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WHAT PROSPECTS FOR AN ALTERNATIVE VISION OF SUSTAINABLE ECONOMIC ACTIVITY?

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George Allen, employed as economic advisor to Lloyd George in 1930, consulted many economists and financiers about practical proposals to raise British growth and reduce soaring unemployment. Almost everyone he consulted agreed that:

(1) Britain should not “abandon” the Gold Standard; and

(2) “the competitive strength of British industry in the world’s markets, and ultimately a satisfactory level of employment, could best be restored by a *general reduction in wage rates*” – the only question being how this was done.

Most also agreed on:

(3) the need for “a steep reduction in public expenditure”. (One of the few dissenters was a Cambridge-based economist named Mr Keynes, whose main proposal was for a tariff on imports – rejected by everyone else.)

The other side of this prevailing consensus was the conviction on the part of politicians and civil servants that they could not effectively manage the economy or “put the world to rights”. As Allen commented, looking back from 1975, “They belonged to a breed that produced the senior civil servant who expressed his disapproval for unseemly enthusiasm by saying to me, ‘If I leave the office on Saturday feeling confident that in the past week I have done no harm, then I am well content’”.¹

At the World Economic Conference of 1933, held in London, the British government tried to get much the same agenda endorsed by the participating countries, including, as a top priority, free capital movement. But already the tide was turning. Newly elected President Roosevelt came out against the British

¹ G.C. Allen, “Advice from economists – forty-five years ago”, *Three Banks Review*, 106, June 1975, 35-50, emphasis added. Compare the attitude of East Asian policy makers, in Robert Wade, *Governing the Market*, Princeton University Press, 2004.

agenda when he excoriated “the fetishes of so-called international bankers”. The New Dealers began to roll out their state-sponsored programs, US public expenditure went up, and the economists around Keynes and Joan Robinson at Cambridge University slowly formulated – like flatworms moving towards the light, Robinson was later to say -- a theory which explained why cutting wages and public expenditure in a recession might not be a good idea – the theory presented in *The General Theory* in 1936.

One can suppose that had Allen consulted the same people in 1938, or in 1950 or 1960, many of them would by then have changed their minds. As J.K. Galbraith said, “the conventional wisdom” gives way not so much to new ideas as to “the massive onslaught of circumstances with which [it] cannot contend”.²

But what is chilling is that for all the new thinking and the increase in public spending, the Great Depression ground on for year after year through the 1930s. In the US, government spending rose from about 10% of GDP in 1929 to 15% by 1934 (while GDP fell by 25% between these dates), and stayed at around 15% till 1940. Unemployment shot up from 4% in 1929 to 25% in 1933 and remained about 18% or higher till 1940 (including those on public relief work as unemployed). What brought unemployment abruptly down, to reach as low as 2% by 1943, was the explosion of government spending from 15% of GDP in 1940 to 48% in 1943 – thanks to the Second World War. The Obama stimulus package is about 5% of US GDP, similar to the size of the 1930s one.

These events from the 1930s are worth keeping in mind when considering the current Global Slump. The Geneva Workshop of the Policy Responses to Unfettered Finance (PRUF) Project is to examine the impact of the global crisis on low-income countries and consider “what should be done” to improve their development prospects, nationally and internationally. The present paper discusses some questions which are “upstream” of these ones. The great danger of “what should be done” discussions is that they remain unanchored in a forensic analysis of the causes of the situation against which the “should” is measured, and unconcerned with the difference between “what should be done” and “what can be done”.

The paper first discusses whether the Washington Consensus – the core set of consensual development policy prescriptions for the past 25 years -- is “dead”, as the G20 political leaders announced in April 2009 and as several development economists have declared. The answer matters to the governments of low income countries, because it will help them understand the broader set of ideas from which the specific policy prescriptions advocated by the multilateral development organizations and bilateral donors derive. Anyone hoping for fresh thinking from the multilateral organizations and the G7 countries has to take account of the remarkable ability of the ur-ideas behind the Washington Consensus – about the virtues of markets and the stupidities of governments – to

² J.K. Galbraith, *The Affluent Society*, London: Penguin, 1999, 17.

penetrate into every nook and cranny of thought and to resist empirical evidence except at the outer margins, and to replicate themselves in the minds of incoming students and policy makers around the world. That is one of the lessons of the George Allen story.

Second, the paper discusses how long the global slump is likely to last. In particular, it queries the now frequently heard argument that we are, as of May 2009, at “the beginning of the end”, as “green shoots of recovery” appear all around. The answer to how long the global slump is likely to last sets the magnitude of the adjustments facing governments of low income countries, because for all the talk of growth in developing countries becoming “decoupled” from growth in the North, the reality remains that growth in most of the South is still closely dependent on growth in the North. The answer also matters for the likelihood of significant reforms of the global financial architecture. The shorter the global recession lasts, the lower the chances of significant reforms, other things being equal. In a recent cartoon, two CEOs sat looking at a chart of plunging GDP, and one said to the other, “We have to hope that things turn around before there’s time for any lessons to be learnt”.

Third, the paper briefly overviews the impacts – to date, and to end 2009 – on developing countries.

