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**Global Economic Recovery: the role of China and Other Emerging Economies**

**“Bubbles, froth and substance: world recession, world recovery, developing countries and the China factor”.**

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## **Introduction:**

In late 2008 throughout 2009 and into 2010 there have been continuing tales of woe concerning the fate of the developing world, due to its integration with the developed world and the financial collapse of the financial instruments derived from the after the event appropriately named, sub-prime mortgages, saw continuing predictions of gloom and doom for all in the wake of an apparently dysfunctional or suspect global financial system. Some of the major economies of the world were seen as being in sufficient difficulty that potential imminent collapse of both the developed and developing world's economies was likely, with the most open or globalised economies seen as being particularly vulnerable.

Subsequent investigation of the actual numbers for Trade in goods and services, Investment flows and Migration and Remittances suggested this degree of pessimism, some verging on expectations of complete disaster might be unwarranted, certainly less than totally substantiated, unless slower growth rates were considered complete disaster. Trade was clearly and directly affected adversely through the mechanism of declining imports and exports, but other indicators were less negative in their outlook or reports. Despite this China was seen as one of those at risk with talk of 1930s style global depression for Asia in general, overriding the passing thought that the Asian financial crisis of the late 1990s, bad though it was, had not witnessed inter-war levels of downturn, except in particular cases such as Indonesia. The fears of the Western financiers were being transferred across the globe rather than rational analysis.

More recently some of the same observers and commentators have taken a more positive tone, with China even seen as a potential source of recovery for the world economy. The Chinese stimulus package with its anticipated 4 trillion yuan or more, injection into subsidies and other transfers as well as direct public expenditure is no longer portrayed as a doomed to failure - Keynesian experiment, but rather in the words of a World Bank forecast statement of 2009: a ray of hope of stabilisation by mid 2009 and recovery in full in 2010, contributing to pulling the world economy out of recession. Should we believe the optimist version any more than the pessimists of yester-year? Is it all bubbles and froth or is there substance? Is the housing derivative bubble to be replaced by another – a development micro-finance derivative bubble perhaps? Is Chinese development and recovery necessarily indicative of better times for the world, or even just for the entire developing world? Is the Chinese stimulus package going to be more effective than the “bail out of the financial institutions” and if so, from whose perspective?

This paper reflects on some of these and some associated questions, investigating the available quantification of the “crisis” and reflecting on the hysteria of manias with some thoughts as to the merits of a good dose of scepticism as to the sayings of both the prophets of doom and those seeing the imminent return of a global cornucopia.

Part one reflects on the past international experience of financial booms and busts in the light of these recent experiences and poses the question as to the relative real versus financial impact of fluctuations, especially from the developing country perspective.

Part two then considers the financial collapse and its undoubted significant impact on developing countries, but considers collapse as too strong a description, unless we consider particular parts of the economic system or the impact on particular sections of the society.

Part three looks at the recovery phase of the current experience and something of the the particular part played by China, with comments on the likelihood of realising expectations of China performing a role in driving the world economy forward.

Some conclusions are then drawn as to the vulnerability or otherwise of developing countries in an increasingly integrated global economy and reflects on the origins of the growth process in terms of external and internal drivers.

### **Part one: International Fluctuations in Historical Perspective.**

Financial bubbles and recessions are nothing new as a quick glance at Reinhart and Rogoff's study of the available material for the last eight hundred years superbly demonstrates and as the title of the first chapter of *Mania Panics and Crashes* also suggests, it being: *Financial Crisis: A Hardy Perennial* (Kindleberger, 2000), That book also contains what seems now to be topical coverage of swindling, international contagion and lenders of last resort. Such factors and such crises do have some consistent features over time, not only in the nature of the economic and financial theory and policy analyses of their cause and the response to them, but also in respect of the psychology of business promoters and more importantly the rationality or otherwise of investors. The classic bubbles associated with banking or the promotion of mining shares or whatever else, have some consistent aspects. The suspect deal becomes the outrageous and eventually the illegal with apparent seamless consistency and ease. For a series of mining examples of bubble mania and such effects there are many references including a good recent one (Dumett, 2009).

