

FROM LIBERALIZATION TO INVESTMENT AND JOBS: LOST IN TRANSLATION

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*There is nothing so disastrous as a rational
investment policy in an irrational world.*

John Maynard Keynes

A. Global economic integration and the labour market

The past two decades have seen an increased global integration of labour markets to a degree unprecedented in recent history despite continued barriers to labour mobility, particularly for low-skilled and unskilled workers. This has been driven by a rapid opening to and expansion of international trade and capital flows, and a growing spread of global production networks, outsourcing and offshoring. The total number of workers producing for international markets in goods alone rose from around 300 million in 1980 to almost 800 million at the turn of the millennium. This has been associated with a significant increase in the share of developing countries in world trade in manufactures. Accordingly, about 90 per cent of the labour participating in world trade is now low-skilled and unskilled (Akyüz 2003:100-101). Integration of labour markets has also been reinforced by increased trade in services, traditionally seen as non-traded activities, particularly through expansion of cross-border supply of certain services from the territory of one country to the territory of another, and consumption and commercial presence abroad. Services trade has expanded not only in low-skill, low-value-added activities such as call centres or transaction processing, but also in high-value added sectors that involve

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skilled-labour, notably in information technology, finance and health. Developing countries have become suppliers of some of these services, including in high value-added sectors.

It has been argued that China's shift to capitalism, India's turn from autarky and the collapse of communism have added to economically active persons in the world by almost 1.5 billion workers, doubling the global labour force (Freeman 2004 and 2005). As a consequence there has been a major shift in the global balance between labour and capital because the new entrants brought little useful capital with them; it is estimated that the global capital-labour ratio has been cut by more than 50 per cent. This works against labour not only because labour productivity and pay tend to increase with the capital-labour ratio, but also because it shifts the balance of power in markets towards capital as too many workers chase too few jobs or too little capital to employ them. While capital and workers from the new entrants are the main winners, the pressure is felt primarily by workers already participating in the global economy, both in developing and industrial countries.¹

Closer integration of developing countries with large surplus labour into the trading system and their greater openness to foreign firms have no doubt increased the global reserve army of labour and created new opportunities for capital to find cheaper locations for production for world markets and to connect them within international production networks. Since labour cost absorbs a large proportion of corporate revenues, wage differentials relative to productivity (i.e. differences in unit labour costs) is one of the main factors in the decisions by transnational corporations (TNCs) for location of production through foreign direct investment (FDI). This underlines the so-called process of "global labour arbitrage" wherein high-wage jobs in the developed world are seen to be eliminated in favour of low-wage jobs in the developing world (Roach 2004).

¹ It seems that these arguments draw on elements of both the neoclassical theory of distribution and growth where return on capital is inversely related to capital intensity, and bargaining models where wage-profit distribution is linked to balance of power between labour and capital influenced not only by the scarcity of capital vis-à-vis labour but also by socio-political factors including labour market institutions.

Thus, even though labour mobility remains restricted, conditions in labour markets of different countries have become increasingly interdependent as many jobs have become highly mobile, moved from one location to another through international trade and investment.² The distribution of jobs across countries is also influenced by rapidly growing international financial flows through their impact on exchange rates, competitiveness and trade flows. Consequently, unemployment has increasingly become a global issue and it has become more and more difficult for any country to address its labour market problems independently of what is happening elsewhere.

It should, however, be recognized that global economic integration and interdependence of labour markets have not advanced as much as it is popularly believed. The participation of many countries with large amounts of surplus labour in the expansion of international production networks, international trade and investment is still limited. Furthermore, closer external integration has not always been accompanied by greater internal integration but by the emergence of enclave economies (Wade 2003: xlviii-li). Informal labour markets continue to absorb rising numbers of workers, particularly in countries which have experienced deindustrialization as a result of rapid liberalization (UNCTAD TDR 2003: chap. 5). Despite rapid expansion of FDI in developing countries, labour employed by TNCs is only a fraction of the total work force. This is so even in China where foreign-funded enterprises employ around 4 million workers and in India where employment in the entire IT services is one million. More importantly, evidence shows that despite rapid expansion of trade and FDI, large inter-country differences have persisted and indeed increased in wages in similar occupations, in large part because of differences in labour market institutions and average productivity levels (Freeman and Oostendorp 2000).

Even though growth of international trade and labour arbitrage has so far had limited impact in terms of convergence of incomes and wages, there is little doubt that differences in labour costs have become increasingly important in the determination of international trade and

² Labour was much more mobile in the previous episode of globalization, typically dated from the 1870s until the First World War, than the recent period of deepened economic integration; see Nayyar (2002) and O'Rourke and Williamson (2000: chap. 7).

investment flows, and in the distribution of jobs across countries, not only between the North and the South but also among developing countries. The combination of rapid economic integration and widespread global unemployment has become the main source of insecurity among workers. Growing competition among labour located in different countries, together with increased international mobility of capital, is putting pressure on labour and creating popular backlash against economic integration almost everywhere, including in industrial countries. This combination has also become a major source of tension in international economic relations as countries are inclined to export unemployment through mercantilist, beggar-my-neighbour exchange rate, trade and investment policies, creating frictions in international economic relations reminiscent of the difficulties that pervaded the world economy during the interwar period. It is the single most important reason why trade negotiations are facing increased difficulties from one round to the next, from one ministerial to another. It is also providing humus to xenophobia. All in all, the fate of globalization appears to hinge very much on the resolution of the problem of global unemployment.

The labour market problems in industrial countries cannot be traced to the expansion of North-South trade, but originate primarily in macroeconomic and financial policies pursued after the 1970s (UNCTAD TDR 1995: part 3; Akyüz, Flassbeck and Kozul-Wright 2002). Similarly, massive unemployment and underemployment in developing countries have their origins in structural weaknesses rather than in liberalization and integration. However, global labour arbitrage has certainly been aggravating labour market problems in many industrial countries, particularly for low-skilled labour. Similarly, a large number of developing countries have suffered deindustrialization and serious job losses as a result of rapid liberalization of trade and investment. Capital has become increasingly footloose everywhere, including within the developing world, shifting location of labour-intensive production in response to profit opportunities created by the emergence of cheaper producers.

That liberalization of trade and investment flows causes displacements in labour markets should not come as a surprise. However, the key problem is that global economic integration is serving more to redistribute investment and jobs among countries than to accelerate capital

accumulation and job creation. International trade has been growing faster than ever, capital flows, including FDI, have been booming, but global income growth is slower and the world economy is allocating a smaller proportion of its income to fixed capital formation. This is why globalization is increasingly seen as a zero-sum game. This problem is due to a major shortcoming in the approach to international economic integration. Rather than aiming at full employment and rapid growth as a basis for expansion of international trade and investment, policy in recent years has emphasized liberalization and global economic integration as a remedy to high unemployment and sluggish growth. This stands in sharp contrast with the approach adopted by the architects of the post war economic system at the Bretton Woods and Havana Conferences which saw full employment as a necessary condition for closer economic integration³ — an approach which produced the golden age of capitalism with gradual but continuous liberalization and expansion of trade in the context of full employment and rapid growth.

With few notable exceptions, capital accumulation and job creation has been slow and erratic in developed and developing countries alike in large part because policy has neglected these key determinants of social welfare. Consequently, at the level of existing production capacity and skill profile, the labour force cannot all be productively employed - that is, it is not possible to provide decent jobs to all. Even though there is excess capacity in some countries that could allow expansion of employment if adequate effective demand is forthcoming, the solution to unemployment lies primarily in the acceleration of capital formation and improvements of the skill profile of labour. In this process capital formation plays a key role because it also helps develop human skills by allowing application of knowledge acquired in formal education, and through learning by doing.

³ This was most clearly stated in the charter of the still-born International Trade Organization (Chapter 2, Article II): “The Members recognize that the avoidance of unemployment or underemployment, through the achievement and maintenance in each country of useful employment opportunities for those able and willing to work and of a large and steadily growing volume of production and effective demand for goods and services, is not of domestic concern alone, but is also a necessary condition for the achievement of ... the expansion of international trade, and thus for the well-being of all other countries.” See Akyüz (2002).

This paper focuses on capital accumulation. The following section will review the experience regarding investment and growth over the past two decades. While attention will concentrate mainly on developing countries, features of developed countries that are similar in nature will also be discussed. A main conclusion that emerges is that the performance of a large number of developing countries which have adopted a strategy of reigniting a dynamic process of capital accumulation and growth through a combination of rapid liberalization, increased reliance on foreign capital and reduced public investment and policy intervention is highly disappointing. The review of the experience is followed by an examination of the role that policies have played in accumulation and growth in three areas. Section C will focus on the link between investment and profits and discuss the experience of late industrializers in harnessing profits through industrial-*cum*-investment policies for faster accumulation. Sections D and E will examine the impact of macroeconomic and financial policies respectively on accumulation, employment and growth. The paper will end with a discussion of policy priorities at the national and international levels.

B. Capital formation, growth and employment

1. Issues at stake

There is a broad agreement that capital accumulation holds the key to economic growth even though there is no consensus on the precise nature of the link between the two. While there is no singular relation between investment and growth, in empirical studies capital accumulation emerges as the single most important variable with a robust and independent influence on economic growth.⁴ This influence arises not only because investment, as a dynamic component of effective demand, generates income, but also it expands productive capacity and carries strong complementarities with other elements of growth, notably technological progress and

⁴ On the significance of capital accumulation in growth accounting and regressions see Kenny and Williams (2001) and Bosworth and Collins (2003).

productivity growth.⁵ Clearly the structure of investment has an important bearing on the impact of accumulation on growth. Investment in machinery and equipment, as opposed to residential and non-residential construction, appears to have a close linkage with growth across all developing regions (De Long and Summers 1993). Since much technological change is embodied in new equipment, and application of technology to production through use of machinery and equipment is essential for learning by doing, the scope for productivity growth would be limited in the absence of capital accumulation.

The impact of accumulation on labour is shaped by the extent to which growth is associated with increases in productivity and employment. Productivity growth is essential to increase labour income. In developing countries this typically takes place through the absorption of surplus labour by industry. However, when productivity growth is strong and demand is sluggish, the impact of growth on employment would be limited. This creates a potential trade-off between employment and productivity growth. However, since investment is an important component of effective demand and there are limits to raising productivity by substituting capital for labour, rapid growth in productivity can be combined with sizeable increases in employment if the pace of accumulation is strong.

The experience of both Japan and Korea show that there need not be a trade-off between employment and productivity growth. During the 1960s and early 1970s in Japan overall labour productivity grew at a rate of 9 per cent per annum while the unemployment rate was around one per cent, thanks to a very high rate of gross fixed capital formation (GFCF) which stood at some 32 per cent of GDP.⁶ Productivity and wage growth in Korea was even more impressive during its strong drive for industrialization which also generated rapid increases in employment (Amsden 1989). In the 1980s it was argued that high unemployment in Europe compared to the United States was due to its faster productivity growth, but the United States was able to combine a rapid increase in productivity with falling unemployment in the 1990s as a result of a

⁵ While Easterly and Levine (2001) argue that there is no strong support for the contention that factor accumulation ignites faster growth in labour productivity, a recent study by Bond, Leblebicioglu and Schiantarelli (2004) of 98 countries found that an increase in investment as a share of GDP predicts a higher growth rate of output per worker.

⁶ Figures on Japan are from OECD (1986).

strong investment drive and growth.⁷ In the past ten years productivity growth has been slower in the euro area where unemployment is higher than both the United States and the United Kingdom.

How much growth is needed to make a dent in unemployment and how much investment is needed to generate such a growth are matters difficult to judge a priori because of the complexities in the relations among accumulation, growth and employment. Nevertheless, on underlying trends in growth of labour force and productivity, some 3 per cent is generally considered as the minimum rate needed to start reducing unemployment in advanced industrial countries.⁸ In developing countries labour force has been growing at around 2 per cent per annum, and it could even grow faster if accelerated growth increases the participation rate. Productivity growth would need to be at least 3 per cent in order to narrow the income gap with the industrial world, and again with increased accumulation and capital deepening productivity could be expected to increase even faster. On current trends, therefore, developing countries appear to need an average growth rate of at least 5 per cent in order to close the productivity gap with the industrial world and improve conditions in the labour market by raising wages and reducing open and disguised unemployment. For the reasons noted, such a growth rate could be generated by different rates of investment, but thresholds of 20 and 25 per cent of GDP are identified for low-income and middle-income countries respectively as the minimum rates of accumulation needed (UNCTAD TDR 2001; ECLAC 2000).

2. *The record*

On these criteria the recent performance of the world economy is poor. The period from 1980 to 2000 witnessed a remarkable collapse of growth in many parts of the world. In industrial countries, on average, growth of output per worker slowed from an annual rate of some 3 per cent in 1960-1980 to 1.5 per cent during 1980-2000. The slowdown was similar for

⁷ For an earlier critique of the trade-off argument see Gordon (1995).

