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Toward a Switchover of Locomotives in the Global Economy

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The recovery in advanced economies is now exhibiting several signs of fragility and the medium-term growth prospects for these economies also look difficult. Could developing economies "switch over" to become locomotives in the global economy, providing a countervailing force against downward trends? The view taken here says, yes, as long as appropriate domestic policies and reforms are pursued in developing countries.

Developing countries as a whole have been growing faster than advanced economies, even before the start of the current global economic crisis. In 2007 and the first three quarters of 2008, as the signs of increasing financial fragility and economic stagnation in the major advanced economies were becoming clear, much was said about a possible "decoupling" of emerging markets. This was just as promptly followed by talks of a downward "reverse coupling," when these emerging markets 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.

Developing countries as a group have also been recovering faster than advanced economies, while also maintaining the positive growth premium that emerged prior to the global financial crisis (figure 1). Indeed, growth in developing countries is projected by the World Bank to reach 6.0 percent in 2010 and 5.9 percent in 2011, while corresponding figures are 2.2 percent and 2.4 percent for high-income countries. Almost half of global gross domestic product (GDP) growth is currently coming from developing countries.

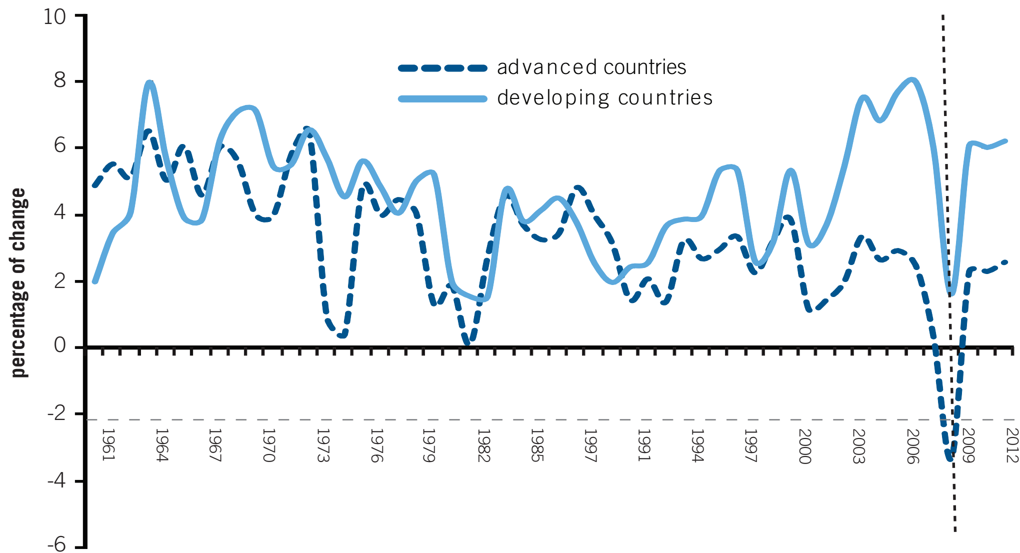
The current recovery in advanced economies is now exhibiting several signs of fragility and the medium-term growth prospects for these economies also looks difficult. In this environment, two questions arise: Will developing economies experience a renewed downward "recoupling" as a result of a low-growth 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 a slowing-down train?

In the view presented in this note, there is indeed a scope for a switchover where developing countries as a whole take on a greater role as a global locomotive and move global growth forward, offsetting those forces moving toward a negative recoupling, which are derived from less buoyancy in the advanced countries. Nevertheless, a comprehensive homework in terms of domestic policies and reforms will be fundamental to accomplishing that mission.[1]

Legacy of the Global Financial Crisis on the Growth Trends of Advanced Economies

High-income countries are facing strong headwinds in the wake of the global financial crisis. It is still an open bet as to 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 of this support becomes inevitable. If postwar recessions in Organisation of Economic Co-operation and Development (OECD)

Figure 1. World Output Growth, 1961–2012



Source:World Bank WDI and DEC Interim Forecasts April 2010.

countries serve as a template, the switchover from public to private sectors will not be automatic, because recessions associated with credit crunches, house price busts, or equity price busts tend to be both deeper and longer than typical recessions. In fact, very few OECD recessions in the postwar period—4 out of 122—have occurred with a credit crunch, a housing bust, and an equity bust: the present crisis combines all three, and in a severe form (Claessens, Kose, and Terrones 2008).

