GLOBAL ECONOMIC LANDSCAPE AND PROSPECTS

Yılmaz Akyüz [*]

Presentation made at the briefing for developing countries on
Global Trends and Linkages to Geneva Multilateral Processes
13 February 2017, Palais des Nations, Geneva

My presentation today will be in three parts. First a brief account of recent trends in the world economy and the underlying factors. Second and more importantly the medium-term prospects, taking into account systemic problems of growing inequality, structural demand gap and financial fragility on the one hand, and uncertainties in three key economies, the US, Europe and China, on the other. Finally, I will briefly discuss the challenges and policy issues that all these raise for emerging and developing countries at three different levels; policy response to possible external shocks, global economic integration and global economic governance.

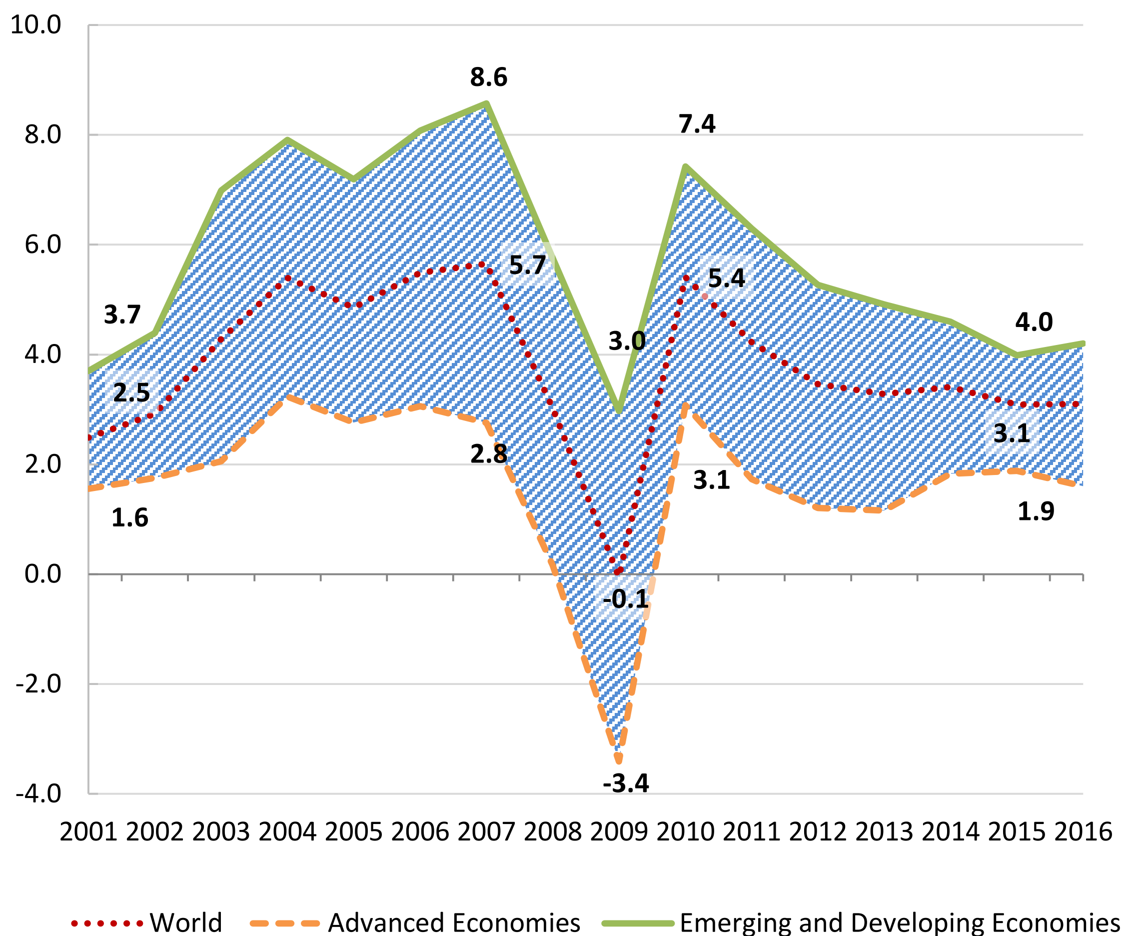
1. Global Trends

Growth in the world economy, North and South

The world economy is in a bad shape. Economic growth is at the lowest level since the crisis and almost half of what it was during the pre-crisis peak. Misguided policies in the US and Europe in response to the crisis, namely fiscal orthodoxy, creditor bailouts, debtors' austerity and ultra-easy monetary policy have played an important part in this state of affairs (SCRP 50). They have not only failed to secure a rapid recovery, but also aggravated the global demand gap by widening inequality, and have increased financial fragility by producing a massive build-up of debt and speculative bubbles in asset markets in several countries, including in the South.

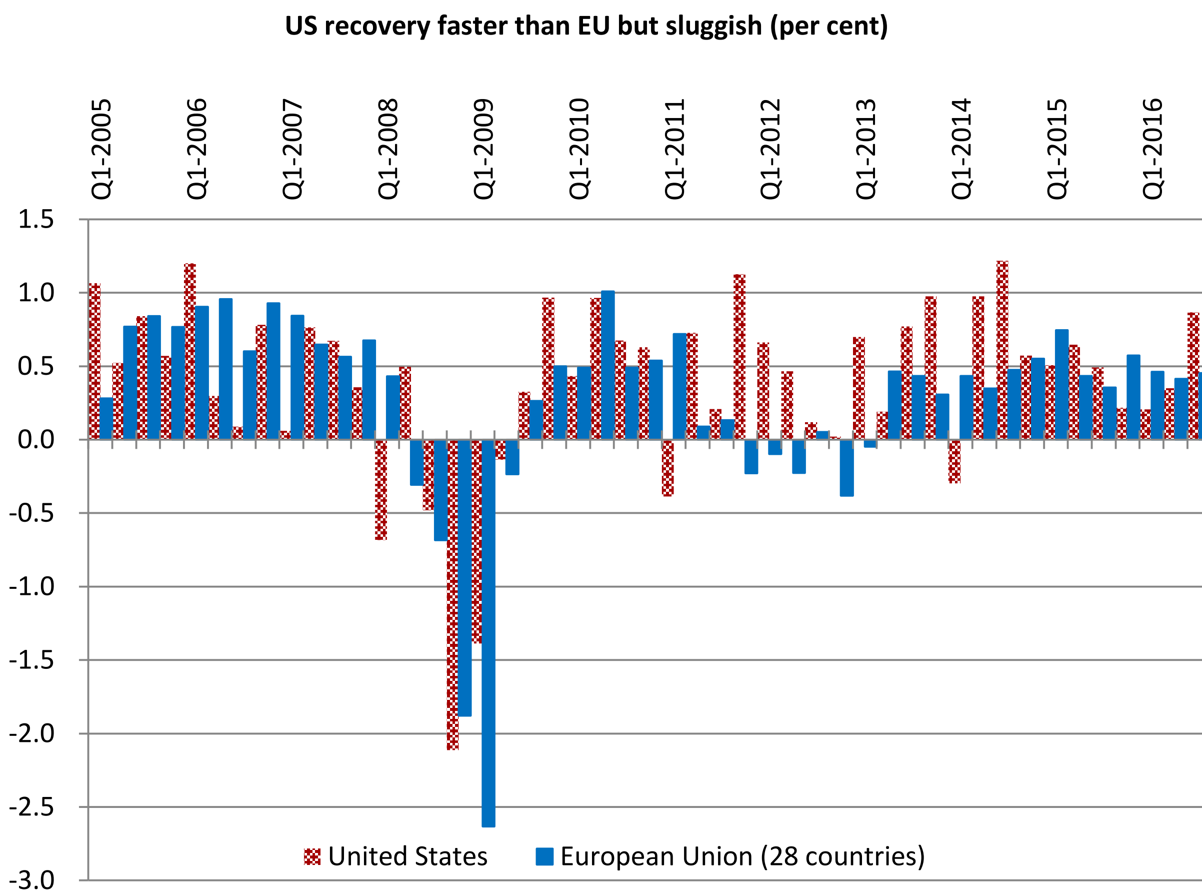
[*] Chief Economist, South Centre, and former Director, UNCTAD, Geneva. Edited version for clarification. Also includes discussion of the issues raised in the general debate.

