

# TRADE AND DEVELOPMENT REPORT, 2014

## *Chapter II*

### TOWARDS A SUSTAINED ECONOMIC RECOVERY: REVIEW OF POLICY OPTIONS



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## **TOWARDS A SUSTAINED ECONOMIC RECOVERY: REVIEW OF POLICY OPTIONS**

This chapter examines some of the main macroeconomic policy stances in developed and developing countries and their policy options. It shows that not only is the recovery of global growth since the financial crisis rather weak, but also its drivers are inadequate. Indeed, in several major economies, policies intended to spur the recovery are similar to those that led to the latest global crisis in the first place, which raises justifiable doubts about the sustainability of the modest GDP growth attained so far. The chapter then undertakes an empirical modelling exercise to highlight the possible consequences of current policies, and offers an alternative set of policy options. This methodology helps to highlight issues of consistency (or the lack of it) between diverse policies applied at the national level, as well as the interrelationships between the outcomes of those policies in different countries and regions.

Section A analyses the policy approaches adopted by developed and developing countries. These policies consist of a varied mix of wage compression, reduced public sector spending, and a heavy reliance on liquidity expansion that causes asset appreciations and debt bubbles, especially in developed countries. While such policies may contribute to faster growth in a subset of countries in the short run, such a pattern of expansion sows the seeds of a future crisis. To the extent that labour incomes do not increase and public sector services and social protection are cut

back, there can be no solid growth of real demand to fully absorb the additional liquidity created by expansionary monetary policies. To date, most of the extra liquidity has flowed instead into speculative activity or moved abroad. Policymaking in developing countries is further challenged by these trends, which have either distorted prices or shifted resource allocations away from primary development goals. Altogether, risks of a hard-landing are increasing, and if this occurs, it could have strong negative effects on global demand and financial stability.

Section B assesses this configuration of policies with the help of the United Nations Global Policy Model (GPM), and evaluates the macroeconomic implications for the medium term. It measures the impact of current policies on growth, demand, financial stability of the public and private sectors, and external balances. The modelling framework is then used to examine the impact of a different set of policy choices that replicate some of the more favourable conditions that prevailed not so long ago. This hypothetical exercise demonstrates that coordinated incomes policies which would restore the patterns of distribution of the mid-1990s, combined with supportive fiscal policies and investment promotion policies, could deliver a robust, sustained and more balanced growth performance than a baseline which assumes a prolongation of current policy stances.

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## A. Policy threats to a global economic recovery

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To many observers, the improvement, albeit small, of the growth performance of some of the major economies in 2013 came as a pleasant surprise. That momentum is expected to continue through 2014. Meanwhile, projections for some developing and transition economies suggest that growth is likely to be slower than expected, but nevertheless considerably faster than in most developed economies. Overall, there is likely to be some improvement in global growth performance in 2014. At an initial glance, this would appear to be a welcome trend, but a deeper look at the nature of this growth revival raises concerns. The analysis that follows suggests that the recent growth in a number of important economies may not be based on sound policies. Thus, even if the current pace is maintained for some time, vulnerability to financial shocks persists, due to a repeat of the policy failings that led to the 2008 global crisis.

### 1. Policy stances in the developed world

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#### (a) Synchronized premature fiscal contractions

In most developed economies, there was a sharp turnaround of fiscal policy in 2010, with the apparent withdrawal of fiscal stimuli, but which was effectively a contraction of government spending (chart 2.1). The chart shows the differences in real government spending on goods and services between the second quarter of 2010 and the last quarter of 2013, as a per cent of real 2010 Q2 GDP (thus reflecting the cumulative contribution of government spending to GDP growth). However, this may not be the ideal measure, since it assumes that zero growth of government spending is a neutral stance. In fact, after extraordinary measures, such as a fiscal stimulus, are

removed, a truly neutral stance would be to return to a “normal” growth path of real spending, which can be estimated in the form of a long-term trend.<sup>1</sup> Hence, chart 2.1 also compares the actual value of real government spending with what could have resulted if government spending had followed its long-term pace of growth, which is a more meaningful indication of the degree of the fiscal adjustment from mid-2010.

Chart 2.1 confirms that the most pronounced cases of fiscal austerity have been in the peripheral countries of the euro area. The negligible size of the European budget and the reluctance of the European Central Bank (ECB) to assume the role of lender of last resort affected the degree and timing of fiscal adjustments in these countries. Due to such institutional flaws, national governments had to absorb the costs of the crisis, in many cases leaving them little alternative but to subsequently squeeze public spending. By the last quarter of 2013, real government spending on goods and services in Greece, Ireland, Italy, Portugal, Slovakia and Spain was below the level of 2010, showing shortfalls in the range of roughly 1 per cent to 2.5 per cent of GDP over this period (2010 Q2–2013 Q4). Comparing these observed patterns with the long-term trend of government spending, the implied adjustment turns out to be more than twice those figures. Other economies in the euro area also changed their fiscal stance. Even if government spending in real terms remained close to the levels of 2010, when compared with the long-term trend, almost all these other economies effectively adopted a contractionary fiscal stance from 2010 Q2 to the end of 2013.

Several developed economies outside the euro area followed a similar path, prompted by the threat that fiscal deficits, whatever their cause, may be viewed as a sign of economic “indiscipline” and result in credit downgrades. It was feared that such

downgrades might cause stampedes by concerned investors. Among these economies, a closer examination of the United Kingdom and the United States can offer some useful pointers. In the former, the fiscal stimulus adopted to avert a deeper recession after the financial crisis was reversed prematurely, causing a second recession. Initially, a recovery in exports helped weather the recession, but that recovery turned out to be short-lived. A moderate relaxation of the fiscal stance eventually followed in response to the weak growth performance. The cumulative effect of government spending from 2010 Q2 to 2013 Q4 accounted for a mere 0.6 per cent of GDP, and by the end of that period, real GDP in the United Kingdom remained below the level of 2007.<sup>2</sup>

In the United States, adjustments imposed upon financially stretched state and local governments started in 2009 Q4,<sup>3</sup> followed in 2010 by cuts in federal spending in the wake of discussions on the debt ceiling. Contributions of real spending to GDP growth by the government sector as a whole have been consistently negative since 2010 Q3, amounting to a cumulative negative contribution of 1.6 per cent by 2013 Q4. Compared with the long-term trend, there was a cumulative gap in real government spending of more than 3 per cent of real GDP from 2010 Q2 to 2013 Q4.

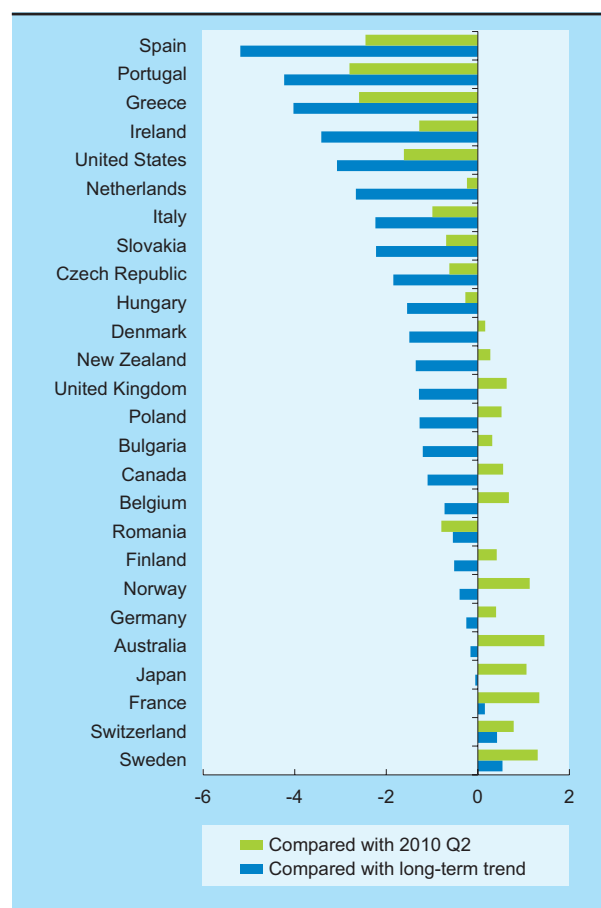
On the whole, governments in developed countries adopted contractionary fiscal stances from mid-2010 to the end of 2013, when compared with the long-term trend. Only Japan and France maintained the trend growth of spending over this period. The case of Japan is revealing. It experienced a long deflationary period before being adversely affected first by the global crisis and subsequently by the earthquake of 2011. The Government's adoption of strong monetary and fiscal stimuli over the past two years (referred to as "Abenomics") has met with some success so far. Domestic demand has been a more important driver of Japan's GDP growth than its net exports, which in turn implies a positive effect on global demand. This is the kind of adjustment that should be expected from a surplus country to help avoid a global deflationary trap.

Finally, in Sweden and Switzerland public spending increased above the trend after 2010, which is consistent with their slightly better growth performance compared with most EU countries.

Chart 2.1

### CHANGE IN REAL GOVERNMENT EXPENDITURE, SELECTED DEVELOPED COUNTRIES, 2010 Q2–2013 Q4

(Per cent of real 2010 Q2 GDP)



**Source:** UNCTAD secretariat calculations, based on Economist Intelligence Unit (EIU), *CountryData* database.

**Note:** Long-term trend is estimated by applying from 2010 Q2 onwards the average expenditure growth of the period 1997 Q1–2010 Q2.

