

# The Financial Crisis, the Great Recession and the Developing World

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## Abstract

This article analyses the implications of the global economic crisis for developing countries, situated in the wider context of the world economy, and suggests that the crisis also provides an opportunity for rethinking policies at the national level and contemplating collective action at the international level, so that outcomes are more conducive to development. The world economy witnessed a collapse in international trade and a sharp contraction in output and employment. But the developing world coped better than industrialised countries and transition economies as the impact was less adverse and the recovery was somewhat quicker. China, India and Brazil stand out as exceptions. Initial conditions, policy responses and domestic demand shaped their resilience and recovery. These emerging economies or parts of the developing world cannot drive recovery or turn into engines of growth for the world, but their experience suggests important policy lessons. The prospects of recovery in the world economy remain uncertain. The supposed trade-off between financial stability and economic growth is a false dilemma. Recovery is sustainable only if it is based on a rebalancing of the world economy that extends beyond current account deficits and surpluses to income–expenditure gaps and income distribution within countries. An increase in the share of wages in GDP would be conducive to growth everywhere. This is possible if wages keep pace with productivity growth and full employment is the primary objective. In the global context, international collective action is an imperative for crisis management and crisis prevention.

## Policy Implications

- Macroeconomic objectives should be redefined so that the emphasis is on fostering employment creation and supporting economic growth rather than on price stability alone.
- There is a need to integrate short-term fiscal and monetary policies, which are powerful and versatile instruments, with long-term development objectives.
- It is necessary to exercise restraint in the deregulation of domestic financial sectors, and hasten slowly with capital account liberalisation, or retain the option of capital controls.
- Rebalancing of the world economy requires some redistribution of incomes within countries.
- Increased employment can provide a sustainable solution to the crisis and in the process deliver growth with equity.
- Institutional mechanisms should be developed, with representation and participation, in order to implement international collective action.

The financial crisis in the United States, in late 2008, spread through contagion across the world. Its transmission to the real sectors of economies was also rapid as it led to a sharp contraction in output and employment. The downturn moved quickly into a recession. Even if cycles are embedded in the nature of capitalism, it is clear that this Great Recession is the deepest crisis in capitalism since the Great Depression more than 75 years ago. There is, however, an important difference between then and now. Developing countries were not

as connected with the world economy at that time. The focus then, it is no surprise, was on industrialised countries. Developing countries are much more significant and integrated into the world economy now. Hence, this time around, any meaningful analysis of crisis and recovery in the world economy must also focus on the developing world.

The object of this article is to analyse the implications of the financial crisis and the Great Recession for developing countries, situated in the wider context of the

world economy, and to suggest that the crisis also provides an opportunity for rethinking policies at the national level and contemplating collective action at the global level, so that outcomes are more conducive to development. Section 1 examines the impact of the crisis on the developing world. Section 2 considers why the impact of the crisis and the recession on some emerging economies and on some parts of the developing world was less adverse and why their recovery was significantly faster than in industrialised countries. Section 3 explores how developing countries might address the problem in their respective national contexts, to mitigate the impact of the Great Recession at the present time and to reduce their vulnerability in the event of a future crisis. Section 4 analyses the prospects of recovery in the world economy with a focus on the underlying macroeconomics to suggest that a sustainable solution requires stability with growth. Section 5 discusses the logic and possibilities of international collective action, with particular reference to the opportunities for cooperation among developing countries, which is needed for crisis management and essential for crisis prevention.

It should be obvious that this article seeks to consider a wide range of issues, in an endeavour to sketch the big picture. However, it needs to be said that there are some issues it does not consider. It does not attempt to outline the sequence of events or examine the underlying causes that led to this global economic crisis.<sup>1</sup> It does not attempt to survey the emerging literature on the impact of the financial crisis and the Great Recession on the developing world.<sup>2</sup> It does not attempt to examine the implications and consequences of the triple crisis, as the financial crisis has roughly coincided in time with the food crisis and the environmental crisis, for the developing world. Clearly, these aspects are also important but such a discussion would require another essay.

## 1. Economic impact on the developing world

It is important to set the stage by highlighting the initial impact of the global crisis on development. The most obvious consequence was the slowdown in economic growth in much of the developing world. The channels of transmission for the slowdown in growth were exports, remittances and capital flows. For exports from the developing world, primary commodities witnessed a collapse in prices, which was juxtaposed with sharply reduced levels of demand, while manufactured goods that are labour intensive in production witnessed a phenomenal contraction in demand across the world market. Indeed, in 2009, the sharp decline in world trade, almost unprecedented at 12.2 per cent, was far more pronounced than the reduction in world output at 2.3 per cent.<sup>3</sup> The rapid growth in remittances, particularly from migrants in industrialised countries, experienced a

sharp slowdown.<sup>4</sup> And it is no surprise that foreign direct investment in the world economy was much reduced.<sup>5</sup> There was a complete collapse in flows of private capital and portfolio investment to the developing world.<sup>6</sup> But that might have been a blessing in disguise for most countries. It is clear that the slowdown in growth shaped outcomes in development through these channels of transmission. In the ultimate analysis, however, development is about the living conditions of ordinary people.

In a narrow sense, the poor are people who live below the poverty line of purchasing power parity (PPP) drawn at \$1.25 per day. This number is in the range of 1.35 billion people, which is a little more than 20 per cent of the world's population. These are estimates made by the World Bank which, some scholars argue, probably underestimate absolute poverty (see, e.g., Kaplinsky, 2005; Pogge and Reddy, 2002). However, if the poverty line is drawn at PPP \$2 per day, the number of the poor is much larger at 2.55 billion people, which is almost 40 per cent of the world's population.<sup>7</sup> It is the population between the two poverty lines, almost as large at 1.2 billion, which is vulnerable in times of crisis, because any shock, such as a bad harvest, high inflation or employment cuts, can push them further into poverty. Of course, those already below the poverty line of PPP \$1.25 per day are even more vulnerable as such shocks erode their critical minimum levels of consumption.

