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Note by the UNCTAD secretariat

Executive summary

Several developing countries have emerged as additional drivers of global economic growth. This “rise of the South” has been accompanied by growing trade and investment flows among developing countries. However, much of this growth remains closely linked to the fortunes of developed countries. The expected protracted period of slow growth in developed countries requires policymakers to search for policy alternatives. At the international level, re-regulating international finance and stemming the encroachment of multilateral disciplines and bilateral trade and investment agreements on developing countries’ policy space are required. At the national level, appropriate macroeconomic policies, along with industrial policy and active labour market policies, can help to strengthen the employment content of growth and increase the wage share, thereby boosting inclusive growth. Commodity-producing countries need a fair share of resource rents and should take savings and investment decisions that enhance the diversification of their economies, including through the development of linkages. Coordinated international measures to tackle the causes of excessive commodity price volatility and contain their adverse effects are also required.

I. The new geography of growth, production, trade and finance

1. The shape of the world economy has changed significantly over the past two decades. Several developing countries and regions have emerged as additional drivers of global economic growth. This new global geography of growth has been combined with changes in the way global production is organized, as well as with new patterns of trade, investment, finance and innovation.

2. The difference between the average growth of developing countries and that of developed countries has considerably widened over the past three decades, from about 2.5 percentage points in the 1990s, over 4.5 percentage points during the period of rapid global growth between 2004 and 2007, to about 5 percentage points during the period 2008–2012. This faster growth in the developing economies has led the contribution of this group of countries to global growth to evolve from approximately one third in the 1990s to almost 90 per cent over the past five years.

3. Not all citizens have benefitted from this economic growth. The rapid increase in income inequality in developed countries in the last three decades is well documented. This feature concerns in particular a sizeable increase in the income share of the top income earners, combined with a hollowing out of the middle-income bracket, characterized by middle-income workers experiencing a decline in wages and employment relative to other workers. In developing regions, trends in income distribution have diverged since the turn of the millennium, perhaps most importantly in Asia where inequality is generally lower than in other developing regions – inequality has increased since the early 1980s in terms of both income disparities across all income groups and the share of the top income groups in total income. But this widening inequality has accompanied rapid economic growth. By contrast, in Latin America and in parts of Africa and South-East Asia, income inequality has narrowed over the past decade. This has occurred in a context of improved external conditions, especially higher international commodity prices and lower debt service burdens. Some resource-rich countries, especially in Latin America, have succeeded in translating terms-of-trade gains into broad-based income growth in the economy as a whole since 2002 and, thus, in narrowing the income gap. They have achieved this by augmenting fiscal revenues and by targeted fiscal and industrial policies, which has helped to create good quality jobs outside the commodities sector.

4. Cross-country differences in the evolution of income inequality within countries underline the need to assess global inequality on the basis of population-weighted differences in income levels both between and within countries. A decomposition of inequality on this basis shows that, in 2008, about three fourths of total inequality is due to differences between countries, while the rest is due to differences within countries. A comparison of the per capita income of the richest 15 countries with that of the poorest 15 over the past few decades confirms this widening gap: the incomes of the richest countries were 44 times those of the poorest in the 1980s, 52 times in the 1990s and 60 times in the 2000s. However, there has been a change in the trend during the last decade, with the ratio declining from 62.3 in 2000 to 55.8 in 2009.¹

5. Much of the recent growth experience of developing countries has relied on export-oriented growth strategies with developed country markets being the main destination. The increasing role of global production sharing, organized around global value chains, has played an important role in this strategy. China's integration into the world economy has been an important feature in this context, especially as this country has evolved as the world's largest manufacturer, increasing its share in world manufacturing output six fold

¹ *Trade and Development Report 2012*, UNCTAD.

over the past two decades. Manufacturing activities have become more prominent also in many other developing countries, especially in Asia. By contrast, Africa and some parts of Latin America have been suffering from deindustrialization with respect to the 1980s.