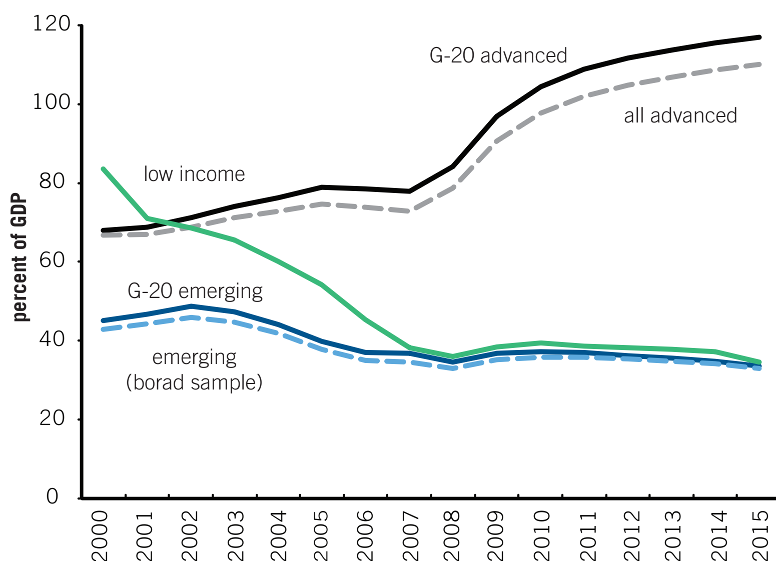
Several factors point to a reduction of actual and potential growth in the medium term. First, at some point, fiscal consolidation will become a major issue among advanced economies once—or even before—recovery is fully established. Many advanced economies entered the crisis with weak structural fiscal positions, and these have been eroded further, not only by anticrisis 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 the reversal of temporary anticrisis measures, public debt in advanced G-20[2] economies is expected to reach 118 percent of GDP by 2014 (figure 2). According to the International Monetary Fund (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 postcrisis levels will also not be enough because it will reduce the ability of fiscal policy to deal with future shocks and will push postcrisis 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 3.5 percent of GDP in 2010 to a surplus of 4.5 percent of GDP in 2020—an 8 percentage point swing in one decade—and keeping it at that level for the following decade.

Thus, even considering that different features of national fiscal packages will have corresponding different consequences in terms of long-term growth

Figure 2. General Government Gross Debt Ratios



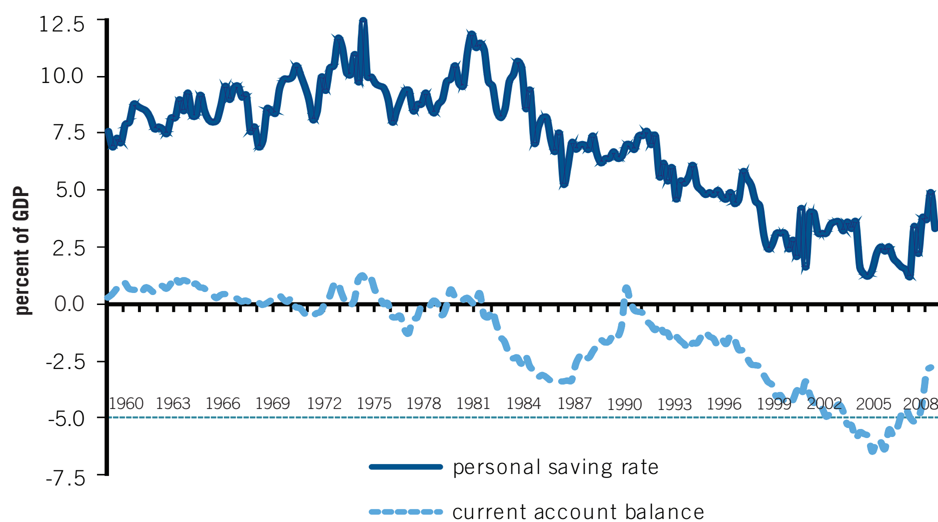
Source: IMF staff estimates based on IMF (2010).

