OVERVIEW
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In 1997, the Trade and Development Report argued that a return to faster growth and full employment in developed economies was a prerequisite for tackling the problem of rising inequality, and warned that failure to achieve this could provoke a “backlash against globalization, which might put the gains of global economic integration at risk”.

What happened next in the developed economies was a short boom-bust cycle linked to the dot-com bubble, followed by a period of steady growth and slowly falling unemployment. This was backed by an easy monetary policy in the United States that shored up investor confidence, triggered a surge of international capital flows and boosted global trade. Economists suggested that the world had entered a period of “great moderation”. Some proceeded to explain how hyperefficient, self-regulating markets, under the watchful eye of astute central bankers, had finally overcome the challenge of what then Federal Reserve Chairman Alan Greenspan called “risk transfer and financial stability”.

It was a comforting narrative, but one which ignored how growth was being fed by a massive explosion of debt and an unhealthy addiction to high-risk bets amongst financial market players. In this “great gambling”, inequality, rather than falling, continued to rise, in some countries to levels not seen since the 1920s.

The luck of the financiers finally ran out, beginning with the subprime crisis in early 2007 and ending with the collapse of the investment bank, Lehman Brothers, in September 2008. Sentiment transformed swiftly from euphoria to panic, not only sending financial sectors across the globe into a tailspin, but also triggering the biggest global contraction since the Great Depression.
Governments intervened rapidly to save their financial systems, turning on the money tap as well as initiating more targeted actions tailored to local circumstances; and the G20 stepped in to coordinate a Keynesian-style fiscal expansion. Greenspan apologized, acknowledging that “I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms”.

Thirty quarters after the crisis hit, developed countries are still struggling to return to a solid growth path, and policymakers were predicting tougher times ahead even before Brexit gave another jolt to financial markets. Growth forecasts have been regularly scaled back, and a new vocabulary has emerged to describe an underperforming economy faced with the choice between episodic growth spurts and financial stability. Developing economies, having for a while believed they had decoupled from events in the developed economies, are increasingly worried that policy actions in the latter could trigger a deflationary spiral and a new round of debt crises.

While the current situation seems less ominous than in 2008, it is proving more difficult to manage. With the financial system on a firmer footing, politicians and policymakers have recovered their sense of impotence in the face of supposedly insurmountable global forces, and have made “business as usual” their default policy option. Financial markets are chastened but unreformed, debt levels are higher than ever and inequality continues to rise. Most of the upside gains have resulted from asset price rises and increased corporate profits. Meanwhile, most of the downside adjustment has fallen on debtor countries and working families, with wages, employment and welfare provision under constant pressure from a return to austerity measures.

This conjuncture might appropriately be described as a “Polanyi period”, in which the regulatory and normative framework on which healthy markets depend, having already warped, is beginning to buckle as the weight of Greenspan’s mistake is felt in an ever-widening swathe of economic and social life – from precarious employment conditions to corporate tax inversions to undrinkable tap water. Trust in political leadership is at an all-time low, just when the need for decisive political action is at an all-time high. This is particularly true for a series of interconnected global challenges, codified in the Sustainable Development Goals, which
can only be met through effective international cooperation and action.

Reflecting on a similar period between the two world wars, Karl Polanyi insisted that a “great transformation” would be needed if markets were to work for a stable and prosperous future for all. Trust would have to be rebuilt, regulations strengthened, and rights and representation expanded. Western governments after the Second World War were able to strike a balance between market-driven efficiency and the demands for shared prosperity and greater economic security. Managing such a transformation in our highly interconnected global economy is today’s big political challenge, for countries and communities at all levels of development.

The global economy: A year of living dangerously

The world economy in 2016 is in a fragile state, with growth likely to dip below the 2.5 per cent registered in 2014 and 2015. The mediocre performance of developed countries since the 2008–2009 economic and financial crisis is set to endure, with the added threat that the loss of momentum in developing countries over the past few years will be greater than was previously anticipated. Without a change of course in the former, the external environment facing the latter looks set to worsen, with potentially damaging consequences for both their prosperity and stability in the short to medium term. More widespread contagion from unforeseen shocks cannot be ruled out, knocking global growth back more sharply. The decision by voters in the United Kingdom to leave the European Union (EU) is one such shock.

Growth in the United States this year is likely to slow down, as the momentum that was built through the quick detoxification of its banking system and a more aggressive use of monetary policy loses traction. Moreover, given its weak underlying employment rate, the number of distressed households with high levels of debt and exporters already struggling with a strong dollar, there are no guarantees that the economy will enjoy a robust period of growth any time soon.
Recovery in the euro zone has lagged behind that of the United States, in part because of the more timid use of monetary policy in the years immediately following the crisis and a greater proclivity for severe austerity measures in some members of the zone. The tentative pick-up of growth from 2015 seems likely to stall this year, and could even be reversed due to the uncertainty triggered by the announced departure of the United Kingdom from the EU. Economic growth continues to be held back by weak domestic demand and only sporadic signs of an improvement in real wages. Efforts to tackle the sharply diverging economic performances of the countries in the euro zone are complicated by political uncertainties, such as the ongoing migration crisis, and doubts about the future pace and direction of European integration.

European economies outside the euro zone have performed better in recent years, mainly because the monetary authorities in many of those countries have been willing, and able, to orchestrate financial bubbles. The economy of the United Kingdom, even without the threat of Brexit, was destined for a difficult period owing to its high level of indebtedness and a persistently large trade deficit. The longer term consequences of the Brexit vote are still unclear, given the unprecedented nature of the decision and the political uncertainty it has created, though growth will undoubtedly slow down in the short term. Just how steep the drop could be, given the highly financialized and flexible markets in the United Kingdom, is difficult to predict.