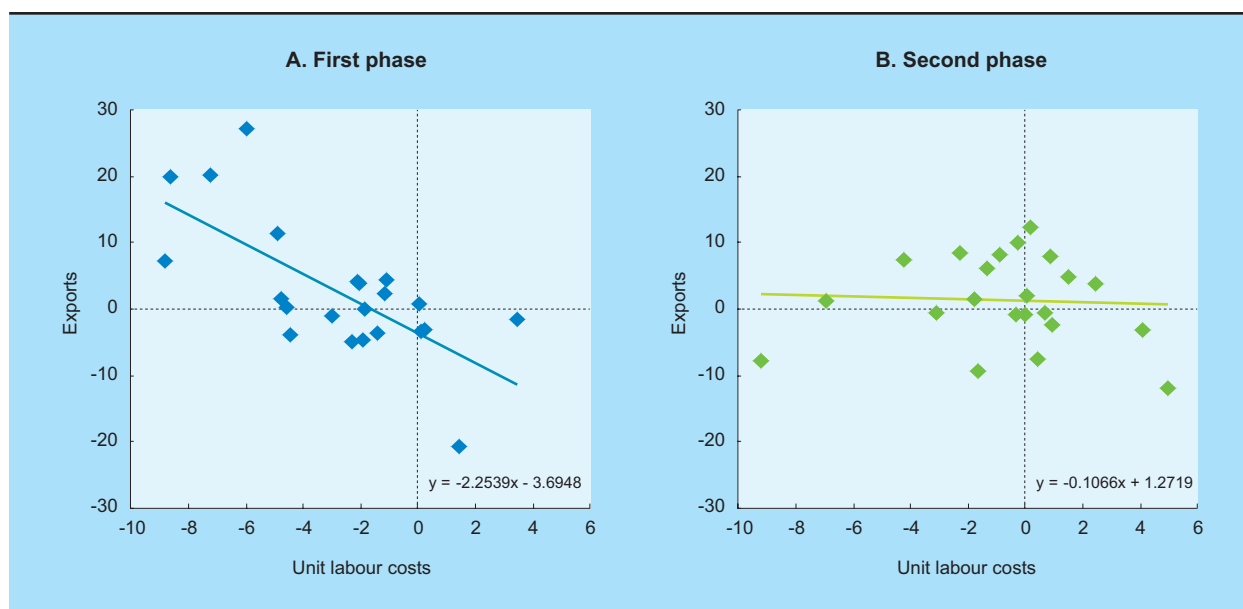
#### (b) Mercantilist race to increase exports

In the aftermath of the financial crisis it is normal to expect subdued spending by households, which were affected by a fall in asset values and heavy debt burdens. This narrows the options for policy-makers in attempting to revive aggregate demand. But if public sector demand is also suppressed, the only remaining alternatives are net export recovery or a revival of "animal spirits" that trigger a push in private investment.<sup>4</sup> Unless households' balance

Chart 2.2

### CHANGES IN REAL UNIT LABOUR COSTS AND EXPORTS, SELECTED EUROPEAN COUNTRIES, 2010 Q3–2013 Q4

(Per cent)



**Source:** UNCTAD secretariat calculations, based on *Eurostat*; *OECD.StatExtracts*; and *UNCTADstat*.

**Note:** Countries included are Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and the United Kingdom. In the first phase, data for real unit labour costs refer to the change between 2010 Q3 and 2012 Q1, while data for exports refer to the change between 2011 Q1 and 2012 Q3. In the second phase, data for real unit labour costs refer to the change between 2012 Q1 and 2013 Q2, while data for exports refer to the change between 2012 Q3 and 2013 Q4.

sheets regain strength and consumer confidence recovers, especially when employment levels are low, a resumption of productive investment for the domestic market seems unlikely. Given these constraints, any possible chance of success for this strategy rests on stimulating private investment in export sectors.

Over the years, *TDRs* and other studies have argued that relying on an export-led recovery cannot be a solution for all at the same time. Yet, in the current circumstances of minimal global coordination, aggregation issues are not a primary concern of policymakers; each country, individually, expects to become a winner. Accordingly, compression of wage incomes has become a key component of the prevailing “structural policies” aimed at increasing competitiveness. It is believed that such policies will induce investment, while a depreciation in the real exchange rate, derived from relatively lower wages, will help to gain market shares. The seeming success

of a handful of countries in translating improved cost competitiveness into export growth tends to reinforce such beliefs. There is also the added fear that countries that do not join this race risk being left behind.

Such beliefs call for a deeper examination of the empirical evidence. This can be done by taking the European countries as a sample. This choice offers the advantage of concentrating on the recent period in which there has been concurrent pressure in these countries to reduce labour costs in order to gain export shares. The additional advantage of taking Europe as a sample is that feedbacks similar to those found with global aggregation can be captured to a significant degree, since a fairly substantial proportion of trade in the region is internal to this market. The correlation between wage compression and export growth in the short run cannot be fully ignored, as reflected in chart 2.2A. Taking a two-year period starting in 2010, when policies shifted away

from fiscal stimuli and towards a competitive race to gain export market shares, the scatter plot shows that, despite great diversity of outcomes, exports seem to have been inversely correlated with changes in real unit labour costs among the selected sample of developed economies. However, in most cases such an effect fades over time (chart 2.2B). Efforts towards achieving greater cost competitiveness through labour market flexibility and wage compression face known constraints: competition becomes harder, as there is a limit to how much labour costs can be cut without seriously affecting social stability and productivity. What is more, declining labour incomes affect revenues of households that have a higher propensity to spend, further eroding, in the aggregate, consumption and investment demand. This eventually has an adverse impact on imports, and thus on the exports of the whole set of countries.

These dynamics are captured in chart 2.3. Under normal conditions that would allow sustained demand expansion, real unit labour costs should at least be stable or rise, but starting in 2010, the index of real unit labour costs (weighted) contracted. Three or four quarters later, real GDP in these economies stopped growing, and as a result, import volumes decelerated sharply. In the aggregate, imports remained flat throughout 2013, with a small upturn in the last two quarters, largely in response to asset appreciations fuelling demand in the major economies (see below). The relevant point is that the ratio of imports to exports declined considerably. Hence, the apparent success of a net-export-oriented strategy mostly reflects, in the aggregate, an adjustment on the import side. In other words, a strategy based on a compression of labour incomes alone, if carried out by a significant number of countries, runs the risk of exacerbating a deflationary trap for all of them.

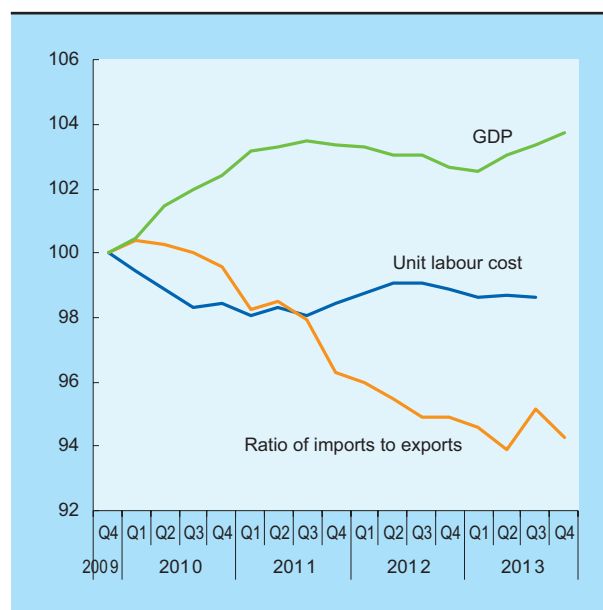
### (c) Declining labour-income shares and global imbalances

Further clarifications can be provided from longer term analyses, as the most recent evolution of real unit labour costs and GDP growth in Europe suggests some ambiguity about the relationship between these variables (chart 2.3). Despite a seeming pause in wage compression in Europe, though no real growth in wages, GDP seems to be gaining traction. Likewise, there were periods in the past when GDP growth in developed countries remained

Chart 2.3

### REAL GDP, REAL UNIT LABOUR COST AND RATIO OF IMPORTS TO EXPORTS IN EUROPE, 2009 Q4–2013 Q4

(Index numbers, 2009 Q4 = 100)



**Source:** UNCTAD secretariat calculations, based on *Eurostat*, *OECD.StatExtracts*; and *UNCTADstat*.

**Note:** Europe includes Belgium, Czech Republic, Denmark, Finland, France, Germany, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, Slovakia, Spain and the United Kingdom. Unit labour cost is weighted by imports.

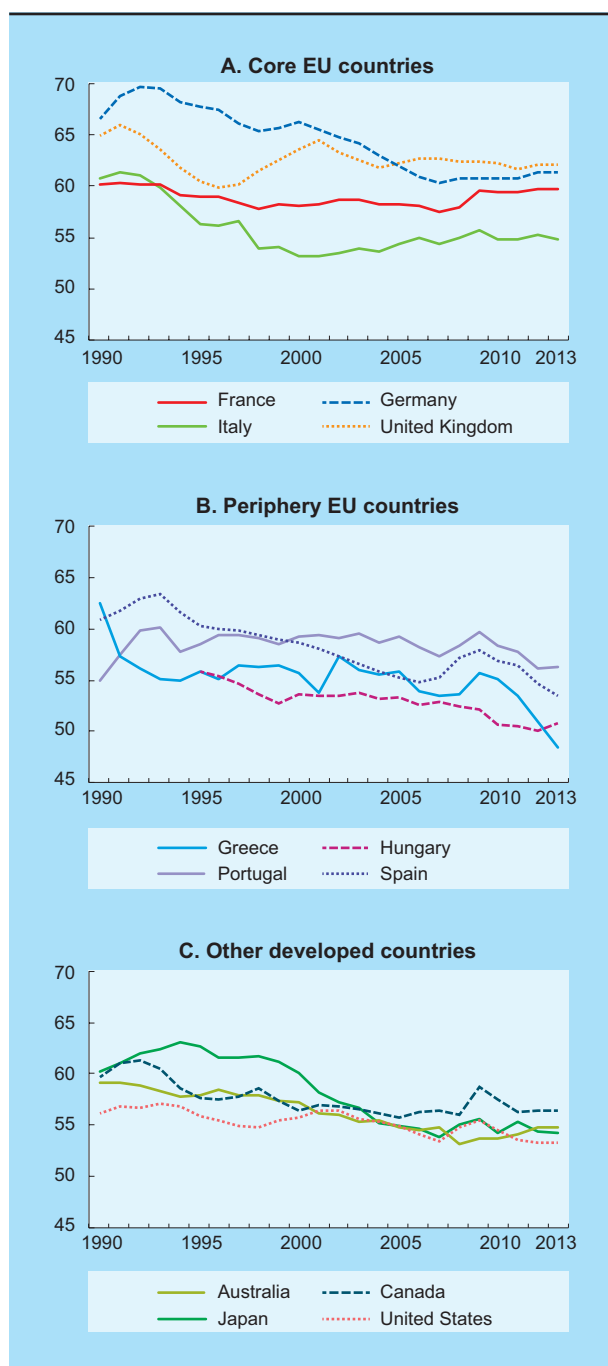
relatively strong even though labour income shares in GDP were falling, or only marginally rising. At least from the early 1990s, there was a marked long-term tendency for wage shares to fall in a number of developed economies (see chart 2.4, where wage shares are the national accounts equivalent of real unit labour costs), though in a few of them some stabilization has taken place in recent years.

These data can be complemented with the historical investigation of Piketty (2014). His detailed analysis of tax returns and other datasets in a number of countries and across decades (and, in a few cases, centuries) has the advantage of showing the evolution of income not only among wage and profit-earners, but also across the distribution of households. The results point to the continuing stagnation in earning of low- and middle-income groups in a number of developed countries over time, together with a dramatic

Chart 2.4

### LABOUR INCOME SHARE IN GDP, SELECTED DEVELOPED COUNTRIES, 1990–2013

(Per cent)



**Source:** UNCTAD secretariat estimates, based on UN-DESA, *National Accounts Main Aggregates* database; European Commission, *AMECO* database; Eurostat, *Annual National Accounts* database; University of California at Davis and University of Groningen, *Penn World Tables* version 8.0; United States Bureau of Economic Analysis, *National Income and Production Accounts*; and United Kingdom Office for National Statistics, *United Kingdom Economic Accounts*.

rise in the earnings of the top decile, and of the top percentile in the United States, but also in Australia, Canada, France, Japan, the United Kingdom and more than 20 other countries.<sup>5</sup> The rise at the very top of the distribution of earned incomes is so staggering that it is reasonable to suggest that such earnings should actually be conceptualized as “rents” from accumulated wealth.

