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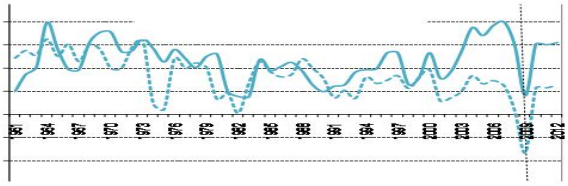
Recoupling or Switchover: Developing countries in the global economy



By **Otaviano Canuto**
May 2010
http://go.worldbank.org/2U94VVZFN0

Forthcoming in Canuto, O. And Giugale, M. (eds.), "The day after tomorrow: economic policy challenges for developing countries after the crisis", World Bank, 2010.

Recoupling or Switchover:
Developing countries in the global economy

Otaviano Canuto[1]

Developing countries as a whole had been growing faster than advanced economies for several years prior to the current economic crisis. As the signs of increasing financial fragility and forthcoming economic slowdown in major advanced economies became clear in 2007 and the first three quarters of 2008, much was then spoken about a possible "decoupling" of emerging markets. This was just as promptly followed by talks of a downward "reverse coupling," when these and other developing economies were also impacted by the near-collapse of finance and international trade during the last quarter of 2008 and in early 2009.

More recently, though, developing countries as a group have been recovering faster than advanced economies while also maintaining the positive growth premium that emerged prior to the crisis. Indeed, growth in developing countries is projected by the World Bank to reach 6.0% in 2010 and 5.9% in 2011, while corresponding figures are 2.2% and 2.4% for high-income countries. Almost half of global GDP growth is currently coming from developing countries.

The current recovery in advanced economies is now exhibiting several signs of fragility and the medium term growth prospects for these economies also looks difficult (World Bank, 2010). In this environment two questions arise. Will developing economies experience a renewed downward "recoupling" as a result of a low-growth scenario in advanced economies? Or, on the contrary, could developing countries "switch over" to become locomotives in the global economy, providing a countervailing force against an otherwise slowing-down train? In this note, we try to sketch what would be the factors pushing in these two opposite directions.

Cyclical coupling and trend decoupling

As can be seen in figure 1, there has long been a close correlation between economic cycles in advanced and developing economies. Developing country growth has fallen sharply in 2009 through several channels: declining exports to developed countries, steep falls in private capital inflows and domestic financial freeze as a form of contagion. So there has been no decoupling in the cyclical component of developing country growth.

On the other hand, looking only at global aggregates may obscure an emerging story about *trend decoupling* between advanced and developing countries. More recently, since the early 2000s, the cyclical synchrony has been combined with systematically higher growth rates in developing relative to advanced economies. As the exercise of trend-cycle decomposition depicted in figure 2 reveals, while before the early 2000s the trend growth in developing countries was close to that in advanced countries, since then it has become substantially higher: a "cyclical coupling" has arguably continued as in the past together with some trend decoupling in underlying rates of growth.

[1] Vice President and Head of Network (Poverty Reduction and Economic Management), World Bank.

Figure 1

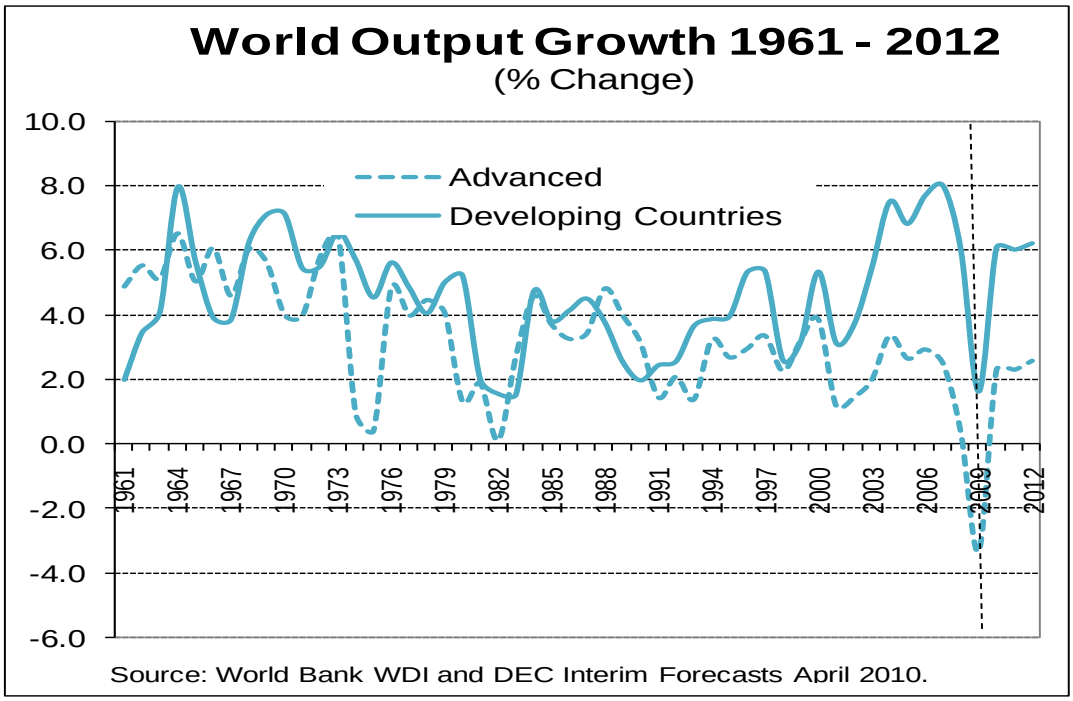
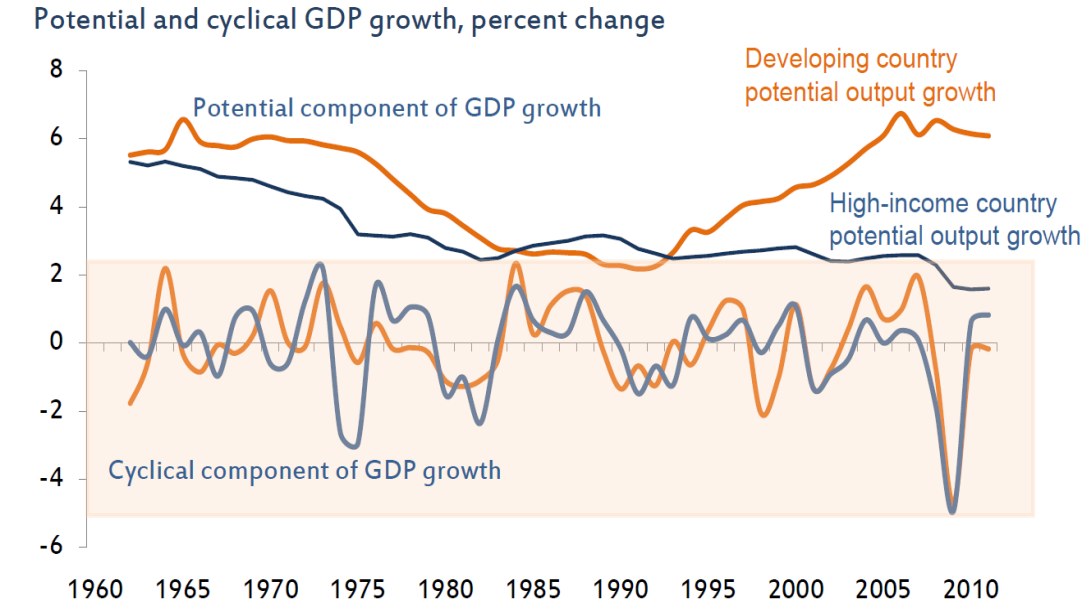