Japan continues to exhibit a distinct set of economic characteristics stemming from decades of underperformance, with persistently low and erratic growth accompanied by a low unemployment rate and a declining active population, a high domestic debt and a strong payments position. Consumption has remained slack due to stagnant wages, leaving exports as the preferred source of expanding demand. In recent years, with the weakening of global markets and an appreciating yen, efforts have turned to stimulating the economy through government spending, but with only a modest response so far.
The upshot is that continuing weak demand in developed economies is stifling growth in the global economy. The expected positive impacts of lower commodity prices, particularly oil, have not materialized. Higher levels of public debt are failing to stimulate demand and boost growth, largely because these are a consequence of balance sheet adjustments in other parts of the economy. The persistent drag on growth in most developed countries is due to a falling wage share and insufficient household demand that have not been offset by higher investment spending.

Neither financial bubbles nor export surges offer a sustainable solution to the tepid growth and weak labour market conditions. Financial bubbles can provide a temporary boost, at best, but they tend to aggravate the deflationary gap by increasing inequality, and create supply-side distortions that impede productivity growth. Export surpluses can certainly benefit countries that achieve them, but are ultimately a beggar-thy-neighbour response in a world of insufficient global demand.

In the absence of concerted recoveries in the developed economies, international trade is in the doldrums for the fifth straight year. To date, protectionist tendencies have been kept in check, but risk surfacing if the real causes of this slowdown are not tackled effectively. The major problem is weak global demand due largely to stagnant real wages.

The slowdown of trade has stalled growth in many developing countries, particularly commodity exporters, and recent growth spurts have relied largely on capital inflows. As capital begins to flow out, there is now a real danger of entering a third phase of the financial crisis which began in the United States housing market in late 2007 before spreading to the European sovereign bond market.

Developing economies will likely register an average growth rate of slightly less than 4 per cent – as in 2015 – but with considerable variation across countries and regions, along with mounting downside
risks. Damaging deflationary spirals cannot be ruled out. Indeed, these are already occurring in some countries, including large emerging economies such as Brazil, the Russian Federation and South Africa, where recession has returned, or is imminent, with likely negative spillover effects on neighbouring economies.

Other economies are also set for hard times ahead, smaller commodity producers being particularly vulnerable. The commodity cycle is in its second year of a sharp downturn, and the commodity price index is well below the level it was at when the financial crisis hit. With investors still exiting developing and transition economies, net capital flows turned negative in the second quarter of 2014, and amounted to -$656 billion in 2015 and -$185 billion in the first quarter of 2016. Even though there was a respite in the second quarter of 2016, there remains a risk of deflationary spirals in which capital flight, currency devaluations and collapsing asset prices would stymie growth and shrink government revenues, and cause heightened anxiety about the vulnerability of debt positions.

Size can provide somewhat of a buffer against strong headwinds from the global economy. The two largest developing economies, China and India, may escape the worst of the adverse external environment due to their expanding domestic markets and a combination of sufficient foreign reserves and an effective use of their policy space.

China’s economy has slowed down sharply over the past few years, although it is still maintaining a relatively high growth rate of 6.5–7 per cent. While this partly reflects its ongoing shift away from an excessive reliance on external markets to boost growth, the surge of domestic credit in response to the crisis has created a debt bubble which, along with excess capacity in several sectors of the economy, will not be easy to manage if it bursts. Financial volatility in early 2016, which saw capital outflows from China of around $160 billion in the first quarter of the year and a further drop in foreign reserves, is a warning sign of the possible turbulence ahead.
India has so far managed the downside risks of the post-crisis period better than other emerging economies, and is now growing faster than China. Private investment, which began rising strongly from the start of the millennium, continued to grow even as the crisis hit. However, it is now showing signs of weakening, along with emerging debt servicing difficulties. Meanwhile public investment has yet to take off, exposing infrastructure gaps that could hinder future growth.

**Working out the debt problem**

In recent years, developing countries have steadily opened their domestic financial markets to non-resident investors, foreign banks and other financial institutions, and have eased restrictions on their own residents investing abroad to allow portfolio diversification. In addition, their financial institutions have diversified into cross-border activities unrelated to international trade and investment. These developments have deepened their financial integration and amplified boom conditions across all developing regions. But they have also created new sources of vulnerability.

There have been growing concerns about financial fragility in emerging economies due to a deluge of financial flows and cheap credit since 2009, fueled to a considerable extent by extensive quantitative easing programmes in developed economies. Alarm bells have been ringing for a while over the exploding corporate debt incurred by emerging market economies. According to the Bank for International Settlements, the debt of non-financial corporations in these economies increased from around $9 trillion at the end of 2008 to just over $25 trillion by the end of 2015, and doubled as a percentage of gross domestic product (GDP) – from 57 per cent to 104 per cent – over the same period. Past experience shows that if much of the non-performing private sector debt is large and denominated in foreign currency, as in Latin America, for example, it tends to end up on public balance sheets, thus risking a sovereign external debt crisis. The exception is China, where corporate debt is about 170 per cent of GDP, up from 100 per
cent in 2008, but it mainly consists of domestic bonds and claims by domestic banks. While there is no danger of an external debt crisis, the high debt level is exerting considerable pressure on the domestic banking and financial sector.

In poorer developing economies, the benefits reaped from the debt relief initiatives of the 1990s and early 2000s and a rushed integration into international financial markets post-2008, are fast evaporating. Only a couple of years ago, the amount of debt that low-income developing economies could have sold to eager investors seemed almost limitless. International sovereign bond issuance in these economies rose from a mere $2 billion in 2009 to almost $18 billion by 2014. But a prolonged commodity price shock, steep currency depreciations and worsening growth prospects in a deteriorating global economic environment have quickly driven up borrowing costs and debt-to-GDP ratios.

