RETHINKING DEVELOPMENT STRATEGIES AFTER THE GLOBAL FINANCIAL CRISIS*

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Abstract

The global financial crisis that erupted in 2008 and its long-standing effects have evidenced a number of fundamental flaws in the way in which the word economy has been functioning under a "finance-driven globalization". This has been characterized by increasing income inequality and a diminishing role of the State in the economy. The crisis has evidenced a changing structure of the word economy, with a larger share in global output and trade for developing countries. Development strategies should thus rely less on export-led growth oriented to developed countries markets and more on domestic and regional demand, based upon better income distribution.

In this framework, there is an essential role for a developmental State on both the demand and the supply side. Developing countries need to preserve and creatively use the remaining policy space within the multilateral rules to implement industrial policies to diversify and upgrade their economies. They also need to strengthen their domestic sources for financing investment and reinforce the fiscal space, which is essential for a successful developmental State.

Introduction

The situation in the global economy has always provided the framework for development processes, setting specific configurations of trade, migratory flows, capital movements and the exchange of knowledge and technology. These exchanges have been shaped by the rules established in multilateral, regional or bilateral spheres; moreover, they are also affected by the action and policies of influential actors, including governments, domestic elites, international banks and transnational corporations (TNCs). However, the global context has not completely determined the development path: developing countries have always had some room for manoeuvre regarding the way in which they have integrated this international environment.

All these factors – the international economic environment, the situation of developing countries

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and the role of relevant actors – have been upset by the global financial crisis. The perceived nature and depth of the crisis crucially determines the need to redefine development policies and how such a reorientation should be designed.

According to the view that the crisis was an accident caused by policy mistakes, excessive risk appetite and regulatory shortcomings, it may be possible to return to the pre-crisis growth regime without major changes in the development strategies. From this perspective, some structural reforms may be helpful – in particular, those aimed at further trade and capital account opening, labour market flexibilization and reduced state intervention in the economy. However, these reforms would reinforce the features of the pre-crisis economic system rather than transforming them.

This chapter adopts an alternative approach, in line with UNCTAD's analysis of the crisis (see in particular *TDRs 2009* to *2014*). It contends that the global financial crisis that erupted in 2008 has evidenced a number of fundamental flaws in the way in which the world economy has been functioning under a "finance-driven globalization" (UNCTAD, 2011). The crisis thus marks a breaking point, after which it will be neither possible nor desirable to return to the pattern of growth that prevailed before the crisis. Accordingly, developing countries need to rethink their development strategies in accordance with the new environment.

I. A "big crisis"

A. Causes and nature of the crisis

The global financial crisis has been extraordinary in several respects. Regarding its severity, global output contracted for the first time since the Second World War (2.1 per cent in 2009). It was also extraordinary for its reach, as it spread to virtually all regions in the world. Output fell in absolute terms in developed and transition economies, while in developing countries, there was a mix of reductions of gross domestic product (GDP) and significant growth slowdowns. The strength and speed of the transmission of the crisis were also remarkable. An apparently minor shock – the burst of the subprime bubble in the real estate market of the United States – severely struck international financial markets and affected global economic activity and employment, as well as international trade. The rapidity with which the crisis spread contrasts with the sluggishness of the recovery, especially in several developed countries that continue struggling to restore a sustainable and employment-creating growth path.

Therefore, this is a "big crisis" regarding its magnitude, extension and time length. It may also be characterized as a "big crisis" in the different – more qualitative – meaning, which was introduced by Robert Boyer (1979). The history of capitalism has been punctuated by many crises. Most of them (the "small crises") were functional to the endogenous adjustment (the "regulation") of the economy: they corrected excess expenditure and credit, adjusted relative prices (including real wages), depreciated and concentrated the real and financial capital in a way that re-established the conditions for growth. These were crises *within* an economic regime (*mode de régulation*). A different case in point is that of a "big crisis", i.e. a crisis *of* the economic regime itself. This happens when the economic system enters into a prolonged recession from which it cannot recover without changing some of its fundamental aspects. In this situation, market mechanisms and short-term adjustment measures (e.g. automatic stabilizers) cannot restart growth on a solid basis because they do not address the roots of the problem.

An important indication of the nature of the crisis is the fact that this time its epicentre was in the most advanced countries in the world. This contrasts with the financial crises that have recurrently hit developing or transition economies since the beginning of economic and financial liberalization in the early-1980s. The global financial crisis originated in the most sophisticated financial markets from countries that were leading in all the rankings of financial efficiency and good governance prepared by different "market friendly" institutions. The crisis was not due to imperfect functioning of institutions or

bad implementation of liberalizing policies, but rather to the very nature of those institutions and policies.

The crisis reveals a number of fundamental problems of the economic system that have accumulated tensions and imbalances at both the national and global level in recent decades. These went largely unnoticed in the pre-crisis years of widespread complacency – a period known as the "Great Moderation". It was then thought that, thanks to the wisdom of independent Central Banks, inflation was definitely under control and that the complete liberalization of all markets (including financial markets) would lead to strong and sustained growth within this framework.

The optimism in a context of positive economic growth that prevailed during those years masked rapidly mounting internal and external disequilibria. Some imbalances were too large to be ignored, such as the current account deficit of the United States (6 per cent of its GDP in 2006). However, rather than being a cause of concern, they were seen as proof of the United States' economic strength. It was contended that the rest of the world was generating a "savings glut", which could not find a use as profitable as in the United States, a country where the investment opportunities exceeded its population's desired savings (Bernanke, 2005; see also Economic Report of the President, 2006).

These external imbalances resulted from internal problems, which were also ignored or underestimated. If the United States and other developed countries had rising deficits, it was not only because their consumption was very high, but also because they consumed a large proportion of imported goods and services. Their firms had lost market shares and capital inflows tended to finance consumption rather than investment. Furthermore, the rise in households' expenditure did not primarily reflect the rising income of wage earners, whose share in total income had been declining in several countries over the last few decades; rather, it largely resulted from expanding consumption and mortgage credit. This evidenced the rising income and wealth inequality since the 1980s, following the increasing dominance of globalized finance, the erosion of the welfare State and the weakening of workers' bargaining power (*TDR 2012*).

Real wage growth lagged behind that of productivity, and in some countries they did not increase at all. Therefore, many households had to resort to debt, not only for financing housing, but also for consumption. Their access to credit was boosted by the rising price of real estate and financial assets, which were used as collateral. This set in place a classical financial bubble, whereby expanding credit supported the rise in the prices of the real estate and financial assets, which in turn backed new credit to finance consumption and the continued acquisition of financial assets.

Firms also had to increase their borrowing, since their managers were under pressure to increase equity values and thus used benefits to distribute dividends rather than reinvesting them. This reflects an increasing hegemony of shareholders in the governance of firms in developed countries, which contrasts with the previous dominance of the "techno-structure", i.e. corporate management, analysed by John K. Galbraith (1972).