These issues pave the way for subsequent discussion of new development agendas; and the effects of reform proposals being considered in the West on development prospects in the low income parts of the world. My conclusion is that leaders in low-income countries should prepare for a global recession lasting several years, with slow growth in most of their export markets and slow if any growth of remittances, foreign investment or aid. But at the same time, there will be sustained pressure for significant reforms in the North, and new global governance fora like the G20 have the potential (no more than potential) to give developing country governments more of a role in the shaping of global reforms.

I. IS THE WASHINGTON CONSENSUS DEAD?

The Washington Consensus, as crystallized out by John Williamson around 1990, endorsed macroeconomic propositions about the virtues of macroeconomic stability and microeconomic propositions about the virtues of free markets and private property. Later, others added other desiderata, including free capital mobility and the rule of law and “good governance” more generally. The ideas of the Washington Consensus (or globalization consensus, or neoliberal consensus – these phrases are used interchangeably) were transmitted into policies and institutions around the world not only through graduate education in economics and through publications like the World Bank’s *World Development Reports*, but also through the conditions on access to multilateral resources.

How would we know whether the Washington Consensus is “dead”? By what measures of consensus? The measures have to include both what people say and write and also the criteria of the operating procedures of organizations able to confer resources or market access on others, like the World Bank and IMF.

The Washington Consensus and surveys of economists’ opinions

Surveys of economists’ opinions show that western economists in general, and American economists especially, from at least the early 1980s onwards, have shown a strong consensus on both positive and normative propositions about the effects of economic openness – and specifically, consensus on the desirability of free trade policy for all countries, developed and developing, and the desirability of floating exchange rates and more or less free capital mobility.

For example, a survey of economists in five industrial countries around 1980 (America and four continental European countries) presented them with about 30 positive and normative propositions about the economy, and asked them to “agree”, “agree with qualifications”, “disagree”. Overall, they agreed most with the proposition, “Tariffs and import controls lower economic welfare”. 55% of them said “agree”, more than for any other proposition. *Of the Americans, 79% said “agree”*. Of the French at the other end, only 27% said “agree”. In general, American economists showed high consensus on microeconomic propositions about openness, privatization, and the like, and less consensus on propositions about macroeconomic stability (because by 1980 Keynesian propositions were coming under stronger attack from Friedman-style monetarism). The continental European economists in 1980 were somewhat less wedded to free market propositions than the Americans, the French least of all. Later surveys of American economists, one in 1990, another in 2000, showed continuing high consensus around positive and normative propositions about openness.³ For example, *about the same high proportion of US economists said “agree” to the above proposition about tariffs and import controls in 2000 as in 1980*.

If we can take the results of the 2000 survey of American economists’ opinions as a guide, reports of the death of the Washington Consensus are greatly exaggerated.

³ See Bruno Frey, W. Pommerehne, F. Schneider, and G. Gilbert, "Consensus and Dissensus among Economists: An Empirical Inquiry," *American Economic Review*, 74 (1984), 986-94; and Dan Fuller and Doris Geide-Stevenson, "Consensus among economists: revisited", *J. of Economic Education*, Fall 2003, 369-87.

The Washington Consensus and the conditions of access to multilateral resources

The World Bank and the IMF hard-wired strong liberalizing and privatizing conditionality into their loans to developing countries. For example, in 1996-97, the IMF targeted Ethiopia – of all poor countries, of no interest to international investors – and twisted the government’s arm to make it open its capital account and to establish a Treasury bill market, partly to signal to the rest of Sub-saharan Africa that *everyone* should liberalize the financial sector. The IMF refused to extend Ethiopia’s eligibility for Extended Structural Adjustment concessional finance, although Ethiopia had met all the other Fund conditions; and the Fund’s refusal cut Ethiopia off from other concessional funds, such as World Bank IDA funds and Paris Club concessions. Then the East Asian crisis hit, and despite the energetically-promulgated consensus that the crisis was due to cronyism or state intervention in the crisis-affected countries -- and not to fragility induced by open capital accounts -- the Fund backed off demanding that Ethiopia and other African countries open their capital accounts.⁴

Starting in the 1990s the World Bank adopted a Country Policy and Institutional Assessment (CPIA) formula by which borrowing countries were scored – by Bank staff and other experts – according to the “pro-developmental” impact of their policies and institutions. The score counted heavily in the allocation of International Development Association (IDA) loans for the Bank’s low-income borrowing countries, and also affected Bank lending to middle-income countries. The scoring criteria for the economic dimensions reflect the Washington Consensus. For example, a country could get the top score on its trade regime only if it had a virtually free trade regime – with maximum tariff under 15%, a low average tariff, negligible quantitative restrictions, and no export subsidies or taxes.

Also in the 1990s the Bank adopted a “global pension policy” which encouraged developing countries to switch from pay-as-you-go systems -- current taxpayers pay current pensions -- to a pension fund system, in which individuals pay contributions to a fund of their choice while working and at retirement receive a pension related to the performance of the fund’s investments.⁵ The Bank was especially keen on this switch as part of a larger strategy to build a particular type of capitalism in developing countries, one with open capital markets as the pivot. Individuals would pay into one or other of the funds; governments would privatize state-owned enterprises and float the shares on the national stock market; the funds would invest in both foreign shares and local shares – so the supply of shares of newly privatized companies would be matched by a demand for shares coming from the pension funds in a virtuous circle. The Bank even pushed for mandatory, defined contribution pension funds in

⁴ Robert Wade, “Capital and revenge: the IMF and Ethiopia”, *Challenge*, Sep/Oct 2001, 67-75.