Global growth lowest since the crisis: Down more in South than in North (per cent)



Source: IMF WEO Database

The US recovery from the crisis has been faster than Europe, but “quite disappointing” in the words of the Federal Reserve chairwoman Janet Yellen – sluggish by historical standards and unbalanced between the poor and the rich, and finance and industry. The employment record of the US is also better than Europe, but labour participation has been declining and many jobs created lack legal protection, health insurance and pensions. While recovery of aggregate income to its pre-crisis level was completed in 2011, real wages and incomes of a large majority of the population have lagged significantly and concentration of wealth has continued to increase. Potential output has been falling due to lack of investment despite historically low interest rates, and productivity slowdown.



Source: OECD Stat

Europe has been unable to resolve its financial crisis let alone economic and social crisis. The Greek debt problem has become chronic. Doubts about the sustainability of monetary union continue unabated. The Eurozone as a whole completed its recovery only in 2016, that is, 5 years after the US, and incomes in several countries are still below pre-crisis levels and not expected to recover in the next several years. Unemployment fell only moderately, from an all-time high of some 12 per cent in 2013, and is still far above the pre-crisis level. In some periphery countries hit by the crisis, it has been higher than the levels seen during the Great Depression. Output gap is greater than in the US and the decline in potential growth is more severe, posing the threat of persistent stagnation over the longer term.

The South is not in a better shape. There is a feeling that the crisis has moved to emerging and developing economies in a third wave after having swept from the US to Europe. These economies had exceptional growth in the run up to the crisis, surpassing growth in advanced economies by an unprecedented 5 percentage points. They also had a rapid

recovery from the 2009 downturn. All these created a widespread belief, promoted by the IMF, that the South had decoupled from the North and several major emerging economies were becoming locomotives for the world economy. However, as was pointed out in a South Centre Research Paper (SCRP 44), rapid growth in the South was due not so much to improved fundamentals such as investment and productivity growth as to exceptionally favourable global economic conditions, notably the twin booms in commodity prices and capital inflows, brought about by policies in the three key economies. When the booms petered out, growth in the South started to converge to the depressed levels of advanced economies. Today it is less than half of what it was on the eve of the financial crisis and the growth differential with the North fell from 5 percentage points to 2 points. Average growth in BRICs now is well below the level recorded at the depth of the crisis and Latin America has been in recession. Africa has slowed down significantly, dashing the hopes that the continent was ready for a major transformation.

International Trade

After growing almost twice as fast as world income, at an average rate of some 6 per cent during 1995-2005, world trade has slowed considerably, now barely matching the growth in world income. This has been creating panic in the neoliberal camp that globalization is stalling and protectionism is on the rise. Although protectionism has now become a serious challenge to global integration, the real causes of slowdown of trade in recent years are to be found elsewhere. First, merchandise trade is already liberalized significantly through multilateral, bilateral and unilateral channels and there is no more big-bang liberalization of the kind seen in the South in the past two decades – the last major one was through Chinese accession to the WTO at the beginning of the new millennium. Second, the expansion of global supply chains has lost its initial momentum after the surge in the 1990s and early 2000s. Third, the slowdown in investment is a major reason for the slowdown in international trade because investment has higher import content than consumption, particularly of services which account for a large proportion of private spending. Fourth, there has been a surge in foreign investment for local markets in some countries, notably by Chinese firms in the US, through takeovers or newly-built capacity with cheap credit. Such market-seeking FDI may accelerate in the coming years relative to cross-border trade with

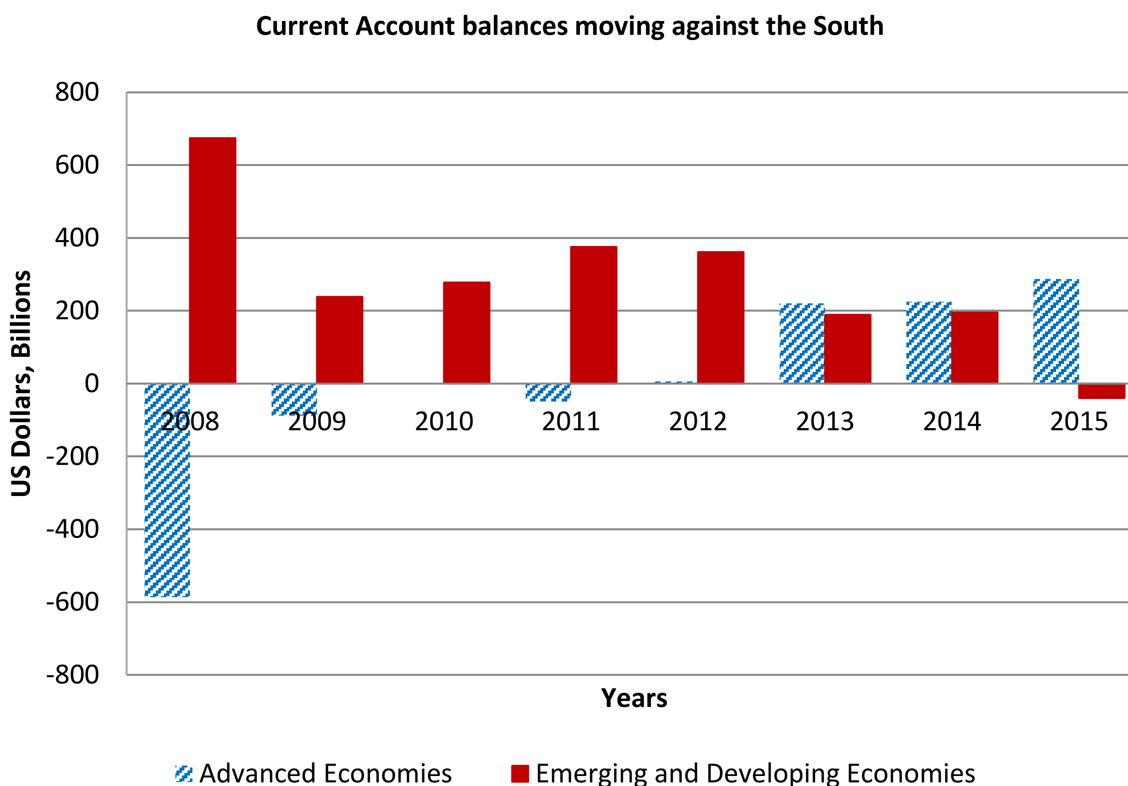
the rise of protectionism in the US. Fifth, the rebalancing of external and domestic demand by China after the crisis has resulted in a slowdown in its imports because Chinese exports are much more import intensive than domestic demand (SCRP 27). Finally, there is significant import substitution in export sectors in China where imported parts and components used for manufactured exports have gradually come to be produced domestically, reducing the import content of exports from 60 per cent in the mid-1990s to around 35 per cent in recent years.

World trade is slowing (per cent)

Source: IMF WEO Database

The slowdown in world trade has been associated with significant shifts in external balances. There are basically three tendencies. First, current account balances have been moving against the South and in favour of the North. On the eve of the crisis in 2008, advanced economies had a combined current account deficit of some $600 billion; they now run a surplus of about $300 billion. Accordingly, the current account balance of emerging and developing economies has shifted from a surplus of $675 billion to a deficit of almost