6. The growing importance of South–South trade in global trade has accompanied these changes in global growth and production pattern. Much of South–South trade in manufactures has involved intermediate production inputs and been linked to global production sharing, while Africa and some countries in Latin America have increasingly exported their primary commodities to the rapidly industrializing and urbanizing economies in Asia. Accelerating South–South trade has been accompanied also by rising flows of foreign direct investment between developing countries.

7. The relative importance of developing countries as recipients of international capital flows has changed significantly over the past few decades. It expanded between 1976 and 1982 and again between 1991 and 1996, followed in both cases by abrupt declines. Developing countries reached their highest share in global capital flows on record in the period 2008–2011, with their levels in 2010–2011 exceeding pre-crisis levels for Africa, Latin America, as well as China. The composition of capital flows to developing countries has changed considerably, with private sources dominating official flows. Large capital inflows remain a challenge for developing countries, especially because they tend to appreciate their currencies and generate domestic credit bubbles, and also because large inflows have often been followed by sharp and abrupt reversals, sometimes ushering in financial crises.²

8. The global diffusion of information and communications technologies has widened the scope for knowledge transfer and location of innovation. Developing countries have substantially increased their investment in human capital, as well as science and technology. Some of them have drastically increased their registration of patents. Although patent filings is not the most informative indicator of development-relevant innovative activity in many less-developed markets, it is nevertheless a reference. Large gaps with developed countries persist in these areas. To facilitate structural transformation and technological advancement, it is necessary for countries to build domestic capabilities to allow individuals, firms and organizations to engage in learning processes.³ In this context, governments should seek to adopt policies that help expand the opportunities for such learning, especially in new industries that offer wide learning opportunities. The software industry is such an industry. As a general-purpose technology, software has wide application throughout the economy and society. It is also characterized by relatively low capital barriers to entry and its relevance is likely to remain high in the future.

9. Nonetheless, developing countries are witnessing accelerating domestic demand, especially household consumption expenditure, which provides strong incentives for domestic firms to engage in the creation of new marketing and distribution modes, as well as product-related innovation that allows these firms to compete successfully with developed-country firms and capture the accelerating demand in their domestic markets. This needs to be supported with proactive, coordinated investments in several domains, including human capital, infrastructure, and mechanisms and incentives for collaborative learning, to enable knowledge accumulation and diffusion and to promote structural change through productive specialization into industries with higher productivity. Despite a few successful cases of this process in Asia, its widespread emulation by middle-income

² Report of the Secretary-General of UNCTAD to UNCTAD XIII, “Development-led globalization: Towards sustainable and inclusive development paths”, document UNCTAD (XIII)/1 (2012).

³ *Information Economy Report 2012*, UNCTAD.

developing countries to help them enter markets for goods with a higher technological content seems to be a daunting task.

10. If difficulties could be surmounted and such trends were to be sustained, developing countries could become an even stronger driver of global economic growth and continue on a separate trajectory from that of the unsatisfactory performance of developed countries. However, much of what sometimes has been called “the rise of the South” has remained closely linked to the fortunes of the developed economies. Several countries have also suffered from misallocation of human capital to low-skills, low-productivity industries with possible long-term implications for their ability to adopt knowledge and innovation-driven growth strategies. The pros and cons as well as possible complementarities of different development models of developing countries require further study. Rapid growth in developed countries before the crisis, in turn, was very much boosted by the detachment of financial markets from the real economy and the ensuing tying of wealth creation to the rapid accumulation of debt and rising asset prices – rather than to steady productivity improvements and increasing labour incomes – and the channelling of innovation to financial engineering rather than to technological progress. This growth strategy has proven to be neither economically stable nor socially fair. Rapid growth in developing countries since the onset of the economic and financial crisis has been related to these countries’ adoption of large countercyclical stimulus packages. The more recent growth slowdown in these countries indicates that the effects of this stimulus are petering out and poses the question as to the policy alternatives available to policymakers.