⁵ Mitchell Orenstein, “The new pension reform as global policy”, *Global Social Policy*, 5 (2), 2005, 175-202.

countries like Kazakhstan, which had hardly any trained accountants and where each of the dominant clans established their own fund, which the clan leaders proceeded to treat as their personal income.⁶

The Washington Consensus, globalization, and the US primacy project

By 2004, “Washington Consensus” and “globalization” were buzzing loudly, and in that year Martin Wolf, doyen of *The Financial Times*, published a globalization manifesto called *Why Globalization Works*. Wolf argued, first, that the world’s people had the opportunity to make huge advances in material well-being by pushing on with economic integration between states, a process which, he said, had barely begun.

“The failure of our world is not that there is too much globalization, but that there is too little. *The potential for greater economic integration is barely tapped*. We need more global markets, if we want to raise the living standards of the poor of the world”.

Indeed, he held up the United States as the model for the world – a globalized world where national governments have no more influence on transactions across their borders or on domestic political economy arrangements than do the governments of the states of the United States.

Wolf argued, second, that this opportunity for huge advances in material well-being was under threat by “anti-globalists”. In the face of this threat,

“Social democrats, classical liberals and democratic conservatives should unite to preserve and improve the liberal economy against *the enemies mustering both outside and inside the gates*. That is the central argument of this book”.⁷

Wolf’s sentiments echo those of American geopolitical strategists defending America’s high-minded mission to reshape the world in its image, including its image of its own political economy. As recently as 2008 foreign minister Condoleezza Rice reiterated what she called “a uniquely American realism” that teaches “*it is America’s job to change the world, and in its own image*”.⁸

⁶ Lutz Hoffmann, et al., *Kazakhstan 1993-2000: Independent Advisors and the IMF*, New York: Physica-Verlag, 2001.

⁷ Martin Wolf, *Why Globalization Works*, Yale University Press, 2004, 4, emphases added.

⁸ Condoleezza Rice, “Rethinking the national interest”, *Foreign Affairs*, July/August, 2008, emphasis added. On mechanisms of US influence in the World Bank, see Robert Wade, “US hegemony and the World Bank: the fight over people and ideas”, *Review of International Political Economy*, 9, 2, 201-229.

Conclusion: Is the Washington Consensus dead?

All this is to urge caution about accepting at face value the declaration of politicians and development economists that the Washington Consensus is anything like dead. We will have to wait to the survey of 2010 to see to what extent American economists have changed their minds about the virtues of maximum economic openness, and other such ideas. We would also have to know to what extent organizations like the World Bank have changed their advice (eg on pension reform), their conditionalities, and their lending criteria (specifically, the Country Policy and Institutional Assessment formula).

But the omens are not good from the perspective of those hoping for a more than cosmetic rethink of the Washington Consensus. For example, the UK finance minister wrote to participants at the G20 finance ministers' meeting in mid March 2009 to say that "Open, innovative financial markets are critical in driving forward economic growth.... Our second objective, therefore must be to retain and build on the benefits that open financial markets bring to the world economy"⁹ – an echo of the British government's agenda at the World Economic Conference of 1933.

Again, the IMF's latest research paper on capital account liberalization substantially backs away from an earlier research paper which reported little evidence for favourable effects on economic growth and good evidence for increased consumption volatility. The new paper admits, "There is still little robust evidence of the growth benefits of broad capital account liberalization". But it goes on to claim large *indirect* benefits. "The indirect benefits of financial globalization on financial sector development, institutions, governance and macroeconomic stability are likely to be of far more importance than any direct impact via capital accumulation or portfolio diversification". (The paper gives little weight to negative effects of foreign savings substituting for domestic savings, or increased danger of financial instability caused by surges in or out.)¹⁰ Given the IMF's long history of policy-based evidence making,¹¹ one has to wonder whether this latest paper – with its emphasis on the large size of elusive indirect benefits – is part of the same tradition; and whether the paper signals a movement within the IMF and the US and UK governments to seize the crisis as an opportunity to resume the push for full capital account liberalization across the world (as the UK finance minister's statement to the G20 suggests).¹²

⁹ Quoted in "Overhaul of international institutions: is the G20 willing to deliver?", *Bretton Woods Update*, Jan/Feb 2009, 1.

¹⁰ M. Ayhan Kose, E. Prasad, K. Rogoff, S.J. Wei, "Financial globalization – a reappraisal", IMF Staff Papers, 56, 2009, 8-62. The quotes are from the abstract. The earlier paper was E. Prasad, K. Rogoff, S.J. Wei and M. Ayhan Kose, "Effects of financial globalization on developing countries", IMF Occasional Paper 220, 2003.

¹¹ See Independent Evaluation Office, #####

¹² Robert Wade, "The gathering world slump and the battle over capital controls", *New Left Review*, 231, Sep-Oct 1998, 13-42.

What this means is that the governments of developing countries should not expect much rethinking of core development prescriptions coming from the multilateral development organizations or most of the bilateral donors. But the global crisis has probably shaken the certitude in these prescriptions, and developing country governments may therefore have more opportunity than before to assert their own strategies without being cut out of resources.

II. HOW LONG IS THE GREAT RECESSION LIKELY TO LAST?

The longer the global recession drags on, the more impeded is the development of low income countries; but the better the prospects of significant reforms to global financial architecture, and for a rethinking of the Washington Consensus.

