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Effects of crisis & recovery on South countries

A view of the audience during the South Centre conference.

Below is a report of the presentation of economics professor Dr. Deepak Nayyar at the South Centre Conference in Geneva. He addresses the situation of developing countries in the aftermath of the financial crisis, while focusing on their real economy variables.

By Kinda Mohammadieh

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Dr. Deepak Nayyar, emeritus professor of economics at Jawaharlal Nehru University and member of the South Centre's board, addressed the situation of developing countries in the aftermath of the financial crisis, while focusing on their real economy variables. He noted that developing countries on the whole have fared better than industrialized and transition economies in the aftermath of the crisis. Yet, some high-income emerging economies that depend on exports to the United States and the European Union were hard hit, Nayyar noted. In contrast some large developing countries did not fare badly. For example, the growth performance of Sub-Saharan Africa and some least developed countries has been robust.

Dr. Nayyar explained that the impact of the global crisis was less adverse due to four factors, including the robust initial conditions before the crisis, specifically macroeconomic stability, moderate inflation, and large foreign exchange reserves combined with economic growth. All of these factors provided for structural stability at macro and micro levels, Nayyar noted. Other factors include the fact that the financial liberalization was somehow restrained in many developing countries, safety nets for the poor and vulnerable were in place, and domestic consumption was helpful in many of the large economies.

Professor Nayyar noted that the economic recovery of most developing countries was faster for three reasons. First was the fact that they adopted expansionary countercyclical macroeconomic policies, which have been unusual till then in the developing countries. Their response to the crisis was effective and fast. Second, the size of the home market made a difference, and the increase in demand came from segments of the population with a high propensity to consume. Third, the financial sectors were less fragile and more regulated than elsewhere, and did not absorb scarce resources from stimulus packages or bailouts. Easy monetary policies in these countries meant lending to the real sector, Nayyar underlined.

Generalizations are difficult when the underlying factors are different, Nayyar cautioned. Yet, there is little doubt that initial conditions, policy responses, and domestic demand shaped resilience, Nayyar added, while prudence in deregulation and liberalization of financial sectors made a difference along with fiscal space available to governments.

The significant increase in the share of developing countries in world income and trade meant that there were external resources and markets available to them, other than the industrialized countries.

This performance of several emerging economies led some analysts to the wrong conclusions, whereby they proposed that these countries could drive the recovery in the world economy, Nayyar cautioned. Yet, the ‘decoupling’ theory does not hold, Nayyar stressed. It is clear that these countries cannot turn into engines of growth for the world economy, and none of these countries could provide resources for development, finances for investment, or needed technologies as Britain did in the 19th century and the United States did in the 20th century, he added. Thus, the prospects and pace of recovery in the world economy depends on the pace and nature of recovery in the industrialized world, particularly in the United States.

Nayyar noted that recovery has been slow, uneven, and fragile, and prospects uncertain. It would seem that the problem has been compounded by the return to orthodox economic policies everywhere, he added. The United States and Japan seem an exception, whereby there is a recovery in output but not much in employment. In the European Union countries, decisions to sharply reduce fiscal deficits are being implemented. Nayyar noted that he sees those approaches as possibly turning out worse than the problem.

Many of the large developing countries, and the so-called ‘emerging economies’ such as Argentina, Indonesia, Turkey, China and others have experienced slowdown in growth attributed to the great recession in the developed economies, Nayyar explained. For China, the slow recovery in the United States and recession in the European Union have been challenging factors, given that exports to those markets were critical for China.

However, the slowdown in other larger developing countries is attributable significantly to their own mistakes, Nayyar stressed. Macroeconomic policies are back to being pro-cyclical, high interest rates have stifled investments, attempts to reduce fiscal deficits have curbed public spending and domestic demand, strong exchange rates to sustain portfolio investment flows have effected export performance, and the dependence on these inflows of capital is currently greater. Nayyar pointed out that given this reality, it is not a surprise that the

announcement of the phase-out of monetary easing in the United States is having such strong impact on these economies.

