I. New realities and persistent challenges

A. Significant advances

13. Since early 2000, the overall performance of developing countries and their ability to catch up with the richest countries have improved in an impressive way in several crucial areas. The recovery of the world economy since the end of the dotcom bubble has stimulated growth in nearly all regions and countries. Despite enormous and persistent differences in absolute income, developing countries increased their real income (GDP deflated by consumer prices) by 71 per cent in the decade 1996–2006, compared to 30 per cent in the G-7 countries. Real income in Latin America, despite serious setbacks due to financial crises in Brazil, Argentina and some smaller countries, grew by 39 per cent, Africa by 55 per cent and the economies in transition by 57 per cent. In 2006, five years after the beginning of the global recovery, only two of 132 developing countries recorded falling real income, compared to seven countries in the period 2000–2005 and 13 in the half decade before that. At the same time, volatility of growth has come down to levels normally observed only in highly developed economies.

14. In this favourable external economic climate, most developing economies have seen strong growth in employment or succeeded in stabilizing or slightly reducing unemployment rates. However, measured unemployment in developing countries is much less responsive than unemployment in developed economies to high growth rates. The main reason for this slow response in developing regions and emerging markets (sometimes confounded with jobless growth) may be found in the huge reserves of labour that are stimulated to enter more formal markets only during a sustained period of rising demand for labour and rising wages. As some emerging economies, including China, show, the process of integrating a large number of previously underutilized workers into the officially measured labour force may take many years of high growth rates.

15. The dynamic growth in developing countries has been stimulated by extraordinary export growth. Real exports of developing economies nearly tripled between 1996 and 2006, whereas those from the G-7 only rose by some 75 per cent. In this area, Asia clearly dominated the picture, with transition economies and Latin America coming in second, and Africa showing exactly the same increase as the G-7. In terms of imports, the expansion in different regions was much closer. Asia was the strongest importer, with a 170 per cent increase, while the transition economies had a 150 per cent increase. Africa's outcome was quite balanced, with real imports increasing almost as much as exports. Since 1995, world merchandise trade has been growing at an annual average rate of 7.5 per cent, sustaining the strong growth rates that emerged in the early 1990s, though still not matching the averages of more than 10 per cent witnessed through the 1960s and 1970s. Overall, the share of developing countries in global trade increased from 29 per cent in 1996 to 34 per cent in 2006.

16. A related development has been the sustained rise in South–South exchanges. For example, South–South merchandise trade is estimated to have expanded from $577 billion in 1995 to $1.7 trillion in 2005. This resulted in a concomitant increase in the South–South share of world merchandise exports to 15 per cent in 2005, compared to 11 per cent in 1995. During the last two decades, the shares of a number of emerging economies in international merchandise and services trade have

grown considerably. Seven countries in particular have contributed immensely to this trend: Brazil, India, China, Mexico, the Russian Federation, South Africa and the Republic of Korea. The share of merchandise exports of these countries in global exports increased from 10.6 per cent in 1995 to 17.2 per cent in 2005. This robust trade performance contributed to a high economic growth rate in these emerging economies, with annual real GDP growth of 5.7 per cent.

17. As a consequence of this favourable trade performance, the overall current accounts of developing countries have swung to a surplus for the first time since the end of the Bretton Woods monetary system at the beginning of the 1970s, while those of developed economies are in deficit, mainly due to the huge deficit of the United States. The swing can be observed in the three big regional groups and, even more surprisingly, in most of the bigger regional subgroups. In 2005, sub-Saharan Africa – if South Africa, with a deficit of 6 per cent, is excluded – recorded a current account surplus of more than 6 per cent of GDP on a clearly rising trend. In South America, a deficit of 2.5 per cent in 1995 turned into a surplus of 3 per cent by 2005; excluding Brazil, it amounted to 4.5 per cent of GDP. The only exception is the group of transition economies in Eastern Europe, if the oil producers of the region are not included.

18. There is a close correlation between the improvement of overall economic performance and the reduction of current account deficits and emerging surplus regimes in the globalized economy in the wake of financial crises. This shows that huge price effects on both the export and import sides brought about the turnaround in the balance of payments and at the same time stimulated growth. However, there are two different classes of such stimulants.