II. Towards a post-crisis development agenda

11. The global economy has still not overcome the legacies of the busts in the financial and housing markets of major developed countries that ushered in the Great Recession. Households have strongly reduced debt by paying off debt with attendant adverse effects on household consumption expenditure or, often, by defaulting. The combined effect of financial bailouts and recession has led to rising public deficits, triggering sovereign debt crises in some countries and stalling the recovery in others. Everywhere, employment creation has lagged behind, raising the threat of growth in unemployment and the spectre of protectionist responses. These economic problems of developed countries are spilling over to developing and transition economies through weaker demand for their exports, increased volatility in capital flows and commodity prices, and reduced development assistance.

12. Countercyclical, expansionary monetary and fiscal policies were adopted by the major developed countries, and especially by the United States of America, in the immediate aftermath of the onset of the Great Recession. It is clear that such policy stimulus will need to be withdrawn at some point. The appropriate timing, pace and mode of exiting from crisis-related policies depend on the state of the economy and the health of the financial system. However, an exaggerated fear of maintaining the stimulus for too long, supposedly thus distorting private incentives and creating risks to price, financial, and fiscal stability, has led some countries to move towards fiscal consolidation before a self-sustaining recovery has set in. This risks a downwards spiral of lower growth, investment and demand without necessarily resolving excessive indebtedness.

13. To stem adverse spillovers to developing countries from what is likely to remain a difficult external economic environment for a number of years to come, a battery of policy measures and institutional reforms at the national and international levels can support rising living standards in these countries, build their resilience to external shocks (including through reserve accumulation and capital controls), and help them pursue a balanced integration with the global economy. A crucial issue at the international level concerns re-regulating international finance and stemming the encroachment of multilateral disciplines

and bilateral trade and investment agreements on developing countries' policy space, which is still needed to develop the domestic productive capacities and spur inclusive growth.

14. Strengthening the employment content of growth and raising the wage share is particularly important for inclusive growth. In many developing countries, where the labour force is expanding quickly, particularly in urban areas, job creation remains the only assured way of tackling poverty on a sustained basis. However, for inclusive development, jobs must also bring steadily rising household incomes and expanding local markets. In this respect, in many developing and transition economies, the wage share (of national income) has tended to decline since the early 1980s. Much of this phenomenon has followed from the almost universal adoption of export-oriented growth strategies during the 1980s and 1990s, which led the corporate sector in developing and transition economies to make decisions on wages and employment with reference to external demand and competition on global markets. The decline of the wage share was accentuated by other factors such as technological progress, trade globalization, and financialization and decreasing union density, all of which have eroded the bargaining power of labour.

15. More appropriate macroeconomic policies, along with active labour market policies, can help to manage the threats to employment. Incomes and employment policies, such as the implementation of legal minimum wages, complemented with enhanced public employment can address these threats, along with strategies to improve the viability of small-scale production, including in agriculture. There is, in addition, an array of measures, from transfer payments and microfinance schemes to public work programmes, which can be used to improve the effectiveness of labour markets even in the poorest countries. In developing countries with large informal sectors and subsistence farming, policies should target the lifting of entry barriers into the mainstream economy. These can be technical, such as enterprise development and basic infrastructure, or regulatory, such as property and land rights and inclusive financial policies. On the industrial front, downstream and sidestream linkage activities can be stimulated around natural resource exploitation activities, including small-scale mining and energy products retail vending.

III. Industrial policy

16. Industrial development remains a priority for many developing countries because of the opportunities it provides to raise productivity and incomes, and to get the most from international trade. But a wider sectoral approach, including a focus on the primary sector in many least developed countries, is needed in order to ensure that measures to diversify economic activity are consistent with job creation, the assurance of food and energy security and effective responses to the climate challenge.

