Part I

Markets

1

Recoupling or Switchover? Developing Countries in the Global Economy

Otaviano Canuto

Developing countries as a whole had been growing faster than advanced economies for several years prior to the 2008–09 economic crisis. As the signs of increasing financial fragility and impending economic slowdown in major advanced economies became clear in 2007 and the first three quarters of 2008, much was said about a possible "decoupling" of emerging markets. This was quickly followed by talk of a downward "reverse coupling," when these and other developing economies were also impacted by the near collapse of finance and international trade during the last quarter of 2008 and in early 2009.

More recently, however, developing countries as a group have been recovering faster than advanced economies while also maintaining the positive growth premium that emerged prior to the crisis. Indeed, growth in developing countries is projected by the World Bank to reach 6.1 percent in 2010, 5.9 percent in 2011, and 6.1 percent in 2012, while corresponding figures are 2.3 percent, 2.4 percent, and 2.6 percent for high-income countries. Almost half of global gross domestic product (GDP) growth is currently coming from developing countries.

In this environment, two questions arise: Will developing economies experience a renewed downward "recoupling" as a result of a low-growth scenario in advanced economies? Or, on the contrary, could developing

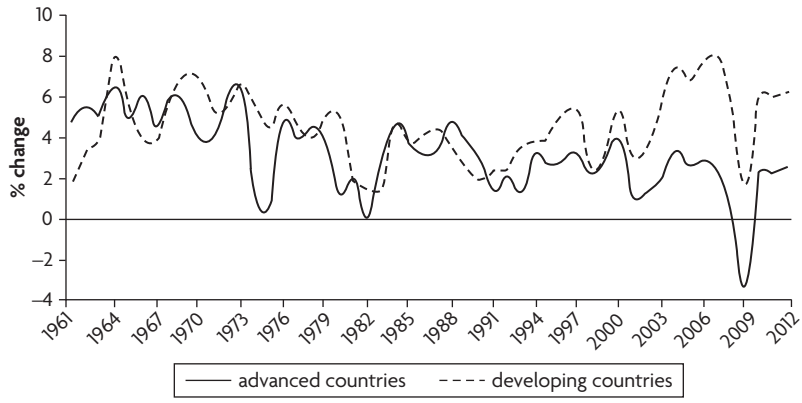
countries "switch over" to become locomotives in the global economy, providing a countervailing force against an otherwise slowing train? This chapter discusses the factors pushing in these two opposite directions.

Cyclical Coupling and Trend Decoupling

As figure 1.1 shows, there has long been a close correlation between economic cycles in advanced and developing economies. Developing-country growth fell sharply in 2009 through several channels: declining exports to developed countries, steep falls in private capital inflows, and domestic financial freeze as a form of contagion. So there has been no decoupling in the cyclical component of developing country growth.

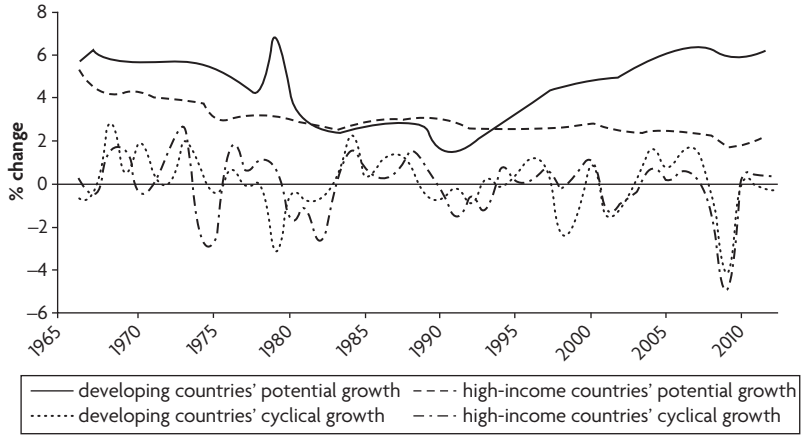
On the other hand, looking only at global aggregates may obscure an emerging story about *trend decoupling* between advanced and developing countries. More recently, since the early 2000s, the cyclical synchrony has been combined with systematically higher growth rates in developing economies relative to advanced economies. As the exercise of trend-cycle decomposition depicted in figure 1.2 reveals, before the mid-1990s the trend growth in developing countries was close to that in advanced countries. Since then, it has become substantially higher: a "cyclical coupling" has arguably continued, as in the past, but together with some trend decoupling in underlying rates of growth.