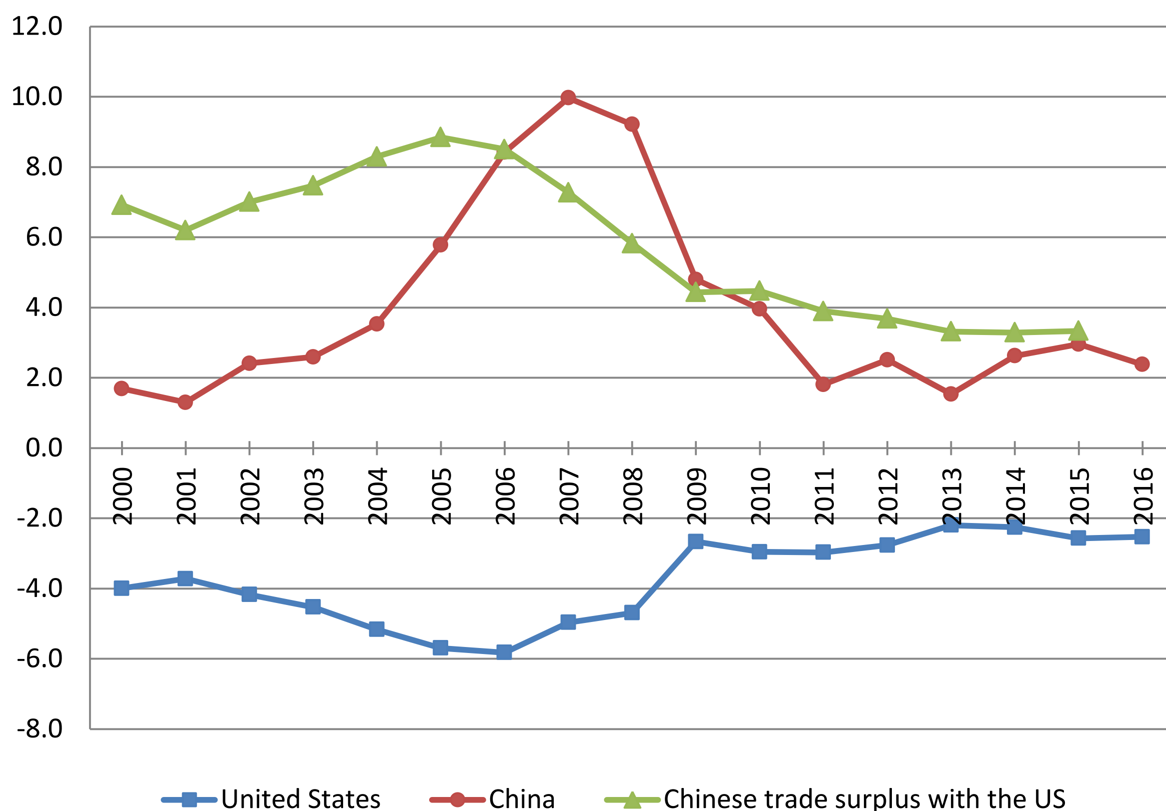
$100 billion during the same period (note that global current account deficits and surpluses do not add up to zero).



Source: IMF WEO Database

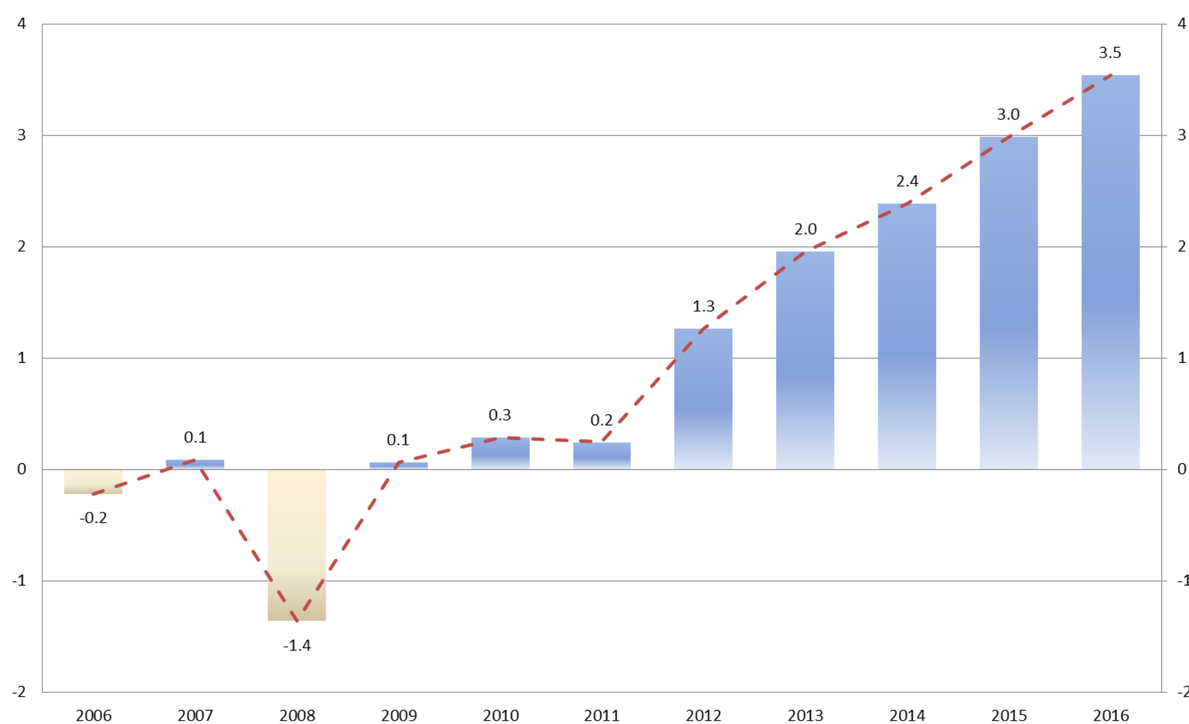
Second, there is a remarkable convergence between US and Chinese current account balances: Chinese surplus fell from a peak of 10 per cent of GDP on the eve of the crisis to around 2 per cent while the US deficit fell from a peak of 6 per cent of GDP to 2.5 per cent over the same period. This convergence has also been associated with a significant decline in the bilateral trade imbalances between China and the US, with China's surplus with the US falling from a peak of around 8.8 per cent of its GDP in 2005 to 3.3 per cent in 2015.

US and China Current Account balances converging (percent of GDP)



Source: US Department of Commerce, IMF WEO Database and World Bank WDI

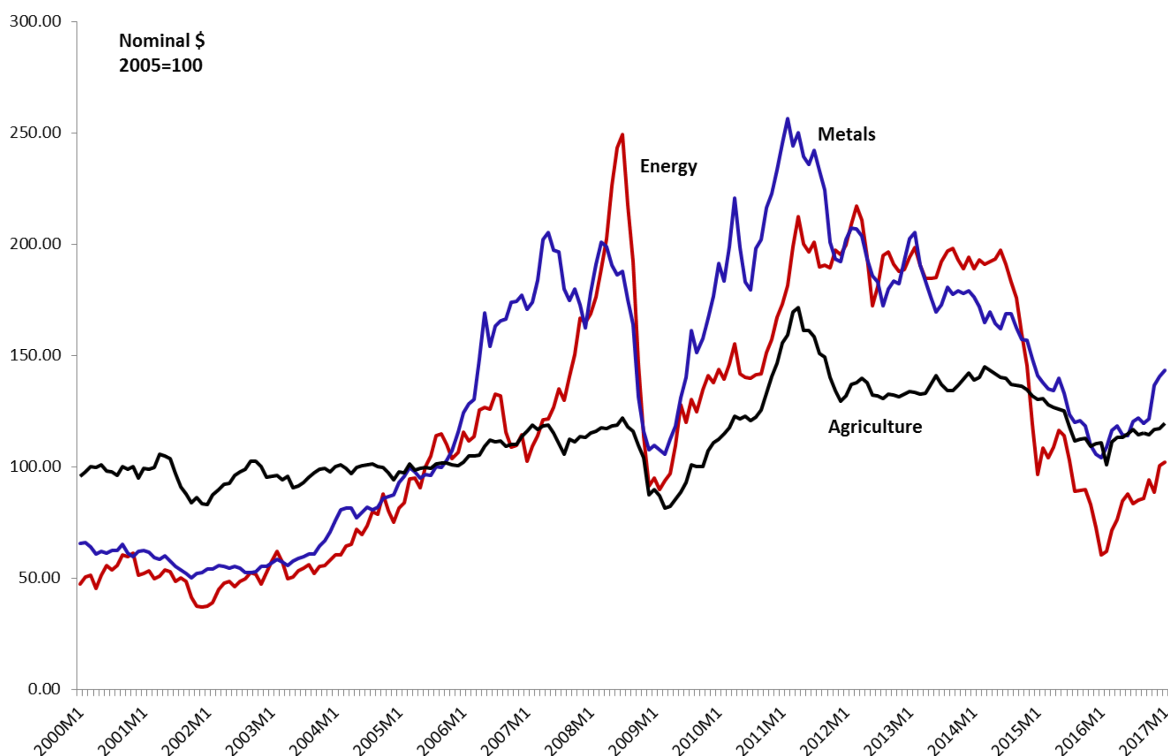
Finally, there is a large shift in the external balances of the Eurozone as a result of austere policies pursued in response to the crisis. The current account balance of the region as a whole has swung by over 5 per cent of GDP since the crisis, from a deficit to a surplus, sucking in demand from the rest of the world and exporting unemployment. Germany is the main culprit; its current account surplus rose from 5.5 per cent of GDP to 8.5 per cent, surpassing Chinese surplus by a large margin. Germany also led the crisis-hit periphery countries to reduce their current account deficits significantly, mainly by retrenching growth and imports.