Rothermund's (1996) study of the impact of the inter-war depression, at first sight appears to fill in some of the gaps in terms of the effects felt in Asia, adding to our knowledge of the period and to that of the usually chosen reference point, the 1930s, used to judge the impact of more recent downturns. The inter-war period, however, does not provide us with a large volume of material relating to the Asian or specifically Chinese experience. As Rothermond explains China was not that open to the world economy (p. 110) and he suggests the depression hit as late as 1933 (p. 133) Silver flows into and out of China were linked to American monetary practices and there was a significant role played by the Chinese diaspora in such flows. There are some strong similarities here to the nature of the players in the current drama, even if the details of what the flows were and how they occurred is different.

Rothermond also suggests there were certainly supposedly disastrous consequences for China by 1935, leading to a need for a currency reconstruction and the supposition that the depression was possibly harder hitting by this time in China compared to elsewhere (Rothermond, 1996, p.113). Wright's (1991 & 2000) descriptions of events is somewhat different to Rothermond's, however. Similarly other compilations of data relating to various economic assessments of Chinese performance at this time suggests a rather different story, having a 1931 downturn followed by continuing growth in outputs of manufacturing activity where these were measured (Myers, 1989,

pp. 256-258). Rothermond's main purpose was to look at the use of Keynesian policies and the workings of the gold standard, rather than to give a fully detailed account of the Asian depression experience and he does not use the statistical material available to go against his story. What he does do, however, is to give fuller attention to Asia than do most writers on the depression. How Asia was suffering in the 1930s was not of great concern to most contemporary western writers, nor to most subsequent western economic historians. The recent expressions of concern regarding the present crisis, would also appear to be focused on China in particular and only in so far as it affects the prospects for recovery in their own country.

Possibly the most useful thoughts to come from the inter-war period for present purposes are to look at the continuing debate as to whether the underlying causes were monetary or real in nature. Peter Temin's work was influential in this regard, but like most of the other contestants the result of his study eventually proved to be somewhat less than definitive. Did the stock market "bubble" that burst in 1929 bring about the great depression is a proposition that Temin rejects. Relative to corporate earnings he sees stocks as not being vastly over priced by the late 1920's, with the wealth effects of the subsequent price fall as not being a significant cause of the problems (Temin, 1976).

Temin's concern is concentrated on the American experience. The New York stock exchange experience was not that of all stock markets as the briefest of looks at chapter five of Kindleberger's 1973 work well demonstrates. The experience of Germany saw downturns in 1927, the United Kingdom in 1928 and France in the February of 1929, all well in advance of the late 1929 New York crash, others including Vienna were later and as seen already yet others, such as China were also delayed. Depression's impacts were more felt by 1931 onwards. It should be noted that Kindleberger's account agrees with Temin in the sense of suggesting that stock prices were not out of line with their adjusted values in other eras, including at the time he was writing, taking the Dow Jones peaks for both 1968 and 1970 and comparing them to that for 1929 (Kindleberger, 1973, pp. 108-9).

If we move from the inter-war period to the late 1990s, Arndt and Hill's (1999) edited volume produced a comprehensive survey of the Asian crisis, the mechanism and details of which is important in this case too, since there were fears at the time of contagion spreading globally as well as regionally and that in reverse to the current direction of the spread of contagion, Asian integration with the global economy could have seen a crisis beginning there spreading out to set off a global recession affecting Europe and the U.S.. Hal Hill's overview of the late 1990s is reminiscent of comments made now regarding China and the initial impacts and declines in growth rates, when he said that from usually looking to explain why economies were growing for so long, so quickly before 1997, observers and analysts had to switch to why things had gone sour so fast (Hill, 1999, p.1). However, the extent of the impacts on Asia, and China particularly, are very different to the switch from the late 1990s from a net inflow of private capital to a net outflow for the whole region and the extreme problems suffered by Indonesia particularly, which definitely made the case for strong comparison with the inter war depression experience.

Suggestions that China was the source, if not the cause of the current financial crisis, have been forthcoming from many quarters. Exchange rate policy and controls on

investment flows have attracted criticism. Athukorala's passing comment on the late 1990s that China came through the crisis rather better than most, along with Taiwan and that both used controls on short term capital movements (1999, p. 37) is interesting, but the two situations are rather different.

