural imbalances and fragilities that culminated in the current crisis. The world economy suffers from underconsumption because of low and declining share of wages in national income in all major AEs including the US, Germany and Japan, as well as China. In the OECD countries, the wage share dropped by 10 points in the past 25 years. In China the share of wages and household income in GDP are much lower than in AEs.[31] The wage share has dropped by about 10 percentage points since the mid-1990s (Chart 12). The decline in wage shares has also been accompanied by increased concentration of wealth, notably in AEs, implying growing inequality in the distribution of income from real and financial assets.

[30] These stand in sharp contrast with OECD (2013a) projections that China will overtake the US by 2016, with a rebound to 8.5-9.0 per cent growth in the coming years from 7.8 per cent in 2012.

[31] A very large proportion of household earnings in China consist of wages since government transfers and investment income are very small; Akyüz (2011a and 2011b).

Financialization, welfare state retrenchment and globalisation of production are found to have made a robust negative effect on wage shares, including in DCs.[32]

Chart 12: Wage Share as Per Cent of GDP, 1985-2010



Source: Eurostat and China Statistical Yearbook.

Still, until the Great Recession the threat of global deflation was avoided thanks to consumption binges and property booms driven by credit and asset bubbles in the US and a number of other AEs, particularly in Europe. Several Asian DCs, notably China, also experienced investment and property bubbles while private consumption grew strongly in many DCs elsewhere, often supported by the surge in capital flows and asset and credit bubbles (Akyüz, 2008 and 2012). This process of debt-driven expansion created mounting financial fragility in the US and the EU and growing global trade imbalances, with the US acting as a locomotive to major surplus countries, Germany, Japan and China, and running large and growing deficits, as well as to imbalances within the EZ, culminating in the most serious post-war economic crisis with which the world is still grappling.

The likelihood for the world economy to reverse the increased inequality and move to a path of growth that is both stable and strong is slim. In the US and Europe the crisis has widened income and wealth inequality. In the EZ, the structural reforms advocated for removing intra-regional imbalances are likely to extend wage suppression further to the periphery and widen the deflationary gap. In China, despite the recognition of the problem of underconsumption due to low shares of wages and household income in GDP, the distributional rebalancing is progressing very slowly.

[32] See Stockhammer (2012) for an empirical analysis of the determinants of changes in wage shares. See also Akyüz (2011b) on the downward trend in the shares of wages and consumption in GDP.

a. The United States: business as usual?

Longer-term global prospects depend a lot on the US due to its central position in the world economy and the international reserves system. Despite a downward trend in the share of wages in GDP that has been under way since the early 1980s, the US has avoided an under-consumption crisis thanks to surges in private spending supported by financial bubbles – first the dot-com boom in the 1990s driven by a stock market bubble and then the sub-prime boom in the 2000s driven by a rapid credit expansion.

It is highly unlikely that the US can move to a wage-led growth in the near future. Nor can it shift to export-led growth. This would require, inter alia, exports to grow faster than domestic demand and the share of private consumption in GDP to decline.[33] This is difficult to achieve given that for decades the US has constantly lived beyond its means thanks to its exorbitant privilege as the issuer of the central reserve currency. Besides, there is no other economy that could act as a locomotive to the US. A shift of the US to export-led growth would require major surplus economies to make a significant rebalancing of external and domestic demand by reversing the downward trend in wages - something which is as unlikely as that happening in the US.

Thus, a key question is if the US would be inclined to go back to "business as usual" and rely on credit and asset bubbles in search for a relatively rapid expansion. This is closely connected to the exit from the ultra-easy monetary policy that the US has been pursuing in the past five years − notably whether or not it would be allowed to degenerate into asset, credit and spending bubbles, ultimately culminating in yet another and possibly more serious crisis.

Clearly, exit implies not just monetary tightening but also the normalization of monetary policy − the federal funds rate to become again the primary instrument of policy; a significant contraction in the size of the Fed's balance sheet and the volume of excess reserves that depository institutions hold at the Fed; and a large shift of the Fed's asset composition back to short- and medium-term Treasuries from long-term Treasuries and mortgage-backed securities built-up as a result of crisis intervention (Plosser, 2011). Monetary tightening would call for raising interest rates on excess reserves and this will be reflected in long-term rates.[34] The latter would also rise as a result of portfolio rewinding. Even a gradual return of the Fed balance sheet to "normal" size and composition may result in a considerable interest rate hike. According to projections of a recent report by the US Treasury, based on market expectations of the Fed's exit strategy, a tightening beginning in

[33] In the US private consumption grew faster than GDP by almost 0.4 percentage points from mid-1990s until the onset of the subprime crisis with its share in GDP rising from under 67 per cent to 71 per cent.

