CAN DEVELOPING COUNTRIES BE A NEW ENGINE OF GROWTH?

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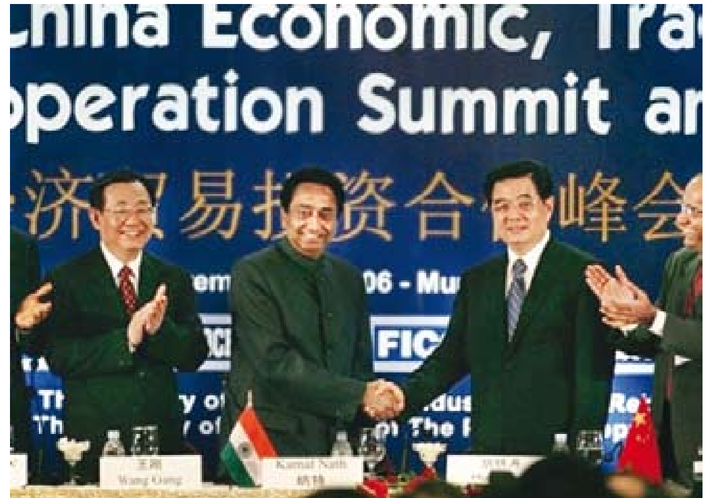
All Moscow was burnt down, you know, by a penny candle," says a character in Ivan Turgenev's 1861 novel, Fathers and Sons. He could well have been speaking about the current global financial meltdown, which was sparked by default on a few housing mortgage payments in the United States, which went on to engulf the mighty investment banks on Wall Street and then spread rapidly to financial centers around the world. Sixty trillion dollars of wealth have been destroyed by a mere $50 billion loss on subprime loans.[1]

If that were not enough, the financial meltdown is now pushing the world economy into recession. The US, the European Union and Japan are already in it, and other advanced economies are slowing to a standstill. Recovery is not projected until 2010.

The rescue efforts by the US and other G-7 authorities aim mainly to stabilize the banking and financial system, less to restore economic growth. So far this year upwards of 8 trillion dollars has been allocated for bank bailouts, while the amounts for fiscal stimuli are much less: $168 billion in the US, $257 billion in the European Union and $251 billion in Japan.[2] The incoming US Administration has pledged to shift the focus from bailout to jobs – which could mean a substantial fiscal stimulus of $400 to $600 billion -- but that will have to wait till next year.

The only good news is that developing countries continue to grow in spite of the financial turmoil and economic downturn in the developed economies. To be sure, developing countries are subject to downward pressures as demand for exports

weakens, credit tightens and investment slows. But many developing countries, including in Africa, are continuing to grow, albeit at a slower rate, through South-South trade and investment. Can this growth be sustained? Can developing countries be a new engine of growth?



De-Linking: Myth or Reality?

Although most economists would say that developing countries cannot “de-link” from their traditional trading partners or from global financial markets, there is one who argues otherwise. “The answer is in the affirmative,” says a Princeton University Economics Professor and Nobel Prize winner. His name is Sir Arthur Lewis. He came from the Caribbean island of Saint Lucia. He spoke 29 years ago:

“For the past hundred years the rate of growth of output in the developing world has depended on the rate of growth of output in the developed world. When the developed grow fast the developing grow fast, and when the developed slow down, the developing slow down. Is this linkage inevitable? The developing countries can solve the problem only by accelerating sharply their trade with each other. ” [3]

The developing countries can solve the problem only by accelerating sharply their trade with each other

When Sir Arthur Lewis delivered his Nobel laureate lecture in December 1979, the world economy was in a recession since 1974. Our present crisis is more serious and more global but, at the same time, the developing countries are more dominant players. His argument carries more force today, at least let’s hope so.

Today, developing countries contribute 30% to world output and 40% to world trade, some 10 % points higher than in 1979. However, Arthur Lewis based his argument on the potential for developing countries to trade with each other: the potential for their inter-trade to take up the slack in declining import demand and slowing growth in developed countries. This potential has increased greatly in the intervening years.