19. The first can be observed in many cases of middle-income countries such Argentina or Brazil. Both countries anchored their currencies to the United States dollar at the beginning of the 1990s to bring down inflation. This strategy implied a real appreciation of their currencies and a loss of competitiveness over time because the nominal exchange rate was absolutely stable (Argentina) or depreciated less than needed to compensate for inflation differentials (Brazil). In both cases, the current accounts went into deficit. Only after a painful financial crisis and a sharp currency devaluation did they swing into surplus. In both countries (as in other cases in Europe and elsewhere) devaluation was at first a way out of the crisis, but proved to be beneficial in terms of export performance and import compression in manufacturing for a much longer time. In other words, the overall competitiveness of a number of developing countries increased dramatically, owing to forced currency devaluation after the crisis.

20. However, many other countries have lost part of the gains of competitiveness of that period due to renewed appreciation of their currencies. In particular, this is the case in some countries in Asia such as the Republic of Korea, Thailand and Indonesia, and in the biggest country in Latin America, Brazil, where speculation-driven appreciation of the currency has resulted in a deterioration of post-crisis advantages in competitiveness. In Eastern Europe and in the transition countries in general, the global position in trade has worsened due to rapid wage growth and overvalued currencies, which are reflected in huge current account deficits of the non-oil producers in that region.

21. The second class of stimulants to developing economies' current accounts in the last decade clearly relates to commodity price hikes and the concomitant

improvement in terms of trade of commodity-producing countries. Again, it was due to an external shock that the prices of commodities increased relative to manufactured goods; given the low elasticity of demand for these products, the revenues of the producers reached all-time highs, improving their external balances.

22. Investment in particular has been positively affected by the favourable environment since the turn of the century. Whilst real investment in the G-7 countries has remained rather flat (and investment–GDP ratios have declined), developing economies were able to trigger an investment boom (in absolute terms and relative to aggregate demand) once the financial crises were overcome. In fact, the most dynamic region in terms of investment was Africa, outpacing even Asia with a doubling of fixed investment since 2000. Given the fact that Asia received a much higher share of foreign direct investment, domestic investment growth in Africa is truly remarkable, despite the rather low level of its investment ratio compared to that of Asia.

23. Most countries also managed to trigger stable expansion of domestic demand. Real private consumption increased steadily in the last half of the 1990s and has accelerated remarkably since. As employment did not grow much over this period, the growth in consumption is more associated with growth of real incomes of private households. Since 2003, the growth rate of real private consumption in all regions has been strong, with Asia the most dynamic.

B. Apprehension

24. Global trade and financial integration have reached unprecedented depth, involving a continuously growing number of economies, goods, services and financial instruments. Nearly all countries are facing the challenges of globally open markets and the greater power of global players on these markets. In Asia, new driver nations of this global economy have emerged which are bigger and more dynamic than their predecessors in the 1970s and 1980s. This has spread uncertainty and apprehension.

25. Paradoxically, globalization fears are common in rich and poor countries alike, though for very different reasons. Exports from dynamic Asian economies such as China and India penetrating the world market for certain consumer goods are taken as proof of the dangers that the new global drivers portend, even if the successful firms exporting from these emerging economies are owned by internationally-versatile companies from developed countries. This apprehension is intensified by the increasing offshoring of information technology-driven services to some developing countries and the export of high-technology plants to low-wage locations. The 1.5 billion workers in the emerging economies with small endowments of capital are viewed by some economists and influential politicians in the developed countries as an addition to the existing work force in their economies. This is often simplistically interpreted to imply that the global supply of labour has increased by 50 per cent, which in turn means that, in the last decade, the global capital–labour ratio has halved, thereby creating a new abundance of labour (in particular low-skilled labour), pushing down wages, raising profits and creating upward pressure on interest rates because of the relative scarcity of capital. Hence, a dramatic shift of market power and income to the owners of capital occurs. As a result, the notion of "competitiveness of nations" has acquired a new connotation and greater influence in developed countries, and has even made its mark in

international negotiations, including those in the World Trade Organization (WTO). It has created a fundamentally wary attitude towards countries with low wages, and has led to demands for higher social and environmental standards for developing countries.

