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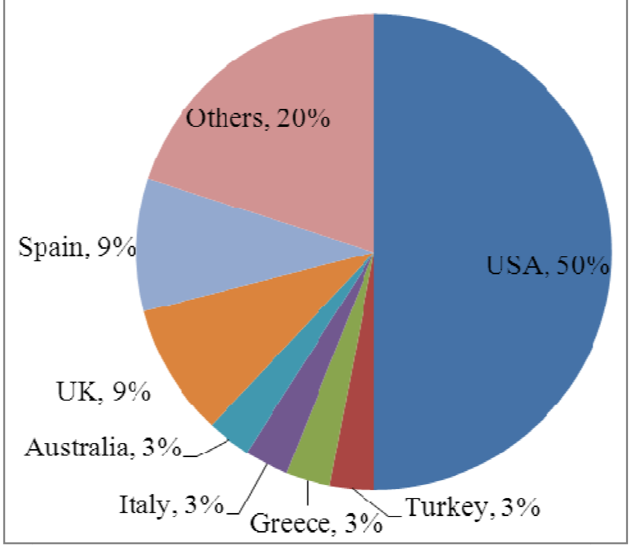
THE DISTRIBUTIONAL IMPACT OF THE CRISIS[1]

Jomo Kwame Sundaram

In analyzing the effects of the crisis on distribution, the full impacts of financialization and the larger picture must be integrated and seen in a global and historical context.

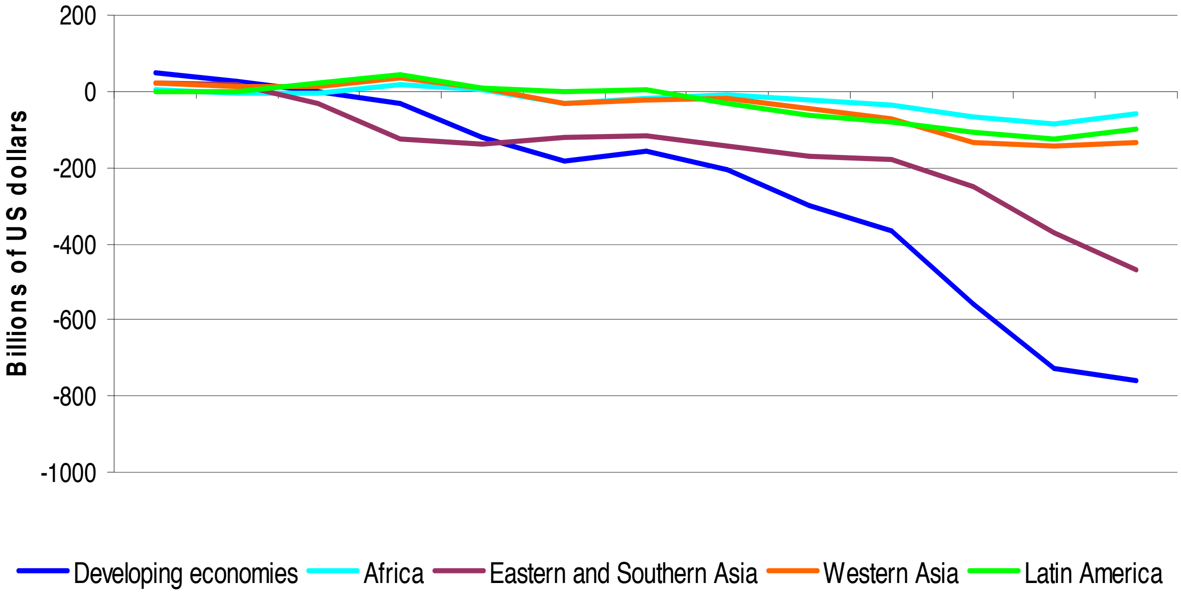
After the end of Bretton Woods in 1971, no alternative system for regulating exchange rates was put in place. This rendered international economic governance more unmanageable by leaving exchange rate movements to financial markets. This situation was compounded by capital account liberalization and rapid financial globalization. While financial globalization was expected to increase both growth and stability, it has instead led to greater economic fragility in general. In addition, financial globalization has not favored most developing countries, in particular the poorer and least developed ones. There are now fewer resources for the needy; fiscal space has been reduced substantially; and policy space has tightened in developing countries. The lack of a system for coordination of global recovery has allowed a number of detrimental effects of the crisis to become broadly manifest. The distributional effects of these changes vary, and depend on specific conditions and policy responses.

Figure 1: Net Capital Importers



Several factors have played a role in the gestation of this crisis. First, there is general agreement that the process of financial globalization over the last three decades has resulted in what Paul Romer refers to as "capital flowing uphill". The net flow from the capital poor to the capital rich, from the global South to the North, contradicts theoretical neoclassical expectations. It postulated that freer markets should lead to the relative scarcity of factor inputs determining their remuneration, and with more freedom of movement for capital relatively higher returns for capital in South should lead to flows to those regions. The United States (U.S.) has been the single largest recipient of capital flows and the world's single largest borrower in recent years. As shown in Figure 1, the U.S. accounted for half of total capital imports, whereas developing countries received less than a fifth of global capital inflows. Over the past decade, developing countries have seen net outflows of financial resources rise sharply, reaching to over US$700 billion in 2008 (See Figure 2 on historical net capital flows). There has thus been a significant net outflow of funds from developing to developed countries over this period.