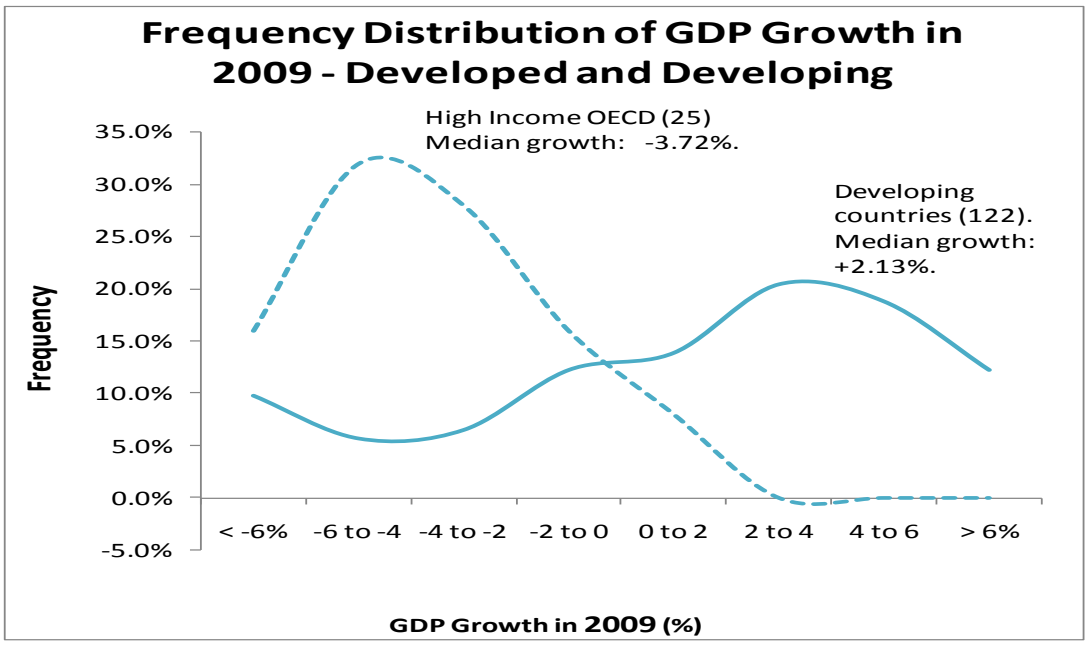
Figure 2 – Trends and cycles



Source: World Bank, DEC Prospects Group.

The improved growth performance in developing countries is not just a reflection of strong performance by the two largest developing countries, China and India. Figure 3 shows the frequency distributions of individual country growth rates in 2009, the expected trough of the crisis. Median growth in developing countries was substantially higher (2.13%) than in advanced economies (-3.72%). And a much larger proportion of developing countries have continued to enjoy positive growth than among advanced or high income countries.

Figure 3



Most of the developing countries situated at the right-side tail of the corresponding distribution benefited from better macroeconomic, structural and other policies adopted over the last couple of decades. They had the capacity to resort to fiscal, monetary and financial counter-cyclical policies, as well as to use foreign-exchange reserves and exchange-rate fluctuations as elements of their responses to the shock (Lin & Canuto, 2010). On the opposite side of the distribution, one can find those countries that had combined financing via "bubbles" in high-risk lending in advanced economies with shaky domestic growth foundations – as in several Eastern European and Central Asian countries. There one can also find some cases in which trade and financial integration led to severe impacts - such as Mexico and some Central American and Caribbean countries. In any case, one may associate the overall high performance of developing countries as a whole before and during the crisis to an improvement of quality of economic policies in the previous decade or so.

Legacy of the crisis on growth trends of advanced economies

High-income countries are facing strong headwinds in the wake of the crisis - not to speak of new unexpected shocks such as the one derived from the Greek crisis which erupted at the end of 2009. It is still an open bet whether the promptness and strength of recovery in private absorption (consumption and investment) will be sufficient to render unnecessary the current "life support" provided by aggressive monetary and fiscal policies, before their unwinding becomes inevitable. If post-war recessions in OECD countries may serve as a template, the switchover from public to private sectors will not be automatic, as recessions associated with credit crunches, house price busts or equity price busts tend to be both deeper and longer than normal. In fact, very few OECD recessions in the post-war period - 4 out of 122 - have occurred with a combination of a credit crunch, a housing bust and an equity bust. The present crisis entailed all three in a severe form (Claessens, Kose & Terrones, 2008).

Several factors point to a reduction of both actual and potential growth in the medium term.

First, sooner or later fiscal consolidation will become a major issue among advanced economies once – or even before - recovery is fully established. Many advanced economies entered the crisis with weak structural fiscal positions, and these have been eroded further, not only by anti-crisis measures but also by underlying spending pressures. Structural primary deficits in advanced countries are expected to have worsened by 4 percentage points of GDP between 2007 and 2010.

Even with reversal of temporary anti-crisis measures, public debt in advanced G20 economies is expected to reach 118 percent of GDP by 2014 (Figure 4). According to the IMF "simply letting the stimulus expire would still leave the government debt of many advanced countries on an explosive path" (IMF, 2009). Stabilizing debt at post-crisis levels will also not be enough because it will reduce the ability of fiscal policy to deal with future shocks and will push post-crisis real interest rates much higher.

On average, according to the IMF, bringing government debt-to-GDP ratios in advanced economies to a prudent level below 60 percent by 2030 would require steadily raising the structural primary balance from a deficit of 3½ percent of GDP in 2010 to a surplus of 4½ percent of GDP in 2020—an 8 percentage point swing in one decade—and keeping it at that level for the following decade. Figure 5 shows the most recent IMF estimates of both the factors likely to be responsible for debt increases until 2014 and those thresholds of primary structural balances required to stabilize public debts.

Thus, even considering that different features of national fiscal packages will have corresponding different consequences in terms of long-term growth drivers, some future fiscal contraction negatively affecting the private sector will be the price paid for the role of fiscal stimulus in rescuing advanced economies from the brink of the abyss during the crisis. And even if monetary policy maintains its current accommodative stances for some time, managing to sustain basic short-term interest rates at low levels, the yield curve on public debt may still steepen.