26. For developing countries, the apprehension arises from the slow realization of the gains from trade and liberalization, and the uncertainties and lack of national autonomy associated with fast-moving global markets that are very much driven and steered by the major economies. Lack of diversification of export structures, reliance on foreign direct investment, technological dependence and the slow pace of the process of catching up and reducing absolute poverty are taken as grounds to question the mutual benefits promised by the open market reform agenda. In addition, the integration of the developing countries into the global division of labour during the last decade has not been as smooth as many expected. Financial crises have undermined many promising development programmes and led to traumatic experiences and dependence on international capital markets and major donors. In part due to these concerns, in recent years the imperative of regaining control and widening the scope of national policies has preoccupied the developing countries' international development agenda.

27. On closer examination, the reality of the impact of globalization lies somewhere between the divergent fears and points of view presented above. The fears of developed economies about low-wage labour in the emerging South are clearly overstated. Internationally, the mobility of labour is extremely low and the mobility of fixed capital, which should not be confused with short-term financial flows, is rather limited. Consequently, the equalization of factor prices and of labour in particular does not happen overnight. Indeed, from the perspective of many populous developing countries, this is still seen as a frustratingly slow process. The structural change induced by this rather smooth integration has neither impeded growth in the developed world nor forced the kind of shocks that accompanied the rise in unemployment in the industrialized world in the 1970s and 1980s. By contrast, as labour productivity in emerging economies has improved and their domestic income and consumption expanded, demand for products from the rest of the world has increased.

28. Furthermore, the positive effects stemming from the Asian growth dynamics and spilling over into other regions of the world economy need to be given due consideration. The boom in commodity demand and the rise in commodity prices have offered long-missed opportunities for many commodity producers in the developing world, and have led to significant and prolonged improvement in the terms of trade of these countries. Even Africa as a whole looks back to a half decade of growth rates beyond 5 per cent annually, notwithstanding the adverse external environment for some non-commodity-producing countries. Most importantly, despite externalities such as climate change, it is neither coincidental nor necessarily a transient phenomenon that the performance of the world economy since 2000 has been stronger than at any time in the 30 preceding years. All around the world, growth rates have accelerated and proved to be rather stable over a relatively extended period.

C. Persistent challenges

29. Despite the impressive performance of developing countries as a whole in recent years, many countries, in particular the least developed and other low-income economies, have not been lifted by the recovery, and continue to rely on exports of low value added primary commodities. These countries have suffered from worsening terms of trade, highly volatile world prices and a decline in their share in world trade. The export share of the 50 least developed countries (LDCs), the majority of which are in sub-Saharan Africa and commodity-dependent, fell from 2.5 per cent in 1960 to about 0.5 per cent in 1995, and have since hovered around this level, though the improvement in commodity prices helped raise their share to 0.8 per cent in 2006.

30. There is strong evidence that high rates of economic growth have not been translating effectively into poverty reduction in many cases. This is partly related to the fact that agricultural productivity is very low and, with rising populations, average farm sizes are getting smaller, thereby creating a situation where it is difficult to make a reasonable living from the land. More and more people are seeking work outside agriculture. But most LDC economies are simply not able to generate productive employment opportunities for these people. In four fifths of them, non-agricultural labour productivity in the new millennium was lower than it had been 20 years earlier, and agricultural labour productivity actually declined in one third of them.

31. There is also increasing differentiation amongst developing countries within each region of the world, including the LDCs. This trend has been particularly apparent since 1980, but it has intensified recently. Estimates suggest that, in 1980, 64 per cent of international income inequality amongst developing countries (excluding China) could be explained by differences between regions, and 36 per cent by differences within regions. But by 2001 those proportions had almost totally reversed, so that 62 per cent of international income inequality amongst developing countries (excluding China) was explained by differences within regions and 38 per cent by differences between regions.

32. These estimates reflect the fact that some countries within each region are doing well whilst others have very sluggish growth. In Latin America, for example, recent estimates of changes in the incidence of poverty between 1999 and 2005 show that poverty was clearly falling in six countries (Chile, Colombia, Ecuador, Honduras, Mexico and the Bolivarian Republic of Venezuela), whilst it was clearly increasing in five others (Argentina, Bolivia, El Salvador, Panama and Uruguay). In four other countries for which data are available, there was little change.

