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THE STAGGERING RISE OF THE SOUTH?

Yılmaz Akyüz

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SOUTH CENTRE

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SOUTH CENTRE

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THE SOUTH CENTRE

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THE STAGGERING RISE OF THE SOUTH?

Yılmaz Akyüz

This paper argues that the unprecedented acceleration of growth in the developing world in the new millennium in comparison with advanced economies is due not so much to improvements in underlying fundamentals as to exceptionally favourable global economic conditions, shaped mainly by unsustainable policies in advanced economies. The only developing economy which has had a major impact on global conditions, notably on commodity prices, is China. However, growth in China has been driven first by a rapid expansion of exports to advanced economies and more recently, after the global crisis, by an investment boom, neither of which is replicable or sustainable over the longer term. To maintain a rapid growth, export-led Asian economies need to reduce their dependence on foreign markets. For Latin American and African commodity exporters, gaining greater autonomy and achieving rapid and stable growth depend on their success in reducing reliance on capital flows and commodity earnings – the two key determinants of their growth which are largely beyond national control.

I. INTRODUCTION AND SUMMARY

In the early days of the global economic crisis, growth in developing and emerging economies (DEEs) was widely expected to be decoupled from the difficulties facing advanced economies (AEs). Strong growth that many DEEs had been enjoying since the early years of the millennium was expected to continue with some moderation and prevent AEs and the world economy from falling into recession. In the event, however, growth in DEEs slowed considerably in 2009 as a result of contraction of exports and financial contagion. AEs fell into recession and world income declined for the first time in several decades.

Nevertheless DEEs recovered rapidly, with many emerging economies restoring growth rates close to those enjoyed before the crisis. By contrast, growth in the US has been anaemic and erratic, and deepened debt difficulties and financial fragility in the Eurozone have raised the spectre of a second dip. This two-track world economy, the widening growth gap between the South and the North, has resuscitated the decoupling hypothesis that growth dynamics of emerging economies have gained considerable autonomy. While it is generally recognized that it may take several years for AEs to overcome their debt overhang and return to stable and rigorous growth, it is also believed that the rise of the South will generally continue unabated in the coming years and income levels in several DEEs will converge rapidly to those in early industrializers. Thus, the global crisis is seen as a turning point in the economic balance of power between the North and the South, with many emerging economies such as China, India and Brazil gaining greater presence and role in the world economy.

Strictly speaking decoupling means desynchronisation of business cycles. This is not really consistent with increased global integration of markets or "globalization". Indeed, evidence shows that the deviations of economic activity from underlying trends continue to be highly correlated between DEEs and AEs. This was also evident during the post-Lehman downturn when a large majority of DEEs experienced a significant slowdown despite strong counter-cyclical policy responses.[2]

There is, however, a more important question of whether trend growth in the developing world has shifted up relative to that in AEs. Even though business cycles are synchronized, a significant rise in trend growth in DEEs could still result in a rapid increase in living standards and convergence to income levels of AEs. This was basically the issue raised by Arthur Lewis in his Nobel Lecture:

> *For the past hundred years the rate of growth of output in the developing world has depended on the rate of growth of output in the developed world. When the developed grow fast, the developing grow fast, and when the developed slow down, the developing slow down. Is this linkage inevitable? More specifically, the world has just gone through two decades of unprecedented growth, with world trade growing twice as fast as ever before. … During these prosperous decades, the less developed countries (LDCs) have demonstrated their capacity to increase their total output at 6 percent per annum, and*

[2] Kose, Otrok and Prasad (2008) find decoupling between AEs and DEEs, but increased coupling within each group. Wälti (2009) argues that assessment of decoupling should not be based on actual growth rates but deviations from trend (or potential output) and on that basis there is no decrease in the synchronicity between DEEs and AEs. Rose (2009) comes to broadly the same conclusion while Yeyati (2009) argues that the 2000s witnessed an increase in the correlations of DEEs and G7 cycles. For further discussion see also Kose and Prasad (2010).

> *have indeed adopted 6 percent as the minimum average target for LDCs as a whole. But what is to happen if the more developed countries (MDCs) return to their former growth rates, and raise their trade at only 4 percent per annum: is it inevitable that the growth of the LDCs will also fall significantly below their target? (Lewis 1980: 555).*

Lewis thus saw trade as the main link between growth in the South and the North. His main concern was that since the growth gap between the two was small, some 2 percentage points, a significant deceleration in AEs and hence in world trade would mean that the South would not be able to make significant progress in development. He then went on to propose that DEEs should develop internal and regional markets to gain greater autonomy.

Growth in the South no doubt shows a rapid shift in the new millennium compared to previous decades, including even the post-war golden age which Lewis was referring to. The central question in this paper is thus whether and to what extent this rapid rise of the South constitutes a shift in the trend growth of DEEs relative to AEs. This calls for an explanation of the sudden surge of growth in the South, to identify the factors and conditions driving it and to assess whether they can be sustained over the longer term. In making such an assessment, discussions here will focus on major emerging economies which constitute a large part of the developing world both in population and income, and particularly on China because of its strong impact on other DEEs. However, many of the conclusions also apply to smaller economies, exporters of both manufactures and commodities.

A correct assessment of respective roles played by domestic and external factors in the acceleration of growth in DEEs is necessary in order to avoid complacency and reduce exposure to shocks. In this respect the main conclusion here is that while there have been significant improvements in economic management in DEEs after the recurrent crises of the 1990s and early 2000s and these may have somewhat raised the trend growth in some, the exceptionally favourable international economic conditions made a major and in many cases much greater contribution to the general acceleration of growth in the South. These conditions were shaped mainly by policies in AEs. The only emerging economy which has had a major impact on global conditions, notably on commodity prices and hence on commodity-exporting countries is China, but its own growth depends very much on exports to AEs because of its development strategy and underlying structural characteristics.

Until the outbreak of the global crisis, policies in AEs created, directly or indirectly, a favourable global environment for DEEs in trade and investment, capital flows and commodity prices. But the credit, consumption and property bubbles resulting from the same policies led to financial fragility and global imbalances which culminated in the Great Recession. The crisis brought to an end the expansion of markets in the North, the boom in commodity prices and capital flows to DEEs. However, sharp cuts in interest rates and quantitative easing in response to the crisis in AEs has restored the surge in capital flows to DEEs. This, together with a strong countercyclical policy response in major emerging economies, notably in China, has restored growth in the South and reversed the downturn in commodity prices. Consequently, growth in major emerging economies, including in export-oriented economies, has increasingly come to depend on domestic demand and this is reflected by a sharp reduction in current account surpluses in East Asia and growing deficits elsewhere.

The pace and pattern of domestic-demand-driven growth that emerging economies have been enjoying since 2009 cannot be sustained. First, in deficit countries such growth depends on continued and, in fact, increased inflows of capital, but the conditions driving the recent surge in capital inflows cannot be expected to last forever. There are already strong signs of growing nervousness among international investors and lenders, creating heightened instability in capital flows to emerging economies and asset and currency markets. Second, the major growth pole in the South, China, cannot keep on creating investment bubbles in order to fill the demand gap triggered by the slowdown of its exports to AEs, as it has done since the outbreak of the crisis. Furthermore, even if AEs can return to rigorous and sustained growth, it would not be possible for China to go back to the pre-crisis pattern of growth, rapidly increasing its penetration of markets of AEs, with the US acting again as a global locomotive and running growing deficits and debt. Such a process is not sustainable and could seriously destabilize the international trading and monetary systems.

Emerging economies such as BRICS and others need to reconsider their development strategies in order to gain considerable autonomy in growth and become major players in the global economy, rather than remaining as *markets* for Goldman Sachs and the like. First, starting with China, the East Asian surplus economies need to reduce their dependence on markets in AEs by promoting national and regional markets. They need to expand domestic consumption rapidly and this calls for a significant increase in the share of household income in GDP. China has already become a major driver of growth in commodity rich economies because of its growing demand for commodities. It can also become an important market for manufactures from other DEEs provided that it shifts from export-led to consumption-led growth and increases the import content of its consumption.

Second, deficit DEEs need to reduce their dependence on foreign capital. Most of them also need to increase investment significantly. The majority of these countries are commodity exporters and the two key determinants of their economic performance, capital flows and commodity prices, are largely beyond their control. Reducing vulnerability on both fronts crucially depends on their progress in industrialization. This is also true for deficit countries relying on export of services and remittances, such as India.

II. THE GROWTH RECORD

At the end of the 1990s and the early 2000s, many economies in the developing world were in disarray. East Asia was still recovering from the 1997 crisis while a host of other emerging economies were falling into payments and financial crises one after another; Brazil and Russia in 1998, Turkey 2000-01 and Argentina 2001-2002. The prospects for the global economy were dimmed by the bursting of the dot-com bubble in the US at the beginning of the decade, coming on top of prolonged deflation in Japan and uneven growth in the EU.

For the entire period from 1990 to 2002, the average growth in DEEs exceeded the average growth in AEs by just over 1 percentage point and in per capita terms there was hardly any income convergence. The picture was even worse in the 1980s when a large number of DEEs were suffering from severe payments difficulties caused by a debt overhang and sharp declines in commodity prices. Until the new millennium the only major economy in the South that was able to close the income gap with AEs by leaps and bounds was China, with an average growth rate close to 10 per cent during 1990-2002 compared to less than 4 per cent in the rest of the developing world (Table 1).

Table 1: Real GDP growth in selected economies (Annual percentages of constant price)

	1990-2002 average	2003-2007 average	2008	2009	2010	2011
All AEs	2.7	2.7	0.1	-3.7	3.1	1.6
All DEEs	3.9	7.6	6.0	2.8	7.3	6.4
Africa	3.0	6.0	5.4	3.1	5.0	3.9
Western Hemisphere	2.9	3.3	1.0	-3.0	3.9	2.4
Asia Pacific	4.8	7.2	5.0	3.4	8.2	6.2
Selected DEEs:						
Argentina	2.1	8.8	6.8	0.8	9.2	8.0
Brazil	2.0	4.0	5.2	-0.6	7.5	3.8
China	9.7	11.7	9.6	9.2	10.3	9.5
India	5.4	8.6	6.2	6.8	10.1	7.8
Indonesia	4.4	5.5	6.0	4.6	6.1	6.4
Mexico	3.1	3.4	1.2	-6.2	5.4	3.8
Russia	-0.7	7.5	5.2	-7.8	4.0	4.3
South Africa	1.9	4.8	3.6	-1.7	2.8	3.4
Turkey	3.6	6.9	0.7	-4.8	8.9	6.6
Malaysia	6.7	6.0	4.8	-1.6	7.2	5.2
Korea	6.7	4.3	2.3	0.3	6.2	3.9
Thailand	5.0	5.6	2.6	-2.4	7.8	3.5

Source: IMF *WEO* (September 2011).