The optimists' story

Since the latter part of the first quarter of 2009 the upturn in a number of indicators and in a number of regions, including the US and Asia, has prompted relieved talk of “green shoots of recovery”. Optimists expect that Asia, North America, and much of Europe will resume positive economic growth by early 2010 or before. The optimists tend to place their faith in statistical models of business cycles, and to assume that this recession is a fairly ordinary recession like the western world has seen many times in the past several decades, but a bit worse.

Many who take this line also hope that recovery will come before any significant financial “reforms” are made of a kind that would place more constraints on financial actors. They are hoping for a repeat of what happened after the East Asian crisis (1997-99). While that crisis was under way alarmed western governments talked about the need for a much stronger layer of supranational authority in financial markets, even of reforms of similar magnitude to those initiated at the Bretton Woods conference in 1944. Once it became clear that the crisis would not ricochet out of the periphery into the core – once it became clear that the East Asian crisis did not constitute a “massive onslaught of circumstances” for westerners -- the talk moderated, and instead we got the Financial Stability Forum, the G20 meeting of finance ministers, and a host of standards of best practice in banking supervision, risk-management systems, financial accounting, and corporate governance -- compliance with which was, of course, voluntary.¹³

Already, there is growing optimism on Wall St that the mildness of the Treasury's conditions on the gigantic bailouts means that the US government has no intention of undertaking reforms in the financial system in exchange for the

¹³ Robert Wade, “A new global financial architecture?”, *New Left Review*, 46, July-Aug 2007, 113-129. Jakob Vestergaard, *Discipline in the International Economy?*, Routledge, 2009.

bailouts. A lawyer described by The New York Times as a “Wall Street eminence grise” assured an audience in May 2009 that the future of Wall Street would be little different from its recent past, because “I am far from convinced there was something inherently wrong with the system”.¹⁴

In the UK, a journalist for The Guardian reported recently that “A newly emboldened City is already pushing back at attempts at reform”.¹⁵ City firms are already beginning to recruit traders with offers of salaries as long as telephone numbers. A future Conservative government in Britain will make sure that the City is regulated no more than Wall Street.¹⁶

The material incentives for optimism

It is understandable why representatives of the financial industry devoutly hope that recovery will come before any significant constraints are imposed (of a kind difficult to bore loopholes through). A high proportion of the top 1% in the US income distribution is based in finance, and the top 1% has accrued gigantic gains over the past 30 years. Its share in US household income distribution increased from about 10% in 1980 to 23% in 2004 (including realised capital gains) – an upwards redistribution made possible by the Reagan/Thatcher model of the liberal capitalist economy. Its income increased in real terms (2006 dollars) by 3.2 times between 1973 and 2006, while the average income of the bottom 90% fell in real terms. (In the two decades before 1973 the income of the bottom 90% grew twice as fast as that of the top 1%.) *During the Clinton government the top 1% captured 45% of the total growth in pre-tax household income, and during the Bush government it captured 73%!¹⁷* From the perspective of households in the top 1%, the political economy arrangements – including the organization of the financial sector – which enabled this upwards redistribution are to be strongly defended.

¹⁴ Paul Krugman, “Stressing the positive”, *International Herald Tribune*, 9-10 May 2009.

¹⁵ Dan Roberts, “Return of the bankers’ bet”, *Guardian*, 16 May 2009.

¹⁶ Anatole Kaletsky, economic guru for *The Times*, is one of the cheerleaders for quick recovery. British banks have stabilized, the British housing market has stabilized, consumer confidence indicators are rising, interest rates are practically zero, he says (BBC Radio 4 Today program, 25 May 2009). He skates lightly over the problem that Britain’s exports have collapsed because of the state of the rest of the world. His bias to optimism, combined with lurches to the opposite extreme, give his predictions the reliability of a drunkard’s walk. The following quotes are from his *Times* columns in 2008. 14 January: “I believe that the global credit crisis, far from taking a turn for the worse, is now almost over”. 21 March: “I feel equally confident... that the banking cycle is now at, or very near, its nadir and that conditions in America will soon start improving”. 12 June: “The credit crunch is no longer a big threat to the world financial system”. 8 September: Last night’s announcement [Treasury rescue of Fannie Mae and Freddie Mac] was unqualified goods news... A US economic recovery is now assured”. 16 September: “The prophets of doom may have been right after all... We are now unquestionably in the worst financial crisis since the Great Depression”. 20 September: “Fears of bank failures and financial panics should soon dissipate”. 25 September: “American capitalism is on the brink of disaster... [We are in] a global catastrophe...the death-spiral of financial values”.

¹⁷ Gabriel Palma, “The revenge of the market on the rentiers: How neo-liberal reports on the end of history turned out to be premature”, *Cambridge Journal of Economics*, forthcoming, July 2009.

The realists' story

It is understandable why representatives of finance and the top 1% wish to talk up the green shoots of recovery, but they almost wilfully downplay the interlocking difficulties ahead. I argue that the world economy is in for several years of low global economic growth and high unemployment. If there is a silver lining to this cloud, it is that the longer the recession lasts the higher are the chances of serious reforms, as suggested by the comparison between the “onslaught of circumstances” in the west in the 1930s and 1940s, and the lack of onslaught of circumstances *in the West* in 1997-99.