The channels of transmission outlined above play a part in this process. In developing countries, exports are a very important source of employment and livelihoods. This is not only true for small countries that are export dependent. It is just as true in large economies such as China and India. It is widely recognised that China depends on the world economy, in particular the United States, as a market for its manufactured exports. India might appear less dependent. However, significant segments of its manufacturing sector, not only information technology but also clothing, leather, gems, jewellery, handicrafts and carpets, which export a very large proportion of their output, are an important source of employment. And it is people in these sectors, often the poor or the vulnerable employed in the production of leather, handicrafts and carpets, who have lost their livelihoods from the contraction in exports. Such vulnerability is obviously far greater in smaller countries of the developing world which have a much narrower range of specialisation in exports. Remittances, research suggests, are much higher per capita for migrants at lower levels of income and skills than for migrants at higher levels of income and skills because such remittances support either household consumption among the poor in the home country of the migrant or provide resources for assets that generate self-employment.<sup>8</sup> It is these that have come down significantly. And, last but not least,

foreign aid inflows that have contracted in the least developed countries have had a serious impact on levels of social consumption because they are often a primary source of finance which supports social consumption in countries where governments are strapped for cash or are in a perpetual fiscal crisis. The poor in the developing world are obviously the most vulnerable. Hence, the initial impact must have been adverse.

It is now two years since the crisis surfaced. Although it is not possible to come to definitive conclusions, available evidence on GDP growth rates suggests that outcomes are mixed. Growth performance was in conformity with longer-term trends in 2007, but it was dampened by the financial crisis in 2008, while the full impact of the global economic crisis was felt in 2009. Annual GDP growth rates in these three years, respectively, were: 3.8 per cent, 1.6 per cent and  $-2.2$  per cent for the world economy; 2.6 per cent, 0.5 per cent and  $-3.5$  per cent for industrialised countries; 2.1 per cent, 0.4 per cent and  $-2.5$  per cent for the United States; 2.9 per cent, 0.8 per cent and  $-4.1$  per cent for the European Union; 8.4 per cent, 5.5 per cent and  $-6.5$  per cent for the transition economies; 7.6 per cent, 5.4 per cent and 1.9 per cent for developing countries; 5.6 per cent, 4.1 per cent and  $-2.1$  per cent for Latin America and the Caribbean; 6.0 per cent, 4.9 per cent and 1.6 per cent for Africa; 5.0 per cent, 4.6 per cent and  $-1.0$  per cent for West Asia; and 9.3 per cent, 6.3 per cent and 4.3 per cent for East Asia and South Asia (see United Nations, 2010).

The impact of the crisis was not confined to a contraction in output. It also led to a sharp contraction in employment. It is estimated that, between 2007 and 2009, the number of unemployed people in the world rose from less than 180 million to 210 million, so that global unemployment increased by more than 30 million.<sup>9</sup> Of this increase, three-quarters were in the industrialised countries and one-quarter was in the emerging economies. The unemployment rate increased by 3 percentage points in industrialised countries and by 0.25 percentage points in emerging economies. And in the major industrialised countries, unemployment rates climbed to double-digit levels. The unemployment rate for youth, mostly new entrants into the labour market, which is historically more than twice that for higher age groups, jumped to unprecedented levels in some countries, such as Spain where it rose from less than 20 per cent to almost 40 per cent. At the same time, the problem of long-term unemployment intensified in the industrialised world. The proportion of those unemployed for more than six months in the total number of unemployed, which has been rising over time, also registered a sharp increase everywhere, and this proportion is now alarming at almost one-half in the United States.

Clearly, the adverse impact of the Great Recession on output and employment in the industrialised world, and in the transition economies, was substantial, while the developing world did not fare as badly as might have been expected. Some market economies in the European Union, in particular Portugal, Ireland, Greece and Spain, and some transition economies in Eastern Europe, are in deep trouble. These countries have large external debts relative to foreign exchange reserves, or domestic financial vulnerabilities in the private sector, some of which have been shifted to the government sector through bailouts. Many of the high-income emerging economies were, and remain, adversely affected. South Korea, Taiwan, Hong Kong and Singapore, and also Mexico and Turkey, which were highly dependent on US and EU markets for their manufactured exports, are hard hit. Similarly, Chile, Malaysia and Thailand experienced a significant contraction in GDP, partly as a consequence of the sharp decline in exports. In contrast, some large developing countries, in particular China, Egypt, India, Indonesia and Nigeria, turned out good economic performances in the aftermath of the crisis, while Argentina and Brazil did not fare badly.<sup>10</sup> Apart from these large developing countries, surprisingly enough, some regions in the developing world, such as South Asia, North Africa and much of sub-Saharan Africa, fared better than might have been expected.<sup>11</sup> But that is not all. The growth performance of the least developed countries was surprisingly robust.<sup>12</sup> The good performance of South Asia and the reasonable performance of sub-Saharan Africa, which are homes to most of the world's poor, imply that, at least so far, the impact of the Great Recession on world poverty may not have been as bad as expected. Obviously, growth, whether rapid or modest, is not sufficient to ensure the well-being of ordinary people but a collapse in growth, or a contraction in output, would almost certainly have hurt the poor more. In fact, growth slowed down but remained positive in several parts of the developing world. It is clear that, in the absence of this growth, outcomes would have been much worse for people.

## 2. Resilience of three emerging economies

Given the diversity of countries in the developing world, it is difficult to provide a general explanation for the unexpected resilience of some economies following the global crisis. But it might be worthwhile to focus on three emerging economies – China, India and Brazil – that seem to have weathered the storm, in so far as the impact was less adverse and the recovery was faster. It is not as if the three were immune from the crisis in the world economy. The impact on some sectors of these economies, particularly those that were export dependent, was devastating in the short run. Yet, in retrospect,

they turned out to be exceptions. Their experience may carry lessons for other developing countries, just as their performance may have implications for the world economy.

The impact of the global economic crisis was less adverse for four reasons. First, the initial conditions before the crisis were supportive. Macroeconomic stability, reflected in fiscal situation, moderate inflation, large foreign exchange reserves, combined with economic growth, provided structural flexibility both at the macro and micro levels. Second, financial liberalisation was restrained. Integration into international financial markets was calibrated and deregulation of domestic financial sectors was paced. Third, safety nets for the poor and the vulnerable, even if limited, were in place. There was social protection in China, the National Rural Employment Guarantee programme in India and *Bolsa Familia* in Brazil. Fourth, the economic size of these countries, in terms of population if not income, meant that domestic consumption was a countervailing force, particularly as economic activity for significant proportions of the population was not quite connected with the world economy.