On the credit-supply side, the financial system allowed for the disequilibria to subsist, and even enlarged them. It benefitted from widespread de-regulation to extend its business without proportionally increasing its capitalization. In particular, it introduced financial innovations (e.g. securitization, financial derivatives) and barely regulated institutions (e.g. hedge funds, investment vehicles). Larger leverage spurred the return on capital, although it also augmented the risk of insolvency. In addition, the banking system relied more on short-term credits and less on deposits for its funding, which increased maturity mismatch and liquidity risk. Financial fragility was further aggravated by incentives that encouraged risky behaviour among financial agents, who received bonuses when they generated gains but suffered no penalties in case of running losses.

These developments led to an extraordinary expansion of the financial system worldwide, with financial assets climbing from $12 trillion in 1980 (1.2 times the global output) to $225 trillion in 2012, which is close to three times the global output.[1] The growing predominance of the financial sector over the real economy also contributed to income inequality. Indeed, a significant part of the very high incomes (those received by the "top 1 per cent") comprises interest payments and substantial compensations and bonuses in the financial system, as well as dividends distributed by firms. This created a vicious circle in which the unequal distribution of income pushed many households and firms to resort to credit rather than current income to fund their consumption and

investment. In turn, this increased financial profits and income concentration.

B. Inadequate policy responses

After a first generalized and short-lasting response to support the economy, policymakers in most developed countries focused on recovering the confidence of financial markets through fiscal austerity (Ostry et al., 2010; IMF 2011a and 2011b). They also tried to expand exports with "supply-side" measures to improve competitiveness, including wage constraints, although this did not address the fundamental causes of the crisis. In a situation of insufficient private demand, these kinds of measures were particularly detrimental to economic growth, and to some extent self-defeating: lower growth in many countries at the same time hampered fiscal revenues and external demand.

Expansionary monetary policy was the only tool that remained to support economic growth. However, this did not translate into larger credit supply. Potential borrowers (households and firms) were trying to reduce their indebtedness, and potential lenders were reducing their leverage. This was an illustration of the well-known debt-deflation situation (or "balance-sheet recession") described by Irving Fisher (1933) and more recently by Richard Koo (2011).

The coexistence of strong monetary expansion with subdued consumption and investment demand in developed countries channelled significant amounts of liquidity to speculative uses and emerging market economies. This again pushed up the prices for a number of financial assets and in real estate markets, contributing to recovering domestic demand in some countries (e.g. the United Kingdom and the United States) at the risk of re-creating financial bubbles. Financial flows also led to an appreciation of a number of developing-country currencies and an increase in primary commodity prices. However, such capital flows tend to be volatile and rather than a sustained rise, they led to increased instability in those markets.

Summing up, rather than a temporary accident, this appears to be the crisis of a pattern of growth (a "big crisis"), whose main features are the dominance of de-regulated finance over the real economy, the mounting inequality in the distribution of income and wealth and the State's lesser role in the economy, which have led to rising domestic and external imbalances that can no longer be sustained. Subsequent policies in developed economies that intended to handle the crisis have not addressed its roots. On the contrary, they have somewhat tended to reinforce some of its causes by accentuating income inequality, restricting governments spending and generating new financial bubbles, while the announced re-regulation of the financial sector is lacking behind.

II. The case for a reorientation of development policies

A. The global economic environment after the crisis

The crisis has changed the economic landscape, particularly for development policies. After growing at an average annual rate close to 4 per cent in 2004–2007, the growth of global output fell to around 2.4 per cent between 2012 and 2014. Economic deceleration affected developed, transition and developing economies alike, although the latter maintained a growth rate of around 5 per cent (table 1).

Even more remarkable is the slowdown in international trade, whose annual average growth rate fell from around 8 per cent in 2004–2007 (twice as much as global output) to around 2.5 per cent in 2012–2014 (similar to that of global output). This is mostly due to stagnating trade in developed countries since 2011 (chart 1). This was a reflection of weak domestic demand simultaneously affecting most trade partners.

Developing countries have not been immune to the slower demand in developed economies. Trade in developing countries kept growing in volume, albeit at half the pre-crisis growth rate. Growth in exports from developing countries decelerated, partly due to the weaker demand from developed economies, which put a break to exports of manufactures to final destinations. Moreover, this affected the trade of

Table 1

WORLD OUTPUT GROWTH, 2004–2014

(Annual percentage change)

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*
World	4.1	3.6	4.1	4.0	1.6	-2.1	4.1	2.8	2.2	2.3	2.5
Developed countries	3.0	2.5	2.9	2.5	0.1	-3.7	2.7	1.5	1.1	1.3	1.7
Transition economies	7.8	6.6	8.5	8.7	5.4	-6.5	4.8	4.6	3.3	2.0	0.9
Developing countries	7.4	6.8	7.7	8.0	5.3	2.6	7.8	5.9	4.7	4.6	4.3
of which:											
Africa	5.7	6.0	5.8	6.1	5.4	2.8	4.9	0.5	5.2	3.2	3.0
Latin America and the Caribbean	5.9	4.5	5.6	5.6	3.7	-1.7	5.8	4.2	3.0	2.6	1.3
West Asia	10.3	7.2	7.6	5.5	4.6	-1.0	6.7	7.5	3.9	4.0	3.4
East, South and South-East Asia	7.9	8.0	9.0	10.0	6.2	5.2	9.3	7.0	5.5	5.7	5.8

Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN-DESA), *National Accounts Main Aggregates* database, and *World Economic Situation and Prospects* (*WESP*): *Update as of mid-2015*; ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 2014*; OECD, *Economic Outlook* No. 96, November 2014; IMF, *World Economic Outlook*, April 2015; Economist Intelligence Unit, *EIU CountryData* database; JP Morgan, *Global Data Watch*; and national sources.

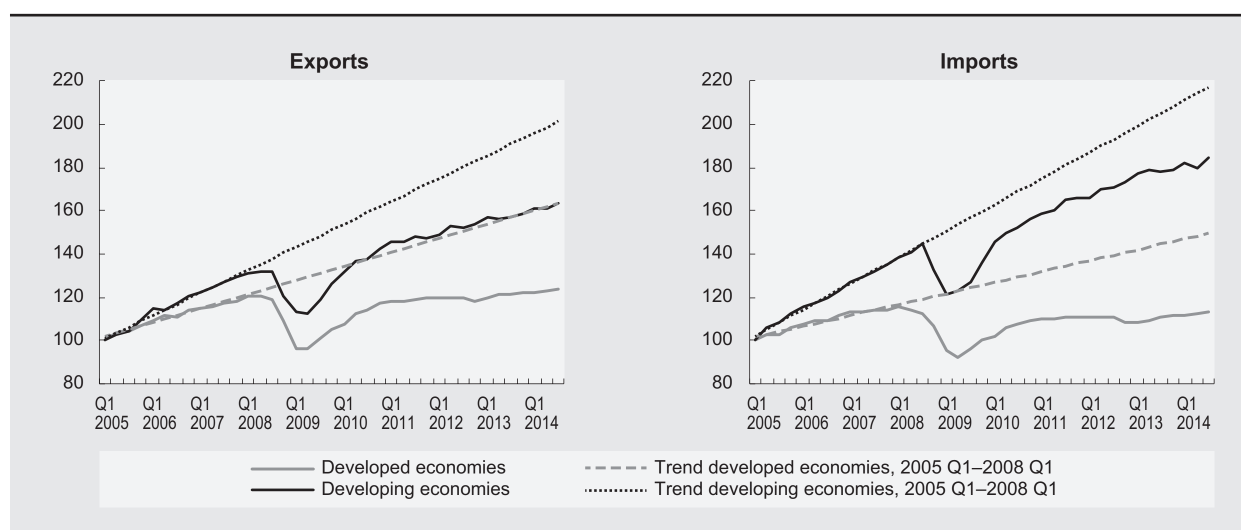
inputs among the developing countries participating in international production networks. Imports were relatively less affected due to the more resilient GDP growth and the gains in the terms of trade that commodity exporters benefitted from during most of the post-crisis period (chart 1).