Figure 1.1 World Output Growth



Source: World Bank, World Development Indicators and Development and Economics interim forecasts, April 2010.

Figure 1.2 Trends and Cycles: Potential and Cyclical GDP Growth

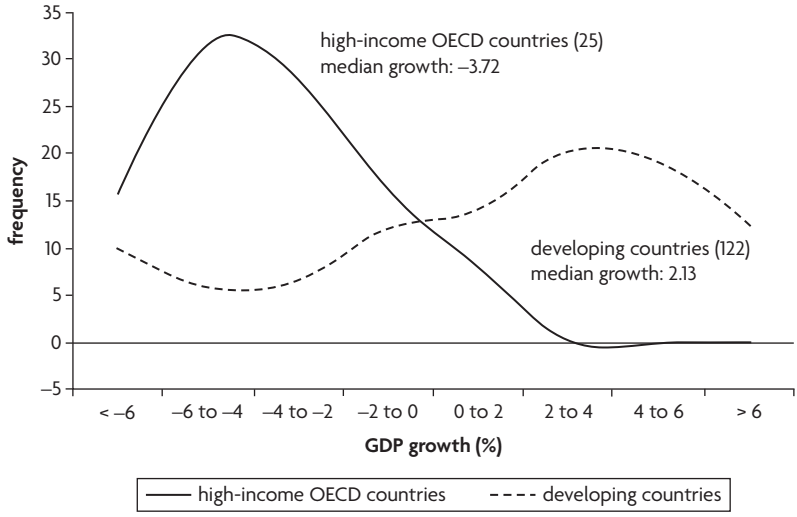


Source: World Bank, DEC prospects group.

The improved growth performance in developing countries is not just a reflection of strong performance by the two largest developing countries, China and India. Figure 1.3 shows the frequency distributions of individual country growth rates in 2009, the expected trough of the crisis. Median growth in developing countries was substantially higher (2.13 percent) than in advanced economies (–3.72 percent). And a much larger proportion of developing countries has continued to enjoy positive growth than among advanced or high-income countries.

Most of the developing countries situated at the right-side tail of the corresponding distribution benefited from better macroeconomic, structural, and other policies adopted over the past two decades. They had the capacity to resort to fiscal, monetary, and financial countercyclical policies, and to use foreign exchange reserves and exchange rate fluctuations as elements of their responses to the 2008–09 shock (Lin and Canuto 2010). On the opposite side of the distribution are those countries that had combined overborrowing and asset price "bubbles" with shaky domestic growth foundations, as in several Eastern European and Central Asian countries. There, one can also find cases in which trade and financial integration led to severe impacts, such as Mexico and several Central American and Caribbean countries. In any case, one

Figure 1.3 Frequency Distribution of GDP Growth in Developing Countries and High-Income OECD Countries, 2009



Source: World Bank data and staff estimates.
Note: OECD = Organisation for Economic Co-operation and Development.

may associate the overall high performance of developing countries as a whole before and during the crisis to an improvement of quality of economic policies in the previous decade or so.

Not Good: Growth Prospects in Advanced Economies

High-income countries are facing strong headwinds in the wake of the crisis—not to mention new unexpected shocks such as the one derived from the Greek crisis, which erupted at the end of 2009. It is still an open question whether the promptness and strength of recovery in private absorption (consumption and investment) will be sufficient to render unnecessary the current life support provided by aggressive monetary and fiscal policies, before their unwinding becomes inevitable. If postwar recessions in Organisation for Economic Co-operation and Development (OECD) countries serve as a template, the switchover from public to private sectors will not be automatic, since recessions associated with credit crunches, house price busts, or equity price busts tend to be both deeper and longer than normal. In fact, very few OECD

recessions in the postwar period—4 out of 122—have occurred with a combination of a credit crunch, a housing bust, and an equity bust. The 2008–09 crisis entailed all three in a severe form (Claessens, Kose, and Terrones 2008).

Several factors point to a reduction of both actual and potential growth in the medium term.