Figure 2: Net transfer of financial resources from South to North

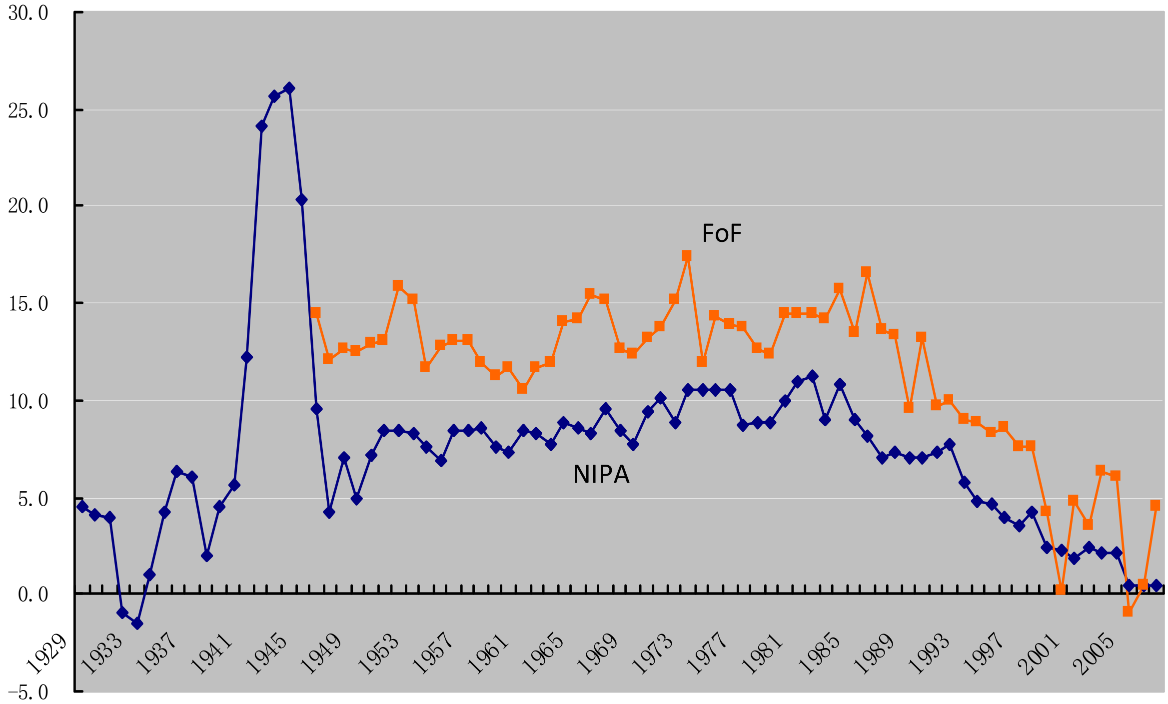


Source: UN World Economic Situation and Prospects 2008 (forthcoming)

Second, the costs of funds have not decreased. The theoretical argument for financial globalization and deepening was that better intermediation as well as other effects would reduce the cost of funds. This effect has not materialized. However, the costs of funds have decreased due to the dominant position of the U.S. economy, and due to the U.S. Federal Reserve having deliberately kept interest rates relatively low since the 2001 recession. This had a benign economic effect on a global scale, but loose monetary policy and other related factors contributed to the housing bubble in the U.S. economy.

Third, personal savings rates in the U.S. have been low for a number of years, and real savings rates have even been negative in some periods, as can be seen from Figure 3. The difference between the National Income and Product Account (blue line) and the Flow of Funds Account (red line) also shows how much the measurement of savings rates differs according to methodology.

Figure 3: *U.S. Personal Savings Rates, 1927-2007*



Another important factor in the current crisis is the global imbalances. The U.S. current account deficit, the flip side of the large capital inflows and savings shortfalls, has been growing since the early 1990's, and has ballooned disproportionately especially since 2000 (Figure 4). The relative size of the Chinese current account surplus shows that the U.S. current account deficit is really against the rest of the world -- including the oil exporters of the Middle East, Germany and other countries -- not just China. While China has had a current account surplus vis-à-vis the U.S. for decades, it was running deficits with the rest of Asia as well as Africa. The U.S. deficit thus has a more global dimension than is often acknowledged, while the Chinese current account surplus is a comparatively recent phenomenon. The main global imbalance thus lies with the U.S., rather than with China.