Their economic recovery was also significantly faster for three reasons. First, these countries adopted expansionary, countercyclical, macroeconomic policies, which were almost Keynesian and most unusual, until now, in the developing world. What is more, the response to the crisis was effective and fast. There was a massive fiscal stimulus in China. In contrast, the fiscal stimulus in India was modest. But there was a significant expansion in the National Rural Employment Guarantee programme and a large increase in salaries for government employees; both these measures were put in place just before the crisis and became a *de facto* stimulus. Expansionary fiscal and monetary policies were introduced in Brazil. The existing macroeconomic situation and the presence of state financial institutions in the three economies made the task easier. Second, the size of the home market made a difference. The increase in aggregate demand came, in significant part, from segments of the population with a high propensity to consume, which was transmitted to the real sector of the economy. It meant that the Keynesian multiplier worked on output and incomes. Thus, domestic consumption drove recovery and sustained growth. Third, their financial sectors, which were less fragile and more regulated than elsewhere, did not absorb scarce resources from stimulus packages in recapitalisation or bailouts, so that easier monetary policies meant lending for investment to the real sector in these economies rather than the creation of financial asset bubbles.

The reasons underlying the resilience of other emerging economies and developing countries that fared better were probably similar. The combination of factors

could not have been the same because of differences in size and circumstances of countries. The relative importance of underlying factors would have been different. Even the underlying factors themselves may have been different. Yet there can be little doubt that initial conditions, policy responses and domestic demand shaped resilience and recovery, while prudence in deregulation and liberalisation of financial sectors limited collateral damage. Fiscal space available to governments also made a difference. The significant increase in the share of developing countries in world income and world trade, which was clearly discernible by the mid-2000s,<sup>13</sup> also meant that there were some external markets and resources other than in the industrialised economies. It is almost certain that robust growth in Asia provided support for this resilience.

China, India and Brazil are large countries. Most small open economies in the developing world do not have similar space or flexibility. Yet the experience of the giant economies does suggest some obvious lessons for smaller countries in the developing world. It would be wise to hasten slowly with capital account liberalisation, or retain the option of introducing capital controls. It would be sensible to exercise restraint in the deregulation of domestic financial sectors. It will be necessary to stay prudent in macro management so that there is some freedom to introduce countercyclical macroeconomic policies. It would be desirable to create social safety nets for the poor and the vulnerable. Of course, such lessons are more about prevention in the future rather than cure at the present time. Even so, it is important to begin introducing correctives wherever possible.

In the wider global context, it is important to recognise the resilience of and the recovery in China, India and Brazil.<sup>14</sup> But it would be a mistake to conclude that these three countries can drive the process of recovery, or turn into engines of growth for the world economy.

Rapid economic growth in lead economies drives economic growth elsewhere in the world by providing markets for exports, resources for investment, finance for development and technologies for productivity. The classic examples – Britain in the 19th century and the United States in the 20th century – provide confirmation of the suggested economic causation and transmission mechanisms. Taken together, before the crisis, China, India and Brazil accounted for 10 per cent of world GDP at market exchange rates (and 25 per cent of world PPP-GDP). Given this reality, economic growth in China, India and Brazil can provide only a limited stimulus to economic growth elsewhere, in large part as markets for exports. But these countries cannot be characterised as engines of growth, at least yet, in any of the other dimensions. Simply put, they are complements, not substitutes, which can provide some stimulus as the old engine of growth slows down.<sup>15</sup>

Even as markets for exports, there should be mechanisms through which these economies can transmit their growth dynamics to the rest of the world. India and Brazil do run current account and balance of trade deficits but, given their share in world trade, cannot contribute much to a recovery in world demand. China has a far larger economy and a much larger share of world trade. But it has a big current account surplus and a massive balance of trade surplus. In principle, China could stimulate growth elsewhere if it reduced its large trade surplus into at least a trade balance or turned it into a significant trade deficit. However, even this transformation would not suffice. The import content of Chinese exports is about 50 per cent, while the import content of its domestic consumption is only 10 per cent. Of its total imports, over 60 per cent are used directly or indirectly for exports, while less than 40 per cent are used for domestic investment or consumption. It would seem that China is a major importer but not a major market. Thus, *ceteris paribus*, a \$100 shift in the composition of aggregate demand from export markets to domestic consumption would reduce Chinese imports by \$40.<sup>16</sup> Obviously, China cannot turn into an engine of growth for the world economy even as a market for exports.

We know from experience, during the second half of the 20th century, that the United States economy has been, for better or for worse, the engine of economic growth in the world, in so far as it provides markets for exports, resources for investment and finance for development. There is reasonably strong evidence to suggest that growth in the United States leads the process of growth in the world economy.<sup>17</sup> This is attributable, in part, to the size of its economy in terms of income. But this is also attributable to its dominant role in the world economy, in terms of trade, investment, finance or technology, reinforced by its countercyclical stance in macroeconomic policies. Therefore, the prospects for recovery in the world economy, in the medium term, depend to a significant extent on the pace and the nature of recovery in the industrialised world, in particular the United States. These prospects are uncertain. And it is important to recognise the possibility that the Great Recession could persist. It would then become essential for developing countries to address the problem as best as they can in a national context.

### 3. The national context: constraints and choices

Ironically enough, there is an opportunity in this crisis for developing countries, in terms of rethinking policies and rethinking development. The dominant ideology of our times is beginning to lose its stranglehold on thinking, at least in political processes, if not in the ivory towers of academia. There is a growing recognition that

markets are no magic wand, that the invisible hand of the market is not visible because it is not there and that markets are good servants but bad masters. And there are a number of ways in which this crisis could provide reasons to rethink policies and rethink development. The discussion that follows is illustrative, not exhaustive, because it seeks to focus on some selected issues, where orthodox prescriptions often accentuate rather than resolve problems of development.

First, there is both the need and the opportunity to reflect on macroeconomic objectives and macroeconomic policies. Such a rethinking must begin by redefining policy objectives. In the short term, or in crisis situations, the prime concern should not be the stability of prices alone. The stability of output and employment is just as important. In the medium term, or in normal times, the essential objective of macroeconomic policies cannot simply be the management of inflation and the elimination of macroeconomic imbalances. It should be just as much, if not more, about fostering employment creation and supporting economic growth. The rethinking must also extend to reconsidering policy instruments. Fiscal policy cannot be reduced to a means of reducing government deficits or restoring macroeconomic balances. It is a powerful instrument in the quest for full employment and economic growth. Monetary policy cannot be reduced to a means of controlling inflation through interest rates. It is a versatile instrument where both the price and volume of credit can be most effective in the pursuit of development objectives. In sum, it is essential to return a developmental approach to macroeconomic policies, which is based on an integration of short-term countercyclical fiscal and monetary policies with long-term development objectives. This should shift the focus from the financial sector to the real economy, from the short term to the long term and from equilibrium to development. Economic growth with full employment should be the fundamental objective of macroeconomic policies, which must be an integral part of the mandate for central banks and finance ministries. It must be stressed that such a role for fiscal and monetary policies is critical not simply in crisis situations but also in the pursuit of development.