Here in summary form are some of the events and trends which are interacting to prolong the Great Recession.¹⁸

- *In the US, unemployment is soaring, half of households have insufficient savings to sustain expenses for more than one month, and the rate of house foreclosure continues to rise*

A *Financial Times* report of mid May 2009 says, “A disaster of historic proportions is still unfolding in the US labour market, where the pace and depth of job losses already make this the worst recession in half a century”.¹⁹ Job losses have risen by over 500,000 in each of the past six months (to May), and well over 10% of the labor force is unemployed (using international rather than American definitions of unemployment). High unemployment puts downward pressure on the wages of those still in work. The labor market interacts with the housing market. As the number of houses being foreclosed continues to rise, house prices continue to fall and still more households are thrown into negative equity. Negative equity and falling house prices reduce the ability of people to move in search of jobs. Several recent polls have found that almost half of US householders say their savings are so small that they could cover their expenses for at most one month without a paycheck.²⁰

Rising unemployment, broken household balance sheets, and rising house foreclosure combine in a vicious circle to prolong the fragile state of the US financial system.

- *The US financial system is proving difficult to fix: Congress is blocking more funding for bank recapitalization and is opposed to bank nationalization*

¹⁸ See further, Robert Wade, “From global imbalances to global reorganizations of capitalism”, Cambridge Journal of Economics, July 2009.

¹⁹ Krishna Guha, “US should turn to Europe for help in caging serial jobs killer”, *Financial Times*, 19 May 2009.

²⁰ Jennifer Waters, “Financial fears grow”, *Market Watch*, 20 March 2009.

Recent reports say that the US government needs much more money to rescue the banks than it is currently authorized by Congress to spend for this purpose.²¹ The current bank rescue policies do not sufficiently recapitalize the banking system, and without a functioning banking system the US will not achieve sustainable growth. However, Congress is in no mood to approve more public funds for bank bailouts. And there is even less political support for the alternative solution -- nationalizing the big insolvent banks, whether openly or in the guise of taking them into receivership.

The US is likely to stumble on with its least-common-denominator “zombie bank” strategy, whereby by the big banks are recapitalized by enough to keep them solvent but not enough that they can expand lending while maintaining the thicker capital cushions which newly risk averse investors are demanding. This is a recipe for continued stagnation, *despite the fiscal stimulus*.

- *US public debt is out of control*

Public debt is out of control, as tax revenues collapse and public expenditure soars (for bank bailouts, stimulus plans, Detroit rescues, health care reform). Since Obama took office in January 2009 public debt has exploded from 8% to 13% of GDP! The federal budget deficit in fiscal year 2009 will probably be three to four times bigger than in the previous fiscal year, itself a record. As the deficit rises the cost of borrowing rises (as in the yield on 10 year Treasury bills). Still more borrowing is needed to pay the extra interest, which crowds out private investment, and makes the US more dependent on the willingness of foreign governments and investors to stuff themselves with US Treasury bills. There is a non-trivial risk of US debt default – or if not default, a severe devaluation of the dollar, which leaves investors almost as badly off.

- *The US stimulus package is unlikely to do more than slow the rate of decline up to end of 2009*

With household and firm balance sheets still in bad shape, only the public balance sheet can expand. Fiscal stimulus is crucial in order to get aggregate demand rising – and without it, very loose monetary policy may have little effect, as noted earlier. (As the saying goes, you can lead a horse to water – make very cheap credit available to banks -- but you can't make it drink – make the banks lend to households and firms whose ability to repay is in doubt.) But fiscal policy is not only an essential complement of monetary policy, it is in a tug-of-war with it – because the larger the fiscal deficit the higher are long-term interest rates as would-be buyers of long-term government debt become more jittery, even as central banks are trying to keep rates low.

²¹ Edward Luce, “Bank stress tests deepen headache for Obama”, *Financial Times*, 17 April 2009; “Capitol capital”, editorial, *Financial Times*, 17 April 2009.

The other big problem with fiscal stimulus is that any country implementing a large stimulus package which involves a steep increase in government spending (as distinct from just tax cuts) faces a big “absorption” problem.

The experience of European countries with the EU’s “structural” funds and the EU’s subsidies to the new member states shows clearly that it takes *years* to improve bureaucratic skills and procedures to the point where a large incremental of funds can be effectively spent. But years are what the US does not have; the Obama government wants urgent results. Most likely the outcome of the US stimulus package will be waste, corruption, unused funds, and a modest slowing of the rate of decline.

In other words, the stimulus package will be much less effective in reversing the decline than is generally thought.

- *China’s efforts to escape the “dollar trap” raise the chances of a dollar crash*

The four US propositions show why the US government has a strong distress demand for more foreign loans, particularly from the giant surplus country, China. US political leaders and experts are hoping and expecting that China, already the biggest foreign buyer of US Treasury bills and dollars, will continue to buy even more – and prevent a dollar crash. In 2008 China bought almost half of total foreign purchases of US Treasuries. It currently holds some \$1.5 trillion of USD-denominated assets (equivalent to about one third of China’s GDP), thanks to its giant export surpluses.