Various implications of relevance to the policy diagnosis of this chapter can be extracted from Piketty’s work. First, aggregate statistics of labour income shares based on national accounts do not fully capture the true extent of deterioration of the incomes of middle- and low-income wage earners. Removing the rising proportions of earned income of the top decile, and especially the top percentile in most, if not all, the developed economies, and characterizing them instead as profit earnings, would significantly accentuate the declining trends of labour income noted above.<sup>6</sup> Second, Piketty observes relatively constant patterns of worsening distribution over considerably long periods, measurable in decades, interrupted only by wars or serious crises. The author argues that returns on capital tend to increase at a faster rate than the growth of income and wages, particularly as GDP growth decelerates in the process of development.<sup>7</sup> The more that capital is accumulated at the top, the more the economic structure is likely to be shaped to favour rents and profits over wage income, which then reduces the reliance of the owners of capital on faster GDP growth. Policy-driven efforts to bring about wage competitiveness with the aim of triggering faster growth of GDP would exacerbate, rather than reverse, this trend. Third, Piketty advances a possible interpretation of the global financial crisis of 2008–2009 on this basis. In his opinion, the long-run tendency towards an increase in the wealth-to-income ratio, together with the rise of cross-border capital, which presumably took place as wealth-holders sought higher rents through a reallocation of their portfolios in global markets, contributed to greater global financial vulnerability and, eventually, to the global crisis.

A growing body of research has shed light on the global implications of worsening income and wealth distribution on growth and stability (Baker, 2009; Cripps et al., 2011; Galbraith, 2012). Based on this, it would seem that the tendency towards declining wage shares may not require an export boost to generate faster growth everywhere; as long as global



imbalances are allowed to rise, a declining wage share can coexist with rising domestic demand in a number of economies where credit expansion can compensate for lower household incomes. This is confirmed by developments in the 1990s and 2000s, which were decades of fairly strong global growth in which wage shares consistently declined (chart 2.4). It is the combination of these patterns which brought about the large macro-financial imbalances and the subsequent collapse in the form of the global financial crisis.<sup>8</sup>

Some authors stress a more direct causal link between wage compression and the formation of credit bubbles: as the relative erosion of labour incomes creates insufficient real demand, capital is mostly diverted towards financial operations, which generate asset bubbles and volatility. This in turn becomes the source of temporary real economic expansion (Foster, 2010; Patnaik, 2010). The growing financialization of developed countries and “subordinate” financialization in developing countries (Epstein, 2005; Lapavitsas, 2013) can be explained in these terms. As a result, economies become more prone to crises, which adversely affect employment and productive activities, and also lead to greater concentrations of wealth and income. The resulting drag on GDP growth is ameliorated only by unsustainable episodes of debt-driven consumption booms.<sup>9</sup>

#### (d) *Asset appreciations and real balance effects*

From the above arguments, it seems clear that the synchronized fiscal contraction and slow growth of labour income across many developed countries will likely lead to either of two outcomes: a protracted slowdown (secular stagnation), or a temporary growth spurt driven by an unsustainable expansion of demand through greater indebtedness in a few major economies. The latter situation characterized the pre-crisis years, and, to a lesser degree, it has been repeated in the recent past. Moreover, it has been exacerbated by the creation of liquidity by central banks, with a direct impact on asset markets across the world.

Elements of this situation appear to be most prominent in Australia, Canada, the United Kingdom and the United States. In these economies the mechanisms at work have strong commonalities: the expansion of liquidity has generated record highs in

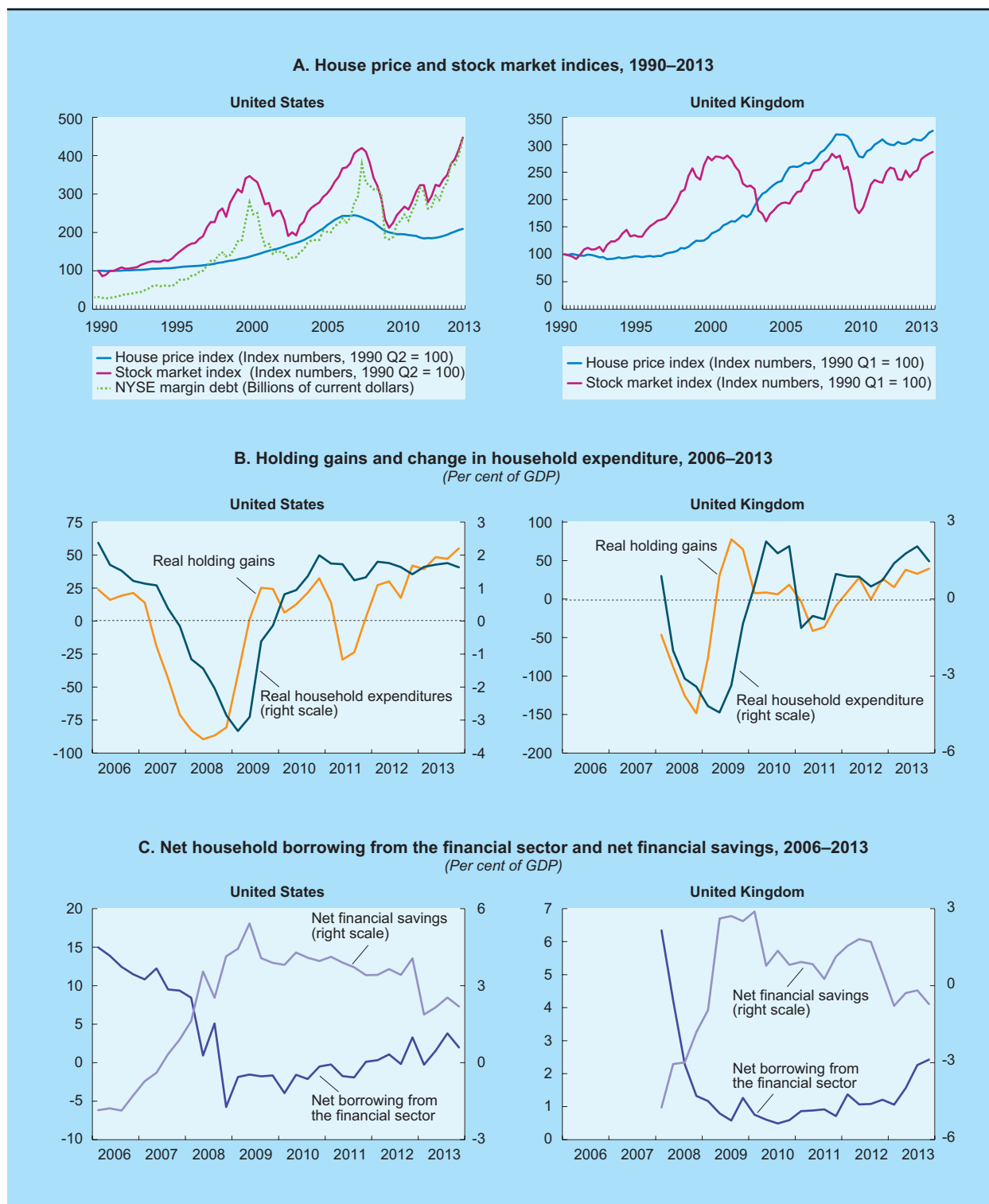
stock markets, and rapid price increases in real estate markets, particularly in the United Kingdom and, to some extent, in Canada. As a result, households are continuing to experience a positive shock on the asset side of their balance sheets and feel more encouraged to reduce their savings. If previous cycles are any guide, household lending capacity (total income minus total expenditure, including investment) may even turn negative, so that the additional spending will be fully financed by debt. The process can go on for as long as asset prices keep rising and liquidity is made available for the purchase of assets.

These mechanisms are illustrated empirically for the United States and the United Kingdom (chart 2.5).<sup>10</sup> Chart 2.5A shows the indices of stock market and house prices in the United States since the early 1990s, and tracks the dot-com boom, the recession of 2001 and the subsequent expansion leading up to the financial crisis of 2008. Since then, in the wake of an ultra easy monetary policy, stock market prices have climbed significantly, reaching unprecedented levels. The speculative nature of these patterns is highlighted in the chart by the inclusion of the New York Stock Exchange (NYSE) “margin debt” series (margin debt being the dollar value of the securities purchased with funds borrowed from investors’ accounts at the NYSE), which have also risen to unprecedented levels. The housing market in the United States has started to recover, but has not yet displayed the exuberance of the mid-2000s.

Real holding gains<sup>11</sup> of the household sector have fluctuated considerably over the past few years (chart 2.5B). In the United States, balance sheets of households were subject to positive shocks equivalent to about 25 per cent of real GDP during the financial boom years, followed by negative shocks equivalent to almost 100 per cent of real GDP during the crisis. Asset prices recovered quickly in the wake of policy stimuli in 2009–2010, but fell once again in 2011 in response to “risk-on, risk-off” fluctuations in speculative markets, presumably reflecting changes in the level of confidence in the financial sustainability of the public sector and the banking sector in the United States and elsewhere. Since then, there has been a continuous recovery of asset prices and, to some extent, real estate prices following quantitative easing programmes. Real holding gains towards the end of 2013 can be estimated to equal about 50 per cent of real GDP, a non-negligible increase in the net worth of the household sector as a whole. Even though these

Chart 2.5

### ASSET PRICES, CHANGE IN HOUSEHOLD EXPENDITURE, AND HOUSEHOLD BORROWING AND NET FINANCIAL SAVINGS IN THE UNITED STATES AND THE UNITED KINGDOM



**Source:** UNCTAD secretariat calculations, based on BIS, *Residential property price statistics* database; Bloomberg; United States Federal Reserve, *Financial Accounts* database; United Kingdom Office of National Statistics and Bank of England databases.

**Note:** Real holding gains refers to capital gains due to changes in asset values, after discounting CPI inflation (3-quarter centred moving average). Net savings refers to total disposable income less total spending (including investment) of the household sector.

holding gains are not cash-flow income, the rise in the value of net worth may induce a proportional increase in spending through wealth effects. With a moderate lag of one to two quarters, there is a fairly strong correlation between holding gains and real spending (chart 2.5B). In turn, the increments of real household spending represented a contribution to GDP growth of about 1.6 per cent in 2013, which is about 60 per cent of total growth.