Source: IMF WEO Database

The sharp decline in commodity prices is an important factor in the swing in current account balances between the North and the South, but it is not the only factor since some non-commodity developing economies have also seen their external balances worsen as they shifted from exports to domestic demand after the crisis. The so-called commodity super-cycle that began in the early 2000s and continued after a brief spell during the crisis came to an end from 2011 onwards. Price declines have been broad-based though much steeper in metals and energy. Slowdown in China and other emerging and developing economies is an important factor – there is two-way causality between commodity prices and growth in emerging and developing economies since these economies provide important markets for each other's commodities. But perhaps an even more important factor is the excess capacity created in energy and metals with cheap credit. Despite the recent recovery driven by the OPEC agreement and the upturn in demand in China, excess supply persists.

The commodity boom is over



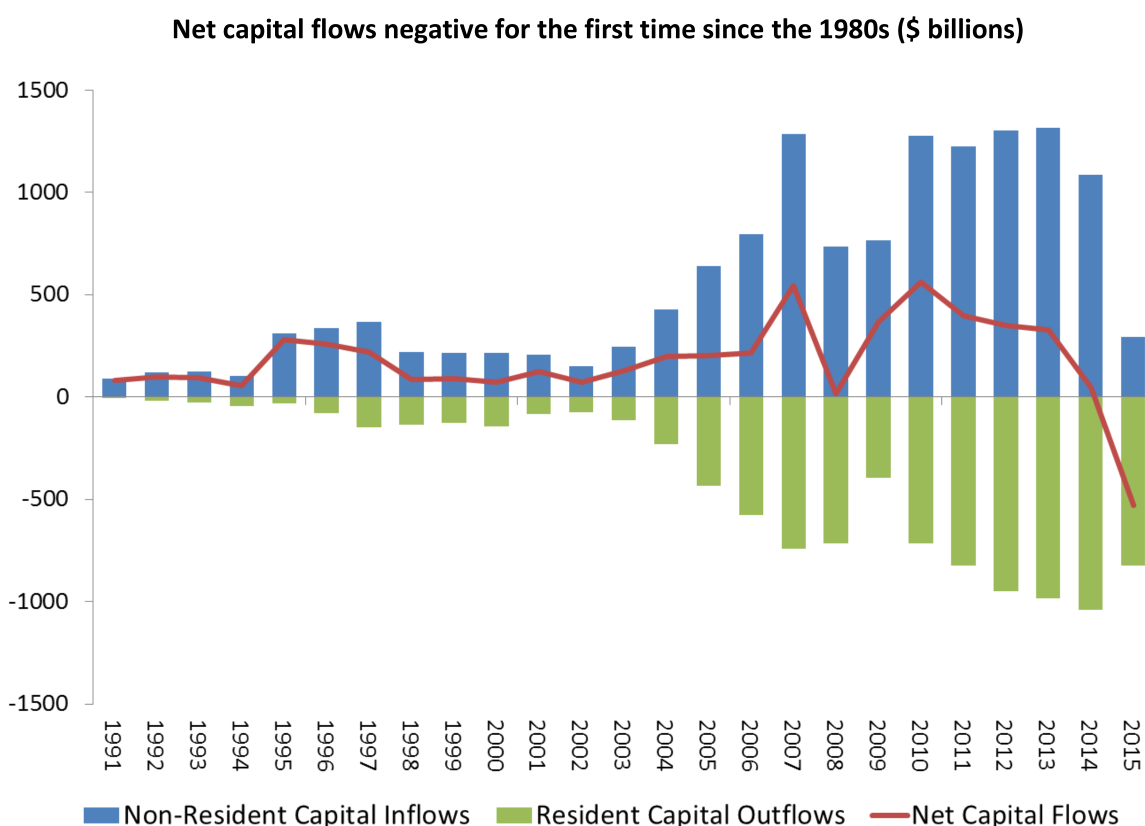
Source: IMF Commodity Price Indices (2005=100)

The impact of commodity price declines on balance-of-payments and growth in the South is negative even though some non-commodity economies such as China, India and Turkey have benefited significantly from price declines, particularly in energy. The impact on global growth is at most neutral and in all likelihood negative – lower prices, notably of energy, are not generating much additional spending in the North, but resulting in deleveraging in heavily indebted commodity sectors and, unlike in previous price declines, sharp cuts in spending in major oil exporters, notably in the Gulf.

Capital Flows to emerging economies

The third post-war boom in capital inflows to emerging economies that started soon after the turn of the century, greatly helped by policies of low interest rates in the US and Europe that culminated in the global crisis came to a brief halt during the 2009 crisis. But it recovered rapidly as a result of the ultra-easy monetary policies pursued in response to the crisis (SCRP 37). However, they have shown significant short-term instability due to changes

in market sentiments and global risk appetite, often driven by news and expectations about shifts in US monetary policy. Despite the recovery in absolute magnitudes, non-resident inflows to emerging economies show a decline as a percentage of GDP of recipient countries in the post-crisis period, from a peak of 8.5 per cent of GDP in 2007 to less than 5 per cent during 2010-14. In absolute terms non-resident inflows remained relatively stable until 2015 while resident outflows rose constantly. When inflows dropped sharply but outflows remained relatively high, net capital flows to emerging economies as a whole turned negative in 2015 for the first time since the late 1980s. They were also negative in 2016 with outflows accelerating after the US election in November.



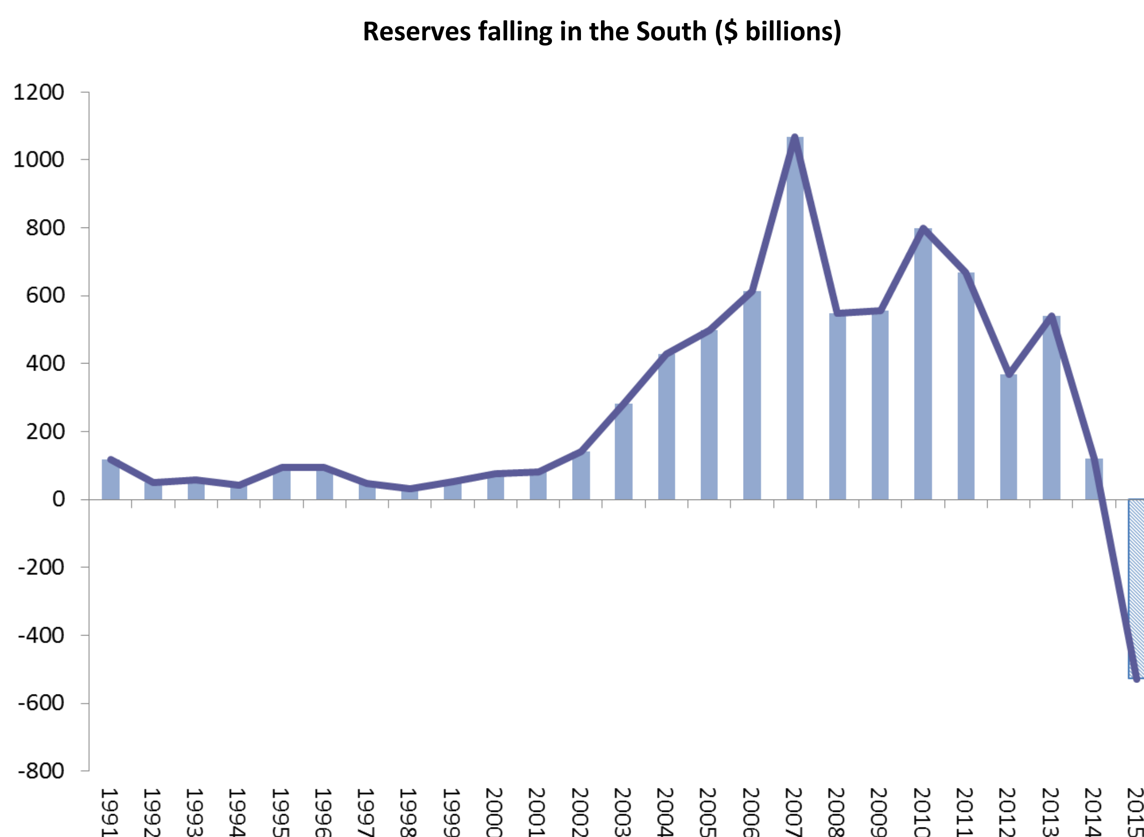
Source: IIF

However, the swing in net flows is due mainly to China – net capital flows in other emerging economies have generally been positive. Outflows from China reached $675 billion in 2015 and $725 billion in 2016. This is driven by two main factors. First, the Chinese firms which had borrowed heavily in dollars at very attractive terms after the crisis started to pay off debt with the prospect of rising US interest rates and weaker yuan. Second, the