Development strategies are highly dependent upon the extent to which these differentials in growth rates of GDP and international trade between developed and developing countries are a short-term phenomenon or a long-term trend. This is particularly the case for developing countries that have engaged in export-led growth policies, where exports were mostly oriented to developed country markets. Taking a long-term perspective, it appears that the growth differential between developed and developing countries was not caused by the crisis; rather, the crisis

Chart 1

WORLD TRADE BY VOLUME, 2005 Q1–2014 Q3

(Index numbers, 2005=100)



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

Table 2

SHARE IN GLOBAL OUTPUT, COUNTRY GROUPS, 1970–2013[a]

(Per cent)

	1970	1981	1992	2003	2013
Developing economies	16.8	22.9	18.0	20.9	36.9
Transition economies[b]	13.4	7.9	2.7	1.6	3.9
Developed economies	69.8	69.2	79.3	77.5	59.2
Total	100.0	100.0	100.0	100.0	100.0

Source: *UNCTADstat*.

a Calculated using GDP in dollars at current prices and current exchange rates.

b Comprises Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Georgia, Kazakhstan, Kyrgyzstan, Montenegro, Republic of Moldova, the Russian Federation, Serbia, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine and Uzbekistan.

simply rendered more visible some trends that were already under way, such as the increasing economic weight of a number of large developing countries.

From 1970 onwards, it is possible to identify four major periods (table 2). Between 1970 and 1981, developed countries represented a relatively stable share of 70 per cent of global output, while developing countries gradually increased their part from 17 to 23 per cent, at the expense of the transition economies.[2] The following decade witnessed a further fall on the part of transition economies, from 8 per cent to 3 per cent of global output between 1980–1981 and 1990–1991 (compared to 13 per cent in 1970–1971), while developing countries lost their previous gains. Developed economies increased their share to almost 80 per cent in 1992. The third period showed little changes, with the share of developing countries slowly increasing, the collapse of the Soviet Union further lowering that of transition economies and developed countries maintaining their part slightly below 80 per cent.

These long-term trends sharply changed since 2003. In only ten years, the share of developing countries jumped from 21 to 37 per cent of world output, that of transition economies improved from 1.5 to 4 per cent and the part of developed countries fell from 78 to 59 per cent. Indeed, the trend towards the increasing share of developing countries and decline in developed ones has continued during the crisis and its aftermath.

This evolution in the contribution to total output was parallel to that of international trade. In 1995, developed economies accounted for 70 per cent of total exports and 69 per cent of total imports; in 2003, these shares had declined to 65 and 69 per cent respectively, and they further fell to 51 and 54 per cent in 2013. Similarly, the part of developing countries in total exports rose from 28 per cent in 1995 to 33 per cent in 2003 and 45 per cent in 2013, and that of imports from 29 per cent in 1995 and 2003 to 42 per cent in 2013 (table 3).

Table 3

WORLD EXPORTS BY ORIGIN AND DESTINATION, SELECTED COUNTRY GROUPS, 1995–2013

(Per cent of world exports)

	Origin \ Destination	Developed economies	Developing economies	Transition economies	Total
1995	Developed economies	52.2	16.6	0.9	69.7
	Developing economies	16.1	11.9	0.3	28.3
	Transition economies	1.0	0.3	0.6	2.0
	Total	69.3	28.8	1.8	100.0
2003	Developed economies	49.5	14.0	1.1	64.6
	Developing economies	17.9	14.5	0.3	32.8
	Transition economies	1.5	0.5	0.6	2.6
	Total	69.0	29.1	2.0	100.0
2013	Developed economies	34.2	14.9	1.6	50.7
	Developing economies	17.8	26.4	0.9	45.0
	Transition economies	2.4	1.1	0.8	4.3
	Total	54.3	42.4	3.3	100.0

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

B. A more balanced approach on the demand side

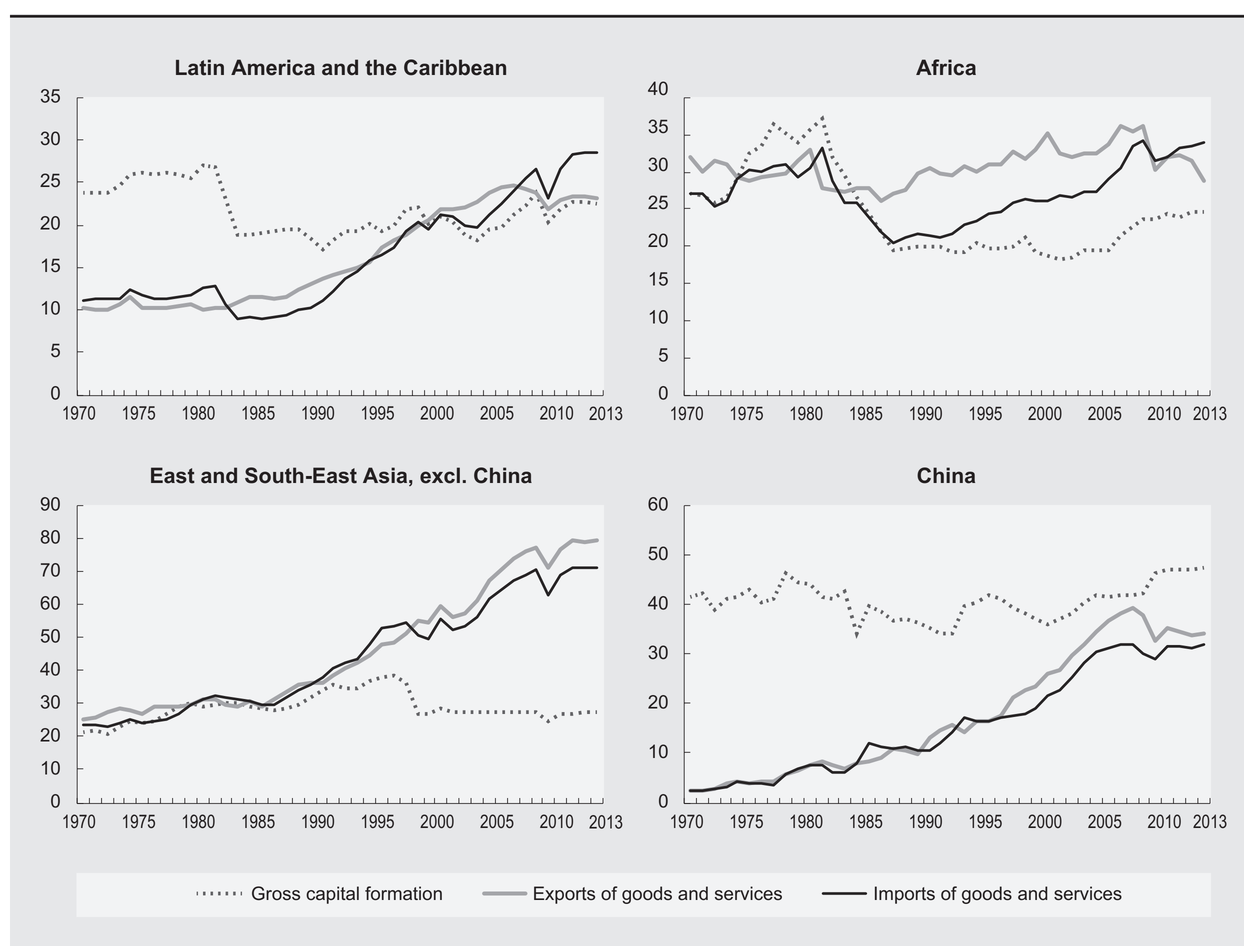
Export-led growth, mainly directed towards developed economies, has long been the preferred development strategy in many developing countries. It involved either exporting directly to those markets or participating in some global value chains, eventually finishing in developed markets. The main debate about this strategy concerned the links between the export-oriented activities and the rest of the economy. Indeed, it was possible (and quite frequent) that a country managed to rapidly expand its international trade without significant improvements in capital accumulation, productive diversification and GDP growth. By themselves, neither larger exports nor foreign direct investment (FDI) inflows necessarily lead to increasing productive capacities. In fact, they may simply develop some outward-oriented enclaves without generating domestic productive linkages or distributing a significant amount of income to local agents. This is the case, for instance, in assembly industries that import most of their inputs, employ low-qualified working force and benefit from fiscal incentives. Likewise, the contribution of activities in extractive industries to domestic growth may be rather small when they generate little employment, import most inputs and services rather than creating linkages with domestic suppliers, export the raw material, transfer profits abroad and contribute insufficiently to tax revenues. As a result, increasing trade openness was not associated with larger fixed capital formation in most developing countries (chart 2).