All these changed in the new millennium. From 2002 until the outbreak of the subprime crisis, the growth difference between the DEEs and AEs shot up to 5 percentage points. This was not because of deceleration in AEs, but an unprecedented acceleration in DEEs where the average growth rate almost doubled from the 1990s. The global crisis led to a loss of momentum in DEEs during 2008-09, but their growth difference with AEs widened further because of a severe recession in the latter countries. Despite subsequent recovery in AEs, growth in DEEs has continued to be faster by about 4 percentage points in 2010-2011 – a margin still considerably larger than those during the 1980s and 1990s. Taking the whole decade from 2002 until 2012, the average growth in DEEs exceeds the average growth in AEs by more than 5 per cent per annum. This is unprecedented. As noted, during the post-war golden age DEEs also grew at a very fast pace, by some 6 per cent per annum, but growth in AEs was also high, with the gap being no more than a couple of percentage points.[3]

However, there has been considerable diversity in the pace of acceleration of growth among DEEs. During pre-crisis years acceleration was faster in Africa than the two other main regions even though African growth rate remained below that of Asia. By contrast, the Western Hemisphere saw only a modest rise in average growth compared to the 1990s. Among analytical groups, fuel exporters saw faster acceleration than either the exporters of non-fuel commodities or manufactures – from just over 1 per cent in the 1990s to 7.5 per cent between 2003 and 2008. Among the major emerging economies, Russia, Argentina, Turkey, India and South Africa enjoyed much faster acceleration than the others. In the first three countries this was due to rapid recoveries from severe crises which had caused large output losses at the end of the 1990s and the early 2000s.

The acceleration of growth in DEEs since the beginning of the new millennium is not due to China. Indeed, growth in China during the 1990s was almost as fast as that in the 2000s.[4] However, it is notable that in the 1990s China was not widely perceived as an emerging economic power capable of challenging the US dominance until it had started running growing trade surpluses with the US and accumulating large dollar reserves.

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[3] For an account of long-term historical trends, see Nayyar (2009).

[4] Nevertheless, the increased weight of China in DEEs raises the average growth of DEEs since Chinese growth has been considerably faster than the rest during both periods.

III. GLOBAL ECONOMIC CONDITIONS

III.1. International trade and investment

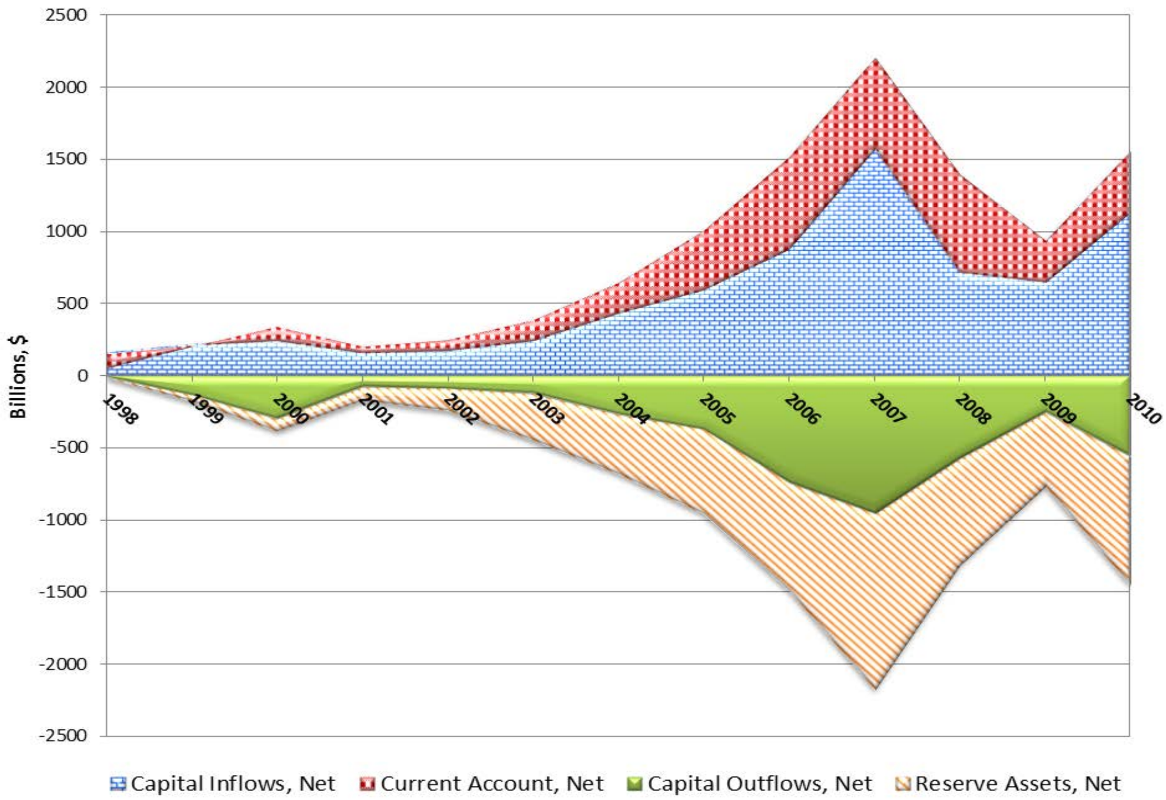
The new millennium witnessed a rapid growth in world trade which increased, in nominal dollars, by 2.5 times by 2008, with the average annual growth in total exports reaching twice the rate of growth of world output. This period also saw a significant increase in the share of DEEs in world trade, rapid expansion of South-South trade and growing global imbalances. The current accounts of AEs as a whole, which had already turned into red at the end of the 1990s, constantly deteriorated until the outbreak of the crisis. This was entirely due to mounting deficits of the US and to a lesser extent the UK, as the eurozone was broadly in balance, and Japan and the remaining AEs were running surpluses. This was reflected in growing surpluses of DEEs, which came to exceed $600 billion in 2007 of which two-thirds belonged to China and smaller East Asian DEEs and the rest to Fuel Exporters (FEs). This, together with large inflows of capital, resulted in an unprecedented rise in the international reserves of DEEs, which reached $5 trillion in 2007 despite substantially increased capital outflows (Chart 1).[5]

The rapid expansion of exports and growing current account surpluses of DEEs owe a great deal to US spending extravaganza. The US private savings had already began to fall and current account deficits to rise in the mid-1990s largely because of a strong wealth effect of the dot-com equity market bubble on private consumption and a boom in the property market. The spending spree continued with greater force in the 2000s when the Fed responded to the bursting of the dot-com bubble by bringing down policy rates to historical lows for fear of asset deflation and recession, and new legislation introduced in the late 1990s allowed greater room for banks to expand high-risk lending for property. Capital gains from rising house prices in the 2000s sustained the spending boom as homeowners increasingly extracted equity to finance consumption. As a result, household savings, which

[5] Here c*apital inflows* refer to the acquisition of domestic assets by private non-residents while sale of assets are negative inflows. *Capital outflows* refer to the acquisition of foreign assets by private residents, including foreign companies and individuals that have established residence in DEEs, and sales are defined as negative outflows. *Net private capital flows* is the difference between net capital inflows and net capital outflows.

was some 6 per cent of GDP in the early 1990s, started to fall rapidly and disappeared altogether on the eve of the 2008 crisis. This was mirrored by growing external deficits − the US current account was broadly balanced in the early 1990s, but it registered a deficit of over 6 per cent in 2007. Indeed the evidence provided by research in New York Fed shows a strikingly strong positive correlation between house price appreciations and current account deficits not only in the US but also in other countries that have subsequently experienced the highest degree of financial turmoil (Ferrero 2012).

Chart 1: Balances of payments in DEEs



Notes: A minus sign indicates an increase.
Capital flows comprise direct investment, portfolio investment, and other official and private financial flows, exclude changes in reserves.
Inflows are adjusted by net official flows.
Source: IMF, *WEO (Various issues)*

In Europe, the UK went through a similar property bubble, but was running a relatively small current account deficit. In the eurozone, deficits in peripheral countries were rising not only vis-à-vis the core economies, notably Germany, but also the rest of the world, reaching on average 7 per cent of GDP in Spain and 9 per cent in Portugal and Greece. These deficits resulted from loss of competitiveness due to wage settlements in excess of productivity increases in conditions of rising private consumption and property spending. The participation of these countries in the European Monetary Union facilitated the financing of these deficits by significantly lowering the risk premium. Banks in Germany, France and elsewhere in Europe were more than willing to pump in funds to finance these deficits – a process which culminated in the eurozone crisis, in much the same way as the boom-bust cycles in lending to several emerging economies in the past. Germany pursued a policy of wage deflation – competitive disinflation – running surpluses against most other eurozone members and the rest of the world, including the US. Japan was in a similar situation, relying for growth on exports and generating current account surpluses which reached 5 per cent of GDP in 2007. Thus, the US was acting as a locomotive not only to export-led East Asian DEEs but also to Japan and Germany (Akyüz 2011b).

The increased outsourcing to the Sino-centric production network by transnational corporations from AEs has made a significant contribution to growing exports from East Asia. China's accession to the WTO in December 2001 significantly accelerated this process by granting that country a Permanent Normal Trade Relations status in the US and eliminating discriminatory, WTO-inconsistent measures against its exports. This removed the uncertainties regarding the issuance of the yearly waiver by the US President, and played a central role in the rapid increase in FDI to China, which doubled the levels of the late 1990s to reach $80 billion in 2007. Thus, China and other East Asian DEEs participating in the Sino-centric production network benefited not only from growing exports to AEs, but also from investment and technology brought in by transnational corporations to expand exportables.[6] Until the global crisis, Chinese exports to AEs and FDI inflows reinforced each other. After 2008, when exports slowed down considerably, FDI inflows to Chinese manufacturing

[6] Reduction of tariffs and non-tariff barriers in China after its accession to the WTO also facilitated the emergence of East Asian trade networks and growing intra-regional trade – see ADB (2011).

remained sluggish, even though China was able to restore growth on the basis of expansion of domestic demand.[7]

III.2. Capital flows and remittances

The new millennium witnessed the beginning of the third post-war boom in capital flows to DEEs, mainly as a result of exceptionally low interest rates and rapid expansion of liquidity in AEs, including the US, the EU and Japan.[8] Both net flows and net inflows to DEEs peaked in 2007 before the outbreak of the subprime debacle (Charts 1 and 2). The surge in capital inflows was accompanied by rapidly narrowing spreads on emerging-market debt, brought about by significantly improved risk appetite. This, together with low interest rates in AEs, resulted in a sharp decline in the cost of external financing for DEEs. Most DEEs enjoyed the increased risk appetite and shared in the boom in capital inflows irrespective of their underlying fundamentals.

Although capital flows among DEEs have also been increasing rapidly and China has become a major investor in some resource-rich DEEs, a very large proportion of capital came to DEEs from lenders and investors in AEs. However, China contributed to the expansion of capital inflows to DEEs by investing its twin surpluses in current and capital accounts in reserves, mostly in dollars.[9] Large acquisitions of US Treasuries by China and FEs helped to keep long-term rates relatively low even as the US Fed started to raise short-term rates. Thus, while growing US external deficits were being financed "officially" there was plenty of highly-leveraged private money searching for yield in DEEs. A mutually reinforcing process emerged between private flows to DEEs and official flows to the US – the former were translated into reserves of DEEs and constituted an important part of official flows to the US, and supported lower rates there and private flows to DEEs.

