



TRADE AND DEVELOPMENT REPORT, 2013

OVERVIEW



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OVERVIEW

Five years after the onset of the global financial crisis the world economy remains in a state of disarray. Strong expansionary monetary policies in the major developed economies have not succeeded in fostering credit creation and strengthening aggregate demand. Fiscal austerity and wage compression in many developed countries are further darkening the outlook, not only for the short term, but also for the medium term. The burden of adjustment of the global imbalances that contributed to the outbreak of the financial crisis remains with the deficit countries, thus strengthening deflationary forces in the world economy.

The dominance of finance over real economic activities persists, and may even have increased further. Yet financial reforms at the national level have been timid at best, advancing very slowly, if at all. In 2008 and 2009, policymakers of several economically powerful countries had called for urgent reforms of the international monetary and financial system. However, since then, the momentum in pushing for reform has all but disappeared from the international agenda. Consequently, the outlook for the world economy and for the global environment for development continues to be highly uncertain.

Some developing and transition economies have been able to mitigate the impact of the financial and economic crises in the developed countries by means of expansionary macroeconomic policies. But with the effects of such a response petering out and the external economic environment showing few signs of improvement, these economies are struggling to regain their growth momentum.

Prior to the Great Recession, exports from developing and transition economies grew rapidly owing to buoyant consumer demand in the developed countries, mainly the United States.

This seemed to justify the adoption of an export-oriented growth model. But the expansion of the world economy, though favourable for many developing countries, was built on unsustainable global demand and financing patterns. Thus, reverting to pre-crisis growth strategies cannot be an option. Rather, in order to adjust to what now appears to be a structural shift in the world economy, many developing and transition economies are obliged to review their development strategies that have been overly dependent on exports for growth.

It is not a new insight that growth strategies that rely primarily on exports must sooner or later reach their limits when many countries pursue them simultaneously: competition among economies based on low unit labour costs and taxes leads to a race to the bottom, with few development gains but potentially disastrous social consequences. At the present juncture, where growth of demand from developed countries is expected to remain weak for a protracted period of time, the limitations of such a growth strategy are becoming even more obvious. Therefore, a rebalancing of the drivers of growth, with greater weight given to domestic demand, is indispensable. This will be a formidable challenge for all developing countries, though more difficult for some than for others. In any case, it will require a new perspective on the role of wages and the public sector in the development process. Distinct from export-led growth, development strategies that give a greater role than in the past to domestic demand for growth can be pursued by all countries simultaneously without beggar-thy-neighbour effects, and without counterproductive wage and tax competition. Moreover, if many trade partners in the developing world manage to expand their domestic demand simultaneously, they can spur South-South trade.

No sustained recovery of the world economy in sight

The global economy is still struggling to return to a strong and sustained growth path. The rate of world output, which was 2.2 per cent in 2012, is forecast to grow at a similar rate in 2013. As in previous years, developed countries are expected to show the poorest performance, with around 1 per cent increase in gross domestic product (GDP). Developing and transition economies are likely to grow by almost 5 per cent and 3 per cent respectively.

Economic activity in many developed countries and a number of emerging market economies is still suffering from the impacts of the financial and economic crisis that started in 2008, and from the unsustainable financial processes and domestic and international imbalances that led to it. However, continuing weak growth in several countries may also be partly due to their current macroeconomic policy stance.

In the European Union (EU), GDP is expected to shrink for the second consecutive year. Economic contraction is likely to be more severe in the euro area than in other EU countries. Private demand remains subdued, especially in the periphery economies, due to high unemployment, wage compression, low consumer confidence and the still incomplete process of balance sheet consolidation. Given the ongoing process of deleveraging, expansionary monetary policies have failed to induce banks to provide much-needed new credit to the private sector that could reinvigorate demand. In this context, the increased tendency towards fiscal tightening makes a quick return to a higher growth trajectory highly unlikely. Indeed, attempts to resolve the crisis in the euro area through fiscal austerity may backfire badly, as it adds a deflationary impulse to already weak private demand. The countries

in the euro zone that have been suffering the most from the crisis continue to operate under extremely adverse conditions, while growth in the surplus countries has largely relied on strong exports. Since governments in the latter countries have been reluctant to stimulate domestic demand by other means than monetary policy, disequilibrium within the zone persists.

At the global level, it is notable that Japan is bucking the current austerity trend by providing strong fiscal stimulus and monetary expansion that are aimed at reviving economic growth and curbing deflationary trends. These measures could help maintain its GDP growth at close to 2 per cent in 2013. The United States is expected to grow at a similar rate, but based on a different set of factors. Partly owing to significant progress made in the consolidation of its banking sector, private domestic demand has begun to recover. On the other hand, cuts in public spending, including for needed investment in infrastructure, are having a contractionary effect. Since the net outcome of these opposing tendencies is unclear, there is also considerable uncertainty about whether the expansionary monetary policy stance will be maintained.

Growth in many developing countries driven by domestic demand

Developing countries are expected to grow by between 4.5 and 5 per cent in 2013, similar to 2012. In many of them, growth has been driven more by domestic demand than by exports, as external demand from developed economies has remained weak. In addition, short-term capital inflows, attracted by higher interest rates than in the major developed countries, have been exerting appreciation pressure on the currencies of several emerging market economies, thus weakening their export sectors.

As before, in 2012 output growth was strong in East, South and South-East Asia, at 5.3 per cent, but recently there has been a slowdown, reflecting weak demand from some of the major export markets. In

China, the contribution of net exports to GDP growth declined further, while fixed investment and private consumption, as a result of faster wage growth, continued to drive output expansion. Domestic demand, encouraged by various incomes policy measures in a number of other countries in the region, such as India, Indonesia, the Philippines and Thailand, is also supporting output growth, which may therefore accelerate moderately in the region as a whole in 2013.

Economic growth in West Asia slowed down dramatically, from 7.1 per cent in 2011 to 3.2 per cent in 2012, a level that is expected to be maintained in 2013. Weaker external demand, especially from Europe, affected the entire region, most prominently Turkey, whose growth rate dropped sharply from around 9 per cent in 2010 and 2011 to 2.2 per cent in 2012. The Gulf Cooperation Council (GCC) countries maintained large public spending programmes to support domestic demand and growth, despite scaling back their oil production during the last quarter of 2012 to support oil prices.