But Beijing is moving in the opposite direction as it tries to escape the “dollar trap”. The government is very worried about a sharp fall in the purchasing power of its enormous reserves.²² Its strategy for escaping the dollar trap is designed to reduce its dollar assets without triggering a mass sell off. First, it has cut back its purchases of US Treasuries (and then only short-term ones). Second, it is selling dollars and buying non-dollar assets, some of it secretly.²³ Third, it has informed other countries that they should be prepared to cooperate in the move away from the Dollar Standard and avoid an “every state for itself” struggle. China is particularly interested in securing cooperation from states in Latin America, Africa and Asia. Hence on the eve of the G20 summit meeting in early April 2009 Beijing sent out the message to the US and the world that the world should move away from the dollar as the international currency

²² Global Europe Anticipation Bulletin No. 34, 16 Apr 2009; Paul Krugman, “China’s dollar trap”, *New York Times*, 2 Apr 2009; Geof Dyer, “China’s dollar dilemma”, *Financial Times*, 23 February 2009.

²³ Brad Setser and Arpana Pandey, “China’s \$1.7 billion bet”, Council on Foreign Relations, Jan 2009; Rachel Zembra, “China’s resource buy”, *RGE Monitor*, 21 Feb 2009.

and to a new system based on a “super-sovereign reserve currency” such as the IMF’s Special Drawing Rights, comprised of a basket of several major currencies.

The upshot of China’s dollar escape strategy is that the US is finding it increasingly difficult to meet its growing demand for foreign loans. This raises the risk of the Fed printing dollars (by buying US Treasuries); or of a severe devaluation of the dollar; or of an outright default. Any of these outcomes would intensify the breakdown of the international monetary system.

- *Continental Europe is doing little to fix its financial system*

For all the faults in the American program, at least the American government is acting. European governments have done rather little. Germany probably has the worst banking problem in the world after the US. German banks are holding vast quantities of toxic assets which have been barely marked to market, to the point where the whole German banking system is probably insolvent.²⁴ Yet the German government is proceeding with a zombie bank strategy even more than the Americans, leaving Germany plagued with doubts about its financial system. The solution would have to be a public bailout, in the form of recapitalization. But as The Financial Times’ Wolfgang Munchau explains, “a bail-out would be unpopular, and the government does not want to touch this issue until the federal elections in September.” Even after the elections, recapitalization is unlikely. “The German political classes have yet to comprehend that recapitalisation is necessary, and that it will end up costing the taxpayer a lot of money”.²⁵ Many Austrian and Greek banks are also in a precarious position, and their governments have similarly adopted schemes that allow the banks to postpone resolution.

A headline in The International Herald Tribune from mid May says, “E.U. slide deepens, outpacing U.S. fall”. The article reports that the 27-nation EU and also the 16-nation eurozone contracted in the first quarter of 2009 at an annual rate of 10 percent, much faster than in the final quarter of 2008 – so the speed of contraction in Europe increased. Only against this standard was the news from the US economy good – US GDP “only” contracted in the first quarter at an annual rate of 6 percent.

- *World trade and export-led growth strategies are collapsing, and surplus countries like China face big obstacles in expanding domestic demand*

Some 740 ships idle at anchor in or near Singapore harbour as of mid May 2009, unable to find cargo. World trade is collapsing much faster than expected –

²⁴ Gillian Tett, “Some effects of an unhealthy fixation on hedge funds”, *Financial Times*, 8 May 2009.

²⁵ Wlfgang Munchau, “Germany needs more than an accounting trick”, *Financial Times*, 18 May 2009.

and much faster than predicted on the basis of the past relationship between world trade and OECD growth.

The gigantic US external deficit (as big as India's GDP in 2006) is falling at the fastest rate on record, which on the face of it is good news; but the fall reflects not rising exports but falling imports (even after taking account of the fall in oil prices).

The engine of recovery in the world economy has to be a country or region other than the US, whose own recovery will be more gradual and based on growth overseas. But Japan, the world's second biggest economy, experienced a contraction in the last quarter of 2008 at an annualised rate of 13%; and manufactured exports, which account for half of manufacturing output, were more than a third lower in value in December 2008 than in the previous December. Indeed, Japan's rate of contraction in the last quarter of 2008 and first quarter of 2009 is faster than that of the United States at any time during the 1930s.

In Germany, too, exports have imploded, GDP fell in the first quarter of 2009 at an annual rate of about 14%, and the country's federal fiscal deficit relative to GDP is the highest ever (projected in 2009 to be higher than Greece or Italy's).

China has mounted a significant stimulus package, but faces big obstacles in quickly expanding domestic demand – indeed, much the same “absorption” obstacles as the US faces. And there is some evidence that real economic growth is lower than the official growth rate (over 6% for the year to the end of the first quarter of 2009). For example, power output has been falling for the past year, including in the past few months; and power output may be a more reliable indicator of economic activity than GDP figures in the context of an economy of China's type.²⁶

Yet if China, Japan, Germany and the other big surplus countries do not quickly expand domestic demand, global imbalances will only intensify and recovery will be more elusive.

- *Many developing countries are in deep economic trouble*

Many developing countries are in or on the verge of financial crisis. The list includes the following, whose population totals 750m.

Europe: Latvia, Estonia, Lithuania, Hungary, Bulgaria Romania, Turkey, Ukraine;

²⁶ The Economist considers the official GDP growth rate of 6% is about right. “Economics focus: the art of Chinese massage”, The Economist, May 23, 2009, 84.