Figure 4: *Global imbalances ballooning*

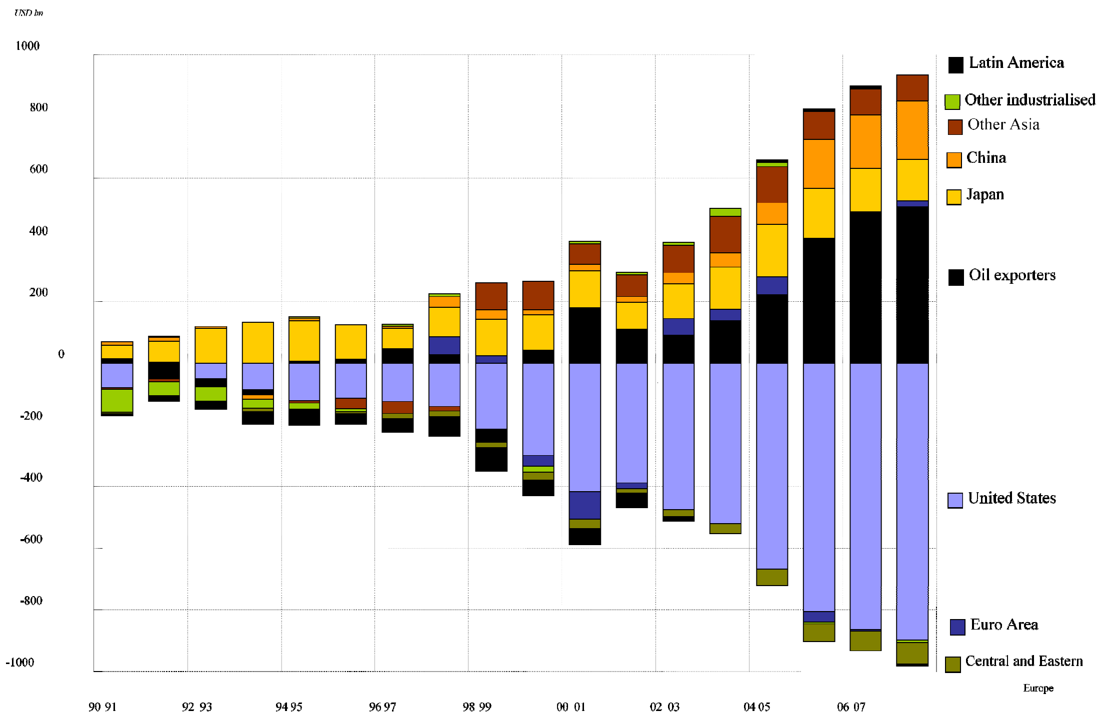
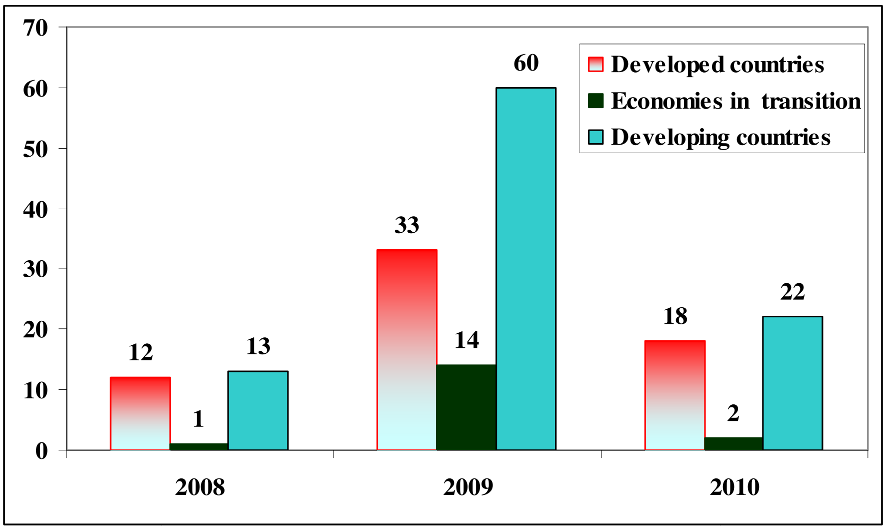


Figure 5: *Countries shrinking, 2008-2010*



Regarding the macroeconomic effects of the crisis, at least 60 developing countries (of the 107 countries for which data are available) probably suffered declining per capita incomes in 2009. Meanwhile, only 7 registered per capita GDP growth of 3 per cent or higher – considered the minimum required for achieving significant poverty reduction – down from 69 countries in 2007 and 51 in 2008 (see Figure 5). At the global level, preliminary data suggest a decline in the growth rate of 3.4 per cent (see Table 1). However, the impact of the recession has been uneven. The contraction of per capita GDP growth in 2009 in developed countries was about 4.1 per cent, while the average per capita growth of developing countries was around zero. The least developed countries have fared slightly better with a per capita GDP growth rate of 0.3 per cent in 2009, following weak growth of 3.6 per cent in 2008. However, the numbers also mask significant differences among developing countries. China's growth rate at over 8 per cent, robust growth in India, and positive growth in Brazil obscured the fact that many other developing countries were faring badly.

Table 1: *Growth by Country Groups*

	2004-07	2008	2009	2009/2008	2009/2004-07
World	2.6	0.9	-3.4	-4.3	-6.0
Developed Economies	2.1	0.3	-4.1	-4.4	-6.1
Economies in Transition	7.7	5.5	-2.6	-8.1	-10.2
Developing Countries	5.7	4.0	0.1	-3.9	-5.6
LDCs	5.2	3.6	0.3	-3.3	-4.9

Most developed countries have been coming out of the recession since mid-2009. The GDP of the U.S. is expected to grow by 2.1 per cent in 2010, from a slump of 2.5 per cent in 2009, while recovery in both the European Union and Japan is projected to be weaker, with GDP growing by 0.5 and 0.9 per cent respectively in 2010. The 'new' European Union (EU) economies are expected to grow by 1.2 per cent in 2010 (Figure 6). Despite continued stabilization of financial markets, credit constraints remain an impediment to recovery in developed economies. The effects of both existing policy measures and cyclical inventory adjustment are expected to diminish over time. Furthermore, increasing unemployment rates and weakened income and wealth positions will continue to limit household consumption and business investment, so that growth of consumption demand in the major developed economies is not expected to provide a strong impetus to global growth in the near future. Recovery in transition economies remains weak and uncertain. CIS countries are expected to grow by 1.7 per cent in 2010 after an average sharp contraction of GDP of 6.7 per cent in 2009 (Figure 7). Southeast European economies are expected to expand by only 0.7 per cent in 2010 following a drop of 3.7 per cent in 2009.