⁸ For OECD as a whole average labour force growth is around one per cent and productivity growth 2 per cent per annum; OECD (2005b: Annex tables).

developing countries taken as a whole, from 2.3 per cent to 0.6 per cent. Notable exceptions include China and India where growth increased by 7 and 3.5 percentage points respectively between the two periods (Bosworth and Collins 2003: tables 1 and 5).

This performance is shaped in large part by policies pursued in response to disequilibria and instability that pervaded first the developed countries then the developing economies in the late 1970s and early 1980s. In industrial countries the wage-price spiral set off by the first oil shock and accommodating macroeconomic policies resulted in rapid inflation. As the burden was placed largely on profits, incentives for private investment were reduced, resulting in stagflation. The policy response to the second oil price shock in 1979 was different. Aggregate demand policy no longer accommodated the acceleration in inflation induced by the oil price rise. “It was considered important not only to reduce inflation in its own right, but also to moderate growth of labour costs relative to product prices, and to restore profit margins to levels sufficient to support a higher rate of investment” (OECD 1982: 9).

This medium-term financial strategy, supported also by supply-side policies including liberalization of labour, product and financial markets, was indeed successful in bringing inflation under control. By the end of the 1980s the downward trend in profits which had set in during the 1970s was already reversed. With increased mobility of capital, there was a rapid upward convergence of profits, and as of mid 1990s both capital income share and the rate of return on capital in the business sector in the G-7 countries reached the pre-1970s levels (UNCTAD TDR 1995: part 2, chap. 3; and 1997: 95-98). However, this did not generate the expected boom in investment. In industrial countries taken together, investment as a percentage of GDP was lower in the 1990s than in the 1980s, and this decline continued further in the new millennium (table 1). Growth in output and employment mirrored the trends in capital accumulation. After staying at 4 per cent, the average unemployment rate in the OECD rose to 7.5 per cent in the 1980s. Despite subsequent recovery in the United States and the United Kingdom, it fluctuated around an average rate of 7 per cent during 1990-2004 without any long-term tendency to decline, in large part because at some 2.6 per cent average growth in industrial

countries has remained below the 3 per cent threshold needed to make a dent in unemployment (OECD 2005a: 237, table A).

Policy response to the second oil-shock and ongoing stagflation by industrial countries caused serious dislocations for developing countries. The combination of the hike in interest rates and sharp declines in commodity prices brought about by the 1980-82 recession in major industrial countries caused acute balance of payments problems, notably in commodity-dependent countries. Economic difficulties were aggravated as international banks behaved procyclically and cut lending to indebted countries, notably in Latin America, forcing many of them to generate trade surpluses by cutting economic growth and imports, eventually leading to a debt crisis and a lost decade. The policy response to falling growth and rising unemployment and inflation was essentially the same as the earlier response of industrial countries to stagflation, although it was much less orderly. The predominant objective was first to stabilize prices and balance of payments through monetary and fiscal tightening, and secondly to undertake market-friendly reforms in wide areas of policy with a view to overcoming structural difficulties that had rendered these countries highly vulnerable to external shocks and balance of payment crises. Stabilization and structural reforms that constituted the so-called Washington Consensus were to prepare the ground for sustained growth based on a rapid recovery in investment.

However, this policy approach failed to deliver on its promises. In developing countries taken together investment as a proportion of GDP was not higher in the 1990s or in the new millennium than the levels reached in difficult times of the 1980s (table 1). Average growth in the 1990s was somewhat faster than in the 1980s (3.2 compared to 2.7 per cent) since the underutilized capacity that emerged during the times of import strangulation in the 1980s allowed output to rise without additional investment as external constraints eased up.⁹ There has also been an acceleration of growth in the new millennium as private capital flows to emerging markets recovered sharply thanks to exceptionally low international interest rates and ample global liquidity. But, even an average growth rate of 4.5 per cent attained in the past few years would not make much of a dent in unemployment even if it could be sustained.

⁹ Growth figures in this section are from World Bank (2005a: table A.8).

This broad picture conceals considerable diversity among developing countries. In terms of investment and growth two regions stand out: East Asia and South Asia (tables 2 and 3).¹⁰ Both regions have improved their investment performance since the 1980s and maintained an average growth rate above 5 per cent. The performance of these regions is dominated by two large economies, China and India, which have adopted a measured and gradual approach to liberalization, but most of the remaining countries, including both the first-tier newly industrializing economies (NIEs), notably Korea and Taiwan, and the second-tier NIEs, Indonesia, Malaysia and Thailand, have also had strong investment and growth performance. Clearly the sheer weight of China and India implies that their performances matter a lot more than that of the other developing countries in reducing global unemployment and poverty. Indeed, the income convergence that is claimed to be taking place between the North and the South in the past two decades is due largely to rapid growth in these countries.¹¹

But there are also important differences between China and India in terms of accumulation and growth. In the 1990s investment in China generated a lot more growth than in India. During the decade the average investment rate in China was 60 per cent higher than in India while its growth exceeded that of India by a greater margin (10.1 per cent against 5.5 per cent). This relation appears to have been reversed in the more recent period as China deepened its integration into the global economy at a faster pace, and experienced a surge in inflows of FDI, an investment boom and rapid growth of exports and imports. The investment rate in China rose in the new millennium, averaging at some 41 per cent of GDP, while its average growth was 8.5 per cent. By contrast, in India growth accelerated compared to the 1990s, averaging at some 7 per cent between 2000 and 2005, while its investment rate was only marginally higher, suggesting that since the turn of the decade investment in India has generated more growth than in China. Among the factors mentioned for apparently high overall capital-output ratio in China

¹⁰ Investment figures in table 2 include inventory changes as well as GFCF. This difference notwithstanding, investment will be used throughout this paper for fixed capital formation.

¹¹ Fischer (2003) and Freeman (2004). However this does not mean that more people converge globally in terms of income since income distribution is generally worsening, including particularly in China; UNDP (2005).

compared to India are excess capacity, misallocation of resources and a gross wastage of capital.¹²

There are only 18 developing countries with an average growth rate of 5 per cent or more during 1990-2003 and 8 of them are in Asia (World Bank 2005: table 4.1). Only two of these, Chile and the Dominican Republic, are in Latin America. In that region capital accumulation fell sharply during the debt crisis of the 1980s, but the recovery that began at the end of the decade was not robust enough for it to return to earlier levels. After many years of reform along the lines of the Washington Consensus and a reasonable degree of success in restoring fiscal and monetary discipline and price stability, the region has continued to suffer from low investment and anaemic growth, failing to address deep-seated structural difficulties, including massive unemployment and underemployment. Furthermore, the more recent period saw a weakening of the link between accumulation and growth despite extensive market-oriented reforms undertaken to improve the efficiency of allocation and use of resources. In the 1960s and 1970s both GFCF and GDP rose, on average, at similar rates, around 6 per cent per annum. In the 1980s GFCF stagnated and there was little growth in GDP. During the 1990s, GFCF grew on average by some 5 per cent, about the same rate as in the 1960s, but GDP growth was slower, staying around 3 per cent. This weakening investment-growth link is associated with a decline in the share of investment in and imports of machinery and equipment in several countries of the region (UNCTAD TDR 2003: 80-82).

The situation is much the same in sub-Saharan Africa. The region enjoyed relatively rapid accumulation and growth in the 1960s and early 1970. However, these investment booms were often followed by slumps rather than being translated into a virtuous growth process. During the 1980s and 1990s, even where adjustment policies were rigorously implemented, they failed to establish a sustained accumulation process, with growth lasting as long as commodity prices and/or aid flows were favourable (Akyüz and Gore 2001: 272). Even though in sub-Saharan Africa there are 8 countries with growth rates of 5 per cent or more during 1990-2003,

¹² Nagaraj (2005). See also Kuijs and Wang (2005) who argue that continuing with the current growth pattern in China would lower employment growth in industry from 2.9 per cent achieved over 1993-2004 to 1.7 per cent in the coming years, and the task of absorbing agricultural surplus labour would fall on services.

GFCF in the region as a whole is below the 20 per cent threshold, and at some 3 per cent average growth is too weak to make a tangible improvement in the conditions of labour. Furthermore, as in Latin America the investment-growth link is weak compared to the 1970s.

2. *Public investment*

The past two decades have seen a considerable retrenchment of the public sector in most countries both in the North and the South through privatization of state-owned enterprises and cuts in public investment. In the more dogmatic version of the Washington Consensus the withdrawal of the public sector has been advocated not only from industry and commerce, but also from public utilities on the assumption that the private sector would be willing and able to invest in these areas if the investment climate is right, and downsizing the public sector is one way of improving the investment climate. Thus, many governments simultaneously divested through privatization, stopped investing in industry and commerce, and started reducing investment in physical and human infrastructure to allow the private sector a greater role. Where governments run large deficits and debt, such arguments gained additional force, and invariably the burden of fiscal adjustment fell on public investment.

This approach is based on the premise that public investment would have little or even a negative effect on economic growth. On this view, over the short-term a higher level of public investment would crowd out private spending by pushing up interest rates, and the impact would be felt primarily by private investment as the most interest sensitive component of private demand. Second, it could drive out the private sector by entering activities that might otherwise offer acceptable returns to private investors. Third, the public sector tends to make bad investments because state-owned enterprises operate under a soft budget constraint. Finally, since, for the same reason, public enterprises are not run efficiently, even investment of the same quality would generate higher output in the hands of the private than in the hands of the public sector.

While there are widespread inefficiencies in the public sector in many countries, the argument that state-owned enterprises are invariably inefficient and government investment is unproductive cannot stand against evidence. In many developing countries public enterprises played a strategic role in industrialization and generated significant positive externalities for the private sector while in industrial countries there is ample evidence that government capital is productive, even more so than private capital.¹³ Again the evidence on crowding out does not lend support to any definite conclusion on the impact of public investment on private investment and overall capital accumulation.¹⁴ It is often the case that even when there is a crowding out effect, a higher level of public investment is rarely associated with a lower level of aggregate investment. It has, thus, been recognized by the IMF (2004: 6) that the “possibility that a declining share of public investment in GDP could have adverse consequences for economic growth over the longer term is a legitimate concern, although the empirical evidence in this area is inconclusive.”

Despite the evidence that the impact of public investment on overall capital accumulation and growth is generally positive, this indiscriminate attack on public ownership and investment gained wide acceptance, resulting in deep cuts in public investment. In most OECD countries the downward trend in public investment started already in the 1970s, on average falling from around 4.5 per cent of GDP in the early 1970s to 4 per cent at the end of the decade. The decline accelerated with the rise of neo-liberalism in the 1980s, and by the end of the millennium the ratio of public investment to GDP was as low as 3 per cent for the OECD as a whole (IMF 2004). The decline is more marked in Europe, particularly in the United Kingdom where public investment fell to 1.5 per cent of GDP in recent years. In the United States there was a recovery in the early 1980s, followed by a relatively stable rate around 3 per cent of GDP. In Japan, there

¹³ On developing countries see UNCTAD TDR (1992: part 3, chap. 2) and Chang (2003: chap. 6). A recent study using comparable data on industrial countries confirms that the elasticity of output with respect to public capital is positive and quite large for some countries; Kamps (2004). For a review of the literature on the effect of public investment on output, productivity and growth see IMF (2004: Appendix I). For a restatement of orthodoxy on the inefficiency of state-owned enterprises see World Bank (2003: 95-96).

¹⁴ For a review of the literature see Everhart and Sumlinski (2001) where 5 of the 20 studies reviewed find crowding out. A more recent study finds that a 10 per cent increase in public investment is associated with a 2 per cent increase in private investment in developing countries while crowding out occurs in developed countries; Erden and Holcombe (2005).

is no visible downward trend; on average public investment has been above 6 per cent of GDP over the past two decades. With the notable exceptions of Japan, Sweden and some smaller European countries, there have been sharp declines in the public net capital stock relative to GDP (Kamps 2004).

Public investment as a proportion of GDP is typically higher in developing than in developed countries. The 1960s and 1970s saw a rapid increase in public investment which reached 10 per cent of GDP at the end of the 1970s in developing countries taken together. In some regions such as South Asia and North Africa, it was even greater than private investment (Everhart and Sumlinski 2001). In Latin America the decline that started with the debt crisis in the 1980s continued in the 1990s and public investment as a proportion of GDP fell even below the levels of some industrial countries with much better human and physical infrastructure (table 4). In Turkey public investment as a proportion of GDP fell as debt burden increased; during 2002-2004 it averaged at around 2 per cent of GDP while interest payments from the budget stood at some 16 per cent (ISSA 2005: table 12). By contrast in East Asia there has been no downward trend in public investment and currently its share in GDP is more than three times the average rate in the major Latin American countries and Turkey. In Africa where data are limited, public investment in a selected number of countries fell from over 12 per cent in the late 1970s to some 7 per cent in the 1980s. There was a weak recovery beginning at the end of the 1980s, with public investment staying around 9 per cent of GDP throughout the 1990s (IMF 2004: figure 2).