South-South trade has been expanding faster than North-South trade for more than a decade. Their inter-trade was about 20% of their exports in the 1970s; it is now about 50%. Today, developing countries export about as much to each other as they do to developed countries. And, it is not all raw materials and natural resources. It is also agricultural products, chemicals, metals, mechanical and electronic appliances and vehicles.

Also, expanding inter-trade has been accompanied by investment. South-South Foreign Direct Investment (FDI) tripled in the past decade. Today, there are some 20,000 transnational corporations based in developing countries, making up a fourth of all multinationals worldwide. The 100 largest multinationals from developing countries had $570 billion of foreign assets in 2006.[4]

Developing countries tend to trade and invest within their regions. Trade flows among Asian countries are particularly dynamic, growing twice as rapidly as their trade with developed countries. But, equally, inter-regional flows have grown rapidly, particularly between Asia and Africa, and Asia and Latin America. South-South FDI is a particularly important source of capital for the smaller and weaker economies: it is underpinning near six percent growth in Sub-Saharan Africa in 2009.

A number of countries in all developing regions rank as emerging markets. Their capital markets have performed well. Even after the recent turbulence, their equity prices in early October 2008 were still well above their 2003 level. South-South cross-border investment has helped insulate the emerging market economies from the financial crisis in the North.[5]

So, can developing countries “de-link” and be a new engine of growth? The IMF says growth in 2009 will come mostly from emerging market economies.[6] That is a good news indeed, and a vindication of Sir Arthur Lewis: at least one third of the world economy -- the developing world -- will continue to grow

in spite of the downturn in the developed economies.

But can it be sustained? On one hand, the gains to date were helped by the robust world economic environment of recent years. Per capita income grew by more than three per cent in over 100 countries in 2007. But the global environment will be more of a drag than a boost in 2009. On the other hand, much of the recent expansion in investment and trade was led by developing countries. The current upturn in global FDI demand was led by them in 2004, even as FDI into developed economies was still declining. If they have done it before, they can lead again.

Much depends on the global policy response. The arrangements being put in place among the G-7 central banks to replenish the international credit markets need to extend to developing countries. The IMF will disburse financing with streamlined conditionality to countries in difficulty. The World Bank will triple lending to developing countries and expedite grants to the poorest countries. The policy forum has broadened from the G-7 to the G-20. Hopefully, such actions and others[7] will limit the collateral damage of the financial crisis on developing countries.

South-South Policy Response

"The real problem is whether developing countries will persist in rapid growth despite the slowdown of the developed countries," argues Arthur Lewis. And, for that, the solution is for developing countries to shift to more balanced growth paths, relying more on internal demand to sustain growth. He reasoned as follows: "It is not possible for all developing countries to make this switch and neither is it necessary; for if leading developing countries grow fast and import heavily they will substitute to some extent for the former rapid growth of developed countries."

Indeed, several developing countries with adequate reserve positions – like Brazil, China, India and Nigeria – have leeway to take proactive measures to sustain their growth. China has already announced $586 billion of investments in infrastructure and social welfare over the next two years to stimulate internal demand. India has announced a $4 billion stimulus. A number of additional countries – as in South East Asia - have economies capable of self-sustaining growth and generating trade for others. "If they are specially linked to each other by preferential trade and currency arrangements," said Arthur Lewis, "one may even speak of the creation of a new centre consisting of former peripheral nations that have built a new engine of growth together."

This could happen now. Asian countries are pursuing anew the establishment of an $80 billion fund to restore liquidity in their financial markets. Their joint fund will supplement foreign reserves and enhance the currency swap arrangements instituted under the Chiang Mai initiative of 2000.

In Africa, Chinese state banks and African banks have developed a $6 billion joint fund to invest in the continent, which includes not only South Africa, Egypt, and other North African countries, but also, what the IMF calls, a "second generation" of emerging markets in sub-Saharan Africa: Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda and Zambia.

In Latin America - Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and Venezuela agreed last year to create a Bank of the South -- Banco del Sur -- with up to $7 billion in initial capital. This initiative has fresh urgency.

Additionally, at the national level, India and China can fast track their existing bilateral investment funds – announced at $5 billion each – to be quick disbursing for Asian-African trade and investment.