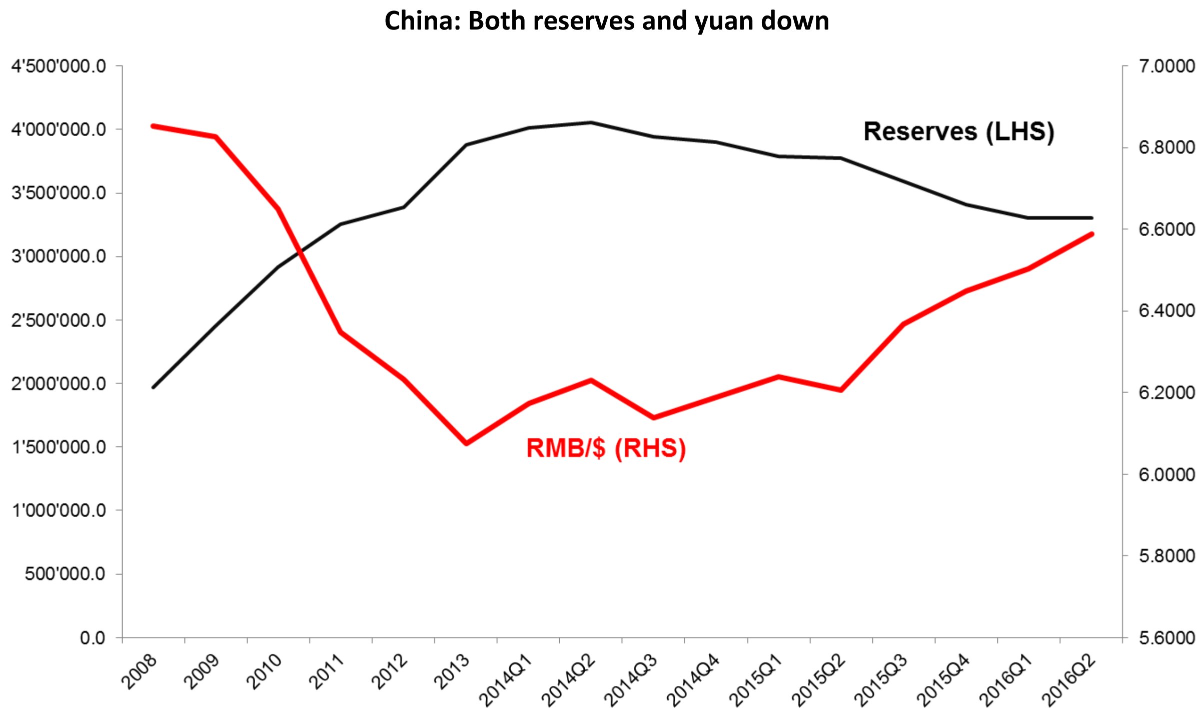
liberalization of resident capital outflows, albeit subject to limits, has resulted in a portfolio adjustment, a shift away from yuan to dollar assets, and this is accelerated by the tendency of the yuan to weaken against the dollar and facilitated by rapid expansion of domestic liquidity.

As a result of the combination of worsened current account balances and declines in net capital flows, reserves in emerging economies as a whole started to fall for the first time since the 1990s, by some $500 billion in 2015 and a similar amount in 2016. But again this is mainly due to China where continued but reduced current account surpluses now fall short of net capital outflows.

Reserves falling in the South ($ billions)