Such rethinking is easier said than done, because it requires dispensing with two shibboleths that have shaped orthodox macroeconomic policies, particularly in difficult times or crisis situations: that government deficits must be reduced and that economies must accept the pain of adjustment. This belief system was dented in the response to the global economic crisis but is beginning to resurface.

The obsessive concern about deficits in government finances borders on fetishism. It is essential to recognise the fallacies of such deficit fetishism.<sup>18</sup> Orthodoxy believes that reducing gross fiscal deficits is both necessary

and sufficient for macroeconomic adjustment. This is a myth. The size of the fiscal deficit, or the amount of government borrowing, is the symptom and not the disease. And there is nothing in macroeconomics that stipulates an optimum level to which the fiscal deficit must be reduced as a proportion of GDP. Indeed, it is possible that a fiscal deficit at 6 per cent of GDP is sustainable in one situation while a fiscal deficit at 4 per cent of GDP is not sustainable in another situation. The real issue is the allocation and end-use of government expenditure in relation to the cost of borrowing by the government. Thus, government borrowing is always sustainable if it is used to finance investment and if the rate of return on such investment is greater than the interest rate payable. There is a similar fetishism about monetised deficits. It serves little purpose to eliminate the monetised deficits for fear of inflation if the government continues to borrow as much from elsewhere, instead of the central bank, but at a much higher cost. There are other important macroeconomic consequences of such monetarism. For one, it makes public debt much less manageable and reduces fiscal flexibility for governments as interest payments pre-empt a much larger proportion of government expenditure. For another, high interest rates, which may not dampen government borrowing in the short or medium term, crowd out private investment, as rates of return on borrowed capital used to finance investment need to be much higher.

The other shibboleth also dies hard. For economies in crisis, orthodoxy believes that governments should not attempt to attain full employment. Instead, governments are urged to accept the pain of adjustment, in the form of lower output today, for a higher output tomorrow. This recommendation conforms to the strong spring analogy: the harder you push the spring down, the greater the force with which it bounces back. But a weak spring might be a more appropriate analogy for the economy, for when it is pushed too hard, it may simply remain there if its restorative forces are destroyed. These are mere analogies but there is evidence in support of the latter. In developing countries, under normal circumstances, there already exists a pro-cyclical pattern to macroeconomic policies, which are always the softer option for governments. Indeed, there are strong, embedded, incentives or disincentives for governments to adopt pro-cyclical fiscal policies (see Ocampo, 2003). The probability of such outcomes increases with orthodox stabilisation and adjustment programmes, which advocate a restrictive fiscal policy and a tight monetary policy. In downturns, the social costs of pro-cyclical fiscal policies are high, while growth is dampened, if not stifled. The correct response would be countercyclical macroeconomic policies, which are adopted as a rule by governments in industrialised countries.<sup>19</sup>

In the aftermath of the global economic crisis, the response of most developing countries, contrary to the orthodox belief system, was to adopt countercyclical policies in the form of a fiscal stimulus or monetary easing or both. There were three factors that made this possible. First, the response of the industrialised countries was clear in the form of expansionary macro policies. Second, there was an international effort, through the G20, to coordinate macroeconomic policies across countries. Third, much of the developing world, particularly the emerging economies, witnessed rapid economic growth combined with macroeconomic balances in the period before the crisis. In the process, obsessive concerns about governments' deficits were also given up for some time. However, even as the Great Recession persists, the shibboleths have surfaced once again. There are some exceptions, but the stimulus is coming to an end almost everywhere and the process of reversing the stimulus has begun in several countries. The message from the G20 is growth-friendly fiscal consolidation, which represents a return to orthodoxy through the back door. Following such advice would almost certainly be counterproductive at this juncture. It is essential for developing countries to resist this temptation and use the window of opportunity provided by the crisis to reinvent macroeconomic policies for development.

Second, there are important lessons to be learned from the experience of financial deregulation and capital account liberalisation, in both industrialised countries and developing countries, about what should not be done. It is clearly essential to learn that financial deregulation, such as doing away with the distinction between banking and non-banking financial intermediaries, is fraught with risk. At the same time, in thinking of integrating with international financial markets, it is clear that it would be wise to hasten slowly with capital account liberalisation. For the same reason, it would be unwise to rely on portfolio investment inflows to finance current account deficits because portfolio investment represents the intersection of two somewhat thin, very unstable, markets in developing countries: namely stock exchange markets and foreign exchange markets. Indeed, wherever countries have moved to capital account liberalisation, the option of introducing capital account controls must be retained.<sup>20</sup>

Third, it is essential to rethink the relative importance of the external and the internal in the process of development, in terms of markets and in terms of resources. It is necessary to recognise that the domestic market is critical in the process of development and that external markets are at best complements but cannot be substitutes for the domestic market even in smaller countries. Of course, the validity of this argument depends in part on the size of a country. Even so, domestic markets are, at one level, constitutive of development because it

means that ordinary people have purchasing power and are, at another level, instrumental in the process of development because they can drive processes of growth. Similarly, it is desirable to rely more on domestic resources for investment and think of external resources as complements rather than substitutes.

Fourth, in the national context, the time has come to recognise that there is a complex relationship between the state and the market. In the 1950s, most believed that the state could do no wrong, but four decades later the dominant orthodoxy persuaded most that the state could do nothing right. The answer lies somewhere in between. The state and the market are complements and not substitutes. What is more, the relationship between the state and the market cannot be defined once and for all as ideologues attempt to do. In fact, the state and the market must adapt to each other as circumstances and times change.<sup>21</sup> If we look at the difference between success and failure in development during the 20th century, we find that successes have come in countries that have found this right blend of state and markets. It is time to give up the belief in the magic of the market to consider a more proactive role for the state, not just in education and health as the World Bank advocates, but in terms of trade policy, industrial policy and technology policy. If development is to be people friendly, it does mean that the state has to play a critical role in terms of providing investment in infrastructure, which is not forthcoming from the private sector, whether domestic or foreign players. The state also has to focus on expenditure in social sectors because, if development is about improving the living conditions of people, allocating resources to support social consumption is both constitutive of, and instrumental in, development. Most important, perhaps, it is vital to redress the balance in the respective roles of the market and the state, where the pendulum has swung to one end, because the exclusion of large proportions of the population from well-being cannot even sustain growth let alone lead to development. And there is a developmental role for the state. So much of what needs to be done can only be done by the state. The reason is simple. Governments are accountable to people. Markets are not.