The retrenchment of public investment outside some Asian countries has gone to such an extent that it has become a major concern even to the Bretton Woods Institutions (BWIs). In a recent report the IMF (2004: 9-10) has expressed concern that much of the cuts in public investment were undertaken as part of fiscal adjustment rather than for allowing greater room for private initiative, noting that such cuts in the 1980s in Latin America were on average more than three times the cuts in current spending, and that half of the fiscal adjustment in several countries during the 1990s reflected compression of investment in infrastructure. It is noted that the decline in public investment reduced long-term growth by 1.5-3 per cent in Latin America.

There is a sizeable infrastructure gap in most developing countries. Despite increased emphasis on private-public partnerships the private sector has not increased infrastructure investment as hoped for. It is also recognized that this not only compromises the growth prospects of these regions but also reduces the likelihood of meeting MDGs.

3. *FDI and capital formation*

Another important ingredient of the new development strategy has been increased reliance on FDI. In addition to the belief that it would provide resources for development and balance of payments support, FDI has been seen as a crucial factor for success in industrialization because of its role in transfer of technology and entrepreneurial know-how, in linking developing countries to international production networks and enhancing their access to global markets for goods and finance. Many countries have thus removed impediments to FDI and provided foreign investors incentives and security through unilateral action or bilateral investment agreements, over and above those enjoyed by national investors.¹⁵

These policies, together with the increased outreach of TNCs, have resulted in a rapid increase of FDI flows to developing countries, rising from some \$20 billion at the end of the 1980s to \$160 billion a decade later and almost \$240 billion in 2005 (IMF 2005). While in absolute terms much of the increased FDI has concentrated in the larger East Asian and Latin American countries, almost all regions shared in this expansion, particularly when measured as a proportion of income. In South America FDI has been attracted primarily by privatization of public enterprises; on some estimates about two thirds of the FDI inflows to the region was linked to privatization (UNCTAD TDR 1999: 118-119). In several countries in Central America and East Asia, including Mexico, Malaysia and China, FDI has been in the form of greenfield investment, designed to link these low-cost locations to international production networks for production of labour-intensive manufactures for global markets. In Africa FDI has concentrated mainly in countries rich in natural resources, particularly fuel and minerals (UNCTAD 2005). In East Asia efforts to promote FDI have been premised on its potential contribution to technology,

¹⁵ On tax concessions see Hanson (2001) and World Bank (2003: 80-82).

know-how and market access rather than to balance of payments. By contrast in Latin America where liberalization of regimes governing FDI has gone further, the prime objective has been the financing of public sector and external deficits and debt.

The impact of FDI on capital accumulation and growth is highly contentious.¹⁶ Its contribution to balance of payments appears to be generally negative over the long-term even though it may provide net positive transfers in the short-run before profit remittances pick up. This is so not only where FDI is concentrated in non-traded activities, but also in export-oriented sectors linked to international production networks because of high import content and profit margins.¹⁷ This appears to be the case even in China and Malaysia, two of the most successful countries in attracting export-oriented greenfield FDI (Akyüz 2005a).

When FDI is in the form of acquisition of existing public or private assets, it has no direct contribution to domestic capital formation although changes in ownership can give rise to productivity gains or stimulate investment that would not have otherwise taken place. Privatization could also add to domestic capital accumulation if the proceeds are used for investment, but not if they are used for servicing debt. When FDI is in greenfield investment, its contribution to GFCF would depend on its effect on the behaviour of domestic investors. Research on whether FDI crowds in or crowds out domestic investment is not conclusive and it appears that the impact of FDI depends on other variables endogenous to the growth process, including those linked to policy (Blomstrom, Lipsey and Zejan 1994; Alfaro, Chanda, Kalemli-Ozcan and Selin Sayek 2001; Borensztein, Gregorio and Lee 1998).

That the recent surge in FDI flows has contributed not so much to an acceleration of capital formation and growth as to a reallocation of production facilities, jobs and ownership across different countries can be clearly seen in table 1. For the world economy as a whole, in

¹⁶ For the issues involved and the evidence see UNCTAD TDR (1999: chap. V), Milberg (1999), Agosin and Mayer (2000), Hanson (2001), Ghose (2004), and Gallagher and Zarsky (2005). One of the problems in research on the impact of FDI on GFCF is that no distinction is made between acquisition of existing assets and greenfield investment. This problem is partly due to the absence of such a distinction in FDI statistics.

¹⁷ Most TNCs apply hurdle rates of return in the order of 20 to 25 per cent; Kregel (1996: 58).

recent years the share of FDI as a proportion of GDP has almost tripled compared to the 1980s but the proportion of world GDP allocated to investment has fallen by 2.5 percentage points. The contrast is even sharper in developing countries where the increase in total FDI inflows as a proportion of GDP is almost fivefold during the same period.

There is again considerable diversity in the relation between FDI inflows and capital formation in developing countries. Figures in table 5 show that the difference between East Asia and Latin America in the policy approach to FDI is also reflected by its relation to domestic capital formation. Both regions witnessed a significant increase in FDI inflows as a proportion of GDP during the 1990s compared to the 1980s. However, in Latin America there was a widespread association of increased FDI with reduced fixed capital formation. For the region as a whole FDI as a proportion of GDP was higher in the 1990s than in the 1980s by more than 1.7 percentage points, but the share of GFCF in GDP was lower by some 0.6 percentage points. In all major Latin American economies FDI as a proportion of GDP rose strongly while GFCF either stagnated or fell between the two periods. The picture is much the same when FDI inflows are compared with private investment alone. It is also notable that the inverse association between GFCF and FDI is found not only in countries where FDI has been attracted primarily by privatization, such as Argentina and Brazil, but also in Mexico where there was considerable greenfield investment stimulated by NAFTA. Again in several countries in Africa FDI and GFCF moved in opposite directions. By contrast in none of the rapidly growing East Asian NIEs was rising FDI associated with falling domestic GFCF.¹⁸

Even in the presence of a crowding-out effect, higher FDI tends to result in increased GFCF since domestic investment is unlikely to fall to the same extent as FDI rises. In this respect the negative association between the two in Latin America is quite revealing. Whatever the direct impact of FDI on domestic capital formation may have been, this is a clear indication that the economic conditions that attracted foreign enterprises were not conducive to faster capital formation, and that the two sets of investment decisions can be driven by different

¹⁸ These observations are consistent with the findings from empirical studies testing the impact of FDI on capital formation and growth by Agosin and Mayer (2000) and Kumar and Pradhan (2002).

considerations. As discussed in subsequent sections, in many economies experiencing strong surges in FDI but stagnant or declining GFCF, macroeconomic and financial policies have played an important role in creating conditions favourable to asset acquisition but not to fixed capital formation.

4. *Policy failure: Omission or commission?*

The evidence thus shows that investment and growth have generally been too weak to improve labour market conditions in most developing countries. The outcome of the strategy adopted for activating a dynamic process of capital accumulation, technological progress and growth based on rapid domestic and external liberalization, reduced public investment and policy intervention, and increased reliance on FDI is disappointing. The slowdown in accumulation that emerged in the course of adjustment to the debt and balance of payments crises of the 1980s has become a more permanent feature of these economies. Weak private investment has been associated with declines in the share of public investment in GDP, and the surge in FDI encouraged by rapid opening up, privatization and special incentives has failed to ignite growth by accelerating capital formation. Furthermore the link between accumulation and growth has weakened despite measures adopted to improve the allocation and utilization of resources.

The poor outcome in terms of investment and growth has not given rise to a fundamental rethinking of Washington Consensus policies despite the rhetoric to the contrary. In fact, there has been a tendency to attribute failure to omissions and slippages in reforms rather than shortcomings in the policies recommended. Originally, it was expected that restoring macroeconomic stability through monetary and fiscal orthodoxy would prepare the ground for sustained growth based on private investment. The subsequent failure of investment to recover despite the apparent success in stabilization and structural reform was interpreted by the World Bank (1992: 34-45) as a temporary “investment pause” in the “transition to a new relative price regime.” However, as the investment pause became a permanent feature for most economies and it became clear that the first generation reforms of “getting the prices right” failed to deliver on their promises, attention has turned to second generation reforms emphasizing “getting the

investment climate right” by combining macroeconomic stability with good governance and policies promoting greater competition. It has been argued that richer and faster growing countries tend to have more competition and fewer barriers to entry, and promotion of productive investment would require removing barriers to imports and foreign investment, and dismantling administrative obstacles to private business (World Bank 2003: 85-95).

Once again this is an act of faith. First, the relationship between economic openness and growth is highly controversial, both theoretically and empirically. Second, even though there are still barriers to international trade and investment, there has been considerable liberalization in these areas. Similarly while some administrative obstacles to business remain, governance has improved considerably in most developing countries. Therefore, shortcomings in these areas cannot explain why investment and growth performance has failed to improve and, in fact, has in many cases worsened. More importantly, as discussed in the following section, it is a gross exaggeration to claim that successful examples of rapid accumulation and growth in East Asia relied on competitive market forces.

C. Managing profits and accumulation

Despite increased international mobility of capital, a very large proportion of domestic investment continues to be supported by domestic savings in both developed and developing countries.¹⁹ The conventional theory tells us that the savings propensity increases with income; that is, the rich save proportionately more than the poor and richer countries are capital-abundant compared to less developed economies. In reality, however, some countries save and invest a lot more than the others at similar levels of per capita income, and more equitable income distribution is not always associated with lower savings and investment.

¹⁹ This is to say that over the long term investment rates do not correlate with current account deficits. This observation was first due to Feldstein and Horioka (1980).

This is certainly the case in the industrial world as exemplified by a comparison between Japan and the United States.²⁰ But perhaps it is even more so in the developing world. For the sample of countries in table 3 there is a very weak correlation between investment rates and per capita incomes.²¹ Countries such as Argentina, Brazil, Mexico, Uruguay and Venezuela with per capita incomes at least three times the levels in China, India and Indonesia have much lower savings and investment rates. Again in many Latin American countries income concentration measured as the percentage share of the richest quintile of the population in national income is much greater than the concentration ratio in high-saving and high-investing Korea and Indonesia (table 6). Some second-tier NIEs such as Malaysia and Thailand have concentration ratios comparable to Latin America, but considerably higher private investment ratios. Regression estimates show that no more than 36 per cent of the variations in investment rates for countries in table 6 for the period 1995-2000 can be explained by inter-country differences in per capita income and the concentration ratio.

Evidence shows that after the initial stages of development, when agricultural incomes provide the main source of investment, private capital accumulation in industry is financed primarily by profits in the form of corporate retentions. Indeed in the course of industrial development, dynamic interactions between profits and investment, or the profit-investment nexus, become the main driving force whereby profits constitute simultaneously an incentive for investment, a source of investment and an outcome of investment (Akyüz and Gore 1996). A high rate of profit retention is usually associated with a high rate of corporate investment since the decision of corporations to save (i.e. to retain profits rather than distribute them as dividends) is not independent of their decision on investment.

In major industrial countries up to 95 per cent of corporate investment was financed by retained earnings during 1960-1990, with the ratio being higher in the United States, United

²⁰ In Japan the savings ratio in the past ten years has averaged at around 28 per cent while the investment ratio around 24 per cent. The corresponding figures for the United States where income is less evenly distributed are 16 and 19 per cent respectively (IMF 2005: table 43).

²¹ Simple correlation coefficient for 1990-2004 between average investment rates and per capita incomes of the countries in table 3 is 0.09.

Kingdom and France than in Japan and Italy.²² In most of these countries the contribution of gross profits to total savings and capital formation was as high as and even higher than household savings. Household gross savings did not significantly exceed household gross capital formation, and voluntary household savings were just sufficient to meet housing investment while mandatory savings in pension contributions, together with gross retained earnings, financed corporate investment.

For the more recent period there appears to be a decline in the extent to which corporate profits have been channelled into investment in the major industrial countries. As already noted aggregate capital formation as a proportion of GDP has been stagnant or falling in the G7 countries even though the rate of return on capital has been rising since the early 1980s. Indeed, there is a visible downward trend in the ratio of investment to capital income in the business sector. As seen in chart 1, during 1980-2000 this ratio moved in parallel with the overall business cycle, falling at times of stagnation or recession (namely 1980-1982; 1991-1992 and 2001-2002) and rising subsequently. However, each recovery appears to be weaker than the previous one. Thus, for the G7 countries taken together, investment is now generating higher returns than before while profits are generating less investment.