33. The challenge for policymakers is how to promote inclusive development and preserve the main features of the current favourable scenario beyond a cyclical backlash. This requires a new approach to global economic governance as well as a new focus for national policies. The prevailing consensus, putting liberalized markets and flexible prices at centre stage, has proved to be insufficient in the light of the complex challenges that the new generation of globalization poses. A concrete vision of the global partnership for development has to emerge based on the new realities, which call for a more equitable and effective balance between open global markets, the sovereignty of the nation-State, and the rule of law and related international regulations.

34. More broadly, it should be acknowledged that conventional economic wisdom may not have all the answers to the challenges that many poor people face in a globalizing world. Experience shows that policy advice for integration has resulted in some communities being exposed to hitherto unknown risks, making them vulnerable to even the slightest external shocks. Ten years ago, many Asian countries learnt to their cost the dangers of excessive reliance on debt finance, both foreign and domestic. In Thailand, the response to the crisis relied to a large extent on the "Sufficiency Economy" philosophy that the King of Thailand developed over many years. Sufficiency Economy is not a policy prescription, but a philosophy that incorporates universal values of relevance to day-to-day economic and human relations. It emphasizes responsible consumption: living within one's means; moderation; sustainable use of resources, especially in agricultural production; nurturing the development of small and medium-sized enterprises; and building capacity through development from within. It is worth exploring whether these principles could be applied in other developing countries to help them build up resilience to the shocks of globalization and formulate people-centred development.

D. The capital flows paradox

35. For a number of years now, global capital flows have reversed as current accounts swung around and developing countries became net exporters of capital and developed countries net importers. For the first time in decades, developing countries as a group have attained a rare moment of independence from international capital markets. Capital surplus could be used to lower interest rates through national monetary policy measures and has further stimulated domestic investment. It has also opened up new opportunities for current and future "emerging" economies for proactive policy management of inward and outward financial flows (official and private), domestic resources and appropriate fiscal and monetary policies.

36. Most orthodox development theory would consider such net export of capital from poorer countries as a constraint on domestic investment. Yet the realities of rising domestic investment in capital-exporting developing countries cannot be denied. Exports of capital from poor developing countries – supposedly endowed with little capital – to the rich North – supposedly endowed with plenty of capital – have not constrained these countries' ability to invest larger sums in fixed capital at home than any time in the last 30 years, a fact that poses a new challenge for orthodox development theory. It implies a need for a rethinking of the most crucial assumptions about how developing countries can best manage the functional relation between savings, investment, capital flows (including both foreign direct investment (FDI) and official development assistance) and the alternate policies, and paths that such policy diversity offers for catching up.

37. The belief, held in many development circles over many years, that poorer countries have a chronic "savings gap", due to the inability of their private households to save, and can rely only on permanent net inflows of capital to catch up, needs to be re-examined in the light of the recent performance of a large number of emerging economies in all regions. The apparent paradox behind this performance and the wider policy space it implies has been driven mainly by several powerful developing economies with market access (in Asia, Latin America and Eastern Europe), and appears both sustainable and relevant to other emerging

economies. However, its wider significance for very poor and other lower- and middle-income countries remains to be seen.

38. Nevertheless, the implications of these new developments for development policy and the future of the open global market are remarkable and point to a new meaning of interdependence during this latest phase of globalization. If developing countries are able to create (and export) capital, this should allay growing apprehensions in developed countries about the impact on their economies of offshoring and capital scarcity in developing countries. It is these latter factors that are often considered to be exerting downward pressure on wages in developed economies. In fact, with reverse capital flows, this may not be the case.

39. Developing countries such as China and India are on a similar path to that pursued by countries such as Japan and the Republic of Korea when they were developing 30 years ago: catching up by applying high technology in a low-wage environment, thereby lowering unit labour costs. The leapfrogging of stages of the usual domestic technological evolution and the improvement of overall competitiveness by realizing temporary monopoly rents are made possible through this combination of high productivity with low wages. This model has come into full swing since the crisis-driven devaluation corrected the exchange rate misalignments of the 1990s. This policy mix has proved its feasibility and relevance to the realities that labour-and-capital-surplus emerging economies need to tackle on the long march to development without actually aggravating global imbalances or welfare in the North.