#### 4. Recovery prospects in the world economy

On the surface, it would seem that the process of recovery has begun. Projections suggested that GDP growth in 2010 would be positive everywhere: in industrialised economies, in transition economies, in developing countries and in regions across the world, and also in major industrialised countries and emerging economies. It is expected that growth rates will be significantly higher than in 2009, possibly close to 2008 levels (see IMF, 2010;

United Nations, 2010). The recovery in growth is expected to be the strongest in developing countries and the weakest in transition economies. There can be little doubt that this outcome is attributable, in large part, to countercyclical macroeconomic policies that were an integral part of strong national action and some international coordination. The fiscal stimulus and the monetary easing across countries were reinforced by massive bailouts for the financial sector in industrialised countries. This policy response pre-empted a protectionist reaction to the sharp contraction in world trade. But the prospects of recovery in the world economy remain uncertain. It is not clear whether recovery will be in the shape of a V (an upturn that would reverse the losses in output and employment), a U (output and employment would remain sluggish for some time despite positive growth) or a W (with a double dip that might follow a premature exit from stimulus packages).<sup>22</sup> The stimulus has come to an end almost everywhere, as there are no further cuts in interest rates or easing of credit, just as there are no more cuts in tax rates or increases in government expenditure. In fact, a reversal of the stimulus is on the cards, as monetary tightening has begun, while fiscal retrenchment is a distinct possibility. The message from the G20 is growth-friendly fiscal consolidation, while in the EU (not only economies in crisis but also Germany and the UK) decisions to reduce fiscal deficits sharply are in the process of implementation. This change in policy stance, somewhat premature, is bound to inflict social costs on these countries and dent the prospects of recovery in the world economy. For that reason, the mounting pressure in some industrialised countries to return to business as usual in macroeconomic policies must be resisted.

In a sense, the sequence of events that began in the lead-up to the crisis continues on its course.<sup>23</sup> To begin with, the financial sector players sought to pass on bad loans to each other and spread toxic assets through the financial system. The next stage was that the financial sector sought to pass on assets to the rest of the private sector, which in turn was motivated by greed but ended up with a debt overhang that led to deleveraging. And when the crisis surfaced, the state provided the private sector, mostly in finance, with bailouts. This damaged government finances in deficit countries but rescued surplus countries from a demand contraction, as private deleveraging was partly compensated for by public leveraging. Ultimately, this process eroded the confidence of financial markets in the government finances of deficit countries. Fiscal retrenchment is now on the cards as the next step. It is not clear how the system will adjust to what follows when government deficits are reduced. But it is clear that the fallacies of deficit fetishism in the national context could turn out to be even more dangerous in the international context.

The world economy is confronted with a serious dilemma. Restoration of growth based on debt-driven consumption and asset price inflation in the United States and the EU deficit countries will only postpone adjustment, or the day of reckoning, and accentuate financial fragility. Fiscal consolidation and retrenchment by deficit countries and indebted consumers, even if they reduce financial fragility, will lead to global deflation and stagnation. But this supposed trade-off between financial stability and economic growth is a false dilemma, because neither growth nor stability would be sustainable for long. What we need is both. Stability *and* growth, together, can provide a sustainable solution.

Recovery will be sustainable if, and only if, there is a progressive reduction in and ultimate elimination of global macroeconomic imbalances. In this context, there is a natural focus on the United States, which is the largest importer and the reserve currency country, and China, which is the largest exporter and biggest lender to the United States. But such a characterisation of imbalances is incomplete and insufficient. For one, the current account deficits and surpluses of economies reflect gaps between income and expenditure at a macro level. For another, as well as the United States, some EU countries run large current account deficits, just as China, Germany and Japan run large current account surpluses. The United States and the EU deficit countries have lived beyond their means for quite some time, while China, Germany and Japan have lived below their means for quite some time. This provides a more complete picture of imbalances in the world economy. The rebalancing that is needed, however, is easier said than done.

In the current account surplus countries, there is a serious problem of underconsumption.<sup>24</sup> In China, for example, since the late 1990s, there has been a continuous decline in private consumption as a proportion of GDP which is attributable to the steady decline in the share of wages in GDP.<sup>25</sup> Similarly, in Germany and Japan, during the 2000s, there has been a discernible decline in the share of wages in GDP which has led to a decline in private consumption as a proportion of GDP since 2005, which was significant in Germany and modest in Japan. In the United States and the EU deficit countries, the share of wages in GDP has witnessed a similar decline, but private consumption has been sustained by debt financing and asset inflation, both of which have now come to an end. The global imbalances, then, are a matter of economics rather than geography. It is income distribution that lies at the heart of the problem. In these industrialised countries, and even more so in China, real wages lagged behind productivity growth, so that the share of wages in GDP fell while the share of profits in GDP rose. It is no surprise that mar-

kets and globalisation strengthened capital and weakened labour. The mobility of capital and the immobility of labour, combined with flexible labour markets, reinforced the process.<sup>26</sup>

The rebalancing in the world economy, therefore, needs some redistribution of incomes within these countries. China needs to shift from export-led growth to consumption-led growth. Germany and Japan need to shift from external markets to domestic markets as a source of growth (see Akyuz, 2010). This is possible only if there is an increase in the share of wages in GDP and real wages keep pace with productivity growth. It requires the pursuit of full employment and an acceptance of higher wages. The United States and the EU deficit countries need to shift from consumption-led growth to export-led growth. It may be difficult for exports to lead growth in the short run as competitiveness is not simply a matter of exchange rates. And it may be difficult to squeeze consumption levels for people who have seen almost no increase in their real wages over a long period of time. Consumption based on household debt is obviously not sustainable. But consumption that is based on more employment and higher wages would be sustainable and could provide domestic demand to drive growth. Therefore, even in the deficit countries, an increase in the share of wages in GDP should be conducive to growth. The moral of the story is simple. It is time to place full employment centre stage once again as the primary objective of macroeconomic policies. For what is good for employment is good for economic growth. The connection is causal. It is only increased employment that can provide a sustainable solution to the crisis and in the process deliver growth with equity. Such a rebalancing would also provide stability with growth.