Available evidence also shows that high rates of capital accumulation in more successful developing countries have been associated with high rates of corporate retention and investment. This is particularly true in East Asian countries including Korea, Taiwan, Malaysia, Thailand and China where the impressive savings-investment performance over the past decades compared to other developing countries owed a great deal to significantly higher business savings and investment rates rather than higher household savings, except in Malaysia and Singapore where household savings were particularly high due to compulsory savings schemes. During the 1980s in these countries business savings were in the order of 8-14 per cent of GDP, financing between

²² For corporate savings and investment in developed countries see UNCTAD TDR (1997: table 42). In Japan the retention rate was very high, but exceptionally high corporate investment necessitated greater reliance on household savings. In general households in Japan generated a much greater surplus to support public and corporate investment than in other countries- see Horioka (1995). In Italy the inclusion of unincorporated enterprises in the household sector in the national accounts is an important reason for a lower corporate savings/investment ratio.

42 per cent and 65 per cent of corporate investment.²³ Evidence for the more recent period also shows a strong relationship between a high savings rate, a high share of manufacturing in GDP and a high profit share in East Asia while in Latin America savings rates were lower than expected on the basis of the share of profits in income (Ros 2000: 79-83).

The accumulation/concentration ratio in table 6 provides a measure of the animal spirit of the entrepreneur class in countries for which data are available. It effectively gives the ratio of private investment to income received by the richest quintile of the population. Since private investment is undertaken primarily by the richest strata, this ratio is a reasonably good indicator of the propensity of the rich to save and invest. Successful East Asian countries again top the table. The ratio in Korea is more than twice the ratio in Argentina, Brazil and Mexico. Furthermore, all second-tier NIEs have higher ratios than all Latin American and African countries. A comparison with the earlier figures in the last column shows that while East Asian NIEs and South Asian countries experienced increases in this ratio in recent years, this is not always the case for Latin America despite the recovery from the debt crisis of the 1980s.²⁴

A strong profit-investment nexus does not emerge spontaneously from market forces. Market-based incentives and competition do not always translate profits into investment or ensure that investments generate adequate profits to justify undertaking them. Indeed an important element of the successful industrialization in East Asia was the willingness and ability of governments to intervene effectively to accelerate accumulation and growth by animating the investment-profits nexus, rather than relying on market forces alone.

²³ For the evidence on corporate savings and investment in East Asia compared to other countries see Akyüz and Gore (1996) and UNCTAD TDR (1997: table 44). Despite high retentions from profits, corporate leverage in East Asian NIEs was also high because of very high rates of accumulation, as in Japan in the earlier period; see Wade and Veneroso (1998).

²⁴ The high propensity to consume of property-owning classes in Latin America is not of recent origin. Kaldor (1964) noted that in the 1940s and 1950s the capitalist class in Chile spent on personal consumption three quarters of their net income, absorbing more than 20 per cent of national resources as opposed to less than 8 per cent in the United Kingdom, and suggested that part of this income could be released for investment if “effective measures were taken to encourage retention of profits by enterprises” (p. 266).

The kind of measures used is studied extensively in the literature (Amsden 1989 and 2001; Wade 2003; Chang 1994; Rodrik 1995; Akyüz and Gore 1996; and Akyüz 1999). They fall into two broad categories. First, a number of fiscal instruments such as tax exemptions and special depreciation allowances were employed in order to raise gross profits and encourage their retention. Second, a range of selective trade, financial and competition policies were used to increase profits over and above the levels that could be attained under free market conditions, provided that protection and support were reciprocated by faster accumulation and productivity growth. Measures were introduced in all these areas to coordinate investment decisions, to direct investment to sectors with greater potential for learning and productivity growth, to prevent investment races and to control external borrowing. They were supplemented by restrictions over luxury consumption through import control and progressive taxation, and by measures designed to close unproductive channels of wealth accumulation and speculation. High retention ratios resulted in relatively equitable personal income distribution despite high share of capital income in value added, and rapid accumulation and job creation provided social justification for high profits.²⁵

Such policies have not been fashionable in recent years in many parts of the developing world. The scope for managing profits and accumulation is also severely restricted by WTO rules, conditionalities attached to multilateral lending by the BWIs, and liberalization of the capital account (Chang 2005; Gallagher 2005). These, together with the neglect of accumulation and employment in macroeconomic and financial policies, explain in large part why investments now generate more profits than previously, but profits generate less investment. Inequality within developing countries, as measured by the Gini coefficient, increased substantially between 1980 and 2000 (Freeman 2004), but this has not been associated with increases in savings or investment ratios. This is true not only collectively but also for a large majority of developing countries taken individually. For the countries in table 6, there is a visible weakening of the relation between income concentration and capital accumulation in recent years. The

²⁵ Corporate retentions do not appear among personal incomes. If these are added to the top quintile, differences in income inequality between East Asia and other regions narrow down considerably. For the relation between functional and personal distribution see UNCTAD TDR (1997: 172-173).

positive correlation observed between the two during 1980-1995 disappeared altogether in the second half of the 1990s.²⁶ This is also true for the significance of the coefficient for the concentration estimated in a cross-country regression of investment share on per capita income and the concentration ratio.²⁷ Although such simple statistics have their limits in revealing the underlying relations, their significance lies in confirming the general trends discussed above.

Even some countries in East Asia have not been spared from the winds of orthodoxy. It is true that many of the policies designed for support and protection in the earlier stages of industrialization are no longer needed because they have succeeded in meeting their objectives. However, in two areas the break with past practice has proved troublesome and made significant contributions to the East Asian financial crisis: policy guidance of investment and control over external borrowing. Abandoning investment coordination was an important reason for misallocation and overinvestment while capital account liberalization proved fatal when firms were allowed to raise money abroad without the traditional supervision and control, and became extremely vulnerable to an external debt run (Akyüz 2000).

D. Macroeconomic policy: what policy?

With few exceptions, macroeconomic policy has not been directed towards maintaining a high and stable level of employment and rapid capital accumulation either in developed or in developing countries. In the developed world there have been persistent inconsistencies in the mix and stance of monetary and fiscal policies both within and across major industrial countries, which served not only to dampen growth but also to generate global imbalances and instability. In many developing countries, the scope to use monetary and fiscal policy for macroeconomic management has largely been restricted by financial liberalization and increased public indebtedness. Policy stance has generally been pro-cyclical, aggravating boom-bust cycles in

²⁶ The correlation (Pearson) coefficient is 0.26 for 1980-1994 and -0.01 for 1995-2000. The rank correlation coefficient fell from 0.31 to 0.09 between the two periods.

²⁷ In the estimates for 1980-1994, the coefficient for the concentration ratio was positive but statistically insignificant while in those for 1995-2000 it turned out to be negative and significant at the margin.

economic activity associated with rapid surges and exits of capital, thereby contributing to instability in key relative prices that affect investment decisions such as interest rates and exchange rates.

1. Imbalances in the industrial world

Fiscal policy has generally ceased to be an instrument of macroeconomic management in industrial countries with the result that too much pressure has been placed on monetary policy for ensuring growth and stability - a task which it could not fulfil satisfactorily. In the United States monetary policy focussed entirely on inflation in the early 1980s, combined with supply-side tax cuts. This combination of tight monetary policy with fiscal laxity resulted in a sharp appreciation of the dollar and provided considerable growth stimulus to Europe and Japan, allowing them to undertake fiscal adjustment without seriously affecting aggregate demand and employment. However, as the resulting United States budget and external deficits threatened global stability, an agreement was reached in 1985 for macroeconomic policy coordination to realign the dollar and reduce global imbalances without sacrificing growth or stability. But the United States failed to relax monetary policy and focussed on expenditure reduction and then tax increases while Europe and Japan were unwilling to undertake expansionary macroeconomic policies. The result was a hard landing of the dollar and the 1987 global stock market crash (UNCTAD TDR 1992: part 2, chap. 2).

The depreciation of the dollar and recession led to a swift payments adjustment in the early 1990s. As inflation came down the Federal Reserve paid more attention to economic activity than in the 1980s while fiscal tightening and growth brought a rapid correction to budget deficits, producing a surplus in the second half of the 1990s. However, monetary policy neglected the conditions in financial markets, notably the increased fragility resulting from excessive investment in high-tech sectors, supported by a stock market (dot-com) bubble and highly inflated and leveraged asset prices. The boom was associated with large inflows of capital into the United States, resulting again in a persistent appreciation of the dollar, adding to growing trade imbalances caused by disparities in demand creation among the major industrial

countries. However, the recession brought about by the bursting of the dot-com bubble and the stock market collapse at the turn of the millennium was short-lived as massive supply-side tax cuts and increased military spending, together with repeated cuts in interest rates, brought a swift recovery, before the cyclical downturn could improve the United States external balance.

Europe and Japan both relied for growth primarily on markets abroad, notably in the United States, rather than expansion of domestic demand. This, together with inappropriate mix of policies in the United States, has been a major factor in the emergence of large trade imbalances, both in the 1980s and more recently. Europe was preoccupied in much of the 1980s with inflation and in the 1990s with convergence to conditions deemed to be necessary for monetary union, which consisted of arbitrary limits to inflation, government debt and deficits set first by the Maastricht Treaty and then by the Stability and Growth Pact. These arrangements in effect denied Europe counter-cyclical monetary and fiscal policy, and even introduced procyclical elements in the management of public finances. Even after control over inflation was firmly established the Bundesbank and subsequently the European Central Bank continued to adhere to monetarism; they were generally unwilling to use monetary policy for anything other than disinflation. All these factors constrained the willingness of the private sector to expand production capacity and employment beyond the limits assumed by the policy makers to be compatible with stability.²⁸

Japan enjoyed export-led growth in much of the 1980s. Its policy response to the appreciation of the yen was to relax monetary policy to allow an adjustment based on accelerated investment. The result was a financial bubble with sharp escalation of prices in stock and property markets and overinvestment which eventually led to a prolonged process of debt deflation and three fully-fledged recessions. The first came in 1991 when Japan moved to halt the boom in asset prices by tightening monetary policy; the second one was associated with the large appreciation of the yen and the East Asian financial crisis in 1997-1998; and the third one

²⁸ These limits are often expressed in terms of potential growth rate and NAIRU (non-accelerating inflation rate of unemployment) which are both subject to hysteresis; if policy makers act on the assumption that a sustained growth rate faster than, say, 2.5 per cent or an unemployment rate lower than 7 per cent would lead to an acceleration of inflation, the private sector would unlikely expand production capacity and employment faster so that these assumptions would become self-fulfilling prophecies.

came at the beginning of the new millennium. As deflation set in and prices started to fall, conditions reminiscent of the Keynesian liquidity trap developed and the limits of monetary policy were reached. In effect Japan is the only major industrial country which tried to respond to economic slowdown and contraction with fiscal expansion, introducing several packages throughout the 1990s in order to ignite recovery. However, fiscal stimulus has never been translated into sustained increases in private spending. As a consequence growth has been sluggish and erratic, and government debt and deficits have grown faster than output since the early 1990s.

In both Continental Europe and Japan consumer spending has been generally weak, not making a significant contribution to demand expansion. This is in large part due to the behaviour of wages. In the United States and the United Kingdom real wages broadly kept up with productivity growth after the mid-1990s. By contrast, in Continental Europe and Japan they stagnated for over seven years. In France real unit labour costs were flat while in Germany they actually fell between 1996 and 2002. In Japan the decline in real unit labour costs was deeper, partly due to sharp falls in profit-related earnings such as bonuses. In particular while the Japanese system of compensation based on links to enterprise profits has the advantage of providing the firms with flexibility regarding costs, it tends to accentuate economic recessions by adding to downward pressures on demand (UNCTAD TDR 2002: chap. 1; 2003: chap. 1).

Despite the aversion to Keynesian fiscal management, chronic public deficits have emerged and public debt has grown faster than output in both the United States and Europe. In the United States Federal debt as a proportion of GDP rose from 32 per cent in 1980 to 63 per cent at the end of 2004 due to an inappropriate mix of monetary and fiscal policies that pushed up the cost of public borrowing throughout the 1980s and to supply-side tax cuts. In the euro area despite efforts to bring down public debt after the Maastricht Treaty of 1991, the average ratio of public debt to GDP has remained around 72 per cent because of high interest rates and low growth. Increased indebtedness, in turn, has made an important contribution to budget deficits. In the euro area, the general government budget has had a primary surplus since 1995, but the overall budget has been in deficit on account of interest payments which averaged at close to 4

per cent of GDP. Interest payments from the budget in the United States was also close to 4 per cent of GDP in the 1990s, coming down only in the new millennium as interest rates fell to historically low levels

Of all the major industrial countries the United States economy appears to have benefited considerably more from increased global integration, enjoying faster growth in output, jobs and productivity in the past two decades. However, this performance has not been based on a judicious combination of monetary and fiscal policy, or an appropriate cross-country pattern of domestic demand growth. As a result, it has been associated with large domestic and global imbalances which pose serious threats for growth and stability over the coming years, not only for the United States itself, but also for rest of the world, including developing countries.²⁹

It is generally agreed that maintaining the recent pattern of growth in the United States would exacerbate trade imbalances and lead to an unsustainable process of debt accumulation. Adjustment based on fiscal tightening would imply a slowdown in growth unless accompanied by rapid and sustained growth in exports which would require acceleration of demand growth in its major trading partners. Faster growth in Europe is unlikely without governments ignoring the constraints placed on fiscal expansion by the Stability and Growth Pact or the ECB abandoning monetarism. Not much additional stimulus can come from Japan where policy interest rates are effectively zero and, at some 7 per cent of GDP, fiscal deficits are higher than even the United States. Nor could one expect a swift turnaround in the savings-investment balance in the East Asian developing countries running trade surpluses with the United States, since they are, notably China, already investing at very high rates. If, on the other hand, too much pressure is put on the dollar for external adjustment, then the United States could face a dilemma in monetary policy between maintaining growth and price stability, particularly if the decline of the dollar does not generate a swift turnaround in its trade balance. All in all, the chances of an orderly adjustment to these imbalances while maintaining strong and sustained growth and exchange rate stability and without frictions in international trade appear to be no greater than adjustment to the imbalances that had emerged in the first half of the 1980s.

