African Research Review

An International *Multidisciplinary Journal, Ethiopia*
Vol. 6 (4), Serial No. 27, October, 2012
ISSN 1994-9057 (Print) ISSN 2070--0083 (Online)
DOI: http://dx.doi.org/10.4314/afrrev.v6i4.3

Uncertainty in Less Developed Countries in the Face of Crisis

(Pp. 24-39)

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Abstract

The global financial crisis that started in September 2007 with a rather limited problem in a market for non-tradeable goods (houses) challenged the way we have been thinking for decades about globalization, development and vulnerability. The crisis confronts social scientist, not just economist, with many issues that need reflection. This article concentrates on the developing and emerging economies in order to gain fresh insight into the challenges that the crisis poses to development strategies and policies. The crisis has serious social outfalls, slowing down the fight against poverty, sometimes increasing poverty, deteriorating income equality and reducing access of social service. This crisis also creates political conflict, generates new sets of priorities (both in the developed and developing economies) threaten food security and illuminates the need for better global governance frameworks. The role of the state as a leading actor in fostering economic growth and well-being has remained for some and emerged for others as a new paradigm. There is no 'one -size-fit-all' strategy, but in this article, there are

some proposals for development of LDCs. These countries still have some room to manoeuvre despite their loss of policy space.

Introduction

Until very recently, globalisation appears to be very robust. There has been no repeat of the contagious market crises of 1997-98. The credit market anxieties of 2007 produced little echo in Asian emerging markets, with the result that many commentators began to speak of a “decoupling”. The resilience of the world economy is sometimes, but erroneously, interpreted as a demonstration of the inexorable character of globalization. In reality, there is much vulnerability.

James (2008) noted that the world globalizers are suffering a collective loss of nerve. They are right to be uncertain and nervous. There is nothing inexorable about globalization. Past episodes ended badly. A great deal of historically informed literature on globalization makes the point that there were several previous eras of increased worldwide integration that came to a halt, and were reversed, with painful consequences, the most familiar precedent for modern globalization is that of the nineteenth and early twentieth centuries, that ended definitively with the inter war Great Depression.

The financial bubble in the United States of America attracted savings from across the world, including from the poorest developing countries [Bank for International Settlement,(BIS) 2008]. Developing countries government opened up their markets to trade and financed gave up monetary policy and pursue fiscally ‘correct’ deflationary policies that reduced public spending. So development projects remained uncompleted and citizens were deprived of the most essential socio-economic rights.

Prior to the crisis, many African countries enjoyed robust economic growth as a result of instituting sound economic policies as well as the favourable external environment, i.e. increased external support in the form of debt relief, higher aid flows and a commodity boom (IMF, 2008) as more than 11 countries registered 10 per cent growth in the two years prior to the crisis. This led to an acceleration of inflation and dampened growth prospects. The financial crisis compounded the problem further; threatening some of the progress Africa has made to meet numerous MDG goals

While the recent boom (the financial bubble in the US) was not suitable or inclusive, either across or within the countries, the crisis has been rather more inclusive, forcing those who did not gain earlier to pay for the sins of irresponsible and unregulated finance. Financial crisis are not new for developing countries, but this was the first time that almost all of them have been infected by a crisis that originated in the financial markets in the North(developed countries).Developing countries are not responsible for the crisis, but they are severely affected by it in ways that are worse than the developed countries as they also lack the means to counter the effects. There is thus growing anxiety in the developing countries that the crisis will certainly last longer than originally expected.

In today's world, many channels exist through which economies are linked. International capital flows such as foreign direct investment, remittance, bank lending, migration and development aid are influenced by the downturn in OECD economies. International capital flows may provide resources when developing and emerging economies are under strain, but these have 'in spite of souring needs, not raised, they have fallen'.