[34] At the beginning of May 2013 excess reserves of depository institutions at the Fed, defined as total non-borrowed reserves minus required reserves, reached $1750 billion, up from less than $2 billion at the end of 2007. The Fed was authorized in October 2008 to pay interest on banks' holdings of reserve balances. Explaining the exit strategy, the Fed Chairman has pointed out that "[b]y increasing the interest rate on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates, as banks will not supply short-term funds to the money markets at rates significantly below what they can earn by holding reserves at the Federal Reserve Banks. Actual and prospective increases in short-term interest rates will be reflected in turn in longer-term interest rates and in financial conditions more generally" − Bernanke (2010).

2015 could raise the ten-year rate by 200 bp by 2018 and the average interest on government debt from 1.7 per cent to 4.3 per cent over the next ten years.[35]

The way the exit is engineered would have significant consequences for growth and macroeconomic and financial stability. Uncertainty abound because there are not many historical precedents for zero bound interest rates and QE. One scenario is that, given the high level of unemployment and a large output gap, the Fed may be tempted to adopt a slow exit in pursuit of real objectives as it did during the sub-prime boom. It may also want to go slow in order to protect its own balance sheets and remittances to the Treasury against losses from asset price declines and to avoid a sudden shock to financial markets (Davies, 2013). Indeed, the Fed seems to hold the view that it could exit from QE3 and still maintain low interest rates for several more years in order to support growth and employment and use the so-called macro-prudential regulations to check bubbles, limit systemic risks and prevent financial instability.[36]

However, such a process may not be engineered without jeopardizing financial and macroeconomic stability. First of all, macro-prudential policy is uncharted waters; there is considerable ambiguity over what it contains and how it may be operationalized and related to broader areas of policy that influence systemic risks, including monetary policy. They cannot be relied on to prevent excessive risk taking and credit and asset bubbles if there is plenty of money available at low interest rates. In all likelihood, monetary instruments may have to be deployed as part of macro-prudential policy if bubbles start to threaten stability, but this would cut growth. If they are not and interest rates are kept too low for too long, the outcome may well be another boom-bust cycle. Secondly, it is not at all clear where rapid growth would come from if credit and asset bubbles are prevented to form one way or another. When wages are sluggish, household spending cannot expand rapidly without a build-up of debt or without capital gains from asset bubbles. On the other hand, low interest rates may stimulate corporate investment but cannot sustain it without a strong expansion of consumption and/or exports.

Alternatively, if concerns about the risks of asset purchases and significantly expanded bank liquidity and the effectiveness of macro-prudential measures in restraining bubbles dominate, the Fed may be inclined to exit rapidly once unemployment fell below 6.5 per cent – and on recent trends this could happen sooner than expected.[37] This would result in a hike in interest rates and give a major shock to the financial system as in 1994, but could avert a boom-bust cycle. It would result in slower growth and stronger dollar – a combination that would no doubt breed problems for DCs. A nightmare scenario for DCs would be a Volcker-like exit, pushing overnight rates to double-digit figures. A too rapid an

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[35] US Department of Treasury (2013). According to projections by Carpenter *et al.* (2012), market participants do not expect the Fed balance sheet to return to a "more normal size" before August 2017 and its composition to return to "normal" before September 2018.

[36] According to the President of the Federal Reserve Bank of Minneapolis, unusually low interest rates may persist for the next five to ten years. It is recognized that low rates could lead to financial outcomes that signify instability and pose macroeconomic risks, but these are better addressed by effective supervision and regulation of the financial sector than monetary policy actions – Kocherlakota (2013). See also Roubini (2013).

[37] Some such concerns are reported to have been expressed in the January 2013 meeting of the Fed – Oprita (2013a). It is also known that some Fed Governors have strong reservations about the efficacy of macro-prudential measures in limiting excessive risk taking – see Roubini (2013).

exit and re-pricing of substantially increased stock of debt could in fact cause a hard landing in the US by leading to large losses for bond holders and depressing private spending.