Within this export-led approach to growth, many developing countries sought to accelerate

Chart 2

TRADE AND INVESTMENT AT CONSTANT PRICES, 1970–2013

(Per cent of GDP)

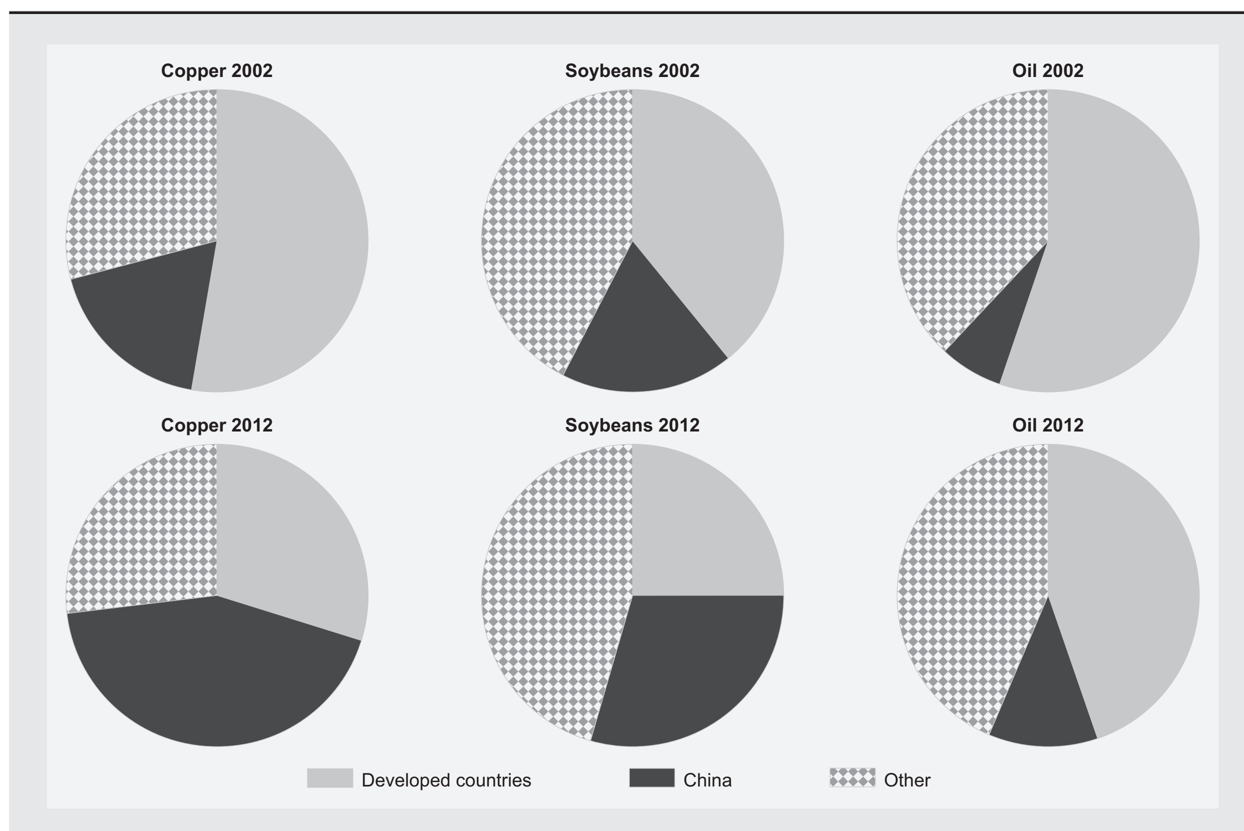


Source: UNCTAD secretariat calculations, based on *UNCTADstat*.

Chart 3

CONSUMPTION OF COPPER, SOYBEANS AND OIL IN SELECTED GROUPS OF COUNTRIES, 2002 AND 2012

(Share in global consumption in per cent)



Source: UNCTAD secretariat calculations, based on *World Bureau of Metal Statistics Yearbook 2013*; BP, *Statistical Review of World Energy 2013*; and United States Department of Agriculture (USDA), *Production, Supply and Distribution* online database.

their integration with developed economies by signing bilateral free trade and investment agreements. However, such agreements severely restricted their ability to apply the accompanying macroeconomic and industrial policies that were needed to make this integration conducive to development (*TDR 2007*). In other words, there seemed to be a trade-off between market access and policy space. With the crisis and the subsequent loss of dynamism in developed country markets, the gains from market access are more uncertain. Thus, the terms of this trade-off may have changed: if those markets have entered into a prolonged period of slow growth, the export-led strategy directed to them is not viable. Therefore, there is a need for a more balanced approach in development strategies, giving a larger role to domestic and regional markets and, more generally, to South-South trade.

Some factors of such a reorientation on the demand side are already visible. As mentioned above, the composition of global trade is changing, with a larger participation of South-South trade, which exceeded 26 per cent of total trade in 2013, compared to only 11 per cent in 1995. The rapid expansion of very large countries, and particularly China, India and Indonesia, has modified the trade geography, as well as its composition. Strong GDP growth associated with rapid urbanization and industrialization lead to an expanding demand for commodities. China alone has deeply transformed these markets in just a decade (chart 3).