In many countries, particularly and crucially in the poorer countries, crises are regarded as business as usual. These countries experience and managed slow-downs without perceiving these as the unique events and potential systems breakdown that OECD observers have tended to see. The business-as-usual approach to crisis is one of the important differences between observers in the industrialized countries and in the developing world. It is relevant to analyse how countries and institutions in the developing world have learned lessons from previous crises and how this has influenced their response to the global crisis.

During 2010 the world economy continued to show important weaknesses. The crisis and its aftermath raise a myriad of questions about future sources of global economic growth and the challenges this poses to existing mechanisms of global economic governance. However, due to the crisis the global geography of economic strengths and financial fragilities has dramatically shifted. Crisis creates opportunities, and we need to put more efforts in upgrading and building reserves for the future.

Channels which the crisis transmitted

While the initial effects of the financial crisis were slow to materialize in Africa, the impact has become very clear. It has swept away firms, mines, jobs, revenue and livelihoods. In the majority of African countries, few automatic stabilizers exit, such as well-functioning social safety nets. IMF research in 2009 has shown the main channels which Sub-Sahara Africa is being affected. These include:

Declining private financial flows

The drying up of liquidity in international financial markets has resulted in reduced levels of foreign direct investment. The large, financially integrated countries such as Egypt, Nigeria, South Africa and Kenya were the first to be affected. A visible manifestation of this has been the postponement, closure and cancelling of planned investment. Foreign Direct Investment (FDI) plans in mining exploration in Tanzania, DRC, Zambia, South Africa, Cameroon and Central African Republic were suspended; governments' attempts to raise long-term finance through sovereign bond issues have failed (south Africa), been cancelled (Ghana telecom bond issue) or delayed(Eurobond issues for Kenya, Nigeria, Tanzania, and Uganda). In addition, planned private sector projects were suspended as some investors withdrew due to uncertainty. Stock markets in South Africa, Nigeria and Kenya plunged and tighter credit conditions were imposed in Ghana and Zambia.

Worsening terms of trade

Global recession worsen the terms of trade for Africa due to massive drops in export receipts. The sectors most affected by the crisis are mining, tourism, textile and manufacturing. The AFDB(2009) and IMF(2009) has estimated losses from export revenues of $250 billion for 2009 and $277 billion for 2010, much of it based on projections of commodity price movements. As a result, from a comfortable overall current account surplus of 2.7 per cent of GDP for both 2008 and 2007, the continent was expected to register an overall current account deficit of 4.3 per cent of GDP in 2009. Growth forecasts for Africa have been revised downward for 2009 and beyond. Global recession is worsening the terms of trade for Africa. Prices for African commodities fell sharply, but have rebounded in recent times for commodities like oil.

Declining remittance

Remittances constitute an increasingly important source of external financing for low income countries and are integral to poverty reduction at the household level. In the past they have been relatively stable, even surpassing level of ODA. The World Bank now expects remittances of Africa, which had peaked at about $20 billion a year in 2008, to decline by 4.4 per cent in 2009. The impact is quite severe in countries with high dependency on remittance (measured in per cent of export earnings). For example, remittance to Kenya, largely from the US, fell by 12 per cent in the first six months of 2009 compared to the same period in 2008, Cali and ell' Ebra(2009).

Decline in official development aid (ODA)

Even before the onset of the crisis, there has been a growing concern that the donor community has not kept its aid commitment to Africa, both in terms of volume and quantity (Accra Meeting of September 2008). ODA to Africa since 2000 was approximately $40 billion a year. This is likely to decline as traditional donors redirect their attention to tend to their own domestic economic crisis aid is pro-cyclical in two ways: on the aggregate donors tend to reduce aid flows in bad economic times; secondly, aid is pro-cyclical when countries fail to meet the targets set in agreed upon conditionality.