Growth in Africa is expected to slow down in 2013, owing to weaker performance in North Africa, where political instability in some countries has been mirrored in recent years by strong fluctuations in growth. In sub-Saharan Africa, by contrast, GDP growth has remained stable, at above 5 per cent, owing to continued high earnings from exports of primary commodities and relatively strong public and private investment in some countries. However, the two largest economies of the region, Nigeria and South Africa, face considerable downside risks due to faltering external demand and some weaknesses on the supply side. In addition, several least developed countries (LDCs) of the region remain vulnerable to sudden and drastic swings in demand for certain commodities.

Growth is also expected to remain relatively stable in Latin America and the Caribbean, at around 3 per cent, on average, as a slowdown in some countries, including Mexico, is likely to be offset by faster growth in Argentina and Brazil. Overall, growth in the region is being driven by domestic demand, based on public and private consumption.

The transition economies have experienced a downward trend in their economic performance. Under the impact of the continuing crisis in much of Western Europe, most of the transition economies of South-Eastern Europe entered into recession in 2012. The members of the Commonwealth of Independent State (CIS) maintained a growth rate of over 3 per cent in 2012 based on sustained domestic demand, but this is expected to slow down slightly in 2013. The economic outlook for the region remains closely linked to the performance of the economy of the Russian Federation and to commodity price developments.

As the rapid expansion of developing economies as a group has further increased their weight in the world economy, a new pattern of global growth seems to be emerging. While developed countries remain the main export markets for developing countries, the share of the latter's contribution to growth in the world economy has increased, from 28 per cent in the 1990s to about 40 per cent in the period 2003–2007, and to close to 75 per cent since 2008. However, more recently, growth in these economies has decelerated. If developing countries can increase the role of domestic demand and South-South trade in their development strategies, they may continue to grow at a relatively fast pace, with increasing potential to rely on each other for the expansion of aggregate demand. However, they cannot be expected to lift developed countries out of their sluggish growth pattern through higher imports from them.

Global trade expansion has virtually ground to a halt

International trade in goods and services has not returned to the rapid growth rate of the years preceding the crisis. After a sharp fall in 2008–2009 and a quick recovery in 2010, the volume of trade in goods expanded by only 5 per cent in 2011 and by less than 2 per cent in 2012, and it affected developed, developing and transition economies alike.

Sluggish economic activity in developed economies accounted for most of the slowdown in international trade. In 2012, European imports of goods shrank by almost 3 per cent in volume and by 5 per

cent in value. Extremely weak intra-European trade was responsible for almost 90 per cent of the decline in European exports in 2012. Japan's exports have not yet recovered from their sharp fall caused by the earthquake of 2011, while the volume of its imports has continued to grow at a moderate pace. Among the major developed economies, only the United States maintained a positive growth rate in its international trade, although this appears to be slowing down in 2013.

Trade also decelerated considerably in developing and transition economies. Both exports and imports grew sluggishly in 2012 and the first months of 2013 in most developing regions. The sole exception was Africa, where exports recovered in countries previously affected by civil conflict. Export growth declined to 4 per cent in the developing countries as a whole. This slowdown included Asian countries that had previously played a major role in boosting international trade.

The rate of growth of China's exports, by volume, declined from an average annual rate of 27 per cent during the period 2002–2007 to 13 per cent in 2011 and to 7 per cent in 2012, a lower rate than its GDP growth. Concomitantly, China's imports, by volume, decelerated to 6 per cent in 2012 from 19 per cent, on average, between 2002 and 2007. Only regions exporting a large proportion of primary commodities (i.e. Africa, West Asia and, to a lesser extent, Latin America) saw a significant increase in their exports to China. Several exporters of manufactures in Asia registered a sizeable slowdown of growth in their external trade. This was the result not only of lower imports from Europe, but also of slower growth in some developing regions, in particular in East Asia.

The crisis of 2008–2009 has altered trade patterns in both developed and developing countries. Imports by all developed regions remain below their pre-crisis level, and only the United States has managed to increase its exports to a higher level than their previous peak of August 2008. On the other hand, exports from the group of emerging market economies were 22 per cent above their pre-crisis peaks, while the corresponding figure for their imports was 26 per cent higher. However, the pace of growth of trade of these economies

has slowed down significantly: during the pre-crisis years, between 2002 and 2007, their export volume grew at an average annual rate of 11.3 per cent, but fell to only 3.5 per cent between January 2011 and April 2013. Growth in the volume of their imports also slowed down from 12.4 per cent to 5.5 per cent over the same period.

Overall, this general downward trend in international trade highlights the vulnerabilities developing countries continue to face at a time of lacklustre growth in developed countries. It is also indicative of a probably less favourable external trade environment over the next few years.

The particularities of a protracted downturn in developed countries

The difficulties of the developed countries as a group to find their way towards a path of sustained recovery following the recession of 2008–2009 suggests that the latest crisis is of quite a different nature than the cyclical crises of the past. From 2008 to 2012, global output growth averaged just 1.7 per cent. This is much slower than during any of the five-year periods that followed recessions in the global economy since the 1970s.

In this situation, expansionary policies would be needed to spur domestic demand and restore the confidence of households and firms. However, policymakers have instead been focusing their attention on restoring the confidence of financial markets. A central element of this strategy in developed countries has been fiscal austerity, based on the belief that high public debt ratios may eventually trigger a general aversion to sovereign debt, which could increase the risk premium and thereby impose a heavier debt burden on public finances. This strategy has not yielded the expected results. The outcome of fiscal contraction has negatively affected growth and job creation, as the expected increase in private demand has not materialized to compensate, or overcompensate, for the cuts in public spending. In addition, the fact

that several countries that had strong trade relations with each other have been following austerity regimes at the same time has amplified their deflationary impact in the same way as simultaneous fiscal stimulus in 2009 generated very positive results. Moreover, monetary policies have proved ineffective in the sense that strong monetary expansion has not translated into an increase in loans to the private sector. This shows that, without the prospect of a growth in demand, the increasing availability of credit is not enough to stimulate private investment and create jobs.

Experience has shown that an expansionary fiscal policy can have a much stronger impact in such a situation, because this is precisely when it has a particularly strong multiplier effect. The legitimate objective of improving fiscal balances is more likely to be achieved through an expansion of aggregate demand, and thus the tax base, than by fiscal contraction which reduces income and employment growth. In addition, central bank operations that focus on reducing the risk of sovereign debt and maintaining low interest rates would enable a reduction in public debt servicing, and thereby lower medium- to long-term public debt ratios that are considered too high.

Structural reforms are needed, but what kinds?