Given the size already attained by the Chinese economy, it is likely to continue playing a key role in global commodity demand in the foreseeable future, even if it grows at slower rates than before the crisis. Between 2007 and 2013, China's GDP in current dollars increased from $3.5 to $9.6 trillion. A more moderate growth rate of 11.5 per cent in current dollars (and 7.6 per cent at constant prices) in 2013 represented a larger increase in global demand

($960 billion) than that generated in 2007 ($711 billion) with a growth rate of 25.5 per cent in current dollars (and 14.2 per cent in real terms), according to UNCTADstat data.

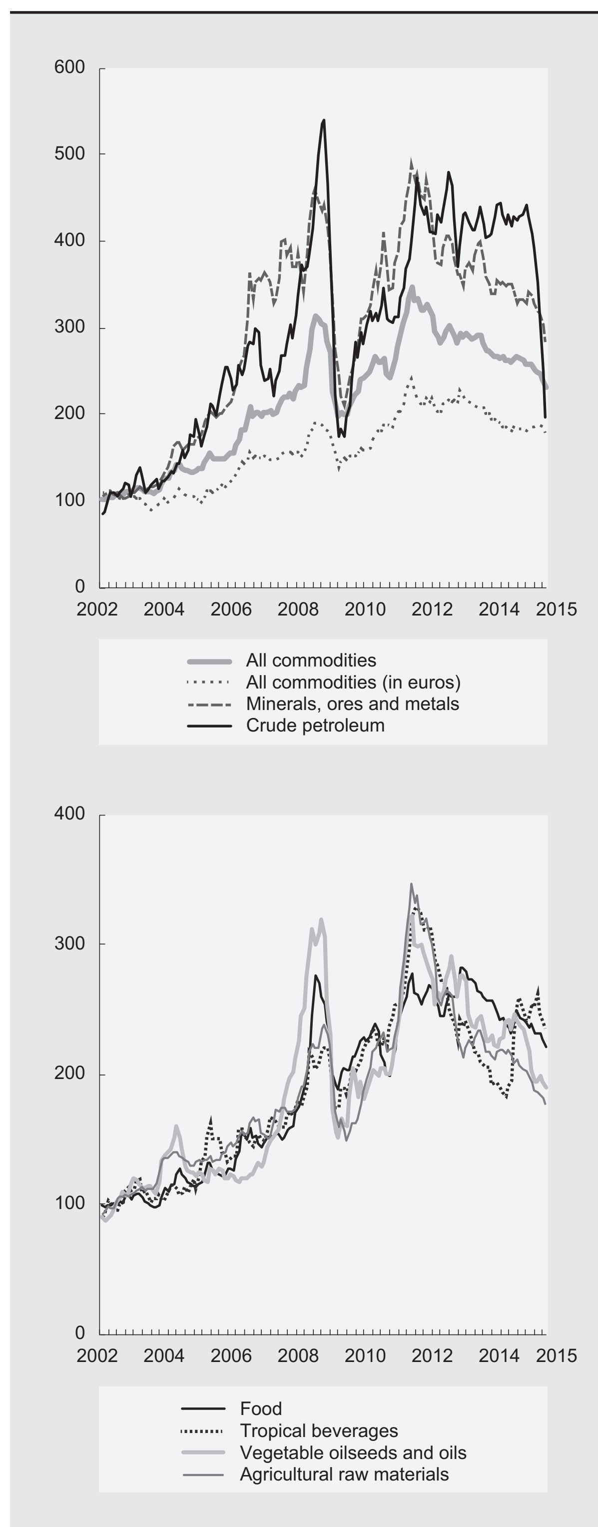
However, this does not guarantee that commodity prices will keep growing indefinitely. In response to the high prices, new supply capacities also came to the fore, particularly in mining and hydrocarbons. It is mainly developments on the supply side that explain the substantial reduction of prices experienced in 2013–2014 (*TDR 2014*). In addition, in financialized commodity markets, prices are affected by financial operators that tend to exacerbate upward and downward movements. Moreover, geopolitical factors (which play a strong role in hydrocarbon markets) can also influence commodity prices; therefore, these prices are very difficult to forecast, especially in the short run. Taking a long-term perspective, however, it is important to analyse whether the present downward movements evidence the declining phase of a "super cycle", which would bring back commodity prices to the early-2000s levels. On the other hand, the new conditions of demand may have pulled durably commodity prices to a higher level, even if they remain subject to wide oscillations. This is illustrated by the fact that even after the substantial reduction experienced in 2013–2014, commodity prices remained well above their 2002–2007 average (chart 4).

UNCTAD has leaned towards the second view on the prospects for commodity prices. The size already attained by the economies of China and India, the evolving consumption pattern of their population and their persistently large investment needs are structural factors that provide the basis for sustained demand for commodities in the coming years (*TDR 2013*).[3] Nonetheless, this should not lead to complacency in commodity exporting countries, as strong price volatility continuously shows. In particular, they should strengthen their domestic production linkages around these activities. They should also use the revenues generated in export-oriented primary industries to diversify their economies and thus reduce their dependence on commodities. The government's role is key in this process, as it is the actor that can capture a significant part of the rent generated in primary production and apply it in social and economic investment. Moreover, diversifying production and generating production and incomes linkages tends to develop domestic markets, which are essential to establishing a sustained development process.

Chart 4

MONTHLY COMMODITY PRICE INDICES, SELECTED AGGREGATES, JAN. 2002–JAN. 2015

(Index numbers, 2002=100)



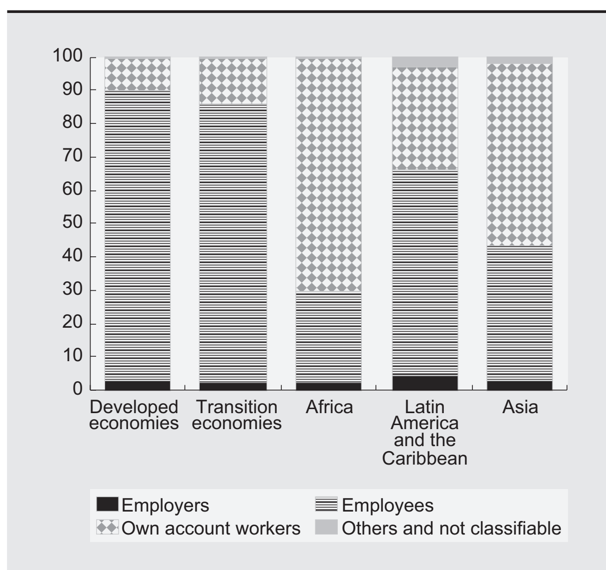
Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics Online* database.

Note: Crude petroleum price is the average of Dubai/Brent/West Texas Intermediate, equally weighted. Index numbers are based on prices in current dollars, unless otherwise specified.

Chart 5

COMPOSITION OF EMPLOYMENT BY REGIONS, 2008

(Per cent)



Source: UNCTAD secretariat calculations, based on *ILO Laborsta* database; and national official publications.
Note: Own account workers include contributing family workers.