Figure 6: *Most Developed Countries slowly out of recession*

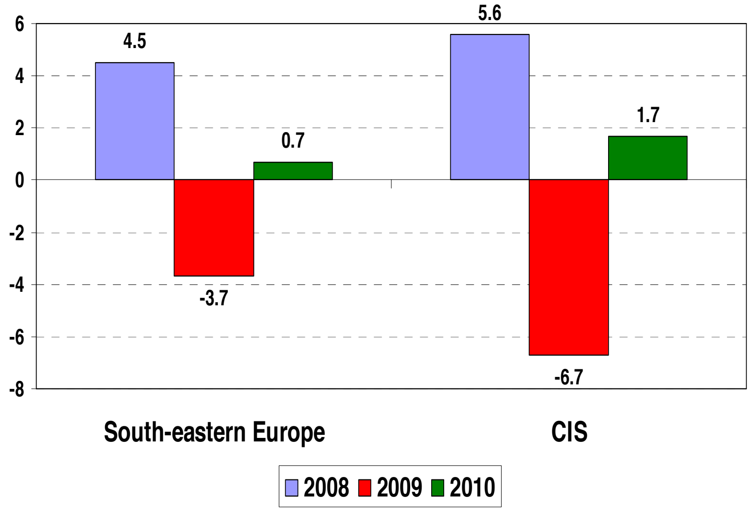
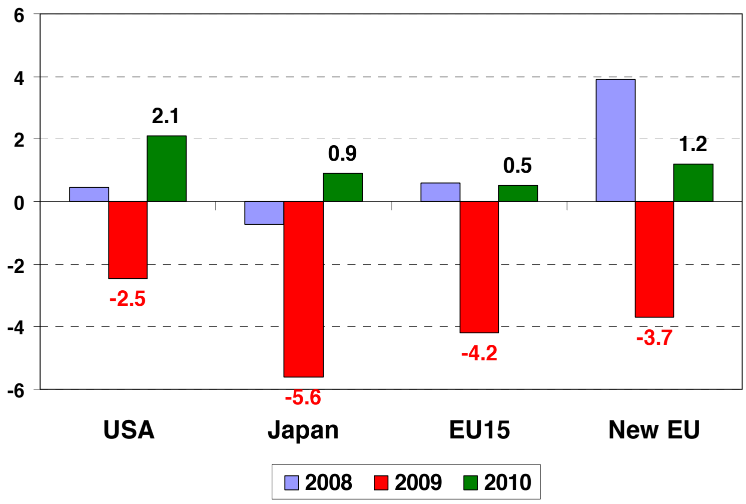
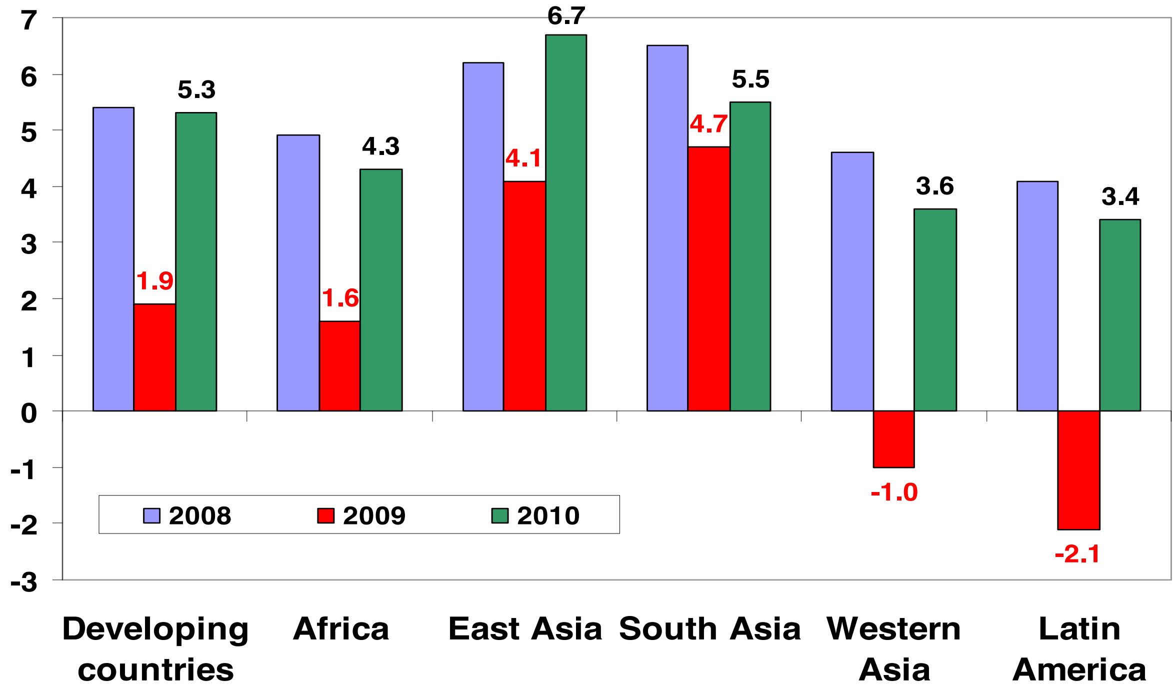


Figure 7: *Uncertain weak recovery in transition economies*



In developing countries, recovery has been below potential, although GDP for developing countries is expected to grow, on average, by 5.3 per cent in 2010. This will be a recovery from the estimated growth rate of 1.9 per cent in 2009, but still lower than growth before the crisis (Figure 8). The damage caused by the global financial crisis to low-income developing countries could be long lasting, and may undermine their growth potential in the medium and long run. For example, after dropping to 0.6 per cent in 2009, for the next few years, growth in sub-Saharan Africa may not resume the pace of over 6 per cent registered before the crisis. Even if they attain the pre-crisis growth rate, their output level would be below the level had there been no crisis. Therefore, they need to grow at a much faster rate to be able to close the gap between the current level and the pre-crisis potential.