West Asia: Armenia, Azerbaijan, Belarus, Georgia, and Moldova;

South and East Asia: Pakistan, Indonesia, South Korea;

Latin America: Ecuador, Argentina, and Venezuela.

Conclusion: How long will the global recession last?

The interlocking mechanisms described above – fiscal and political constraints on the restructuring of banks, which limit the impact of fiscal and monetary stimulus; limits to fiscal expansion set by the willingness of foreign buyers to stuff themselves with US Treasury bills; limits to the big surplus countries' switch to domestic demand growth; China's expectation that the US will go even further into debt in order to buy its exports; and so on – generate strong momentum for economic activity to remain depressed.

The experience of earlier financial crises points in the same direction. In the five worst crises in the developed countries since the Second World War, the stock market fell on average by 55% over 3 ½ years, house prices fell 35% over 6 years, and output fell by 9% over 4 years.²⁷ If the current crisis follows these averages we will not see much bottoming out and upturn before 2011, taking 2007 as the turning point.

After the East Asian crisis it took Thailand 7 years to regain its pre-crisis (real) per capita income, Indonesia, 8 years, Malaysia, 4 years, South Korea, 3 years.²⁸

If the current Great Recession goes on for several more years it will generate momentum for new rules for international finance and more participation of developing countries in global financial governance. But the wish is not the father of the thought.

III. THE DEVELOPING COUNTRY BOOM AND BUST, 2002-09

The collective GDP of developing countries (DCs) grew at about 5% a year between 2002-07, the fastest rate for decades (the average for 1980-2000 was 3.4%).²⁹ The reasons had little to do with “endogenous” sources of growth and a lot to do with the boom in the developed countries (ACs) – a lot to do with continued tight “coupling”. Thanks to the AC boom, DCs received increased external resources of four main types:

²⁷ Carmen Reinhart and Kenneth Rogoff, “Banking crises: an equal opportunity menace”, NBER Working Paper 14587, December 2008, www.nber.org.

²⁸ Edsel Beja, “A retrospective on the Asian financial crisis”, *Challenge*, 50, 5, 2007, 57-72.

²⁹ Justin Yifu Lin, “The impact of the financial crisis on developing countries”, Korea Development Institute, Seoul, Oct 31, 2008.

- (1) Exports grew fast (from 29% of collective GDP in 2000 to 39% in 2007).
- (2) Foreign direct investment and portfolio equity inflows grew fast (from 2.7% of collective GDP in 2002 to 4.5% in 2007).
- (3) Remittances grew fast.
- (4) And aid flows increased.

The combination of inflows helped to produce an investment boom in DCs (helped also by the more “endogenous” factor of better fiscal balance and lower inflation at the start of the boom than in previous decades).

However, after several years of fast growth many DCs began to show the same vulnerabilities as ACs – such as booming property markets and equity markets. By 2007, the soaring US twin deficits (fiscal and current account) led to jitteryness about the dollar, and rising volatility in commodity prices. And after years of fast growth, about half of all DCs were running current account deficits greater than 5% of GDP.

As the crisis unfolded in the ACs through 2007 and 2008 the mechanisms that had earlier transmitted growth impulses to DCs went into reverse. Private capital flows to DCs have fallen. Remittances have fallen (so instead of being, as they normally are, counter-cyclical, they have been pro-cyclical, because the crisis began in the ACs). Export values have fallen, due to rapid fall in commodity demand and commodity prices. Also, migrants have been returning in large numbers from Europe and North America, putting additional pressure on local resources. Countries which earlier gained from tourism have experienced a sharp cut back in foreign exchange earnings from this source (also highly pro-cyclical).

Sub-saharan Africa (SSA) is about the worst hit DC region.³⁰ Private capital inflows had been growing fast in the several years before 2008, raising the hope that the region had finally “turned the corner” away from aid dependency; indeed private inflows exceeded aid flows in 2007 for the first time ever. But in recent months capital has been rushing out, causing the postponement of much needed infrastructure and commodity-based investments. Remittances are expected to fall by at least 5% in 2009 (75% of SSA’s remittances come from Europe and North America). Many SSA countries are experiencing a rise in current account deficits as export revenues fall faster than import costs. Aid flows to SSA rose in 2008, but will probably fall in 2009 (judging from what happened in Norway, Sweden and Finland during their financial crises of the early 1990s).

In South Africa, manufacturing fell in the last quarter of 2008 at an annualised rate of 22%, the fastest rate since records began; mining production fell; consumer spending fell; credit to the private sector fell; house prices fell; and

³⁰ Shanta Devarajan, “Africa: least integrated, worst hit by the crisis”, at Africa Can...End Poverty, World Bank, April 20, 2009.

GDP fell at an annualised rate of 2%. About the only good news is that the projected current account deficit for 2009 fell from 9% to 6%, as import demand fell even faster than exports.³¹

Two World Bank researchers estimate the impact of the crisis on growth in developing countries by comparing the World Bank's projections of October 2007 with those of April 2009.³² In October 2007 the Bank projected growth in private consumption per head in 2009, for developing countries in aggregate, at 5.1%. In April 2009 it projected the same measure for 2009 as 0.7% (one seventh of the earlier estimate).