The impact of the crisis

Almost all developing countries adopted an export-led growth model, which in turn was associated with suppressing wage cost and domestic consumption in order to remain internationally competitive and achieve growing shares of world markets. Household consumption as share GDP in some of the more 'successful' developing economies declined over this period, in some cases quite significantly, reflecting the strategy of suppressing the home market in order to push out more export. Gosh (2009), pointed out that this led to a particular situation of rising saving rates and falling investment rates in developing countries. In South Korea and Malaysia, investment rates plummeted from 42 percent of GDP to 21 per cent between 1998 and 2006, even as savings rates rose from already high levels to rates in excess of 40 per cent.

The patterns of production and consumption that emerged meant that growth also involved rapacious and ultimately destructive exploitation of the environment. The cost-in terms of excessive congestion, environmental pollution and ecological degradation- are already being felt in most developing societies quite apart from the implications such expansion has on the forces generating climate change. There were other negative effects associated with the growth pattern. Within several developing countries, it led to an internal 'brain drain' with adverse implications for future innovation and productivity growth. The skewed structure of incentives generated the best young minds towards and large material gains rather than painstaking but socially necessary research and basic science. The impact of relocation of certain industries and the associated requirement for skilled and semi-skilled labour did lead to increased opportunities for educated employment, but it also led bright young people to enter into work that is typically mechanical and does not require much originality or creativity, with little opportunity to develop their intellectual capacities in such jobs. ILO (2008) pointed out that, at the same time, crucial activities that are necessary for the economy were in adequately rewarded. Farming in particular became increasingly fraught with risk and subject to growing volatility and declining financial viability, and the attack on peasant livelihoods also put the crucial task on food production on a more insecure footing in many countries. Meanwhile, non-farm work did not increase rapidly enough to absorb the labour force even in the fastest growing economies in the region.

Past experience of crisis had also led to a more cautious and calibrated approach to banking and financial sector reform in some countries like China and India, and also allowed the region as a whole to recover faster from the crisis. The impact of the crisis is not uniform across the continent. Rather, it has and will affect various African national economies differently, depending on their levels of integration in the global economy and the particular type of goods and services that they produce for world markets. IMF (2009) pointed out that oil and metals exporters have been hardest hit, oil prices fell over 60 per cent from their mid-2008 level. This has impacted negatively on fiscal and external accounts. On the other hand, oil importers benefited from falling oil prices but are affected by the decline in the prices of the other commodities. Moreover, the impact of the crisis is on various segments of the financial and banking sectors on the one hand, and the real economy on the other hand.

When examining the impact of the crisis in Africa, two contradictory realities emerge. On the one hand, Africa's marginal position in the global economy (i.e. little financialization of the economy; rigid controls on foreign exchange; limited foreign ownership of banks) appears to have shielded the continent from the disruptive effects of the crisis (apart from Kenya, South Africa and Nigeria, that are increasingly integrating into the world economy). On the other hand, as has been the case in previous global downturns, Africa is most likely to receive the most serious knock-on from the current crisis (Cheru, 2011). The crisis has unfolded a lot of issues.

First, the problems in finance remain just below the surface. They have not been adequately addressed or dealt with, and therefore, they are likely to strike again quiet soon. The underlying problems of stagnating or declining real estate markets and concerns with sovereign debt are compounded by continuing disincentives for excessive risk-taking in financial markets. Moral hazard is greater than ever before, because bailouts were not accompanied by adequate regulations (Stiglitz, 2009, Kregal 2010). So the problems in global finance are far from over, and are likely to return with even greater ferocity in foreseeable future. This is also true in developing countries, many of which are even being encouraged to deregulate their own financial markets.

Third, the crisis has direct implications for certain global markets that directly affect people's lives: those for food and fuel. It is now an open secret that the huge price volatility in food and oil prices was not related to any real economic forces, but rather significantly related to the involvement of financial players in such markets (Wahl 2009 and Gosh 2010). This was particularly so because future contracts allowed the emergence of 'index investors' who simply bet on changing prices and thus drove up prices far beyond those necessitated by any real changes in demand and supply.