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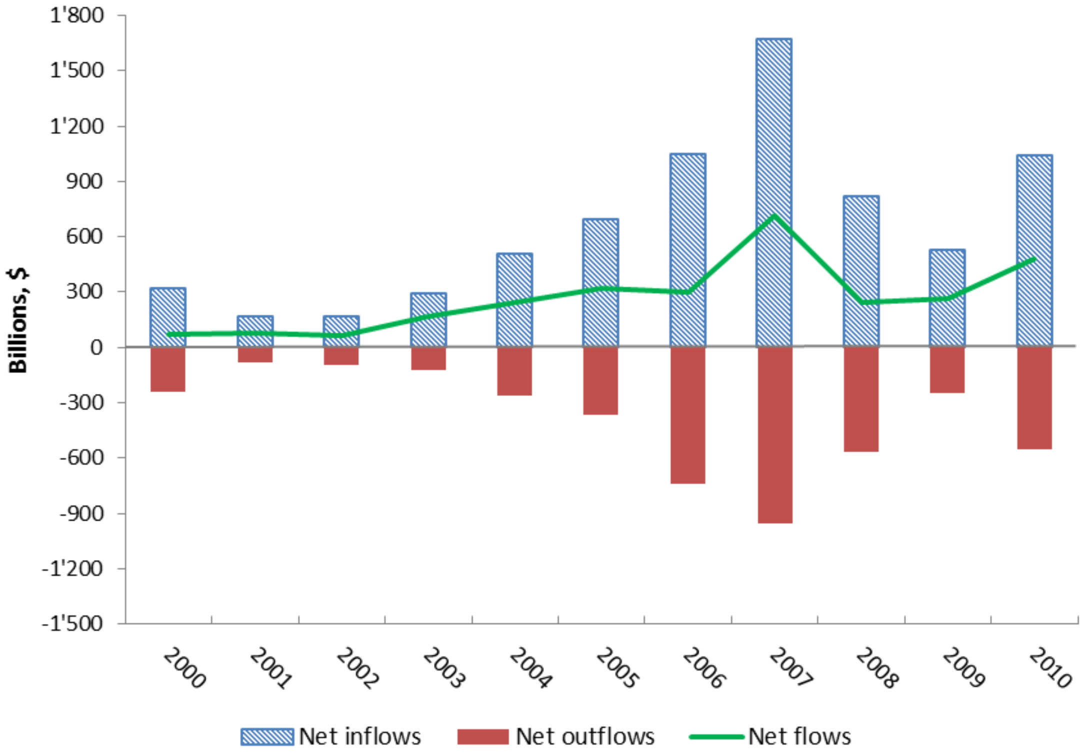
[7] FDI inflows to China peaked in 2008 before it fell in 2009. In 2010 they were still below the level of 2008 (UNCTAD WIR 2011). Moreover, there was a sharp increase of foreign investment in property, with the share of FDI going into real estate rising to 23 per cent in the latter year (SAFE 2011).

[8] This and the following section draw on Akyüz (2012).

[9] Here capital account surplus is used for surplus on non-reserve financial account.

Chart 2: Net private capital flows to developing countries, 2000-2010



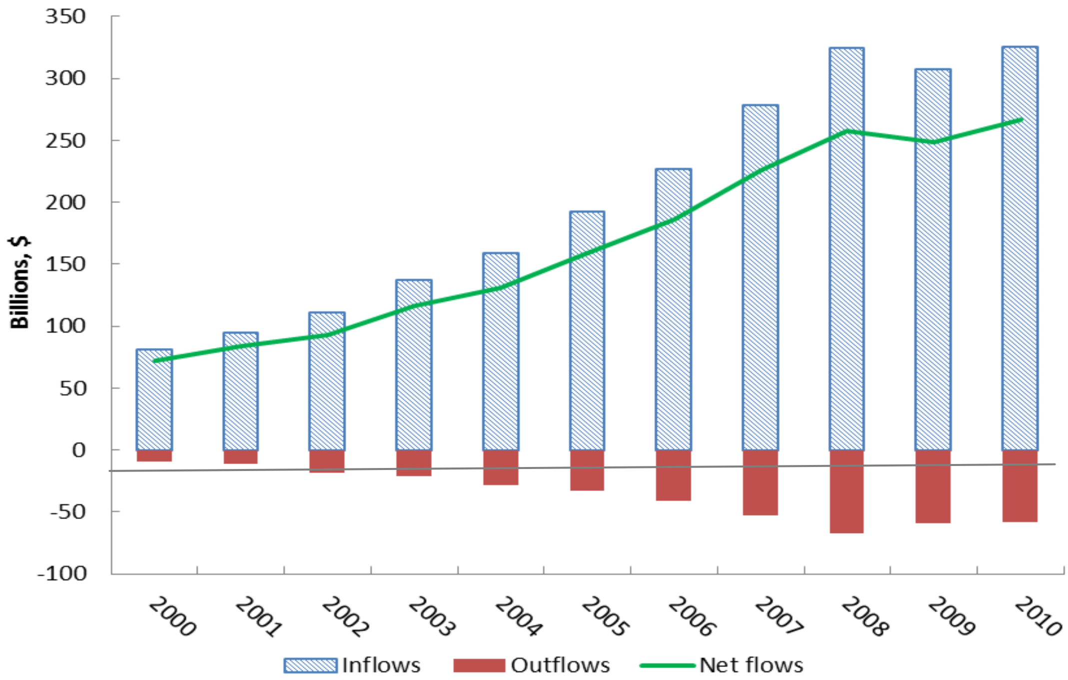
Source: IMF, *WEO* (September 2011 and September 2010).

Private capital inflows to DEEs held up initially during the subprime debacle despite growing strains in credit and asset markets in the US and Europe. However, with the collapse of a number of leading financial institutions in the US, notably the Lehman Brothers, the boom came to a halt in the second half of 2008. The rapidly growing volatility in financial markets led to an extreme and generalized risk aversion, pushing up spreads on emerging-market debt and triggering a flight to safety into US Treasuries and appreciation of the dollar vis-à-vis other major currencies, even though the US was the epicentre of the crisis.

However, the contraction of private capital inflows to DEEs was short-lived. They started to recover in the first half of 2009, driven by historically low interest rates and rapid expansion of liquidity in major AEs brought about by monetary policy response to the crisis as well as better growth performance in DEEs and a shift in risk perceptions against AEs. In the second half of 2011, a generalized increase in risk aversion led to exit of capital from several DEEs (IMF WEO 2012 January update), but according to the latest available projections by the IMF (WEO September 2011), both net private inflows and net flows will continue to remain strong in 2012, though still below the 2007 peaks.

DEEs also enjoyed a rapid growth of workers remittances, at an average annual rate of some 20 per cent between 2002 and 2008, rising from less than \$100 billion at the beginning of the decade to more than \$320 billion in 2008, exceeding all categories of capital inflows except FDI (Chart 3). Much of these also came from AEs, with Europe accounting for almost half of total inflows followed by the US. Some major emerging economies were among the top receivers, including India, China, Mexico and Indonesia. In 2007 remittances amounted to 1–1.5 per cent of GDP in China and Indonesia, around 3 per cent in India and Mexico, over 4 per cent in Pakistan and 11 per cent in the Philippines. In many of these countries they led to a significant improvement in the current account, reducing deficits and even generating surpluses despite large trade deficits.

Chart 3: Remittances flows in developing countries, 2000-2010



Source: *World Development Indicators,* World Bank.

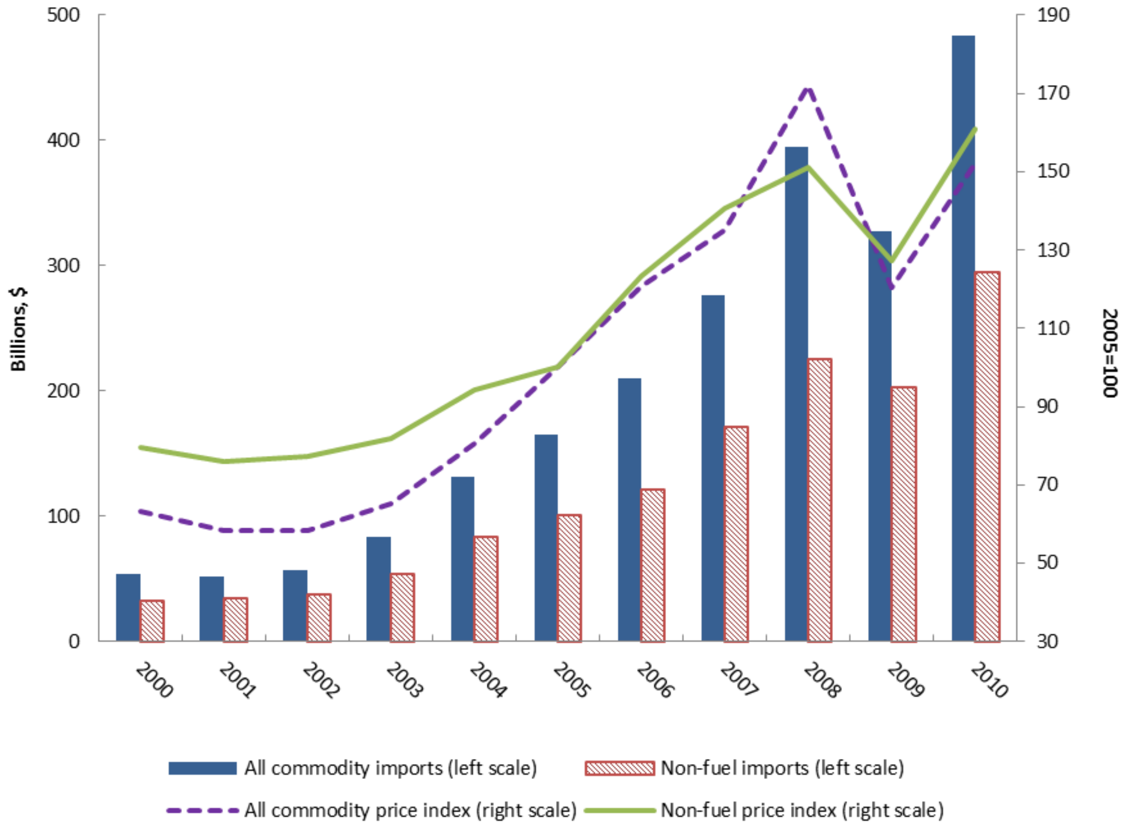
With the outbreak of the crisis remittances registered a moderate decline in 2009. However, the subsequent recovery has been weak; during 2010-11 they are estimated to have grown by less than half of the rate observed during pre-crisis years. According to recent projections by the World Bank (Mohapatra *et al*. 2011) they would grow by 7-8 per cent per annum in the coming years, subject to serious downside risks associated with persistent unemployment in Europe and the US and hardening political attitudes toward new migration.

III.3. Commodity prices

With rapid liquidity expansion and acceleration of growth in the global economy, commodity prices started to rise in 2003, gaining further momentum in 2006 (Chart 4). The factors driving the boom included a strong pace of activity in DEEs, notably in China, where commodity-intensity of growth is high, low initial stocks, weak supply response and relatively weak dollar. These markets also became increasingly financialized after the beginning of the decade as financial investors sought to diversify into commodity-linked assets and low interest rates led to a search for yield in commodity markets (UNCTAD TDR 2011). In the case of food, diversion to bio-fuels and rising cost of fertilizers and transport due to high oil prices also played a role.

Despite growing financial strains in the US, commodity prices continued to increase before they made a sharp downturn in August 2008. This boom-bust cycle in commodity prices in the middle of the subprime crisis was largely due to shifts in market sentiments regarding the future course of prices. Initially, the subprime crisis was seen as a hiccup and the downturn in economic activity was expected to be short-lived, including by the IMF (WEO, July 2008), followed by a rapid and robust recovery. However, with mounting financial difficulties in the US and the collapse of the Lehman Brothers, sentiments turned sour and growth prospects were dampened. Investors pulled out large amounts of money from oil and non-oil futures, more or less at the same time as capital flows to DEEs were reversed and the dollar started to strengthen. By the end of October 2008, food was 27 per cent and oil 45 per cent below their peaks.