²⁹ The risks entailed by these imbalances have been analysed by several economists belonging to different schools of thought: see, e.g., Godley and Izurieta (2004), Goldstein (2005), Izurieta (2005), Mussa (2005) and Cline (2005).

2. *Fiscal constraints and procyclical policy in emerging markets*

Macroeconomic policy in developing countries has been circumscribed by global economic conditions shaped in large part by the mix and stance of policies in industrial countries. In this respect developments in financial conditions, notably with respect to international liquidity, risk spreads and interest rates, and capital flows have exerted much greater influence on the scope and effect of policies in the developing world than those in world trade and commodity markets, except for the poorest countries.

There has been considerable diversity among developing countries regarding overall macroeconomic conditions and the scope to use monetary and fiscal policy for macroeconomic management. Policy constraints have generally been tighter in most middle-income Latin American countries with high and volatile inflation, chronic budget and payments deficits, and high levels of public debt than Asian countries with relatively stable prices and sustainable fiscal and external balances. In most low-income countries, notably in sub-Saharan Africa, with moderate inflation but relatively high and volatile fiscal and payments deficits, the stance of policy has generally depended on external aid and the conditions attached to its availability.

Notwithstanding this diversity, evidence strongly suggests that macroeconomic policy in developing countries has generally been pro-cyclical, and much more so for fiscal than monetary policy.³⁰ Stabilization programs supported by the BWIs in low-income countries facing payments difficulties have almost invariably promoted fiscal and monetary austerity, emphasizing adjustment rather than financing regardless of the origin of budget or external deficits. Aid has been increasingly volatile, particularly since 1990, and much more so than government revenues or GDP. It has also been procyclical, introducing a deflationary bias to macroeconomic adjustment. Unexpected declines in aid to low-income countries facing payments difficulties typically necessitated sharp cuts in imports and economic activity as most

³⁰ For evidence and a brief review of the literature see Kaminski, Reinhart and Végh (2004). Talvi and Végh (2000) find that government spending rises and taxes fall during expansions, while the reverse is true in recessions. They argue that procyclical fiscal policy can be optimal since surpluses create political pressure to increase spending.

of these countries have had little access to private markets, which are, in any case, even more procyclical.³¹

Following a series of failed attempts to bring down inflation under control through traditional stabilization policies relying on fiscal and monetary tightening and currency devaluations, most high-inflation countries adopted exchange-rate-based stabilization programs in the 1990s with the support of the BWIs, often accompanied by rapid trade and financial liberalization, relying on capital inflows to finance fiscal and external deficits. This populist policy mix served to avoid hard policy choices and allowed price stability to be achieved without running into distributional conflicts. However, disinflation has generally been achieved at the expense of increased financial instability, leaving many of these countries in conditions as fragile as those prevailing in the 1980s.

In countries with exchange-rate-based stabilization programs macroeconomic policy mix has generally been inconsistent, combining relatively tight money with pro-cyclical fiscal policy.³² An examination of the monetary conditions index, defined as a weighted average of changes in real effective exchange rate and the ratio of the real short-term interest rate to the trend growth rate, shows that monetary conditions were on average much tighter and more volatile in Latin America during the 1990s than in East Asia.³³ In Latin America the boom phase of the cycles generally combined sharp currency appreciations with high real interest rates. Declines in nominal interest rates lagged considerably behind inflation as tight monetary policy

³¹ For a discussion of aid volatility and pro-cyclicality see World Bank (2005a: 104-106), and procyclicality of private capital flows Kaminski, Reinhart and Végh (2004).

³² The evidence on monetary policy is inconclusive. Kaminski, Reinhart and Végh (2004) find some evidence that policy rates are lowered in goods times (when output is above trend) while recognizing the difficulties in empirically identifying the policy component of monetary aggregates. According to Mohanty and Scatigna (2003: 52-55 and table 7) in some countries monetary policy was expansionary at times of fiscal expansion, suggesting the accommodating nature of monetary policy. But they also point out that there were various episodes of inconsistent mix of monetary and fiscal policy during the 1990s. In general, recent years have seen both excessive tightening of monetary policy to bring inflation under control and several episodes of credit boom associated with surges in capital inflows.

³³ In Latin America the index fluctuated between 70 per cent and -8 per cent during 1990-1999 with an average value of 22 per cent while in East Asia the range of fluctuations was much narrower, between 4 and -8 per cent, with an average index value of -1.8 per cent (an index number of zero indicates neutrality of monetary conditions, a positive index indicates restrictive monetary policy); see UNCTAD TDR (2003: 136).

designed to attract foreign capital and high credit risks offset much of the benefits of lower inflation and exchange rate stability. When the bust came, currencies collapsed leading to an easing of the overall monetary stance, but often this was more than offset by hikes in interest rates, recommended by the IMF to restore confidence. Overall, monetary conditions in Latin America in the 1990s were too stringent and unstable to encourage growth based on rapid and sustained capital accumulation. In East Asia where interest rates were much lower because of low and stable inflation, and currency appreciations were limited, boom in capital flows and economic expansion were associated with neutral monetary conditions while the 1997-1998 crisis led to a procyclical tightening.

Fiscal policy has been procyclical in most developing countries but above all in Latin America (BIS 2003; Moreno 2003; Mohanty and Scatigna 2003; Mihaljek and Tissot 2003; Ocampo 2002; Kaminski, Reinhart and Végh 2004). In the latter region most countries started stabilization programs with large budget deficits and where there was some success in fiscal adjustment, it was based on unsustainable spending cuts rather than expansion of government revenues. Surges in capital inflows thus presented an opportunity to raise public spending and cut taxes by facilitating government borrowing and bringing some additional cyclical revenues. This reinforced the expansion fuelled by increased capital inflows and private consumption. However, increased public debt, interest rate hikes, sharp declines in currencies and economic contraction necessitated a retrenchment of public spending at times of reversal of capital flows and financial crises, thereby deepening deflation. In East Asia there does not appear to be a systematic procyclicality in fiscal policy. There was no notable fiscal expansion during the surge in capital inflows in the mid-1990s, but pro-cyclical fiscal tightening added to deflationary pressures at the time of the 1997-1998 crisis in countries following the IMF recipe. However, this policy stance was reversed soon and most East Asian countries were able to respond to the weakness of global demand after 2000 by fiscal and monetary expansion while such policy space was not available to Latin America and Africa facing stringent financial conditions (UNCTAD TDR 2003; Moreno 2003:5-6; Mohanty and Scatigna 2003:38-43).

As a result of boom-bust cycles in international capital inflows and recurrent financial crises, public debt has been rising in emerging market economies both in Latin America and Asia since the mid-1990s. Although external sovereign debt has declined in Latin America and stayed relatively stable in Asia, there has been a considerable increase in domestic debt in both regions (IMF 2003: chap. 3). Much of this increase is accounted for by interest and exchange rate movements and the assumption of private liabilities by the public sector, notably through recapitalization of insolvent banks, as well as excessive borrowing by some governments during surges in capital inflows. As a result the average public debt in emerging market economies now stands at around 70 per cent of GDP.

An outcome of increased public indebtedness is to narrow the scope for discretionary public spending and reduce fiscal flexibility. Given that many countries with high public debt also face high real interest rates and have relatively low potential growth rates, they need to generate large amounts of primary surplus in order to avoid debt explosion.³⁴ With a debt/GDP ratio of 70 per cent and a potential growth rate of 4 per cent, debt sustainability would require a primary surplus of some 2.8 per cent when the real interest rate is 8 per cent. This figure would be doubled when the interest rate is 12 per cent, and it would rise further to 7.2 per cent when sovereign debt is 90 per cent of GDP.

Given the political difficulties in sustaining a high rate of primary surplus, even a moderately high ratio of public debt to GDP is unlikely to remain stable over time. It has been argued that the threshold debt ratio above which a country becomes vulnerable to external shocks that may threaten sustainability is in the order of 25 per cent of GDP even though it is generally recognized that the threshold depends on a host of other factors (Moreno 2003: 2-3; Mihaljek and Tissot 2003: 16-22; IMF 2003: chap. 3; Goldstein 2005: 54). This is far above the debt

³⁴ More specifically since $\Delta D = rD - P$ where D is the stock of public debt, r the real interest rate and P the primary surplus, and since sustainability of debt requires that the growth rate of debt stock should be equal to or smaller than the growth rate of real income (g), the primary surplus as a proportion of income (Y) needed to sustain debt is given by $P/Y \geq (r-g)(D/Y)$.

ratios in most emerging market economies.³⁵ At present such ratios appear to be sustainable because of highly favourable global financial conditions including exceptionally low interest rates, and exchange rate appreciations. However, many of these economies which have been enjoying a surge in capital inflows in recent years appear to be vulnerable to a hike in interest rates, a reassessment of risks and reversal of capital flows. Thus, fiscal and monetary policies in such countries could be challenged by deterioration in global financial conditions (Goldstein 2005: 57). A rise in interest rates due to changed perceptions of risk and an increase in the ratio of public debt to GDP resulting from sharp currency depreciations could necessitate much higher rates of primary surplus, thereby forcing the governments into excessively procyclical fiscal positions, and adding to deflationary forces triggered by rising interest rates.

E. Financial instability, investment and employment

1. Financial boom-bust cycles

Until recent bouts of financial boom-bust cycles in industrial and developing countries, it was generally believed that price stability was both necessary and sufficient for economic and financial stability. However, in many countries in East Asia, as well as in the industrial world, asset price bubbles, excessive credit creation, and currency appreciations and gyrations all occurred under conditions of price stability. In the more extreme cases, as in Latin America, disinflation has been achieved at the cost of increased financial fragility and instability, through exchange-rate-based stabilization programs relying on unstable capital flows.

Not only have financial markets become the single most important source of instability, but the influence of financial developments over economic cycles have increased significantly. This is particularly so in the developing world where financial instability associated with greater

³⁵ As of 2004 the sovereign debt ratio was around 90 per cent in the Philippines and Turkey, 75 per cent in India and Brazil, 60 per cent in Malaysia, Hungary and Indonesia, 50 per cent in Colombia, Poland and Thailand, and 40 per cent in South Africa and Venezuela. The ratio in Argentina was 121 per cent, not accounting for the default. Notable exceptions with sovereign debt ratios below 30 per cent include Mexico, Russia, China and Korea; see Goldstein (2005: table 8).

mobility of capital has been mirrored by sharp changes in economic activity. Both theoretical and empirical literature shows that high volatility has an adverse effect on long term economic growth and that financial liberalization tends to strengthen the trade off between growth and volatility.³⁶ On the one hand, growing uncertainties created by sharp and unexpected swings in key relative prices such as interest rates, exchange rates and real wages, as well as increased fluctuations in the level of demand increase the risks associated with irreversible investment decisions, shorten planning horizons and promote defensive strategies.³⁷ On the other hand, greater opportunities for quick capital gains presented by a high degree of volatility of asset prices encourage speculative behaviour. These exert a significant influence on the pace and pattern of capital accumulation and the conditions in the labour market.

With rapid financial liberalization boom-bust cycles have become common features of both currency and asset markets. These reflect abrupt and unexpected changes in markets' assessment of risks which cannot always be attributed to policy shifts. A plausible explanation is provided by the theory of endogenous fragility developed by Minsky (1977), which sees financial cycles as an intrinsic feature of market economies.³⁸ Booms generated by improved opportunities for profitable investment lead to an underestimation of risks, over-expansion of credits and over-indebtedness. Excessive risk-taking eventually results in a deterioration of balance sheets and increases in non-performing loans. Lenders respond by reassessing risks and sharply cutting credits, which in turn lead to credit crunch, debt deflation and defaults. However, while crises are almost always associated with a certain degree of financial fragility, they can also take place in the absence of serious economic weaknesses, because of the so-called self-fulfilling prophecies resulting from the existence of multiple equilibria and debt runs associated with herding behaviour and collective action problems (Obstfeld 1996; Krugman 1996 and 1998).