From mid-2008, commodity prices started falling as index investors started to withdraw, accentuated by the global recession. But prices started rising again from early 2009, even before there was any real evidence of global output recovery. The price increase between January 2009 and June 2010 was 20 per cent for all food items as a group (IMF Commodity Trade Statistics September 2010). Once again the increase does not reflect real economy forces as global demand and supply for most commodities remain broadly imbalance. Such forces were able to be active because there had been no regulation of commodity future markets and the bulk of contracts were still conducted in OTC trading rather than in regulated exchanges with sufficient margin requirements position limits. Food prices in most developing countries were in general considerably higher in early 2010 than they were two years previously (FAO 210), and much more higher than increase in nominal wage income (which has been mostly stagnant).

Developing countries are caught in a pincer movement: between volatile global prices on the one hand, and reduced fiscal space on the other hand. Price volatility and changes in marketing margins means that the benefits of prices increase generally do not reach the direct producers, even as consumers (already hit by stagnant wages and falling employment) suffer from higher prices. Among more vulnerable populations, the effect of renewed food price increase on real incomes, hunger and under nutrition is likely to be devastating (Chhibber, Gosh and Palanivel 2009).

Fourth, both the nature of the previous boom and effect of the current crisis suggest that for various reasons, consumption demand is likely to remain suppressed for some time, and this will prevent a more balanced recovery. The constraint on expanding consumption in the US and Europe are now well known: both public and private sectors have very significantly high debt to GDP ratios, and the process of rectification of these balance sheets is either already under way or likely to start very soon (Papadimitrious, Hansen and Zezza 2009).

Fifth, some re-orientation of economic growth in the world economy has been made more difficult by pro-cyclicality of adjustment measures being imposed on developing and transition economies that have been hit hardest by the crisis. Despite all the statement to the contrary, the IMF has continued to impose stringent pro-cyclical conditionality on most of the countries that seek emergency assistance, and others are being forced into deflationary measures by the combination of falling exports and capital flow reversals. For example, in Pakistan, Hungary and Ukraine, the IMF assistance has come with conditions and reducing fiscal deficits through measures as lowering public expenditure, gradually eliminating energy subsidies, raising electricity tariffs, freezing public sector wages, placing a cap on pension payments and postponing social benefits. In monetary policy, the focus on inflation targeting has led the IMF to suggest or insist upon higher interest rates even in the context of recession in Latvia, Pakistan, Iceland and other countries (Third World Network 2009). Even in developing countries where the impact of the global crisis was less extreme, fiscal balances have been upset first by rising oil and food prices(in importing countries) and then by recession that affected tax collection.

Mehdi (2009) examine the impact of the external shocks resulting from the recent global economic crisis on industrialization of lest developed countries. They are marginalized in international trade and output, yet they are highly integrated into the world economy, suffer from structural weakness, balance of payments and fiscal constraint, and they are dependent on production and exports of primary commodities and external sources of finance. The commodity boom of 2003-08 which allowed them to accelerate their GDP was followed by a “bust”. Food and fuel importing LDCs, in particular, have suffered from both the "boom" and the "bust". As a result of the decline in their exports, workers' remittances and external sources of finances, most LDCs have suffered from significant declined not only in their GDP, the closure of a number of their factories, thus unemployment, but also in their investment in production capacity. Yet, their policy space has diminished due to pre-mature trade liberalization and "market oriented" strategies imposed on them. The global economic crisis is as wake-up call for LDCs to reconsider their long-term industrial and development strategies.

How the African governments have responded

Government from developing countries became so sensitive to the possibilities of further crises that they adopted very restrictive macroeconomic policies and restrain public expenditure even in crucial sectors.