The depiction of a causal process for the late 1990s, suggested that the preceding bubble contains the seeds of the following bursting of the bubble. To quote: "The financial crisis that hit Indonesia, Thailand, Malaysia, and Korea was a by-product of the large inflow of international capital since the mid – eighties and of the boom it inflated. The boom atmosphere in turn attracted yet more inflows of international capital which made for lax government policies..." (Sadli, 1999, p. 20). To set a scene of problems with a degree of similarity to today, it is worth noting that there was in the era before the late 1990s, deregulation of the banking sector in Indonesia and an explosion in the number of commercial banks formed and operating, all desperately seeking business and, it can be inferred, employing a number of relatively inexperienced staff who quickly adjusted to a situation of the expectation of growth and high profit as the normal state. It is also worth noting Myers also found that the Chinese banking system in the 1930s was essentially a free, or in his words a freewheeling one, with individual bank notes being issued only controlled by a partial linkage to the bank's holdings of silver. (Myers, 1989, p. 254). Financial laxity was more than possible in both cases.

The sources of international capital are not the principal players in any of these dramas and the similarity of the process with the events preceding 2008 and the subsequent unfolding of the financial derivatives downturn and contagion seem strong. Overshoot and collapse type of processes seem likely to have occurred in both the late 1990s and the late 2000s with psychology being as applicable in terms of seeking explanations, as economic theory. After the initial onset of the bursting of the big bubble there followed the bursting of the subsidiary bubbles in various economies connected to the process around the globe. If resort is made to the use of an analogy prompted by a reading of an investigation of the physics of bubbles published in the June 2010 issue of *Nature*, with its concerning reference to the inherently unstable nature of the material after the initial burst (Bird, de Rooter, Corbin and Stone, 2010), the possibility of further instability or successively smaller bubbles continuing to burst, can be thought of as potentially disastrous, whichever bubble is thought of.

The role of China and more generally the other individual countries of the developing world in all of this may be viewed as being more important to their neighbours than to the world economy at large. Trade is largely regional within Asia and the larger powers such as India and China pose a threat and an opportunity to their smaller neighbours. Certainly the Asian crisis was most significant in its regional impact.

In addition if openness dictates influence through external effects on other's internal economies then the size and impact of the degree of openness matters in each case. China was relatively little exposed in terms of trade to income ratios in the 1930s but is far more integrated now.

## **Part Two: the Financial Collapse and Asia.**

Suggesting China's trade surplus as being the cause of the derivative bubble by supplying the necessary liquidity seems to be stretching the case, in depicting a possible facilitating role as a causal one. That does not seem to have stopped some from claiming it to be so.

In an interesting recent article by Wim Naudé (2010), the effects of the downturn are summarised quite neatly in terms of the impacts through to late 2009 and the relative lack of response and concern, by the developed world. Developing countries escaped better than the US and Europe, but were still affected with declines in stock market prices and export receipts falling. The consequences included falling activity, unemployment increases and falls in government revenues (Naude, 2010, pp. 216-217). The overall expectations were for falling exports, reductions in investment and aid with falling growth predictions made by the World Bank (Naude, p. 221).

What else could such events produce? Reinhart and Rogoff's study of banking crises demonstrate a significant rise in public debt ratios, resulting largely from the continuing effects of recession and fiscal expansion rather than the initial stimuli given to the economies concerned and the banking system bailout in particular. They found that the consequences of financial slumps were severe, long lasting and affected not only the decline in share prices and the house price assets associated with the sub prime collapse, but with significant declines in real output (9 percent average over the cycle) and employment, with unemployment rising by an average of 7 percentage points during the downturn.

Reinhard and Rogoff estimated there to be a significant average increase in Government debt of some 86 percent on average in the three years following incidents of all banking crises occurring since 1945 (Reinhart and Rogoff, 2009, p xxxii), causing significant problems for public financing in the period after the onset of the crisis and continuing into the recovery period. They studied not only sovereign debt problems, but banking crises and significantly note the paucity of data for Asian and African countries as meaning they may appear to have a better record than they deserve.

As far as China specifically is concerned they mention that the pre-communist era saw a government default. (Reinhart and Rogoff, 2009, p. xxx). Holding down the exchange rate in the modern era, has not so far appeared to be viewed as having the equivalent size of impact to that of a default, although complaints as to its impact are frequent as well as persistent.