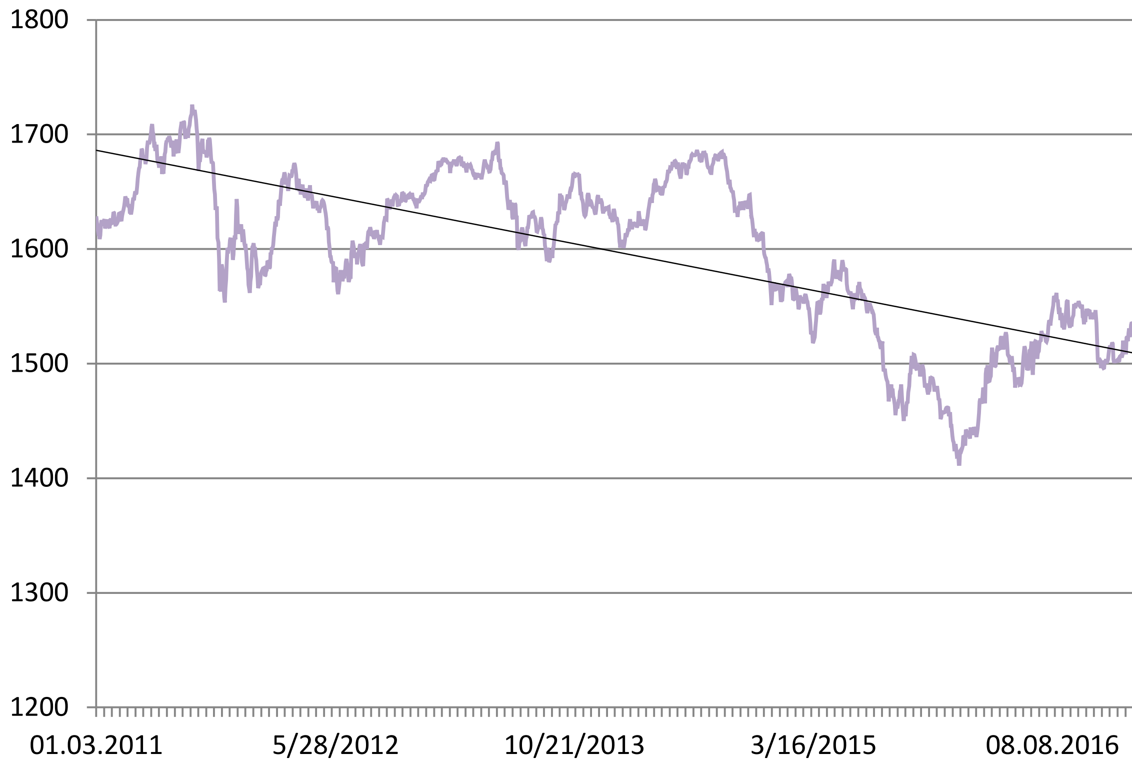


Source: IIF

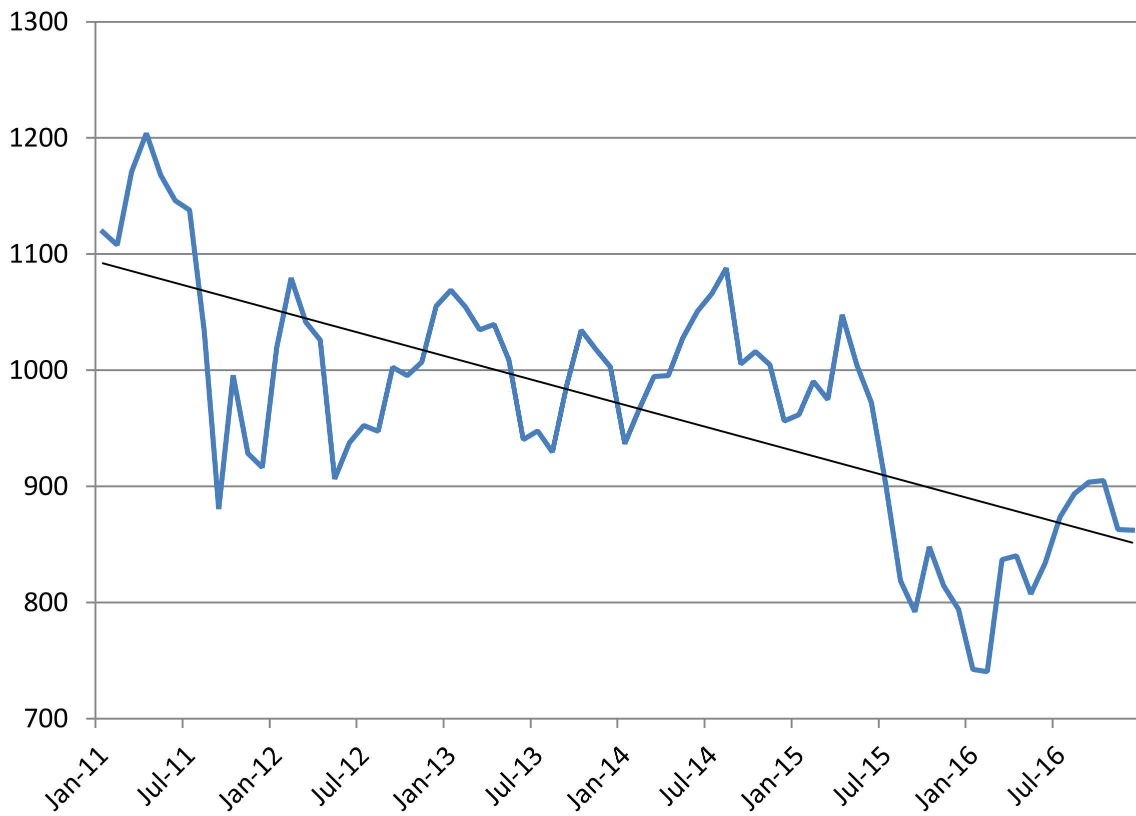


Source: IMF IFS and BOP/IIP

Currency and equity markets of emerging economies have also shown significant instability since 2011 depending on changes in the mood in international financial markets and global risk appetite and capital inflows. Although there have been periods of upward movement, the trend of currencies of most emerging economies has been downward since 2011, with particularly sharp declines in BRICS, Malaysia, Mexico and Turkey. This is also true for equity markets, particularly for prices in dollars.



Source: MSCI



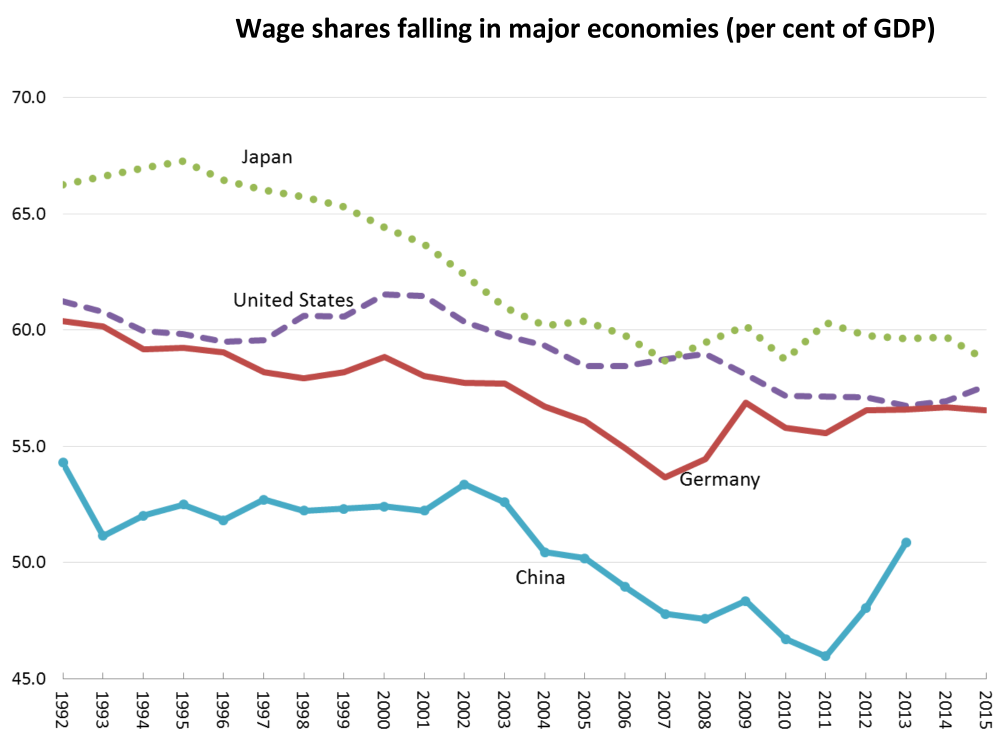
Source: MSCI

2. Global Economic Prospects

The evolution of the world economy over the coming years will depend very much on how systemic and structural problems will play out and on policies and conditions in three key economies, the US, Europe and China.

Inequality, demand gap and financial fragility

The global economy suffers from a deflationary gap because of growing inequality in major economies (SCRP 73). Contrary to the predictions of mainstream economics, the share of labour in national income has been on a downward trend in all major advanced economies including the US, the EU and Japan since the 1970s. This was also the case in China until 2011 when it was reversed thanks to efforts to rebalance external and domestic demand, and investment and consumption. Still, compared to major advanced economies, the shares of wages and private consumption in China are still very low, hovering around 50 per cent and 38 per cent, respectively.



Source: AMECO, European Commission and NBS China

Declining and low share of wages in income, together with increased concentration of wealth and asset incomes at the top means that the purchasing power of workers over the goods and services they produce have been falling, resulting in underconsumption and a structural demand gap in the world economy. This is also the main reason why investment has been sluggish despite historically low interest rates. In other words, rising inequality is not just a social problem but has also become a macroeconomic problem.

Sluggish wages also reduce inflationary pressures and allow and encourage central banks to pursue expansionary monetary policy**.** This is all the more so because, with unrelenting fiscal orthodoxy, monetary policy has become the only instrument left for stimulating growth and employment. In the US, for instance, over the past three cycles the Federal Reserve pushed its policy rates sequentially lower, cutting it more and more during downturns and raising it less and less during upturns, creating a downward bias in interest rates. Thus, there is a remarkable correlation between declining wage share and declining real interest rates**.** Moreover, a strong inverse correlation is found between declining real interest rates and rising debt as a proportion of GDP in major advanced economies. Since rising debt makes it even more difficult for central banks to raise interest rates, wage suppression and growing inequality tend to push capitalist economies into a debt trap.

Countries respond to demand gap resulting from rising inequality in two different ways. First, they create debt-driven spending booms, mainly in consumption and property. The US has done this constantly in the past three decades – first the Savings and Loans bubble in the 1980s, then the technology (dot-com) bubble in the 1990s, followed by the subprime bubble in the new millennium, and now the zero interest rate and quantitative easing bubble created in response to the subprime crisis. Second, they rely on foreign markets to fill the demand gap, generating export surpluses through macroeconomic, labour market, trade and exchange rate policies, as done by Germany throughout the new millennium, and Japan and China before the crisis. Now with Donald Trump the US seems to be striving to join this group.

The problem with debt-driven spending booms is that they often culminate in crises and aggravate the problem of demand gap and stagnation. The boom-bust cycles create supply-

side distortions. Financial expansion crowds out productive sectors and artificially favourable financial conditions sustain many activities that would not be viable under normal conditions. They also redistribute to the top, widening the demand gap. When the crash comes, the economy would need even bigger bubbles to recover and grow. In the US the bursting of the dot-com bubble in the early 2000s was followed by a bigger property bubble and the policy response to the subprime crisis generated even more debt and greater inequality.

Until the crisis China, Germany and Japan all relied on foreign markets to close the demand gap and had GDP growing faster than domestic demand. In relative terms reliance on exports was greater in Germany and Japan than in China which had a strong growth in real wages and domestic demand. Germany suppressed domestic demand and engaged in "competitive disinflation" (internal devaluation) by keeping wages behind productivity and bringing down inflation rapidly relative to its main trading partners both within and outside the Eurozone. After the crisis China rebalanced domestic and external demand and shifted to a debt-driven investment boom. By contrast Germany has relied even more on exports. Now Japan is also seeking export-led growth through Abenomics, by printing money and weakening the yen: at 4.5 per cent of GDP Japanese current account surplus in 2016 was the highest since 2007.

Debt-driven bubbles are part of the problem of stagnation and demand gap rather than the solution. Similarly, for large economies export surpluses cannot provide a sustainable solution since they suffer from fallacy of composition and entail conflicts. To address the demand gap and stagnation it is necessary to rebalance capital and labour, restrain finance and assign a greater role to the public sector in aggregate demand management and income and wealth distribution. However, the dominant neoliberal ideology rules out such socially progressive and economically effective solutions. Consequently, stagnation is likely to remain the new normal in the years to come with governments attempting to reignite growth by creating credit and asset bubbles and/or trying to export unemployment through beggar-thy-neighbour policies, thereby generating financial and economic instability and tensions in international economic relations with significant repercussions for emerging and developing economies.