This does not mean that there is an opposition between domestic and external markets. Much on the contrary, international trade cannot revive without a significant recovery of domestic demand in a sufficiently large number of countries. In fact, too many countries seeking to grow through net exports and gain competitiveness in ways that depress domestic demand would necessarily lead to a fallacy of composition: weak domestic markets, if generalized, also weaken global markets.

In addition to recognizing the importance of domestic demand for a more balanced and sustainable growth, it is necessary to consider the composition of that demand, which in turn critically depends on income distribution. Very unequal distribution patterns concentrate consumption in high-income sectors, with a high proportion of imported goods and services and weak domestic production linkages. Therefore, this kind of domestic demand has little impact on domestic growth and employment, negatively affects the trade balance and does not provide the necessary support for industrialization (Prebisch, 1963; Pinto, 1970). On the contrary, a more equal income distribution has a positive impact on total domestic demand (as low- and middle-income social groups have a higher propensity to consume than high-level income groups). It also alters its composition by increasing the share of goods (including manufactures) and services that are more likely to be supplied by domestic and regional producers. Consequently, a better income distribution not only supports consumption but also investment.

Governments can use several policy tools for reducing income inequality and combine them according to specific situations. They can support job creation, in particular in the modern and formal sector; moreover, they can also implement incomes policies so that wages increase (at least) in line with the average productivity growth in the economy plus the targeted inflation rate. With this aim, they can establish minimum wages, empower unions with a nation-wide mandate, implement collective bargaining mechanisms and provide general guidance within these negotiations. However, in many developing countries (particularly in Africa and Asia), a large part of workers are self-employed or employed in the informal sector and thus they do not benefit from wage policies (chart 5). Therefore, specific measures aimed at increasing the income of small peasants (through changes in their production and commercialization schemes) are also needed. Public policies for income redistribution also need to be developed, through progressive taxation and social transfers. Recent improvements in income distribution in Latin America largely resulted from a larger redistributive role of the State (*TDR 2012*).

Giving a larger place to domestic and regional demand (especially to low- and middle-income groups) is not only important for providing a stronger and more reliable source of growth, but more importantly because it leads to a more inclusive kind of growth.

III. The need for policy space[4]

A. Rediscovering industrial policies

Strengthening domestic demand, and particularly that of the low- and middle-income social groups, is a necessary yet not a sufficient condition for economic development. Inadequate production capacities for responding to rising demand and a limited possibility of financing increasing imports with exports may lead to balance of payments restrictions. As discussed above, the prospects for expanding exports mainly depend on expanding domestic demand in a large number of countries. The involvement of large economies is particularly relevant. In this sense, current policies aimed at reorienting the structure of demand in China towards domestic markets and consumption can help to boost global demand. Indeed, a number of countries are incorporating large parts of their population into a middle class. Demand in this group is not only increasing in volume, but also diversifying in composition, providing new opportunities to domestic and foreign producers (see *TDR 2013*, chapter II).

It is also essential that developing countries expand and adapt their production capacities to respond to the new demand pattern, although such adjustments would not take place spontaneously. In order to increase investment, firms not only need to have good demand prospects, but also supportive macroeconomic and industrial policies, basic infrastructure and long-term finance.

Industrial policies were sidelined for many years, during which the main strategy involved liberalizing trade and capital flows (see Robert Wade's contribution in this volume). The only active policies frequently used were providing incentives and advantages to TNCs. It was expected that through these means the country would expand its commodity exports or entry into international production networks (depending on their static comparative advantages) and engage in export-led growth. Since industrial policies no longer seemed relevant, losing policy space through World Trade Organization (WTO) disciplines and even more by signing Bilateral Investment Treaties and Regional Trade Agreements with developed countries (mostly in the 1990s) seemed a low price to pay compared to the promise of larger market access and FDI inflows. However, subsequent experience has shown that even in export-led growth schemes, public policies were essential to avoid the country remaining locked into low-value added activities or seeing their extractive industries becoming enclaves with barely any domestic productive linkage and little income (including taxes and royalties) distributed within the country.

Since the beginning of the financial crisis, many countries, both developed and developing, have acknowledged the importance of industrial policy to sustain or expand their manufacturing sectors and firms. Both the United States and the European Union launched economic packages aimed at smoothing the impact of the crisis, particularly on their manufacturing sectors. With a longer-term perspective, the American Recovery and Reinvestment Act of 2009 allocated an $800 billion package to favour the structural adjustment of the manufacturing sector, the repatriation of offshore manufacturing and the development of clean energies. Furthermore, the Government of the United States has been supporting strategic industries and the development of new technologies by funding very risky research and creating innovation networks. The European Union seeks to support research and development, innovation and competitiveness in the context of the Lisbon Strategy (adopted in 2000) and the Horizon 2020 Programme (adopted in 2010) (see *TDR 2014*: 93–96).

With the Uruguay Round Agreements in 1995, developing countries have at least partly lost some of the tools that several East Asian countries used for their rapid industrialization. Indeed, they now face restrictions in the use of subsidies, they cannot set export requirements or domestic content to foreign firms and are not allowed to reverse engineering and imitation for technology access.[5] However, the remaining room for manoeuvre is not negligible. WTO members can use tariff policy when there is a gap between bound and applied tariffs and modulate it to support specific industries. They may use certain flexibilities through export credits or environment-related subsidies, compulsory licensing and parallel imports and sector-specific entry conditions on FDI (see *TDR 2014*: ix and 84–86). They can also offer tax incentives, provide long-term credit at moderate interest rates and use government procurement to support local providers. Much of these remaining flexibilities may disappear if developing countries accept the terms of Free Trade Agreements or

Bilateral Investment Treaties that contain more stringent provisions than those included in the multilateral regime ("WTO-plus") or go beyond the multilateral agreements ("WTO-extra" provisions). When considering the signature of those new agreements, developing countries should carefully consider their costs in terms of the loss of policy space (see *TDR 2014*: 86–89. See also Mayer, 2008).

Any process of structural change is normally associated with "creative destruction". Industrial and macroeconomic policies should aim at ensuring that creation prevails over destruction. This was not the case with neoliberal reforms that took place in many countries of Latin America in the 1980s and 1990s. Growth and employment were greatly affected because rapid and unilateral opening to trade and capital movements, regressive income distribution and dismantling of the developmental State strongly hit the tradable sectors, particularly those dependent on domestic markets. The destruction of capital and human qualification in the affected sectors was not compensated by expected improvements in other sectors. This was partly because these losses on both the demand and supply side created a downward spiral that depressed investment, despite the availability of foreign capital. Furthermore, openness to capital movements led to an appreciation of domestic currencies (which undermined exports from the supposedly competitive sectors), generated debt overhang and boom-and-bust episodes and led to severe financial crises (Calcagno, 2008). To be successful, structural change must be driven by the expansion of new sectors, whereby the decline of other sectors (in relative or absolute terms) should be the result of that expansion, and not the other way around.

B. Foreign capital flows and domestic sources of finance

The global financial crisis evidenced the flaws and risks entailed by a financial globalization characterized by huge private capital movements and large foreign-held capital stock without proper international or national financial governance. In this framework, access to abundant international finance, which could have been a blessing for many developing countries by easing their balance of payment restriction, became in many cases a problem.