40. For example, in a globalized world in which the horizons of Governments and companies are fast expanding, it is increasingly recognized that countries may use both inward and outward FDI to upgrade the competitiveness of their indigenous resources and capabilities. In both cases, foreign assets (resources, capabilities, access to markets, patents, trademarks, entrepreneurial skills and institutions) are acquired. This facilitates structural change, thereby promoting dynamic comparative advantage and enhancing a country’s development potential. Increasingly, developing countries engage in a combination of inward and outward FDI. Of course, some developing countries might be in a more favourable position to exploit or gain new assets via outward FDI, while others might better advance their competitive/comparative advantage by encouraging inward FDI, so the balance varies considerably between countries. For example, over the course of the last two decades, China has moved from heavy reliance on inward FDI to a relatively greater utilization of outward FDI.

41. It is also noted, however, that the share of FDI in this process in China in particular is higher than it was in Japan and the Republic of Korea in the past. However, the fact that increasing numbers of developing countries, despite higher inflows of FDI, are net exporters of capital raises the question as to whether it is the scale of foreign capital import as such that is critical or, more significantly, the import of know-how that comes with capital. Whether the owner of the plant in a developing country is a domestic or a foreign investor is a question of secondary importance in capital-surplus countries. In other words, if integrated within a comprehensive set of development policies, the impact of today’s offshoring need not be different from the impact of former catching-up processes, namely those driven by imitation and the import of technology. The economic consequences are more or less the same for developing and developed economies. Clearly, the

development effects of FDI for the host economy depend on a range of factors, including the amount of technological spillovers from affiliates to domestic enterprises, the creation of forward and backward linkages within the economy, and the impact on domestic investment.

42. There can be no doubt that the pace of development in the big emerging economies can contribute to an acceleration of structural change in many countries, developing and developed alike. For developed economies, the Japanese challenge of the 1960s or the challenge by the "small tigers" of the 1980s is replaced by the Chinese or Indian challenge today, though on a scale not witnessed in previous epochs. As in earlier times, certain sectors or groups of low-skilled workers are endangered by low-wage competitors abroad employing sophisticated machinery. In many countries, it is feared that the pace of structural change could overstretch the ability of employers and employees to adjust. Unemployment and low growth would follow.

43. However, there is no evidence that this process has endangered the social safety net or the growth performance of developed countries in general in the last 10 years. The opposite seems to be closer to truth. The fact that those developed countries with large deficits in their current accounts, such as the United States or the United Kingdom, do much better in terms of growth and job creation than the big surplus countries, such as Japan and Germany, clearly points to other factors explaining the latter group's dismal performance.

E. From "getting prices right" to "getting development right"

44. During the 1980s and 1990s, most developing countries undertook far-reaching market-oriented reforms. The international financial institutions played a dominant role in this context, both as lenders, imposing their policy conditionality on borrowing countries, and as setters of the international development agenda. The market-oriented reform agenda was based on the expectation that capital accumulation, technological progress and structural change would result from more efficient resource allocation following improvements in the incentive structure and reduced State intervention. "Getting the prices right" was the catchword for this agenda.

45. However, from the very beginning, the orthodox reform agenda, which came to be known as the "Washington Consensus", stood in stark contrast to the successful catching-up of a number of East Asian economies that had based their development strategies on capital accumulation, supported by pragmatic and proactive industrial policies combined with more measured and often strategic integration into international markets and proactive macroeconomic policies.

46. This strategy seemed to falter when, in the second half of the 1990s, some of these countries experienced a dramatic, albeit short-lived, downturn in their economic growth performance. But, as shown by UNCTAD at the time, the financial crisis resulted to a large degree from premature capital-account liberalization, which made their economies vulnerable to the vagaries of international capital markets. Other countries in the region, which had maintained prudent integration and proactive policy strategies, experienced buoyant economic performance. With the global recovery under way after 2000, even the crisis-stricken economies returned to a steep growth path.

47. Against the backdrop of recurrent crises of the global economic system, the formulation of the Millennium Development Goals in 2000 reflected a certain dissatisfaction among global policymakers with progress in development and in the fight against poverty under the conditions that had prevailed over the previous two decades. In 2002, the Monterrey Consensus recognized, among other things, the challenge facing developing countries in creating the necessary internal conditions for adequate levels of productive investment and ensuring complementary public investment in the development of local capacities – aspects that had been largely neglected in earlier reform programmes. At the same time, policymakers in many developing countries began to reconsider their development strategies, guided by the successful industrialization strategies of a range of East Asian economies, as well as the earlier experience of the now-developed countries. All of this testified to the growing uncertainly about the commitment to the orthodox reform agenda and reflected a common finding: proactive macro, trade and industrial policies are needed for successful integration and for sustained improvements in the standards of living and incomes of all population groups.