## 5. International collective action: logic and possibilities

The logic of international collective action was recognised more than six decades ago. It was an integral part of the conception of the Bretton Woods institutions that were created at the end of the Second World War and in the aftermath of the Great Depression. The recognition of its significance diminished with the passage of time. In fact, with the advent of markets and globalisation, by 1980 it was almost forgotten. There is an irony in the situation. In the mid-1940s, our understanding of collective action, the circumstances under which public, as opposed to private, action is necessary and desirable, was somewhat underdeveloped in terms of economic theory even if it was shaped by actual experience in the Great Depression. In the late 2000s, in terms of economic theory, our understanding of collective action is far more complete. Markets, by themselves, may not lead to efficient or

otherwise desirable outcomes. And such market failure may occur when there are public goods (or bads), externalities and incomplete or imperfect markets. More than six decades later, actual experience of market failure that straddles geographical borders is also much greater. There are several examples: recurring financial crises, impending climate change, trafficking of people, trading in human organs, a growing narcotics trade and so on. Clearly, the logic of international collective action is far stronger. Indeed, given the interdependence in the contemporary world economy, the need for international public action to address problems arising from market failure is greater than ever before. Yet, the effort is much less.

The recent global economic crisis is at least a prompt if not a wake-up call. It has, perhaps, led to a much needed recognition of the logic of international collective action, which had been almost forgotten. Its significance is now widely accepted. But it would seem that the willingness and the ability of governments to coordinate, in terms of implementing such collective action, is not quite there. Both have to be created. The former needs economic persuasion and political acceptance. The latter requires the creation of institutional mechanisms and a rethinking of national sovereignty. The domains where this is necessary and desirable are many: global macroeconomic management, international financial markets and climate change are the obvious examples but there are several others such as international migration or international crime. But the institutional mechanisms that exist are neither adequate nor appropriate.

The global economic crisis has highlighted the clear need for international collective action in coordinating global macroeconomic management, regulating international financial markets and reforming the international financial architecture. It would mean too much of a digression to enter into a discussion of these issues here.<sup>27</sup> Consider, for example, the attempt to coordinate macroeconomic policies after the financial crisis in late 2008. The G8 may provide a forum for consultation but it cannot provide an institutional framework for the coordination of macroeconomic policies. The reason is simple enough. It cannot suffice in part because it is driven largely by G8 (if not G1) interests and in part because it needs much wider representation. The G20 is wider in its membership but narrower in its jurisdiction, for its concerns are limited, despite recent attempts to make it larger than life at Washington DC, London and Pittsburgh. Similarly, the conference on climate change at Copenhagen in December 2009 floundered, in part, because of the absence of an institutional mechanism for consultations and negotiations. The outcome, such as it was, which was shaped by informal consultations between the United States on the one hand and Brazil, China, India and South Africa on the other, was not

endorsed because most countries were not part of the process. The least developed countries were almost always marginalised or ignored. This time around, even the EU was left watching on the sidelines.

The much needed institutional mechanisms will materialise only when the costs and benefits of unilateral self-insurance within countries are compared with the costs and benefits of international collective action across countries.<sup>28</sup> In principle, it is possible to contemplate cooperation among nation states to create rules and norms for the market that transcend national boundaries, just as the nation state created rules and norms for the market within national boundaries. In practice, however, recognition of the benefits of such cooperation might not be motivation enough. Cooperation among nation states is far more likely to materialise, much like stable coalitions, if and when the costs of noncooperation cross the threshold of tolerance. In either case, the nation state is the most important player in the game. Therefore, it is not possible to imagine good governance in the world without nation states, just as it is not possible to have good governance in countries without governments.

There is another window of opportunity at this juncture, and it is about the possibilities of cooperation among developing countries, which has so far been in the world of rhetoric rather than reality, words rather than substance. But this subset is an integral part of the logic of international collective action. What is more, the world has changed. In 2005, developing countries accounted for 81 per cent of world population and 22 per cent of world income (almost 45 per cent of world GDP in PPP terms). But that is not all. In the same year, 2005, developing countries accounted for 34 per cent of world exports, 33 per cent of world manufactured exports, 25 per cent of world manufacturing value added and 30 per cent of the stock of inward foreign direct investment in the world economy. It would seem that developing countries are much more integrated with, and far more significant in, the world economy than they were 25 years ago.<sup>29</sup> It needs to be said that much of this significance is concentrated in a few developing countries: China, Hong Kong, India, Indonesia, Korea, Malaysia, Singapore and Thailand in Asia; Argentina, Brazil and Mexico in Latin America; and South Africa in Africa. In 2005, these 12 countries accounted for 60 per cent of the population and 68 per cent of the income in the developing world. These 12 countries also dominated the engagement of developing countries with the world economy in international trade, international investment and international finance.<sup>30</sup> Even so, it is plausible to argue, though impossible to prove, that this changed situation represents the beginnings of a shift in the balance of economic and political power in the world.<sup>31</sup> This, in turn, opens up possibilities.

In the international context, where the distribution of economic and political power is so unequal, the increased economic significance and political influence of developing countries provides an opportunity to reshape rules and institutions even in a world of unequal partners. Developing countries as a group with mutual interests are more likely to be heard than single countries by themselves. There will always be some conflict of interest but there will always be areas where it is possible to find common cause and accept trade-offs. This is already visible in the World Trade Organization (WTO) where solidarity among developing countries has enabled them to voice their concerns even if they have not yet been able to shape outcomes in negotiations.