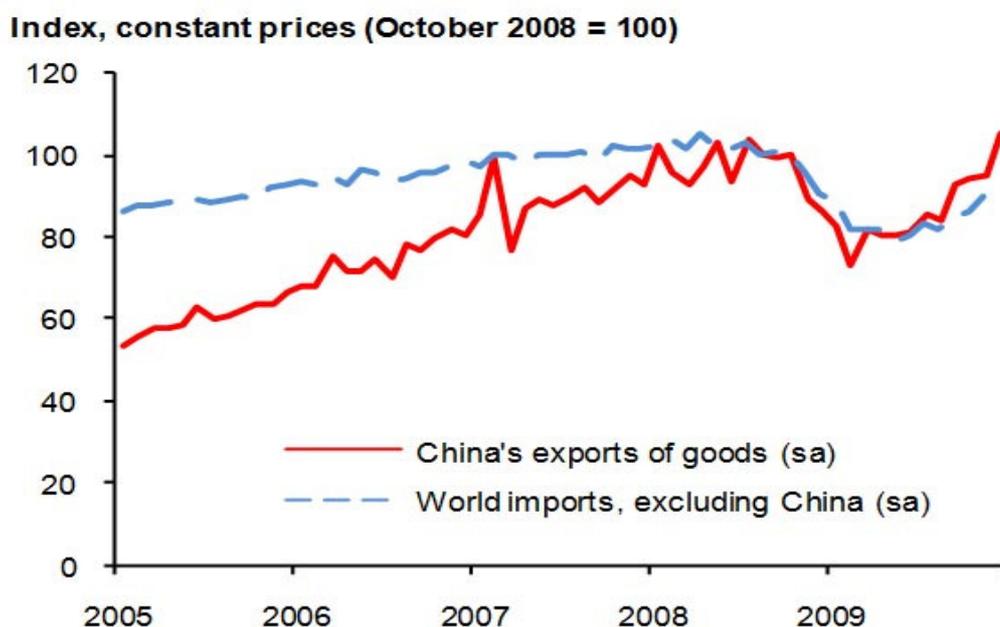
China was said by some to have a poor long-term look out because of its short run maximising. This could be seen as a possible strength in recession rather than a weakness, exposing the economy to less volatility. Whether the suggestion is valid is another matter and depends on the importance placed on other concepts than economic growth, including the issue of sustainability, particularly in an environmental sense. By contrast Oliver Blanchard from the IMF said in Press releases recently that there was no China bubble danger and that long term growth there would continue. China and India may of course be something of a special case.

What can be said is that Chinese remittance amounts grew strongly, by over 25 per cent between 2007 to 2008, and were only estimated to fall by some 3 per cent in

2009 (World Bank, 2010). Since original estimates by the World Bank were for a far higher decline than this, it would appear that not only are the actual numbers not as expected, even the estimates are showing a far lesser expected impact than originally thought. India fares only a little worse in the estimates for 2009 (down approximately 6 per cent over 2008).

Trade reflected in both import payments and exports receipts had picked up by 2009 as can be seen from the following graph which has been directly from the World Bank (2010) site. 2009 was bad, but full recovery appears to be imminent.

**Figure 6. China's overall exports have recovered impressively**



*Source:* CEIC, Centraal Plan Bureau, staff estimates.

FDI inflows have not declined by as much as was feared. In fact FDI sent into developing countries was performing strongly although substantially slanted towards China and India at the expense of their neighbours. Inward Chinese FDI is 44 per cent sourced through Hong Kong, (Liu, 2009, p. 3) although foreign owned corporations operating there or channelling investments through there may account for a significant part of this.

The World Bank quarterly report for March 2010 shows Chinese GDP reported to have grown by 8.7 per cent in 2009, down on the average for the decade 2000-2009, but strongly growing rather than significantly down as per earlier predictions and expectations. The 2010 expectation was put at 9.5 per cent.