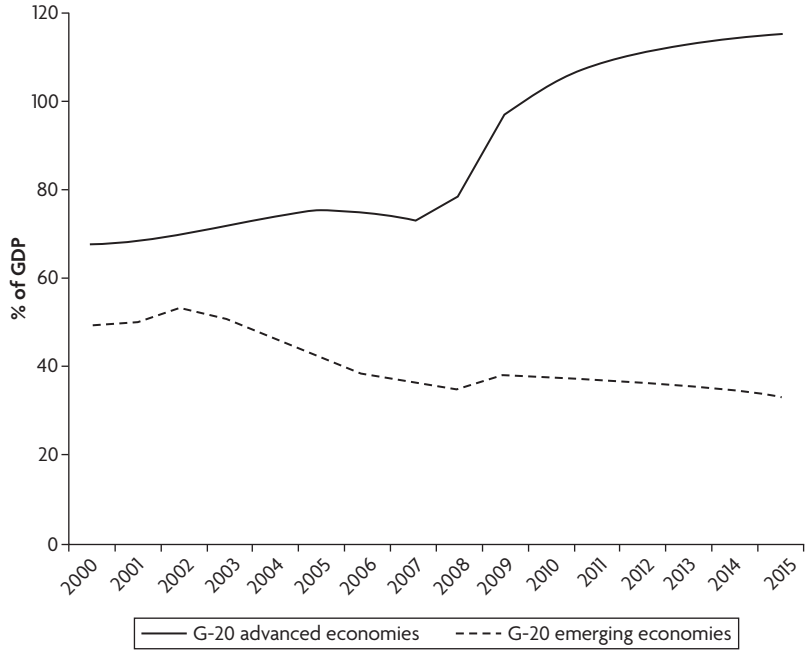
First, sooner or later fiscal consolidation will become a major issue among advanced economies once—or even before—recovery is fully established. Many advanced economies entered the crisis with weak structural fiscal positions, and these have been eroded further, not only by anticrisis measures, but also by underlying spending pressures. Structural primary deficits in advanced countries are expected to have worsened by 4 percentage points of GDP between 2007 and 2010.

Even with the reversal of temporary anticrisis measures, public debt in advanced G-20 economies[1] is expected to reach 118 percent of GDP by 2014 (figure 1.4). According to the International Monetary Fund (IMF), "simply letting the stimulus expire would still leave the government debt of many advanced countries on an explosive path" (IMF 2009:21). Stabilizing debt at postcrisis levels will also not be enough because it will reduce the ability of fiscal policy to deal with future shocks and will push postcrisis real interest rates much higher.

On average, according to the IMF, bringing government debt-to-GDP ratios in advanced G-20 economies to a prudent level below 60 percent by 2030 would require steadily raising the structural primary balance from a deficit of 5.3 percent of GDP in 2010 to a surplus of 4 percent of GDP in 2020—a 9.3-percentage-point swing in one decade—and keeping it at that level for the following decade. Those are large, politically difficult adjustments to make.

Thus, even if one considers that different features of national fiscal packages will have corresponding different consequences in terms of long-term growth drivers, some future fiscal contraction negatively affecting the private sector will be the price paid for the role of fiscal stimulus in rescuing advanced economies from the brink of the abyss during the crisis. And even if monetary policy maintains its current accommodative stances for some time, managing to sustain basic short-term interest rates at low levels, the yield curve on public debt may still steepen.

Figure 1.4 General Government Debt, Real and Projected

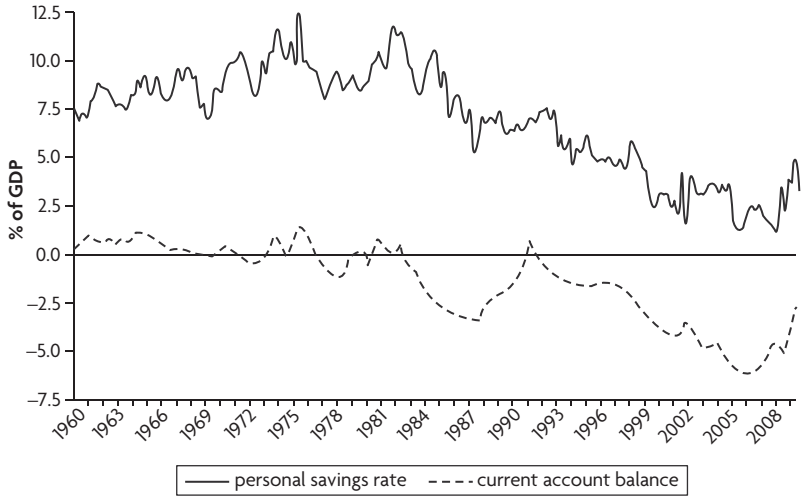


Source: World Bank calculations based on International Monetary Fund data.