³⁶ See Aizenman and Pinto (2005) for a review. See also Kose, Prasad and Terrones (2005: 59) who find that "financial integration ... seems to strengthen the negative relationship between growth and volatility" but de-emphasize this finding.

³⁷ For a discussion of investment under uncertainty see Dixit and Pindyck (1994).

³⁸ The approach goes back to Fisher's analysis of the Great Depression: see Davis (1992: chap. 5).

Boom-bust cycles also involve mutually reinforcing and destabilising feedbacks among credit, capital and currency markets. Booms in capital markets tend to increase opportunities for capital gain, attracting capital flows from foreign investors or encouraging foreign borrowing for investment in domestic asset markets. These would, in turn, appreciate the currency, thereby widening profit opportunities. In the downturn, falling asset prices reduce attractiveness of domestic investment, leading to a rapid exit of capital and a depreciation of the currency. Similarly, credit cycles are often associated with cycles in property and equity prices. Booms in stock and property markets raise collateral values, which in turn encourage domestic credit expansion by loosening credit standards, reducing the cost of borrowing and increasing the availability of credit. Where the banking sector holds sizeable amounts of stocks (as in Japan), stock market booms can expand credit by raising bank equity relative to current exposure. Faster growth in bank lending in turn serves to increase the market valuation of these assets, setting off a mutually reinforcing process of credit expansion and asset price inflation. This process works in the opposite direction when asset prices are declining and economic conditions are deteriorating; falling asset prices reduce the value of collaterals, raise the cost of borrowing and lead to cuts in lending and credit crunch.

In a world of unstable capital flows every country with an open capital account is vulnerable to sharp and unexpected swings in the external value of its currency. However, in industrial countries currency instability rarely spills over to domestic capital and credit markets. For instance during the 1992 EMS crisis there were sharp drops in the lira and pound sterling, but these did not provoke serious financial crises in Italy and the United Kingdom. Again in recent years there have been sharp swings in the dollar vis-à-vis other reserve currencies, but these did not generate destabilizing spillovers to domestic financial markets of the countries concerned.

By contrast, in developing countries domestic financial cycles have often been associated with sharp swings in external capital flows and exchange rates. It is very rare that currency crises in developing countries are contained without having a significant impact on domestic financial conditions, economic activity and living standards. The greater vulnerability of

domestic financial conditions in developing countries to currency instability is due primarily to the existence of large stocks of public and/or private debt denominated in foreign currencies; i.e. the so-called liability dollarization.

While country-specific factors no doubt influence the volume and terms of private capital flows, global financial conditions were the dominating factors in the two postwar boom-bust cycles in such flows to developing countries. The first boom started in the early 1970s and was driven by the rapid expansion of international liquidity associated with oil surpluses, and facilitated by financial deregulation in industrialized countries and rapid growth of Eurodollar markets. Excess liquidity was recycled in the form of syndicated bank credits, and this was encouraged by the BWIs fearing a collapse of global demand. It ended with a debt crisis in the 1980s as a result of the hike in United States interest rates, global recession and a sharp cutback in bank lending. The second boom came in the early 1990s, after almost ten years of suspension in private lending to developing countries. It was encouraged by the success of the Brady Plan for sovereign debt restructuring, liberalization and stabilization in developing countries, and rapid expansion of liquidity in the United States and Japan in conditions of economic slowdown. Unlike the first boom, a large proportion of private inflows were in equity investment, rather than international lending, attracted by prospects of quick capital gains and short-term arbitrage opportunities. It again ended with a series of crises in Latin America, East Asia and elsewhere.

These cycles were thus driven by temporary and special factors beyond the control of recipient countries, including monetary and financial policies in industrial countries. Aggregate flows to developing countries have manifested a degree of instability not justified by changes in the underlying fundamentals in the recipient countries. For instance in the last cycle, total annual net private capital inflows fell from more than \$200 billion in 1996 to less than \$20 billion in 2000-2001, and after the East Asian crisis until 2002 net international private lending to developing countries was negative. These swings in the volume of private capital are also mirrored in sharp changes in their terms. Booms tend to be associated with the underestimation of risks and relatively low spreads while crises led to overpricing of risks, generalized increases

in spreads and shortening of maturities (UNCTAD TDR 2003: 27; Cunningham, Dixon and Hayes 2001; Sy 2001).

A third boom now appears to be under way, driven by a combination of highly favourable conditions including historically low interest rates, abundant international liquidity, oil surpluses, strong commodity prices and buoyant international trade. Total inflows to developing countries are currently above the peak of the previous boom, and almost all emerging markets have shared in this recovery. But as noted by the IIF (2005a: 4) “there is a risk that the pickup in flows into some emerging market assets has pushed valuations to levels that are not commensurate with underlying fundamentals.” Thus, a combination of tightened liquidity, rising interest rates, slowing growth and persistent global trade imbalances can reverse the boom, hitting particularly countries with weak fundamentals and incomplete self-insurance (IIF 2005b; Goldstein 2005).

2. *Financial and investment cycles*

Almost all financial bubbles give rise to excessive investment in certain sectors which loses its viability with the return of normal conditions, leading to prolonged underutilization and even destruction of production capacity. Such investment is concentrated not only in areas susceptible to speculative influences such as housing and commercial construction, but can also be in machinery and equipment. This is true both for industrial and developing countries. However, in the latter countries the abrupt change of economic regime, particularly in the sphere of money and finance, has made it difficult for investors to identify underlying trends and separate them from cyclical developments. Long-term decisions affecting the balance sheets of corporations through acquisition of assets and assumption of liabilities on the basis of favourable cyclical conditions have thus resulted in increased financial fragility and waste of resources.

A notable example from recent history is the Japanese experience since the early 1990s.³⁹ After the Louvre Agreement in 1987 Japan relaxed monetary policy in order to help reduce trade

³⁹ For financial and investment cycles in industrial countries see UNCTAD TDR (1991: chap. 2; 1992: chap. 2; and 2001: chap. 1).

imbalances with the United States and to facilitate the adjustment of the industry to yen appreciation. The result was a rapid expansion of liquidity and a decline in the cost of capital almost to zero through a sharp escalation of prices in the stock market. The share of capital spending rose from 27 per cent of GDP in 1987 to 32 per cent in 1990. However, when increased concern with asset price inflation led to monetary tightening, the bubble burst, resulting in sharp declines in stock and property prices, which, in turn, threatened the solvency of banks and highly leveraged corporations. This set off a debt deflation-*cum*-recession process which crippled the economy for a decade, necessitating disinvestment and debt restructuring and raising unemployment to exceptionally high levels by Japanese standards.

Expansionary phases of business cycles in the United States in the 1980s and 1990s were also associated with financial excesses and investment bubbles that subsequently hampered the ability of the economy to maintain steady and robust growth. The rapid increase in lending against real estate in the second half of the 1980s led to massive overbuilding, and when the bubble burst in the early 1990s, the outcome was a sharp decline in occupancy rates, increased defaults and delinquency, and drying up of bank lending. The economy went into a double-dip recession as private investment dropped from some 17 per cent of GDP to less than 13 per cent. Even more remarkable was the expansion in the 1990s sustained by a boom in business investment which lasted much longer than in other major industrial countries and in previous investment cycles in the United States itself. This was driven primarily by investment designed to exploit new advances in information technology, and greatly facilitated by easy financial conditions, notably the boom in venture capital funding and the stock market bubble. These allowed the emergence of many companies that would not have been created under normal financial conditions. Thus, a sudden reversal of expectations about the future earning capacity of these companies led to collapse in their share prices, producing a sharp drop in investment spending at the turn of the millennium.

In developing countries boom-bust financial cycles driven by capital flows have almost invariably been mirrored by sharp movements in capital accumulation.⁴⁰ Even in Latin America

⁴⁰ See UNCTAD TDR (2000: chap. 4; and 2003: chap. 4) and World Bank (2003: 23-26).

where surges in capital inflows were invariably associated with booms in consumption, investment tended to follow the boom-bust cycles in capital flows. This was much more so in East Asia where surges in capital flows were more closely tied to private investment booms. In response to rapidly falling prices in the mid-1990s of many of the manufactures exported from East Asia, notably semiconductors, which accounted for more than 40 per cent of exports of some countries in the region, many firms augmented investment in the hope of increasing productivity and market shares, and expanded into new areas of production, very much in the same way as the response of Japanese firms to loss of competitiveness in the late 1980s. This process was facilitated by easy access to cheap foreign credits. There was also a speculative surge in the property market supported by borrowing abroad, notably in Thailand. Some firms also invested heavily in other non-traded activities including infrastructure with the funds borrowed abroad. Excessive investment was thus a key factor in the subsequent financial difficulties and the sharp drop in accumulation and growth when cheap foreign capital was no longer available. While in the boom the investment ratio rose by 3-14 percentage points in the four countries most affected by the crisis, the decline was sharper during the bust, ranging between 15 and 18 percentage points of GDP (UNCTAD TDR 2000: chap. 4).

The recent investment boom in China too has certainly been supported by the surge in private inflows, including FDI. In 2004 fixed capital investment grew by almost 28 per cent over the previous year, reaching 44 per cent of GDP while net private capital inflows set a record at \$101 billion.⁴¹ As noted, there is evidence of excessive and wasteful investment in some sectors. It has indeed been argued that the current investment boom is unsustainable and will probably take several years to undo (Goldstein and Lardy 2004). However, while an unwinding of the boom may generate financial difficulties in certain sectors, it is unlikely to be coupled with the kind of currency and debt crises experienced in several other emerging markets in recent years, given China's solid payments and reserve positions.

Investment is generally the most unstable component of aggregate demand and especially vulnerable to external shocks in developing countries. Evidence shows not only that it has been

⁴¹ For investment figures see Qin, Cagas, Quising and He (2005), and for capital inflows IIF(2005c)

more volatile than GDP almost everywhere, but volatility has increased in the 1990s compared to the turbulent years of the 1980s in both developed and developing countries (World Bank 2003: 23-26). This is clearly associated with financial rather than trade shocks, and particularly boom-bust cycles in capital flows. Furthermore, both the level of and the increase in volatility is high in low-income countries where macroeconomic and financial conditions can be easily altered by movements of small sums of money.

Increased volatility of investment resulting from financial cycles has two adverse consequences for capital accumulation and job creation. First, investment tends to fall a lot faster under financial busts than it rises during financial booms; that is, the average investment rate over the cycle tends to be lower. Secondly, financial booms distort the composition of investment, increase its speculative components and lead to excessive expansion of productive capacity in certain sectors. Clearly, these two phenomena are related: financial busts result not only in sharp declines in investment but also in the waste of existing productive capacity which becomes unviable with changed conditions.

3. *Bubbles, crises and jobless recoveries*

Any adverse effect of financial instability on capital accumulation and economic growth would no doubt be transmitted to the labour market. But boom-bust cycles also generate dislocations and instability in employment and wages independent of their impact on capital accumulation. Booms can temporarily lift employment and wages above their long-term levels, while crises depress them significantly on a more durable basis. In particular, in recoveries from deflation-*cum*-recessions, both employment and wages tend to lag considerably behind income growth. While this is also true for industrial countries, the boom-bust cycles driven by capital flows in developing countries is particularly harmful for labour, causing large adverse shifts in unemployment, wages, income distribution and poverty.

The experience of the United States in this respect is quite revealing. As noted above, the periods of expansion in the 1980s and 1990s were both characterised by excessive investments in certain sectors, asset-price inflation and increased private indebtedness while the recessions that followed involved widespread financial difficulties and debt-deflation. In both episodes recoveries from recessions were commonly described as jobless. In the former cycle the recovery that started in the course of 1991 was not felt in the labour market until well after several years of growth. Although investment soon picked up, it was designed for industrial restructuring rather than capacity expansion, focussing on ITC sectors. Income was soon restored to its pre-recession peak, but employment started increasing only in 1993, and the unemployment rate did not return to its pre-recession low of 5.3 per cent before 1996, after reaching 7.5 per cent in 1992. Similarly wages did not share in the recovery of productivity until the second half of the 1990s (UNCTAD TDR 1994: 78-84; and 1995: 62-65).

In the second cycle the economy went through a short recession in spring 2001. The recovery that followed was the worst in recent United States history for employment creation. In terms of investment it was also the weakest since 1949. From the end of the recession in the third quarter of 2001 until the end of 2003, job losses outside the farm sector amounted to over 2 million, with employment falling particularly steeply in over-expanded ITC sectors, but GDP rising by 2-3 per cent per annum. As of end 2005, real weekly and hourly wages were still below where they were at the start of the recovery in November 2001, and jobs in the private sector were up only by 0.8 per cent, compared to an average 8.8 per cent increase at the same stages of previous business cycles. The combination of falling wages and employment with surging profits not only worsened income distribution but also increased poverty (Freeman and Rodgers 2005; UNCTAD TDR 2003: 7; EPI 2004; Mishel and Eisenbrey 2005).