South East Asia has economies capable of self-sustaining growth and generating trade for others

At the 2006 Sino-Africa summit for 50 African leaders, China proposed a doubling of trade between China and Africa to $100 billion by 2010, and pledged to double aid by 2009. Subsequently, in 2007, China initiated the China-Africa Development Fund to support Chinese equity and quasi-equity investment in African agriculture, manufacture, energy, transportation, telecommunications, urban infrastructure and natural resource exploration. The initial plan called for a start-up capital of one billion dollars, to be increased over three phases to five billion dollars. This schedule should be fast tracked, and the Sino-Africa summit should be reconvened to generate the political consensus to make it possible.

In April 2008 India hosted its Summit for 14 African leaders and offered $5 billion in financial credit and $500 million in development grants to Africa and preferential market access for all exports from least developed countries. These pledges

need to be fast tracked. Doing so, will sustain India's internal growth by facilitating domestic demand for food, energy and natural resources, as well as its exports, more than half of which are destined to Africa and other developing regions. Indian firms are also active investors and contractors in Africa. South-South is a win-win for India.

Japan, too, established a $2.5 billion bilateral investment fund for Africa but, unlike China and India, has had limited success in seeing its companies invest in Africa. The fund should be re-oriented towards supporting triangular South-South investment in which Japanese companies are encouraged to partner with other Asian firms which have been successful in investing in a business environment similar to their own in earlier years.

In West Asia and the Arabian Gulf, there is increasing focus within the region and in other developing regions. Their sovereign wealth funds -- which have considerable assets exposed to the financial turmoil in developed countries -- have begun to diversify their portfolios and are increasingly investing in the developing world at attractive risk-adjusted returns. Their direct investments are currently about $10.5 billion, mainly in Asia but also some in Africa and Latin America. There is considerable potential to expand such investments in the developing world (where the rate of return is above 10%), and diversify risks at the same time.

On the trade front, 26 African countries have just agreed to consolidate into one free trade zone their three trade blocs -- Southern African Development Community (SADC), the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA). This agreement will facilitate intra-regional trade and promote investment in infrastructure and energy projects which are a focus of developing country transnational firms.

Generally, tariffs among developing countries are relatively high; however, where these tariffs have been reduced, trade among countries has expanded rapidly. Trade among the 43 developing countries in the Generalized System of Trade Preferences expanded by 50% in 2000-2005, faster than the 39% growth of their trade with the rest of the world. The scheme should be broadened and enlarged: it includes Brazil, India, Mexico and other large and dynamic developing economies but China and South Africa and several West and Central Asian economies are not members and they should all be invited to join.

The South Summits (in 2000 and 2005) recognized the need for platforms to better identify business opportunities and networks to promote public-private partnerships, and it is timely that Qatar will host the first South-South Trade and Investment Fair in Doha in 2009.

South-South Benefits All

Sustaining South-South growth in the current global meltdown is in the interest of all countries. Developed countries have a commitment to aid the poorest and will benefit from their growth and development. Arthur Lewis concluded his Nobel lecture by noting that "dependence is mutual," and that developing countries, by their prosperity, can help a little to sustain prosperity in developed countries. "What we all really need is that world trade recapture its growth rate of eight per cent per year."

Moscow, of course, was reconstructed. The unfortunate disaster provided the authorities an opportunity to plan a new city, which they did. Hopefully, our present crisis will yield a new financial system, more transparent and better regulated, with a revamped IMF but more broadly reliant on regional institutions. Developing countries – the new engine of growth -- should fully participate in the re-design. IER

Endnotes and Additional Thinking

1. A full accounting of this still unfolding crisis awaits future economic historians.
2. These numbers, which are still accumulating, are as of November 2008.
3. Sir Arthur Lewis, The Slowing Down of the Engine of Growth, Nobel Prize Lecture, Economics, 8 December 1979.
4. United Nations Conference on Trade and Development, World Investment Report 2008.
5. International Monetary Fund, Global Financial Stability Report (October 2008).
6. International Monetary Fund, World Economic Outlook (October 2008).
7. See, for instance, the Statement issued by the Board of the South Centre, Revamping the Global Financial Architecture (29th October 2008; http://www.SouthCentre.org).

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)