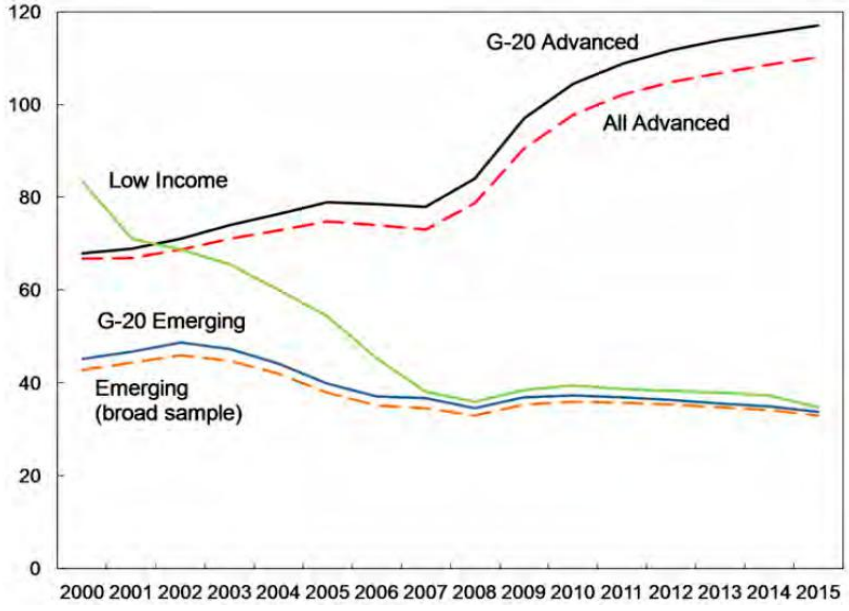
Secondly, the process of US households' balance-sheet deleveraging and adjustment is far from complete. Consumption spending growth is likely to remain weak and/or wobbly in the absence of large renewed hikes in asset prices. In the past strong US consumer spending was buttressed by rising housing prices, allowing rising household debt and reduced personal savings (Figure 6).

Lower savings were reflected in a rising US current account deficit, a major source of US domestic demand and of export demand for the rest of the world. Now, as housing and other household assets prices have fallen substantially, deeply indebted households are unlikely to undertake a new spending spree any time soon. Rebuilding household balance sheets will be a lengthy process.

A third aspect to weigh against a return to a high-growth path is the likely jobless nature of the current recovery in many high-income countries. Figure 7 shows that the recent evolution of unemployment in advanced economies can only partially be attributed to Okun's Law – relationships between output fluctuations and unemployment. Were these relationships to prevail, the current GDP recovery would bode well in terms of a positive feedback loop with labor markets. However, slow-to-reverse shocks – a financial crisis combined with a house price bust, cross-sector differentiated job creation/destruction - have also been in play and continued macroeconomic uncertainty is also countering employment growth (IMF, 2010: ch.3). The share of temporary workers has been on the rise in most advanced economies for years (right side of figure 7), reflecting institutional changes in labor markets. Recent crisis-related increases in temporary employment will tend to have a limited effect in enhancing expenditures while uncertainty regarding macroeconomic and sectoral prospects remains high.

Figure 4

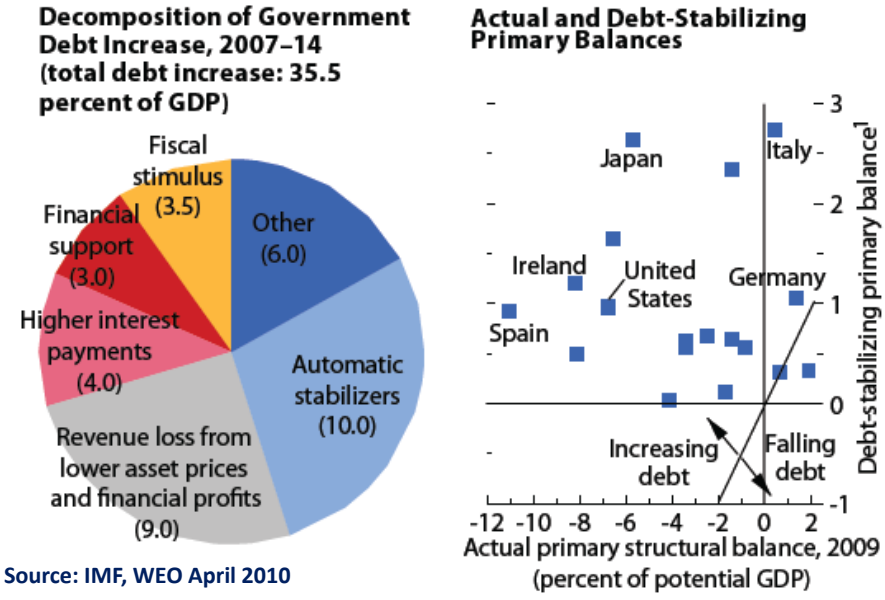
G20 Countries: General Government Debt to GDP Ratios (2000 – 2015)