Chart 4: Commodity prices and commodity imports of China, 2000-2010



Source: UNCTAD, *UNCTADstat* and IMF *WEO* (September 2011)

Again the downturn in commodity prices was short-lived and the upturn in 2009 coincided with the recovery of capital flows to DEEs and the decline of the dollar. After falling in late 2008 and early 2009, index trading also started to gain momentum as commodity prices turned up in spring 2009 as a result of increased demand from DEEs, notably China, in conditions of continued expansion of international liquidity and historically low interest rates. Investment in commodities recovered rapidly while the number of exchange traded options and futures rose to unprecedented levels (BIS 2010). Despite recent weakening of markets for metals and minerals and several agricultural commodities, prices remain significantly above the levels of the early 2000s.

IV. IMPACT ON MACROECONOMIC BALANCES IN DEEs

The past ten years have witnessed considerable improvements in macroeconomic conditions in DEEs. Alongside the acceleration of growth, fiscal and payments deficits have declined considerably and inflation has been brought under control in a large majority of countries. Improvements in economic management and institutions, following a number of policy errors resulting from adherence to the Washington Consensus, have no doubt played an important role in bringing these about. However, extremely favourable global conditions have also made a major contribution and indeed played a more crucial part in many countries.

DEEs have generally manifested greater fiscal discipline in recent years. Average central government deficits were hovering around 3.5 per cent of GDP at the beginning of the 2000s (IMF WEO October 2007). By 2006-07 they came down to around 0.5 per cent. During the same period, the average external debt of DEEs declined from around 40 per cent of GDP to 25 per cent. Total public debt as a proportion of GDP also declined considerably in many highly-indebted emerging economies, particularly on account of rapidly falling external debt. In the seven largest Latin American economies, the public debt fell, on average, from over 50 per cent of GDP in the early 2000s to 35 per cent in 2007 while the share of the foreign currency debt fell from some 60 per cent to less than 40 per cent in the same period (IDB 2008). Securing the conditions for overall debt sustainability has become an overriding objective in fiscal management even though it has occasionally resulted in highly regressive tax regimes relying increasingly on indirect taxes.[10]

Considerable progress has also been made in bringing inflation under control since the beginning of the decade. Average consumer inflation in DEEs was close to 30 per cent per annum throughout the 1990s. It came down to single-digit levels, just over 6 per cent during 2003-07. This is largely because of sharp declines in inflation in Latin America towards the levels of more stable Asian economies.

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[10] This has been the case in Turkey where special consumption and value added taxes account for a growing proportion of total tax revenues. By contrast, there have been improvements in the distributional impact of taxes as well as the tax/GDP ratio in Latin America; see, Cornia *et al.* (2011).

Drawing on the lessons from past crises, DEEs have generally been more successful in managing exchange rates, capital flows and balance of payments, even though there are notable exceptions, including many countries in Central and Eastern Europe, Turkey and South Africa – those more seriously affected by the 2008-09 crisis. Almost all emerging economies moved away from fixed currency pegs which had proved highly damaging by encouraging boom-bust cycles in capital flows, exchange rates and current account balances, with severe impact on employment and growth. Many DEEs, particularly in Asia, followed various shades of managed floating, heavily intervening in currency markets in pursuit of strong payments and reserve positions. Even though several DEEs, notably in Latin America, have adopted inflation-targeting and left their currencies largely to markets, they have nevertheless paid greater attention to their current account positions and the adequacy of reserves in meeting short-term external obligations. The resilience of domestic financial institutions and markets to shocks has also been improved through tighter prudential regulations and supervision, and significantly increased capitalization. All these have been reflected in significantly improved credit ratings of major emerging economies.

However, improvements in macroeconomic balances in DEEs have not been independent of the favourable international economic environment. In Latin America, an important part of the decline in budget deficits after 2002 was due to rising commodity prices, with revenues from commodity taxes, profits and loyalties accounting for as much as 50 per cent of the total increase in the fiscal revenue ratio in some countries (Cornia *et al*. 2011). Indeed, the fiscal record was less impressive in terms of structural balances since several governments in the region pursued pro-cyclical expansion in spending. According to the IMF (REO November 2007) during 2006-07 structural primary (non-interest) balances in the region were weaker than actual primary balances while the IDB (2008) finds that only Chile was in structural fiscal surplus. Similarly, an ECLAC report (Jiménez and Gómez-Sabaini 2009) argued that much of the improvement in the fiscal situation after 2002 was the result of the steady increase in commodity prices and warned that a sharp decline in these prices could seriously jeopardize the fiscal achievements. Indeed, the fiscal space gained during the subprime expansion was largely lost with the reversal of commodity prices in 2008-09 when budgets went into deficits in the region by some 3 per cent of GDP (ECLAC 2010).

The situation is much the same for current account balances in commodity exporters in Latin America and Africa. At the end of the 1990s and early 2000s current accounts in these regions registered deficits in the order of 3-4 per cent of GDP. By 2007, both regions had moved to a surplus, at a rate of some 1 per cent of GDP in Latin America and over 3 per cent in Africa. Again, an important reason was the increase in oil and non-oil commodity prices, which resulted in a 50 per cent improvement in the terms-of-trade in Latin America between 2002 and 2006. It is estimated that without terms-of-trade gains from commodity price increases, the current account of the region would have shown a deficit of about 4 per cent of GDP, more or less at the same rate as that observed before the Tequila crisis (Calvo and Talvi 2007; Ocampo 2007). Indeed, external deficits started to grow after 2008 with the decline in commodity prices and increased reliance on domestic demand for growth.

In several cases, success in bringing inflation under control also owes a greater deal to favourable international financial conditions and the generalized surge in capital flows. Even though fixed pegs were abandoned and floating was adopted along with inflation targeting, the exchange rate operated as an anchor for inflationary expectations, as net capital flows exceeded current account deficits and led to nominal appreciations. In countries such as Brazil and Turkey high interest rates did not bring inflation under control by restricting credit expansion and domestic spending – in both cases credits expanded by 20-30 per cent per annum and growth was driven by consumer spending. Rather, they accelerated capital inflows, particularly carry-trade, resulting in significant appreciations of the nominal exchange rate. In such cases currency appreciations also played an important part in reducing the ratio of foreign-currency denominated debt to GDP.

Finally and more importantly, not all DEEs enjoying acceleration of growth in the 2000s have seen commensurate improvements in domestic savings, capital accumulation or productivity – a factor which raises considerable doubt about sustainability of strong growth. The average savings rate in middle-income countries during 2000-08 was lower than the rate in the 1990s while the record on investment and productivity was mixed (World Bank 2011).

Among the major emerging economies, apart from China, only India has registered large increases in domestic savings and investment alongside rapid growth (Table 2).

However, despite reforms designed to promote manufacturing, almost three-quarters of Indian growth in the 2000s came from services while the share of manufacturing has stagnated at around 15 per cent of GDP, more or less the same level as in the early 1990s. In manufacturing and services the well-performing export sectors are capital- or skill-intensive rather than labour-intensive, manifesting a vent-for-surplus style expansion based on the mobilization of a backlog of underutilized skills (Gupta *et al.* 2008). Infrastructure bottlenecks top the list of impediments to manufacturing development. Unless these are removed and manufacturing starts expanding rapidly, the Indian resurgence may well remain a one-off miracle of the kind seen in some countries in past decades, such as Brazil in the late 1960s and the early 1970s and Turkey in the 1980s.

Table 2: Gross national savings, investments and current accounts in selected DEEs (Per cent of GDP)

Year	2000			2002			2007			2010		
	Savings	I	CA	Savings	I	CA	Savings	I	CA	Savings	I	CA
Argentina	13.0	17.5	-3.1	20.5	10.8	8.5	26.6	24.1	2.4	22.8	24.4	0.8
Brazil	14.5	18.3	-3.8	14.7	16.2	-1.5	18.4	18.3	0.1	17.0	19.3	-2.3
China	36.8	35.1	1.7	40.3	37.9	2.4	51.9	41.7	10.1	53.4	48.2	5.2
India	23.3	24.3	-1.0	25.5	24.1	1.4	36.7	37.4	-0.7	34.2	36.8	-2.6
Indonesia	27.1	22.2	4.8	25.4	21.4	4.0	27.3	24.9	2.4	33.3	32.5	0.8
Korea	33.3	30.6	2.8	30.5	29.2	1.3	31.5	29.4	2.1	31.9	29.2	2.8
Malaysia	35.9	26.9	9.0	32.7	24.8	8.0	37.5	21.6	15.9	32.9	21.4	11.5
Mexico	22.8	25.5	-2.8	21.5	23.5	-2.0	25.7	26.5	-0.9	24.4	25.0	-0.5
Russia	36.7	18.7	18.0	28.5	20.0	8.4	31.3	25.4	5.9	25.1	20.3	4.8
South Africa	15.6	15.7	-0.1	16.7	15.9	0.8	14.3	21.2	-7.0	16.5	19.3	-2.8
Thailand	30.4	22.8	7.6	27.5	23.8	3.7	32.8	26.4	6.3	30.6	25.9	4.6
Turkey	17.0	20.8	-3.7	17.3	17.6	-0.3	15.2	21.1	-5.9	13.6	20.1	-6.6

Source: IMF *WEO* (September 2011).

In Latin America the average savings rate has shown a moderate increase, largely on account of improvements in fiscal balances resulting from the commodity bonanza. In Argentina the increase is sizeable but in Brazil the savings rate has continued to remain at too low a level to provide a reliable basis for capital accumulation needed for rigorous and sustained growth. In Turkey, despite rapid growth and improvements in public savings, domestic savings declined substantially and an important part of investment was financed by capital inflows as the savings gap reached almost 6 per cent of GDP during the boom years of 2006-07 (Uygur 2011).

Again there is considerable diversity in the pace of capital accumulation among the DEEs which enjoyed a significant acceleration of growth in the 2000s. In Latin America private investment rose as a share of GDP, but remained well below the levels in other regions (IMF REO October 2008). As noted by IDB (2008), Latin American private investment and productivity during the post-2002 expansion did not perform significantly better than during the previous expansion of the 1990s even though external conditions were exceptionally more favourable – with world growth stronger by 1.4 percentage points, commodity prices higher by 76 per cent and emerging market bond spreads lower by some 400 basis points. In Brazil, at less than 20 per cent of GDP, investment has remained too low to provide a rapid increase in productive capacity. High real interest rates, extremely low public investment as well as the long-standing problem of lack of a strong animal spirit among the entrepreneurial class have been major factors.[11] Low rates of investment in Brazil, as well as some other DEEs in the region, is a major reason why Latin America continues to have a poor record in productivity compared to East Asia (Palma 2011). The average total factor productivity growth in the seven largest Latin American countries during 2003-06 is found to have been lower than that during the 1991-94 expansion (IDB 2008).

In several economies in East Asia, including Malaysia, Singapore, the Philippines, Taiwan (China) and Indonesia, investment rates have been hovering around 20 per cent of GDP in recent years, less than half the rate in China. Large current account surpluses in some of these economies reflect low rates of domestic investment rather than exceptionally high domestic savings rates. For instance, in recent years savings rates have been quite similar in India and Malaysia, but while the current account in India has been in balance or deficit, Malaysia has had a surplus reaching double-digit figures as a per cent of GDP. In none of these East Asian economies have investment rates recovered the levels attained before the 1997 crisis.[12] Even recognizing that the pre-crisis investment booms were

[11] A measure of this is the ratio of private investment in GDP to the income share of the top 20 per cent. This ratio was around 25 per cent in Brazil both in the 1980s and 1990s compared to 70 per cent in Korea in the former period and over 53 per cent in the latter (UNCTAD TDR 2003). Palma (2011) uses private investment as a percentage of the income share of the top decile and finds that in 2009 this ratio was twice as high in Asia, including Korea, China, India and Vietnam as in Latin America, including Brazil, Mexico, Argentina and Chile.