Economic policies and conditions in the US, Europe and China

Given their importance in international trade, investment and finance, policies and conditions in the US, European and Chinese economies will have significant influence over the course of the world economy and the external economic environment of emerging and developing economies in the coming years. In this respect attention has recently focussed particularly on the US in view of radical policy changes advocated by the newly-elected president Donald Trump.

The United States

It is not clear to what extent the Trump policy mix of tax cuts for high-income groups and corporations, large-scale infrastructure investment, and import taxes and export subsidies could be implemented and with what effects on the US itself or the rest of the world. However, it is generally expected to give a boost to growth in the US, and result in rising public deficits and debt, tighter labour market conditions and faster wage increases. Under these conditions monetary policy is likely to be normalized much faster than hitherto envisaged, producing a steeper path to interest rates. This combination of tight money and expansionary fiscal policy could lead to a significant appreciation of the dollar, as seen during the Reagan years in the 1980s. This tendency would be reinforced to the extent that trade measures improve the US current account balance.

However, different components of this policy mix push in different directions and create counteracting influences on fiscal and trade balances, and growth and employment. The balance of these forces would determine the outcome in these respects. While tariffs would add to fiscal revenues, tax cuts, investment and export subsidies and higher interest rates would increase public deficits and debt. The latter effects may well dominate and rising public debt could start acting as a break over economic expansion, eventually leading to a policy reversal. Again a strong dollar operates on the current account against tariffs and export subsidies, offsetting the impact of trade measures on jobs. The stronger the dollar, the higher the tariffs needed to improve the US current account and fiscal balances, but there is a limit to how much tariffs the US can impose on the rest of the world.

While there is considerable uncertainty regarding the benefits of these policies for the US economy, they can inflict severe damage on the rest of the world. Hikes in US interest rates could trigger global deleveraging and impair growth. Strong dollar and higher US interest rates are anathema to instability and crises in the South through their effects on commodity prices and capital flows. Steeper rise in interest rates can also cause severe disruptions in US financial markets addicted to cheap money for almost a decade. This is why the Fed seems to be uneasy about fiscal expansion.

Tariffs and export subsidies can significantly reduce the benefits that faster US expansion might provide to the rest of the world through trade. The incidence of these depends on how they are designed as well as trade linkages of countries with the US.

The US incurs bilateral deficits in its trade with a large number of countries, large and small. The South account for 60 per cent of US imports and 70 per cent of its trade deficits. China alone accounts for almost half of US trade deficits. However, if measured as a proportion of total trade to allow for differences in the size of the economies trading with the US, differences in trade surpluses with the US narrow significantly. Vietnam tops the list in terms of the surplus it generates with the US per dollar of trade, followed by China. Germany and Japan are also in the top 5. Measured as a proportion of GDP, the top five countries running trade surpluses with the US (receiving the largest demand stimulus from the US relative to domestic economy) are all in the South; Vietnam, Mexico, Malaysia, Thailand and China in that order.

Merchandise trade with the United States: 2015

Country	Total Trade	Exports to US (in Billion $)	Trade Surplus	Exports/GDP	Surplus/GDP (per cent of GDP)	Surplus/Trade (per cent of trade)
China	598.0	482.0	366.0	4.3	3.3	61.2
Canada	575.0	295.0	15.0	19.7	1.0	2.6
Mexico	531.0	295.0	58.0	25.9	5.1	10.9
Japan	204.0	139.0	73.0	3.5	1.8	35.8
Germany	175.0	124.0	74.0	3.7	2.2	42.3
Korea	104.0	62.0	21.0	4.4	1.5	20.2
India	64.0	42.0	20.0	2.1	1.0	31.3
Malaysia	40.0	27.0	14.0	9.1	4.7	35.0
Thailand	38.0	26.0	14.0	6.5	3.5	36.8
Vietnam	30.0	25.0	20.0	13.1	10.5	66.0
EU	*699.0*	*426.0*	*153.0*	*2.8*	*1.0*	*21.9*

Source: Office of the US Trade Representative and WB WDI

Blanket tariffs on all imports, including tariffs proposed as a border adjustment tax (SouthViews) or destination-based corporation tax would affect countries according to the share of their exports to the US in GDP, independent of their trade balances with the US. In this respect Mexico and Canada top the list, followed by three economies in the South, Vietnam, Malaysia and Thailand. However, with the exception of Mexico, the shares of these countries in total US trade deficits are very small compared to China, Germany and Japan. If a blanket tax is used to eliminate the US trade deficit by reducing its imports from all countries, China, Germany and Japan, as well as smaller Asian emerging and developing economies, Vietnam, Malaysia and Thailand, would continue to run surpluses with the US, albeit at reduced levels, while Mexico and particularly Canada would start running large deficits. Such a plan cannot be defended on grounds of adjustment of international imbalances and can create significant frictions in the trading system. Thus, it would not be easy to implement.

On the other hand, country-specific tariffs, such as those mentioned for imports from China and Mexico, would allow new entrants to replace obstructed importers, particularly in areas where the US lacks competitiveness. Clinton's tariffs on import of tires from China did not result in a large increase in production in the US but in imports from other countries. They

also entail other complications resulting from trade interdependencies among exporters to the US. Tariffs on hubs in international production networks such as China and Mexico would also hit their suppliers since their exports are highly import-intensive. In China the average import content of exports is in the order of 35 per cent, mostly parts and components supplied by Japan, Korea and Taiwan (China) and other East Asian emerging economies. This proportion is much higher in processing exports which constitute a very large share of Chinese exports to the US (SCRP 27). Thus, a sharp cut in Chinese exports to the US would hurt East Asian suppliers as much as China itself. Exports from Malaysia, Vietnam and Mexico have even higher import contents than exports from China.

The burden of tariffs also falls partly on profits of TNCs since a relatively important part of the domestic value-added generated by Chinese exports accrue to foreign firms. Again this is particularly the case for processing exports where foreign firms are dominant. In China profits of foreign-owned enterprises, including US firms, account for two-thirds of domestic value-added generated in export sectors. Because of high-import content of exports and high profits by TNCs, China earns no more than $30-$35 from every $100 worth of exports to the US. Thus, about one-third of income losses resulting from the relocation of such firms to the US would fall on China and the rest on its suppliers and the profits of TNCs. In fact since total exports by all foreign firms in China do not cover their total imports and profit remittances (SCRP 63), their exit could improve China's balance of payments.

There are strong arguments that the trade measures proposed by Trump are not WTO-compliant although this may have little practical consequences in view of shortcomings in the WTO dispute system (SouthViews). The US often resorted to currency manipulation argument in threatening its trading partners with protectionism. The current watch list of the US Treasury includes Germany and Japan as well as China. But this is now very difficult to invoke. In China the yuan has been left largely to markets since 2015. Now it is also included in the SDR with a weight higher than that of the yen and the pound sterling, enjoying the blessings of the IMF as a reserve currency. Furthermore, China is now fighting against depreciation rather than appreciation of the yuan. As for Germany and Japan, the monetary policies that push their currencies down are no different from those practiced by the US since 2008.

All these create considerable uncertainty over trade policy measures that may be adapted by the new US administration in the period ahead and their possible effects. However it is quite likely that the US will engineer a reduction in its trade deficit – be it through unilaterally imposed tariffs or self-restraints by exporters or agreements on voluntary export restraints with surplus countries of the kind that it imposed in the 1980s and 1990s.

Europe

Even without further shocks and disruptions, Europe does not promise much growth or stability in the years ahead. Policy has allowed the crisis to inflict a permanent damage on the potential of the Eurozone to grow. The region is financially highly fragile. Too many banks have been allowed to survive the crisis and many of them are now infested with bad debt. The spectre of Grexit has not gone away. The country's debt is clearly unsustainable but its European creditors are refusing to write-off debt, pushing the country to the brink of default. There is no agreement between the EU and the IMF on how to remove the debt overhang, but both are imposing austerity on the country which has already lost over a quarter of its real income since the beginning of the crisis, as much as the US during the Great Depression.