Source: IMF, *Fiscal Monitor*, May 2010

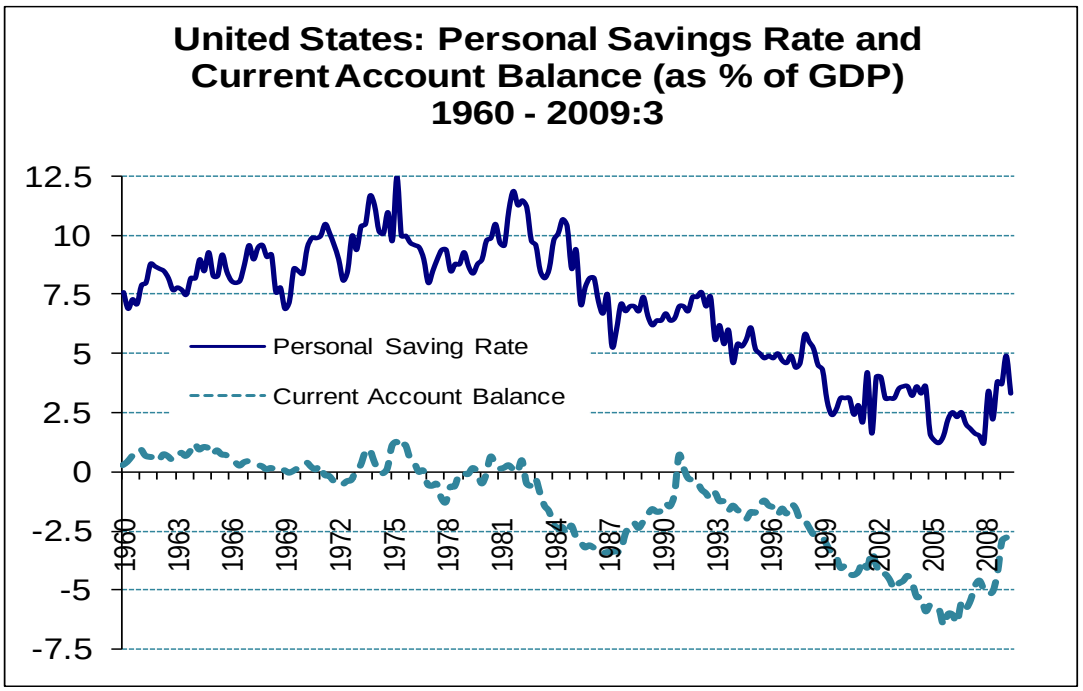
Figure 5

Bumpy road to fiscal stability in advanced economies



Source: IMF, WEO April 2010

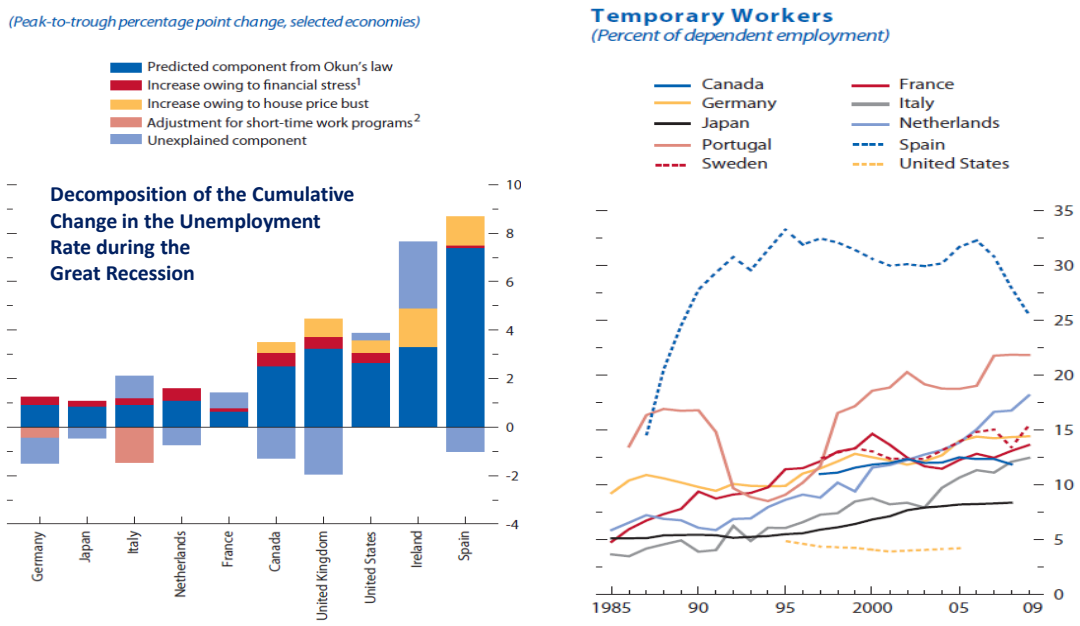
Figure 6



Source: US Bureau of Economic Analysis

Figure 7

Jobless recovery in advanced countries



Source: IMF, World Economic Outlook, April 2010

Fourth, all financial sector re-regulation proposals under discussion point to higher costs of financial intermediation. After all, the general purpose is to curb the unbridled "endogenous liquidity factories" and excessive leverage that led to widespread asset bubbles in the run-up to the economic crisis (Canuto, 2009). Regardless of the long-run payoffs of such moves, access to long-term finance –including R&D and venture-capital funding - could stay harder to obtain and costlier as compared to prior to the crisis, no matter how accommodative monetary policies remain. New bouts of pressure on bank balance sheets are also likely as new sources of financial stress emerge, for example corporate restructurings (Dubai), sovereign debt stress (Southern Europe) and so on.

Therefore, it is not by chance that most analysts expect the crisis – and its response – to leave advanced economies with a legacy of lower growth of both potential output and aggregate domestic demand.

Recoupling or switchover

Two questions follow from the previous sections:

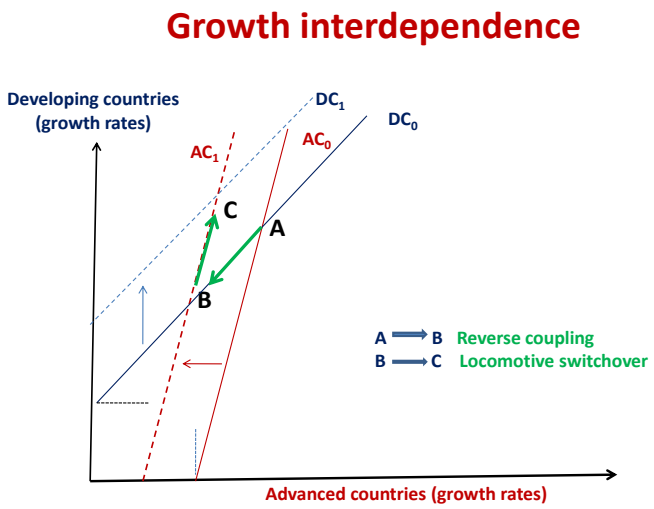
(i) How really sustainable is the "trend decoupling" exhibited by developing countries in figures 1 and 2; how high can both actual and potential growth rates of developing countries remain as advanced economies face headwinds; and

(ii) To what extent can a high-growth performance by developing countries provide a positive feedback loop for advanced economies, helping to avoid a situation where, even though developing countries continue to grow faster than advanced economies, both do so at relatively low rates.

Figure 8 on the growth interdependence between the two groups of economies may provide a simplified illustration of what we have in mind. Channels for growth interdependence may be interpreted here as trade and corresponding investment prospects, as well as factor incomes abroad (return on foreign assets, remittances).

The steepness of the lines for Advanced Countries (AC) reflects the heretofore smaller weight of Developing Countries (DC) for their performance, whereas the greater sensitivity of DC to variations in AC growth rates is expressed in the slopes of its corresponding lines. The legacy of the crisis on AC is exemplified by the shift from AC_0 to AC_1. The adverse impact of slower advanced country growth on developing countries – which we call the negative "recoupling" of developing countries – is reflected in a global move from point A to point B. However, if new "autonomous" sources of trend growth in DC can be tapped and DC_0 shifts to DC_1, then the global economy can settle at point C. Here, not only can developing countries escape from the negative recoupling, but there can also be a "switchover", where developing countries become the global growth locomotives and partially rescue advanced economies.

Figure 8



The weight of developing countries as a whole in the global economy has been rising steadily since 2000 and the continuation of that trajectory comes out in most GDP projections. In terms of levels, the size of G7 countries at market prices is still 60% of GDP and the major potential new poles of growth (China, India, and Brazil) might count no more than 30%. As time passes by, however, the absolute size of the two groups of countries may reverse positions. Most recently, IMF forecasts for global GDP with PPP-adjusted exchange rates indicate developing countries as a group as bypassing advanced economies before 2015. Although developing Asia has the lead in that dynamic, rising shares in global GDP are also a feature of other regions. Let's then suggest some of the railroad tracks on which the struggle between backward recoupling and switchover powers will be defined. [2]

Autonomous sources of potential growth in developing countries and their challenges

Scope for higher degrees of leverage in private and public balance sheets

The fast recovery in many large emerging markets has reflected the good shape and sustainability of their national balance sheets. The recent financial frenzy in many developed economies did not lead to a serious deterioration of local financial conditions in emerging markets as a whole (with several well known exceptions – especially in Eastern Europe). It suggests that the boom in most emerging markets prior to the crisis was not too dependent on the "bubbly" financial conditions in developed countries. Furthermore, the availability of some fiscal space, as well as large foreign-exchange reserves and scope for monetary relaxation were fundamental for the implementation of policy responses to the financial and trade crunches of late 2008 and early 2009 (Lin & Canuto, 2010).