[12] Except for a property boom in Singapore; see Lim and Maru (2011).

unsustainable bubbles driven by massive capital inflows, recent investment rates have been too low to produce rapid and sustained growth of the kind many of these economies had enjoyed during the earlier phases of their industrialization, creating concerns that some of them run the risk of getting caught in a middle-income trap (Radhi and Zeufack 2009).

V. IMPACT ON GROWTH IN DEES

The exceptionally favourable global economic conditions prevailing before the outbreak of the crisis not only improved internal and external balances and stability in DEEs, but also contributed to the expansion of economic activity, directly or indirectly. China and other export-oriented East Asian DEEs benefited significantly from credit, consumption and property bubbles created by speculative lending and investment in the US and Europe, growing rapidly based on exports to these markets, running increasing current account surpluses and accumulating large amounts of reserves. In most DEEs in Latin America and Africa, the combination of increasing commodity prices and declining cost of external financing significantly reduced the payments deficits and allowed to expand domestic demand and accelerate growth. In oil-importing emerging economies such as India and Turkey, capital inflows were more than sufficient to meet the deficits created by oil price shocks, again allowing rapid growth based primarily on domestic demand. India additionally enjoyed a rapid growth in workers' remittances which reached 3.3 per cent of GDP in 2007.

Low interest rates in AEs and the surge in capital inflows also allowed most emerging economies to pursue expansionary monetary policies and maintain historically low interest rates, stimulating domestic demand. Large inflows of capital in excess of current account needs in deficit countries or coming on top of current account surpluses in surplus countries, contributed to expansion by creating asset bubbles. Equity prices rose sharply between 2002 and 2007 both in dollar and local currency terms. The increase was particularly strong in Brazil, China, India and Turkey, and many of these also experienced credit and property booms both due to increased entry of non-residents to domestic asset markets and the impact of capital inflows on domestic monetary conditions (Akyüz 2010). In several countries growing workers' remittances from abroad were also translated into domestic consumption, thereby adding to demand, output and employment.

It is not always easy to identify precisely the relative contributions of global conditions and domestic policies to growth in DEEs. However, evidence strongly suggests that extremely favourable global conditions played a much more predominant role in the acceleration of growth in DEEs in the new millennium than is typically appreciated in the popular debate on the rise of the South. This is particularly true for commodity-rich economies of Latin America and Africa which, together with India and Turkey, account for much of the recent acceleration of growth in the South.

Empirical research in the Inter-American Development Bank on the role of external factors in boom-bust cycles in Latin America over 1990-2006 has come to the conclusion that an important part of growth in the period after 2002 could be explained by improved global conditions (Izquierdo *et al*. 2008; IDB 2008). Using industrial production in AEs, US interest rates, the terms-of-trade and risk spreads on international sovereign debt as proximate measures of international economic conditions, it is found that growth in Latin America after 2002 would have been lower by 2 per cent had these variables remained at the levels predicted in the late 1990s on the basis of their historical patterns. Growth would have been lower even by a greater margin if the unfavourable global economic conditions (high risk spreads and interest rates, low commodity prices and severely depressed capital inflows) that were prevailing in the aftermath of the Russian crisis had persisted. Cohan and Yeyati (2012) have reached similar conclusions on the impact of external conditions on the performance of Latin America, using a Global Wind Index consisting of three basic indicators of the external environment – risk appetite, commodity prices and global growth.

Until the outbreak of the crisis, growth in East Asian DEEs relied heavily on exports. In China during 2002-08 exports grew on average by 25 per cent per annum while domestic consumption lagged income growth (Table 3). During this period, about one-third of GDP growth in China was due to exports, taking into account their direct and indirect import contents. If the multiplier effect of exports on domestic consumption and knock-on effect on domestic investment are added, this proportion goes up to almost 50 per cent.[13] Much of these exports went to AEs (Table 4).

Table 3: Growth of real GDP and its components in China (Per cent)

	GDP	Consumption	Gross Capital Formation	Exports	Imports
2002	9.1	7.4	13.2	29.4	27.4
2003	10.0	6.6	17.2	26.8	24.9
2004	10.1	7.1	13.4	28.4	22.7
2005	10.4	7.3	9.0	24.3	11.4
2006	11.6	8.4	11.1	23.8	15.9
2007	13.0	10.1	11.4	19.9	14.0
2008	9.6	8.8	10.2	8.6	5.1
2009	9.1	8.5	19.8	−10.4	4.3
2010	10.3	8.0	11.6	27.6	21.8
2011f	9.3	8.0	10.7	12.4	13.2

Source: World Bank CQU (various issues).

Table 4: Manufactured exports of China to various regions

	2005		2007		2010	
Partner	Billions, $	% of Total	Billions, $	% of Total	Billions, $	% of Total
Africa	10.4	1.5	19.7	1.7	29.8	2.0
Latin America	17.2	2.5	40.0	3.5	70.7	4.8
Asia	92.0	13.2	169.5	14.9	248.0	16.8
Total DCs (Africa +LA+Asia)	119.6	17.1	229.3	20.2	348.5	23.6
The rest:[a]	579.2	82.9	904.8	79.8	1125.7	76.4
World	698.7	100.0	1134.0	100.0	1474.3	100.0

Source: UNCTAD Stat.

Note: regions are defined according to Global System of Trade Preferences countries (GSTP).

a: Includes AEs, emerging countries in Central and Eastern Europe and CIS.

Exports of East Asian DEEs closely linked to the Sino-centric production network, including Korea and Taiwan (China) and the major ASEAN countries (Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam) also grew rapidly during this period, but except Vietnam, not as rapidly as China's. The share of exports in GDP is higher in the

[13] On the estimation of import content of exports and the contribution of the exports to growth in GDP in the East Asian countries discussed in this section, see Akyüz (2011a).

majority of these countries than in China, both in gross-value and value-added terms. This, together with relatively rapid growth of exports, meant that pre-crisis growth in ASEAN+2 depended even more on exports than in China. Indeed estimates suggest that during 2003-07 about 60 per cent of growth in Korea, Taiwan (China) and Thailand and even a greater proportion of growth in Malaysia, Singapore and Vietnam came from exports, taking into account their import contents. Most of the exports went to AEs, directly, or through China by providing the latter country parts and components for its exports to AEs.

VI. THE ROLE OF SOUTH–SOUTH TRADE AND CHINA

Rapid growth in DEEs in the new millennium has not only resulted in a significant increase in their share in world income, but has also been associated with a sizeable increase in their share in world trade and an unprecedented expansion of South–South trade. These are often taken as a manifestation of decoupling of the South from the North and the increased capacity of major DEEs such as BRICS to provide growth impulses to other developing countries and even to AEs. However, a closer examination shows that the picture is much more nuanced than is portrayed by this popular presentation of the increased role of the South in the world economy.

There is no doubt that the share of DEEs in world income has increased rapidly in the new millennium as a result of their significantly faster growth than AEs regardless of how it is measured (Table 5). However, the measurement of the shares of economies in world income in Purchasing Power Parity (PPP) as an indication of their relative importance is highly misleading. It is the market (exchange) values of goods and services, not the PPP values that determine the economies' contributions to global supply and demand and the expansionary and deflationary impulses they transmit to others. The share of DEEs in world income is considerably smaller when measured in market exchange rates, both in current or constant (2005) dollars, than when measured in PPP. In fact, despite a large increase, in constant dollars the share of DEEs taken together is still less than the share of the US. In current dollars, their share is considerably higher because of a sharp appreciation of the currencies of most major DEEs against the dollar. China is the only country with a significant share in world income in comparison with AEs; in current dollars it is second only to the US. Its share would be considerably higher if it had allowed its twin surpluses to appreciate the yuan faster than has been the case.

The share of DEEs in world trade has also increased significantly, in the order of 10 percentage points between 2000 and 2010, both for imports and exports, to reach around two-fifths of total world trade (Table 5). China accounts for the bulk of the trade by DEEs. It exports more than any other economy in the world and it comes second after the US in imports. The shares of other DEEs, including Brazil and India, in world imports and exports are much smaller.

South-South trade as a proportion of world trade has also seen a significant increase in the new millennium (Table 6). East Asia accounts for three-quarters of South-South trade

Table 5: Share of selected economies in world income, exports and imports in 2000 & 2010 (Per cent)

	GDP						Exports		Imports	
	In constant dollars (2005)		In current dollars		In PPP		In current dollars		In current dollars	
	2000	2010	2000	2010	2000	2010	2000	2010	2000	2010
United States	28.6	26.1	30.9	23.1	23.5	19.5	12.1	8.4	18.9	12.8
EU	31.9	28.5	26.4	25.8	25.0	20.4	38.0	33.9	37.7	34.2
Japan	10.9	9.3	14.5	8.7	7.6	5.8	7.4	5.1	5.7	4.5
DEEs	18.5	25.8	20.3	34.2	37.2	47.9	31.9	41.8	28.8	39.1
Argentina	0.4	0.5	0.9	0.6	0.8	0.9	0.4	0.5	0.4	0.4
Brazil	2.0	2.2	2.0	3.3	2.9	2.9	0.9	1.3	0.9	1.2
China	3.6	7.6	3.7	9.3	7.1	13.6	3.9	10.4	3.4	9.1
India	1.5	2.4	1.5	2.6	3.7	5.5	0.7	1.5	0.8	2.1
Indonesia	0.6	0.8	0.5	1.1	1.2	1.4	1.0	1.0	0.6	0.9
Mexico	2.0	1.8	2.1	1.6	2.5	2.1	2.6	2.0	2.7	2.1
South Africa	0.5	0.6	0.4	0.6	0.7	0.7	0.5	0.6	0.5	0.6
Turkey	1.0	1.1	0.8	1.2	1.2	1.3	0.4	0.8	0.8	1.2

Source: GDP in current dollars and PPP terms from IMF *WEO* (September 2011), GDP in constant 2005 dollars from World Bank database; and Exports and Imports data from UNCTAD, *UNCTADstat*.

and China's share is around 40 per cent. China also comprises close to 60 per cent of South-South imports in Asia and 58 per cent and 65 per cent of Asian DEEs' imports from Africa and Latin America, respectively (ADB 2011). Again, the shares of other DEEs in South-South trade are small – for India it is around 5 per cent and for the rest of the developing world, including Latin America and Africa, it is around 25 per cent.

These imply that major DEEs other than China, including India and Brazil, cannot act as a driving force for the South. In any case, the expansionary impulses that these economies could generate for other DEEs depend very much on large and continued inflows of capital, because they tend to run current account deficits except at times of strong growth in the rest of the world.

Table 6: South-South trade (Per cent)

	2000–01	2006–07	2009
South–South trade as share of world trade			
Exports	10.2	15.0	17.7
Imports	9.6	14.1	16.1
Trade	9.9	14.5	16.9
Developing Asia's share of South–South trade			
Exports	79.8	79.8	80.3
Imports	71.6	69.3	68.5
Trade	75.7	74.6	74.4
China's share of South–South trade			
Exports	35.1	40.8	41.6
Imports	36.9	37.8	38.4
Trade	36.0	39.3	40.0
India's share of South–South trade			
Exports	3.1	3.7	4.9
Imports	1.6	2.4	5.8
Trade	2.4	3.0	5.4
Other South's share of South–South trade			
Exports	20.2	20.2	19.7
Imports	28.4	30.7	31.5
Trade	24.3	25.4	25.6

Source: ADB, *Asian Development Outlook 2011.*

There is considerably double counting in the estimated shares of DEEs and South-South trade in world trade. Since trade is conventionally measured in gross-value not in value-added terms, a country's exports contain imports from and, hence, value-added generated in other countries. Typically, the import content of exports of DEEs has been growing as a result of their increased participation in international production networks supplying final goods to AEs. It is also greater than the import content of exports of AEs (Koopman et al. 2010; Akyüz 2011a; Riad et al. 2011). This is particularly true for East Asian DEEs participating in the Sino-centric production network as well as for Mexico which has become an assembly hub in NAFTA. This means that in value-added terms, the share of DEEs in world exports would be lower and that of AEs higher than the shares indicated by official figures.