The response of the African governments to the crisis has been quite different than in previous crises. Governments have learned from the better experience of the adjustment decades of the 1980s and 1990s how to avoid macroeconomic mistakes, excessive borrowing and controllable spending that had given rise to growth collapse in the past. Many Governments have set up special monitoring units to identify the advance of the crisis and growth while introducing social protection programs to protect the poor and the vulnerable. The policies put in place have been rather eclectic, according to the report of the Central Bank Governors (2009) established to monitor the crisis, and include a combination of the following:

- Fiscal stimulus (Mauritius, Nigeria, Liberia, Senegal and South Africa). While Mauritius proposed 10.4 billion Mauritius Rupees, or some 3 per cent of its GDP to boost domestic demand and increase job creation, Liberia proposed a 10 per cent reduction in corporate and income tax rates to stimulate private sector activity. South Africa also proposed on adjustment of personal income tax to middle and lower income earners.
- Targeting assistance to sectors (Nigeria, Rwanda and Uganda). In Uganda, the government provided assistance to the transport sector by writing off public loans to companies while Nigeria injected N70 billion into several weakened textile industry.
- Imposition of capital and exchange controls. In Tanzania, for example, profit repatriation has been regulated to minimize

contagion; new regulations in the banking sectors (e.g. in Egypt, a deposit insurance fund has been established to boost public confidence in the banking sector; and in Nigeria, the Central Bank has aggressively intervened in the foreign exchange market to stem the slide of the naira.

- Implementation of expansionary monetary policy (e.g. Cutting interest rates in Botswana and Egypt; the Central Bank of Namibia and the Reserve Bank of Namibia and the Reserve Bank of South Africa reduced their purchase rate to stimulate borrowing and boost private investment and consumption).
- Freeze on Government borrowing. Unlike in the past, African government have not gone around borrowing and they are yet run down reserves. Many of them simply adjusted by cutting down budget. They have done so in consultation with civil society and the business community so that the cost of drastic adjustment is not undermined substantially the social gains made over the past decade or so.

The pragmatic response by African government to the crisis is a clear indication of how development policy practices on the continent have come over the past decades. This is an encouraging development and it implies that African governments are no longer beholden to the one-size-fit all 'Washington Consensus' prescription and are more open to experiment with 'heterodox' but pragmatic policies to stimulate growth and reduce poverty while striving to expand policy space in determining their own development path.

It is now a cliché that every crisis is also an opportunity. As the global financial crisis unfolds and creates downturns in real economies everywhere, it is easy to see only the downsides as jobs are lost, many firms go bankrupt, the value of financial savings of workers is wiped out and material insecurity becomes widespread. But in fact this global crisis offer a greater opportunity than we have had for some time now, for the world's citizens and their leaders to restructure economic relations in a more democratic and sustainable way. Clearly, if countries in which the majority of the population are concentrated are actually to achieve their development project in a sustainable way, new and more creative economic strategies way, new more creative economic strategies have to be pursued. When the post-crisis strategy was also associated with continued credit for small borrowers, it tended to reduced financial inclusion even while it increased financial fragility, as is now evident in countries like Indonesia (Gosh and Chandrasekhar, 2009).

Conclusion

An important point to observe is that the current crisis affects developing countries more than previous crises did. World Bank's Global Economic Prospects for 2010 (World Bank 2010) argues that the severity of this recession is far larger than that of earlier recessions. These observations are at variance with assessments on the effects of the current recession on developing countries. The IMF 2008 World Economic Outlook (IMF 2008) argued that greater delinking was taking place between industrialized and developing economies and those developing countries would be less affected by crisis which started in developed world.

The unwinding of global macroeconomic balances that is already under way means that the United States cannot continue to be the engine of growth for the world economy. So other countries must find other sources of growth, especially in domestic demand (which should ideally be through wage-led exports (UNCTAD 2010). stimulating more bubbles in non-tradeable sectors like real estate and stock markets in the hope that this will once again generate more real economic growth is not a sustainable alternative to this, yet this is the direction that most policy measures have taken.