Returns on financial assets in emerging economies have shown remarkable resilience during the current crisis. Sovereign spreads spiked much less than in previous episodes of global financial stress, and have come down substantially since the peak of financial stress. The standard deviation of spreads across countries has also maintained unexceptional levels.

The IMF in its WEO of October 2009 calculates an index of financial market stress, covering foreign exchange, sovereign debt, banking sector and equity markets in emerging markets. After adjustment for the higher level of stress in advanced economies during the current crisis, the IMF finds that: (1) emerging market financial stress rose much less than in previous episodes and (2) financial market resilience was observed in most emerging market countries.

What explains the greater resilience in most emerging financial markets? Three factors may be highlighted: (i) improved macro conditions in emerging economies, including better fiscal positions and higher foreign reserves; (ii) declining foreign currency exposure among borrowers, and (iii) in many cases, low levels of financial leverage in corporate and household balance

[2] Though not approached here, the discrepancy in population growth will be one factor contributing to divergent potential growth between developed and developing countries. Population under 24 represents almost half of the total in developing world, whereas in industrial countries it is just a third. On the other hand, some Emerging Markets (China, Russia) will face aging similar if not worse than developed countries.

sheets. The share of local currency lending in overall lending by foreign banks rose dramatically during the 2000s – with the exception of euro-denominated loans in Eastern Europe - perhaps reflecting the development of better regulated financial systems and stronger macro policy frameworks.

Low-income countries displayed a more heterogeneous set of cases, nonetheless with an overall picture better than many expected. Whether due to debt-reduction processes in the recent past, sound macroeconomic frameworks being put in place, or the relative resilience of primary commodity prices, or other factors, the fact is that the average situation in low income countries has remained reasonably favorable from a fiscal, monetary and growth standpoint.

Looking forward, there is in principle a wide range of greenfield investment opportunities in developing economies that may benefit from higher financial leverage by both public and private sectors. Take the obvious example of infrastructure. Given its relative scarcity, social marginal returns as measured in terms of "total factor productivity" tend to be high in projects that address the many existing bottlenecks. If projects are well-designed, the partial monetary capture of those returns by either public- or private-sector entities may well constitute feasible vehicles for asset creation and finance.

Nonetheless, potential pitfalls or obstacles will have to be faced:

(a) Public sector management capacities and appropriate governance mechanisms must be in place so as to guarantee the use of adequate criteria in project choices and designs, as well as to avoid misappropriation of returns. While this principle applies to public-sector operations and budget in general, the long-term and risky nature of infrastructure investments puts an especially high premium on its due following.

(b) There are limits beyond which increasing leverage on developing country balance sheets will also lead to increased financial fragility. Euphoria with recent successes may well lead to a careless walk on such a slippery slope, particularly if ad-hoc unconventional measures recently adopted as part of the response to the crisis are not unwound.

(c) The incoming flood of sovereign-debt issues by fiscally strapped advanced economies may crowd-out corresponding issues by developing countries. This is one of the mechanisms through which "backward re-coupling" powers may bite.

(d) Higher overall costs of finance in advanced countries will also charge a toll on developing countries, in both public and private sectors. Estimates presented by the World Bank in the latest Global Economic Prospects suggest that US base interest rates 100bp higher than pre-crisis levels combined with spreads prevailing at October 2009 levels would lead to -0.7% as a transitional impact on potential GDP growth (World Bank, 2010).

(e) The current combination of solid growth in many developing economies - and ensuing upward pressure on domestic interest rates - with prolonged monetary laxity in advanced economies is likely to remain for some time. This is already leading to another surge in private capital flows to emerging markets with a profile potentially conducive to fostering asset market bubbles, rather than to building greenfield assets. The pathway towards funding long-maturing investment projects may then become problematic, with increased volatility and over-valuation of existing assets.

However, careful economic management should help address at least some of those "backward recoupling" factors and risks, allowing countries to tap into a high-growth potential with infrastructure and corporate investment leverage.

Convergence gap and non-rival use of existing technologies

A two-fold feature of technologies in general is worth remembering (Nelson & Winter, 1982) (Canuto, 1995). Notwithstanding the fact that any specific technology application requires some tacit and idiosyncratic component of knowledge, as well as some degree of embodiment in hardware or blueprints, there is also usually some degree of transferability and possible replication. By the same token, the use of that transferable technology is non-rival, i.e. one application does not preclude others.

With some country and sector exceptions, most developing countries face a technological convergence gap relative to the frontier level of knowledge in advanced economies. There is thus a wide scope for technological learning and catching-up, with corresponding positive impacts on local productivity. Unexploited latecomer advantages are a venue for local productivity improvements via technology transfer and adaptation that remains open and wide even if the advance of technology frontiers slows down in high-income countries (Rodrik, 2009). Recently flourishing possibilities of technology transfer among developing countries may further facilitate such technological diffusion.

The obstacles to more rapid technology diffusion are the same that ultimately have often hindered it in the past: information asymmetries and uncertainties plaguing investments in technology that are common in advanced economies often appear more intensively in developing economies; complementary factors such as reliable infrastructure, access to finance, and provision of formally educated labor force are sometimes not available; institutional factors that negatively affect the "investment climate" tend to harm investments in technology even more; institutional barriers to competition curb the selection process that would operate in favor of good technology performers; etc.

On the other hand, global changes in recent years have been making technological transfer easier than before (Canuto, Dutz & Reis, 2010): "increased international trade in goods and services, FDI, Intellectual Property and technology licensing flows; (…) increases in data storage and transmission capabilities, fall in costs and uptake of information and communication technologies"; etc.

Again, the balance in favor of high potential growth will tip depending on domestic policy action. In this case, the removal of those barriers to creative technological absorption and diffusion mentioned above will be of the essence.

Trade and structural change as vents for surplus labor

The extraordinary growth performance of some Asian economies and China in particular – like some other past experiences of long periods of growth in the developing world – cannot be fully understood without taking into account that to a large extent they expressed a peculiar process of "structural change" (at least at the start of the process): the dislocation of large contingents of low-skilled workers from stagnant and low-productivity activities to others whose value at world prices is significantly higher and where there also exists a wide scope for productivity increases.[3] These workers moved from occupations in which their – physical and monetary - marginal productivity was close to zero, as in production for subsistence in many rural areas, to light-manufacturing production with much higher market value, a move generally accomplished without the need for major increases in worker skills. This is the move depicted in the pioneer work by Lewis (1954) and Fei & Ranis (1964) in their stylized model of transition from traditional surplus-labor rural economies to modern industrial ones. More recently Rodrik (2009) refers to a dislocation from the production of "traditional, primary products" to "non-traditional tradable activities".