The Sino-centric East Asian production network involves considerable South-South trade in intermediate goods, parts and components closely linked to final exports to AEs. In that region goods-in-process often cross borders several times before reaching their final destinations while in NAFTA – as well as in the European production network – foreign inputs usually come directly from AEs and there are little imports from other DEEs for exports to AEs (Riad et al. 2011). It is estimated that only 22 per cent of exports of major East Asian DEEs to each other are destined to final demand in these economies while 60 per cent go to final demand in the US, Europe and Japan (Lim and Lim 2012).

In China, imported parts and components and other intermediate goods that are directly or indirectly used in the production of exportables reach 40 per cent of gross value of exports. By contrast, the import content of consumption in China is much lower than that in AEs – about a quarter of the import content of US consumption. During 2003-07, around 60 per cent of total Chinese imports are estimated to have been used for exports, under 15 per cent for consumption and some 20-25 per cent for investment.

Chinese merchandise imports are dominated by manufactures (Table 7). More than half of these come from DEEs. East Asian DEEs account for a large proportion of these imports, mostly in parts and components used in China's export industries (Athukorala 2011; Lee, Park and Wang 2011). China also imports intermediate parts and components from

AEs. In fact, Japan is its largest supplier, with a share of 17 per cent of such imports by China.

Table 7: Manufactured & commodities imports of China from various regions (Billions, $)

a) Commodities imports of China from various regions

Partner	2003		2007		2010	
	non-fuel	fuel	non-fuel	fuel	non-fuel	fuel
Africa	2.3	4.9	7.9	26.1	19.5	41.5
Latin America	10.0	0.4	37.5	5.3	66.7	13.0
Asia	15.5	19.5	48.3	56.1	66.6	100.0
Total DCs (Africa +LA+Asia)	27.8	24.9	93.7	87.6	152.8	154.5
The rest:	27.3	4.3	80.3	17.6	146.0	34.5
World	55.1	29.2	174.1	105.1	298.9	189.0

b) Manufactured imports of China from various regions

	2003		2007		2010	
Partner	$, billions	% of Total	$, billions	% of Total	$, billions	% of Total
Africa	0.8	0.3	1.8	0.3	2.6	0.3
Latin America	4.4	1.4	8.1	1.2	11.4	1.3
Asia	161.1	49.2	373.3	55.3	473.1	53.2
Total DCs (Africa +LA+Asia)	166.3	50.8	383.2	56.8	487.1	54.7
The rest:	160.9	49.2	291.2	43.2	402.6	45.3
World	327.2	100.0	674.5	100.0	889.8	100.0

Source: *Direction of Trade,* IMF and *UNCTADStat*, UNCTAD.

Note: Hong Kong, Korea, Macau, Taiwan, Singapore are defined as developing countries and reported externally. Nonfuel commodities are defined as industrial metals, food, beverages, and agricultural raw materials in terms of the SITC (Revision3) classification groups with codes 0, 1, 2, 4, 67, and 68 also including precious metals and stones (667+ 971); the manufactured goods (SITC 5 to 8 less 667 and 68); fuels (SITC 3).

High import content of exports means that a relatively important part of Chinese exports receipts accrues to countries that provide direct and indirect inputs to export industries in China. In processing exports, which constitute close to 80 per cent of China's total exports to the US, more value-added is earned by East Asian economies supplying parts and components to China than by China itself. China has become the single most important market for many of them, particularly for Korea and Taiwan (China) – the two main suppliers of parts and components other than Japan. In the pre-crisis years only about 12 per cent of exports from Korea and Taiwan (China) went directly to the US and EU each, but as much as

25 per cent to China. However, a large proportion of the latter also ended up in the US and EU as inputs in Chinese exports to them.

This means that growth in many East Asian DEEs depends on exports to AEs directly and through China, even to a greater extent than growth in China itself. Although East Asian DEEs absorb about one-fifth of Chinese manufactured exports (Table 4), these are partly in parts and components for exports to AEs, not for domestic consumption. More importantly, economic activity in these countries and hence their imports from China depend very much on their exports to AEs, both directly and through China. Many of these economies suffer from underconsumption as well as sluggish investment noted above. Thus, they do not provide a strong autonomous market for China's exports and an alternative to AEs. A slowdown in AEs would reduce their exports to them both directly and through China, thereby slowing economic activity and hence reducing their imports from China.

The share of oil and non-oil commodities in China's imports has been growing. It now exceeds one-third of the total, compared to less than 20 per cent in the early 2000s (Table 7). Over 60 per cent of these now come from DEEs, including Africa and Latin America. Although they are also used as inputs into exports, it can be expected that the commodity-import content of Chinese exports is less than their manufacturing-import content. Thus, a greater proportion of commodity imports are used to meet domestic demand than manufactured imports in China.

China has started to exert a strong and growing influence on commodity prices since the beginning of the new millennium (Farooki and Kaplinsky 2011; Farooki 2012). As seen in Chart 4, there is a close correlation between the evolution of Chinese imports and commodity prices. After hovering around 4 per cent of world commodity imports in the late 1990s and early 2000s, China's share started to rise, doubling by 2007 when the global growth and commodity prices peaked and reaching almost 11 per cent in 2010. In 2009, total world demand, Chinese imports and commodity prices all fell. By the end of 2010, total world demand was still below the peak of 2008, but commodity prices went up along with a strong recovery in Chinese imports, which surpassed its 2008 peak by 22 per cent.

Empirical evidence suggests that the impact of China on Latin American business cycles is stronger through rising commodity prices and demand spillovers to third markets than through bilateral trade, and much greater than that of India (Lederman et al. 2009). It is also found that because of these indirect effects, since the mid-1990s, the impact of shocks to Chinese GDP on Latin America has grown by three-times while that of shocks to US GDP has declined by half (Cesa-Bianchi et al. 2011). Still, it should be borne in mind that until the crisis, a large part of China's growth itself depended on its exports to AEs

VII. CRISIS AND RECOVERY

With the outbreak of the crisis the international economic environment deteriorated rapidly in all areas that had previously supported expansion in DEEs. Capital inflows were reversed and net flows turned negative. Commodity prices made a sharp downturn, losing much of the gains recorded after the beginning of the decade. Economic activity contracted rapidly in AEs, leading to a sharp drop in world trade and exports of DEEs.

The reversal of capital flows created a generalized downward pressure on the currencies of almost all DEEs. India, Korea, Turkey and South Africa experienced sharp depreciations and suffered large reserve losses. Equity markets of all major DEEs came under heavy selling pressures and lost over 80 per cent of the gains made during the earlier boom in a matter of a few months. However, the reduced exposure to currency risks, large stock of reserves accumulated during the boom, greater readiness of international financial institutions to provide liquidity to countries threatened by contagion and, above all, the quick recovery of capital flows prevented the instability from being translated into a fully-fledged financial crisis even in economies heavily dependent on foreign capital.[14]

Trade has been by far the most important channel of transmission of deflationary impulses from the global crisis, both for exporters of manufactures and commodities. After

[14] According to IDB (2010), the increased readiness of international financial institutions to provide liquidity played a central role in restraining financial instability in Latin America.

growing by close to 10 per cent per annum during the years before the crisis, world trade volume started to fall sharply in the last quarter of 2008 and throughout the first half of 2009. Despite the subsequent recovery, it registered a decline of close to 13 per cent for the year as a whole.

The impact of export contraction on economic activity varied according to the contribution of exports to growth in comparison with domestic demand. Exports of East Asian DEEs, including China, made a sharp downturn in the last quarter of 2008, falling at double-digit rates in 2009 (Table 3). On average this reduced GDP by 5-6 percentage points. With spillovers to domestic demand, the figure reaches almost 8 percentage points.[15] Loss of output due to declines in exports was more moderate in India and Turkey, in the range of 3-4 percentage points. In these countries declines in exports were comparable to those in East Asia, but export ratios were much lower both in gross-value and value-added terms and growth had relied more on domestic demand. This was also true for some major commodity exporters such as Brazil. In other words, the more successful exporters with high exports–GDP ratios were hit particular hard by the crisis.

The growth outcome depended not only on the incidence of shocks but also on the policy response. The policy space was limited in countries which were running large current account deficits on the eve of the crisis, such as Turkey and South Africa where the combination of sharp declines in capital flows and export earnings resulted in large drops in GDP. However, even where there was a rigorous counter-cyclical policy response, growth rates were lower during 2008-09 than in pre-crisis years, in some cases by a very large margin. Among the regions the largest drop was in Latin America, which went into recession in 2009 (Table 1).

There has been widespread resort to cuts in policy interest rates and monetary and fiscal expansion, but the policy response in East Asia, notably in China, played a central role in the subsequent recovery not only in the region alone but also in a wider range of DEEs.

[15] According to an estimate by ESCAP (2010, Box 1) for East Asian DEEs and Japan, the impact of the 2009 shortfall in exports on GDP reached 7.8 percentage points, accounting for both direct and indirect effects.

The countercyclical fiscal response was unprecedented, not only for the region alone but also the developing world as a whole.[16] On some estimates, the fiscal package in 15 Asian DEEs amounted to 7.5 per cent of 2008 GDP, almost three times the average level in G7 countries (ESCAP 2009). China introduced a large package, close to $600 billion or 13 per cent of GDP. Fiscal packages were also relatively large in Thailand, Malaysia, Singapore and Korea, but somewhat smaller in India.[17] Unlike in AEs, they placed much less emphasis on tax cuts but focussed on increases in spending, particularly in infrastructure and property investment.

In China less than 20 per cent of the fiscal package was allocated to social spending with the rest going mainly to investment. It pushed the investment rate towards 50 per cent of GDP financed by rapid credit expansion and debt accumulation by local governments. This has created unused capacity in infrastructure and added to excess capacity that had already existed in several industries such as steel because of overinvestment in previous years. More importantly, policies designed to revive real estate demand and an unprecedented growth of mortgage lending created a bubble in the property market with real estate investment growing by close to 40 per cent. While private consumption held up thanks to several incentives such as subsidies for vehicle and appliance purchases, it did not provide much impetus to offset the sharp decline in exports. Around 80 per cent of growth in 2009 was due to investment. As the effects of this package started to fade out, another investment boom emerged, with fixed investment growing by 26 per cent and property investment by 33 per cent year-on-year in the first half of 2011 (Xinhuanet 2011). As of end-2011, property investment doubled as a share of GDP from the early 2000s, accounting for more than half of the rise in total investment.

The Chinese stimulus package gave a strong push to economic activity in Latin America and Africa by helping reverse the decline in commodity prices. Indeed, changes in

[16] For fiscal stimulus packages, see United Nations (2010), Khatiwada (2009), ESCAP (2009 and 2010), ADB (2010), and IMF WEO (October 2009).