Again, these recent developments have led some analysts to hasty conclusions. In August 2013, Morgan Stanley presented Brazil, Indonesia, South Africa, Turkey, and India as the 'fragile five' economies, for they were too dependent on foreign capital inflows to finance their current account deficits and support their growth. Soon after, an asset management firm in Boston called 'Fidelity' coined the term 'MINTs', standing for Mexico, Indonesia, Nigeria, and Turkey. According to 'Fidelity', the 'MINTs' are emerging economies with a promising future since the BRICS (i.e. Brazil, Russia, India, China and South Africa) were running out of steam. Interestingly, Indonesia and Turkey feature in both groupings. It is clear that such thinking is shaped by the conjecture and framed in the shorter-term perspective, Nayyar stressed.

In the medium-term perspective such thinking is inappropriate, if not misleading, Nayyar stressed. He pointed out that in contemplating the future of the world economy, it is essential to focus on a larger group of developing countries and a longer-term perspective rather than the next quarter or next year. The time horizon to consider should be 2025 instead of 2015, according to Nayyar.

Nayyar underlined that there is much that developing counties can do in terms of correcting their policies; they could redefine macroeconomic objectives and policies to make employment and growth the central objectives rather than focusing on managing inflation. They could also recognize that external markets are at best complements rather than substitutes to domestic markets. They could also begin to correct market fundamentalism and recognize the role of the state as critical for recovery and sustained growth.

In regard to the future prospects for larger developing countries, assuming that these corrections are introduced, Nayyar noted that there is potential for growth but with real constraints. The determinants of potential growth in developing countries are a source of good news, according to Nayyar, and in principle these countries could sustain high rates of growth for some time. These determinants include their population size that is large and income levels that are low. Thus, possibilities of growth are greater. Moreover, their high proportion of young people means that the increasing workforce is conducive to growth provided education spreads across society. Furthermore, their wages are significantly lower than the rest of the world, which is an important source of competitiveness.

In practice, the developing world will not be able to realize this potential due to constraints that may differ across space and time, Nayyar cautioned. There are some general constraints such as poor infrastructure, weak institutions, inadequate education, unstable politics, and poor governance. There are constraints that may arise from the process of growth such as economic exclusion, social conflict, and environmental stress. There are other constraints that are external, such as worsening terms of trade, inadequate sources of external finance, restricted market access, possible crisis in the world economy, in addition to other country specific constraints.

Nayyar stressed that developing countries need to introduce correctives in the management of their economies, although this is easier said than done. The biggest challenge lies within, beyond policies and institutions that are the focus of conventional wisdom, Nayyar noted.

Nayyar called upon developing countries to address problems of rising inequalities that could be the dominant constraint on growth in the future. They must ensure that benefits of economic growth are distributed more equally among peoples across and within countries.

Nayyar cautioned that economic growth could not be sustained in the long-term if it does not

improve the living conditions of ordinary people. This is the only sustainable way forward because it will enable them to mobilize people for the purposes of development and reinforce the process of growth through a virtuous cycle of cumulative causation, recognizing that there is an interaction between the supply and demand sides. Wages could be seen as costs on the supply side, which is what orthodoxy chooses to focus on, Nayyar noted. But wages are also incomes on the demand side that could drive growth, Nayyar stressed. He called for combining economic growth with human development and social progress.

In this process the real checks and balances come from political democracies. Nayyar concluded that in contemplating the future of developing countries, there is need to concentrate on a larger group of developing countries and not only emerging economies, think of longer-term horizons, and shift the focus from short-term equilibrium to longer-term growth and from the financial sector to the real sector of the economy.

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Author: Kinda Mohammadieh is a Researcher at the South Centre. Contact: mohamadieh@southcentre.int.

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For more information, please contact Vicente Paolo Yu of the South Centre: Email yu@southcentre.int**, or telephone +41 22 791 80 50.**