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South facing unfavourable global conditions; rethinking growth strategies is imperative

The high-growth performance of many developing countries in 2003 to 2008 and then their quick recovery from the 2008-9 global financial crisis was largely due to favourable external conditions, including the policies in developed countries. (This was analysed in the previous issue of South Bulletin). However, these conditions do not exist today and in fact the global conditions have turned unfavourable. Hence developing countries are now facing serious vulnerabilities and risks to their economic situation, with each category of countries facing their own specific problems. Developing countries have to consider changing their growth and development strategies, in light of the changing global situation. .

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There are a number of reasons to believe that the forces that have been driving growth in developing and emerging economies (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 advanced economies (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. 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).

RISKS AND VULNERABILITIES NOW FACING DEVELOPING COUNTRIES

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 (see graphs). India has seen FDI disappear and even China is reported to have experienced net capital outflows during October and 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.

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 Developing and emerging economies 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 2012; 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.

RECONSIDERING POLICIES AND STRATEGIES IN THE SOUTH

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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