Second, the process of U.S. households' balance-sheet deleveraging and adjustment is far from complete. Consumption spending growth is likely to remain weak, wobbly, or both in the absence of large renewed hikes in asset prices. In the past, strong U.S. consumer spending was buttressed by rising housing prices, allowing rising household debt and reduced personal savings (figure 1.5). Lower savings were reflected in a rising U.S. current account deficit and in export demand for the rest of the world. Now, as housing and other household asset prices have fallen substantially, deeply indebted households are unlikely to undertake a new spending spree anytime soon. Rebuilding household balance sheets will be a lengthy process.

A third aspect to weigh against a return to a high-growth path is the likely jobless nature of the current recovery in many high-income countries. The recent evolution of unemployment in advanced economies can only partially be attributed to Okun's Law—relationships between output fluctuations and unemployment. Were these relationships to

Figure 1.5 United States: Personal Savings Rate and Current Account Balance, 1960–2009



Source: U.S. Bureau of Economic Analysis.

prevail, the current GDP recovery would bode well in terms of a positive feedback loop with labor markets. However, slow-to-reverse shocks—a financial crisis combined with a housing price bust, and cross-sector differentiated job creation and destruction—have been in play, and continued macroeconomic uncertainty is also countering employment growth (IMF 2010a, chapter 3). The share of temporary workers has been on the rise in most advanced economies for years, reflecting institutional changes in labor markets. Recent crisis-related increases in temporary employment will tend to have a limited effect on enhancing expenditures while uncertainty regarding macroeconomic and sectoral prospects remains high.

Fourth, proposals for the reregulation of the financial sector point to higher costs of financial intermediation. After all, the general purpose is to curb the unbridled "endogenous liquidity factories" and excessive leverage that led to widespread asset bubbles in the run-up to the economic crisis (Canuto 2009). Regardless of the long-run payoffs of such moves, access to long-term finance—including for research and development and for venture-capital funding—could stay harder to obtain and costlier compared to prior to the crisis, no matter how accommodative

monetary policies remain. New bouts of pressure on bank balance sheets are also likely as new sources of financial stress emerge, such as corporate restructurings (Dubai, the United Arab Emirates), sovereign debt stress (Southern Europe), and so on.

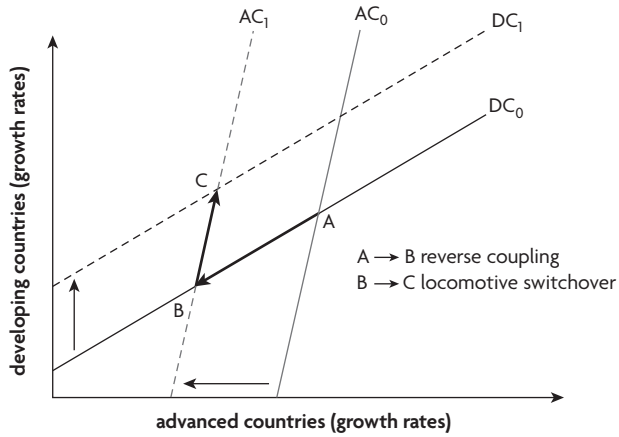
Therefore, it is not by chance that most analysts expect the crisis—and the response to it—to leave advanced economies with a long-term legacy of lower growth, both in potential output and in aggregate domestic demand.

Recoupling or Switchover? Switchover

Three questions follow from the previous sections: (a) how sustainable is the "trend decoupling" exhibited by developing countries; (b) how high can both actual and potential growth rates remain in developing countries, if advanced economies face headwinds; and (c) to what extent can high-growth performance by developing countries provide a positive feedback loop for advanced economies, helping to avoid a situation where, even though developing countries continue to grow faster than their advanced peers, both do so at relatively low rates?