Financial excesses at times of expansion were an important reason for jobless recoveries in both cycles, but above all after the more recent downturn following one of the strongest post-war expansions in the United States driven by the dot-com bubble. In both cases deflation-*cum*-recessions exposed financial fragility and over-indebtedness, and the efforts of corporations during recoveries focussed on restoring the health of their balance sheets. Increased profits were

used either for industrial restructuring or for reducing debt rather than expansion of production capacity and employment, and downsizing and labour shedding resulted in a combination of falling employment with rising labour productivity and profits.⁴²

Jobless recoveries from recessions triggered by crises are even more marked in emerging market economies. The impact of financial crises on the labour market and social conditions last much longer in these economies because of financial difficulties created by liability dollarization and the external constraint. Even after income recovers to levels prevailing before the crisis, both employment and wages tend to lag, remaining well below not only their pre-crisis (boom) levels, but also their pre-boom levels.

At times of a surge in capital flows real wages generally rise alongside the appreciation of the currency, but what happens to employment depends on a host of factors. If the boom is driven by consumption and productivity growth is sluggish, employment tends to fall in traded goods sectors due to loss of competitiveness while rising in services. High wages and cheap imports of capital goods, together with easy access to credit, can also lead to higher investment and capital deepening in an effort to restructure industry and raise productivity to meet foreign competition. When investment is strong and currency appreciation is limited, industrial employment can remain relatively stable or even rise despite loss of competitiveness. Under such circumstances financial booms would be associated with falling unemployment rates.

Available evidence suggests that in almost all emerging market economies which went through boom-bust cycles in the 1990s, real wages rose rapidly at times of surges in capital inflows and financial booms, but employment changed in different ways in different episodes.⁴³ In Korea, Malaysia, Indonesia and Thailand where the boom was driven by investment, productivity growth kept up with wages. In all these countries except Indonesia the

⁴² UNCTAD TDR (1994: 80-84; and 2003: 6-9). For corporate debt in the United States see Arestis and Karakitsos (2003). Many other explanations have also been advanced for the recent jobless recovery; see Bernanke (2003), Groshen and Potter (2003), and Freeman and Rodgers (2005).

⁴³ For evidence cited in this section on the evolution of employment and wages in boom-bust-recovery cycles in emerging markets see UNCTAD TDR (2000:chap. 4), ILO (2004), and van der Hoeven and Lübker (2005).

unemployment rate fell during the boom and full employment was secured. By contrast, in Latin America productivity growth lagged behind real wages and the rate of unemployment was either stable or higher at times of the boom. Unemployment hit manufacturing industries particularly hard because of loss of competitiveness brought about by currency appreciations.

At times of crisis wages fell almost everywhere. The decline was particularly sharp in Indonesia, Mexico and Turkey, between 11 and 25 per cent per annum. In East Asia unemployment went up rapidly, exceeding the levels prevailing not only during the boom but also the pre-boom period. The impact in Korea and Indonesia was particularly strong, raising the unemployment rate to 6.5 per cent. The only exception was Malaysia where rising unemployment mostly affected migrant workers and was reflected in the statistics of their countries of origin including Indonesia and the Philippines. In Latin America where unemployment was already on the rise, the crisis took it to exceptionally high levels. The Mexican crisis in 1995 led to a doubling of open unemployment within a year, pushing several workers to the informal labour market. In Argentina where the currency board and the fixed exchange rate were maintained despite worsening external conditions, unemployment shot up in the wake of the Mexican crisis, reaching almost 20 per cent in 1995. In Brazil open unemployment rose to almost 10 per cent in 1999, up from 6 per cent in the mid-1990s. A similar increase was registered in Turkey during the 2001 crisis.

The pace of recovery again differed among countries, more robust in East Asia, except Indonesia, than in Latin America. At the time when GDP was restored to its pre-crisis level, real wages regained their pre-crisis levels only in Korea while they remained depressed elsewhere in the region. In Latin America, during recovery phases real wages were lower than the peaks reached during the booms. In all countries in both Latin America and East Asia, employment lagged considerably behind output growth. Post-crisis open unemployment rates were higher than pre-crisis rates by one percentage point in Brazil and Mexico, 5.5 points in Argentina and 4 percentage points in Korea and Indonesia. In Turkey the 2001 crisis was followed by a strong recovery driven again by a surge in capital inflows, leading to a rapid appreciation of the currency and a worsening of the current account. But growth averaging over

7 per cent during 2002-2005 did not make any dent in unemployment while real wages barely recovered after a sharp decline during the 2001 crisis.⁴⁴ The deterioration in the conditions of labour, particularly among the unskilled, is a major reason why poverty levels have stayed high despite economic recovery not only in Turkey and Latin America, but also in East Asia.

Thus, in emerging market economies, as in industrial countries, during recovery productivity and profits tend to rise while wages and employment remain depressed compared to their long-term sustainable levels. Dislocations created by crises in the balance sheets of banks and non-bank corporations in developing countries are much greater than those generated by asset-price deflations in industrial countries because of the impact of currency collapses and pro-cyclical monetary and fiscal policies. This is a major reason why recessions are deeper, and recoveries are slower in generating jobs. An additional factor accounting for the failure of employment to follow recovery in GDP is changes in the composition of output. The collapse of the currency eventually leads to a recovery in exports, particularly in countries with a robust industrial base. The shift in economic activity from non-tradable services towards tradable industries lowers the employment content of aggregate GDP since average productivity in industry is typically higher than that in services.

F. Policy priorities

A number of conclusions can be drawn from the recent experience of developed and developing countries with respect to economic stability and growth. First, while macroeconomic stability may be necessary to sustain rapid accumulation and growth, it is certainly not sufficient. Secondly, price stability on its own cannot secure stability in key macroeconomic aggregates and relative prices, since it is not sufficient to secure financial stability. Accordingly, the source of

⁴⁴ The unemployment rate rose to 8.2 per cent during the 2001 crisis, from 6.3 per cent in 2000. It continued to rise afterwards, staying over 10 per cent in each year between 2002 and 2005; OECD (2005b; Annex tables). Real wages in manufacturing dropped by more than 20 per cent during the 2001 crisis and the decline continued in 2002-2003 despite economic recovery. They rose around 2 per cent per annum during 2004-2005, but in mid-2005 they were some 25 per cent below their pre-crisis levels; see CBRT (2005).

macroeconomic instability now is not instability in product markets but asset markets, and the main challenge for policy makers is not inflation but unemployment and financial instability.

At the national level a reorientation of policy would need to focus on three areas in developing countries. First, fiscal policy would need to be employed in a counter-cyclical way, with a view to combining stability with a high level of economic activity. Second, a whole array of policy instruments would need to be redeployed in order to reduce financial instability and prevent boom-bust cycles in capital flows. Third, in most countries at intermediate stages of industrialization, action needs to be taken at the sectoral level in order to directly influence the volume and composition of investment.

Bringing back fiscal policy as an instrument for macroeconomic management calls for restoring fiscal autonomy which, in turn, requires elimination of chronic, structural deficits. In many cases this should be possible through a reform of taxation and primary spending. However, in some countries it would be necessary to act directly on the stock of public debt, notably the domestic debt, as the single most important determinant of fiscal sustainability. As pointed out by Keynes long ago in his analysis of what he called “progressive and catastrophic inflations” in Central and Eastern Europe during the early 1920s, there are three ways of dealing with a debt overhang: repudiation, inflation and capital levy. He argued that of these, “the capital levy, ... is the rational, the deliberate method. But it is difficult to explain, and it provokes violent prejudice by coming into conflict with the deep instincts by which the love of money protects itself ... But if it has become clear that the claims of the bond-holder are more than the taxpayer can support, and if there is still time to choose between the policies of a levy and of further depreciation [inflation], the levy must surely be preferred on grounds both of expediency and of justice” (Keynes 1971: 53-55). Clearly, inflation is even a less viable option today given the short maturities of debt in many countries and open capital accounts. A once-and-for-all capital levy on the holders of government debt (or other equivalent measures such as swapping old debt with new debt at a discount) may indeed be the only option to eliminate the debt overhang in countries facing unsustainable debt stocks.

Using fiscal policy in the Keynesian tradition for macroeconomic management implies that governments should run deficits at times of contraction but generate surpluses during upturns so that over the full cycle the budget should be balanced or in a small surplus. If the revenue and expenditure structures are appropriately designed, much of the task would be done by automatic stabilizers. But there would often be a need for discretionary fiscal action according to the strength of underlying contractionary and expansionary impulses. It is in particular important to pursue counter-cyclical fiscal policy in the boom in order to have adequate fiscal space during contractions. This should be undertaken mainly by adjustments in spending on public works which is, *inter alia*, politically easier to control than current spending. There may also be adjustments on the revenues side including value-added taxes or financial transaction taxes, which can also be particularly effective in checking consumption and credit booms while providing additional revenues.⁴⁵

In what way the budget should be balanced is a contentious matter. On one view, over the cycle total expenditures including both current and capital spending should be balanced by revenues from taxes and charges for public services. This implies that any debt incurred during recessions should be repaid by surpluses generated during expansions. However, there may be a sound rationale for the public sector to incur debt across the cycle provided that it is used to finance productive investment. An alternative way of conducting fiscal policy is thus by making a distinction between current and capital spending and using the Golden Rule of public finance; that is, governments should be able to borrow to invest, but not to finance current spending — an old idea which has recently been revived in the debate over fiscal constraints imposed by IMF conditionalities and the European Stability and Growth Pact. Such an approach would have the advantage of preventing the burden of adjustment falling disproportionately on public investment. It would also imply that analysis of fiscal sustainability should not focus on gross public debt alone but also consider assets built up on the other side of the balance sheet of the public sector.

⁴⁵ For a discussion of these issues see Ocampo (2002: 29-31).

In some industrial countries such as the United Kingdom and Japan fiscal policy is conducted on the basis of the Golden Rule.⁴⁶ A number of reasons have been given against using such an approach in developing countries, including financing constraint, lack of fiscal discipline and debt overhang.⁴⁷ These may be valid for many countries, particularly in Latin America, but without resolving these problems in the first place, it would not be possible to use fiscal policy as an effective counter-cyclical device, whether one targets the overall fiscal balance or current balance alone.

Just as counter-cyclical fiscal policy should start in the boom, prevention of unsustainable booms in capital inflows and currency appreciations holds the key to greater financial stability in developing countries. In this respect monetary policy on its own is quite ineffective. Avoiding currency appreciations and overheating would require sterilization, but this would lead to higher interest rates and increase the international arbitrage opportunities. It would also entail large carry costs since interest on government paper used for sterilization typically exceeds the rate that could be earned on reserves. Higher reserve requirements for banks may be used for this purpose, but these would raise intermediation costs and could push the borrowers towards foreign creditors, and/or encourage foreign banks to seek regulatory arbitrage by lending through their affiliates abroad.

To a certain extent traditional prudential regulations can help prevent excessive risk taking, credit creation and borrowing at times of economic expansion. Rules governing provisions, capital requirements, collateral valuation and other measures affecting conditions in credit and asset markets, such as margin requirements, could be employed in a counter-cyclical manner, tightened at times of boom and loosened during contractions.⁴⁸ However, there are limits to what such measures can do in checking excessive risk-taking and build up of fragility in

⁴⁶ In the United Kingdom the government combines the Golden Rule with a sustainable investment rule of keeping the national debt below 40 per cent of GDP; HM Treasury (2003: 6). In Japan there is a second budget alongside the central budget which provides for financing public investment programs, and only the spending financed by bonds issued to cover the central deficits is considered as deficit financing; UNCTAD TDR (1993: 78).

⁴⁷ See IMF (2004) which also gives arguments in favour of using such an approach, and tries to find a middle way.

⁴⁸ For a discussion of these measures see BIS (2001: chap VII), Ocampo (2003), and Akyüz (2004).

developing countries particularly when arbitrage opportunities are large and market perceptions are highly favourable. They thus need to be supplemented by direct and indirect controls over capital inflows of the kind extensively used in industrial countries in the postwar era until as recently as the 1980s. Taxes on capital inflows would be effective not only because they would reduce or eliminate arbitrage margins but also because they would facilitate counter-cyclical fiscal policy.

None of these may guarantee prevention of financial crises even in economies with good track records in macroeconomics and development. The policy response by most emerging market economies facing such situations has generally involved pro-cyclical fiscal and monetary tightening designed to restore market confidence, combined with IMF interventions to bailout international creditors and investors. However, this often failed to prevent financial meltdown, and in fact deepened crises. A more viable and equitable alternative, which would also facilitate counter-cyclical macroeconomic policies, would be to impose temporary debt standstills and suspension of capital account convertibility, as implemented successfully by Malaysia during the 1997-98 crisis.⁴⁹

A third key area of policy intervention concerns measures affecting the volume and composition of investment since macroeconomic stability as such would not be enough to secure a rapid pace of accumulation of productive capital. The kind of policies used for this purpose in more successful examples of industrial development has already been discussed. The space to use some of these policy measures has no doubt been narrowed down by global economic integration and multilateral rules and practices in trade and finance. Nevertheless, there is considerable space to influence the pace and pattern of capital accumulation. In particular taxes and certain financial instruments could still be effectively used to ensure that allocation of profits and credits favour productive investment rather than luxury consumption or unproductive forms of wealth accumulation. Furthermore, policies at sectoral levels may need to be so designed as to lessen the uncertainties associated with investment decisions.