If the global economy were to slow down more sharply, a significant share of developing-country debt incurred since 2008 – not only debt issued and held within the borders of individual economies, but also cross-border debt, including debt accumulated by private residents and governments – could become unpayable and exert considerable pressure on the financial system. Thus, the international community will need to prepare itself for managing debt work-outs in a faster, fairer and more orderly manner than it has done so far.

**Changing policy direction**

A world economy populated by consumers with insufficient purchasing power and too much debt and producers with large profits and a weak propensity to invest is unlikely to provide the stable economic foundation on which a sustainable and inclusive future can be built. At the same time, global productivity growth appears to be stuck, adding to the unbalanced state of the world economy. This is due not least to the protracted nature of the recovery from the 2008 crisis. However, the weight of financial markets on economic decision-making and the
related rise of inequality, both of which have increased unchecked over several decades, is of particular concern. In addition there is growing recognition that excessive concentration in some markets, along with excessive competition in others, is compounding economic imbalances and adding to the difficulties for policymaking everywhere.

Separately, a slowdown of productivity growth, rising inequality, insufficient global demand and mounting levels of debt represent enormous challenges for policymakers at the national and international levels. Together they pose a serious threat to shared prosperity and stability. The worry that an unforeseen event, such as Brexit, could trigger widespread economic disruption is now being put to the test. The International Monetary Fund (IMF) has warned policymakers to be alert; perhaps it is also time for them to become a little more alarmed.

While there is agreement that these challenges are closely interconnected, there is no sign of a concerted move towards policy coordination among systemically important economies. The United States has begun to recognize that its economic policy decisions have impacts beyond its own borders, with the Federal Reserve responding with a more cautious stance on interest rate rises. But a more ambitious policy package is needed to address existing imbalances and ease the constraints on faster growth, whether in large or small countries, surplus or deficit economies, commodity or manufacturing exporters, creditors or debtors. A global new deal will need to move beyond business as usual.

As argued in past Trade and Development Reports, the policy package in developed economies will need to combine a proactive fiscal stance, both on spending and taxation, with supportive monetary and credit policies, stronger financial regulations and redistributive measures through an incomes policy, minimum wage legislation, progressive taxation measures and welfare-enhancing social programmes. The specific policy mix will, of course, vary across countries, although large public infrastructure spending would need to be a common thread. Developing countries also will need to adopt proactive policies
– including fiscal, financial and regulatory policies – to restore growth rates to their pre-crisis levels and ensure that such growth is more inclusive and sustainable. For this, they will require sufficient policy space both to manage unforeseen economic shocks and to pursue the kind of structural transformation strategies previously undertaken by today’s developed economies. Such policy space should be guaranteed through more flexible international rules. Other initiatives that need to be taken at the multilateral level include measures aimed at stemming tax evasion and avoidance, and financing infrastructure development with a low-carbon footprint.

There are signs that international bodies, such as the IMF, are rethinking their approach to macroeconomic adjustment along these lines. The necessary next step is for them to move away from a narrow discussion of structural reform that promotes a familiar package of liberalization and deregulation measures, and instead consider the wide range of actions needed to diversify the structure and level of sophistication of economic activity. Such actions should aim to increase productivity, create more and better jobs, boost household incomes, increase fiscal revenues and investment, and foster technological progress, and all this in the context of a world that is rapidly moving towards a low-carbon future.

The antinomies of globalization

Beginning in the early 2000s, all developing regions saw growth accelerate significantly more than in developed countries, and at a pace which helped bring about a dramatic reduction in levels of extreme poverty. In some countries it also helped reduce income gaps with the North. This convergence trend continued in the aftermath of the financial crisis, but is now losing steam as growth decelerates across the developing world. Lessons need to be drawn from this recent experience if convergence is to resume and be guided along more transformative growth paths.
Looking at the period since the early 1980s, it is possible to discern three major trends that have helped reshape the global economic landscape: the persistent slowdown of developed economies, the consistently strong performance of East Asia, and the uneven performance of other developing countries, both over time and across regions.

East Asia’s economic take-off began in the 1960s with the newly industrializing economies in the North-East, and spread South-East in the 1980s, albeit with a weaker momentum. It was reinvigorated in the new millennium as China’s post-reform transformation took hold. Of the 11 fastest growing non-island developing economies since 1980, 9 are from East Asia.

Elsewhere in the developing world catch-up growth has been more intermittent. Indeed, many developing countries are further behind the developed economies today than they were in 1980, despite recent growth spurts.

One possible explanation for this variation relates to the reconfiguring of the global environment over the past three decades, which has benefited some countries (and communities) but held back others. Certainly a confluence of favourable economic factors – greater trade and capital flows, increased remittances and aid flows, and higher commodity prices – explains the general acceleration of growth across the South at the start of the millennium, but such growth occurred along development paths that had been set in the previous two decades. As the global economic tide begins to ebb, those paths are being exposed to the elements of a less favourable environment.

The big investment push that was expected to drive structural transformation in developing regions remains one of the unfulfilled promises of a more open global economy. Financial openness has certainly improved access to capital and made it cheaper, while foreign direct investment has reconfigured segments of the international division of labour. However, capital flows in most developing countries have
become more volatile, and have not always triggered new investments in productive capacity or changed productive structures. Shocks and crises were frequent threats to forward planning until the early 2000s, when a short-lived period of calm was established and investment increased, albeit gingerly. Taking the period since the early 1980s in its entirety, there appears to have been a weak, and possibly inverse, relationship between capital formation and financial openness.