Figure 1.6, on the growth interdependence between the two groups of economies, provides a simplified illustration of possible outcomes. Channels for growth interdependence may be interpreted here as trade and corresponding investment prospects and as factor incomes abroad (return on foreign assets, remittances). The steepness of the lines for advanced countries (AC) reflects the precrisis smaller weight of developing countries (DC) in the former's performance, whereas the greater sensitivity of DC to variations in AC growth rates is expressed in the slopes of the corresponding lines. The legacy of the crisis on AC is exemplified by the shift from AC_0 to AC_1. The adverse impact of slower advanced-country growth on developing countries—which we call the negative "recoupling" of developing countries—is reflected in a global move from point A to point B. However, if new "autonomous" sources of trend growth in DC can be tapped and DC_0 shifts to DC_1, then the global economy can settle at point C. Here, not only can developing countries escape from the negative recoupling, but there can also be a "switchover," where developing countries become the global growth locomotives and partially rescue advanced economies.

Figure 1.6 Recoupling and Switchover



Source: Author.

The weight of developing countries as a whole in the global economy has been rising steadily since 2000, and the continuation of that trajectory comes out in most GDP projections. In terms of levels, the size of G-7 countries[2] at market prices is still 60 percent of GDP, and the major potential new poles of growth (China, India, and Brazil) might count for no more than 30 percent. As time passes, however, the absolute size of the two groups of countries may reverse positions. IMF forecasts for global GDP at purchasing-power-parity-adjusted exchange rates indicate that developing countries as a group will bypass advanced economies before 2015. Although developing countries in Asia have the lead in that dynamic, rising shares in global GDP are also a feature of other regions. What will make the developing world run, if developed nations walk? What will be the autonomous sources of growth?[3]

Autonomous Sources of Growth in Developing Countries and their Challenges

Scope for Higher Degrees of Leverage in Private and Public Balance Sheets

The fast recovery in many large emerging markets has reflected the good shape and sustainability of their national balance sheets. The 2008–09 financial frenzy in many developed economies did not lead to a

serious deterioration of local financial conditions in emerging markets as a whole (with several well-known exceptions, especially in Eastern Europe). This suggests that the boom in most emerging markets prior to the crisis was not very dependent on the "bubbly" financial conditions in developed countries. Furthermore, the availability of some fiscal space, and large foreign exchange reserves and scope for monetary relaxation, were fundamental for the implementation of policy responses to the financial and trade crunches of late 2008 and early 2009 (Lin and Canuto 2010).

The IMF in its *World Economic Outlook: Sustaining the Recovery, October 2009* (2009b) calculates an index of financial market stress covering foreign exchange, sovereign debt, the banking sector, and equity markets in emerging markets. After adjustment for the higher level of stress in advanced economies during the 2008–09 crisis, the IMF found that emerging market financial stress rose much less than in previous episodes, and financial market resilience was observed in most emerging market countries.

What explains the greater resilience in most emerging financial markets? Three factors may be highlighted:

- Improved macro conditions in emerging economies, including better fiscal positions and higher foreign reserves
- Declining foreign currency exposure among borrowers
- In many cases, low levels of financial leverage in corporate and household balance sheets.

Looking forward, there is a wide range of greenfield investment opportunities in developing economies that may benefit from higher financial leverage by both the public and the private sectors. Infrastructure provides an obvious example. Given its relative scarcity, social marginal returns as measured in terms of total factor productivity tend to be high in projects that address the many existing bottlenecks. If projects are well designed, the partial monetary capture of those returns by either public- or private-sector entities may well constitute feasible vehicles for asset creation and finance.

Nonetheless, potential pitfalls or obstacles will have to be faced, including the following:

- Public sector management capacities and appropriate governance mechanisms must be in place to guarantee the use of adequate

criteria in project choices and design, and to avoid misappropriation of returns. While this principle applies to public sector operations in general, the long-term and risky nature of infrastructure investments puts an especially high premium on following it.

