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What Explains the South's Recent High Growth — And Can It Continue?

Recently there emerged a view that developing countries had "de-coupled" their economies from the developed countries and had taken off to a path of high growth. But this is an overly-optimistic view. This article by the South Centre's Chief Economist examines the growth record of developing countries and analyses how the good performance was based mainly on external factors that no longer exist. The next issue of SouthViews will have a follow-up article on the need for a new development strategy in the South.

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The Growth Record of Developing Countries, 1990-2011

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 (developing and emerging economies) exceeded the average growth in AEs (advanced economies) 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.

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.

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. 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.

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.

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 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).

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

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. Both net flows and net inflows to DEEs peaked in 2007 before the outbreak of the subprime debacle. 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. 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.

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. 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.

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.

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. 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.

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.

Improved domestic economic indicators — but significantly due to external factors

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.

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.

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. 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). 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. 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. The exchange rate operated as an anchor for inflationary expectations, as net capital flows exceeded current account deficits and led to nominal appreciations.

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).

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). 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).

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. In none of these East Asian economies have investment rates recovered the levels attained before the 1997 crisis. 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).

Conclusion: What then accounts for the South's Growth?

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). 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. 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.

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.

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. Much of these exports went to AEs.

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 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.

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