THE STATE OF THE WORLD ECONOMY AND LONGER-TERM PROSPECTS

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Macroeconomic Challenges in Development Policies Post 2015

DESA, 5-6 December, New York, UNHQ

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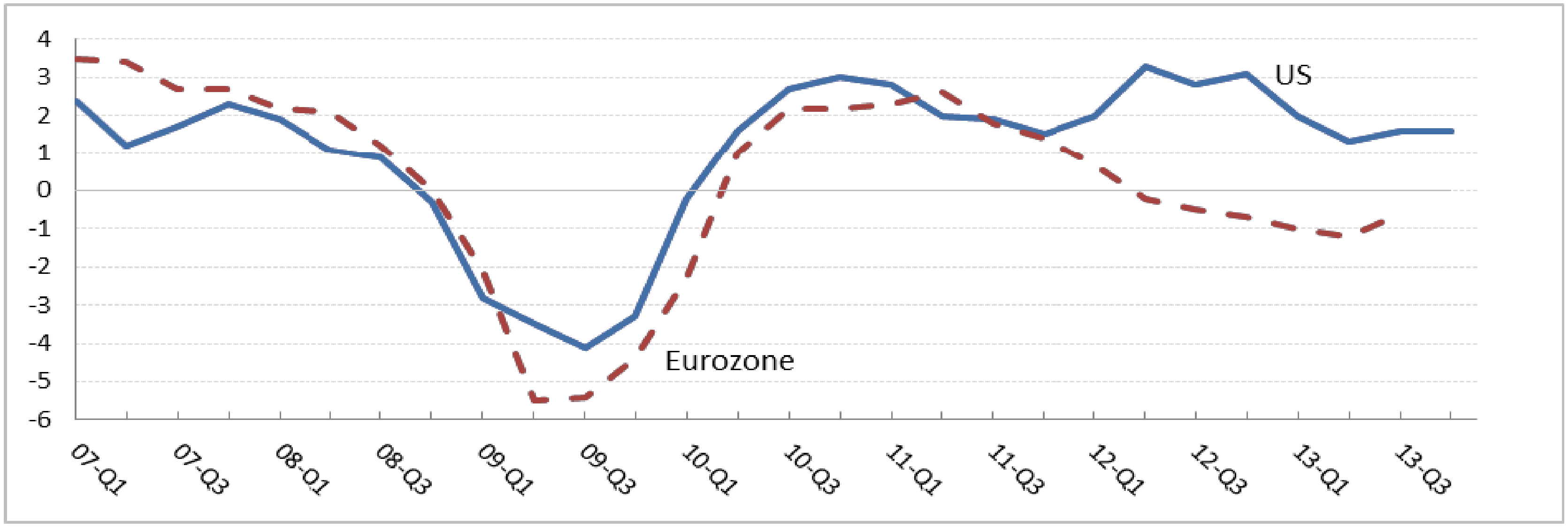
ISSUES AT STAKE

