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Developing Countries – even China – Cannot Rescue the World Economy

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Many analysts believe that developed countries will recover very slowly from the global economic crisis. Consequently, they have looked to the emerging economies of the developing world to help stabilize the world economy and generate a stronger recovery. Indeed, when the financial crisis first engulfed the rich countries in 2008 and early 2009, growth in developing economies was not affected as their banks and financial systems faced neither credit problems nor a more serious meltdown. It is true that some foreign investors, particularly institutional investors, withdrew their money from developing countries with large stock exchanges, setting off stock price declines and some currency devaluations. But this did not affect the "real" economy of production and employment. There was a wide belief that many developing economies were "decoupled" from the rich economies and could continue to grow and this growth would buoy the world economy. Even when output declined dramatically in the developed economies, reducing the demand for developing countries' exports, it was expected that growth in the larger emerging economies would not be significantly affected. This has been borne out by subsequent events. Growth in China has been 8-9 percent and in India about 6 percent in the first three quarters of 2009.

For developing countries to act as an engine of growth for the world economy as a whole over the next few years, growth in these countries must be sufficient to generate a large enough demand for the exports of industrialized countries such as to significantly boost output and employment in their export industries.[1] Developing countries are becoming more important in the world economy and the larger developing economies have the potential to become major players in the next decade or two. But their potential to stoke a world recovery is limited in the short run because of balance of payments (BOP) and fiscal limitations. Also, although developing countries as a group are important, no individual developing country is as yet very significant in the world economy. For reasons explained below, even China cannot be an engine of growth for the world economy.

Global economic recovery will have to depend on growth in the US and Europe. However, lending programs by the international financial institutions (IFIs), if properly designed to maximize spillover effects, could increase the potential for the developing countries to buoy the world economy.

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Importance of Developing Countries for the World Economy

Developing countries enjoy a rising share of the increase in the world's GDP. This share increased to 43.5 percent in 2006-2007 from 17 percent in the early 1990s.[2] While the share of all developing regions has risen, East Asia and Latin America fared best, accounting for 13 percent and 12 percent respectively of the increased world income in 2006-2007. Another trend is the rising importance of exports in the GDP of both developed and developing countries. For the developing countries the share of exports in GDP increased to 33 percent from 23 percent between 1990 and 2007 and for developed countries to 27 percent from 21 percent. More significant, perhaps, is that the share of world exports destined for markets in developing countries has increased to almost 28 percent from 23 percent over the same period; and more exports from both developed and developing countries are destined for markets in developing countries. Exports to developing countries are particularly important for the US and Japan among developed countries and for South Asia and Sub-Saharan Africa among developing regions. Among the large emerging economies, exports to developing countries are significant for Brazil, India and Russia.

Growth in developing countries as a group has the potential to bolster the world economy insofar as these countries provide a significant portion of current global growth and are important export destinations. When a calculation is made of the potential impact created by a stimulus package in different countries on the incomes of other countries, we find that the effect of a stimulus in the developing countries is much larger than the effect of the stimulus in the developed countries for the US and equal for Japan. This is because more of the exports of the US and Japan are destined for markets in developing countries than is the case for Europe.[3] Among developing countries, however, the multiplier for stimulus in developing countries is much smaller for countries in East Asia and Latin America than for countries in South Asia and Sub-Saharan Africa, so the former regions derive smaller benefits from expansionary policies in other developing countries than would South Asia and Sub-Saharan Africa. Among the larger developing economies, China and South Africa do not benefit much from expansionary policies in developing countries as more of their exports go to markets in developed countries.

Realizing the Potential of the Developing Economies

Two important issues need to be tackled if the developing countries' potential as drivers of substantial new growth in the world economy is to be realized. The first issue is how to utilize the potential presented by developing countries as a group, even though individual countries are not very significant. The second issue is that few developing countries are expected to grow rapidly because of BOP and fiscal problems, and these problems must be resolved so that more developing countries can raise their rate of growth.

While the entire group of developing countries has a substantial influence on the world economy, few individual countries have a large impact. For instance, exports to the whole of developing East Asia, including China, account for only about 8 percent of US exports. Although exports to Latin America account for over 20 percent of US exports, only Mexico is significant as it takes in more than half of these; and since many of these exports are returned as re-exports into the US, these exports essentially depend on demand in the US economy and cannot on their own generate increased demand in the US economy. Exports to developing countries are important only for Japan; but these are almost entirely to East Asia, which takes in about one-quarter of Japan's exports. The share of Europe's exports destined to markets in developing countries is small, so that growth in developing countries provides only a limited stimulus to European exports and growth.

With only limited exceptions, few developing countries are expected to grow because of the impact of the crisis on their economies. The situation in most Sub-Saharan Africa countries is precarious. Their good performance in the pre-crisis years was caused by healthy commodity prices, but these prices have tumbled in the recession and are expected to remain low for some time. Similarly, growth prospects for much of Latin America are poor. Most of the developing countries that are expected to do well are in East and South Asia. The growth rate in these regions is projected at 6 percent for 2009 and even higher for 2010.

Budgetary and balance of payments problems limit the ability of many developing economies to implement expansionary monetary and fiscal policies that could improve their potential for fostering growth of the world economy. This is the case even in South Asia. Pakistan has been following restrictive monetary and fiscal policies to rein in inflation. In Bangladesh, programs have been expanded to protect the vulnerable population but other expenditures have been cut back to avoid creating a fiscal imbalance so the effect is little net stimulus. Even India's fiscal stimulus is small compared to China's because the budget already has a large deficit. Many developing countries that have responded to the crisis by trying to boost exports have done so largely by providing easier credit to exporters.