Despite marked differences in economic performance across regions, in general, policies pursued over the past three years have not succeeded in resolving the crisis. There can be little doubt that, in addition to demand-enhancing policies, structural reforms are needed in many countries to lead their national economies and the global economy back to a path of sustained growth. Several proposals for reform have been made, in particular relating to the financial sector, the labour market, public finances and central banking, but not all of them have adequately addressed the causes of the crisis.

A major reason for the crisis has been the dominance of the financial sector over the real sector. Financial liberalization has resulted in governments being increasingly influenced by the belief that they

need to maintain or regain the “confidence” of financial markets. The reforms adopted since 2008, which aim at improving supervision and capitalization of the banking system, are helpful but are unlikely to be sufficient to prevent activities of the financial markets from posing a threat to economic stability. Governments need to control financial markets more resolutely than in the past and limit the power of those markets over national, regional and global economies.

For many years preceding the financial and economic crisis, structural reform was virtually synonymous with introducing greater flexibility into the labour market, especially wage flexibility, and such reform is again suggested as a way out of the crisis. But a strategy aimed at strengthening the competitiveness of economies by reducing labour costs completely neglects the fact that wages are usually a major source of domestic demand. Moreover, when such a strategy is pursued by many countries at the same time, it leads to a race to the bottom, worsens income distribution and poses a threat to social cohesion. And greater inequality of income distribution was one of the factors that led to the crisis in the first place. Instead, an incomes policy aimed at accelerating consumption growth could contribute decisively to restoring national economies, and the global economy, to a stronger but also more balanced growth path.

Reforms aimed at fiscal consolidation may be necessary in many countries, but they need to consider the overall macroeconomic context. Public finances cannot be managed like the finances of a household because they inevitably have an impact on the entire economy and the spending behaviour of the private sector. Attempts to achieve fiscal consolidation in the short run have been unsuccessful at best, and counterproductive and procyclical at worst. Such consolidation can only be achieved after several years of sustained economic growth, and should not be considered a prerequisite for economic recovery.

Central banks of many developed countries have responded to the financial crisis, and, in the euro zone, to the crisis in some member States’ public finances, with a number of unorthodox measures. But

they may also have to find new ways of making credit available to non-financial agents to use in a way that generates demand, income and employment.

These various national reforms also require more determined international cooperation, including long overdue reform of the international monetary system, in order to achieve greater symmetry of adjustment efforts among deficit and surplus economies. In the present situation, several countries with large current account surpluses could probably do much more to help revive the world economy.

Developing and transition economies: better performance but continued vulnerability

One of the most significant changes in the shape of the world economy has been the increase in the share of developing countries in global GDP. The onset of the global economic and financial crisis initially reinforced this trend, as growth in developing countries in 2008–2009 decelerated less and recovered more rapidly than in developed countries. As a result, the share of developed countries in global GDP declined from 79 per cent in 1990 to about 60 per cent in 2012, while that of developing countries more than doubled, from 17 per cent to 36 per cent, over the same period. Most of this change occurred from 2004 onwards.

Nevertheless, economic developments in developed countries remain crucial for growth in developing countries. Indeed, the growth acceleration in the latter set of countries during the 1990s, and especially during the period 2003–2007, was associated with a larger proportion of international trade in the composition of their aggregate demand. Combined with the generally favourable external economic environment, such as growing imports by developed countries (especially the United States) and historically high commodity prices, particularly during the five years prior to the onset of the current crisis,

the greater outward orientation of developing countries contributed to their growth.

However, an export-oriented growth strategy also implies greater vulnerability to a deterioration of the external environment, as has occurred since 2008. The international price and demand shocks during 2008–2009 had a severe impact on both exporters of primary commodities and exporters of manufactures. The subsequent rebound was more rapid and its beneficial impact greater on countries whose exports comprise a large proportion of primary commodities than for countries that export mainly manufactures.

Weaker demand from developed countries suggests that South-South trade may need to play a greater role in developing countries' growth strategy. In this respect, it offers greater potential than in the past, given that the share of South-South trade in total world trade increased from slightly less than 30 per cent in 1995 to slightly more than 40 per cent in 2012. Moreover, the share of manufactures in a developing country's exports to other developing countries and the value added in such trade are usually much higher than they are in its exports to developed countries, which is testimony to the potential developmental role of South-South trade.

Commodity price trends and outlook

Up to the financial crisis and the Great Recession of 2008–2009, rapid output growth in many developing and transition economies was the result of their strong increase in exports of manufactures to developed countries. This in turn contributed to higher export earnings of other developing countries that relied on exports of primary commodities. Since the turn of the millennium, these latter countries have also benefited from a trend change in the terms of trade. This change reflected not only an upward movement in the medium-term commodity price trend, interrupted only briefly in 2008–2009, but also

a decline in world prices of certain manufactures, especially labour-intensive manufactures.

The increasing demand for commodities in rapidly growing developing countries, notably China, and the resulting higher price levels of many primary commodities, signifies a structural shift in physical market fundamentals. The upward trend in prices has also been supported by a slow supply response, as historically low price *levels* in the 1990s had led to a long period of underinvestment in production capacity for several key commodities, especially in the mineral and mining sectors. At the same time, the increasing presence of financial investors in commodity markets has accentuated the problem of price *volatility*. Projections about the further evolution of commodity prices are particularly difficult in the current uncertain global economic environment, but there is little doubt that the growth outlook for developing countries will have a significant impact on future commodity demand trends.

Continuing fast population growth and rising income in developing countries should lead to greater demand for several food items. Moreover, as production is unlikely to increase in line with the growing demand, including for biofuels, agricultural commodity prices could remain high over the next decade.

Demand conditions in the markets of many primary commodities that are used as inputs for the production of manufactures and for construction are determined by a number of factors. One factor is whether China succeeds in rebalancing its growth through an increase in domestic consumption. Another is whether other highly populated and rapidly growing developing countries will move to a more commodity-intensive phase of economic growth and industrialization. Even if China's GDP growth slows down, resulting in a lower use of some commodities, its ongoing industrialization and per capita income growth could continue to have a considerable impact on global markets, given the size of its economy. If, in addition, other large and highly populated developing countries also pursue a path of rapid industrialization, the

demand prospects for industrial commodities, particularly metals, could remain robust. Infrastructure development associated with rapid urbanization also offers strong potential to increase demand for commodities.

In addition, rising living standards in many developing countries may boost demand for energy commodities in the medium term, despite improvements in energy efficiency that could contribute to a decline in energy use per unit of GDP. Oil prices could remain historically high, even if they fall slightly compared with their 2011–2012 levels, as demand from some of the rapidly growing developing countries will continue to rise and because the exploitation costs of new supplies are higher than those from conventional sources.