### **Part Three: the “Recovery and China”.**

Provisional GDP estimates made by Ligang Liu (2009) factor in the fiscal stimulus according to a positive range of between 2.5 to 5.3 percentage points (Liu, 2009, p. 16). Liu’s table 11 (p. 21) gives a breakdown of his estimates of the stimulus with the biggest expenditures going into Medical reform over three years, rural infrastructure and affordable housing. 700 million people are estimated to benefit from the programme worth in excess of 1,800 billion RMB, according to this study (Liu, 2009, p. 21).

World Bank 2010 data and analysis suggested India and China have exhibited the largest absolute numbers in their global migrations, India has the largest remittances flow reported for the World and China dominates India in Foreign Direct Investment This is interesting in the light of India as the emerging Technology centre, whereas one would anticipate from the adverse comments made sometimes in the general literature, that remittances are spent on “unproductive”, basic and consumption-related activity rather than in productive investment and high technology.

Most Chinese growth appears to be concentrated in basics steel, cement, and manufacturing. Investment in infrastructure including electricity generation is also up massively, with new coal fired plants appearing regularly. The fickle nature of short term foreign investment, even when sent through by those who recently left for overseas, can be problematic. Problems with hot money lent on short-term arrangements, is somewhat more difficult to deal with than FDI and other less liquid arrangements. Technological change has posed a challenge in this respect in the sense of making international transactions both easier and quicker. More openness and less regulation in such transactions can lead to even greater volatility in an economic sense.

Reinhard and Rogoff’s study also suggests that there needs to be a degree of caution in anticipating that the pick up in China is a clear indicator that all is now well and will continue to be so in the foreseeable future, not only for China, its neighbours, but also for the world at large. Recovery resulting from Fiscal packages is not guaranteed to secure the future, the nature and effect of the stimulus can have different consequences, depending upon the speed and the way in which the recovery occurs. Infrastructure spending, commodity stockpiling and urban growth certainly appear to be significant in the Chinese case. If poorly working institutions were seen as part of the problems leading to the crisis then institutional improvement could be a further necessary part and parcel of the recovery.

Institutions are taken here in the sense best described by Jason Potts (2000, p. 44) as more than just the embodiment of the North, (1991) view of interactions between the agents involved, but rather concentrating upon the interactions themselves and by extension their economic outcomes. The extension permits analysis of the macro-economic system from a multiple-agent perspective, with public and private agent’s, or actor’s, interactions seen as being determined by various factors including path-dependency. The typical sequence of events is not simply one of an originating shock to a system, the financial crisis in this case, followed by a return towards equilibrium, but an initial shock which is followed by recognition that change has occurred, thinking about consequences and new opportunities and possible ways of responding to the change, choosing and making a response, followed by evaluating the effects of

the response (Potts, 2000, p. 188). Further refining will produce further changes and it is likely that feedback loops will come into play. The initial change may well set off the subsequent ones in a manner, which is in effect path-dependent and certainly is adaptive. It is also very much reflective of how Schumpeter's entrepreneur or Hughes' for that matter might operate. Facilitating the process could then be seen as a target for policy decision making. The recovery from the crisis could then become part of a partial redeeming of the crisis through seeing it as a spark to creative destruction, although this is pulling a very long bow. Such a mechanism could, however, prove useful in terms of characterizing responses to the initial and subsequent events emanating from the financial crisis and looking to benefit fully in a growth sense, from the changes produced by those responses.

Alternatively for an analytical structure there is the role of geography and distance as a proxy for integration. There have been long running discussions on the relative importance of geography (see for example, Sachs starting from 1999) and that of Institutions (see for example Rodrik, Subramanian, & Trebbi, 2004) with the authors disagreeing on much, including the role of geography and institutions, but perhaps agreeing that integration and openness is beneficial and that the effectiveness of the role of geography or institutions are often constrained by limits imposed on them by the absence of integration and openness. China is certainly more integrated in a trade to income ratio sense than it was in the 1930s.

Distance has been taken as a proxy for the geographical difficulties encountered in prompting or driving growth in boom or recovery mode. Distance in this case is usually measured as flight miles between international capitals. The issue here is that Chinese capacity to generate internal consumer demand and places its reliance on the international linkages to a lesser extent in recovery than for many, especially smaller economies. The typical geography determinants, such as those talked of by McCann (2009), for the New Zealand case for example, do not seem to apply in this case.