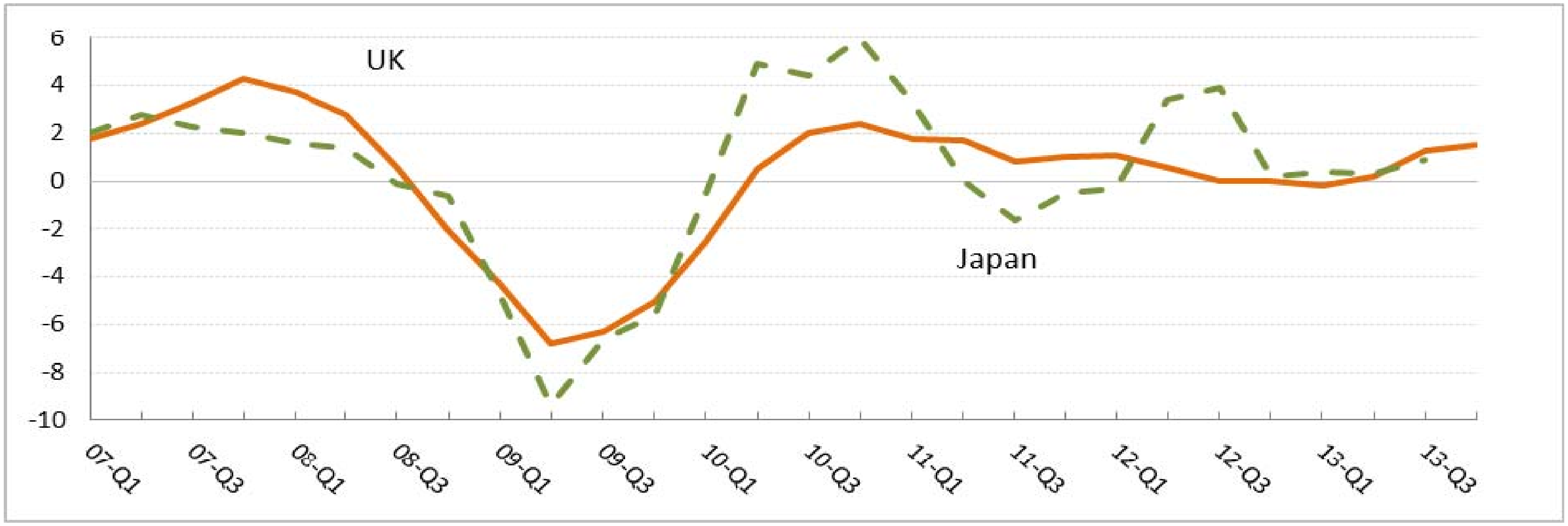
- World economy is in a bad shape: before achieving full recovery there is talk of a new crisis
- Longer-term prospects are bleak
- Crisis is mismanaged in the US and Europe: Policies are not bold enough; do not match the challenge
- Systemic problems aggravated:
  - Income and wealth inequalities
  - Global trade imbalances
  - Financial fragility and systemic instability
- What is to be done? Policy issues

GLOBAL ECONOMIC LANDSCAPE

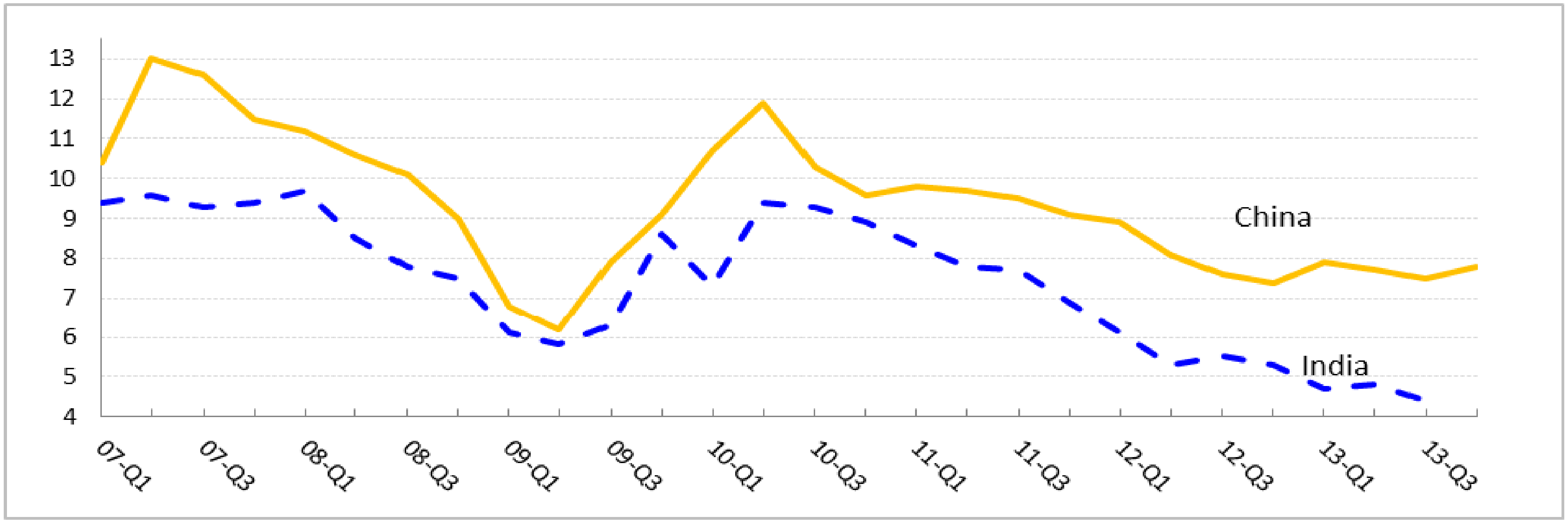
- More than 5 years into crisis little signs of robust growth. Bounce back in 2010 followed by slowdown in both AEs and DCs.
- US better than other AEs; but growth sluggish and fragile, output and employment gaps still large.
- EZ, Japan, UK have all had second or third dips since 2008.
- EZ struggling to get out of recession; in mid-2013 it had 6th consecutive quarters of negative growth. Jury still out on euro.
- Japan contracted in 7 quarters out of 20; outlook not bright despite Abenomics
- DCs: Great Slowdown. Did not manage twin booms (commodity+ capital flows) well. End of myths: “decoupling”, “new engines of growth”. IMF coming to terms after several U-turns and constantly over-predicting growth in DCs after 2010.