Overall, commodity prices may not rise as fast as they have over the past decade, but, following some downward adjustments in the short term, they should stabilize at a relatively high level in comparison with the early 2000s. However, this should not lead to complacency in the design of development strategies in natural-resource-rich countries. Their main challenge remains that of appropriating a fair share of the resource rents and channelling revenues towards investment in the real economy in order to spur the diversification and upgrading of production and exports.

Export-led growth strategies are reaching their limits

A key problem for policymakers in the developing and transition economies that have a large share of manufactures in their exports is that growth of exports and incomes in their countries is likely to be adversely affected by continued slow growth in developed countries' final expenditure for several years to come. In a number of these countries, production of manufactured goods for the world market has driven the expansion of their formal modern sectors, but in most of them domestic demand has not increased apace. This has been partly due to weak linkages between the export sector and the rest of the economy,

and partly to the strategy of their firms and governments to strengthen the international competitiveness of their domestic producers by keeping wages low. Such a strategy will eventually reach its limit, as low wages dampen domestic demand growth, especially when many other countries pursue the same strategy simultaneously. Since the growth of demand in developed countries is likely to remain weak for an extended period of time, the limitations of such a strategy become even more acute. In these circumstances, continuing with export-led growth strategies through wage and tax competition would exacerbate the harm caused by slower growth in export markets and reduce any overall benefits.

The adoption of countercyclical macroeconomic policies can compensate for resulting growth shortfalls for some time. Indeed, most developing countries reacted to the decline in their net exports by increasing the share of government expenditure in GDP. There was also an increase of private consumption as a share of GDP in some of these countries, and of gross fixed capital formation as a share of GDP in some others. However, beyond such short-term responses, developing countries may need to take a more comprehensive and longer term perspective, involving a shift in development strategies that gives greater weight to domestic demand as an engine of growth. Such a move towards a more balanced growth path could compensate for the adverse impact of slower growing exports to developed countries. Moreover, this more balanced growth strategy could be pursued by all developing countries simultaneously without beggar-thy-neighbour effects. However, there are many challenges involved in moving towards a more balanced growth strategy. These include boosting domestic purchasing power, managing domestic demand expansion in a way that avoids an excessive increase in import demand, and nurturing the interrelationship between household and government expenditure, on the one hand, and investment on the other, to enable the sectoral composition of domestic production to adjust to new demand patterns, including through increased regional and South-South trade.

Hence, shifting the focus of development strategies to domestic markets does not mean minimizing the importance of the role of exports.

Indeed, exports could expand further if several trade partners were to achieve higher economic growth at the same time.

Rebalancing domestic and external forces of growth

In seeking greater integration into a rapidly globalizing economy, the critical importance of domestic demand as a major impetus for industrialization is often overlooked. Growth of domestic demand accounts for about three quarters of the increase in domestic industrial output in large economies, and slightly more than half in small economies. Accelerating domestic demand growth could therefore be highly beneficial for output growth and industrialization, particularly in a context of weakening external demand growth. The possibility of changing rapidly towards a more domestic-demand-oriented growth strategy will depend largely on how closely the sectoral structure of domestic production is linked to the pattern of domestic demand. This linkage will be particularly weak in countries that export a large proportion of primary commodities. It therefore remains very important for these countries to use their resource-related revenues to diversify their sectoral structure of production by increasing the shares of manufactures and modern services, both public and private. By developing the linkages between the exporting sectors and the rest of the economy, this diversification would generate new employment and income opportunities, and strengthen the domestic market.

A strategy that places greater emphasis on domestic demand will need to aim at an appropriate balance between increases in household consumption, private investment and public expenditure. There is a strong interrelationship between these three components of domestic demand. Increased consumption of goods and services that can be produced domestically makes producers of those goods and services more willing to invest in their productive capacity. Higher investment is not only itself a source of domestic demand (even if a large share of the capital goods may have to be imported), but it is also a precondition

for the creation of employment and for productivity gains that allow wages to grow along with the purchasing power of domestic consumers. Moreover, higher incomes of households and firms raise tax revenues, which can then be spent by the government for enhancing public services and infrastructure development, even at unchanged tax rates. Higher public spending, in turn, can create additional income for households and firms, and improve the conditions for private investment. Such investment is indispensable for increasing domestic supply capacity, and thus for reducing leakages of domestic demand growth through imports.

Increasing domestic consumption

Labour income is the most important source of household consumption, which generally accounts for between half and three quarters of aggregate demand, even in relatively poor countries and countries with a relatively large export sector. Thus fostering the purchasing power of the population in general, and of wage earners in particular, should be the main ingredient of a domestic-demand-driven growth strategy.

While export-led strategies focus on the cost aspect of wages, a domestic-demand-oriented strategy would focus primarily on the income aspect of wages, as it is based on household spending as the largest component of effective demand. If wage growth follows the path of productivity growth, it will create a sufficient amount of domestic demand to fully employ the growing productive capacities of the economy without having to rely on continued export growth.

In economies with fairly large formal sectors, the functioning of such an incomes policy could be enhanced by building institutions for collective bargaining and the introduction of legal minimum wages. In countries where informal employment and self-employment are widespread, targeted social transfers and public sector employment schemes can play an important complementary role. In countries

with a large rural sector with many small producers, introducing mechanisms that ensure fair prices for agricultural producers – for instance by linking those prices to the overall productivity growth of the economy – would be another element of a strategy to increase domestic consumption, strengthen social cohesion and at the same time induce more productivity-enhancing investments. Moreover, the layers of the population that will primarily benefit from such an incomes policy would be likely to spend most of their income on locally produced goods and services. In addition, governments can take discretionary fiscal actions, such as providing tax rebates on certain consumer goods that are, or can be, produced domestically.

Spurring domestic demand by facilitating access to consumer credit for the acquisition of durable consumer goods tends to be risky, as amply demonstrated by recent experiences in a number of developed countries. The debt servicing burden of households may rapidly become excessive if interest rates rise, growth of household incomes stalls or the prices of assets used as collateral fall.

Increasing domestic investment

Domestic investment, both private and public, plays a crucial role in any growth strategy, regardless of whether it is oriented towards exports or domestic demand. The expectation that future demand will be high enough to fully utilize additional productive capacity is the main incentive for entrepreneurs to invest in expanding that capacity. Since exports are unlikely to grow at the same pace as in the past, given the current state of the world economy, domestic demand growth will become more important in forming the demand expectations of potential investors. A key determinant of their ability to strengthen productive capacity is the availability of long-term finance at an affordable cost and a competitive exchange rate. This in turn depends, to a large extent, on central bank policy and the structure and functioning of the domestic financial system.