⁴⁹ There is a large literature on crisis management and resolution. For an overview of the issues see Akyüz (2005b).

There can be little doubt that such policies at the national level would need to be supported by international policies. In this respect the task falls on multilateral financial arrangements and institutions, notably the IMF. So far the intensive policy surveillance by the Fund has not succeeded to prevent boom-bust cycles in capital flows to developing countries. The standard policy measures recommended by the Fund to prevent unsustainable surges in capital inflows and exchange rate appreciations are not only ineffective but they also entail large costs.⁵⁰ Since there is now increased consensus that crisis prevention calls for prevention of unsustainable booms and that full capital account convertibility is not an appropriate objective for most developing countries, a major task for the Fund is to help these countries to manage capital inflows. For this purpose it is necessary to specify circumstances in which the Fund should actually recommend the imposition or strengthening of capital controls over inflows. The Fund should also develop techniques and mechanisms designed to separate, to the extent possible, capital account from current account transactions, to distinguish among different types of capital flows from the point of view of their sustainability and economic impact, and to provide policy advice and technical assistance to countries at times when such measures are needed.

In the same vein the Fund should stop promoting procyclical policies in countries facing payments difficulties as a result of trade and financial shocks. For poorer developing countries facing export shortfalls, this would mean providing more current-account financing and demanding less adjustment. Many of these countries would also need considerably increased amounts of development finance, but this task should be undertaken by multilateral development banks rather than the IMF. For emerging market economies facing rapid exit of capital, the policy of combining procyclical macroeconomic tightening with bailouts is counter-productive not only because it deepens crises but also it creates moral hazard and leads to an inequitable distribution of costs of crises between debtors and creditors. Instead, the Fund should develop orderly debt workout mechanisms for crisis management and resolution, including temporary standstills and capital account restrictions, and provide international liquidity not to bailout creditors but to support imports and economic activity in the countries concerned.

⁵⁰ For a detailed discussion of the issues taken up in this section see Akyüz (2005b).

While global economic and financial conditions affecting developing countries are shaped primarily by policies in the major industrial countries, the IMF surveillance over these countries has lost its meaning with their graduation from the Fund and the breakdown of the Bretton Woods arrangements for exchange rates. Initiatives taken at various occasions to achieve greater coordination and coherence of macroeconomic policies among the United States, the European Union and Japan have not been successful in removing trade imbalances and bringing about a more stable system of payments and exchange rates. There are serious political difficulties in strengthening the IMF surveillance over the policies of these countries and making the Fund a symmetrical organization between its creditors and debtors, because of political leverage exercised by its major shareholders. Therefore, any reform seeking to secure greater international economic and financial stability would need to address not only the policies and operational modalities of the Fund, but also the shortcomings in its governance structure.

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Table 1: Investment and FDI flows

	Investment as per cent of GDP			FDI as per cent of GDP		
	1981-1990	1991-2000	2001-2004	1981-1990	1991-2000	2001-2004
World	23.8	22.7	21.4	0.67	1.73	1.91
Industrial Countries^a	22.8	22.0	20.3	0.75	1.60	1.74
Developing Countries^b	26.0	25.6	25.5	0.43	2.28	2.57

Source: IMF World Economic Outlook (various issues) and UNCTAD FDI database

a. Includes also newly industrialized Asian economies

b. Includes also countries in Central and Eastern Europe and Commonwealth of Independent States

Table 2: Investment and Growth in Developing Countries

	1981-1990	1991-2000	2001-2004
East Asia and Pacific			
Investment ^a	26.8	31.9	36.1
Growth ^b	7.3	7.7	7.2
South Asia			
Investment ^a	20.2	21.6	23.1
Growth ^b	5.6	5.2	5.9
Latin America and Caribbean			
Investment ^a	20.2	20.0	18.3
Growth ^b	1.1	3.3	1.7
Sub-Saharan Africa			
Investment ^a	19.0	17.1	19.2
Growth ^b	1.6	2.3	3.3
Middle East and North Africa			
Investment ^a	25.5	20.5	21.7
Growth ^b	3.6	3.7	4.7
Europe and Central Asia			
Investment ^a	40.6	23.9	21.0
Growth ^b	1.8	-1.4	4.9

Source: WB (2005a)

a. Per cent of GDP

b. Per cent per annum

Table 3 : Gross Fixed Capital Formation, 1970-2004

	(Per cent of GDP)			
	1970-1980	1980-1990	1990-2000	2000-2004
Argentina	21.5	16.4	16.5	13.9
Bolivia	15.6	11.4	16.8	14.3
Brazil	32.4	25.5	21.8	20.0
Chile	15.4	15.1	20.9	21.1
China	28.2	28.9	32.6	40.9
Colombia	18.4	18.7	18.1	15.4
Cote d'Ivoire	34.1	23.6	13.8	9.6
Ecuador	37.0	30.5	24.0	22.9
Egypt	22.5	29.2	17.5	17.5
Ghana	21.6	16.0	27.5	24.3
India	17.9	19.3	21.0	22.4
Indonesia	-	20.7	23.7	20.4
Kenya	21.1	15.9	15.9	13.2
Korea	19.7	27.5	35.4	30.0
Malaysia	19.4	24.7	32.3	23.8
Mexico	20.4	18.0	18.8	20.3
Morocco	24.9	22.1	20.8	24.7
Nigeria	24.4	17.1	19.6	22.1
Pakistan	21.6	20.5	18.6	16.0
Peru	16.4	16.8	21.1	18.6
Philippines	16.9	18.8	19.7	18.2
Taiwan	19.0	18.8	22.2	19.2
Thailand	31.9	33.6	38.3	22.7
Turkey	15.2	18.6	24.1	18.1
Uruguay	15.5	13.4	13.9	10.5
Venezuela	31.6	25.4	22.0	19.3
Latin America	25.1	20.8	19.8	18.9
Asia	21.6	23.9	28.6	29.9
Asia excluding China	19.4	22.4	26.7	23.3
Sub-Saharan Africa	24.0	19.5	17.4	17.4

Source: Based on World Bank, World Development Indicators and Thomson Financial Datastream

Note: Figures for regions are weighted averages of the values of the countries listed, except for sub-Saharan Africa, where the average is for all countries of the region.

Table 4: Public Investment
(Per cent of GDP)

	1980-1990	1990-2000
Developing Countries	8.6	7.7
Latin America ^a	6.3	3.9
East Asia ^b	12.2	12.3
China	17.6	19.0

Source: UNCTAD TDR (2003)

a. Argentina, Brazil, Chile, Colombia, and Mexico.

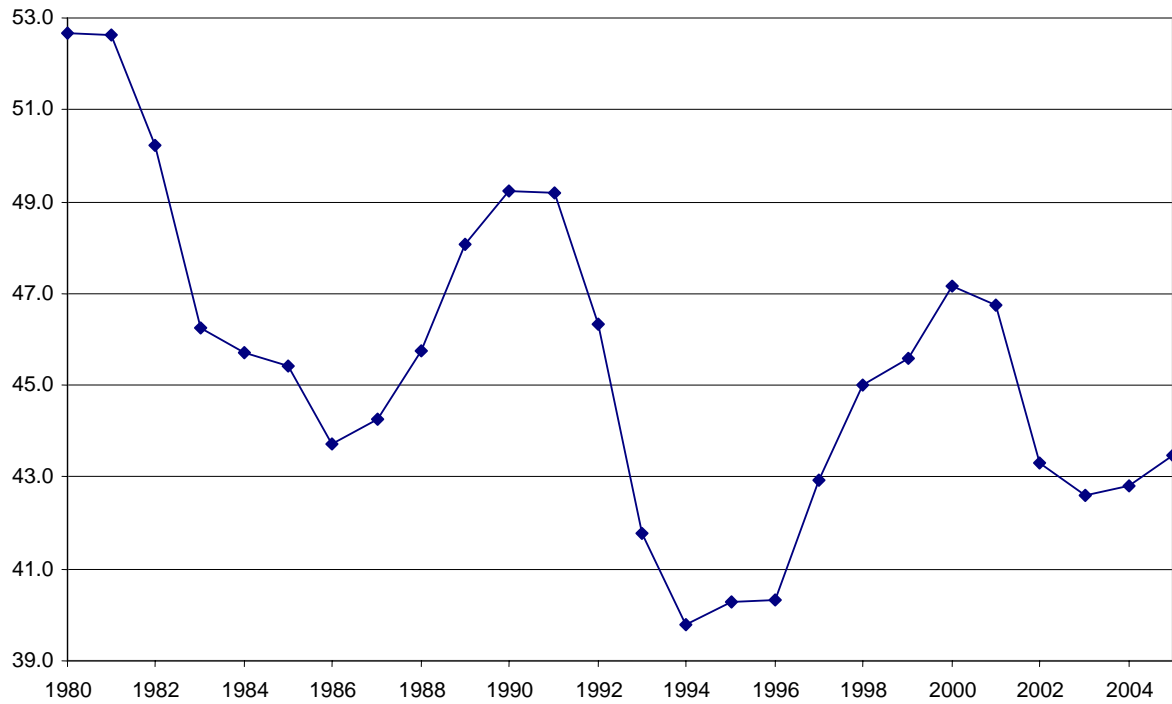
b. Indonesia, Malaysia, the Philippines, Korea and Thailand

**Table 5: Changes in FDI and Gross Fixed Capital Formation:
1990-2000 Compared to 1980-1990**
(Per cent of GDP)

	FDI	GFCF
Latin America and Caribbean		
Argentina	2.0	0.1
Bolivia	4.9	3.2
Brazil	1.3	-1.3
Chile	3.4	5.7
Colombia	0.9	0.5
Costa Rica	1.2	-1.4
Jamaica	3.8	6.6
Mexico	1.5	-0.8
Peru	2.6	-2.5
Uruguay	0.1	0.1
Venezuela	2.4	-2.6
South Asia		
Bangladesh	0.2	5.6
India	0.4	1.7
East Asia		
China	3.5	4.8
Hong Kong	4.4	2.5
Indonesia	0.3	1.7
Korea	0.5	4.2
Malaysia	3.0	5.5
Philippines	1.1	-0.7
Singapore	-0.4	-4.8
Thailand	1.0	4.8
Taiwan	0.2	0.8
Africa		
Cameroon	-0.9	-4.4
Côte d'Ivoire	1.6	-3.5
Egypt	-1.1	-7.3
Kenya	-0.1	-0.7
Mauritania	-0.6	-5.5
Mauritius	0.6	5.2
Morocco	1.2	-1.1
Senegal	1.0	3.5
South Africa	0.6	-6.7
Tunisia	0.9	-0.8
Zimbabwe	1.3	3.1

Source: UNCTAD TDR (2003)

Chart 1: Private Non-residential Investment as a percentage of Capital Income in the Business Sector



Source: OECD Economic Outlook (various issues).

Table 6 : Capital Accumulation and Income Concentration

	I ^a (1995-2000)	IC ^b (1995-2000)	ACR ^c (1995-2000)	ACR ^c (1980-1994)
Korea	27.4	39.3	69.7	52.7
Thailand	23.7	48.4	49.0	45.6
Indonesia	19.3	41.1	47.0	44.4
Malaysia	22.1	54.3	40.7	31.8
Turkey	18.8	47.7	39.4	21.6
Peru	18.4	51.2	36.0	28.7
India	15.5	46.1	33.7	28.1
Bangladesh	14.3	42.8	33.5	16.3
Morocco	14.6	46.6	31.4	28.9
Philippines	16.2	52.3	31.1	32.9
Egypt	12.1	39.0	31.0	18.7
Chile	18.3	61.0	30.1	24.6
Argentina	16.4	55.3	29.7	26.6
Mexico	16.6	57.4	28.9	22.4
Costa Rica	14.5	51.0	28.5	27.7
Tunisia	12.6	47.9	26.2	29.4
Brazil	16.1	64.1	25.1	26.0
Côte d'Ivoire	11.0	44.3	24.8	15.8
Kenya	11.8	51.2	23.0	16.6
Pakistan	9.1	41.1	22.1	18.4
Colombia	10.1	60.9	16.7	17.8
Venezuela	8.6	53.2	16.1	18.8
Ghana	4.9	46.7	10.5	10.4

Source: UNCTAD TDR (2003)

- a. Private investment as a percentage of GDP
b. Income concentration; share of the richest quintile of the population in total income.
c. Accumulation-concentration ratio; share of private investment in GDP expressed as a percentage of the share of the richest quintile of the population in total income.