Those structural changes and corresponding increases of (value) productivity tend not to be well captured in conventional total factor productivity (TFP) analyses, as increased wages and investment outlays that accompany such processes absorb what otherwise would be positive TFP "residuals". Nevertheless, such structural change is deeply transformative and productivity-increasing.

This kind of structural change is not a linear, smooth or automatic process. Even at its "light" stages, industrialization is "lumpy" in products, space and time (UNIDO, 2009): minimum scales and scope of production, agglomeration gains, and minimum thresholds of competitiveness are needed to start operating. Furthermore, some basic market institutions must be functioning. As Rodrik (2009, p.6-7) puts it, there tend to be "various market failures and externalities associated with modern activities, such as learning spillovers and coordination failures", as well as "institutional weaknesses that are felt more intensively in tradable activities, such as poor protection of property rights and weak contract enforcement." (…) "In both cases, industrial activity and investment are underprovided in market equilibrium."

It is worth noticing that there is a global opportunity cost in terms of foregone productivity increases in not having the structural change from traditional to non-traditional activities in developing countries. It corresponds to a global "market failure", since the shift in workers' occupations is not substitutable by equivalent increases of production in advanced economies.

Rising international trade and the technological changes already mentioned in this paper have made such structural change easier. Among technology trends, "a trend towards the standardization, modularization, and codification of technologies, especially in the electronics and auto industries [and in some services, we add – see Ghani & Kharas (2010)] make it easier to deverticalize and off-shore production" (Yusuf, 2009). With fragmentation of production and trade in tasks, as well as decreasing costs of transport and communication, the "lumpiness" barriers become relatively easier to surmount. Local market size becomes less of a constraint on

[3] It is important to frame the question in terms of value, as it is not appropriate to rank physical productivities as "high" or "low": how to compare e.g. productivity levels in terms of rice and shoes?

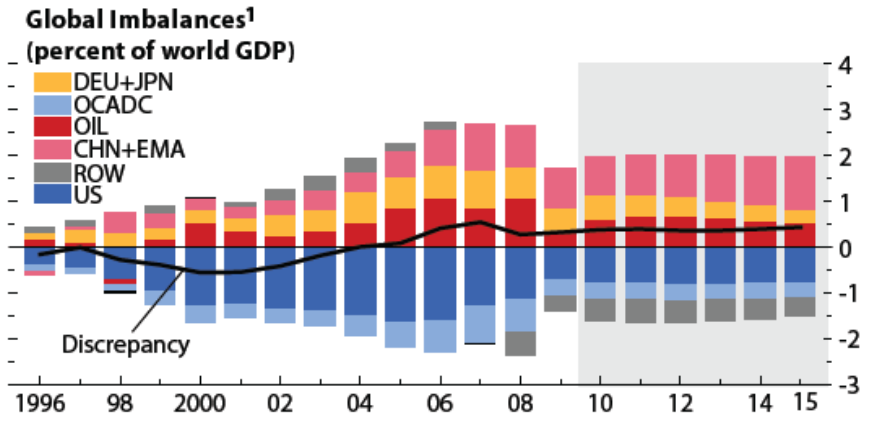
requisites of scale and scope, while learning spillovers and coordination needs may be found through integration in cross-border networks of production. Local institutional requirements remain however.

To take additional steps up the ladder of technological sophistication, moving on beyond early "easy" production of tradables, the economy has to increasingly develop some capabilities that transcend particular existing lines of production at a given moment in time: this requires the ability to learn, master and adapt technologies in a creative way; to manage complex processes of design, production and marketing; etc. Again, recent trade and technology trends have been favorable to latecomers from a cost-competitiveness standpoint, as long as domestic complementary factors – observed in the section on technology convergence - are in place.

There was a second source of opportunities created by trade in recent years, one that is not likely to return with a similar intensity after the crisis: the global market created by debt-fuelled over-absorption and massive current-account deficits in several advanced economies (especially the US) that incurred in massive current-account deficits in the last few years (Figure 9). The likelihood that growth in overall world market size will slow because of the reduction of global imbalances in the wake of the crisis highlights the argument about a possible "fallacy of composition" put forth originally by Cline (1982) – and revisited in Cline (2008).

Figure 9

Over-absorption in Advanced Economies supported growth-cum-structural-change in Developing Countries



Source: IMF staff estimates (WEO, April 2010)
CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand; DEU+JPN: Germany and Japan; OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom; OIL: Oil exporters; ROW: rest of the world; US: United States.

Back in 1982, Cline observed the risks of a "glut" of exports of manufactures if the then very special export-led success of the East Asian tigers (Hong Kong (China), Korea, Singapore, and Taiwan (China)) were to be generalized to other developing economies. There might be limits to such a generalization, particularly if done at high speed, either by generating a protectionist reaction in advanced economies – Cline's main concern – a race-to-the-bottom in price competition or quantitative crowding-out among exporters.

The later emergence of the so-called "flying-geese" model seemed to be leaving space for new exporters as earlier exporters evolved towards more sophisticated products. Nevertheless, although these successive movements along the "product ladder" diminished the risks of a protectionist backlash or predatory competition at sector levels, they required rising aggregate import-GDP ratios among major advanced country importers as new developing countries joined the export-led group.

The fact that more recently several export-led developing countries integrated into value chains with China at the sales end-point did not alter the requisite of an increasing total rate of market penetration at the aggregate level. Even without protectionism, such a trend would eventually face "market saturation" at the aggregate level. Therefore, the huge recent current-account deficits depicted in Figure 9 helped avoid total-market size limits to become binding, as well as China's exports to further crowd-out other exports.

Now, what will be the consequences of a less exuberant pace of domestic absorption in advanced markets in coming years? Will that unwind hitherto successful export-led growth models? Will that make it impossible for new newcomers to undergo structural change and grow by exploiting trade-cum-technology windows of opportunity?

Note that:

(i) The export-led, high-growth experience has still been limited in terms of both geographic- and sector-coverage (Yusuf, 2010). There are many developing countries yet to benefit from trade and technology transfer as a vent for surplus labor. Such a labor surplus may also be found in current contingents of low-paid informal urban workers;

(ii) The present level of imbalances are relatively recent – a phenomenon of the 2000s (Figure 9). Yet developing countries were able to pursue export-oriented strategies previously with relatively limited global imbalances. In other words, export-led growth does not necessarily mean current-account-surplus led growth. This suggests that in the longer term countries could continue to pursue balanced outward-oriented strategies with strong growth in both exports and imports, availing themselves of trade as a means to overcome "lumpiness" in scale and scope;

(iii) The magnitude of the contribution of the recent great current-account deficits should not be oversold. It was to some extent the counterpart of very high oil prices (Figure 9);

(iv) Most developing countries exports are *so small* that there should be plenty of room for them to expand despite broad global rebalancing shifts and less exuberant absorption in OECD countries. China and just 7 other developing countries comprise 85% of all developing countries' exports. These 8 countries' exports are equivalent to 15% of all OECD imports. By contrast another 130 developing countries comprise only 15% of developing countries' exports, equivalent to just 2.5% of OECD imports. The typical country in this group could increase its exports by 40% if it could capture another 0.01% of OECD import market share.