- There are limits beyond which increasing leverage on developing-country balance sheets will also lead to increased financial fragility, particularly if ad hoc unconventional measures adopted as part of the response to the crisis are not unwound.
- The incoming flood of sovereign debt issues by fiscally strapped advanced economies may crowd out corresponding issues by developing countries. This is one of the mechanisms through which "backward recoupling" powers may bite.
- Higher overall costs of finance in advanced countries will also imply increased financial costs for developing countries, in both the public and the private sectors. Estimates presented by the World Bank suggest that U.S. base interest rates that are 100 basis points higher than precrisis levels, combined with the spreads prevailing in October 2009, would lead to a transitional impact of –0.7 percent on potential GDP growth (World Bank 2010).
- The mix of solid growth in many developing economies—and ensuing upward pressure on domestic interest rates—with prolonged monetary laxity in advanced economies is likely to remain for some time. This may cause another surge in private capital flows to emerging markets with a profile potentially conducive to fostering asset market bubbles rather than to building greenfield assets. The pathway toward funding long-maturing investment projects may then become problematic, with increased volatility and overvaluation of existing assets.

However, careful economic management should help address at least some of those "backward recoupling risks", allowing countries to reach a higher potential growth plateau through infrastructure and corporate investment leverage.

Convergence Gap and Nonrival Use of Existing Technologies

A twofold feature of technologies in general is worth remembering (Nelson and Winter 1982; Canuto 1995). Notwithstanding the fact that any specific

technology application requires some tacit and idiosyncratic component of knowledge, and some degree of embodiment in hardware or blueprints, there is usually some degree of transferability and possible replication. By the same token, the use of that transferable technology is nonrival, that is, one application does not preclude others.

With some country and sector exceptions, most developing countries face a technological convergence gap relative to the frontier level of knowledge in advanced economies. There is thus a wide scope for technological learning and catching up, with corresponding positive impacts on local productivity. Unexploited latecomer advantages are an avenue for local productivity improvements via technology transfer and adaptation that remains open and wide even if the advance of technology frontiers slows in high-income countries (Rodrik 2009). The possibilities for technology transfer among developing countries, while still in the preliminary stages, may further facilitate such technological diffusion.

The obstacles to more rapid technology diffusion are many: (a) information asymmetries and uncertainties plaguing investments in technology that are common in advanced economies often appear more intensively in developing countries; (b) complementary factors such as reliable infrastructure, access to finance, and a formally educated labor force are sometimes not available; (c) institutional factors that negatively affect the investment climate tend to harm investments in technology even more; and (d) institutional barriers to competition curb the selection process that would operate in favor of good technology performers.

On the other hand, global changes in recent years have been making technological transfer easier than before, including "increased international trade in goods and services, FDI [foreign direct investment], Intellectual Property and technology licensing flows . . . increases in data storage and transmission capabilities, fall in costs and uptake of information and communication technologies" (Canuto, Dutz, and Reis 2010).

Again, the balance in favor of high potential growth will tip depending on domestic policy action. In this case, the removal of the barriers to creative technological absorption and diffusion mentioned above will be of the essence.

Trade and Structural Change as Vents for Surplus Labor

The extraordinary growth performance of some Asian economies (and China in particular), like some other past experiences of long periods of growth in the developing world, cannot be fully understood without taking into account that to a large extent they expressed a peculiar process of structural change (at least at the start of the process): the dislocation of large contingents of low-skilled workers from stagnant and low-productivity activities to others whose value at world prices is significantly higher and where there also exists a wide scope for productivity increases.[4] These workers moved from occupations in which their physical and monetary marginal productivity was close to zero, as in production for subsistence in many rural areas, to light-manufacturing production with much higher market value, a move generally accomplished without the need for major increases in worker skills. This is the move depicted in the pioneer work by Lewis (1954) and Fei and Ranis (1964) in their stylized model of transition from traditional surplus-labor rural economies to modern industrial ones. More recently, Rodrik (2009) refers to a dislocation from the production of "traditional, primary products" to "nontraditional tradable activities."

This kind of structural change is not a linear, smooth, or automatic process. Even at its "light" stages, industrialization is "lumpy" in products, space, and time (UNIDO 2009): minimum scales and scope of production, agglomeration gains, and minimum thresholds of competitiveness are needed to start operating. Furthermore, some basic market institutions must be functioning. As Rodrik (2009:6–7) puts it, there tend to be "various market failures and externalities associated with modern activities, such as learning spillovers and coordination failures," and "institutional weaknesses that are felt more intensively in tradable activities, such as poor protection of property rights and weak contract enforcement. . . . In both cases, industrial activity and investment are underprovided in market equilibrium."