Another feature of the contemporary globalization process which might offer some clues to these varied growth experiences is the reconfiguring of markets. Free competitive markets are a favourite textbook prescription for enhancing economic prosperity, and it is assumed that the larger those markets the greater will be the prosperity. In reality, some markets have become subject to increasing concentration as a handful of firms have emerged with the resources to gain control, while other markets have experienced an intensification of competition. The danger with such a combination is rent extraction in some areas and a race to the bottom in others. As a result, different countries are facing very different opportunities and pressures.

Global markets can be good servants but bad masters; and ceding more authority to those markets is a matter of political choice, not economic or technological destiny. The economic slowdown in developed economies rules out any simple explanation that those choices are the product of a rigged North-South game. Indeed, the combination of slower growth and rising inequality in these economies has left its own trail of depressed communities. The big political challenge facing the international community is therefore to move beyond a mapping of the winners and losers from globalization to a more constructive narrative of building shared prosperity.
Missing linkages

Development is, at its core, a transformational process, combining a series of interactive and cumulative linkages to create a virtuous circle of greater resource mobilization, increasing employment, higher incomes, expanding markets and more investment, leading to better jobs. Strong aggregate productivity growth is the fuel that keeps this circle going, providing policymakers with the room to better manage trade-offs and conflicting interests, and offering the potential to narrow gaps with the developed economies.

Productivity growth in most developing regions kept pace with developed countries until the late 1970s. The tendency since then has been one of divergence, both on average and across sectors, and, with the exception of countries in Asia, it has continued even as economic growth has picked up in some countries since the start of the new millennium.

These trends have generated renewed interest in the role of structural transformation in fostering sustained economic growth and development, reflected in the new 2030 Agenda for Sustainable Development, one of the goals of which is inclusive and sustainable industrialization.

However, the striking difference between East Asia and other developing regions over the past three decades or so lies not so much in the relative weight of industry in total output, but of manufacturing activity. These regions stand out in that the share of manufacturing in GDP rose steadily to cross a threshold of 25 per cent (South-East Asia) or 30 per cent (North-East Asia) and was maintained for a sustained period of time. The rapid growth of manufacturing was accompanied by strong employment creation and rising productivity, allowing these countries to successfully enter global markets and drive up the rising share of developing countries in global trade in manufactures over the past few decades. In other regions, manufacturing growth has fallen below overall output growth, and employment growth has been associated with little productivity growth, or vice versa.
In successful catch-up experiences, support for the manufacturing sector was not at the expense of other sectors; rather various intra- and cross-sectoral linkages and complementarities further enhanced productivity and employment growth. As the manufacturing sector expanded primary production also tended to become more efficient as a result of declining input prices as well as technology and knowledge spillovers. Similarly, the services sector typically developed in conjunction with manufacturing, with certain service activities being spun off from continued progress in manufacturing. These activities also offered scope for productivity increases, which helped enhance the potential for further productivity growth in the industrial sector by providing more and better quality inputs to manufacturing processes.

Over the past five decades, productivity has grown the fastest in developing regions where the investment-to-GDP ratio and investment per capita were the highest, or where investment growth was the fastest. In addition to investment in productive capacity and technological upgrading, improvements and adaptation of workers’ skills, management know-how and entrepreneurial competence have been key to successful structural transformation. The composition of manufacturing activities, in terms of low, medium and high technology, has major implications for how knowledge and skill acquisition occurs. When learning takes place in design and engineering activities that can be applied in a broader spectrum of sectors, industrial production is characterized by steep learning curves that favour the emergence of intersectoral linkages and improved efficiency overall.

The distribution of the gains from productivity increases in manufacturing activities also affects the pace and sustainability of the transformation process. If productivity gains are used predominantly for increasing profits, those profits may be reinvested in additional productive capacity and technological upgrading, but such reinvestment is not guaranteed and needs incentives, including a supportive macroeconomic framework and prospects of expanding demand. To the extent that productivity gains also translate into higher employment and wages, they lead to stronger domestic demand, which can induce entrepreneurs
to further invest, and to the emergence of economies of scale for domestically produced goods and services of mass consumption. Strong productivity gains also boost government revenues through higher corporate and income taxes without an absolute reduction in private sector incomes. Those revenues can be channelled into productivity-enhancing infrastructure investments, including the provision of public utilities and services. Finally, productivity gains may translate into lower prices for exported goods, thereby helping to gain or maintain global market shares.

Public spending has played a crucial role in the process of structural transformation. Transport, logistics and telecommunication infrastructures, power and water utilities, the provision of education, professional training and research and development (R&D) support, and information and coordination services strongly influence productivity growth in all sectors, as well as the pace and pattern of structural transformation.

Investment, both public and private, is not, however, sufficient to sustain the process of structural transformation over a prolonged period; building linkages between leading subsectors and the rest of the economy is also critical. Linkages take a variety of forms. “Backward” production linkages arise as producers procure inputs from others, and “forward” linkages stem from supplying inputs to others, both within the manufacturing sector and in the primary and services sectors. Investment linkages occur as the viability of an investment in productive capacity, new entrepreneurial ventures and the related extension of manufacturing activities in one enterprise or subsector typically depends on prior or simultaneous investment in other firms or sectors, or specific infrastructures. Knowledge linkages are created from spillovers of skill acquisition and technological learning among firms through formal and informal channels and from education, professional formation and R&D conducted outside firms being put to effective use by various firms. Income linkages lead to changing consumption patterns when growing incomes linked to improved employment conditions translate into higher demand for domestically produced goods, and when higher productivity gains or rents from natural-resource exploitation lead to
an increase in public revenues, enabling greater public investment and service provision.