A Goldilocks scenario in which the exit is neither too slow nor too rapid, allowing sustaining a relatively strong growth without threatening financial stability is no more than a fairy tale. The extended period of easy money has sharpened the trade-off between financial stability and growth by allowing considerable build-up of bank liquidity and distorting the Fed's balance sheet. If the Fed targets growth and pursues a slow exit, credit and asset bubbles could build up rapidly, threatening to culminate in a bust. If it focuses on avoiding bubbles and exits rapidly, then it could cut recovery short and may even push the economy back into a recession.[38] Clearly, neither would bode well for DCs.

b. The Eurozone: bleak growth prospects

The longer-term prospects of the EZ are even less encouraging. Deleveraging and recovery are likely to remain extremely slow in the periphery and many countries cannot expect to recuperate the output losses incurred after 2008 for several years to come. Even if the EZ avoids further turmoil and stabilizes, it would not generate much growth under the current policy approach – something that would also make it difficult to sustain stability.[39] Pre-crisis growth in the EZ was mediocre, barely reaching 2 per cent per annum during 2002-07, and much of that was due to debt-driven expansion in the periphery. Post-crisis growth could even be slower.

The periphery cannot go back to spending spree and large current account deficits that culminated in the crisis. Their return to faster growth would depend, as noted, on a fundamental change of policy in Germany and symmetry in adjustment between deficit and surplus EZ countries. Recent trends and projections for external balances show a decline in deficits in the periphery without a corresponding decline in the surpluses of the core; that is, an increase in the surplus of the region with the rest of the world. The IMF WEO (April 2013) projects that in 2018 the EZ as whole will run a current account surplus of 2.5 per cent of GDP, up from a deficit of 0.7 per cent in 2008. This implies that the periphery would cut deficits either by keeping growth low and unemployment high, or by joining Germany in wage suppression and competitive disinflation and expanding exports to the rest of the world.

Then there is the risk of low-growth hysteresis and growth stalling – weak growth generating its own negative momentum. In its latest report the OECD (2012: 50-52) warned that in some AEs "output growth is now close to or below estimated stall-speed thresholds … with the risk that self-reinforcing endogenous dynamics could push them into outright recession." When a cyclical upswing is below the stall-speed threshold, growth is likely to

[38] IMF WEO (April 2013: 36) also recognizes that exit could be problematic. But its main concern is the emergence of a trade-off between price stability and financial stability, rather than growth and financial stability; that is, too slow an exit could cause inflation to accelerate and too abrupt an exit could undermine financial stability.

[39] It is often suggested that Eurobonds could solve the euro crisis by removing the threat of default and hence the risk premium. However, as recognized by Soros (2013), they would not eliminate intra-EZ divergences in competitiveness and trade imbalances and hence would not be enough to restore growth.

weaken and eventually become negative.[40] On all current projections growth in the EZ in coming years is expected to remain below the stall-speed thresholds.

Thus, without a fundamental change of policy, the EZ may be caught in a self-reinforcing deflation. A protracted weakness in economic activity would bring down the potential growth rate so that the region may get trapped in low growth. Indeed a recent study on the long-term effects of the crisis in the EZ argues that in the absence of bold reforms, the damage will be long-lasting, permanently impairing growth in the region (Boone *et al*., 2013).

c. China: the end of spectacular export-led growth

The response of China to fallouts from the crisis has served to rebalance domestic and external demand, but aggravated the imbalance between investment and consumption, which had already been building up in the period before the crisis. Investment has been the main driver of growth since 2009 and consumption has been growing only marginally faster than income. However, China cannot keep on pushing investment to fill the deflationary gap created by the slowdown in exports in conditions of exceptionally low shares of wages and household income in GDP. That would add more to financial fragility and imbalances than to productive capacity and potential growth. Nor can it go back to export-led growth and constantly increase its penetration of foreign markets. This would be resisted, possibly causing disruptions in the trading system.

Regardless of how the existing financial fragilities created by the credit and investment bubbles are handled, the most likely medium-term scenario for China is a sizeable drop in its trend growth compared to double-digit rates it enjoyed in the run-up to the crisis, with a better balance between domestic and external demand and a gradual rebalancing of domestic consumption and investment. Indeed, research conducted at the Chinese Development Research Centre on growth prospects of China is reported to have concluded that, for a number of reasons on the demand and supply sides, such a transition to slower growth is already under way and the growth rate is expected to come down to 6.5 per cent during 2018-22 after three decades of double-digit levels (Wolf, 2013b). However, the possibility that China may also get caught in a middle-income trap is not excluded (Bertoldi and Melander, 2013; ADB, 2011).

The transition of China to a lower growth path over the next few years implies that its demand for commodities would grow much more slowly than in the past decade. This would result not only from slower growth but also rebalancing of demand towards consumption, which is much less import intensive than either exports or investment (Akyüz, 2011a). Improvements in the efficiency in the use of materials could also reduce the pace of China's demand for materials (UNEP, 2013). Together with a stronger dollar, these could imply significant loss of momentum in commodity prices, short-circuiting the commodity super-cycle and lowering its mean in conformity with the observed historical pattern (Erten and Ocampo, 2012).