Asset appreciations driven by liquidity expansions help to explain the recent recovery in the United States, despite the fall in fiscal spending and labour-income shares. However, these patterns also justify concerns about growth under such conditions. In the United States, net financial savings of the household sector, defined as total disposable income minus total expenditure (including consumption and investment spending),<sup>12</sup> peaked at 5.5 per cent of GDP in mid-2009, but then fell sharply following drastic deleveraging after the crisis (chart 2.5C). Subsequently, net financial savings moved back to close to 3 per cent of GDP, approaching what could be considered the long-term norm. However, over the last two years, it has dropped below 2 per cent of GDP, with the trend pointing downwards. At the same time, household net borrowing from the financial sector has started to climb from its unusually negative levels at the trough of the crisis (chart 2.5C). By the end of 2013, net borrowing by the household sector had not reached the extremes experienced at the onset of the crisis, but the direction was still upwards. Apart from the NYSE margin debt plotted in chart 2.5A, complementary data (not shown here) suggest that consumer credit accounted for the larger proportion of the increases in net borrowings of households. Mortgage debt has only recently stabilized, in aggregate terms, after years of adjustments in the housing market, but it is likely that rising house prices will trigger another debt expansion.

Asset appreciations, holding gains and debt dynamics of the United Kingdom can be assessed using the same methodology (chart 2.5). A most striking feature is the pattern of real estate appreciation, which was higher than in the United States and steeper than the appreciation in the stock market. But the combination of these price swings caused exceptionally high holding gains and losses during the booms and crises, respectively, showing a similar pattern to that of the United States. From 2011 onwards the real net gains of the household sector on account

of asset prices climbed continuously to reach about 40 per cent of real GDP by 2013. After a lag, there seems to have been a clear correlation between real holding gains of households in the United Kingdom and their pattern of spending (chart 2.5B). Despite the fact that labour income shares remained barely flat, asset appreciations appear to have led to a rise in household spending amounting to a contribution to GDP growth of about 1.5 per cent per annum in 2013. Further, the rise in household spending, to the extent that it was partly due to holding gains, was matched by a fall in net financial savings (chart 2.5C). Starting in the first quarter of 2013, the household sector in the United Kingdom shifted to a net deficit position: borrowing from the financial sector started to rise again, though not to the same degree as it did during the pre-crisis boom. As in the United States, the underlying growth dynamics in the United Kingdom point to patterns similar to those that preceded the financial crisis. Experience indicates that these are unsustainable processes, but it also shows that they can continue for a fairly long time. Preliminary investigation of growth dynamics in some other countries, such as Australia and Canada, suggests that they share some of these characteristics.

The rapid growth of household demand in this subgroup of developed countries provides a boost for the exports of other economies, particularly those seeking recovery based on net exports. At this juncture, the implied global macro-imbalances between surplus and deficit countries, as well as the internal imbalances between the asset and liability sides of household budgets in deficit countries, may not be alarming. But relying on these patterns is not a sustainable policy strategy, and a strategy from which it is not easy to exit without an alternative growth agenda.

## **2. Policy stances in developing and emerging economies in a context of growing vulnerability to external shocks**

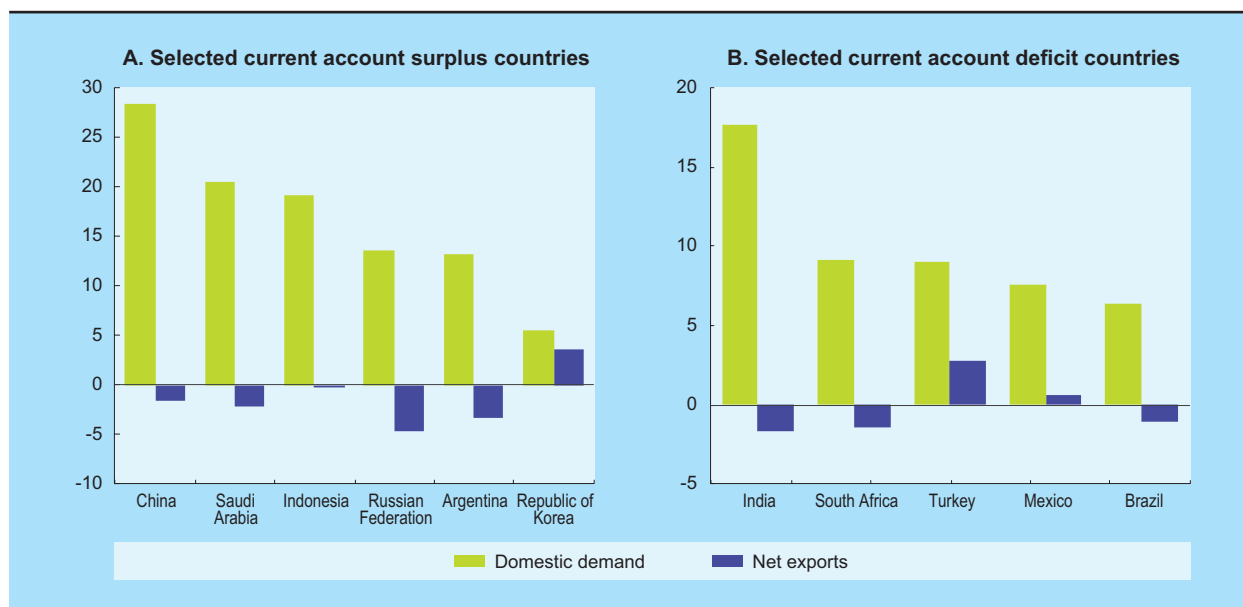
### **(a) The role of domestic demand and incomes policies**

Many developing and emerging economies continued to support domestic demand after 2010, even as developed countries' policy stances shifted

Chart 2.6

### CONTRIBUTION OF DOMESTIC DEMAND AND NET EXPORTS TO REAL GDP GROWTH, SELECTED COUNTRIES, 2011–2013

(Percentage points)



**Source:** UNCTAD secretariat calculations, based on UN-DESA, *National Accounts Main Aggregates* database and *World Economic Situation and Prospects: Update as of mid-2014*; OECD, *StatExtracts*; and EIU, *CountryData* database.

**Note:** Data refer to the 3-year cumulative contribution. The classification of the two groups of countries as surplus and deficit is based on their current account balance in 2010.

towards fiscal tightening. In the context of a global economy that was struggling to recover from the financial crisis, such support helped to maintain their pace of growth, which turned out to be significantly higher than that of developed economies despite a recent deceleration. To the extent that these countries as a group are becoming increasingly important in global trade, their performance contributed to global demand as well, providing growth opportunities for their trading partners.

UNCTAD has often insisted on the need for surplus countries to narrow their external balances by boosting domestic demand and increasing their imports at a faster pace than their exports, instead of forcing deficit countries to adjust and to rely on the compression of labour costs in the hope that this will lead to an export-led recovery. Net import demand from surplus countries would not necessarily make them more vulnerable, particularly if their contribution succeeds in generating new sources of income

in deficit countries, thereby eventually lifting global demand.

Examining macroeconomic indicators of the developing and emerging country members of the G20 is illuminating in this respect. Chart 2.6A shows the cumulative contributions to real GDP growth of countries which were in current account surplus in 2010. Cumulative contributions were calculated for a three-year period, from end-2010 to end-2013. In all these cases, GDP growth was significant, and the major driver was domestic demand, not net exports. Except for the Republic of Korea, which continued to rely on external demand as a significant source of its GDP growth, this subset of developing countries managed to sustain the growth of global demand during the process of recovery from the crisis. Chart 2.6B groups countries that were in current account deficit in 2010. In these countries, the standard approach would be to “adjust” by reducing spending until balance is achieved. But, except for Turkey and Mexico

(which showed a relative improvement in their net trade balances), the other countries' trade deficits increased beyond 2010. In most of these countries, the standard approach was not followed, and their economies continued to be supported by domestic demand. But additional risks were involved, as discussed below.

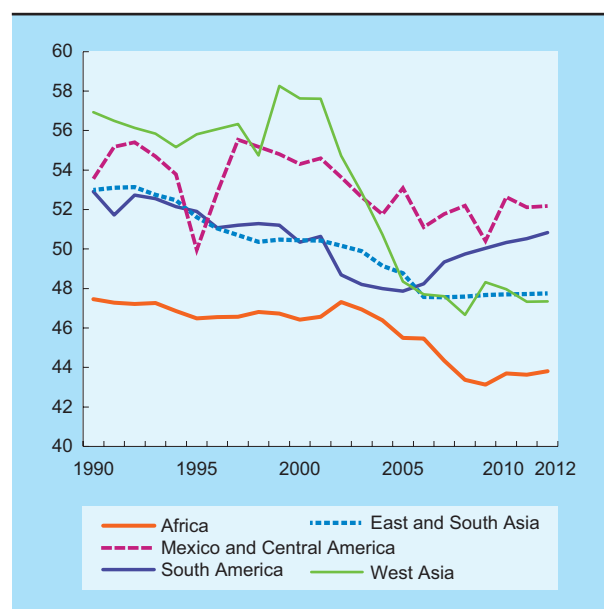
On the basis of this decomposition alone it is difficult to assess whether the countries grouped in chart 2.6B were following sustainable growth strategies. As noted earlier, in some cases net trade gains may be the consequence of competitiveness achieved by wage compression, but this could eventually lead to demand and productivity bottlenecks. Conversely, trade deficits may be the result of an investment-driven strategy aimed at structural transformation, and, to the extent that such deficits are manageable in the medium term, they could result in considerable advantages in terms of long-term growth and development. However, if the trade deficits are the consequence of asset bubbles and excessive consumer borrowing, often accompanied or promoted by a bonanza of foreign capital inflows, they could have hazardous effects and create the need for harsh adjustment measures down the road.

Over the past few decades, in the process of integration into the world economy, many developing and transition economies have adopted policies to attract investors and/or gain market shares by reducing labour income shares (in some cases from already low levels). However, in more recent years these processes seem to have been contained, and in some cases reversed. Based on statistical information available, though incomplete,<sup>13</sup> it is found that there has been varied evolution in the shares of labour income (including mixed income)<sup>14</sup> in GDP (chart 2.7) in different groups of developing countries. The average for South America points to a sustained increase in labour income shares in GDP from the mid-2000s, which reflects an improvement in labour market conditions and deliberate income redistribution policies. The average for countries in Africa shows a similar pattern, albeit starting more recently and from a lower level, and it is less pronounced. Even so, in both regions, this has been insufficient to reach the labour income shares achieved in the past. Meanwhile, other regions in the developing world have managed to contain the deterioration of labour income shares. However, in some cases, such as West Asia, after a sharp decline in those shares, the

Chart 2.7

### LABOUR INCOME SHARE IN GDP, SELECTED DEVELOPING-COUNTRY GROUPS, 1990–2012

(Per cent)



Source: UNCTAD Secretariat estimates based on UN-DESA, *National Accounts Main Aggregates* database; European Commission, *AMECO* database; and University of California at Davis and University of Groningen, *Penn World Tables* version 8.0.