Although market incentives can contribute to the emergence and strengthening of these linkages, this rarely happens spontaneously. Indeed, differences across countries in actively building linkages go a long way towards explaining the varying structural transformation patterns across the developing world.

Using a broad brush approach, it is possible to identify three different trajectories of structural transformation over the past few decades. Such stylized trajectories offer a framework for learning from successes and failures, and for designing appropriate policy responses. The first category is that of *catch-up industrialization* with robust production, investment, knowledge and income linkages built over several decades based on a growing and increasingly diversified manufacturing sector. Other than in today’s developed economies, this path can be observed only in a small number of East Asian newly industrialized economies, although its potential has been exhibited in some other countries for shorter periods of time. China also appears to be on this path, though at a much lower level of development.

These experiences of catch-up industrialization confirm steadily rising per capita investment as a key factor for reaching a critical mass in certain manufacturing activities. They also demonstrate the crucial role played by the various linkages, which were fostered through strong government support for selected industries, including targeted credit allocation, public and publicly-sponsored R&D, and promotion of access to export markets. The public sector facilitated long-term investment in plant and equipment, including through considerable public investment in both physical and relevant knowledge infrastructure. In addition, the creation or strengthening of income linkages was supported by policies to influence more equitable distribution of incomes, which in turn boosted domestic demand.

Much more common among developing countries have been cases of *stalled industrialization*, in which shares of industrial income
and employment begin to stagnate after prolonged periods of growth of manufacturing output, but at lower levels of per capita income and overall productivity. This has been the case in India and Mexico, for example, and, more recently, in several countries in South-East Asia. In other countries, the expansion of manufacturing slowed even before a solid base for sustained industrialization could be established, such as in many sub-Saharan African countries. In countries experiencing stalled industrialization, productivity growth has tended to fluctuate, and has rarely matched even the weakest periods in East Asia. Moreover, it has not been accompanied by a sustained expansion of employment in manufacturing.

In many of these countries, there have been pockets of excellence, where there has been simultaneous growth of productivity and employment in subsectors of the economy, such as in some services in India, and in enclaves of manufacturing dynamism in Mexico that have a heavy FDI presence and have benefited from preferential access to the North American market. However, spillovers have been limited. A hybrid path has been followed in some countries in South-East Asia, such as Indonesia, Malaysia and Thailand. They experienced positive structural transformation until the late 1990s, with continuous increases in employment and productivity across a broad range of industrial activities, including manufacturing, based on rising rates of investment. However, the 1997–1998 Asian financial crisis led to a significant reduction of investment rates and the stalling of earlier progress in employment and productivity in manufacturing.

In sub-Saharan Africa (excluding South Africa), the manufacturing sector has never managed to reach the scale needed to drive a cumulative process of linkage-building. In many countries, structural adjustment policies in the 1980s and 1990s had a negative impact on the expansion of manufacturing. The subsequent recovery of growth in manufacturing output was based on higher employment rather than improved productivity, and has remained insufficient to create strong production and income-related demand linkages. Investment levels, even though increasing, have remained too low relative to requirements
to drive broad-based productivity growth and knowledge generation and diffusion.

The third trajectory of structural transformation is one of *premature deindustrialization*, in which the shares of manufacturing value added and employment started to decline at levels of per capita income much lower than those at which developed economies and successful catch-up industrializers started to deindustrialize. This is accompanied by a sharp fall in relative productivity levels. This trajectory has been observed in a number of countries in South America since the debt crisis of the 1980s. These economies have seen periods of productivity stagnation or decline, in some cases quite prolonged, and in most cases coinciding with sharp falls in investment growth. Indeed, the rate of capital accumulation in Latin America has been the lowest among developing regions in the post-1970 period. A similar trajectory is evident for countries in North Africa, as well as several transition economies that experienced the collapse of a centrally planned system.

Premature deindustrialization has been closely linked to drastic policy changes in the direction of more restrictive macroeconomic policies, lower public investment in infrastructure and knowledge, and, more generally, reduced State intervention to support structural transformation. Large, and sometimes unilateral, trade opening, coupled with periods of currency appreciation, strongly affected the profitability and viability of important segments of the manufacturing sector, while a trend towards more regressive income distribution weakened domestic demand.

**Reconnecting trade to structural transformation**

Developing countries have greatly increased their share in global exports of manufactures, which grew from around 10 per cent in 1980 to nearly 45 per cent by 2014. About one quarter of that trade is South-South, reflecting in part how global value chains (GVCs) have extended the reach of international production networks in some key tradable sectors of the global economy. These developments, and
the trade liberalization that facilitated them, are widely viewed as a promising indicator of the potential for globalization and trade to support industrialization and speed up development.

Part of the reason why export-led industrialization is such a favoured strategy is because of the successes of the first-tier East Asian economies, where the expansion of exports of manufactures was supported by industrial policy and macroeconomic management resulting in the fastest and most sustained record of catch-up development in the modern era. Variants of this approach have spread to other countries in the region, though they have not been able to fully emulate the success of the region’s first-movers. To a large extent, aggregate statistics on the rise of the South in manufacturing trade belie the singularity of Asia’s achievements. In 2014, Asia alone accounted for nearly 90 per cent of developing-country exports of manufactures to the world, and for 94 per cent of South-South trade in manufactures. Nevertheless, a number of developing countries outside the Asia region engage in significant trade in manufactures, with many more pursuing such trade in the hope of realizing the promise of export-led industrialization.