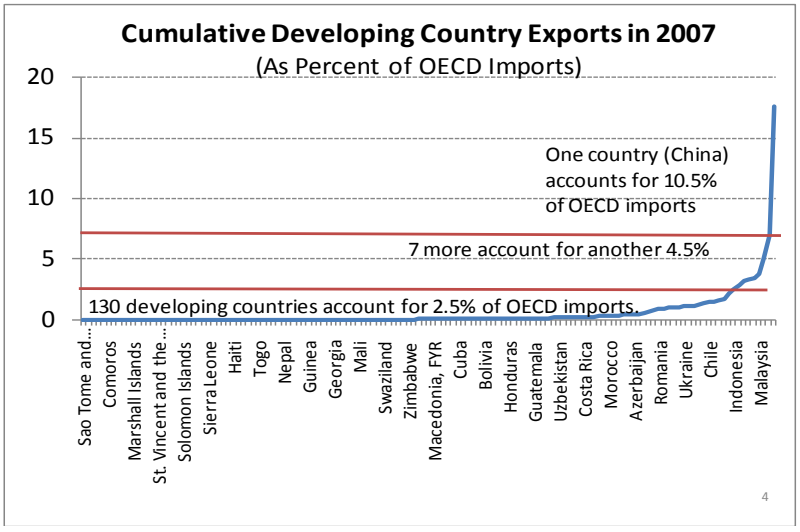
(v) It is true that China as a major counterpart of the OECD deficits acted as a peculiar channel for the transmission of growth. China's huge trade surplus made feasible its high-growth combination of high investment-to-GDP and low consumption-to-GDP ratios. Given China's size, its high growth generated considerable stimulus to regional manufacturing neighbors and to commodity exporters. But in principle such a role as growth pole can be maintained without gigantic trade surpluses. If domestic absorption rises faster than output in developing countries as a whole, especially in China, and South-South trade is further opened and maintains its rising trend of recent years (Canuto, Haddad & Hansen, 2010) (Figure 11), a new round of export-oriented and growth-via-structural-change can be envisaged. [4]

(vi) As for exchange rate realignments, one must remember that real exchange rates are, over longer periods of time, ultimately endogenous to the levels of domestic absorption vis-à-vis production. Unless domestic consumption, private investment or public expenditures adjust downward (upward), real exchange-rate undervaluation (appreciation) sooner or later lead to inflation (deflation). Of course, whether or not real exchange rates are ultimately endogenous is beside the point if the transition time is very long. But our argument is that in the medium term it is conceivable that exchange-rate realignments may follow policy interests dictated by needs of adjustments between domestic absorption and production.

As in the previous items, domestic policy actions will again be of the essence, with respect to investment climate, trade facilitation and logistics. In this context, it is worth highlighting that as trade tariffs and non-tariff barriers have diminished in recent decades, there is increasing perception of the relevance of the "inside-the-border" agenda.

Figure 10

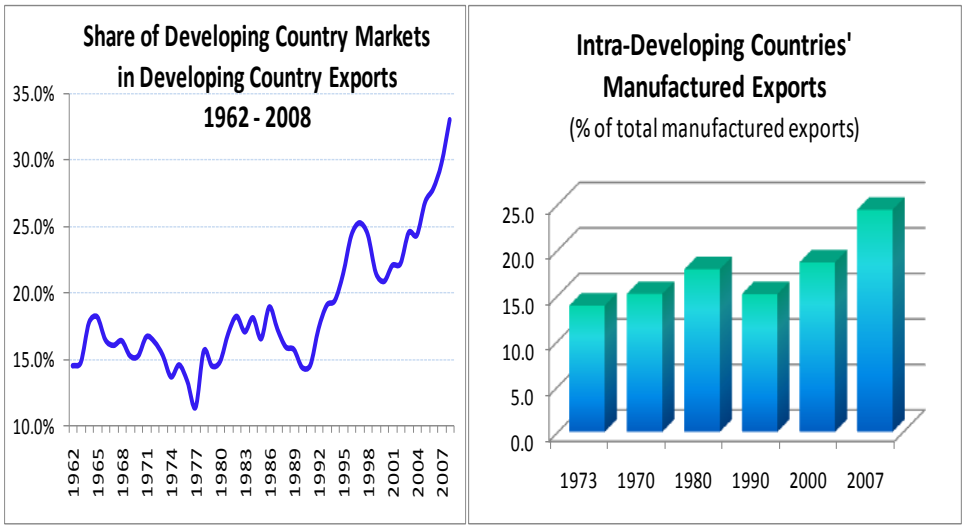
***Most* developing country exports are negligible compared to OECD imports**



[4] An important dimension not approached here is what would be the likely implications of such a rebalancing in global demand, in terms of types of products and production processes. On natural-resource based commodities, we shall say something below.

Figure 11

Rising South-South trade: toward an export-led growth v2.0?



Social trickle-down of growth

After World War II, Europe and Japan sustained a long growth cycle through a process of technological and mass-consumption catching up with the US frontier. Whereas, from the 1990s onward, as we observed, many developing economies achieved high growth facilitated by innovations in IT and other fields (including finance), combined with globalization, but with an important role left to developed countries for absorption of their output. The time may now have come for better matching of increases in production and consumption within developing countries. That rebalancing in itself could become a powerful tool to fasten the speed of reducing poverty and inequality.

As we also remarked, this is not to be confounded with pursuing isolationism through higher local integration per se. Channels for international trade and investment need to be kept wide and open, so that growth-spurts, including an eventual revival of economic dynamism in developed economies, can complement each other. As long as countries stay committed to economic openness, gains of scale and scope can be accrued, and such a process might take place in all economies regardless of their size.

Programs of investment in infrastructure and human capital, poverty reduction, and social inclusion in developing countries would stimulate local consumption and investment, producing positive feedback loops. A higher role for effective networks of social protection and for active poverty-reduction policies in developing countries has therefore become a component of sustainable global growth.

