THE TIMES OF INDIA

Friday, July 16, 2010

# A REVERSAL OF FORTUNES

## The story of the global economic crisis is full of surprises and ironies

Deepak Nayyar

The financial crisis, which surfaced in the United States in September 2008, spread through contagion almost like a forest fire across the world. Its transmission to the real sectors of economies was rapid. Output and employment experienced a sharp contraction. The downturn moved quickly into a recession. It is clear that this Great Recession is the deepest crisis in capitalism since the Great Depression more than 75 years ago. There is, however, an important difference. Developing countries, which were marginal then, are much more significant in the world economy now.

It is just about 21 months, not quite two years, since the crisis surfaced. And outcomes provide a real surprise. Indeed, not many would have predicted the story that has unfolded.

Most industrialized countries are still in the Great Recession. Unemployment levels are high and recovery is uncertain. The persistence of the recession in the United States and the European Union is common knowledge. The impact of the enormous fiscal stimulus is, at best, modest. Much of it was used to recapitalize banks where greed followed by fear created the crisis. However, the financial sector used these scarce resources to rescue their balance sheets, create asset bubbles, and reward itself with bonuses, rather than lend to the manufacturing sector which

would have revived output and employment. But that is not all. Some market economies in the European Union, described as PIGS (Portugal, Ireland, Greece and Spain), as also some transition economies in Eastern Europe, and are in deep trouble. These countries have weak external balance sheets (large external debts relative to foreign exchange reserves) and/or traditional domestic financial vulnerabilities ( a previous boom in private sector foreign borrowing followed by a credit squeeze).
Similarly, many of the high-income emerging economies, success stories until not so long ago, remain adversely affected. South Korea, Taiwan, Hong Kong and Singapore, as also Mexico and Turkey, which were highly dependent on US and EU markets for their manufactured exports, are hard hit.

In sharp contrast, significant parts of the developing world have fared much better in terms of both resilience and recovery. Everybody recognizes that three emerging economies - China, India and Brazil - have weathered the storm and registered rapid growth. But most are not aware that there are several other countries in the developing world, large and small, which have turned out good economic performances in the aftermath of the crisis. Argentina, Egypt, South Africa, Bangladesh and Vietnam, among others, provide examples. Apart from these countries, surprisingly enough, some regions in the developing world, such as North Africa, South Asia and East Asia, as also Sub-Saharan Africa, have turned out performances that range from good to fair.

How can we explain the resilience of these economies in the developing world? It is not as if they were immune from the crisis in the world economy. The impact on some sectors of these economies, particularly those that were export dependent, was devastating in the short run. Yet, in retrospect, they turned out to be exceptions.

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

Their economic recovery was also significantly faster for three reasons. First, these countries adopted expansionary, counter-cyclical, macroeconomic policies, which were almost Keynesian and most unusual, until now, in the developing world. The existing macroeconomic situation and the presence of State financial institutions made the task easier. Second, the size of the home market made a difference. The increase in aggregate demand came, in significant part, from segments of the population with a high propensity to consume, which was transmitted to the real sector of the economy. Thus, domestic consumption drove recovery and sustained growth. Third, their financial sectors, which were less fragile and more regulated than elsewhere, did not absorb scarce resources from stimulus packages in recapitalization or bail-outs, so that easier monetary policies meant lending for investment to the real sector in these economies rather than the creation of financial asset bubbles.

The aftermath of this global economic crisis, as compared with earlier crises, reveals a striking reversal of fortunes. Developing countries that fared worse in the past have performed much better, whereas industrialized countries that might have been expected to do better have fared much worse. What is more, for decades, rich countries lectured poor countries: "do as we say, get policies right". This time around, it will the emerging economies that will be doing the teaching to their industrialized counterparts. The irony is striking.

*The writer is Professor of Economics, Jawaharlal Nehru University, New Delhi.*