Figure 8: *Sub potential recovery in developing countries*

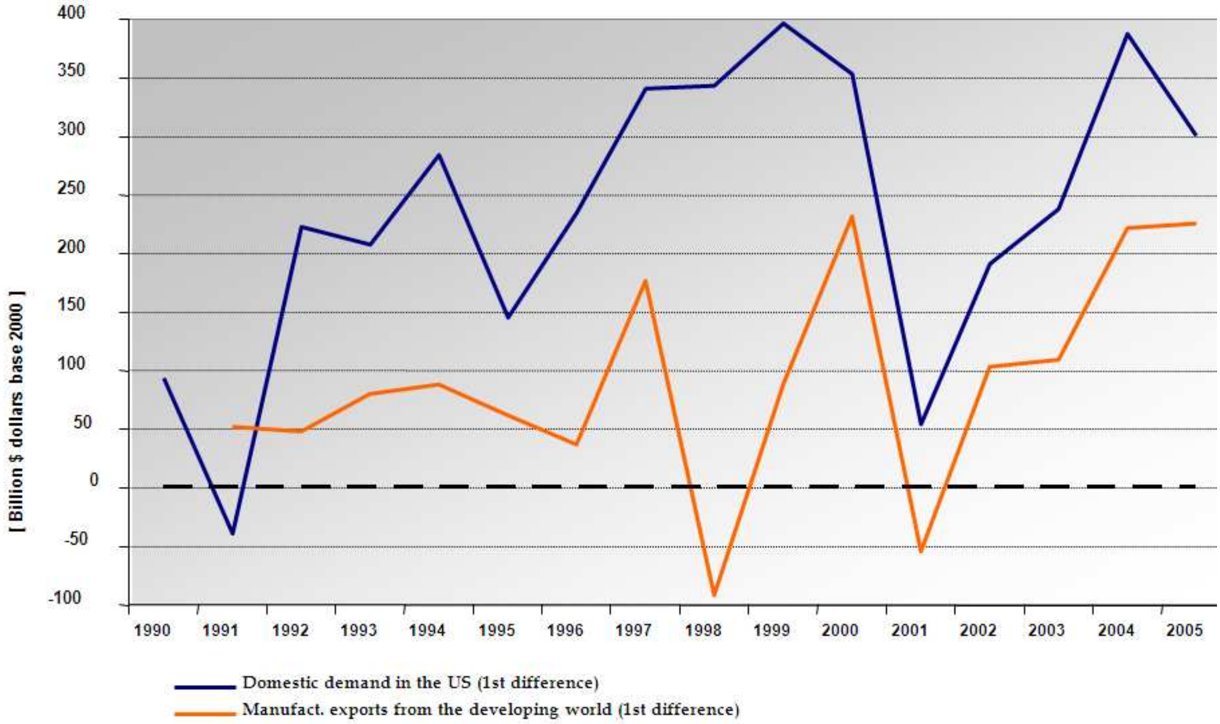


In the half decade preceding the crisis, many developing countries, including the least developed countries, experienced an improved international environment. The rally in demand and higher prices for primary exports enabled them to generate financial resources on a large scale, which gave them the opportunity to consolidate their fiscal balances and to accumulate central bank reserves. This situation was largely ended by the crisis, and developing countries now face a much more adverse international economic situation. The energy and food price spikes in 2008 – caused, among other factors by a flight from finance into commodity futures (from 'Wall Street' to 'Chicago') – put additional pressure on many developing countries' current and fiscal accounts.

The ability of developing countries to rebound out of this crisis has, in large part, been segmented along the lines of sources for demand. For example, the economies in East Asia were expected to expand by 6.7 per cent in 2009, well above the average for developing countries, driven in particular by the powerful policy stimuli in China. However, despite some policy efforts to strengthen their domestic demand, structural problems in many developing economies have not been fundamentally overcome. Growth for developing countries and economies in transition thus remains highly dependent on restoring international trade, commodity prices and investments. Since conditions in these areas have been substantially worsened by the crisis, the economic outlook for these countries is weak for the near future -- even with some expected improvements, the situation will remain challenging.

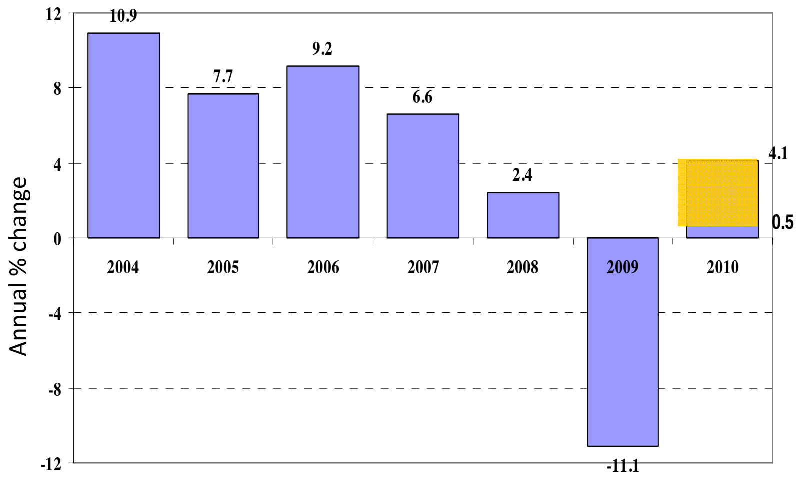
In particular, over-dependence on exports may prove harmful to some developing countries. U.S. demand has served as an important locomotive for developing countries' exports, as shown in Figure 9 by the strong correlation of the time series of the change in U.S. domestic demand and of manufacturing exports from developing countries, especially in the 2000's.