17. The debate on the role of industrial policy in development has revived in recent years. One of the factors that have opened the way for revisiting this issue was the realization during the past decade that the promises of the Washington Consensus, which excluded any role for industrial policy, were not fulfilled. As a result, developing as well as some developed countries started to look for alternative development strategies. This search for alternatives has been accompanied by a rediscovery of classical ideas of economic development, including the recognition of the importance of both domestic demand and of an economy's sectoral structure for the generation of linkages and productivity growth. These tendencies have been spurred by the economic and financial crisis that sharpened the debate about market failures and the need for institutions and rules governing markets. Moreover, accumulated evidence on the institutional and policy bases of actual developmental success stories has become increasingly difficult to ignore and dismiss. This opened the space for and the willingness of policymakers to engage in experimentation and discovery of home-grown solutions. Many of these experiments include a good dose of

industrial policy, such as in Brazil, China and South Africa. The need to address a number of emerging development challenges such as energy security in the context of climate change constraints, or food security, is an important factor in the renewed interest in the interface between industrial and innovation policies.⁴

18. The use of industrial policy to address post-crisis economic challenges is likely to differ across various groups of countries. However, one common factor is the recognition that the global division of labour increasingly requires knowledge, skills and technological capabilities. The ability of countries to sustain improvements in income and welfare depends on their capacities to engage in activities in which their competences and capabilities enjoy some innovation rents.

19. Developed countries such as France and the United States have used industrial policy to retain manufacturing activities or re-shore previously off-shored activities. Natural resource-rich economies will need to invest in new activities and spur production and export diversification. Countries integrated into global supply chains will use industrial policy to redefine their links to the global economy with a view to moving up the value chain. Developing and transition economies with a growth strategy that has emphasized exports of manufactures to developed markets will need to rely more on domestic demand for their growth and use industrial policy to adjust the sectoral structure of their production to better meet the sectoral structure of domestic demand. Certainly, growth strategies based on domestic demand and product development for local markets do not exclude the involvement of foreign firms that might help build up the required productive and innovative capacities.

20. To make national and international policies more conducive to development, the shape of the global partnership for development must be reconsidered. North–South cooperation needs to be reinvigorated. But this needs to be done in a way that reflects the greater weight of developing countries in the global economy and not only by giving developing countries additional voice by adding a chair to the table. Rather, it should reconsider the agenda with a view to reshaping the rules and institutions that constrain the policy space available to countries that are latecomers to development. Moreover, developing countries should strive to realize the full potential scope of South–South cooperation, as well as of regional cooperation among developing countries. The notion that South–South relations are usually based on equity and mutual benefit will be particularly important in this respect.

IV. Fostering the role of commodities in national development

21. The commodities sector is a major contributor to employment and foreign exchange (income and government revenues) in most commodity-producing developing countries. The latest commodities prices boom, which started in 2002, considered as being the longest and the broadest, provides a great opportunity for commodity-exporting developing countries to use their windfall gains to embark on a sustainable growth path. But to achieve this objective they need to gain a larger share of the price windfall and to adopt investment patterns that enhance the diversification of their economies as a basis for self-sustaining development that provides increased employment opportunities and incomes, including reductions in poverty levels.

22. However, many major impediments to this process persist. These include the unequal distribution of resource rents, high commodity price volatility and instability, and

⁴ See *Technology and Innovation Report 2011*, chapters 3 and 5, UNCTAD.

food and energy insecurity. Without appropriate policy responses, a significant improvement in the terms of trade of commodity-exporting developing countries may entrench their existing commodity dependence, as it may reinforce their comparative advantage and draw additional resources into the commodity export sector and away from other important activities. In this context, medium-term savings and investment decisions become critical to the formulation of a development policy that enhances opportunities for linkages between the commodity-producing and related manufacturing and service sectors.

23. The extent to which these opportunities are grasped will be a function of the responses of key public and private stakeholders, in particular the State. All these actors have to undertake concerted efforts to prioritize the development of production linkages in these economies. This would entail the development of downstream commodity processing and commodity-related industries and the stimulation of wider domestic trade and new economic sectors, including manufacturing. In addition, policymakers would need to give greater attention to broadening and deepening upstream or backward linkages (the supply of inputs into the commodity sector) utilizing commodity export windfalls. In the extractive sector where the distribution of rents between host countries and transnational enterprises is highly unequal, the initial response could include a (re)negotiation of contracts to ensure a fairer share of rents for host countries to be used to fund diversification and production-capacity-building activities.

24. At the international level, further examination of the causes of volatile commodity prices and coordinated international measures to minimize them would be required.