Direct and indirect demand effects of public expenditure

The possibility of strengthening domestic demand by increasing public sector spending depends on the initial conditions of the public finances in each country, but also on the effects of increased public expenditure on public revenue. Public spending and taxation are potentially key instruments for shaping the distribution of purchasing power in an economy. Beyond its direct effects on aggregate demand, public investment in infrastructure and/or public services to specific industrial clusters are often a precondition for the viability of private investment, for enhancing the productivity of private capital, and for complementing the market mechanism by facilitating the creation of linkages between export industries and the rest of the economy. In addition, public expenditure on education and training can influence the potential of labour to contribute to productivity growth. Moreover, countercyclical fiscal policy can stabilize domestic demand during periods of slow growth or recession, and thus prevent a lowering of the demand expectations of domestic investors. This stabilization potential will be greater, the larger the share of the public sector in GDP.

Income redistribution through the taxation structure and transfers to households can strengthen the purchasing power of those income groups that spend a larger share of their income on consumption in general, and on domestically produced goods and services, in particular, than higher income groups.

Raising public revenues

The “fiscal space” for strengthening domestic demand, directly or indirectly, through increased public spending in developing countries, especially in low-income and least developed countries, tends to be more limited than in developed countries. This is not only because their tax base is smaller, but also their capacity to administer and enforce tax legislation is often weak. Moreover, in many of these countries public finances are strongly influenced by factors that are beyond the control

of their governments, such as fluctuations in commodity prices and in interest rates on their external debt. But to a large extent fiscal space is also determined endogenously, since spending of public revenue creates income, and thus additional spending in the private sector, thereby enlarging the tax base. These income effects vary, depending on how the tax burden is distributed and public revenue is spent. Taking account of such compositional effects of both the revenue and the expenditure side implies that the scope for using taxation and government spending for strengthening domestic forces of growth may be greater than is often assumed.

In many developing and transition economies, there appears to be scope for more progressive taxation and for taxing wealth and inheritance, as well as for raising additional revenue by imposing higher taxes on multinational corporations. The latter would require that developing countries, in their efforts to attract foreign direct investment (FDI), avoid engaging in tax competition with each other. Such competition, like international wage competition, is at the expense of all the countries concerned. These considerations are of particular relevance for countries that are rich in mineral resources, where often only a very small share of the resource rents remains in the respective countries in the form of private income or public revenue.

In several low-income and least developed countries multilateral financial institutions and bilateral donors would need to help by providing additional resources for social spending, as well as support for improving the administrative capacities needed to strengthen the role of public finances in development strategies.

The rationale for debt-financed public spending

Rebalancing domestic and external forces of growth may also require a different approach to debt financing of public expenditure. It can be a strategic instrument not only in the context of a countercyclical fiscal policy, but also for stretching the fiscal burden of large public

infrastructure projects. Such projects typically help to increase the productivity of the economy at large and generate benefits for households and firms in the future, by which time economic growth would help service the initially incurred debt.

While it may be preferable for governments to pay all public expenditure out of current revenue, a rational approach in a fast-growing developing economy could also be based on the principle that current expenditure, including social expenditure, should be financed by taxation and other current revenues, whereas public investment may be financed by borrowing, since such investment has a pay-off in the form of additional tax receipts from an enlarged tax base in the future. Governments should consider borrowing in foreign currency only to the extent that public investments or government support to private investments require importing capital goods, materials and know-how. Where there is a sufficient possibility for public sector borrowing for these purposes, an increase in credit-financed public expenditure may be considered a way to boost not only domestic demand but also domestic supply capacities.

Changing composition of consumption with rising personal incomes

Consumption patterns are changing with rising income levels. Once the income of individual consumers crosses a certain threshold, they will use a smaller share of that income for satisfying their basic or subsistence needs. The thresholds which trigger an acceleration of demand for other consumption items typically cluster at a level of per capita income at which an individual is considered to enter the “middle class” (i.e. those segments of the population in any society that have a certain amount of discretionary income at their disposal, which allows them to engage in consumption patterns beyond just the satisfaction of their basic needs). The future evolution of consumption patterns therefore depends on the number of people that are at around the entry level of the middle class, where the new spending patterns start emerging.

Based on a number of projections, it has been estimated that the proportion of the middle class in the total world population will increase from 26 per cent in 2009 to 41 per cent in 2020 and 58 per cent in 2030, and that this proportion will grow more than fourfold in developing countries. Asia will account for the bulk of this increase, with the number of people belonging to the middle class in this region estimated to grow sixfold; in Central and South America the number is expected to grow by a factor of 2.5, and in sub-Saharan Africa it should triple. A strategy that gives greater emphasis to domestic-demand-driven growth, if successful, might well accelerate these trends, as it would be associated with faster wage increases and a more equal income distribution than in the past. Therefore, many developing and transition economies could achieve a rapid acceleration of consumption of durable consumer goods in the medium term.

An enlarged middle class may be the most important source of buying power for domestic manufacturers, because it will eventually determine the extent of horizontal complementarities across all industries of the economy. And to the extent that the purchasing power of income groups below the level of the middle class also grows, there may be additional productivity gains in sectors and firms that produce primarily for the domestic market, as the lower income groups tend to spend their incomes on a greater share of locally produced or producible goods and services.

Domestic demand growth and its implications for the development of productive capacities

The import intensity of the three components of domestic demand (i.e. household consumption, government expenditure and investment) varies widely. Imports tend to be strongly correlated, on average, with investment and production for export, but less with consumption (especially consumption by households in the lower income brackets) and public expenditure. Still, if domestic productive capacity is not upgraded in accordance with the changing pattern of demand in a

growing economy, the increase in domestic consumption expenditure will tend to induce higher imports. In order to prevent a deterioration in the trade balance as a result of both faster growth and the changing composition of domestic demand growth, coupled with lower export growth, it will be essential to strengthen domestic investment and innovation dynamics to bring about appropriate changes in the sectoral composition of domestic production.

Efforts to orient domestic production to respond to the changing level and composition of domestic demand will tend to be easier for those countries which in the past have relied significantly on exports of manufactures to developed countries, because they can build on their considerable existing productive capacity and experience in manufacturing activities. However, it will be more difficult if these activities have been geared mainly to the production of sophisticated goods for affluent consumers in developed countries, which few domestic consumers can afford. A rapid shift from an export-driven growth strategy to one that gives greater emphasis to an expansion of domestic demand to drive growth will be even more difficult in countries that have been relying on the production and export of primary commodities.