Chinese growth rates seem to have increased in line with greater openness, but to what extent this is truly significant relies on achieving a greater knowledge of the unknowable counterfactual analysis. The extent of the 2008-9 downturn in exports and the slow down in growth rates of GDP of that period, are in part at least the result of the more open path taken by China in the post-reform period preceding the downturn, by looking at the falloff after 2007 it is the actual path rather than the counterfactual that we are comparing recent performances with.

Problematically the question remains, even if there is a high level of integration or openness, is this really the driver of growth or is it the consequence of growth. Does growth pre-dominantly come from outside or from within? We can return to trying to open the black box of Nathan Rosenberg (1994) and have already in this paper revisited Joseph Schumpeter's (1975) thinking on creative destruction, which originally appeared in 1942. Was the financial crisis creative destruction? It seems unlikely – the crisis can be seen as more monetary than real in cause perhaps, albeit with significant real consequences. Many such issues and thinking form part of the consideration and reflection contained within the following, concluding section.

## **Conclusions:**

The financial crisis has generated much more heat than light in the resulting commentary and observations. Some observers seemed keen to look for any suggestion that the Chinese growth rate was going to collapse and to form a very pessimistic stance on the prospects for China in the downturn and then they in turn were followed by others who saw Chinese recovery as the key saviour of the world economy. Both were extreme forms of the analytical stance which themselves quickly followed an overshoot approach, even when based on elements of analysed outcomes and prediction.

The connection with financial issues and financial markets provides a possible explanation as to why excessive pessimism or optimism is to be seen. With derivatives the investor can quickly become divorced from the reality of the economic scene. Additionally, whilst the degree of interaction and interconnectedness is becoming stronger over time much of the fundamental sources of growth are likely to be found internally as well as externally. It would not seem that the financial bubble was in fact an example of creative destruction, even the financial sector appears not to have significantly changed its products, but rather is trying to seek new markets for an amended version of the old products. Schumpeter gives us a small clue to seeking out the cause of upswings and downswings, however, through his use of the character of the entrepreneur, social effects and psychology embodied in this one character appear to play a part in the onset of the recession and perhaps to maximising the growth benefits to be had from the chosen means of recovery.

The historical experience of periods such as the inter-war depression suggests that western writers neglected the Asian experience and made assumptions that it must have followed the western one at least to the extent that the important (in their eyes) measures were those related to the international scene. Ignorance of the actual experience or lack of written record in western languages led to some major and often erroneous assumptions. What statistics there were related to the international situation and seemed to confirm that the Asian countries followed the western pattern. When a more careful look was taken, however, it was found that the experience was apparently different. Rothermond may have challenged the timing of depression in the 1930s, but not the depth and response in any great detail. Subsequent work, summarised by Myers, Wright and others, has gone into greater and more statistical detail and found that the conventional wisdom is at least contestable if not demonstrably incorrect. Add the most recent studies of the banking situation as revealed in Reinhart and Rogoff and a different picture emerges. As more definitive quantitative evidence is produced for the inter-war period, so the timing, the depth and the relatively small determining impact of the external situation is revealed.

Similarly if the current scene is examined much of the fears of the financial downturn can at least be contested. Actual hard evidence of a continuing severe cutback in trade or any other financial flows from outside appear not to be present for China, Naude's fears remain those of conjecture rather than hard evidence. Investment inflows to China have not declined, the strength of the internal market has held up and the character of the Chinese manufacturing and service sectors are not apparently threatened as much as might have been feared. So the downturn was not the extreme

disastrous threat to a flawed system that some would have had us believe. Nor is the Chinese recovery to double digit growth levels, necessarily:

1. Fragile and in danger of collapse, but it is also
2. Not automatically going to bring the rest of the world back to pre 2008 levels.

The analysis of the recovery suggests Europe and certain economies in particular continue to have a problematic outlook and if there is a danger to the world economy it is one based on the chance that a daughter bubble is nurtured into a new derivative-based financial explosion, divorced from underlying values. What might be the base for that, it is possible to suggest the commercial bundling of micro-finance loans, currently taking place around the world is one possibility, although over-hyping fears of another financial collapse was the opposite purpose to the one this paper started with.

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