Figure 9: *Strong U.S. demand lifted developing countries exports*



But world trade collapsed in 2009, falling by over 11 per cent from 2008, as can be seen in Figure 10. Developing countries have been particularly hard hit by weakened trade. For developing countries as a group, exports dropped more strongly than for OECD countries, in part due to the substantial declines in prices for oil and other minerals from their peak levels in the second half of the 2000's. Food prices have also fallen from their peaks at the end of 2007 and in early 2008, but they are rising again and still well above the levels of the early and middle 2000's.

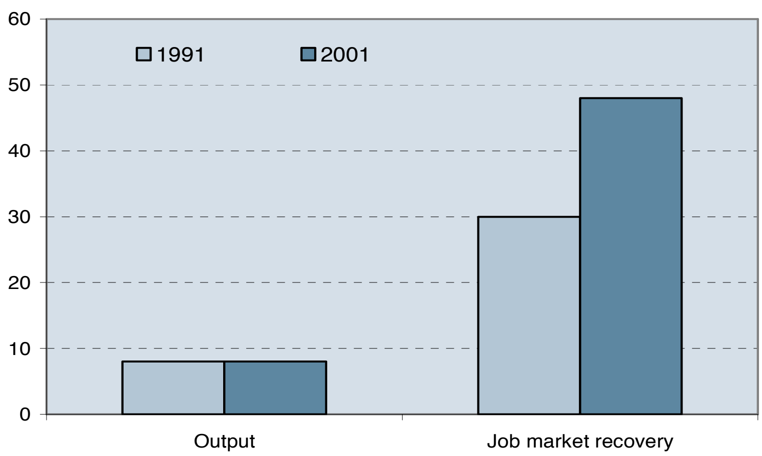
Figure 10: *World trade collapses*



On balance, the impact of the trade environment for developing countries has been negative. The effects of worsening terms of trade for primary goods exporters have been particularly pernicious for mineral exporters, rapidly eroding trade surpluses. Even though a number of middle-income countries were struck by this crisis after they had been running fiscal surpluses and accumulating central bank reserves, the developments in international financial capital and goods markets outlined above have begun to deplete those stocks. However, consumers have benefited from lower food prices than at their peaks for net food importers and from lower oil prices, especially for oil-importing developing countries.

Figure 11:

Duration of output recovery and job market recovery after the 1991 and 2001 US recessions (in months)



The crisis has had a devastating impact on livelihoods, even though there is little agreement regarding the magnitude of its social impacts. Estimates of the International Labour Organization

(ILO) from the end of 2008, based on then still sanguine projections of the International Monetary Fund (IMF) for 2009, suggested over 200 million more working poor as a result of the crisis. Unemployment was expected to rise by an additional 51 million people. Unemployment has certainly risen sharply in developed countries, with detrimental effects on livelihoods and social cohesion in those countries. Historically, in the U.S. the effects of crises on unemployment have taken longer to reverse than their effects on output. Output reached its pre-recession level within 9 months after the last two recessions in the U.S. – the 1991 recession following the savings and loan crisis, and the 2001 recession after the dotcom bust -- though the job market took 30 and 48 months respectively to recover (Figure 11). Without suggesting a trend, the time discrepancy between output and job market recovery in these two instances point to a possibly protracted period of weak demand for labor. A dire economic and social situation may increase civil unrest. A U.S. intelligence report dating from February 2009 cited the crisis as the greatest security risk worldwide.

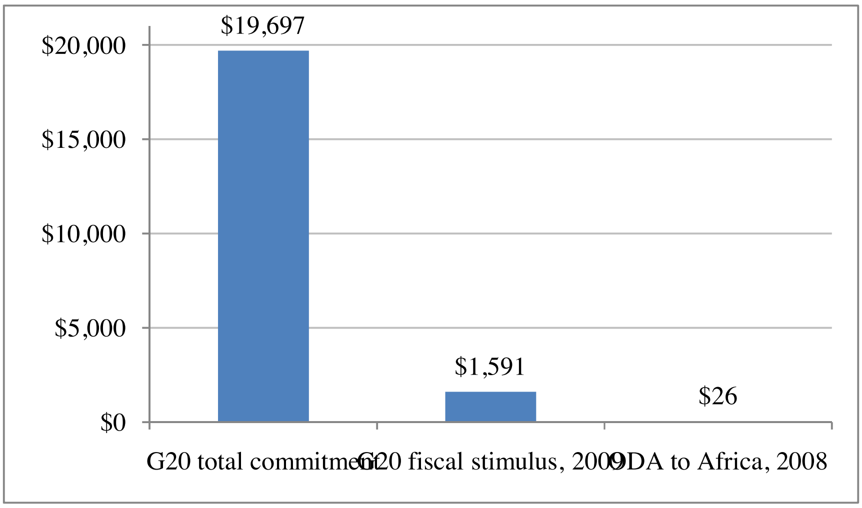
A substantial share of the severe increase in unemployment has taken place in the developing world. This may not be visible in open unemployment as very few can remain unemployed when there is only a very rudimentary public social security system. Most people who are laid off from the formal sector thus survive by moving to vulnerable and low paid informal sector employment, giving rise to the number of working poor. Declining living standards in developing countries directly threaten social peace as well, especially when social protection is not well-developed.