[17] Difficulties in identifying fiscal measures are revealed by widely different figures given by different organizations for some East Asian countries; cf. UN (2010: Table I.4) and ADB (2010: Figure 2.4.1) and ESCAP (2009, Table 1).

the composition of demand from exports towards domestic investment generated especially strong spillovers to commodity exporters. This is because while China's exports have very high import contents in manufactured parts and components supplied by East Asian DEEs and Japan, property and infrastructure investment has typically higher import contents in commodities.[18] For this reason, in 2010 commodity imports of China stood 75 per cent higher than those in 2007 while the increase in manufactured imports was just over 30 per cent (Table 7).

This means that the new demand pattern driving Chinese growth after 2008 has helped commodity exporters more than that during the pre-crisis expansion when Chinese growth was driven mainly by exports. Indeed, this is found to be the reason why Latin America recovered much faster than was initially anticipated: "the evidence shows that Latin American growth owes more to a fast-growing economy that enacted a powerful fiscal stimulus during the global crisis (China), and relatively less to the economy that was at the epicentre of the crisis (United States)" (Cesa-Bianchi *et. al*, 2011: 4).

The shift from exports to investment resulted in a steep reduction in the current account surplus of China, from over 10 per cent of GDP in 2007 to 4-5 per cent in 2010-11. Again, many East Asian countries saw sizeable declines in their surpluses as a result of slowdown of their exports to AEs as well as exports of parts and components to China. In the same vein, in DEEs which had been relying predominantly on domestic demand for growth, such as Brazil, India and Turkey, current account deficits started to grow.

However, so far growing current account deficits have not posed serious payments difficulties because of rapid recovery of capital inflows. In fact, as during the subprime expansion, from early 2009 net flows started to exceed current account deficits, creating currency appreciations and asset bubbles. Equity markets recovered sharply and in most major emerging economies including Brazil, China, India and Turkey, private sector borrowing started rising faster than GDP, posing the risk of overheating (IMF 2011). Major

[18] It has been reported that the property sector accounts for almost half of Chinese steel use and is a major driver of demand for other commodities, such as copper – Plowright (2012).

deficit economies, Brazil, India, Turkey and South Africa, started appreciating faster than East Asian surplus countries. Unlike during the subprime expansion, some of these such as Brazil, as well as several others with sound payments positions, became less willing to see their currencies appreciate as their exports were slowing. They did not only intervene in currency markets more vigorously, but also resorted to market-based capital control measures, though often without much effect on the size of inflows (Akyüz 2012).

As a result of counter-cyclical stimulus packages, the recovery in commodity prices and capital flows, growth in DEEs resumed after a brief interruption during 2008-09 despite the sharp slowdown in AEs. In Argentina, Brazil, India, Korea and Turkey, average growth during 2010-11 approached or exceeded the levels achieved before the subprime crisis (Table 1).

VIII. SUSTAINABILITY AND VULNERABILITIES

However, there are a number of reasons to believe that the forces that have been driving growth in DEEs since 2009 cannot be sustained over the medium term. Nor is it possible to return to the extremely favourable international economic conditions prevailing before the outbreak of the global crisis. This means that unless fundamental changes take place in the way DEEs are integrated into the world economy – unless they reduce their dependence on foreign markets and capital – the recent staggering ascendancy of the South may prove to be a passing phenomenon and the speed of their convergence to income levels of AEs can slow considerably in the coming years.

China is now widely recognized to be suffering from underconsumption due to low shares of wages and household income in GDP and high precautionary savings. The share of wages in GDP has been constantly falling since the mid-1990s, bringing down the share of household income from almost 70 per cent of GDP to less than 60 per cent (Akyüz 2011b). Virtually in every year since the beginning of the 2000s, consumption has lagged GDP, resulting in continued reduction in its share (Table 3). This has also been the case after the outbreak of the global crisis. On the eve of the crisis private consumption accounted for around 36 per cent of GDP, it is now less than 34 per cent – a figure one would expect to see only during war times! The need to raise consumption is recognized by policy makers in China, but the main problem is that they have been trying to raise consumption primarily by reducing the household propensity to save rather than by lifting the share of household income in GDP. Cuts in interest rates generally fail to make a dent in consumption spending, adding, instead, to the property bubble. It is also unlikely that increased availability of consumer credit would boost private consumption.

A reduction in precautionary savings would depend very much on adequate public provisioning of health, education and housing services. Recent focus on investment in social housing is certainly a step in the right direction, but much more is needed in all social areas, including health and education, in order to expect a significant drop in precautionary savings. In any case, even a relatively large drop in the savings rate would not bring much increase in the share of consumption in GDP in the absence of a significant increase in the share of household income in GDP.

Export prospects are equally dim. None of the three major markets for Chinese manufactures, the US, Europe and East Asia, offer much room for expansion. In the US consumers continue to deleverage as the ratio of household debt to GDP still hovers around the levels of 2003 and unemployment remains at historic levels despite recent improvements. The US itself is seeking export-led growth, trying to hit the target set by President Obama in 2010 to double exports over five years. Japan has gone into recession in 2011 and growth prospects in the coming years are not bright (World Bank 2012a). Even if Europe avoids a severe recession, its growth is widely expected to remain anaemic and unbalanced for several years to come. China's exports to the eurozone have already shown double-digit declines in the last months of 2011, leading to a decline in total exports in November on a quarterly basis (Plowright 2012). East Asian DEEs as a major market for Chinese exports are even more vulnerable than China to a slowdown in the US and Europe because of their dependence on these markets, directly or through China. The rest of the developing world does not provide an important market for China – in any case, many commodity exporters themselves depend on strong growth in China to maintain momentum. Therefore, China will have to rely increasingly on domestic demand to maintain its stellar growth.

Nor is the slowdown in exports a temporary, cyclical problem that could disappear with an eventual return of the US and Europe to rigorous and sustained growth. A full recovery in AEs will no doubt give some room to China for faster expansion of its exports. However, it is quite unrealistic to expect that China can go back to pre-crisis pattern of expansion when its growth was driven primarily by exports to AEs. With Germany and Japan continuing to adhere to export-led growth, this would also mean a return of the US to pre-crisis conditions, acting as a locomotive for the rest of the world. That would be a recipe for the breakdown of the international monetary and trading system. If, on the other hand, China cuts the rate of expansion of its exports to a more acceptable level, say to 10 per cent, then, without a fundamental change in the pace and pattern of domestic demand that prevailed before the outbreak of the global crisis, its growth might barely reach 7 per cent (Akyüz 2011a).

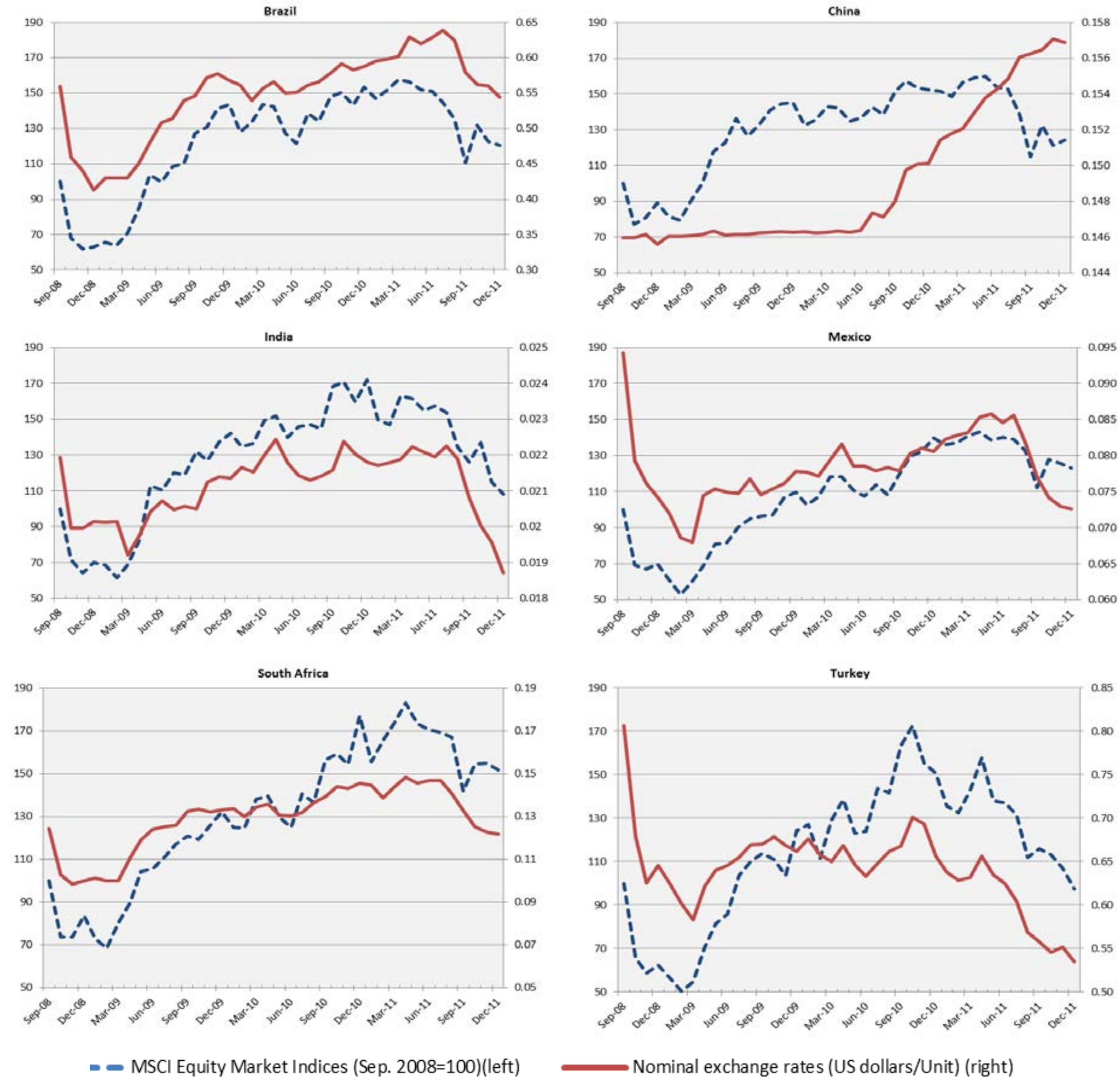
In China a stop-gap strategy of offsetting the slowdown in exports with accelerated investment cannot work indefinitely. Investment in social housing may appear to be a way out, but it is unlikely to compensate for declining investment opportunities in other areas including manufacturing, infrastructure and commercial real estate (Pettis 2011b). Continuing to invest in the latter areas despite excess capacity may help postpone the underconsumption crisis, but only for it to come back with greater force. A debt-driven investment bubble at a rate of 50 per cent of GDP is no less fragile than the US-style consumption and property bubbles or the investment bubbles that several East Asian countries were experiencing before the 1997 crisis. It cannot avoid ending up with massive overcapacity and non-performing loans. The boom in the property sector has already come to an end with property prices falling in a large number of cities, with strong adverse spillovers to other sectors. The increased debt difficulties have prompted the government to call for a rollover of local government loans by creditor banks (Rabinovitch 2012).

A sharp slowdown in China resulting from a contraction in investment or exports would also mean the end of favourable conditions in commodity markets. There is already a softening of commodity prices. Even though oil prices have been relatively stable, non-oil commodity prices, including metals and minerals and several agricultural commodities, have declined since summer 2011, and both oil and non-oil prices are projected to decline further in 2012 (IMF WEO 2012 January Update; World Bank 2012a). A steep fall would no doubt result in sizeable losses for commodity exporters in Latin America and Africa. On the other hand even if commodity prices remain high, growth in Latin America (and Africa) could still fall since commodity prices may affect the level rather than the growth rate of GDP – that is, to maintain a high rate of growth, commodity prices would need to keep on rising (IDB 2008). Growth losses would be more severe if commodity declines are accompanied by worsened global financial conditions. Estimates on the impact of external factors on Latin American business cycles suggest that a combination of a terms-of-trade and financial shocks – reversal in capital flows and hikes in risk spreads – could produce a steep decline of growth in Latin America or even push the region into outright recession (IDB 2010; Izquierdo et al. 2008).