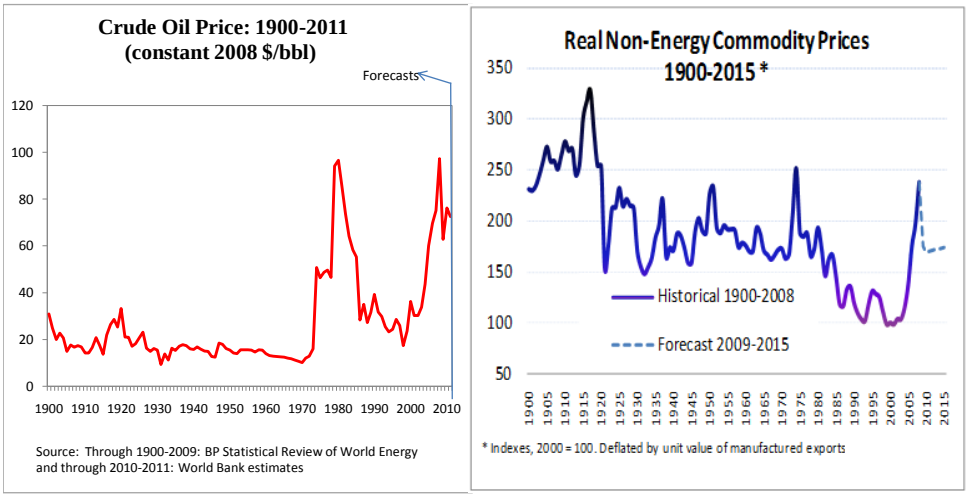
The argument for building effective networks of social protections should not be underestimated because of the recent overall growth performance of developing countries as a whole. First and foremost, the impact of eventual negative shocks is likely to be very large in the absence of such networks, as shocks affect the poorest and most vulnerable most, because they, by definition, live on smaller margins and have weaker safety nets to draw on. But there are also efficiency reasons that justify that protection. Even short lived crises may elicit responses and dynamics that have long term negative implications. The way households cope with crisis, the effects on workers' long term abilities, and the impact on firm creation and firm destruction dynamics are all examples of this: households may be forced to make choices that stave off the crisis over the short term but that have negative long term consequences on human capital, individual earnings potential and economy-wide growth. They may be obliged to take children out of school, or spend less on health and caloric consumption. They may have to run down productive assets, e.g. sell or kill livestock (Paci et al, 2010).

Natural resources as a blessing or a curse

How about countries whose economic dynamics depends substantially on natural-resource commodity prices? It is notable that, while commodity prices have fallen significantly from their peak in 2008, as a result of the crisis, many prices remain higher than previous recession lows, often as high as in 2005-07, a period of robust world growth (figure 12).

Figure 12

Whither the prices of natural resources?



Source: World Bank

38

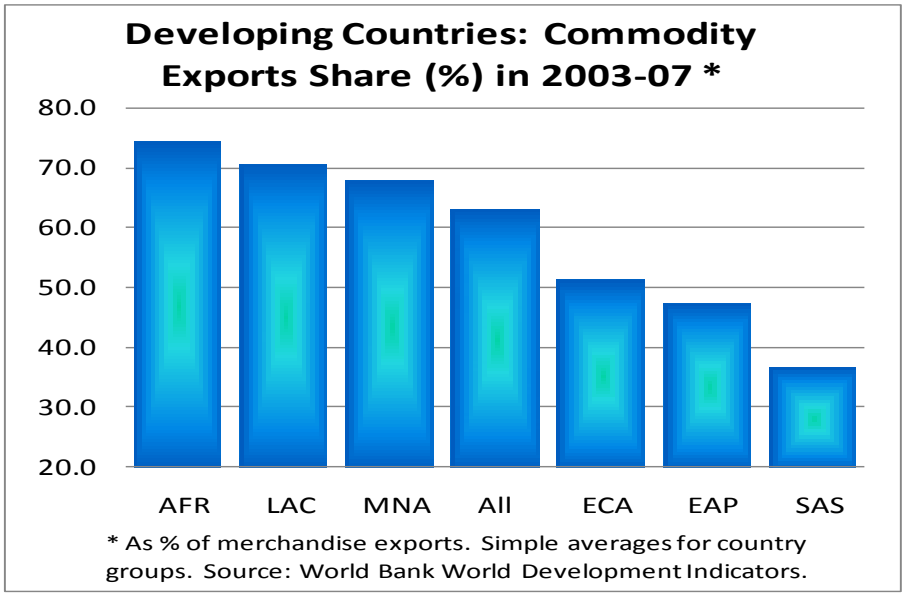
Are there plausible fundamental economic factors to expect a sustained period of high commodity prices? Some considerations (Brahmbhatt & Canuto, 2010):

- Relative demand for commodities could be strong in the medium term to the extent world growth after the crisis will be more dependent on developing countries and demand in these countries is more commodity intensive than elsewhere.
- There is also evidence that real commodity prices are affected by monetary conditions, as low interest rates reduce the costs of carrying long positions in commodity markets (Canuto, 2008). Commodity prices receive a boost from financial markets when real interest rates are low and monetary conditions lax, as at present.
- investment in new capacity in energy and minerals was cut substantially when prices were low in the 1980s and 1990s and is recovering only slowly due to skill shortages, technical difficulties in developing new reserves (e.g. deep offshore) and political uncertainty in regions with new reserves.

So there are both supply and demand factors that could support the current still relatively high level of real commodity prices in the medium term, although these factors will tend to dissipate in the longer term. Current World Bank forecasts are consistent with this scenario, projecting only a gradual easing in real commodity prices from current levels by 2015 (Figure 12).

If a period of secular commodity strength is now in prospect, does it bode well, as commodities still comprise a little over 60 percent of the merchandise exports of the average developing country (Figure 13)? Is there a natural resource "curse" (or blessing)? "The short answer is 'no', or rather 'it depends'" (Brahmbhatt & Canuto, 2010, p.3).

Figure 13



First, any negative long run growth effects of high natural resource prices on commodity exporters are mostly related to oil and minerals – concentrated "point source" resources that can easily become the object of rent-seeking. Second, high oil and mineral prices only have a negative impact on long run growth in exporting countries with bad governance. They have a significant positive impact on growth in exporters with good governance.

There is much that countries can do to ensure that natural resources provide a foundation for broadly based and increasingly diversified economic growth strategy:

- Global efforts like the Extractive Industries Transparency Initiative and domestic governance reforms are needed to tackle problems of rent seeking and corruption.
- Careful fiscal policy management (for example by saving an adequate portion of resource revenues through a Natural Resource or Wealth Fund) can help address problems caused by real exchange rate appreciation (Dutch Disease – see Brahmbhatt, Canuto & Vostroknutova, 2010) and commodity revenue volatility.

Commodity revenues need to be carefully managed. Here the role of reforms to strengthen budget processes and institutions, good cost-benefit analysis, public sector management and evaluation are all crucial. In a nutshell, pending on domestic policies and reforms (as in the other topics approached up to here), the incoming period of reasonably attractive commodity prices may also help developing countries to grow.

Concluding remarks

The bird's eye view taken in this text leads us to conclude that, yes, there is a scope for a switchover where developing countries as a whole take on a greater role as global locomotive and move global growth forward, offsetting forces toward a negative recoupling deriving from less buoyancy in advanced countries. Nevertheless comprehensive homework in terms of domestic policies and reforms will be fundamental to accomplish that mission.

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