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 and manages to sustain basic short-term interest rates at low levels, the yield curve on public debt may still steepen.

Secondly, the deleveraging and adjustment of U.S. households' balance sheets are 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 U.S. consumer spending was buttressed by rising housing prices, allowing rising household debt and reduced personal savings (figure 3). Lower savings were reflected in a rising U.S. current account deficit, a major source of U.S. 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. Slow-to-reverse shocks—a financial crisis combined with a housing price bust and cross-sector differentiated job creation/destruction—have been in play and continued macroeconomic uncertainty is countering employment growth (IMF 2010, ch.3). The share of temporary workers has been on the rise in most advanced economies for years, reflecting institutional changes in labor markets. But 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 3. United States: Personal Savings Rate and Current Account Balance, 1960–2009



Source: U.S. Bureau of Economic Analysis.

Fourth, all financial sector reregulation proposals under discussion point to higher costs of financial intermediation. After all, the general purpose is to curb the unbridled "endogenous liquidity factories" and the excessive leverage that led to widespread asset bubbles in the run up to the economic crisis.

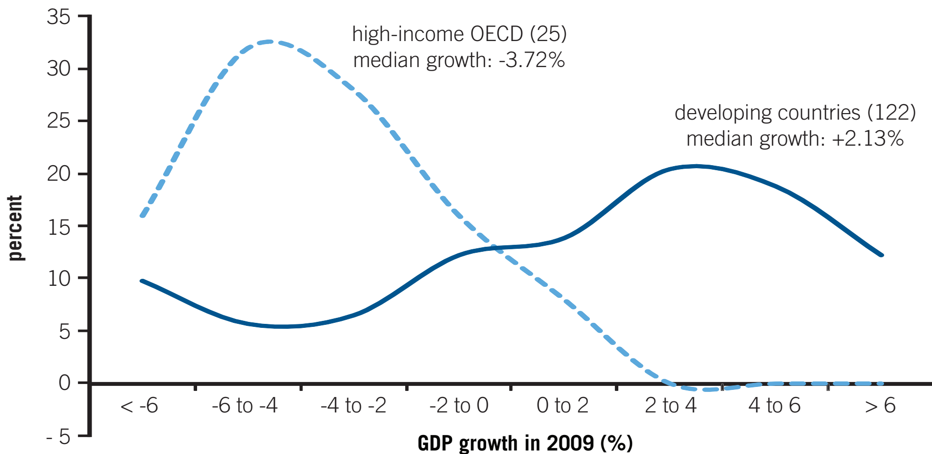
Recoupling or Switchover

The recent improved growth performance in developing countries is not just a reflection of strong performance by the two largest developing countries, China and India. Figure 4 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 percent) than in advanced economies (-3.72 percent). And a much larger proportion of developing countries have continued to enjoy positive growth than among advanced or high-income countries.

Most of the developing countries situated at the right side tail of their 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 countercyclical policies, as well as the ability to use foreign exchange reserves and exchange rate fluctuations as elements of their responses to the shock. On the left side of the distribution are 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 are also some cases in which trade and financial integration led to severe impacts—such as in Mexico and some Central American and Caribbean countries. In any case, the performance of developing countries overall has been high, before and during the crisis, mostly reflecting an improvement in the quality of the economic policies in the previous decade or so.

As one can see in figure 1, there has long been a close correlation between economic cycles in advanced and developing economies. But looking only at global aggregates may obscure an emerging story about trend decoupling between advanced and developing countries. Since the early 2000s, the cyclical synchrony has been combined with systematically higher growth rates in developing relative to advanced economies. While before the early 2000s the trend growth in developing countries was close to that in advanced countries, since then it has become sub-

Figure 4. Frequency Distribution of GDP Growth in 2009: Developed and Developing Countries



Source: World Bank.

stantially higher: a cyclical coupling has arguably continued as in the past, along with some trend decoupling in underlying rates of growth.