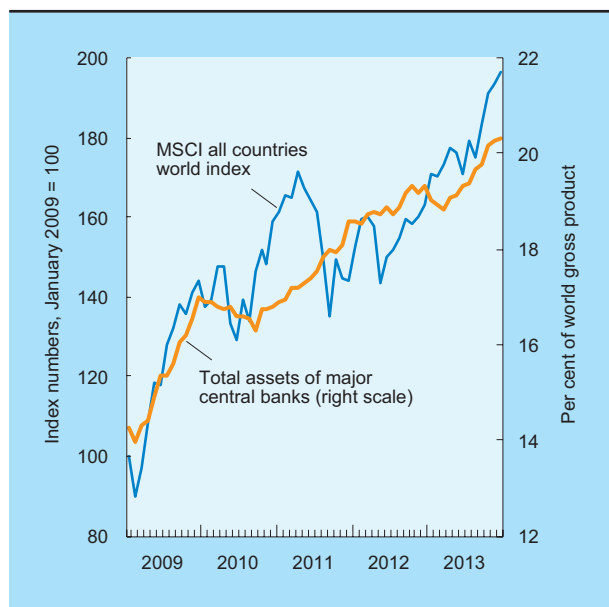
trend has not significantly reversed. Hence, despite significant progress in several countries, the share of labour income needs to expand significantly if it is to provide the basis for a self-sustaining path of growth and development.

#### (b) Challenges from the external financial and trade environment

The vulnerabilities of developing and emerging economies have been heightened by weaknesses in the international financial architecture.<sup>15</sup> It was hoped that the global financial crisis would give rise to sufficient political motivation and intellectual strength to address these weaknesses in a more determined manner. But efforts in this direction, such as those promoted by the United Nations Commission of Experts of the President of the United Nations General Assembly (United Nations, 2009), have been stymied by pressures from global financial interests

Chart 2.8

**TOTAL ASSETS OF MAJOR CENTRAL BANKS  
AND GLOBAL STOCK MARKET INDEX,  
JAN. 2009–DEC. 2013**



**Source:** UNCTAD secretariat calculations, based on United States Federal Reserve database; European Central Bank database; Bank of Japan Accounts database; IMF, *International Financial Statistics* and *World Economic Outlook* databases; and Bloomberg.

**Note:** Major central banks includes the Bank of England, Bank of Japan, European Central Bank, People's Bank of China and United States Federal Reserve.

seeking new investment opportunities, particularly in emerging markets. Justifications for resisting a systematic reform agenda have been widespread. They include the view that adverse financial conditions in major economies are not necessarily transmitted to developing and emerging economies which are virtually “decoupling” from the rest (see, for example, IMF, 2007; Blanchard et al., 2010; Leduc and Spiegel, 2013).

As noted in chapter VI of this *Report*,<sup>16</sup> developing and transition economies have remained susceptible to the kind of boom and bust cycles of capital flows which were commonplace during the period of finance-driven globalization. In the period prior to the crisis most capital flows were triggered by cycles of leveraging and deleveraging by private financial institutions in the developed economies. The last cycle that started in 2010 began with an extraordinary amount of liquidity creation by the central banks of the major

economies. Such monetary injections fuelled asset appreciations not only in the United States and the United Kingdom, as discussed above, but also in many other stock markets, as measured by the MSCI global index (see chart 2.8). Between mid-2010 and the last quarter of 2013, that global index more than doubled, while real economic activity remained subdued. But in some cases, as can be observed by stock market reactions to releases of employment data in the United States and elsewhere, good news on economic activity triggered a fall in the stock market, reflecting the anxiety of speculators about reversals of the liquidity expansion if economic activity and favourable employment conditions were to resume.

Unprecedentedly large volumes of liquidity are currently coursing through highly liberalized capital markets. In the absence of a corresponding increase of demand for credit for productive activities in most developed economies, financial flows are being diverted to portfolio operations within and beyond the issuing economies. In a few exceptional cases, policymakers who are aware of the potentially devastating effects of unfettered capital markets have tried to put in place regulatory measures to protect their macroeconomic environment. In most emerging and transition economies, however, the policy response has resembled more of a revival of the “Lawson doctrine”, which was highly permissive of private capital flows and current account imbalances.<sup>17</sup> Provided that fiscal balances are kept in check, this doctrine recommends against interfering in the portfolio decisions of private agents. Lenders and borrowers, the argument goes, are fully capable of assessing the benefits and risks of their financial decisions. However, such a belief is at odds with the observed highly homogeneous and synchronized risk perceptions of international investors about a quite varied set of developing countries, as evidenced by the strong co-movements of EMBIG indices in chart 2.9. This suggests that investors do not undertake sophisticated analysis specific to very different countries, including the performance of their real economies and their financial structures.

The evidence confirms that many developing and transition economies have been subject to considerable cyclical fluctuations of capital flows, before and after the crisis (chart 2.10). These flows have in turn influenced speculative behaviour, reflected in the rises and falls of stock market indices. The flow series in the chart encompass portfolio flows to the private

banking sectors, including FDI in the form of private equity channelled through domestic financial institutions. They do not include credit to the public sectors of these countries, which was relatively minor during the period under observation. With variations, inflows reached a peak before the crisis and collapsed at its onset in 2008. They resumed sharply after 2009, in some cases reaching new highs,<sup>18</sup> presumably reflecting the vast increase in global liquidity in comparison with previous cycles. Around the second quarter of 2013, with the first announcements of tapering by the Federal Reserve, and before any tapering actually took place, investors began to pull out funds, to varying degrees, from these countries.

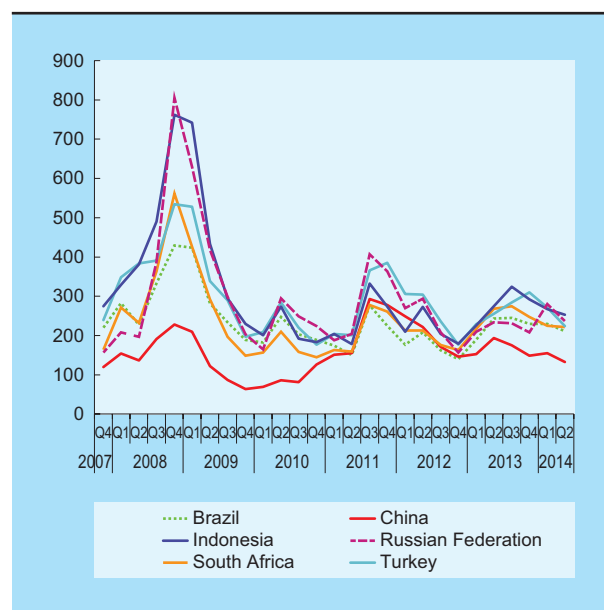
The specifics of country experiences have been well documented and analysed elsewhere.<sup>19</sup> General patterns can be identified through both the upswings and downswings of the cycles. Though the inflows per se are not motivated mainly by the performance of the real economy, it is known that they can have the effect of altering exchange rates, price formation, spending behaviour, financial balances of institutions and policymakers' room for manoeuvre. It is also known that drastic capital reversals can take place for reasons that, again, have mostly to do with changes in the financial conditions of the creditor countries. But these outflows leave behind serious dislocations. Usually, capital reversals have an immediate effect on the exchange rate, making the servicing of the debt or repayment in a foreign currency more difficult. They also have knock-on effects on asset prices, significantly eroding balance sheets. Many of these cases may well represent systemic crises to the extent that the sectors most affected are corporations and financial institutions, with balance sheets which can be greater than a country's GDP. For example, by 2013, the value of assets of the banking sectors in the Republic of Korea, South Africa and Thailand were estimated to be close to three times the size of their respective GDPs, while in Brazil, Chile and Malaysia, bank assets represented about two times their GDP. Under these circumstances, public sector institutions are often forced to come to the rescue. Eventually, public sectors which are not themselves beneficiaries of the inflow bonanza, tend to assume the burden of bad debts once crisis conditions emerge, often leading them to adopt damaging fiscal austerity prescriptions.

Finally, policymakers should be aware of possible negative shocks originating from international trade, particularly in countries that rely on exports

Chart 2.9

### SOVEREIGN BOND YIELD SPREADS, SELECTED DEVELOPING AND TRANSITION ECONOMIES, 2007 Q4–2014 Q2

(Basis points)



**Source:** Bloomberg; JP Morgan Emerging Markets Bond Index Global of sovereign dollar denominated bonds (EMBIG).

**Note:** Data refer to the last value of the quarter and reflect the spread to comparable United States Treasuries.

of only a few primary commodities or low-skill, labour-intensive manufactures. As further discussed in this *Report* (see particularly chapter V), proactive industrial policies need to aim at diversification and upgrading of exports. Indeed, diversification of their productive and export activities remains a pending task for many transition and developing economies. In a sample of relatively open developing economies the index of export concentration increased from the early 2000s (before the commodity boom) to 2012 (table 2.1). Admittedly, in Argentina, China and Mexico the increase in the concentration index was minor and the low value of their respective indices by 2012 suggests that these economies remain quite diversified, though the basket of their export revenues is slightly more dependent on fewer products. Meanwhile, dependence on a smaller set of export products has clearly increased in commodity exporters such as Colombia, Chile, Ecuador, the Bolivarian Republic of Venezuela and the group of transition economies as a whole.

Chart 2.10

**CAPITAL INFLOWS TO THE PRIVATE BANKING SECTOR AND STOCK MARKET INDICES, SELECTED DEVELOPING AND TRANSITION ECONOMIES, 2005 Q1–2013 Q4**



**Source:** UNCTAD secretariat calculations, based on IMF and World Bank, *Quarterly External Debt Statistics* database; and Bloomberg.

**Note:** The stock market index refers to the end-of-period price of the dollar-denominated MSCI index, except for the Republic of Korea, where it refers to the dollar-denominated KOSPI index. Capital inflows refer to 3-quarter centred moving average of the changes in the gross external debt position of the banking sector (except for India and Mexico where they refer to the sum of the banking and “other [private] sectors”).



A complementary measure of the degree to which countries are better prepared to withstand trade shocks, using the UNCTAD Merchandise Trade Specialization Index, produces similar results.<sup>20</sup> The detailed examination of the indices across main categories of products over the period 1995–2012 confirms that, despite the rapid rate of growth of trade in many developing economies over the past two decades, the degree of specialization in the export structure of most developing economies has not varied significantly. Only in a few countries, mostly in East Asia, including China, Malaysia, the Republic of Korea and Singapore, has this structure progressed in the sense that trade balances of manufactures, and particularly of products with higher skill content, improved during this period. Elsewhere, in West Asia, Africa and Latin America, there have been few, if any, improvements, and in some even a clear deterioration, particularly in Africa and among oil exporters.

### 3. Current policies and outcomes from a global perspective

The review of economic policies proposed above suggests that there is need for caution in interpreting current developments. Contrary to the views of some observers, there is no convincing evidence that the world economy is in fact beginning a sustained recovery. The belief that growth in developed economies has finally picked up is overly optimistic; it only serves to claim success for pro-market reforms and to support arguments for a withdrawal of the precautionary measures and stimuli that still remain. This could have grave repercussions. For example, the recommendation that developing countries should pursue fiscal and labour market adjustments similar to those pursued in developed countries is of particular concern. In the light of the discussion in the previous subsection, developing countries could instead consider strengthening incomes policies that still have considerable possibilities to deliver, and could also introduce more effective precautionary measures to mitigate the effects of global financialization and enhance policies aimed at diversifying their economies.