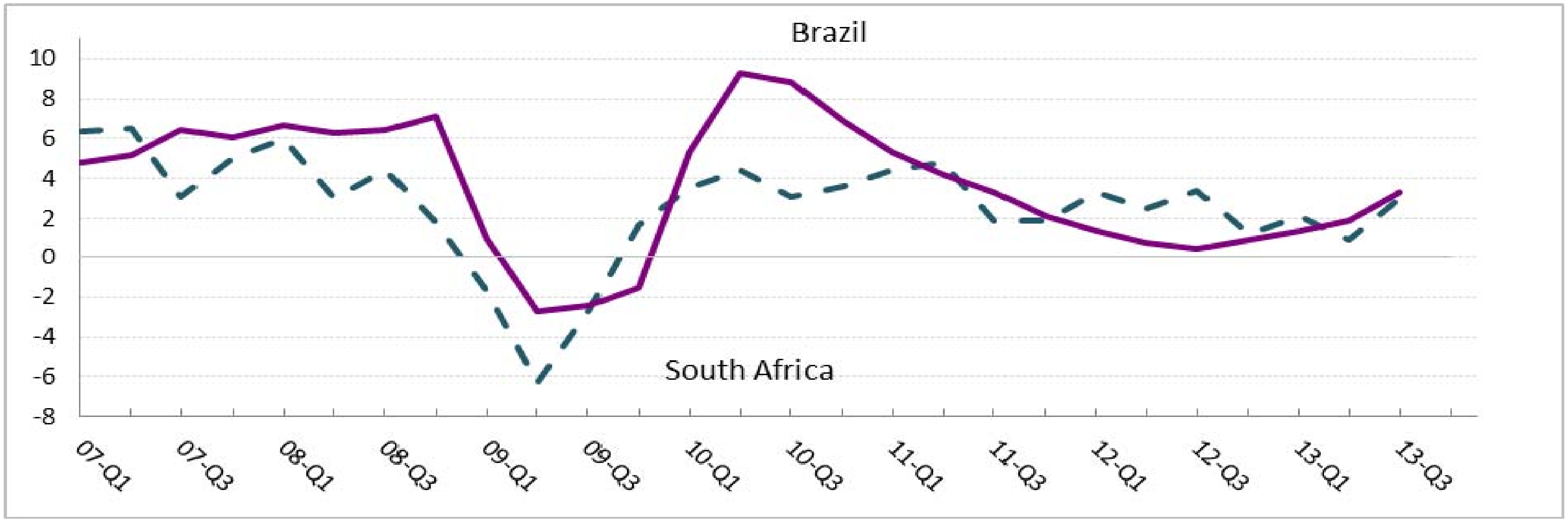
GDP Growth in Major AEs





GDP Growth in Major DCs





WHY TAKING TOO LONG TO RESOLVE THE CRISIS?