Youth unemployment has increased sharply, and this will scar future generations' job prospects. The picture painted by the early ILO forecasts was very dire. With the subsequent downward revision of IMF growth estimates, it was feared that the actual impact of the crisis would be even more severe. Although the so-called 'green shoots' of economic recovery have been evident since mid-2009, it is likely to imperil the timely attainment of the Millennium Development Goals (MDGs) and the other internationally agreed development goals (IADGs).

Social protection has a strong counter-cyclical effect. The maintenance of employment and incomes has wide-ranging positive effects on growth, for example, through the stimulating impact on domestic demand via multiplier effects. But it also has important effects on poverty reduction. The use of fiscal stimuli for job creation is thus an option for developing countries worth pursuing. There has been an extensive debate on the benefits and disadvantages of universal versus limited social protection, and the evidence suggests that targeting is not only costly but also risks leaving out many of the deserving.

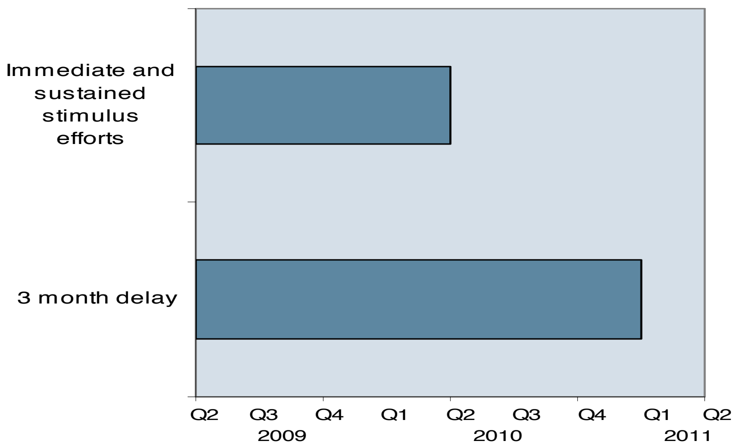
A number of additional factors may worsen the economic situation in developing countries. A prolonged downturn in the world economy is likely to reduce remittances, job creation, tourism and official development assistance (ODA). The financial commitments of developed countries' governments in response to the crisis have been disproportionately higher than their ODA. For example, ODA to Africa amounts to US$26 billion, whereas pledged guarantees for the domestic financial institutions could generate expenditures of up to almost US$20 trillion. Fiscal stimuli, which translate directly into spending obligations, greatly exceed US$2 trillion (Figure 12).

Figure 12: *G20 recovery effort versus ODA for Africa*



Remittances have become a more important revenue source than ODA for many developing countries. In the crises of the 1990's, remittances had a countercyclical effect as workers in destination countries increased remittances to balance the negative income effects of the crises at home. Since the current crisis originated in the countries of destination rather than origin (home countries), workers are suffering job losses and lowered incomes that often do not permit them to even maintain the level of remittances sent previously. The aggregate effects on countries are differentiated, and depend on the countries of destination and of origin as well as sectoral employment trends, and the differential impact of the crisis has varied with all of the above. Most developing countries have seen their remittances decline. The absolute numbers may seem unspectacular, in part due to the depreciation of the dollar against currencies in the countries of origin. However, in the wake of the crisis, remittances to many countries have sharply reversed their strong upward trend of the pre-crisis years, and fallen in some cases.

Figure 13: *Stimulus lags delay recovery*



The policy reaction to the crisis in developed countries was characterized by an early and substantial expansionary monetary policy stimulus, and to a somewhat smaller extent, from fiscal policy. Early responses were undertaken by the U.S. and the United Kingdom (UK) whose economies were perhaps most vulnerable to the crisis due to more advanced financialization in these countries. This reaction was important in the face of evidence that longer lags in responding to crises substantially increase recovery time (Figure 13). Furthermore, UN simulations suggest that coordinated stimuli are much more effective in generating desired recovery effects (Figures 14 and 15). Macroeconomic policy coordination was not undertaken by the G7, who failed to validate their *raison d'être* as a small, ostensibly more nimble forum for global macroeconomic policy coordination.

Figure 14: *Global recovery with coordinated and uncoordinated stimuli, 2010-2015*