Leaders from developed and developing countries deserve credit for the policies they promoted in 2009–2010. However, changes of policy stances

**Table 2.1**

#### EXPORT CONCENTRATION INDEX, SELECTED COUNTRIES, 2003–2012

	Change between 2003–2008 average and 2012 (Per cent)	Index average for 2011–2012
Colombia	18.7	42.0
Chile	10.0	37.1
Ecuador	9.1	50.0
Hong Kong, China	8.3	20.0
Brazil	7.1	15.8
South Africa	5.2	16.9
Indonesia	4.8	17.1
India	4.4	17.8
Bolivarian Republic of Venezuela	3.9	67.4
Peru	2.1	25.2
Mexico	1.7	15.0
China	1.3	10.0
Argentina	1.1	15.4
<b>Memo item:</b>		
Transition economies	10.2	33.0
Major oil and gas exporters	2.2	55.6

**Source:** UNCTAD secretariat calculations, based on *UNCTADstat*.

**Note:** The index ranges from 0 to 100 (maximum concentration).

after 2010, particularly in developed countries, which primarily include flexibilization of labour markets and restrained public spending, are factors that have delayed recovery. If, at present, there is a sense of a growth revival in some of these countries, the new growth patterns should rather be interpreted as reflecting structural problems of the kind already apparent in the years that preceded the global crisis. Under these conditions, economic growth seems to hinge again on excessive liquidity in the context of asset appreciations, which may drive up private expenditure for a while. As long as this can last, growth of consumer debt in deficit countries could fuel export demand in countries that are either leading exporters or opted more recently for promoting exports to exit from the crisis. However, by now it is known that such processes are unsustainable. Continuing on such a path, in the hope that things will work out differently this time appear to be short-sighted at best. It seems worthwhile aiming, instead, for a different strategy, a subject to which the next section turns.

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## B. Economic policies for a sustained global recovery

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The previous section examined the main policy stances which have helped shape the current world economic situation. In some countries policymakers have aimed at boosting global demand; but, for the most part, macroeconomic policies have either exhibited deflationary tendencies or favoured short-term gains that lead to heightened risks in the long term. There are various reasons why the economic policy landscape remains disappointing, including a general mistrust in the feasibility of more proactive and inclusive policy approaches. The aim of this section is to show that a different set of policies could deliver better results, taking into account possible constraints and feedbacks, both domestic and international. Alternative policy scenarios for the global economy are examined using the United Nations Global Policy Model (GPM).<sup>21</sup>

### 1. Policies and outcomes

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The scenarios produced with the GPM consider a “baseline”, representing a continuation of the policy stances described in section A, and an alternative “balanced-growth” simulation. The baseline is not intended to be a forecast and the balanced-growth simulation is not the only measurable combination of policies and outcomes that could bring about the desired results. More importantly, the scenarios are highly stylized and contingent, for reasons given below. Their value resides in demonstrating, with rigorous empirical backing, the direction of change that could be expected from the two sets of policy assumptions. As such, their aim is to encourage policymakers to consider a different course of action.

#### (a) The baseline scenario

The baseline, which is a projection over the next 10 years, assumes a continuation of existing policies

and no exogenous shocks. In particular, it does not include a financial crisis which, as the previous section argues, could result from the current policy stances. Admittedly, from the current combination of policies it is possible to highlight the structural flaws that could eventually cause a crisis. But it is not possible to determine in advance the timing of a crisis of this nature, the concrete measurement of its macro and global implications, and the nature of the recovery that may follow. This is because such a crisis is usually triggered by a sudden shift in market confidence, resulting from news, or even rumours, about signs of heightened financial fragility or losses of a relatively important institution. Likewise, a recovery from such a crisis is triggered by an even more complex combination of changes in the “state of confidence”.<sup>22</sup>

Therefore, the baseline is a projection of current policies and their implied outcomes, assuming away the occurrence of a crisis, the timing and proportions of which are unknown. Accordingly, the baseline also assumes away the possibility that policymakers will decide to change course in order to avert a crash before it is too late. The concrete quantification of the outcomes of the baseline and how they are related to the assumed policy stances are discussed below in conjunction with those of the balanced-growth scenario.

#### (b) The balanced-growth scenario: Policy assumptions compared with the baseline

The balanced-growth scenario is proposed as a departure from the policies discussed in section A of this chapter. It focuses on the following aspects:

- Incomes policies to support growth of demand on a sustainable basis,
- Growth-enhancing fiscal policies,

- Industrial policies to promote private investment and structural transformation,
- Regulation of finance and capital controls to stabilize global financial markets, and
- Development-oriented trade agreements.

The latter two aspects are mostly qualitative in nature and contemplate varied modalities. In the model, regulation of finance and capital flows is imputed as exogenous conditions (usually called ‘add-factors’) to allow smooth adjustments of exchange rates and international prices of traded goods and services.<sup>23</sup> Likewise, development-oriented trade agreements are imputed as add-factors that replicate an expansion of the Generalized System of Preferences (GSP) between higher income economies on the one hand, and lower income economies on the other.<sup>24</sup> Among developing countries, the simulations impute an expansion of existing South-South trade agreements. Together with the other sets of policies proposed in the scenario, the result is an increase in exports of manufactures in low- and middle-income countries by 50–75 per cent in 10 years compared with the baseline. By contrast, trade-related aspects in the baseline are modelled as a continuation of existing conditions, mostly determined by bilateral trade agreements and prevailing investment patterns. As shown in section A, under these conditions, trade specialization does not improve, and the export concentration of very open economies in developing countries increases.

The other three sets of policy assumptions are summarized in table 2.2. The first columns show the evolution of the labour-income share as a percentage of GDP (labour share, for short) for both scenarios (baseline and balanced-growth). The simulation period is represented by five-year averages (2015–2019 and 2020–2024), while the historic period is represented by two points in time: 1990 and 2012.<sup>25</sup> As noted earlier, there was a continuous fall in the labour share for most regions until recently, with some indication that the trend was bottoming out in several regions. For the world as a whole, the labour share fell from about 59 per cent of GDP in 1990 to about 52 per cent in 2012. The baseline assumes that in all the 25 countries and country groups considered in the model, incomes of employees and self-employed informal workers will continue to remain depressed at around their prevailing low levels. By contrast, the

balanced-growth scenario assumes that policymakers in all countries will introduce incomes policies aimed at improving the functional distribution of income closer to the levels of the early or mid-1990s.<sup>26</sup> This degree of improvement seems essential for bringing about a robust growth of consumption, and, consequently, of private investment. It should be noted from the outset that the assumption that all countries proceed at a similar pace of improvement precludes unfair gains in competitiveness in export markets based on seeking advantage of labour costs by a few free-riders.<sup>27</sup>

The other sets of columns in table 2.2 show the growth patterns of government expenditure on goods and services and of private investment. The historic period is summarized by an average for the period 1990–2014, and the projections by averages for two five-year periods. Regarding government expenditure, the projected baseline shows a growth pattern similar to the average for the past 25 years. This means that in most developed countries, protracted fiscal austerity is assumed to imply a weak or negligible growth of expenditure, while in most developing countries the fiscal stance is assumed to be moderately expansionary. By contrast, the balanced-growth scenario assumes a more proactive fiscal policy in all countries, with a more marked increase, compared with the baseline, in developed countries. The assumed patterns of growth of government expenditure of most countries turn out to be closely aligned with the patterns of growth of GDP (discussed below).<sup>28</sup> It is also shown that these assumptions do not imply greater financial vulnerability.

The last columns of table 2.2 show that private investment is assumed to take on a greater role than public spending in developed countries during the projected baseline, leading to growing financial imbalances in the private sector. Private investment in developing countries, on the other hand, is not expected to grow at a similarly fast pace as the historic period. This is partly because demand stimulus remains subdued, but also because a large proportion of investment is related to exports to developed countries, which are expected to remain rather sluggish. Another major reason for the slowdown in private investment is the assumed continuation of China’s policy shift, aimed at strengthening other sources of growth than private investment (which recently accounted for about 40 per cent of GDP). By contrast, the combined assumptions of proactive fiscal and

Table 2.2

**MAIN ASSUMPTIONS OF THE MODEL SIMULATIONS  
IN SELECTED REGIONS AND COUNTRIES, 1990–2024**

	Scenario	Labour-income share in GDP				Government spending on goods and services			Private investment		
		(Per cent)				(Average annual percentage growth)					
		1990	2012	Average 2015–2019	Average 2020–2024	1990–2014	2015–2019	2020–2024	1990–2014	2015–2019	2020–2024
<b>Developed economies</b>	Baseline	60.5	56.1	55.5	55.2	2.0	1.1	1.1	1.1	3.0	3.2
	Balanced growth	.	.	57.9	60.1	.	2.8	3.5	.	3.7	4.8
<i>of which:</i>											
United States	Baseline	56.1	53.2	53.3	53.5	2.4	1.8	2.2	2.0	3.6	4.0
	Balanced growth	.	.	55.4	58.2	.	4.9	3.9	.	3.8	4.4
<b>CIS</b>	Baseline	71.5	57.3	55.9	54.6	1.8	0.9	1.5	4.6	-0.7	1.7
	Balanced growth	.	.	61.1	63.4	.	2.8	4.8	.	0.3	6.6
<b>Developing Asia</b>	Baseline	55.2	48.8	50.6	50.8	6.7	6.3	6.1	7.7	3.9	4.6
	Balanced growth	.	.	53.2	55.9	.	7.9	7.2	.	4.3	5.7
<i>of which:</i>											
China	Baseline	61.0	49.7	52.6	53.4	10.3	7.7	7.0	12.4	4.2	4.8
	Balanced growth	.	.	55.1	58.1	.	9.0	8.1	.	3.7	5.0
India	Baseline	51.0	44.7	46.2	46.0	6.7	5.7	6.5	7.2	5.1	5.6
	Balanced growth	.	.	50.0	53.4	.	8.4	7.8	.	6.1	7.4
<b>Africa</b>	Baseline	47.5	43.8	44.6	44.7	4.3	4.5	4.8	4.8	2.0	3.1
	Balanced growth	.	.	46.4	47.0	.	6.4	7.0	.	5.2	7.7
<b>Latin America and the Caribbean</b>	Baseline	51.8	49.6	49.8	49.1	4.3	2.3	2.5	3.2	1.7	2.9
	Balanced growth	.	.	51.8	53.1	.	4.7	5.6	.	3.4	7.0

**Source:** UNCTAD secretariat calculations, based on GPM.

**Note:** CIS includes Georgia.

industrial policies in the balanced-growth scenario for all countries are consistent with a faster growth of private investment than that of the baseline in all regions.<sup>29</sup> Such an acceleration of private investment in developing countries is an essential component of a strategy of structural transformation, which is required both for sustained welfare as well as for fuller integration into the global trading system.