Three questions then arise:

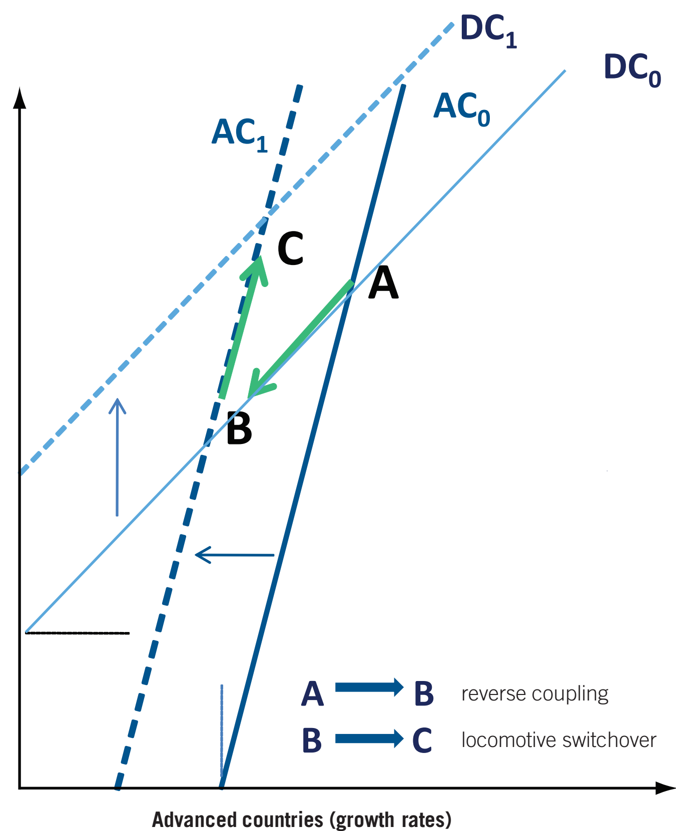
1. How sustainable is the trend decoupling exhibited by developing countries in figure 1?
2. How high can actual and potential growth rates of developing countries remain as advanced economies continue to face recovery challenges?
3. To what extent can a high-growth performance by developing countries 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 grow at relatively low rates?

Figure 5 provides a simplified illustration on the growth interdependence between the two groups of economies. Channels for growth interdependence may be interpreted 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 up until now 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 shown 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—growth that does not depend directly on growth in advanced economies—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.

Developing economies as a whole do not yet have a size big enough to rescue the entire world economy from the scenario of low growth in advanced economies. In terms of levels, the size of G-7[3] economies at market prices is still 60 percent of world GDP, and the major potential new poles of growth (China, India, and Brazil) might account for up to 30 percent.

As time passes by, however, the absolute size of the two groups of countries is poised to reverse positions because the growth premium exhibited by developing countries since 2000 is expected to remain (figure 1). Recent IMF forecasts for global GDP with purchasing power parity (PPP)–adjusted exchange rates indicate developing countries as a group as bypassing advanced economies before 2015. Although develop-

Figure 5. Growth Interdependence



Source: Author's illustration.

ing Asia has the lead in that dynamic, rising shares in global GDP are also a feature of other regions. Therefore, if new, autonomous sources of trend growth in developing economies can be tapped, then not only can developing countries escape from a negative recoupling, but there can also be a switchover, where developing countries become the global growth locomotives and partially rescue advanced economies, thereby helping lift all economies.

The good news is that some possible sources of autonomous growth in developing countries can be found. However, tapping into those sources will depend on the ability of developing countries to implement appropriate policies: let us see why.

Autonomous Sources of Potential Growth in Developing Countries and Their Challenges

First, the fast recovery in many emerging markets has reflected the good shape and sustainability of their national balance sheets—as illustrated for the public sector in figure 2. 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, public sector management capacities and appropriate governance mechanisms must be in place to guarantee the use of adequate criteria in project choices and designs, as well as to avoid misappropriation of returns. Furthermore, euphoria with recent macroeconomic successes must not lead to a careless walk on the slippery slope of increasing leverage. The current surge in private capital flows to emerging markets with a profile potentially conducive to fostering asset market bubbles, rather than to building greenfield assets, is a potential pitfall and must be countered with careful financial monitoring and regulation.