In terms of the impact of the growth slowdown on poverty, the researchers calculate that the poverty headcount for developing countries as a whole (using the PPP\$2-a-day international consumption poverty line) fell at the rate of 0.8% a year between 1981 and 2005. Now, as a result of the growth slowdown, the poverty headcount is increasing – by an estimated *65m* more people consuming at less than \$2-a-day in 2009. As population growth continues, this increase in the absolute number will still go with a fall in the *proportion* of the developing country population consuming at less than \$2-a-day; but instead of a fall from the 2008 figure of 42% to a pre-crisis projected figure for 2009 of 38% (2.17b), the currently projected post-crisis figure for 2009 is 39% (2.23b). However, in Sub-saharan Africa and South Asia, the impact is worse: the fall in the proportion of the population consuming on less than \$2-a-day will stop in 2009 and the absolute number will rise substantially.

The non-income impacts are hard to assess. If children are pulled from school, their earnings later in life will suffer. Children are more likely to be pulled from school if parental incomes are hit. On the other hand, if children's wages go down they may tend to stay longer at school. The evidence suggests that in low-income countries more than middle-income ones, the impact of a crisis is like to be a fall in school enrolments. Similarly, child health and mortality are likely to deteriorate more in low income countries.

IV. CONCLUSION

Even in good times developed countries see no strong national or collective interest in having developing countries catch up with them (in terms of achieving average incomes equal to, say, 75% of theirs); although they see a strong interest in claiming the opposite.³³ This, at least, is a plausible working

³¹ Michele Zini, "Update on the impact of the financial crisis on South Africa", at Africa Can...End Poverty, World Bank, April 9, 2009

³² Martin Ravallion and Shaohua Chen, "The impact of the global financial crisis on the world's poorest", Development Economics Center, World Bank, April 2009.

³³ Robert Wade, "Globalization, growth, poverty, inequality, resentment and imperialism", in John Ravenhill (ed), *Global Political Economy*, 2nd edition, Oxford University Press, 2008. R. Wade, "Economic liberalism and the 'outward alliance' of state, finance and big companies: a perspective from

hypothesis, and more plausible than its conventional opposite. Elites in top countries promote global rules of free trade, free capital mobility, “most favored nation” and “national treatment” because these rules

(1) meet defensible criteria of fairness (all to play by the same rules), and
 (2) boost the relative economic power of the top countries’ big industrial and financial groups by giving them easier access to new resources, markets, and sources of profit.

Elites in top countries appreciate how these rules have cut developing countries’ negotiating power with big international firms, weakened spin-off effects on local production, and made the economy more dependent on external resources – all to the good in terms of protecting the position of the top countries and their big firms.³⁴ Meanwhile the top countries excuse their agricultural, steel, armaments and other high-tech sectors from the rules of free trade.

Moreover, the same rules have allowed the US, riding on the world’s main international currency, to draw capital “uphill”, including from developing countries, to the extent that in 2006 it imported more than it exported by an amount equal to India’s GDP, a country with four times its population. The rule of free capital mobility makes for the most “efficient” use of the world’s savings, says the credo, and the most efficient use is apparently to support US consumers, all of whom, even those in the bottom decile, are in the top two deciles of world income distribution. Naturally the US seeks to convince the world that free capital mobility is good for all countries.³⁵ The UK, as noted earlier, is equally keen.

The figures given earlier on the dramatic increase in the income share of the top 1% in US household distribution since the Washington Consensus/neoliberal reforms illustrate the powerful material interest behind these (positive and normative) ideas. And the account of George Allen’s encounter with British economists and others in 1930 illustrates both the inertia of a paradigmatic consensus and also its dominant-class basis (Allen’s interviewees who urged wage cuts as the solution to unemployment were not thinking of their own salaries).

The G20 has been presented with much fanfare as the new top table of effective global economic governance, and on the face of it the expansion from the G7 to the G20 is an improvement. But so far, in the finance G20 (operating since 1999), participating developing countries have exercised little leadership;

the United Kingdom”, in Paul Bowles, Henry Veltmeyer et al. (eds.), *National Perspectives on Globalization*, Palgrave, 2007.

³⁴ Robert Wade, “What strategies are viable for developing countries today? The World Trade Organization and the shrinking of ‘development space’”, *Rev. Int. Pol. Econ.*, 10, 4, Nov 2003, 621-44.

³⁵ Thomas Ferguson, *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-driven Political Systems*, University of Chicago Press, 1995; R. Wade, “US hegemony and the World Bank: the fight over people and ideas”, *Rev. Int. Pol. Econ.*, 9 (2), 2002, May, 201-29.

for the most part, the Canadians, Australians, British, Americans and Germans run it and shape its “consensus”. It remains the G7 writ large. Similarly, all the talk of raising the stake of developing countries in the governance of bodies like the World Bank and IMF runs into the determination of the G7 to minimize any dilution of their privileges. After all, it took the Japanese government several years of strategizing – with a dedicated division in the Ministry of Finance – to raise Japan’s share of quota and votes in the World Bank from number 5 to number 2, between 1981 and 1984. And that was just an adjustment within the G7.³⁶ Against the rest, the G7 remain united.

The lesson is that the developed countries, the World Bank and the IMF will talk eloquently about their concern to reduce the impacts of the global crisis on low income countries, and their wish to bring more developing countries into deliberations about a new global financial architecture. Developing country governments should believe them at their peril.

³⁶ Robert Wade, “Japan, the World Bank, and the art of paradigm maintenance”, *New Left Review* 217, 1996, 3-36.