Although deeper participation in international trade – both exporting and importing – can increase the pace and extent of industrialization, and raise productivity both within and across industries, these relationships are neither simple nor assured. Trade liberalization, if reciprocal, opens export markets and eases access to the import of capital goods and intermediate products, but it also introduces a number of potential challenges for the industrialization process. Perhaps most formidable is the prospect of increasing competition from industrial imports, which has been linked to premature deindustrialization and informalization across a number of countries. Another challenge is that export markets have become much more crowded and competitive, increasing the globally accessible supply of less-skilled labour at a time of general wage compression and weak aggregate demand.

Whether and to what extent the export of manufactures induces industrialization and productivity growth depends on both the composition
of exports of manufactures (the more technologically-intensive the better), and their share of domestic value added. Moreover, scale probably matters as much as the share of domestic value added and technological intensity, not least because of the need to absorb labour into manufacturing activities in order to achieve aggregate productivity growth. Enclaves of manufacturing excellence are encouraging, but they are insufficient to generate the linkages and the economy-wide productive transformation required to achieve significant industrialization.

Even where scale may be large enough to substantively shape domestic production, the problem of price is still a constraining factor. The fallacy of composition – as an ever more crowded field of exporters pursue the same export-led strategy – compresses price (and ultimately wage) growth, even for the most successful manufacturing exporters in Asia. The terms of trade for developing-country exporters of manufactures declined at an average annual rate of 1.1 per cent between 1980 and 2014, and by 1.5 per cent for exporters of manufactures in Asia. Moving to more technology-intensive exports seems a promising alternative, but the leap has to be large and sustained to outpace the many competitors vying for the same higher priced export markets. The flip side of the fallacy of composition is the concentration of market and pricing power. The rise of GVCs is both a cause and a consequence of this phenomenon. On the one hand, GVCs facilitate a wider participation of developing countries in global trade of manufactures, thereby opening new avenues for industrialization. On the other hand, this wider participation generates more competition, which further strengthens the bargaining and pricing power of lead multinational enterprises (MNEs) based predominantly in developed economies. This makes it difficult for developing-country producers – even the large emerging market suppliers – to raise and capture value added in economically consequential ways.

A big part of the problem is that export-led industrialization in the current era has been a generally disappointing generator of broadly shared, high-wage employment – an often overlooked but essential aspect of successfully linking exporting and industrialization. Even
where productivity gains offer the potential for social upgrading, they may mostly increase profits, or be used to lower prices to solidify an existing competitive advantage, rather than raise wages. If most of the productivity gains are transferred abroad via lower prices, the virtuous circle of productivity supporting domestic demand and investment may be weakened. These competitive dynamics have been particularly problematic for countries in Africa and Latin America, where globalization has been associated with the movement of labour from high- to low-productivity production, but also to the informal economy. Conversely, a number of Asian countries have been better able to exploit the opportunities created by exports of manufactures with a simultaneous increase in productivity and employment.

These employment patterns are particularly pronounced when disaggregated by gender. In Africa and in Latin America and the Caribbean, growth in exports of manufactures has been more strongly associated with an increase in women’s employment in low productivity service sector jobs rather than in the high productivity modern manufacturing jobs that export-led industrialization strategies were expected to create. In Africa between 1991 and 2014, a 1 per cent increase in exports of manufactures was associated with a 0.34 per cent increase in women’s employment in services, but only a 0.12 per cent increase in their employment in industry. The comparable figures for women in Latin America and the Caribbean are 0.29 per cent in services and 0.14 per cent in industry. The causal mechanism here is twofold. On the one hand, increased competitive pressures in export and domestic markets have induced more outsourcing and the proliferation of informal work. On the other hand, combining domestic labour with more capital-intensive production technologies has both lowered the employment intensity of manufacturing and raised the relative demand for skilled labour. Ultimately, it must be recognized that part of managing structural change involves designing an employment policy that ensures inclusive and self-sustaining processes of industrialization.

Many of the weak links between trade in manufactures and industrialization can be traced to the problem of deficient global
aggregate demand. Growth strategies, in both North and South, based on wage compression and fiscal austerity mean there is not enough demand in the traditional developed-country destinations for export-led industrializers. Turning towards more regional, South-based markets offers a promising alternative – particularly for exports of manufactures – as is already partly reflected in the changing geography of international trade. But a successful shift requires that developing countries, especially large emerging economies, change their focus from export-oriented industrialization to domestic-demand driven industrialization. Developed-country markets still serve as important destinations for selling more sophisticated goods, and provide critical opportunities for enhancing production, design and marketing capabilities. However, none of these strategies are capable of sustaining industrialization unless they are supported by growing global aggregate demand.

An unhealthy investment climate

Structural transformation needs a strong investment push. The broad sweep of history suggests that such a push is becoming more demanding the later countries begin to industrialize. But even for middle-income economies that have built some initial capacity, moving ahead often requires a renewed push to break through specific constraints. Financing investment pushes can, at all income levels, be a major constraint on the development process.

Conventional wisdom puts its faith in financial markets to channel available household savings to those best able to use them productively. But in the more successful experiences, governments have played a lead role in using the available economic and institutional space to create conditions within which a mixture of public and private finance can be mobilized for long-term investment projects. Access to credit was often critical for kick-starting an investment drive, and it is no accident that, among the developing regions, East Asia has the most advanced credit system with the highest investment-to-GDP ratios. However, in these and other successful countries, mobilizing the requisite domestic
resources has involved increases in corporate profits and in the profit share in a growing GDP, suggesting that profits have been both a cause of and conditional on increases in productive investment. This dynamic profit-investment nexus has been key to sustained structural transformation.

However growing financial openness and persistent instability in the international financial system have not only weakened the profit-investment nexus in developed economies, but also show signs of corroding that nexus in developing countries, with potentially damaging consequences for sustainable structural transformation.