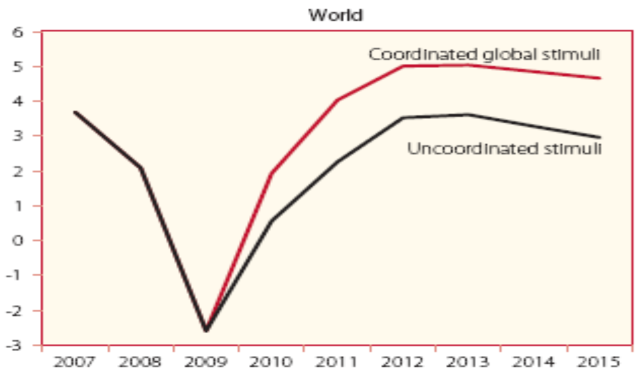
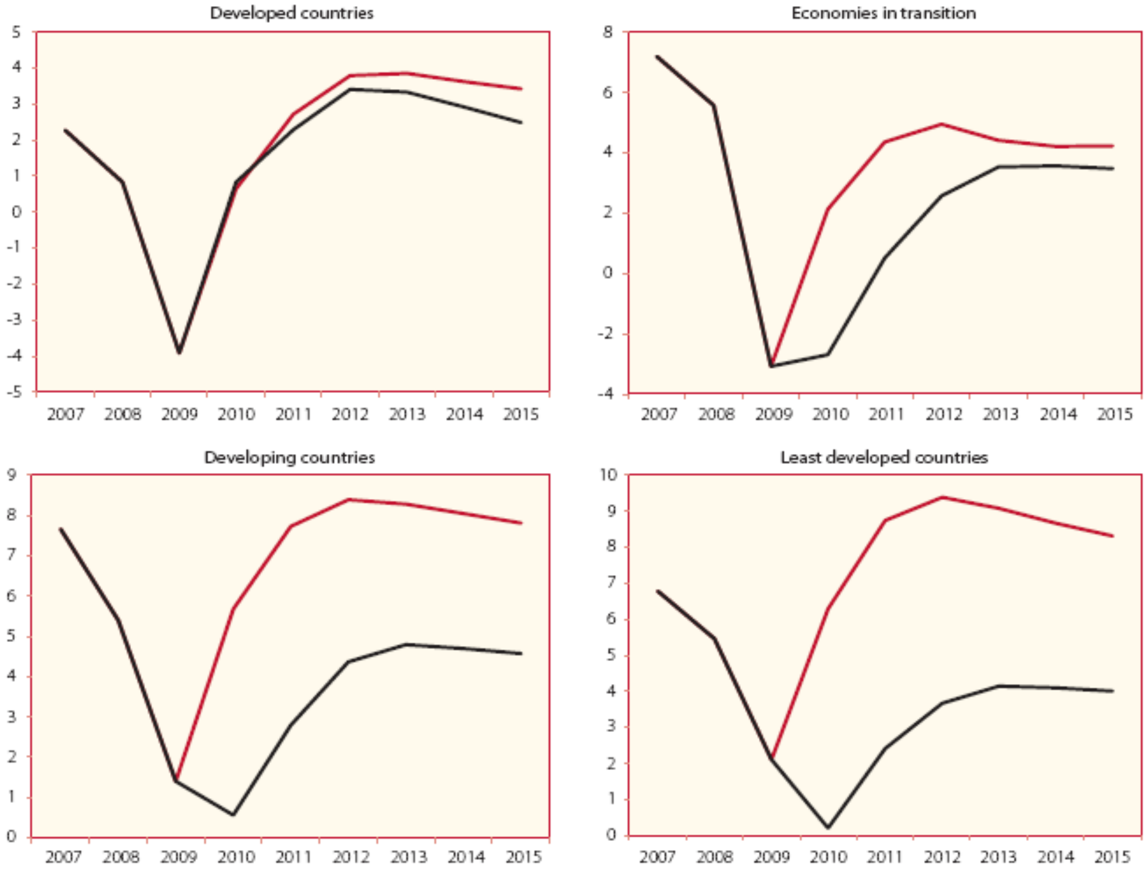


Figure 15: *World Simulations with coordinated & uncoordinated stimuli, 2010-15*



Source: UN/DESA, based on policy stimulations with the UN Global Policy Model.

In the international policy arena, there has been some change in the response to this crisis compared to other crises in recent decades. Critical proposals have been made by the Turner commission, the UN PGA (Stiglitz) commission, as well as the UN Summit on the crisis and its impacts on developing countries in June 2009. Even policy responses by the G7 and the G20 have been different. Both Bretton Woods institutions have also altered their traditional stance towards macroeconomic policy responses to the crisis. Conditions attached to loans have been slightly improved, while the IMF has become less restrictive in its policy advice. However, the IMF continues to discourage strong fiscal stimuli by developing countries that did not have a fiscal surplus to begin with at the time the crisis struck, despite what the U.S. and others have done. Some of the policy changes may have been politically motivated, which has also resulted in uneven access to international funding and some new concerns among observers.

Developing countries' policy reactions to the crisis have continued to be constrained by the international financial institutions' responses. The IMF has imposed fiscal sustainability requirements for stimuli to be undertaken by countries. There are thus substantial constraints being placed on developing countries' fiscal space. Monetary policy has been less effective, especially when independent central banks failed to coordinate with fiscal policy measures. As in previous crises, developing countries' recoveries have continued to be hampered by systemic pro-cyclicality, both in market and in institutional responses. Finally, developing countries have lost productive capacity due to their openness to goods and capital flows.

To conclude, the distributional effects of the crisis have been shaped by several elements, and most importantly, by the factors prevailing before the crisis. Among them are the net capital outflows and higher cost of credit, especially for smaller countries, and the contractionary trade effects, which have had pernicious effects on developing countries now increasingly reliant on external demand for their economic growth. The crisis has an important North-South dimension as well as an important real-financial dimension. Workers have been differentially affected, depending on the sector they are employed in. Larger developing countries, which are members of the G20, have fared better in the current crisis, partly because the sizes of their internal markets are large enough to have allowed them to somewhat cushion the loss in global demand by re-orienting their production toward the national economy. Smaller developing economies, especially in much of Sub-Saharan Africa, do not have this option. The distribution impact of the current crisis is thus strongly linked with the more general financial and economic turmoil and the preceding development problems.

END NOTES

[1] Transcription: Miriam Rehm, editing: Benjamin Mitra-Kahn and Miriam Rehm.
Talk given at the conference on The Effect of Financial Crises on Distribution at The New School for Social Research, March 5 2010. We thank Jomo Kwame Sundaram for the permission to transcribe and publish his remarks