At the same time, the large emerging economies – say Brazil, China, India and South Africa – taken together, may be able to exercise significant influence through multilateralism, whether institutions or rules, in the global context. The United Nations, the World Bank, the International Monetary Fund and the World Trade Organization are among the most important multilateral institutions. In the United Nations, China alone is a permanent member of the Security Council with a right to veto. And it is also a member of the P5. But India, Brazil and South Africa are engaged in knocking at the door, seeking permanent membership of the Security Council, with or without a veto. There can be little doubt that if and when there is an increase in the number of permanent members of the Security Council in the United Nations, these three countries would have the strongest claim to permanent membership. In the World Bank and the International Monetary Fund, China, India, Brazil and South Africa are permanent members of the Executive Boards. Given the democratic deficit in these institutions, which is embedded in unequal voting rights, China, India, Brazil and South Africa together could influence decisions or even reshape rules. So far, however, there is limited, if any, coordination among them for this purpose.<sup>32</sup> They have neither articulated collective voice nor exercised collective influence. The situation in the World Trade Organization is different. India and Brazil have been long-standing advocates of developing countries in the WTO. China has a low profile possibly because of its recent accession. South Africa is not quite part of the strategic alliance among developing countries. But India and Brazil, along with the United States and the European Union, are now members of the Quad which is the principal institutional mechanism for resolving differences and finding solutions. In sum, it would seem that China, India, Brazil and South Africa have considerable potential for articulating a collective voice in the world of multilateralism. Coordination and cooperation among them carries significant potential for exercising influence on multilateral institutions, which could reshape rules and create policy space for countries that are latecomers

to development. Such coordination and cooperation, which are in the realm of the possible, have not yet surfaced in a substantive sense.<sup>33</sup> Even so, it is possible to discern beginnings. Brazil, China, India and South Africa, together with Mexico, constitute the Outreach 5, which have been invited to the G8 summit in recent years. There is a hint of discontent about their status as observers peripheral to deliberations and decisions. And the Outreach 5, acting together, are now seeking a place at the high table with the G8. The Climate Change Conference in Copenhagen saw an attempt at coordination among the four countries that have now chosen to describe themselves as BASIC. Even so, it is important to recognise that once these countries become major players, there is a danger that they might opt for the pursuit of national interest rather than the spirit of solidarity among developing countries or the logic of collective action.

## Conclusions

It is clear that the financial crisis of late 2008, which turned into the Great Recession, is the deepest crisis in capitalism since the Great Depression more than 75 years ago. The difference worth noting is that developing countries, which were marginal then, are much more significant and integrated with the world economy now. This time around, however, the decline in the value and volume of world trade was almost unprecedented. There was also a sharp contraction in output and employment, which was far more pronounced in the industrialised countries. But developing countries also experienced a significant slowdown in growth, some more than others, which was transmitted through exports, remittances and capital flows.

It is two years since the crisis surfaced. On the whole, it would seem that the developing world coped better than the industrialised countries and transition economies. For one, the impact was less adverse. For another, the recovery was somewhat quicker. But this was not so everywhere. Many of the high-income emerging economies were as adversely affected as the industrialised world. Yet, three emerging economies – China, India and Brazil – weathered the storm. Initial conditions, policy responses and domestic demand shaped resilience and recovery. Prudence in deregulation and liberalisation of financial sectors limited collateral damage. Fiscal space available to governments also made a difference. The reasons underlying the resilience of other developing countries that fared better were probably similar, even if the relative importance of underlying factors differed across countries.

There are some obvious lessons for developing countries that emerge from this experience. It is essential to redefine macroeconomic objectives so that the emphasis

is on fostering employment creation and supporting economic growth instead of a focus on price stability alone. It is just as important to rethink macroeconomic policies, which cannot simply be used for the management of inflation and the elimination of macroeconomic imbalances, since fiscal and monetary policies are powerful and versatile instruments in the pursuit of development objectives. It is sensible to exercise restraint in the deregulation of domestic financial sectors. It is prudent to hasten slowly with capital account liberalisation, or retain the option of introducing capital controls. It is necessary to stay prudent in macro management so that there is some freedom to introduce countercyclical macroeconomic policies. It is desirable to create social safety nets for the poor and the vulnerable. It is time to reconsider the relative importance of the internal and the external in the process of development, in terms of markets and resources, because complements cannot be substitutes. It is vital to redress the balance in the respective roles of the market and the state, so that the developmental role of the state is recognised rather than forgotten.

On the surface, it would seem that the process of recovery in the world economy has begun. The recovery is expected to be strongest in developing countries, uneven in industrialised countries and weakest in transition economies. Even so, it is clear that a few emerging economies, or parts of the developing world, cannot drive recovery or turn into engines of growth for the world. What is more, it is not clear that the fragile recovery is sustainable, and prospects remain uncertain. The observed outcome is largely attributable to countercyclical macroeconomic policies that were an integral part of strong national action and some international coordination. There is, however, a change in policy stance. The stimulus has come to an end. And fiscal retrenchment has begun in the leading industrialised economies of Europe. This is premature and is bound to dent the prospects of recovery in the world economy. The supposed trade-off between financial stability and economic growth is a false dilemma. Recovery will be sustainable if, and only if, there is a progressive reduction in global macroeconomic imbalances, which may be manifest in current account surpluses or deficits but reflect gaps between income and expenditure at a macro level. These imbalances are a matter of economics rather than geography. It is income distribution that lies at the heart of the problem. The rebalancing of the world economy, therefore, needs some redistribution of incomes within countries. In fact, an increase in the share of wages in GDP would be conducive to growth not only in the surplus countries but also in the deficit countries. This is possible if wages keep pace with productivity growth and full employment is the primary objective. It is only increased employment that can provide a sustainable solution to the crisis and in the process deliver growth

with equity. Such a rebalancing would also provide stability with growth.

The recent global economic crisis has led to a much needed recognition of the logic of international collective action, which had been almost forgotten. Its significance is now widely accepted. But the willingness and the ability of governments to coordinate, in terms of implementing such collective action, is not quite there. The much needed institutional mechanisms will materialise only when the costs and benefits of self-insurance are compared with the costs and benefits of international collective action across countries. This comparison has been driven home with clarity by the global economic crisis. There is another window of opportunity at this juncture in time, which is provided by the possibilities of cooperation among developing countries in a world where there is a discernible shift in the balance of economic and political power. Even in a world of unequal partners, now more than earlier, developing countries as a group could exercise influence to reshape the rules and institutions that govern the world economy. The large emerging economies could play a leading role in this process.