*(c) Main outcomes of the simulations*

Table 2.3 shows a summary of economic growth outcomes under both scenarios. In the baseline scenario, GDP growth, both globally and in most countries individually, is marginally faster than the historic average.<sup>30</sup> Since crises in the projection period are ruled out by assumption, as noted earlier,

Table 2.3

## GDP GROWTH IN SELECTED REGIONS AND COUNTRIES, 1990–2024

	Scenario	Average annual growth of GDP <sup>a</sup> (Per cent)		
		1990–2014	2015–2019	2020–2024
<b>World</b>	Baseline	3.3	3.4	3.6
	Balanced growth	.	4.7	5.5
<b>Developed economies</b>	Baseline	1.9	1.8	2.0
	Balanced growth	.	2.8	3.5
<i>of which:</i>				
United States	Baseline	2.5	2.3	2.6
	Balanced growth	.	3.3	3.7
<b>CIS</b>	Baseline	2.7	2.0	2.1
	Balanced growth	.	3.3	4.9
<b>Developing Asia</b>	Baseline	6.3	5.5	5.4
	Balanced growth	.	6.7	7.2
<i>of which:</i>				
China	Baseline	9.8	7.1	6.7
	Balanced growth	.	8.1	8.3
India	Baseline	6.3	5.8	6.0
	Balanced growth	.	7.5	7.9
<b>Africa</b>	Baseline	3.8	3.9	3.9
	Balanced growth	.	6.1	7.0
<b>Latin America and the Caribbean</b>	Baseline	3.1	2.9	3.0
	Balanced growth	.	4.5	5.7
<b>Memo item:</b>				
World (based on market exchange rates)	Baseline	2.7	2.8	3.0
	Balanced growth	.	3.9	4.7

**Source:** UNCTAD secretariat calculations, based on GPM.

**Note:** CIS includes Georgia.

**a** Data refer to PPP in constant 2005 international dollars, except in the memo item.

the implication is that structural imbalances will keep growing. Therefore, the baseline scenario, even if showing a moderate rate of growth, is increasingly vulnerable to shocks and financial instability. Given that financial institutions, households and governments in many countries have not yet succeeded in regaining financial strength, such a baseline suggests intolerable risks for weak institutions. The longer such imbalances remain unresolved, the harsher the consequences will be for the world economy.

The balanced-growth scenario, on the other hand, shows considerable improvements in growth rates. The average growth for the world economy (estimated in PPP terms) is significantly faster than

it is under the baseline scenario. This partly reflects an effect of the PPP adjustments, since developing and emerging economies show a growth difference compared with the baseline which is nearly double that of developed economies.<sup>31</sup> More importantly, the faster growth rates for all regions are the result not only of policy stimuli in each country individually, but also of the strong synergy emerging from the coordination of pro-growth policy stances among all regions. Finally, improvements in growth rates for developing countries, especially in Africa, compared with those of developed countries, confirm the strong growth-convergence characteristic of the balanced-growth scenario. This is a most desirable objective to support development and welfare objectives.

Table 2.4 shows the most relevant aspects of financial stability resulting from the balanced-growth scenario, compared with the baseline. The first two sets of columns concentrate on financial conditions in the public sector and the other sets on private sector financial balances and the current account. It was argued in section A of this chapter that many countries, especially developed countries, have tightened their fiscal stance in order to improve financial stability. However, baseline results show that reducing fiscal deficits by cutting spending is a tortuous path with likely unsatisfactory results. Unless policies are effective in enhancing growth, and thus public revenues, fiscal deficits will remain high and reductions in public debt will be slow. In developing countries, the relatively moderate growth of public spending assumed in the baseline for India and Latin America does not lead to an improvement in the government's financial position either. In Africa, a slightly faster growth of public spending in the projected baseline than in the historic period leads to larger fiscal deficits and public debt ratios. This illustrates that, particularly for countries where fiscal policy space is limited, fiscal policies aimed at improving growth and stability could be more effective when accompanied by other, complementary policies.

On the other hand, fiscal deficits and debt ratios in the balanced growth scenario are smaller than in the baseline scenario.<sup>32</sup> This is not surprising, even if a critical ingredient of the policy mix is assumed to be faster growth of public spending on goods and services. Fiscal sustainability is the result of various converging policies, such as those proposed above. To the extent that fiscal support in the form of spending on social protection and infrastructure development is complemented by industrial promotion policies and by incomes policies, positive synergies are created. As a result of such synergies, consumption, private investment, and a more balanced growth of trade help to generate more government revenues. In addition, in order to ensure that the assumed improvements in the functional distribution of income are net (i.e. after taxes), greater progressiveness in direct tax collection is pursued, thus improving domestic resource mobilization. This in turn would contribute to reducing fiscal deficits and alleviating debt burdens.

The baseline results shown in the last two columns of table 2.4 confirm that private sector balances, as well as external balances of the various regions move in diverging directions. Developed

countries as a whole, and particularly the United States (but also the United Kingdom and a few other major economies) tend to pursue policies that result in a continuing decline of net financial savings of the private sector (which also lead to heavier debt burdens).<sup>33</sup> This in turn translates into worsening external deficits, which, by the end of the simulation period, show similar magnitudes as those of the previous peak just before the onset of the financial crisis. Meanwhile, a number of other countries, typically those which accumulated large external surpluses during the pre-crisis period, show similar patterns in the projected baseline, as they will continue to rely on a recovery of their net exports and a relative increase in net financial savings, mostly by the private sector. By contrast, the balanced-growth scenario shows a significant reduction of external imbalances. More precisely, there are increases in the net financial savings of the private sector where originally there were deficits, and reductions of private surpluses where these were too large. Indeed, the proposed policy stimuli trigger robust growth of public and private spending, made possible by increased incomes and enhanced by improvements in the regulation of the financial system and of international transactions. In addition, trade imbalances of low- and lower-middle-income countries improve as a result of the assumed pro-development trade agreements.

## **2. *Summing up: The need for policy consistency and macroeconomic coherence***

The global modelling exercise synthesized above offers an evaluation of the favourable outcomes that can be broadly expected from a break with current policy stances. Clearly, these results cannot be achieved by means of market-driven adjustments. They reveal the need for explicit policy triggers that, estimated on a historical basis, are shown to yield more robust and stable growth patterns, particularly if policies worldwide are combined in a coordinated fashion. However, the use of this modelling tool does not mean that such policy choices will actually be undertaken. It requires a careful examination of what policy space is available, the possible constraints, and the political will of countries' leaders to break with most of the current approaches, all of which is discussed more thoroughly in the chapters that follow.

Table 2.4

## FINANCIAL VARIABLES FOR SELECTED REGIONS AND COUNTRIES, 1990–2024

(Average in per cent of GDP)

Scenario	Public sector balance				Public debt				Private sector balance				Current account balance			
	1990– 2014	2015– 2019	2020– 2024		1990– 2014	2015– 2019	2020– 2024		1990– 2014	2015– 2019	2020– 2024		1990– 2014	2015– 2019	2020– 2024	
<b>Developed economies</b>																
Baseline	-4.0	-4.0	-2.7		79.2	96.2	89.8		3.2	2.5	0.2		-0.5	-1.2	-2.1	
Balanced growth	.	-3.3	-2.8		.	91.2	79.7		.	2.3	1.7		.	-0.7	-0.8	
<b>of which:</b>																
United States																
Baseline	-4.3	-4.5	-3.1		71.1	87.1	78.7		1.4	0.3	-3.1		-2.9	-4.2	-6.2	
Balanced growth	.	-3.6	-3.0		.	83.1	72.5		.	0.8	0.7		.	-2.8	-2.3	
<b>CIS</b>																
Baseline	-0.6	1.9	3.0		57.7	22.7	22.2		4.3	2.5	4.3		3.8	4.4	7.3	
Balanced growth	.	1.3	2.0		.	26.6	27.2		.	1.5	0.9		.	2.7	2.9	
<b>Developing Asia</b>																
Baseline	-2.2	-1.3	-1.2		40.1	44.5	48.7		4.2	3.6	4.3		2.0	2.8	3.5	
Balanced growth	.	-1.2	-1.2		.	43.6	43.9		.	2.5	2.3		.	1.7	1.3	
<b>of which:</b>																
China																
Baseline	-1.8	0.7	1.9		16.3	29.0	32.4		5.1	2.7	3.8		3.3	3.4	5.8	
Balanced growth	.	-0.2	-0.0		.	28.8	29.3		.	1.7	1.5		.	1.5	1.5	
India																
Baseline	-7.7	-7.0	-6.5		76.0	77.6	80.3		7.2	5.1	5.4		-0.5	-2.0	-1.1	
Balanced growth	.	-3.9	-3.0		.	69.4	62.2		.	2.4	2.9		.	-1.4	-0.1	
<b>Africa</b>																
Baseline	-2.1	-3.8	-4.0		59.1	59.6	64.3		2.6	0.3	0.4		0.3	-3.6	-3.6	
Balanced growth	.	-2.8	-1.9		.	57.8	55.9		.	-0.0	0.4		.	-2.8	-1.5	
<b>Latin America and the Caribbean</b>																
Baseline	-3.0	-4.3	-3.5		51.4	54.5	53.5		1.1	1.7	1.9		-1.9	-2.6	-1.6	
Balanced growth	.	-3.0	-2.4		.	51.0	48.2		.	0.7	1.5		.	-2.4	-0.9	

Source: UNCTAD secretariat calculations, based on GPM.

Note: CIS includes Georgia.

In the realm of policymaking, what these model simulations underscore is the need to ensure policy consistency and macroeconomic coherence in order to obtain outcomes similar to those presented above. Policy consistency refers to preventing policy instruments from operating at cross purposes. Current inconsistencies in the configuration of fiscal and monetary policies of many economies after 2010 has been colourfully described as “driving the economic car with one foot on the brake and one foot on the pedal” (White, 2013:1). Instead, monetary expansion should be accompanied by fiscal expansion to prevent liquidity being hoarded or channelled to speculative uses; employment promotion programmes should be accompanied by income distribution policies so that aggregate demand is sustained by rising household incomes rather than debt; and policies targeting inflation should be accompanied by policies that address the causes of inflation, which in turn draws attention to incentives to domestic production and demand. These are but a few examples of policy consistency.

Pro-growth and rebalancing policies need to ensure macroeconomic coherence by addressing primarily the root problems that impede a solid and sustained global recovery. Until very recently, and even now in many developed economies, policymakers have seemed to be excessively concerned with fighting the threat of inflation and have been ignoring the reality of deflation. Likewise, policymakers in many countries have been advocating harsh adjustments in their governments’ fiscal balances but have been neglecting to consider the potential effects on households and enterprises which would find it more difficult to rebuild their balance sheets when aggregate demand and income are depressed.