The risk-return configuration that has so far sustained strong inflows of capital to DEEs is indeed susceptible to sudden changes. Even though it is almost impossible to predict the timing of stops and reversals and the events that can trigger them, it must be clear that the conditions that have been driving the surge in capital flows, historically low interest rates in AEs and favourable risk appetite for investment in DEEs, cannot last forever. The immediate threat is a sharp increase in global risk aversion due to prospects of falling growth and increasing imbalances in major emerging economies, economic contraction and financial fragility in the eurozone, the political stalemate in the US over fiscal policy and geopolitical oil supply risks. Any combination of these could lead to a sharp reversal of capital flows to DEEs and a hike in risk spreads, very much in the same way as seen during the Lehman collapse.

Indeed, growing risks in many of these areas have been making international investors highly nervous, creating considerable instability in capital flows and asset and currency markets. After mid-2011 many emerging economies saw sizeable capital outflows and sharp drops in asset and currency markets (Chart 5). India has seen FDI disappear and even China is reported to have experienced net capital outflows during October and

Chart 5: Equity prices and nominal exchange rates, September 2008 – December 2011



Source: MSCI and ONADA.

November 2011 (Fleming 2012). For the first time since the Asian crisis, Chinese reserves fell in the last quarter of 2011, by almost $100 billion. At the end of 2011, the MSCI equity index was lower by 16 per cent in Mexico and South Africa, 23 per cent in China and Brazil, and over 35 per cent in Turkey compared to the peaks reached in summer 2011. Again, in the second half of 2011, the nominal effective exchange rates dropped by 10 per cent in Brazil and India, 15 per cent in Mexico, and 18-20 per cent in South Africa and Turkey, following strong appreciations after 2009 with the recovery of capital flows. Declines against the dollar were even steeper – about 25 per cent in Turkey and between 15 and 20 per cent in the rest.

These declines have partly been reversed at the beginning of 2012 with improvements in the US economy and perceptions of reduced risk of default in the eurozone. In view of continued expansion of liquidity and historically low interest rates in Europe and the US, this upturn may persist, leading to a renewed surge in capital inflows to DEEs. However, continued global economic and financial fragility could tilt the balance and lead to a rapid flight to safety and liquidity well before monetary conditions and interest rates return to normalcy in the US and EU.

In the event of persistent and sharp declines in capital inflows and commodity prices, the most vulnerable countries are commodity exporters with large current account deficits. Other deficit countries such as India and Turkey are less vulnerable because they could benefit from falling energy bills. Even though most deficit DEEs have relatively large international reserves, these are borrowed reserves accumulated from capital inflows, rather than earned from current account surpluses. They have thus their counterparts in equally large net foreign exchange liabilities, often in the form of liquid portfolio flows and short-term loans, which present a potential threat in the event of loss of confidence. The East Asian DEEs with strong current account and reserves positions may not face severe payments and currency instability even in the event of a generalized and rapid flight from emerging economies. However, their financial markets are highly exposed to destabilizing impulses from abroad because of increased foreign presence and closer integration into the international financial system, as seen during the Lehman collapse. In both deficit and surplus countries, the consequent damage could be more severe since the reversal may last much longer and the policy space in responding to renewed instability and downturn is now significantly narrower.

These latent destabilizing and deflationary impulses are already weighing down on the outlook in DEEs. The latest (January 2012) projections by both the World Bank (2012a) and the IMF (WEO 2012 January Update) have Europe going into a mild recession in 2012 and global growth falling below 3.5 per cent in PPP or some 2.5 per cent in constant dollars.

EIU (2012) projects 1.8 per cent growth in world output at market exchange rates for 2012, gradually rising to 2.3 per cent by the middle of the decade. IMF downside scenario for deepened financial instability and severe recession in Europe puts global growth in 2012 at below 2 per cent in PPP.

It now appears that growth in emerging economies has passed its apex. Current projections by the World Bank (2012a) and the IMF (WEO 2012 January Update), put growth in China at less than 8.5 per cent in 2012 for the first time since 2002. The Chinese government has now lowered the growth target for 2012 to 7.5 per cent, half a per cent below the targets set in the previous seven years, with an export growth target of 10 per cent. Although such targets have generally been exceeded in the past, this reflects the recognition of the difficulties faced in sustaining rapid growth and the need to improve its quality (The Economist 2102; Xinhuanet 2012a and 2012b). Growth could be much lower if exports and/or investment falter. According to the IMF (2012), a deep recession in Europe could bring China's growth to some 4 per cent in the absence of a strong domestic policy response. Again, it is estimated that with zero growth in property investment, ceteris paribus, GDP growth in 2012 could fall to 6.5 per cent, but with a 10 per cent decline, it could come down to 5.3 per cent (Chovanec 2012). On some accounts the crisis has not yet hit China. When it does, the slowdown can be much more severe, with growth coming down to 3 per cent and even less by 2015-16 (Pettis 2011a, 2012). A recent report jointly produced by the World Bank and Development Research Center of the State Council of China (World Bank 2012b) also warns of the risk of a rapid deceleration and crisis but argues that China can maintain over 8 per cent growth until 2015 and between 6 and 7 per cent in the coming two decades, provided that it undertakes the reforms recommended in the report and that it can avert the risk of hard landing in the short–term with counter-cyclical measures supportive of long-term structural reforms. It appears that, these contrasting prognostications differ not so much in the risks facing China but its ability to give appropriate and timely response and the nature of the reforms that need to be introduced.

According to recent projections, India may barely reach 7 per cent instead of climbing to China-like double-digit rates as previously intended by its policy makers. The Indian government is reported to be planning a fiscal stimulus for FY2013 to jumpstart the economy (Lamont 2012). After reaching an Asian-like rate of 7.5 per cent in 2010, Brazil is rapidly decelerating and seems to be poised to go back to its historical average of some 3 per cent. This is also true for the other major economies of Latin America, Argentina and Mexico, with projected growth rates under 4 per cent. Turkey is coming down sharply from 8-9 per cent towards 3-4 per cent and South Africa seems to stick to its paltry recovery from the 2009 recession with a similar growth rate.

IX. CONCLUSIONS: RECONSIDERING POLICIES AND STRATEGIES

Developing countries face two interdependent challenges which call for rethinking of their development policies and strategies. First, in the immediate future, they face the risk of a significant drop in their growth rates which can be quite severe if Europe falls into a deep recession, bringing down the US. Second, over the medium term, DEEs cannot go back to the pace and pattern of growth they enjoyed during the subprime expansion and since 2009 even if AEs succeeded in recovering fully and settling on a rigorous and stable growth path.

DEEs now have narrower policy space for a countercyclical response to deflationary and destabilizing impulses than they had after the Lehman collapse. In many emerging economies fiscal and external imbalances have widened significantly in the past few years. Nevertheless, they need to deploy all possible means to prevent a sharp slowdown of economic activity and a hike in unemployment. Many DEEs, notably in Latin America, have some space in trade policy since their bound tariffs are above the applied tariffs, but the margins are generally quite narrow for the majority of DEEs. A way out would be to invoke, as a last resort, GATT (and GATS) balance-of-payments safeguard provisions, designed to address payments difficulties arising from a country's efforts to expand its internal market or from instability in its terms of trade. If used judiciously, such measures would not necessarily restrict the overall volume of imports but their composition. Selective restriction of non-essential, luxury imports, as well as of imports of goods and services for which domestic substitutes are available, could ease the payments constraint and facilitate expansionary macroeconomic policies by allowing to increase imports of intermediate and capital goods needed for the expansion of domestic production and income.

Provision of adequate international liquidity by multilateral financial institutions could naturally alleviate the need for restrictive trade measures, even though it would not be wise for many DEEs, notably poor countries, to use such liquidity for importing non-essential goods and services. This could be done through a sizeable SDR allocation, in proportion to the needs, not the IMF quotas of DEEs, or lending without pro-cyclical conditionality. Liquidity provision by multilateral institutions should be designed to support income, trade and employment in DEEs, rather than international creditors to them. This means that in the event of continued and large outflows of capital, countries should be prepared to impose exchange restrictions and even temporary debt standstills, and these should be supported by the IMF through lending into arrears.

China cannot introduce another massive investment package to maintain an acceptable pace of growth without compromising its future stability. Any counter-cyclical policy response should be consistent with the longer-term adjustment needed to maintain rigorous growth and should address the underlying problem of underconsumption. An immediate increase in private consumption could be achieved through large transfers from the public sector, especially to the poor in rural areas, and sharply increased public provision of health and education – the former would raise the purchasing power of households and the latter would help reduce precautionary savings. These expenditures and income transfers can be financed by dividend payments by state-owned enterprises, thereby simultaneously curbing excessive investment. China also needs to raise the share of wages in GDP a lot faster than is promised by recent measures in order to shift to a consumption-led growth path (Akyüz 2011a).

Through its growing demand for commodities China is already playing a key role in growth in commodity-dependent economies. However, it is not an important market for exporters of manufactures. At present, the size of its consumer market is less than 20 per cent and its total (direct plus indirect) imports for consumption is less than 10 per cent of those in the US even though Chinese GDP is around 40 per cent of the US GDP. This is not only because of exceptionally low share of household income in GDP and a high household savings rate, but also extremely low import content of consumption. Therefore, to provide an important market for DEEs, China needs not only to raise the shares of wages and household income in GDP and lower precautionary savings, but also to increase the import content of consumption.

A shift to wage-cum-consumption-led growth does not mean that China ceases to be a major exporter of manufactures to finance its growing imports. Even though an important part of the increased consumption demand might be met by domestic producers, such a shift would entail a significant increase in imported manufactured consumer goods. China also needs to export manufactures in order to finance its growing commodity imports which have now reached almost 10 per cent of GDP, and imports of capital goods from more advanced economies. In other words, a shift to consumption-led growth by China may not significantly reduce the share of imports and exports in GDP. These may in fact remain at much higher levels than would be expected for such a large economy.

For other DEEs policy challenges vary, but they are all linked, one way or another, to accumulation and productivity growth. Commodity exporters in Latin America have little control over the two key determinants of their economic performance, namely capital flows and commodity prices, and their main policy challenge is how to break out of this dilemma and gain greater autonomy in growth. They need to reduce dependence on foreign capital. Even though the Latin American wealthy receives a greater proportion of national income than those in Asia, they save and invest a much lower proportion of their incomes. Low levels of investment and productivity growth are the main reasons for Latin American deindustrialization, somewhat aggravated by recent booms in commodity markets and capital flows. In Brazil the need for reversing this process and moving into high-tech manufacturing is widely recognized, but it seems that the country is poised to deepen its dependence on commodities by pinning its hopes on oil in the deep waters of the South Atlantic (Gall 2011). Low public and private investment and high dependence on foreign capital is the very first problem that needs to be addressed, not only in Latin America but also in some exporters of manufactures such as Turkey. As seen in South East Asia, a high rate of savings does not always translate into an equally high level of investment and, as seen in India, a high level of aggregate investment does not necessarily translate into a rapid industrial growth. Overcoming all these difficulties call for targeted public interventions, including a judicious use of macroeconomic and industrial policy tools.

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