The Brexit is another major source of concern for stability and growth in the region. The political tug of war between the two sides may well amplify the global fallouts from the separation by creating significant tension and instability in currency and financial markets. Matters could be made much worse by economic shocks from the US and political shocks from forthcoming elections in a number of major European countries. Before fully resolving the crisis that started 8 years ago, Europe may thus face another one, sealing the end of the monetary union. Even if European integrationists come to power in two key countries, Germany and France, it would take years to repair the damage inflicted by misguided policies and put Europe on the right track.

China

China suffers from over-indebtedness and underconsumption and the jury is still out on whether it can avoid financial turbulence and growth collapse. After the crisis it moved away from exports towards greater reliance on domestic demand. However, rather than boosting household incomes and private consumption, it focused on a debt-driven boom in investment, pushing its investment ratio towards 50 percent of GDP and credit growth well ahead of GDP, creating excess capacity and a debt overhang. Efforts since 2011 to raise household and wage incomes and rebalance domestic investment and consumption, and services and industry have yielded some results, but not enough to provide a sound basis for sustained expansion in economic activity. In fact as the economy started to falter and instability in currency and equity markets heightened, China has turned once again to a debt-driven investment bubble in order to boost short-term growth at the expense of aggravating structural imbalances.

After hovering over ten per cent from the early 1990s until the crisis, growth in China has started to slow rapidly since 2010 falling steadily to less than 7 per cent, once seen as the minimum socially acceptable rate. The slowdown appears to be structural rather than cyclical, reflecting a decline in the potential growth rate. For reasons on both demand and supply sides, the deceleration of Chinese trend growth can be expected to continue in the years ahead, possibly dropping to less than 6 per cent in the coming decade. Demand is likely to remain relatively sluggish because of slow progress in raising the shares of household incomes and consumption, the growing debt burden and limits on export expansion. US protectionism may also accelerate the decline in growth, though not as much as commonly believed for the reasons already mentioned. On the supply side investment is concentrated mainly in traditional, low-productivity, capital intensive sectors in an attempt to boost growth and create jobs rather than secure productivity gains.

Many observers draw a close parallel between the conditions in China today with those in the US on the eve of the subprime crisis and project a similar financial crisis. It is true that debt-driven bubbles jeopardize the prospects of making a soft landing to a lower but sustainable growth path in China. However, a Lehman-type meltdown is highly unlikely in

view of close public control over creditors (banks) and debtors (state enterprises and local governments). On the other hand, global spillovers from a financial turbulence in China can be expected to remain much more limited than those from the subprime crisis. The international financial system is not very much exposed to Chinese banks as they are to US banks. The vulnerability of emerging economies to financial instability in China is also limited since these economies do not have large volume of assets and liabilities in yuan. Nevertheless, turbulence in Chinese financial markets can have a strong impact on global risk appetite with attendant consequences for capital flows to the South.

3. Challenges and policy issues for the Global South

Even in the absence of renewed external trade and financial shocks, emerging and developing economies are unlikely to show a strong growth performance in the years ahead because of their weak underlying growth fundamentals, investment and productivity. On the other hand, their resilience to external shocks is generally weak, particularly in comparison to those from the sub-prime crisis.

The significantly deepened integration of many of these economies into the international financial system in the new millennium has resulted in new vulnerabilities and heightened their exposure to external financial shocks (SCRP 60). There has been a massive build-up of debt by their non-financial corporations since the crisis, reaching $25 trillion or 95 per cent of their GDP. An important part of this is in dollars and hence carries significant interest rate and currency risks. On the other hand, the presence of non-residents in local financial markets of these economies has reached unprecedented levels, increasing their susceptibility to global financial boom-bust cycles.

Second, many countries in the South have seen a significant deterioration in their current account balances and net foreign asset positions since the crisis. In most countries international reserves built up in recent years came from capital inflows rather than current account surpluses. They are thus “borrowed” rather than “earned” reserves – they have their counterparts in increased liabilities to non-residents in one form or another, and are inadequate to meet large and sustained outflows of capital.

Finally, they have limited macroeconomic policy options in responding to deflationary and destabilizing impulses from abroad. Their fiscal space for countercyclical policy response to deflationary shocks is much more limited today than in 2009. There is also a significant loss of monetary policy autonomy and loss of control over the whole spectrum of interest rates as a result of their deepened global financial integration. Flexible exchange rate regimes adopted in many emerging economies since the last bouts of crises are no panacea in the face of severe and sustained financial shocks, particularly in view of currency risks assumed by non-financial corporations.

Briefly, most emerging and developing economies have not only lost their growth momentum but find themselves in a tenuous position with an uncanny similarity to the 1970s and 1980s when the combined booms in capital flows and commodity prices that had started in the second half of the 1970s ended with a debt crisis as a result of a sharp turnaround in the US monetary policy, costing them a decade in development. It would now be difficult for some of them to avoid an international liquidity crisis and even a debt crisis and collapse of growth in the event of severe financial and trade shocks.

This state of affairs raises three sets of policy issues for the South. The first one concerns the policy response to severe balance-of-payments shocks. In this respect they would be well advised to avoid “business as usual”, hiking interest rates, using reserves and borrowing from the IMF to maintain an open capital account and stay current on debt payments to foreign creditors, socializing private liabilities, and resorting to austerity. Rather, they should seek to bail in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills and use selective import controls to safeguard economic activity and employment. They would also need to push for action at the multilateral level in support of such policies through provision of adequate international liquidity without deflationary conditionality and protection against creditor litigation.

Second, there is a need for rethinking global integration. Emerging and developing economies have allowed too much room for global market forces to drive their development, relying excessively on foreign markets and capital, and TNCs. In many economies income and wealth are highly concentrated but there are little savings and

investment by the rich, and hopes are pinned on foreign investors to come and lift the economy. The pendulum has swung too far and would have to be rebalanced, and this requires putting one's house in order in the first place. One of the key lessons of history of economic development is that successful policies are associated not with autarky or full integration into the global economy, but strategic and selective integration suitable to the stage of economic development reached, seeking to use the opportunities that a broader economic space may offer while minimizing the potential risks it may entail.

Many merging and developing economies are bewildered by the popular backlash against globalization in the North. This should not have come as a surprise. It is the outcome of inequalities, instabilities and insecurities produced by global integration driven by corporate interests. This was warned during the heydays of globalization in the 1997 Trade and Development Report (TDR) of UNCTAD which argued that the resolution of inequality in the North was *"essential for defusing the threat of a popular backlash against globalization, which might put the gains of global economic integration at risk."*

What is more surprising is that several emerging and developing economies have been more than willing to join arrangements such as the TPP designed mainly to promote the interests of TNCs, or that backlash against NAFTA did not come from Mexico which has had a poor performance in growth, wages, poverty reduction, productivity and total and manufacturing trade balances since its inception. It is striking that both Mexico and the US could claim that they lost from NAFTA. The question is often posed whether international trade and investment are a zero-sum game among nations, but they are rarely seen as a negative-sum game. But nations are not the correct focus here; it is not nations that lose or gain, but different segments of population – corporations, bankers, workers, farmers etc. So perhaps we should move from a nations-based analysis of the impact of globalization to a class-based analysis to understand the popular backlash.

Finally, the challenges that emerging and developing economies now face raise once again the question of global economic governance – reform of the international trading and financial architecture so as to prevent beggar-my-neighbour policies of major economic powers, to reduce exposure of the South to external shocks, and to introduce adequate

mechanisms for the prevention and effective management of financial crises with international origins and consequences. Several ideas for reform have been advanced in the past three decades in these areas, including the multilateral policy surveillance; governance of international financial institutions; the international reserves and exchange rate systems; regulation of international finance and capital flows; statutory debt workout mechanisms; and mechanisms for the provision of adequate amounts of international liquidity. Although some of these have found their way from time to time into the international agenda, particularly after bouts of virulent crises, hardly any action has been taken to bring them to conclusion because of opposition of major advanced economies.

The global South has not been very effective in pursuing these matters and suffers from a collective action problem. Political solidarity and a common reflection may be needed among them about the policy response against the next major turmoil and in setting priorities and the agenda for change in the global economic governance. But the G77 as a group lacks a strong secretariat to support and coordinate their efforts. UNCTAD is increasingly impaired in pursuing the interest of developing countries and the South Centre has limited capacity. The G20 is increasingly captured by the OECD and the BWIs and developing-country groupings such as BRICS or other South-South organizations are inward-looking, shying away from systemic issues and reform of global economic governance. However, the stakes are getting too high now to continue with business as usual.