But rising international trade and the technological changes already mentioned in this chapter have made such structural change easier. Among technology trends, "a trend towards the standardization, modularization, and codification of technologies, especially in the electronics and auto industries [and in some services, we add; see Ghani and Kharas (2010)] make

it easier to deverticalize and offshore production" (Yusuf 2010). With the fragmentation of production and trade in tasks and the decreasing costs of transport and communication, the "lumpiness" barriers become relatively easier to surmount. Local market size becomes less of a constraint on requisites of scale and scope, while learning spillovers and coordination needs may be found through integration in cross-border networks of production. Local institutional requirements remain, however.

To take additional steps up the ladder of technological sophistication, moving on beyond early "easy" production of tradables, an economy has to increasingly develop some capabilities that transcend particular existing lines of production at a given moment in time. This requires the ability to learn, master, and adapt technologies in a creative way; to manage complex processes of design, production, marketing, and so forth. Again, recent trade and technology trends have been favorable to latecomers from a cost-competitiveness standpoint, as long as domestic complementary factors, observed in the section on technology convergence, are in place.

Will a less exuberant pace of domestic absorption in advanced markets in coming years weaken trade as a source of technological transformation for export-oriented countries? Will it unwind hitherto successful export-led growth models? Will it make it impossible for newcomers to undergo structural change and grow by exploiting trade-cum-technology windows of opportunity?

The following are important to note:

(a) The export-led, high-growth experience has been limited in terms of both geographic and sector coverage (Yusuf 2010). There are many developing countries yet to benefit from trade and technology transfer as a vent for surplus labor. And such a labor surplus may also be found in current contingents of low-paid informal urban workers.
(b) The present level of imbalances is relatively recent—a phenomenon of the 2000s. Yet developing countries were able to pursue export-oriented strategies previously with relatively limited global imbalances. In other words, export-led growth does not necessarily mean current-account-surplus-led growth. This suggests that in the longer term, countries could continue to pursue balanced outward-oriented strategies with strong growth in both exports and imports,

availing themselves of trade as a means to overcome lumpiness in scale and scope.

(c) The magnitude of the contribution of the recent great current account deficits should not be oversold. It was to some extent the counterpart of very high oil prices.

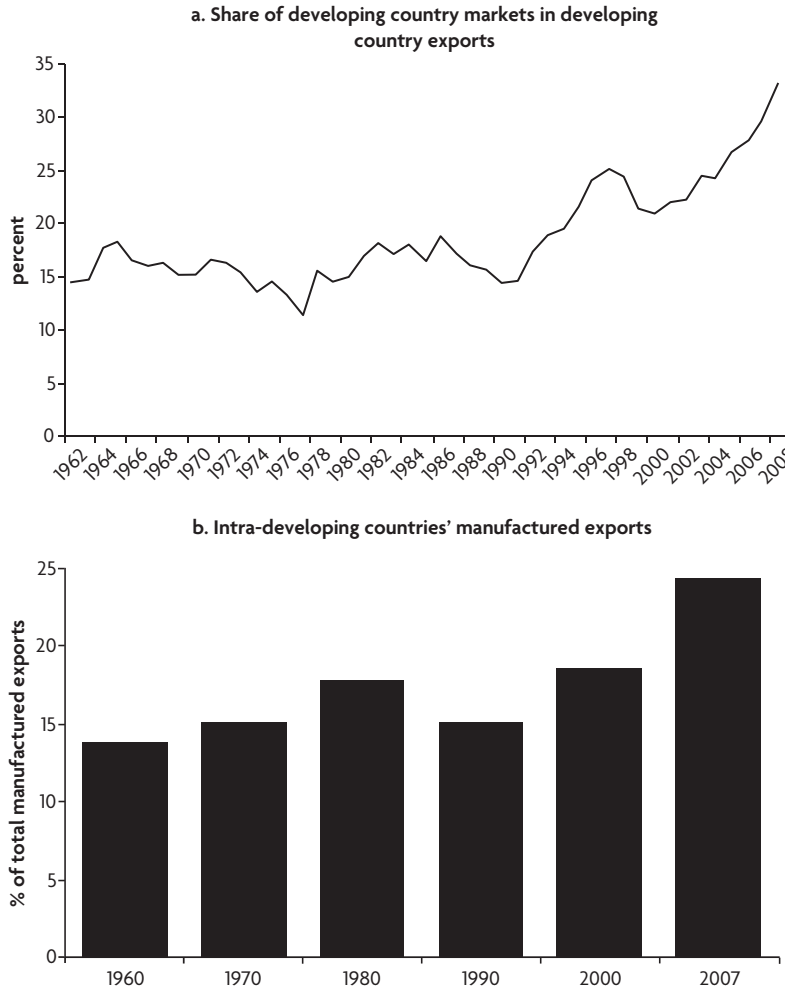
(d) Most developing-country exports are so small that there should be plenty of room for them to expand despite broad global rebalancing shifts and less exuberant absorption in OECD countries. China and just seven other developing countries comprise 85 percent of all developing-country exports. The exports of these eight countries are equivalent to 15 percent of all OECD imports. By contrast, another 130 developing countries comprise only 15 percent of developing-country exports, equivalent to just 2.5 percent of OECD imports. The typical country in this group could increase its exports by 40 percent if it could capture another 0.01 percent of OECD import market share.