In developed economies, substantial increases in corporate profitability over the past 30 or so years have not been the result of rising levels of real investment. In leading developed economies (France, Germany, Japan, the United Kingdom and the United States), while average investment (excluding construction) fell steadily from around 20 per cent of GDP in 1980 to historically low levels of below 16 per cent of GDP in 2015, profit shares followed the exact opposite trajectory, rising from an average 14.6 per cent in 1980 to just below 18 per cent in 2013 (notwithstanding temporary slumps during the dot-com bubbles and the global financial crisis). In these economies, corporate profitability has been driven increasingly by the financialization of corporate strategies, linked to the rise of so-called “shareholder primacy” and a focus on short-term decision-making, cost management and financial engineering under the watchful eyes of institutional investors. While the pace has varied across countries, corporate “refocusing” through managerial practices such as increased dividend distribution, stock buybacks, mergers and acquisitions has meant that conventional “retain and invest” strategies have been progressively replaced by the mantra to “downsize and distribute”.

The repercussions at the macroeconomic level have been felt clearly in developed economies in the form of rising income inequalities (due in part to executive remuneration schemes), progressive tax erosion and, ultimately, weakening aggregate demand, jobless growth, financial
bubbles and further rises in income inequality. As a result, the profit-investment nexus is steadily unravelling.

Meanwhile, in developing countries, the adverse effects of financial globalization have been apparent for some time, particularly in the form of macroeconomic shocks, but more recently these impacts can be clearly discerned at the corporate level. Balance sheet data of non-financial firms in large developing economies showed a decline in investment-to-profit ratios between 1995 and 2014, with a sharp fall in some countries, such as in Brazil, Malaysia, the Republic of Korea and Turkey. While in most developing economies large shareholding corporations are still the exception rather than the rule, there are clear signs that their strategies, too, are becoming more financialized. For those firms that regularly distribute dividends in developing economies, the share of payouts is on the increase despite roughly stable profits. Firms in this category are also accumulating financial assets, in some cases faster than corporate debt, indicating both a lack of profitable long-term investment opportunities as well as greater portfolio investment choices in liberalized financial markets. Rapid increases in the indebtedness of non-financial corporations are fast becoming a serious concern in many emerging economies.

There was a 40 per cent increase in the dollar-denominated debt of non-financial corporations in 13 selected developing countries between 2010 and 2014, a period during which their debt-to-service ratios also soared – a solid warning indicator of systemic banking crises in the making. By this measure, the indebtedness of these corporations skyrocketed by no less than 40 percentage points between end 2007 and end 2015. By way of comparison, levels of indebtedness of non-financial corporations in some major developed economies (Germany, Japan, the United Kingdom and the United States) fell by almost 20 percentage points over the same period.

While it would be premature to suggest a generalized breakdown of the profit-investment nexus in the developing world, it is evident that, whereas corporate profitability has been on the increase almost
everywhere, investment trajectories have varied considerably among countries. Moreover, the adverse macroeconomic impacts of global as well as corporate financialization are clearly increasing. This has been the case not only where recent surges in corporate indebtedness in emerging economies have been fuelled, at least in part, by quantitative easing programmes in developed countries, and the enormous excess liquidity to which this has led. In addition sector-level data reveal how debt-fuelled investment has been concentrated in highly cyclical and natural-resources-based sectors that do not contribute to structural transformation and fast productivity growth. Indeed, only seven sectors – oil and gas, electricity, construction, industrial commodities, real estate, telecommunications and mining – explain more than two thirds of the total increase in both debt and investment.

Reining in corporate financialization, in developed and developing economies alike, will require changes in corporate governance and in the incentive structures of non-financial corporations, for example by strengthening regulatory links between corporate taxation and profit reinvestment for productive purposes.

For many developing countries in the early stages of structural transformation, what is of critical importance is not addressing the weakening of a previously strong profit-investment nexus, but establishing such a nexus in the first place. This requires large-scale economic and institutional efforts to build effective banking and financial systems capable of providing adequate credit and liquidity for rapid productive expansion. It also requires proactive policy measures to overcome early hurdles to viable and profitable private sector initiatives, and to channel them to projects that play a major role in structural transformation. At the same time, vital public investment, in particular at the early stages of catching up, needs to be protected by concerted international actions to tackle tax avoidance, evasion and capital flight that erode States’ revenue base.

This said, long-term and sustainable (external and domestic) financing requires, first and foremost, that systemic shortcomings in
the international financial system be tackled in substantial and lasting ways. It also requires responsible macroeconomic policy coordination among countries. Without reliable macroeconomic stability and a full recovery in developed economies, long-term corporate real investment will continue to suffer in developed and developing economies alike.

**Industrial policy redux**

No country has made the arduous journey from widespread rural poverty to post-industrial prosperity without employing targeted and selective government policies that seek to shift the production structure towards new types of activities and sectors with higher productivity, better paid jobs and greater technological potential. Such policies are conventionally called “industrial policies” though they might be more accurately described as “production transformation policies”.

A great deal has been written about industrial policy tools and experiences in recent decades, with much of the discussion revolving around a sterile debate about whether or not governments can “pick winners”. In reality all policy decisions involve priority-setting, trade-offs and bargaining; and policymakers are doomed to target. The focus of discussion needs, instead, to be on the challenge of linkage-building in support of virtuous development circles, the integrated policy approach this implies, and the institutional geometry that is needed to implement that approach.

Given that a much larger level of investment is required for economic transformation, and the fact that there has been a weakening of the export-investment-profit nexus – a nexus that proved crucial to the success of the East Asian late developers – catch-up growth strategies face enormous challenges. This necessitates a serious rethinking of economic policy approaches and options.