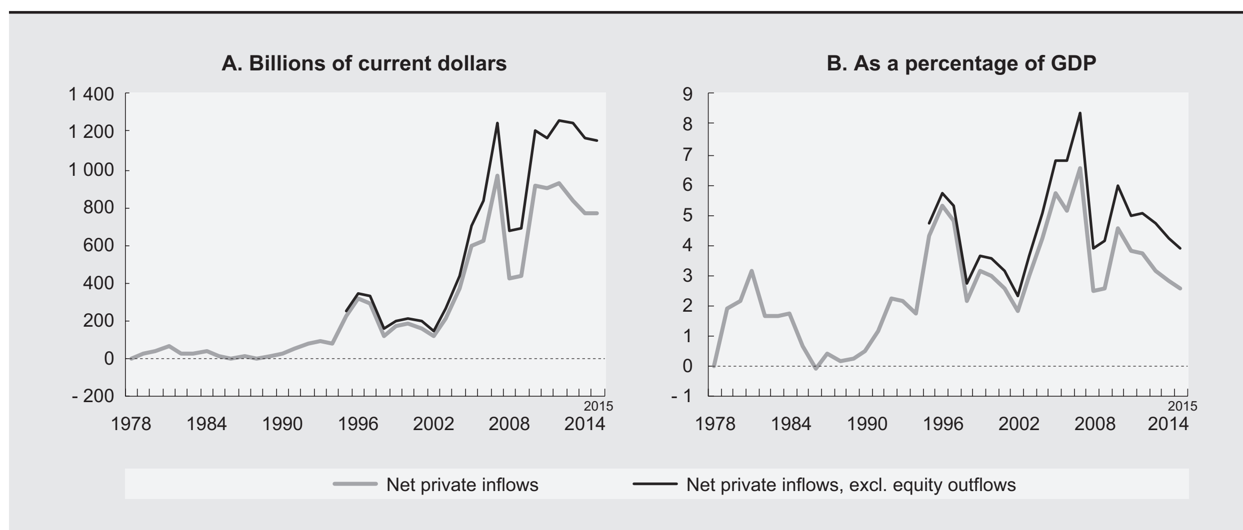
The main issue is that, more often than not, the amount, use and timing of predominantly private capital movements do not respond to developing countries' needs. Capital flows tend to follow a global financial cycle, whereby "push factors" in the developed economies where the main suppliers of international credit are based have more influence than country-specific "pull factors" (i.e. countries' demand for credit; see Akyüz, 2012; Rey, 2013). Indeed, almost all of the major "waves" of capital inflows received by developing countries since the late-1970s have been triggered by expansionary monetary policies in developed countries. They were amplified by the leverage cycles of global banks (chart 6).

The volume of such inflows is frequently too large for relatively small economies (Haldane, 2011). Much of it is channelled by the domestic financial system to consumption, real estate and financial assets, rather than productive equipment and machinery. Consequently, rather than spurring investment and growth, they have frequently generated macroeconomic instability, distorted prices and created trade imbalances and credit bubbles. When economic policies changed in developed countries or any event affected market confidence, a "sudden stop" or reversal of capital flows triggered financial crises. Therefore, it is little wonder that empirical studies have generally failed to find a positive correlation between openness to capital flows and development (see for instance Bhagwati, 1998; Prasad et al., 2003; Prasad et al., 2007; Jeanne et al., 2012; *TDR 2014*, chapter VI).

Development strategies should prevent or at least reduce the macroeconomic instability and economic fragility caused by international capital movements. It is increasingly accepted that as long as multilateral regulation mechanisms are not in place, governments have to resort to capital management measures, including capital controls (*TDR 2011*; IMF, 2012). Managing the *volume* of capital inflows and outflows is essential for prudential reasons, to avoid financial fragility and conduct macroeconomic policies. Similarly important is the regulation of their *composition* and *use* (e.g. long-term credits for investment projects vs. short-term flows for consumption or speculation). A cautious and selective approach towards cross-border capital flows would reduce the vulnerability of developing and transition economies to external financial shocks, as well as channelling foreign capital to development-enhancing purposes (*TDR 2013*, chapter III).

Chart 6

NET PRIVATE CAPITAL INFLOWS TO EMERGING MARKET ECONOMIES, 1978–2015



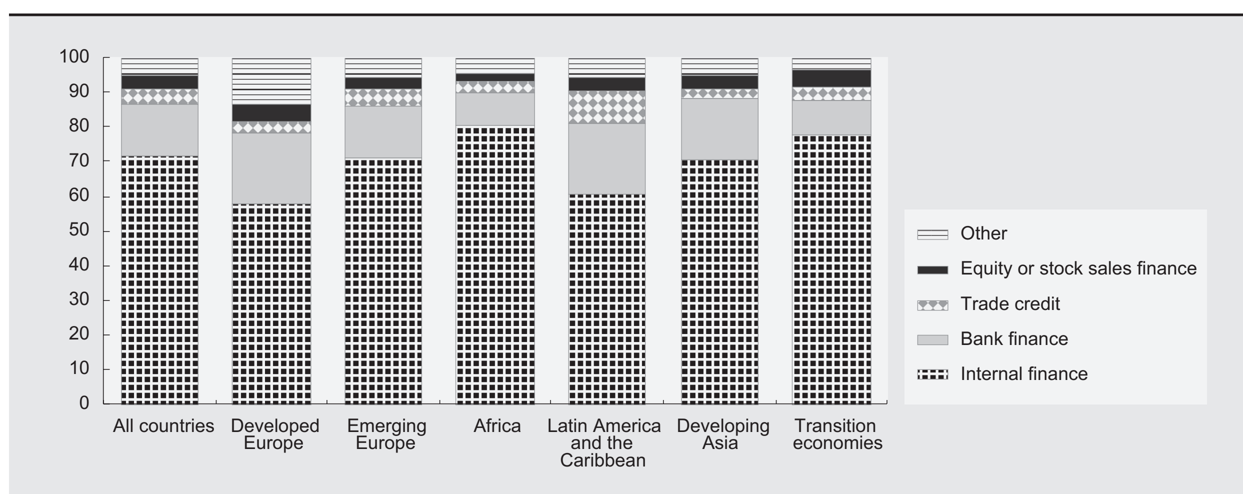
Source: UNCTAD secretariat calculations, based on Institute of International Finance, *Capital Flows* database; and *UNCTADstat*.

The management of capital flows should be seen as a way to make them a complement to domestic sources of investment. Indeed, domestic sources are quantitatively the most important for investment financing, whereby firms' retained profits[6] overwhelmingly constitute the main source of finance for investment, followed by bank credit (chart 7). Economic policies should aim at strengthening the profit-investment nexus and apply active credit policies to increase real investment. This would be more effective in promoting investment than seeking to increase domestic and foreign savings through higher interest rates and capital inflows deregulation. Furthermore, the usual policy tools aiming at increasing savings (e.g. increasing real interest rates, adjusting fiscal spending and increasing income inequality) may actually discourage investment, as they tend to reduce expected demand and profits. If

Chart 7

SOURCES OF INVESTMENT FINANCE, SELECTED COUNTRY GROUPS, 2005–2014

(Per cent)



Source: UNCTAD secretariat calculations, based on World Bank, *Enterprise Survey* database.