(e) It is true that China as a major component of the OECD deficits acted as a peculiar channel for the transmission of growth. China's huge trade surplus made feasible its high-growth combination of high investment-to-GDP and low consumption-to-GDP ratios. Given China's size, its high growth generated considerable stimulus to regional manufacturing neighbors and to commodity exporters. But in principle, such a role as growth pole can be maintained without gigantic trade surpluses. If domestic absorption rises faster than output in developing countries as a whole, especially in China, and South-South trade is further opened and maintains its rising trend of recent years (Canuto, Haddad, and Hanson 2010) (figure 1.7), a new round of export-oriented growth via structural change can be envisioned.[5]

Social Trickle Down of Growth

After World War II, Europe and Japan sustained a long growth cycle through a process of technological and mass consumption catching up with the U.S. frontier. From the 1990s onward, however, as observed before, many developing countries achieved high growth through a combination of innovations in production technology (including finance) and globalization. The time may now have come for better matching of increases in production and consumption within developing countries.

Figure 1.7 Rising South-South Trade: Toward an Export-Led Growth v2.0?



Source: Canuto, Haddad, and Hanson 2010.

That rebalancing in itself could become a powerful tool to hasten poverty reduction.

This is not to be confused with pursuing isolationism through higher local integration per se. Channels for international trade and investment need to be kept wide and open. But programs of investment in human capital, poverty reduction, and social inclusion in developing countries

can stimulate local consumption and investment, producing positive feedback loops of sustainable global growth.

The argument for building effective networks of social protections should not be underestimated by a relatively strong growth performance among developing countries as a whole. First and foremost, negative shocks have the greatest effect on the poorest and most vulnerable; by definition, they live on smaller margins and have weaker safety nets to draw on. But there are also efficiency reasons that justify protection. Even short-lived crises may have devastating long-term implications for growth. The way households cope with crisis, the effects on workers' long-term abilities, and the impact on firm creation and firm destruction dynamics are all examples. Households may be forced to make choices that stave off the crisis over the short term but that have negative long-term consequences on human capital, individual earnings potential, and economywide competitiveness. They may be obliged to take children out of school, spend less on health care, and reduce caloric consumption.

Concluding Remarks

The bird's-eye view taken in this chapter leads to the conclusion that, yes, there is scope for a switchover where developing countries as a whole take on a greater role as global locomotive and move global growth forward, offsetting forces toward a negative recoupling deriving from less buoyancy in advanced countries. Nevertheless, comprehensive efforts in terms of domestic policies and reforms will be fundamental to accomplish that mission.

Notes

1. Members of the G-20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Republic of Korea, the Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union.
2. The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
3. Though not explored here, the discrepancy in population growth will be one factor contributing to divergent potential growth between developed and

developing countries. Almost half of the population of the developing world is under 24 years of age compared to one-third of the population of industrial countries. However, some emerging markets (China, the Russian Federation) will face aging similar to, if not worse than, developed countries.

4. It is important to frame the question in terms of value, since it is not appropriate to rank physical productivities as "high" or "low" across different types of products (say, rice versus shoes).
5. An important dimension not discussed here is what the likely implications would be of such a rebalancing in global demand, in terms of types of products and production processes. Resource-based commodities are addressed in chapter 5.

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