In light of the changes in the global economy, governments in developing countries need to be ambitious but not unrealistic. They
should strive for a high development road by creating new sources of growth and dynamism, rather than simply trying to do the best with what they currently have by taking advantage of existing comparative advantages. Small and incremental steps can be useful, but more radical “comparative-advantage-defying” measures will be needed to shift towards higher value-added and employment-generating activities with high income elasticities and more capacities for creating synergies through knowledge creation. The downside of aiming high is to run the risk of failure. This risk should also be managed, with mechanisms for monitoring performance, observing underperformance, and either rectifying or removing State assistance. Accordingly, the emphasis becomes not on whether to have an industrial policy at all, but on how to design and implement it properly.

The role and effectiveness of industrial policy is not only a concern in developing economies. While the share of industrial activity in developed economies’ GDP has been declining for some decades as part of their evolution towards a post-industrial society, the pace and extent of this shift, which accelerated in the early 2000s, has begun to worry policymakers in several developed economies. Such worries, and attendant concerns about the hollowing out of the middle class in these economies, have intensified since the 2008 global crisis, reinforcing the argument that policymakers should now use industrial policies as part of a rebalancing of the economy away from the lopsided domination of the financial sector. It is an argument supported by the slow recovery of these economies since the Great Recession.

In this context, a distinction can be usefully drawn between “passive” and “active” industrial policies. “Passive” policies essentially accept the existing endowments and institutional structures and aim to reduce the costs of doing business, including coordination and transaction costs. By contrast, “active” policies target deeper changes in corporate structure and behaviour, such as investment, exporting and upgrading. The institutional prerequisites for active and passive policies are likely to be different. In particular, the effective targeting of active measures requires substantial State capacity and a degree of
discipline that is often neglected in discussions of industrial policy. In practice, while an active policy is almost always accompanied by a passive policy, the reverse is not the case.

Active industrial policies require a supportive institutional geometry of developmental States, government-business dialogue, and “reciprocal control mechanisms” that ensure government support translates into desired actions by the private sector. Arguably, the critical step – and often a misstep – in the application of industrial policies is the provision, monitoring and managing of rents in support of structural transformation and upgrading. From a policy perspective, potentially growth-enhancing rents can become growth-reducing if the rent management capacities of the State are missing. If the State does not have the credibility to withdraw or withhold financial support in cases of underperformance, there will not only be short-term costs, but also long-term adverse consequences.

The key lies in the State’s efforts to help build the linkages that can sustain a process of structural transformation, guiding resources towards activities that have the potential to increase productivity and higher paying jobs. In many countries, this will involve examining all the domestic supply chains across sectors, from the stage of primary production to final output logistics of manufacturing firms. In others, it will involve linking up with global supply chains that already exist. In either case it will involve facilitating access to long-term investment finance at reasonable cost for manufacturing firms, especially in targeted sectors, as well as in those activities that can benefit from linkages with firms in those sectors. As such, the tools and levers of industrial policy should also be part of an integrated and interconnected package of policies that align trade, competition, labour and macroeconomic policies with industrialization imperatives. The package needs also to be adaptable, changing when constraints and capacities change.

Today’s policymakers can no longer rely on export-led manufacturing alone to generate the kind of growth achieved by the East Asian late industrializers. This is not to say that countries should stop seeking export
markets; rather, they should recognize that a much more nuanced and strategic approach is needed. They need to be more pragmatic in their choices of products and overseas markets, while also paying closer attention to building domestic and regional markets and to fostering the variety of production, technology and income linkages that an expansion of these markets will require.

In order to promote a structural shift towards manufacturing and industrialization or towards more sophisticated services, governments need to adopt policies with the following objectives:

- Ensure high levels of aggregate demand, high levels of investment, and a stable exchange rate (which may on occasion allow undervaluation but not overvaluation). Supportive fiscal policies are important to create stable but expansionary economic conditions in which economic diversification can flourish.

- Cultivate the capabilities needed to change the composition and sophistication of production activities, and promote a strong learning environment. Public R&D is likely to be critical, along with investment in both formal educational institutions and in shop-floor training.

- Pursue intermediate input substitution industrialization, particularly in middle-income countries that have entered GVCs but are struggling to upgrade their industrial capacities. This will also likely mean transforming export processing zones into more integrated industrial development parks with much stronger backward and forward linkages to the rest of the economy.

- Avoid adopting export strategies that rely on compressing wages; labour is not just a cost of production, but an important source of demand and tax revenue.

- Promote development-oriented competition rules, that can offset the global dominance of MNEs. The combination of increasing
concentration at the top of GVCs and increasing competition at the bottom may require a new institution, such as a Global Competition Observatory, to monitor trends along different segments of the value chains and across sectors, and to ensure that firms outside GVCs are not unfairly affected.

- Bolster access to finance for structural transformation, not only in terms of supporting particular lines of investment, but also as a useful vehicle for monitoring and influencing corporate behaviour in support of long-term decision-making. Financial regulation can promote industrialization by making purely financial transactions less attractive than other, more productive investments.

- Close tax loopholes through fiscal and regulatory measures at the national, regional and international levels, and require greater transparency in corporate decision-making. Effective regulation of distortionary monopolistic practices is essential to ensure that profits are directed towards productive investment.

More ambitious and comprehensive policy action in these areas will be essential for meeting the new Sustainable Development Goals. As discussed in previous Reports, and despite the curtailment of policy space under “finance-led globalization”, there is still sufficient space to pursue the kind of economic programmes that can trigger transformational change but also more inclusive and sustainable outcomes. However, that space needs to be buttressed against the ideological and institutional pressures that have placed market efficiency above shared prosperity.

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