A second potential source of autonomous growth comes from technology. Developing countries face a technological convergence gap relative to the frontier level of knowledge in advanced economies in the majority of economic activities. Unexploited latecomer advantages are a venue for local productivity improvements, through technology transfer and adaptation, that remains open, even if the advance of technology slows down in high-income countries. Global changes in recent years have been making technological transfer easier than before, such as through: increased international trade in goods and services; foreign direct investment; intellectual property and technology licensing flows; increases in data storage and transmission capabilities; and falls in costs and uptake of information and communication technologies (Canuto, Dutz, and Reis 2010).

But again, policy challenges will have to be faced. Complementary factors such as reliable infrastructure, access to finance, and an educated labor force are inadequate and must be gradually improved. Furthermore, institutional factors that negatively affect the investment climate tend to harm investments in technology and must be addressed.

Thirdly, provided that domestic absorption—public and private consumption and investment—in developing countries as a whole rises relative to its own production potential, and South-South trade openness is reinforced, there might be a new round of successful experiences of structural change and export-led growth. After World War II, Europe and Japan sustained a long growth cycle through a process of technological and mass consumption catch-up with the United States. Whereas from the 1990s onward, many developing economies achieved high growth facilitated through innovation in information and communication technologies and globalization, but left an important role 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 as a group, with South-South trade allowing small developing countries to also benefit (Canuto, Haddad, and Hansen 2010).

The extraordinary growth performance of some Asian economies and China in particular—like the previous long periods of growth in Latin America—cannot be fully understood without taking into account that to a large extent they experienced a peculiar process of structural change (at least at the start of the growth period): the dislocation of large contingents of low-skilled workers from stagnant and low-productivity activities—such as subsistence production in many rural areas—to other activities whose value at world prices is significantly higher and where there also exists a wide scope for productivity increases, a move generally accomplished without the need for major increases in worker skills.

Rising international trade and the technological changes have made such structural change easier. Among technology trends, the standardization, modularization, and codification of technologies, especially in the electronics and auto industries and in some services, have made it easier to deverticalize and off shore production (Yusuf 2009; Ghani and Kharas 2010). With fragmentation of production and trade in tasks, as well as decreasing costs of transport and communication, the barriers to structural change have become relatively easier to surmount. Local market size has become less of a constraint on 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 beyond early, easy production of tradable goods and services, 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; and more. Again, recent trade and technology trends have been favorable to latecomers from a cost-competitiveness standpoint, as long as the abovementioned domestic complementary factors necessary for creative technology absorption are in place.

In developing countries, programs investing in infrastructure, human capital, poverty reduction, and social inclusion 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 may therefore become a component of sustainable global growth.

Finally, natural-resource intensive developing countries may benefit from the fact that the relative demand for commodities tends to remain strong in the medium term, to the extent that world growth after the crisis will be more dependent on developing countries as a group and demand in these countries is more commodity intensive than elsewhere (Brahmbhatt and Canuto 2010). Once again, quality of policies in developing countries will determine whether that may become either a blessing or a curse: there is much that countries can do to ensure that natural resources provide a foundation for a broadly based and increasingly diversified economic growth strategy. As long as appropriate governance and revenue administration mechanisms are put in place, particularly to avoid rent-seeking behavior, natural resources should be a blessing for those countries.

The role of reforms to strengthen budget processes and institutions, good cost-benefit analysis, public sector management, and evaluation are all crucial. 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, and Vostroknutova [2010]) and commodity revenue volatility.

Conclusion

The view taken here says, yes, there is a way for a switchover to occur, where developing economies as a whole can take on a greater role as a global locomotive and move global growth forward, offsetting the forces moving toward a negative recoupling to slower growth in advanced countries. Successfully navigating the switchover will depend upon the domestic policies and reforms pursued in the developing countries.

About the Author

Otaviano Canuto *is vice president and head of the Poverty Reduction and Economic Management Network at the World Bank. This note is based on chapter 1 of* The Day After Tomorrow: A Handbook on the Future of Economic Policies in the Developing World. *To read the entire book, please visit: http://go.worldbank.org/TPPWANWXR0.*

Notes

1. A broad landscape of those policies and reforms can be found in Canuto and Giugale (2010).

2. Group of 20 (G-20): Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Russian Federation, Saudi Arabia, South Africa, the Republic of Korea, Turkey, the United Kingdom, and the United States.

3. Group of 7 (G-7) countries: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

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