Note: Developed Europe comprises Germany, Greece, Ireland, Israel, Portugal and Spain. Emerging Europe comprises Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

that is the case, they would be self-defeating since lower investment would lead to lower growth and income generation, and thus lower savings.[7]

C. Fiscal space

The global crisis provided new evidence concerning the importance of the State's role in the economy. Even in the neoliberal view, it was recognized that public action was essential to avoid a complete financial implosion and a deeper economic contraction. Moreover, it was acknowledged that there was a need for a greater participation of the State in the economy on a more permanent basis. In particular, there was certain agreement on the need for improving public supervision and regulation of the financial system. In some countries, incomes policies (including social transfers and employment programmes) for supporting domestic demand and improving low revenues gained wide acceptance. Furthermore – as mentioned above – an increasing number of countries are implementing industrial policies and expanding the public provision of essential services.

Fiscal space is an essential aspect of the policy space needed by the developmental State (see *TDR 2014*, chapter VII). Even if governments are allowed to conduct some development policies within the multilateral, regional or bilateral frameworks, they still need to finance them. To that end, strengthening public domestic revenues is key, given that they are more sustainable in the long run than relying on aid or debt, as well as being less subject to restrictions and conditions that hamper policy space.

Public revenues as a percentage of GDP normally increase during the development processes. On the one hand, higher public revenues reflect the expansion of taxable income, wealth and transactions as economies progress and the informal sector squeezes. On the other hand, they can cover rising demands in terms of social services, public investment and transfers. The specific ways in which economies raise taxes and other public revenues critically depend upon country characteristics and political choices.

However, the globalized economy poses serious challenges to increasing tax revenues, as it prompts tax competition among countries (a "race to the bottom", mainly on direct taxation) to attract foreign capital. This competition has been particularly damaging in mining and hydrocarbons: an estimate for a sample of resource-rich developing countries shows that governments only captured about 17–34 per cent of the rents generated in extractive industries dominated by private firms between 2004 and 2012. This share increased to 64–87 per cent when a public firm had a dominant role in the activity.[8]

Finance-driven globalization has also seen the development of a dense network of tax havens, offshore financial centres and secret jurisdictions that host them. They provide various means for tax avoidance to the main potential taxpayers, including internationalized firms and wealthy households. While the magnitude of tax leakages is difficult to assess, all estimations agree that they are huge (see *TDR 2014*: 175–176).

For instance, Henry (2012) calculated that rich households held between $21 and $32 trillion in tax havens in 2010. A conservative calculation of the resulting loss of public revenues amounts to $190−$290 billion per year, of which $66−$84 billion is lost from developing countries.[9] As for corporates, their main vehicle for tax avoidance or evasion and capital flight from developing countries is the misuse of "transfer pricing" (i.e. when international firms price the goods and services provided to different parts of their business to create profit-loss profiles that minimize tax payments). By this means, developing countries may be losing over $160 billion annually (Christian Aid, 2008).

These examples suggest there are significant potential gains from seriously checking tax avoidance mechanisms and reversing the "race to the bottom" behaviour in tax matters, which only benefits some TNCs. Those gains would not only be important from an economic perspective, but also by introducing some fairness in the distribution of the costs of the crisis. Furthermore, this would represent a true structural change, as these mechanisms allowing for tax leakages are part of modern business practices and are integrated into the trade and financial systems of many developed economies.

Therefore, the first condition to end these practices is to have the political will to place limits upon the globalized financial system, stemming "tax optimization" strategies by TNCs, reducing inequalities and strengthening governments' fiscal space.

This is an ambitious programme that would address the roots of the "big crisis", as well as contributing to generate social and political support for the new development strategy.

IV. Concluding remarks

This chapter argues that the global financial crisis has been a "big crisis", in the sense that it was not just a temporary disruption that could be reabsorbed without any fundamental change in the economic and social framework. Indeed, its resolution would require a number of structural reforms to address a number of fundamental flaws in the world economy. Such reforms cannot result from market mechanisms; rather, they need to be implemented through a political process.

Many observers would agree that structural reforms are needed; however, the content of such reforms critically depends upon the perceived causes of the crisis. The view conveyed in this chapter is that the crisis resulted from a number of long-term trends that gained momentum since the mid-1970s and early-1980s. The most important were the dominance of the increasingly unregulated financial sector over the real economy, the State's diminishing role in the economy and the increasing income inequality. Based upon a different understanding of the causes and nature of the crisis, many of the proposed or on-going reforms – mainly in developed countries – are either too timid in addressing some factors of the crisis (e.g. insufficient financial re-regulation) or they actually worsen its very causes, by further weakening the role of the State in the economy or increasing income inequality.

Developing countries need to adapt their development strategies to the new, less conducive, international conditions. This would not only require applying supportive macroeconomic policies, but more generally reinstating a developmental state and enlarging its policy space. Public action should sustain domestic demand through incomes policies and expand the production capacities, particularly through public investment and industrial policies. Reorienting the financial system and mobilizing resources to finance development policies are challenging tasks, whose success critically depends upon the willingness and ability to tame the globalized financial system and strengthen governments' fiscal space. This ambitious programme would address the roots of the "big crisis" and contribute to generating social and political support for the new development strategy.

Notes

1 Financial assets include equities, bonds issued by the public and private sectors, and loans. See Lund et al. *(*2013).

2 The group "transition economies" has significantly evolved with the incorporation of several former socialist countries into the European Union, which were thus included in the "developed countries" group. For consistency, countries in this group are those still considered in transition by 2014; see the complete list in table 2.

3 In China, it is expected that 400 million persons will move from rural to urban areas in the following 15 to 20 years, which mean building 200 medium-size cities and the corresponding infrastructure. See Aglietta (2012).

4 This section largely draws on *TDR 2014*, chapters V, VI and VII, whose main authors are Jörg Mayer; Alfredo Calcagno and Ricardo Gottschalk; and Diana Barrowclaugh, Pilar Fajarnés and Nicolas Maystre, respectively.

5 These restrictions are established in the Agreement on Subsidies and Countervailing Measures (SCM), the Agreement of Trade-related Investment Measures (TRIMs) and the Agreement on Trade-related aspects of Intellectual Property Rights (TRIPS), respectively.

6 Retained profits include reinvested profits by TNCs, which is a component of FDI flows.

7 This issue refers to the fundamental debate between the neoclassical view that sees savings as a precondition for investment and the Keynesian/Schumpeterian view, which sustains that investment can be financed by banking credit (created *ex-nihilo*) and savings is an endogenous variable resulting from the income generated in the economic process. See *TDR 2008*, chapters III and IV; Dullien, 2009.

8 The study comprised Angola, Colombia, Ecuador and the Bolivarian Republic of Venezuela for oil, and Chile, Ghana, Mali, Peru, the United Republic of Tanzania and Zambia for mining. See *TDR 2014*, chapter VII, table 7.1.

9 In Henry's calculation, this would result from a 30 per cent income tax paid over a hypothetical return of only 3 per cent per year.

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