On the other hand, while developing countries should still seek to develop or adapt new technologies according to their specific needs, an advantage for producers in developing and transition economies that focus more on domestic than on global markets is that technological lagging tends to be less of a constraining factor.

Advantages of proximity to markets and regional integration

Another advantage for producers in developing countries is their proximity to their domestic market and, where applicable, their regional market. Changes in market conditions arising from the expansion and changing composition of domestic demand necessitate the identification of “latent demand” and the “steering” of firms to meet requirements

specific to those new markets. In this regard, the local knowledge of domestic firms for the development of appropriate new products, distribution networks and marketing strategies may become a valuable asset in competing with foreign suppliers of similar goods. In addition, to the extent that developing and transition economies assume a greater weight in global consumption growth, the resulting changes in the pattern of global demand are likely to influence market opportunities for all these economies in areas of production that are more aligned than in the past to the patterns of demand prevailing in developing countries. This in turn will lead to changes in the sectoral allocation of investments in a way that better corresponds to the pattern of domestic demand in those countries.

Moreover, if many trade partners in the developing world were to expand their domestic demand simultaneously, they could become markets for each other's goods and services. The resulting increase in exports would help reduce the balance-of-payments constraints that arise from a slowdown of exports to developed countries. Consequently, strengthened regional integration and, more generally, intensified efforts to strengthen South-South trade, may be important complements to domestic-demand-led growth strategies.

Industrial policies in support of investment and structural change

Experience in developed and developing countries has shown that governments, in addition to market forces, can play an important role in support of industrialization. In the past, industrial policies have often focused on strengthening export capacities and establishing an export-investment nexus. However, a change in the respective weights of foreign and domestic demand may require an adaptation of industrial policy, with a greater emphasis on strengthening the competitiveness of domestic producers in domestic markets and gearing production structures to the changing composition of domestic demand as per capita income grows. Such adaptation may need to fully utilize the

policy space still available to these countries following the Uruguay Round trade agreements and various regional and bilateral trade and investment agreements. Furthermore, some of these agreements may need to be revised to take better account of the interests of developing countries, for example by allowing them a greater degree of temporary protection of certain industries that are at an early stage of development.

Capital formation that responds to changing demand patterns may be supported by helping private firms to identify the product groups that show the greatest dynamism as an increasing share of the population enters the middle class. Public support measures may also facilitate coordination of production along the value-added chain, including fiscal and financial support for new production activities that are considered strategically important for domestic production networks. A proactive industrial policy may be especially important – and have the greatest impact – in economies that are still dependent on natural resources and where there is an urgent need for diversification of production.

Challenges for financial policies in developing countries

The adjustment of productive capacities to changes in the composition of aggregate demand in developing and transition economies requires reliable and low-cost access of their producers to financial resources for productive investment. In the current global context, although there is ample liquidity in the banking systems of the major developed countries, uncertainty in financial markets is particularly high. This increases the risk of emerging markets being affected by disturbances emanating from the behaviour of international capital markets, since a volatile international financial environment, fragile national banking systems and weak domestic financial institutions have often hindered investment in many countries.

This presents a number of challenges for financial policy in developing and transition economies: first, they need to protect their

national financial systems against the vagaries of international finance; second, policymakers should draw the right lessons from past financial crises, in particular, that an unregulated financial sector tends to generate economic instability and resource misallocation; and third, they should aim to make their domestic financial systems, especially their banking systems, more supportive of investment in real productive capacity.

Atypical behaviour of international capital flows since 2008

Over the past three decades emerging market economies experienced frequent waves of international capital flows. Such waves typically started when growth was slow, liquidity was abundant and interest rates were low in the developed countries. This made emerging markets seem attractive destinations for private international capital flows. However, those waves ebbed when interest rates rose in the developed countries or when financial market participants deemed external deficits or the foreign indebtedness of the destination countries to have become unsustainable.

At present, monetary and financial conditions in major developed countries resemble those that in the past proved to be conducive to surges of capital flows to emerging market economies. In developed countries, interest rates have fallen to almost zero in an effort to tackle both the protracted crisis and the difficulties in their financial sectors. Their central banks have also injected large amounts of liquidity into the financial system. However, these measures have not succeeded in inducing banks to increase their lending to the private sector. Moreover, there are fairly large interest rate differentials in favour of emerging markets. So far, these conditions have not resulted in strong and sustained capital outflows from developed to developing countries; rather, where such outflows have occurred, they have been very volatile.

Prior to the eruption of the financial crisis, there were large capital flows from developed countries to emerging market economies,

which ended abruptly in 2008. But, distinct from past episodes, this “sudden stop” was not triggered either by an increase in interest rates in the developed countries, or by excessive current account deficits or debt servicing problems in the emerging market economies. Rather, they appear to have been motivated by uncertainty about the possible repercussions of the financial crisis on the latter economies, and attempts by international investors to minimize their overall risk exposure. When private capital flows to emerging market economies surged again in 2010 and 2011, this too was atypical, because sudden stops are usually followed by a prolonged period of stagnation of inflows or even outflows from these countries. Faced with low profit-making opportunities in the major financial centres, it may have been expected that investors would be encouraged by the rapid resumption of GDP growth in the emerging market economies and the perception that their financial systems were more stable than those of developed countries. However, newly worsening prospects in developed countries in the second half of 2011, including higher perceived risks related to the sovereign debt of some of them, again curtailed capital flows towards the emerging market economies as investors sought to reduce their overall portfolio risks.

The vagaries of international finance remain a threat

Emerging market economies have been relatively resilient in the face of the destabilizing effects of the latest waves of capital flows on their national financial systems. This observation does not mean, however, that they have become structurally less vulnerable. Rather, it shows the merits of their policy reorientation with respect to external finance since the turn of the millennium. An increasing number of developing-country governments have adopted a more cautious attitude towards large capital inflows. Some of them were able to prevent or at least mitigate currency appreciation through intervention in the foreign exchange market, along with associated reserve accumulation. Others also resorted to capital controls. Another factor explaining how several of them were able to cope with the adverse financial events was

their lower levels of external debt and its more favourable currency composition compared with earlier episodes.