## Notes

1. For a discussion of the underlying causes that led to the financial crisis and turned it into the Great Recession, see Stiglitz, 2010; Rajan, 2010; Taylor, forthcoming. See also United Nations, 2009a.
2. The literature on the subject is limited but growing. See, for example, Akyuz, 2010; Naudé, 2010. There are also some studies that examine the impact of the global economic crisis on the developing world with reference to the Millennium Development Goals. See United Nations, 2009b; UNDP, 2010.
3. In fact, the value of world trade in 2009, in terms of US dollars, was 23 per cent lower than it was in 2008, which was in part attributable to the sharp decline in prices of oil and primary commodities. In comparison with the recent past, the contraction was perhaps even sharper than these figures suggest, because the financial crisis and the economic downturn beginning in September 2008 had already dampened growth in world trade and output during that year. In 2008, the volume of world trade increased by a modest 2.1 per cent, much less than the substantial 6.4 per cent in 2007. Similarly, growth in world GDP was only 1.6 per cent in 2008 which was much lower than 3.8 per cent in 2007. For details, see WTO, 2010.
4. Data on remittances in 2009 are not yet available. World Bank (2010) estimates suggest that total remittances in the world fell by about 7 per cent from \$443 billion in 2008 to \$414 billion in 2009, whereas remittances to developing countries declined by 6 per cent from \$336 billion in 2008 to \$316 billion in 2009. The decline was significantly greater in Latin America and the Caribbean at 12 per cent, in Eastern Europe and Central Asia at 21 per cent and in the Middle East and North Africa at 8 per cent. South Asia was the exception where remittances increased by 5 per cent in 2009 but at a much slower pace than in preceding years.
5. For example, in 2009 as compared with 2008, world foreign direct investment inflows dropped by 37 per cent to \$1,114 bil-

- lion while outflows dropped by 43 per cent to \$1,101 billion. This followed a significant contraction in 2008 when inflows fell by 16 per cent and outflows fell by 15 per cent as compared with 2007. Foreign direct investment inflows to developing countries dropped by 24 per cent from \$630 billion in 2008 to \$478 billion in 2009. See UNCTAD, 2010.
6. It is estimated by the World Bank that flows of private debt and portfolio equity to developing countries collapsed from a level of more than \$300 billion in 2007 to about \$50 billion in 2008 and -\$25 billion in 2009. See World Bank, Global Development Finance database online.
  7. The data on the number of the poor relate to 2005 and are obtained from the World Bank, *World Development Indicators*, online database. In 2005, the United Nations Population Division, UNDATA, reported world population as 6.5 billion.
  8. For a discussion on this issue, see Nayyar, 2002b.
  9. For evidence on unemployment cited in this paragraph, see ILO-IMF, 2010.
  10. For evidence on GDP growth rates in the selected developing countries, see United Nations, 2010.
  11. In 2007, 2008 and 2009, respectively, GDP growth was 8.3 per cent, 6.5 per cent and 4.7 per cent in South Asia, 4.8 per cent, 4.4 per cent and 3.5 per cent in North Africa and 7.9 per cent, 6.6 per cent and 2.3 per cent in sub-Saharan Africa (excluding Nigeria and South Africa). See United Nations, 2010.
  12. In the least developed countries, GDP growth was 8.5 per cent in 2007, 7.2 per cent in 2008 and 3.3 per cent in 2009 (United Nations, 2010).
  13. Between 1970 and 2005, the share of developing countries increased from 15.4 per cent to 21.5 per cent of world GDP, from 15.2 per cent to 33.8 per cent of world exports and from 8.8 per cent to 25.4 per cent of world manufacturing value added. See Nayyar, 2009.
  14. Available projections suggest that, in 2010, GDP growth in China, India and Brazil would almost return to its 2008 levels (United Nations, 2010).
  15. The argument set out briefly in this paragraph is developed at length elsewhere by the author. See Nayyar, 2010.
  16. This convincing hypothesis is developed, with supporting evidence and arguments, by Akyuz (2010).
  17. For a more detailed discussion, see United Nations, 2006; Nayyar, 2010.
  18. For a detailed discussion on the problems with such deficit fetishism, whether fiscal deficits or monetised deficits, see Nayyar, 2008.
  19. For a discussion on the wisdom and necessity of countercyclical macroeconomic policies in developing countries, see Stiglitz et al., 2006.
  20. The propositions about capital account liberalisation and integration into international financial markets, set out briefly in this paragraph, are discussed in Nayyar (2002c).
  21. This argument about the relationship between the state and the market is developed in Bhaduri and Nayyar (1996).
  22. For a lucid analysis of the recession and the prospects of recovery, see Akyuz, 2010.
  23. This sequence is set out in a perceptive article by Wolf (2010) in what he describes as a game of 'pass the parcel' which cannot end well. It could also be described as a game of 'musical chairs'. In both games, when the music stops, a person is left holding the parcel or some persons are left standing. Even so, there is one winner at the end. But in this sequence, there are no winners.
  24. This argument is developed, at some length, with supporting evidence, by Akyuz (2010).
  25. In China, private consumption as a proportion of GDP dropped from around 48 per cent in the late 1990s to about 36 per cent in the late 2000s. Over the same period, the share of wages in GDP fell from 53 per cent to 40 per cent, while the share of profits in GDP rose from less than 20 per cent to more than 30 per cent (Akyuz, 2010).
  26. There was a redistribution of incomes from wages to profits associated with an increase in economic inequality, almost everywhere, which was attributable in large part to the advent of markets and the spread of globalisation beginning circa 1980. See Nayyar, 2003; World Commission on the Social Dimension of Globalization, 2004.
  27. For a detailed discussion, see Nayyar, 2002a; Taylor, 2002; Ocampo, 2002. For an analysis of the implications and consequences of financial contagion, see Reinhart et al., 2003. The experience of the recent financial crisis calls for further reforms in the international financial architecture to reduce the vulnerability of the world economy to recurrent crises and to remove the deflationary bias of policies embedded in the existing architecture. For a discussion, see Akyuz, 2010.
  28. For a more detailed discussion, see Nayyar, 2002a.
  29. The evidence on the significance of developing countries in the world economy, cited in this paragraph, is from Nayyar (2009).
  30. For more detailed evidence on this concentration, see Nayyar, 2009.
  31. This hypothesis is developed elsewhere by the author. See Nayyar, 2009.
  32. There is, perhaps, a modest beginning in the G20, where India, Brazil and South Africa, with some participation from China, have made an attempt to coordinate their stance on reform and change in the IMF. But this is no more than a beginning. It has not influenced, let alone shaped, outcomes.
  33. The implications and consequences of the emerging significance of Brazil, China, India and South Africa in the wider context of the world economy are analysed, at some length, in a recent paper by the author. For a detailed discussion, see Nayyar, 2010.

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