If the main problems of the post-crisis period have to do with insufficient aggregate demand and financial instability, the appropriate policy response should be not to inject more liquidity per se, but to encourage credit flows that generate productive activity, while boosting aggregate demand and designing

income policies to make use of such credit flows in a sustainable manner.

There is another aspect of macroeconomic coherence that may easily be overlooked by policymakers when considering their options. In an increasingly interconnected global economy, policies have to be consistent for the world as a whole. There are several examples of why this matters, but two are discussed here. First, after taking into account real and financial feedbacks, it should be clear that a sustained and stable demand-led growth path has to start domestically, rather than each country individually pushing for competitive reductions of costs and imports in order to generate a net-export-led recovery. Robust domestic activity in a sufficient number of countries – a process in which, admittedly, surplus countries have much more to contribute – is the only truly sustainable basis for the recovery of global trade. Second, in the absence of a truly globally inclusive financial architecture, unfettered global financial markets without adequate regulatory control can be pernicious, as the 2008 financial crisis has amply demonstrated. The continuing inadequacy of institutions and mechanisms for international coordination of policy actions affects the rules of the game in fundamental ways, forcing policymakers to adopt strategies that may appear to be convenient for the moment, but which are effectively self-defeating in the medium term. It is essential to continue with efforts to devise a more effective set of globally inclusive institutions to regulate markets, help correct unsustainable imbalances when they emerge, and better pursue the aims of global development and convergence. This may be an ambitious undertaking, for which a great degree of perseverance and vision is required. But as chapter IV highlights, history shows that deep reforms of global scope similar to the ones mentioned here were seriously contemplated in the past. Meanwhile, far more meaningful efforts are needed to coordinate national policy strategies, to consider the implications of their interactions in a global setting, and to manage international transactions and flows accordingly. ■



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## Notes

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- 1 The trend is estimated from the mid-1990s onwards to avoid giving excessive weight to the boom years preceding the crisis, which were deemed unsustainable, as well as to the immediate policy responses during the global crisis, which were clearly more expansionary than the norm.
- 2 At the time of writing, the United Kingdom's Office for National Statistics was in the process of revising its annual GDP statistics (in *United Kingdom National Accounts – The Blue Book, 2014 edition*), and preliminary reports suggest that by 2013 the level of real GDP may be marginally above the pre-crisis level.
- 3 State and local governments in the United States are required by statutory law to balance their primary budgets, which in practice imposes expenditure adjustments relative to tax collection and other revenues.
- 4 This term, which was used by Keynes in his *General Theory*, refers to a burst of optimism that affects the mood of private investors.
- 5 This confirms earlier work on the United States (Piketty and Saez, 2003) and across a large pool of countries in both developed and developing regions (see, for example, Cornia, 2004; and Milanovic, 2005).
- 6 From a different methodological perspective, and using industry-level datasets, other empirical studies suggest that a greater proportion of capital accumulation vis-à-vis wage-earners and the self-employed implies, when properly estimated, a tendency towards a sharper deterioration of labour income (Arpaia et al., 2009).
- 7 While there is broad agreement on the importance of Piketty's empirical findings about long-term trends of inequality, his theoretical explanation, which validates neoclassical growth theory, has been subjected to rigorous critiques (Patnaik, 2014; Taylor, 2014).
- 8 Similar conclusions with variations, depending on underlying economic structures of different countries, have been provided by analytical and empirical evaluations of the "wage-led" versus "profit-led" debate (Storm and Naastepad, 2012; Lavoie and Stockhammer, 2012).
- 9 See earlier *Trade and Development Reports*; also Turner, 2008.
- 10 These two cases together account for a significant share of global consumption, and could therefore have at least some influence in reigniting global imbalances. While other relatively large economies seem to show similar patterns, the investigation on these two countries is facilitated by the availability of detailed balance sheets and asset compositions of their household sectors.
- 11 This is an accounting term that refers to a positive shock to the net wealth of asset owners when asset prices rise. The shock can be estimated by imputing the price changes of the different assets to the underlying structure of the balance sheet. By further discounting consumer price inflation, a measure of real holding gains is obtained. See Izurieta (2005) for a formal methodological justification and earlier empirical estimates. The Financial Accounts of the Federal Reserve of the United States publishes the series of holding gains in nominal terms (see table R.100) before discounted by inflation. The nominal series generated here show a very close match with those of the Federal Reserve, with only negligible errors due to the aggregative nature of the asset prices used. This allows checking against such existing data the estimation methodology applied further below to the case of the United Kingdom, which does not publish holding gains of the household sector. It should be emphasized that these are accounting gains, rather than the gains actually realized through asset transactions.
- 12 "Net financial savings", attributed to Tobin (1982), is the equivalent of the more known concept of surplus or deficit, commonly used in reference to the public sector and the external sector (the current account). Its formal name in national accounts is "net lending" (or "net borrowing" when negative), but this term is not used in the text to avoid confusion with the also commonly used "lending" or "borrowing" in relation to the banking sector.
- 13 The series, which only run up to 2012, were compiled by combining national accounts statistics with survey data and imputed trends from the evolution of wage

or agricultural incomes when available. However, a large margin of error is possible, particularly for countries where the proportion of informal/mixed incomes is large.

- 14 Mixed income in the national accounts comprises incomes earned from the self-employed as well as all incomes earned by unincorporated enterprises and those classified as “non-market output”.
- 15 See also *TDR 2001*; Akyüz, 2002; D’Arista, 2007; Ghosh and Chandrasekhar, 2001; Singh, 2003; Stiglitz, 1999.
- 16 See also Akyüz, 2013 and 2014; Ghosh, 2014; *TDR 2013*; UNCTAD, 2011.
- 17 See Lawson (2011), and also Obstfeld (2012) for a more general appraisal of similar views.
- 18 Ukraine, where capital inflows rose only marginally after 2009, is an example of how a shock like the financial crisis can hit vulnerable sectors causing systemic threats that require more lasting adjustments, often exacerbated by social tensions.
- 19 See, for example Chandrasekhar and Ghosh, 2013 and 2014; Lee, 2013; McKenzie and Pons-Vignon, 2012; Chang, 2013; Kang et al., 2011; Ffrench-Davis, 2012.
- 20 This index is available at: <http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=30953>. It measures, product by product, the evolution of (normalized) balances over time, while controlling for re-exporting activities. The dataset is very disaggregated and detailed, allowing a full mapping across the standard industrial classification, and it also specifies categories by the degree of labour skills within the manufacturing sector.
- 21 The GPM is a fully endogenous modelling framework based on water-tight accounting without “black-holes” and without unexplained residuals. Behavioural relations that determine the macroeconomic adjustments are estimated econometrically using panel (124 countries) and time series (period 1980 to 2012). The model covers 25 countries and country groups, and considers GDP in main sectors; public, private and financial institutions; employment; international trade (five main categories) and finance; and fiscal, monetary and industrial/trade policy (see *TDR 2013*, annex to chapter I). For a more technical discussion, see website: [http://unctad.org/en/PublicationsLibrary/tdr2014\\_GPM\\_TechnicalDescription.pdf](http://unctad.org/en/PublicationsLibrary/tdr2014_GPM_TechnicalDescription.pdf).
- 22 As stated by Keynes (1936: 149), “The state of confidence is relevant because it is one of the major factors determining the former [the rate of investment], which is the same thing as the investment demand-schedule. There is, however, not much to be said about the state of confidence a priori. Our conclusions must mainly depend upon the actual observation of markets and business psychology.”
- Keynes further made a crucial observation to stress how much more difficult it is to know, a priori, about the conditions that enable a recovery after a crisis (1936: 158), “Thus we must also take account of the other facet of the state of confidence, namely, the confidence of the lending institutions towards those who seek to borrow from them, sometimes described as the state of credit. A collapse in the price of equities, which has had disastrous reactions on the marginal efficiency of capital, may have been due to the weakening either of speculative confidence or of the state of credit. But whereas the weakening of either is enough to cause a collapse, recovery requires the revival of both.”
- 23 In this particular case there are only small differences of degree with the baseline. In its construction, in order to avoid crisis conditions, as explained above, the baseline imposes ceilings and floors on exchange rates and commodity prices which would have resulted from the imbalances discussed in section A.
- 24 In the GPM, these preferences apply to countries with a per capita income lower than \$2,000 dollars in 2012.
- 25 The historic period runs up to 2014, but the latest verifiable figures for the share of labour income are not available beyond 2012 for most countries.
- 26 Incomes policies are assumed to be comparatively stronger in the United States, bringing its labour share closer to pre-1990 levels and closer to the levels of other developed economies. More importantly, households in the United States have accumulated serious financial imbalances over time, and the assumed improvement in the functional distribution of income is required in order to generate a sustained growth of private consumption without increasing households’ financial vulnerabilities.
- 27 *TDR 2013* proposed an alternative simulation that assumed that all developing and emerging economies would engage in proactive incomes policies while developed countries would continue to seek net export advantages by compressing wage shares. The model showed that this would result in a net benefit for developed countries at the expense of developing and emerging economies. In this situation, the latter set of countries would naturally exercise considerable caution in adopting similar incomes policies, which, consequently, would result in a weaker impact on growth and distribution.
- 28 In the United States, and to a lesser degree in India, growth of government spending is assumed to be relatively stronger than in the historic period, and it also turns out to be marginally stronger than the growth of GDP in the first five years of the projections. This is because, as discussed earlier, debt-driven spending of the private sector was growing at a fast rate, and to achieve a financially stable path

- of fast GDP growth the public sector had to make a larger contribution than the private sector.
- 29 An exception is China, where the policy shift away from investment growth towards faster growth of household incomes and consumption is assumed to be strengthened during the first few years of the simulation. Under these assumptions private investment in China would tend to stabilize at around 25 per cent of GDP towards the end of the simulation period.
- 30 An exception is China, where a deceleration of growth is expected by policy design, and for many of the periphery countries of Europe which continue to be under pressure by deflationary policies, as well as for many of the oil-exporting countries which will not benefit from a continuing rise in oil prices of the magnitude experienced over the past two decades.
- 31 The balanced-growth scenario has a pro-development bias (without disregarding growth in developed countries), and it is also known that the growth potential of developing and emerging economies is greater than that of developed economies. Regarding measurement, the PPP weights (base 2005 in these simulations) are not re-scaled each year, resulting in a greater weight of developing economies in global GDP along the entire period of the projection.
- 32 Exceptions include members of the Commonwealth of Independent States (CIS) and China. The CIS economies, instead of accumulating larger fiscal surpluses over time, would benefit from reducing surpluses in order to enhance the process of structural transformation. And in China, more emphasis is placed on strengthening social protection in order to promote the growth of household consumption.
- 33 Not all developed countries encourage debt-driven private sector spending. For example Germany and Japan significantly increase their external surpluses in the baseline. Thus, the group of developed countries as a whole does not show a strong pattern in one direction.

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