[40] On the concept and estimates of stall-speed, see OECD (2012: Box 1.3) and Ho and Yetman (2013). The analogy is from aerodynamics – an aircraft flying at its stall speed cannot climb, and an aircraft flying below its stall speed cannot stop descending.

Nor can China be expected to become a locomotive for exporters of manufactures in the developing world. Its imports of manufactures from DCs have so far been destined mainly for exports rather than for domestic consumption which has very low import content (Akyüz, 2011a). A more balanced growth between exports and domestic consumption would imply slower growth of imports of parts and components from other DCs. On the other hand, there is still some time before China could exit from labour-intensive, low-skill manufactures and become a major market for lesser developed countries in these products, relocating such industries, à la Flying Geese, in lower-cost countries in South and South East Asia and Africa.

V. CONCLUSIONS

The crisis in AEs has aggravated the problem of underconsumption that the world economy has been facing due to low and declining share of wages in income and increased concentration of wealth. Rising inequality is no longer only a social problem. It has also become a serious macroeconomic problem, compromising the ability of the world economy to achieve strong and sustained growth and financial stability. The solution calls for strong action on its causes – financialization, the retrenchment of welfare state and globalization of production. However, the likelihood of fundamental changes in these areas is slim. Thus, the post-crisis world economy may either go back to finance-driven boom-bust cycles, enjoying unsustainable expansions followed by deep and prolonged crises, or may have to settle at a slow growth path. It is against this background that DCs need to rethink their development policies.

Not only has the "Great Recession" led to a "Great Slowdown" in DCs (Economist, 2012), pushing growth rates possibly below stalling speeds in some, but also medium-term prospects for global economic conditions look unfavourable compared to pre-crisis years and, in some respects, even compared to the period since the onset of the crisis. Thus the rapid rise of the South that began in the early years of the new millennium appears to have come to an end. This should not come as a surprise since, as argued in Akyüz (2012), the exceptional performance of DCs in the run up to the crisis was driven primarily by exceptional global conditions. There were little signs of tangible improvements in the underlying growth fundamentals or dynamics in DCs experiencing acceleration.

That acceleration took place without any significant progress in industrialization without which most DCs cannot converge and graduate to the levels of productivity and living standards of AEs. Of the so-called BRICS (Brazil, Russia, India, China and South Africa), only China promises sustained catch-up growth and graduation even though it faces a bumpy road. Brazil, Russia and South Africa continue to depend heavily on commodities and have indeed deepened their dependence by expanding the commodity sector relative to industry. The two key determinants of growth in Latin America and Africa, commodity prices and capital flows, are largely beyond national control and susceptible to sharp and unexpected swings. At a bare 3 per cent, the average potential growth rate of Latin America is far too low, even if constantly realized, to close the income gap with AEs. Many second-tier NIEs in Asia seem to be caught in the middle-income trap, facing growing competition from below without being able to upgrade and join those above – the first-tier NIEs and Japan. India has been relying on the supply of labour to the rest of the world, not by converting them into higher-value manufactures, but by exporting unskilled workers and IT and other labour services of a very small proportion of its total labour force (Nabar-Bhaduri and Vernengo, 2012).

As one development practitioner has put it, for DCs it would now be "unwise to count on tail winds; they will likely weaken, become more volatile, or both" (Torre, 2013). The remarkable performance of most DCs in the past decade is in danger of remaining a "one-off success" unless they raise productive investment, accelerate productivity growth and make significant progress in industrialization. Globalization has been oversold to DCs. They have largely left their development to international market forces shaped mainly by policies in AEs and their financial conglomerates and transnational corporations in control of international production chains.

Despite growing disillusionment in the South, the Washington Consensus is dead only in rhetoric. There is little roll back of policies pursued and institutions created on the basis of that consensus in the past two decades. On the contrary, the role and impact of global market forces in the development of DCs has been greatly enhanced by continued liberalization of trade, investment and finance unilaterally or through bilateral investment treaties and free trade agreements with AEs. DCs need to be as selective about globalization as AEs, and reconsider their integration into the global economic system, in recognition that successful industrialization is associated neither with autarky nor with full integration, but strategic integration designed to use foreign markets, technology and finance to pursue industrial development.

This implies rebalancing external and domestic forces of growth and development. Since the end of the so-called import-substitution, inward-oriented policies, the pendulum has swung too far. Dependence on foreign markets and capital should be reduced. There is also a need to redefine the role of the state and markets, not only in finance but also in all key areas affecting industrialization and development, keeping in mind that there is no industrialization without active policy.

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