However, since global financial assets amount to more than three times the value of global output, even minor portfolio adjustments oriented towards developing countries can lead to an increase in such flows at a rate that has the potential to destabilize the economies of these countries in the future. In the current situation of high uncertainty, investor sentiment, rather than macroeconomic fundamentals, is tending to drive capital movements, as has frequently been the case in the past. But there is also uncertainty with regard to the fundamentals. On the one hand, an extended period of low interest rates in the developed countries, combined with stronger growth and a tendency towards higher interest rates in emerging market economies could lead to a new surge of capital flows to the latter. On the other hand, a tightening of monetary policy in the major reserve currency countries could cause a drastic reduction or reversal of net private capital flows from them.

Reducing exposure to international financial markets

As long as the international community fails to agree on fundamental reforms of the international financial and monetary system, developing and transition economies need to design national strategies and, where possible, regional strategies, aimed at reducing their vulnerability to global financial shocks. In the current situation, this means that these economies need to exercise extreme caution towards cross-border capital flows, bearing in mind that the seeds of a future crisis are sown in the phase of euphoria, when a wave of financial inflows is in the making.

For many years, the prevalent view considered almost any kind of foreign capital flows to developing countries as beneficial. This view was based on the assumption that “foreign savings” would complement the national savings of the recipient countries and lead to higher rates of investment there. However, both theoretical considerations and empirical evidence show that even huge capital inflows can be

accompanied by stagnating investment rates, because the link between capital inflows and the financing of new fixed investment tends to be very weak. For the same reason, substantial increases in fixed investment can be accompanied by strong capital outflows.

External financing of developing and transition economies has repeatedly proved to be a double-edged sword. On the one hand, it can be a way of alleviating balance-of-payments constraints on growth and investment. On the other hand, a large proportion of foreign capital inflows has often been directed to private banks for financing consumption or speculative financial investments that have generated asset price bubbles. Moreover, when capital inflows are not used for financing imports of goods and services, they often lead to a strong currency appreciation that makes domestic industries less price competitive in international markets. Financial inflows and outflows, and their instability, have often led to lending booms and busts, inflationary pressures and the build-up of foreign liabilities without contributing to an economy's capacity to grow and service such obligations. A drying up or reversal of inflows exerts pressure on the balance of payments and on the financing of both the private and public sectors. A reliance on private capital inflows has therefore tended to increase macroeconomic and financial instability and hamper, rather than support, long-term growth. Moreover, private capital flows have been mostly procyclical. For both these reasons, they have played a major role in balance-of-payments and financial crises in the developing world over the last three decades.

Greater reliance on domestic capital markets for the financing of government expenditure helps reduce vulnerability to credit crunches and exchange-rate instability. Debt denominated in local currency also allows monetary authorities to counter external shocks or growing trade deficits with a devaluation of the nominal exchange rate without increasing the domestic currency value of that debt. Finally, debt denominated in local currency allows the government a last-resort option of using debt monetization in a time of crisis, thereby reducing the insolvency risk and lowering the risk premium on the debt. On the

other hand, the amount and direction of foreign capital flows are largely determined by factors that are often unrelated to the investment and trade-financing needs of the receiving countries and are beyond the control of their authorities.

Protective measures against external disturbances

Pragmatic exchange-rate management aimed at preventing currency overvaluation can limit the destabilizing effects of speculative capital flows. In addition, interest rate differentials, which often attract carry-trade speculation, can be limited when inflation is kept under control. This can be done not primarily by means of a restrictive monetary policy and high policy interest rates, but with the help of other instruments, such as an incomes policy that aims at keeping average wage increases in line with, and not exceeding, productivity growth and the inflation target of the central bank.

Destabilizing effects of capital flows can also be prevented, or at least mitigated, by resorting to capital controls, which are permitted under the International Monetary Fund's (IMF) Articles of Agreement, and for which there is extensive experience in both developed and developing countries. While the IMF has recently recognized that capital controls are legitimate instruments, it recommends resorting to them only in situations when a balance-of-payments crisis is already evident, and after all other measures (e.g. monetary and fiscal adjustment) have failed. The problem with such an approach is that it does not recognize the macroprudential role that control of capital inflows can play in preventing such a crisis from occurring in the first place.

Reconsidering regulation of the financial system

The hypothesis that deregulated financial markets are efficient because actors in these markets possess all the information necessary to anticipate future outcomes, and will use this information rationally

so that the financial system can regulate itself, has been refuted by the present crisis. This should prompt policymakers in developing and transition economies to draw their own lessons for shaping their countries' financial systems.

Certain regulatory measures that are now envisaged in developed countries may also be relevant and important to developing countries. Such measures include, in particular, those aimed at improving the governance of banks, reducing incentives for highly risky behaviour of market participants, and resolution mechanisms allowing authorities to wind down bad banks and recapitalize institutions through public ownership. The separation of commercial retail banking (receiving deposits, delivering loans and managing payments) from risky investment banking activities is a principle that should also guide bank regulations in developing countries. This would help prevent individual financial institutions from growing excessively large and assuming such a diversity of activities that their performance becomes systemically important. Such measures may be easier to implement in countries where financial systems are still in the process of taking shape, and where the financial sector is still relatively small but bound to expand as their economies grow.

International standards and rules relating to capital requirements and liquidity under the Basel accords, which aim at reducing the risk of bank failure and the need for public bailouts by containing excessive leveraging, may not always be suited to the specific circumstances and requirements of developing countries. Relatively small banks in developing countries may require different rules than large, internationally operating banks in developed countries. But it also needs to be recognized that in many of the developing countries which have experienced serious banking crises since the 1980s, capital and liquidity requirements were much higher than those prescribed by the Basel rules, and that the application of those rules led to a restriction of bank lending, especially to small and medium-sized enterprises (SMEs). These countries should therefore be allowed to adapt prudential rules to their specific situation and needs.

In any case, financial regulation should be conceived in such a way that it is not inimical to growth. In particular, it should encourage long-term bank lending to finance productive investment and discourage lending for unproductive and speculative purposes. This is important because of the interdependence between financial stability and growth: financial stability supports growth because it reduces the uncertainty that is inevitably involved in any financing operation, while stable growth supports financial stability because it reduces the risk of loans becoming non-performing.

Monetary versus financial stability

The current experience in major developed countries shows that massive money creation by central banks has had little, if any, effect on the expansion of credit to the private sector. This suggests that, contrary to the monetarist approach, policymakers should focus more on the volume of bank credit than on money creation for promoting financial stability. Moreover, the purposes for which bank credit is used have an impact on the level and composition of aggregate demand. In providing credit, banks can play a key role in ensuring financial stability. They have to discriminate between good and bad projects, and reliable and unreliable borrowers, instead of behaving like passive intermediaries, or losing interest in the economic performance of their borrowers after securitizing their debt and transferring the risk to another entity.