The Role of International Lending Programs

The question, therefore, is how to utilize the potential of developing countries as a group since individual developing countries have limited impact. This potential can be exploited by changes in the manner in which the International Monetary Fund (IMF) and World Bank operate their lending programs. It is important that the IFIs go beyond their usual country-by-country lending approach. This approach was seen to be flawed during the Asian financial crisis of 1997-98. Conditions attached to the loans extended by the IMF program for each individual country did not take into account the effect of that country's program on the economy of its neighbours. For instance, the IMF program in Thailand reduced demand for exports from neighbouring countries and this was ignored in the programs for the neighbouring countries. Consequently the total decline in demand was larger than anticipated. The spillover effect was ignored by individual countries and the IFIs. Now this spillover effect – whereby increased demand in one country raises demand in other countries – can be used to re-energize the regional economies.

Normally, an individual country planning a stimulus package would not take into account the beneficial effect on other countries. Furthermore, it would be concerned that the increased imports following higher incomes in the country in response to its stimulus package would create a BOP deficit, and so the government would be inclined to limit the size of its stimulus package to its ability to manage the resulting BOP deficit. However, if other countries were also implementing stimulus packages, then their incomes would be increasing and their imports from this country would increase so that the country would not face a BOP problem. In other words, each country would find that demand for its exports would rise because of stimulus packages in other countries and this would balance the increase in imports following its own stimulus package. Consequently, an integrated lending program covering a number of countries would have a larger expansionary effect than lending to individual countries.

China, Other Emerging Economies and the World Economy

Even the largest developing economies – those customarily labeled emerging economies – cannot play an important role in the revival of the world economy. For instance, the shares of Brazil, India, Mexico and Russia are each only about 2 percent of world income and South Africa's share is 0.5 percent, and their share of exports from the developed countries is quite small. The stimulus packages in most are about 1 percent of GDP so that they would add only about a few hundredths of one percent to world demand. The only emerging economy that could perhaps be important is China which has about 6 percent of world income and takes in about 10 percent of the world's exports. Even China's influence is limited as the following paragraph shows.

The US economy's share of world income is 25 percent at official exchange rates and household consumption is 70 percent of US GDP, making US household consumption about 17.5 percent of world demand. On the other hand, China's GDP is about 6 percent of world GDP and household consumption in China, which has been falling, is only about one-third of its GDP or about 2 percent of world demand. If the household savings rate in the US rises by 5 percent, it would reduce world demand by 1.25 percent. For Chinese consumers to compensate for this decline, household consumption in China would have to increase by more than 50 percent. The most important factor in household savings is the age structure of the population and this is not amenable to policy action especially in the short run.

The propensity to consume has increased in East Asian economies over time; the increase, however, has been only about 10 percent of GDP over two to three decades. Another way to look at the impact of changes in the Chinese economy is to look at the problem from the balance of payments view. The current account surplus in China is about 10 percent of its GDP. Halving it would add 5 percent of China's GDP to world demand. This would add 0.3 percent to world demand, obviously not enough to revive the world economy.

Conclusion

As yet, the world's developing countries are individually too small for a higher level of economic activity in these economies to have a substantial effect on the global economy. Recovery from the current recession is therefore going to rely largely on increased economic activity in Europe and the US. Developing economies are, however, becoming more important and will have a larger influence in the future. Even now, developing countries could help the world economy recover better from the current recessionary situation if the IFIs lent to groups of countries to maximize spillover effects within each region rather than following the traditional country-by-country approach. Such integrated lending programs could help to buoy the world economy.

Endnotes

1. The term "developing countries" used here are those low and middle income countries defined as such by the World Bank. The Bank groups these countries into six regions: East Asia and Pacific, Europe and Central Asia, Latin America and Caribbean, Middle East and North Africa, South Asia and Sub-Saharan Africa. See W*orld Development Indicators, 2009.* The term "emerging economies" generally refers to the larger developing economies, such as Brazil, China, India, Mexico, Russia, South Africa, South Korea and Turkey.

2. All the data in this paper are from various issues of the World Bank's annual *World Development Indicators.*

3. In this exercise, we divided the world into developed countries – which were further sub-divided into the US, Europe, Japan and other – and into developing countries and we further looked at the effects of stimuli in East Asia and Pacific, Latin America and the Caribbean, South Asia and Sub-Saharan Africa. A stimulus package in any region increases income in that region and in that region's imports. These increased imports are the higher exports from different regions and so would raise income in the different regions. So we can examine the effect of a stimulus in any region or country on the income of any other region or country.

Who We Are

The Centre for International Governance Innovation is an independent, non-partisan think tank that addresses international governance challenges. Led by a group of experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate, builds capacity, and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events, and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI conducts in-depth research and engages experts and partners worldwide from its extensive networks to craft policy proposals and recommendations that promote change in international public policy. Current research interests focus on international economic and financial governance both for the long-term and in the wake of the 2008-2009 financial crisis; the role of the G20 and the newly emerging powers in the evolution of global diplomacy; Africa and climate change, and other issues related to food and human security.

CIGI was founded in 2002 by Jim Balsillie, co-CEO of RIM (Research In Motion), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario. CIGI gratefully acknowledges the contribution of the Government of Canada to its endowment fund.

Le CIGI a été fondé en 2002 par Jim Balsillie, co-chef de la direction de RIM (Research In Motion). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario. Le CIGI exprime sa reconnaissance envers le gouvernment du Canada pour sa contribution à son Fonds de dotation.

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