48. Historical evidence shows that countries raise the living standards of their populations by raising labour productivity. This is associated with a substantial change in the sectoral pattern of production and employment, from agricultural to industrial products, and a shift from labour-intensive activities to a growing range of capital- and technology-intensive activities. Transformation of the production structure requires entrepreneurs who are capable and willing to invest in activities that are new to the domestic economy. Schumpeter long ago pointed to the importance of innovative investment for economic development, and it has recently been argued that innovation and the consequent rise in productivity account for much of the extraordinary growth in various parts of the world since the industrial revolution.

49. Investment plays a key role because it simultaneously generates income, expands productive capacity and carries strong complementarities with other factors in the growth process, such as technological progress, skills acquisition and institutional deepening. However, the occurrence of innovative investment is not automatic; it can encounter structural and institutional impediments. Moreover, the macroeconomic environment can be inappropriate for encouraging and supporting investors seeking to create or expand productive capacity and increase productivity.

50. Thus, the key to the development process is creating the necessary conditions for innovative investment. The most important condition is that firms have access to reliable, adequate and cost-effective sources for financing their investments. This is least costly when profits are the main source of investment financing. Indeed, if an investment-profit nexus can be ignited, profits from innovative investments simultaneously increase the incentive for firms to invest and their capacity to finance new investments.

51. On the other hand, when enterprises are heavily dependent on borrowing to meet their needs for fixed investment and working capital, as is the case for new enterprises, the stance of domestic monetary policy is of crucial importance, because high levels of nominal and real interest rates tend to increase production and opportunity costs. An overly restrictive monetary policy may bias investment decisions in favour of financial assets or in favour of fixed investment in production activities with known costs and demand schedules. Hence, a wide range of

conditions must come together for firms that are competitive domestically to become successful exporters in the global markets.

52. The linkages between investment, productivity growth, successful integration into the international trading and financial systems and economic development have been seen in recent years through the lens of international competitiveness. A wide range of criteria and measures of competitiveness of countries have been elaborated, some of which have been extensively publicized as global rankings of nations. Indeed, the concept of competitiveness can contribute to a better understanding of the distribution of wealth in a globalized economy if it relates to both national income and international trade performance, particularly the performance of industrial sectors that are important in terms of employment or productivity growth. In this context, competitiveness is achieved as part of a Schumpeterian logic of capitalist development being a sequence of innovative investments associated with dynamic imperfect competition and productivity gains. Such an understanding assigns a major role to economic policy in facilitating productivity-increasing investment and providing the institutional arrangements for a high degree of competitiveness.

53. New technology in the form of added capital per worker (or embodied technological change) is said to be at the heart of the development process through which nations become rich. And embodied technological change is driven by investment based on either innovation of domestic entrepreneurs or putting imported capital equipment to efficient use. Thus, the concept of competitiveness in the context of economic development needs to take account of the interdependence of investment, trade, finance and technology. The key question is how different price, wage, exchange rate and trade arrangements influence innovative investment, and whether productivity gains of individual firms translate into benefits for the overall economy. These benefits can be reflected in rising living standards while maintaining external balances, or into unchanged living standards and rising market shares while maintaining external surpluses.

54. Competitiveness in international markets is determined by both real and monetary factors. It may increase as a result of the relatively strong productivity performance of companies or of the national economy as a whole that is not reflected in higher wage rates. But greater competitiveness can also result from a depreciation of a country’s real effective exchange rate following either a depreciation of its nominal effective exchange rate or a smaller rise in wages compared to productivity growth (i.e. falling unit labour cost growth) than in other countries.

55. It should be noted, however, that the policy concept of competitiveness as outlined above is mainly relevant for middle-income countries, where economic success depends on investment that leads to sustained improvements in productivity. It is less relevant today for many of the poorest countries, where capital accumulation can help raise per capita income and living standards simply by allowing a fuller use of underutilized labour and natural resources without altering the efficiency with which resources are utilized.