The experience of the developed countries in the past few years has shown that monetary stability, in the sense of consumer price stability, can coexist with considerable financial instability. In the euro zone, the elimination of exchange rate risk and low inflation even served to generate financial instability: it favoured large capital flows from banks in the core countries of the zone to countries in the periphery and the virtual elimination of interest rate differentials between these two sets of countries. However, those capital flows were not used for spurring competitiveness and production capacities, but rather for feeding bubbles and the financing of current account deficits. This amplified

intraregional disparities, instead of reducing them, and generated the crisis in the deficit countries within the common currency area. This outcome is similar to that of many developing and transition economies in previous decades, particularly in Latin America and South-East Asia, where monetary stability based on a fixed nominal exchange rate led to financial crises.

Fostering the financing of domestic investment

The financial sector can play a key role in accelerating economic growth through the financing of fixed capital formation that boosts production and generates employment. Thus, in order to support development strategies that promote domestic demand as a driver of growth, it is essential for developing countries to strengthen their financial systems.

Retained profits constitute the most important source for the financing of investment in real productive capacity. At the same time, rising demand is decisive for helping to meet expectations of profitability of additional investment in productive capacity, and that profitability in turn finances private investment, resulting in a strong profit-investment nexus. In addition, bank credit is essential, although its relative importance depends on country-specific circumstances. Bank financing enables firms to accelerate their capital formation over and above what is possible from retained profits. Therefore, growth dynamics depend critically on the availability of sufficient amounts of bank credit at a cost that is commensurate with the expected profitability of investment projects. The banking system as a whole can provide investment credit without the prior existence of a corresponding amount of financial savings. The central bank can support the creation of such credit through the provision of adequate liquidity to the banking system and by keeping the policy interest rate as low as possible.

Beyond that, government intervention may facilitate access to credit, especially for sectors and firms engaged in activities that are of

strategic importance for the structural transformation and growth of the economy. One possibility may be the provision of interest subsidies for the financing of investment in areas of activity that are considered to be of strategic importance; another is influencing the behaviour of the banking system in the way it allocates credit.

The banking system and credit orientation

Public intervention in the provision of bank credit will be especially important in developing countries that are aiming at strengthening domestic forces of growth, since long-term loans for investment and innovation, as well as loans to micro, small and medium-sized enterprises are extremely scarce even in good times. Commercial banks in developing countries often prefer to grant short-term personal loans or to buy government securities, because they consider the risks associated with maturity transformation (i.e. providing long-term credits matched by short-term deposits) to be too high.

A revised regulatory framework could include elements that favour a different allocation of bank assets and credit portfolios. Banks could be encouraged, or obliged, to undertake a more reasonable degree of maturity transformation than in the past. Public guarantees for commercial bank credit for the financing of private investment projects, may encourage private commercial banks to provide more lending for such purposes. Such arrangements would reduce the credit default risk, and hence also the risk premium on long-term investment loans. The resulting lower interest cost for investors would further reduce the probability of loan losses and thus the likelihood of requiring governments to cover such losses under a guarantee scheme.

Similarly, within the framework of a comprehensive industrial policy, co-financing by private banks, which take a microeconomic perspective, and public financial institutions that act in the interest of society as a whole, could help to ensure that investment projects are

both commercially viable and support a strategy of structural change in the economy at large.

There are many examples where credit policy has been implemented with the help of various public, semi-public and cooperative specialized institutions which have financed agricultural and industrial investment by SMEs at preferential rates. National development banks may provide financial services that private financial institutions are unable or unwilling to provide to the extent desired. Such banks played an important countercyclical role during the current crisis when they increased lending just as many private banks were scaling back theirs. In addition, smaller, more specialized sources of finance also have an important role to play in the overall dynamics of the development process.

Changing views about the role of central banks

Strengthening the supportive role of the banking system may also require reviewing the mandate of central banks, and even reconsidering the principle of central bank independence. Indeed, the traditional role of central banks only as defenders of price stability may be too narrow when the requirements of development and the need to stabilize the financial sector are taken into account.

Their use of monetary policy as the sole instrument for fighting inflation has often led to high real interest rates that discouraged private domestic investment and attracted foreign capital inflows of a speculative nature. This tended to lead to currency overvaluation with a consequent decrease in exports, and thus a lowering of demand expectations of domestic producers. An incomes policy based on productivity-related wage growth would facilitate the conduct of monetary policy, because it would exclude, or at least significantly reduce, the risk of inflation generated by rising unit labour costs. This would facilitate the task of the central banks to gear their monetary policy more to the creation of favourable financing conditions for domestic investment.

The need for reconsidering the role of central banks has never been more evident than during the latest financial crisis. Central bank independence did not prevent this crisis, but when it erupted these banks had to take “unconventional” measures to stabilize financial markets in the interests of the economy as a whole, rather than simply maintaining price stability. The concerted action of central banks and governments was indispensable in tackling the effects of the crisis, including by bailing out institutions that were considered “too big to fail”. This experience has led to a recognition that central banks can make a major contribution to the stability of financial markets and the banking system.

A further step would be to recognize that central banks can play an active role in the implementation of a growth and development strategy. Since financial stability depends on the performance of the real sector of the economy, bolstering economic growth should also be considered a major responsibility of these institutions. They can support maturity transformation in the banking system through their role as lenders of last resort and their provision of deposit insurance. The latter reduces the risk of a sudden withdrawal of deposits, which would cause liquidity constraints for banks, while the former could respond to liquidity shortages, should they occur. But there are also numerous examples from both developed and developing countries of central bank involvement in directing credit, through, for example, direct financing of non-financial firms, selective refinancing of commercial loans at preferential rates, or exempting certain types of bank lending from quantitative credit ceilings.

These schemes played a pivotal role in the rapid industrialization of many countries. However, they did not always deliver the expected outcomes. For example, in several countries where public banks sometimes provided credit to other public entities for purposes that were not related to productive investment, non-performing loans burdened their balance sheets and undermined their lending capacities. But it also needs to be recognized that it was the privatization of public banks and the deregulation of financial systems that paved the way to major

financial crises in Latin America and in East and South-East Asia. In light of these different experiences, developing countries need to carefully weigh the pros and cons of government involvement in credit allocation when shaping or reforming their domestic financial sectors. They should also implement well-designed governance and control mechanisms for both public and private financial institutions in order to ensure that these institutions operate in the interests of the economy and society as a whole.



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