The excessively export-oriented model that has dominated the growth strategy of most developing countries and some developed countries (like Germany) for the past few decades needs to be reconsidered. This is not just a desirable shift-it has become a necessity given the obvious fact that the United States can no longer continue to be the engine of growth through increasing import demand in the near future. This means that the countries that have relied on the US and EU as their primary export markets and important source of final demand must seek to redirect their export to other countries most of all redirect their economies towards more domestic demand.

Fiscal policy and public expenditure must be brought back to centre stage clearly, fiscal stimulation is now essential in both developed and developing countries, to cope with the adverse real economy effects of the current crisis and prevent economic activity and employment from falling. Fiscal expenditure is also required to undertake and promote investment to manage the effects of climate change and promote greener technologist.

Recommendations

The on-going financial chaos offers new ideological space and material justification for developing countries to chart a new course- to re-impose exchange controls and re-regulate finance, and to find sources of hard currency not connected to western donors.

Africa's new found position in the global economy provides us with a compelling occasion for the continent to chart a new course- i.e. alternative conditions under which to engage economic exchange with old and new actors that are beneficial to Africans. This will entail the adoption of key reforms at national and regional level and greater economic policy coordination between African states.

Minimizing exposure to risk through diversification of national economies: The financial crisis underscored the critical role of diversification in reinforcing the resilience of economies. The focus now should be on identifying new sources of growth.

Globally, everyone now recognises the need to reform the international financial system, which has failed to meet two obvious requirements: preventing instability and crises, and transferring resources from richer to poorer economies. Not only have we experienced much greater volatility and propensity to financial meltdown across emerging markets and now even industrial countries, but the periods of economic expansion have been based on the global poor subsidising the rich. There is no alternative to systematic state regulation and control of finance. Since private players will inevitably attempt to circumvent regulation, the core of financial system-banking- must be protected.

Investment in education and basic research: Africa cannot flourish unless the continent's intellectual capital is developed and maintained. Despite tremendous gains made since the 1960s in increasing access to education, greater challenges lies ahead. The fiscal crisis, poor student participation, high dropout and repetition levels and low academic achievements are widespread with destructive trends throughout the education system. Strengthening African universities and retaining Africa's best and brightest professionals are important. The goal should be to climb the technological ladder and tap into the global system of information and knowledge (Cheru 2002).

Regional integration and cooperation are important aspects of the 'strategic integration' of Africa into the global economy. Such policies should support the goal of increased international competitiveness, by promoting regional production chains and also hurting the development of regional markets in order to reduce demand-side constraints on growth (UNTCTAD 2009)

Appropriate management of natural resources: How much government get from the resources, the division of rents between extractors and government, how they are used and how effectively public expenditures are used to diversify economy and fight poverty would assert its y will required a major strategic rethinking by African government.

Agriculture-led industrialization: Agricultural transformation must be a critical pillar of an African renaissance. The disappointing economic performance of the continent until very recently has been caused to a large extent by the failure of African governments to create proper condition to take place, which will in turn, propel the process of industrialization and social development.

Expand sound public investment in the infrastructure sector to support private sector activity and enhance competitiveness and diversification. In this respect, deficit financing can be fully justified given the long-term return from infrastructure development.

Harness new relationship with emerging Asian powers carefully and strategically: Central to Africa's economic renewal is the development of a strong, democratic, and activist state that would assert its development role within the context of a common national development vision. The lesson from china and East Asia in general demonstrate importance of home grown national policies that support strategic industries, develop infrastructure, invest in human capital and control financial markets (Ghosh 2011 pp19-34).

Since state involvement in economic activity is now an imperative, it is necessary to develop method and practices to make such involvement more democratic and accountable within our countries and internationally. Large amount of public money are being used and will continue to be used for financial bailouts and to provide fiscal stimuli in the near future. How this will be done will have huge implications for distribution, access to resources and living conditions of the ordinary people whose taxes will be paying for this. It is therefore, essential that developing countries design the global economic architecture to function mare democratically.

There is need for international economic framework that supports all this, which means more than just that capital flows must be controlled and regulated so that they do not destabilize any of these strategies.

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