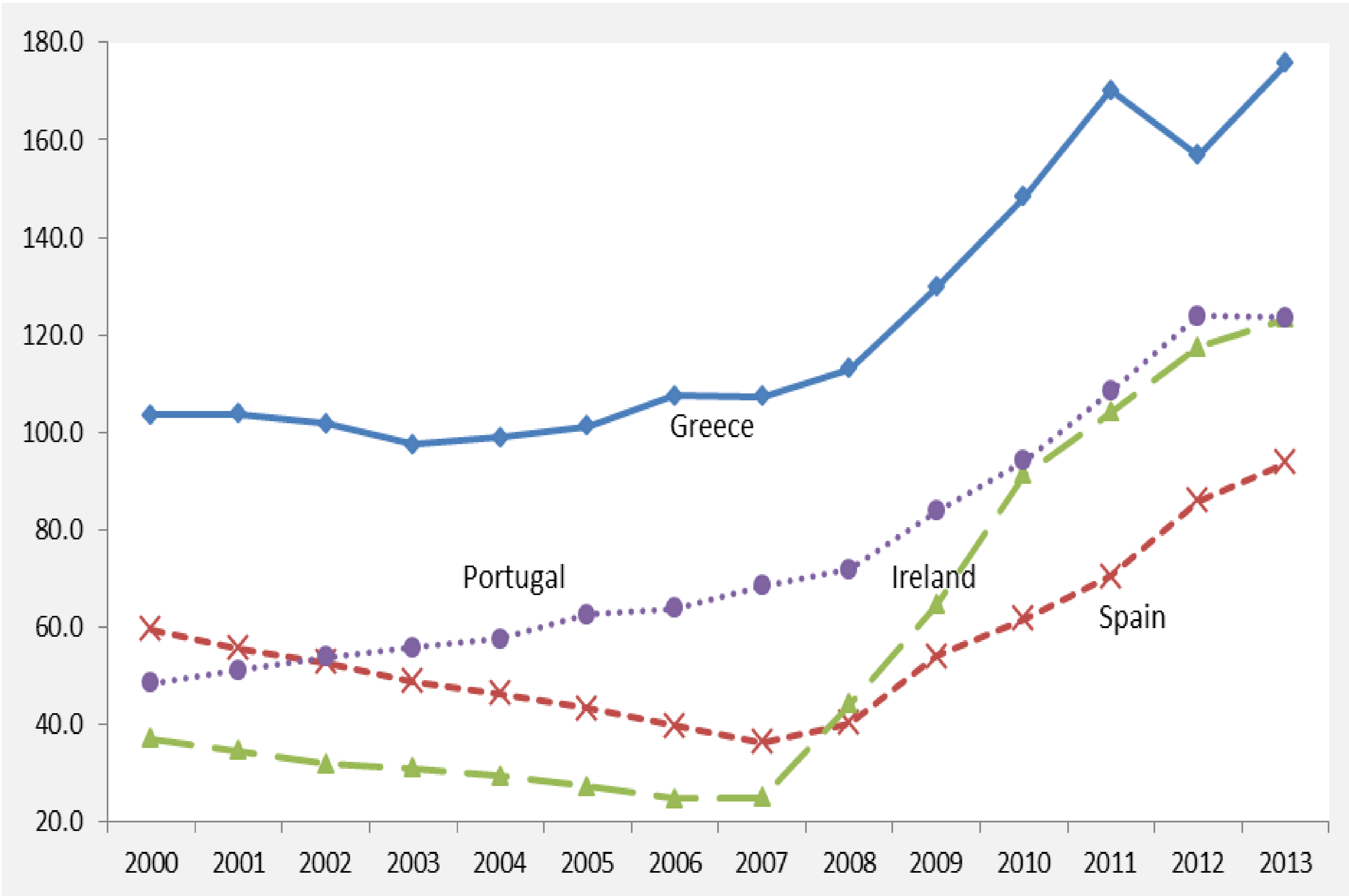
- IMF (Blanchard 2012): crisis could take 10 years to resolve.
- Recoveries from financial crises are sluggish because it takes time to repair balance sheets – debt overhang and excessive and unviable investment.
- But important shortcomings in policy response both in US and EU:
  - Reluctance to remove debt overhang through comprehensive and timely restructuring and write down (mortgages in US and sovereign and bank debt in EU) – resistance to redistribution form creditors to debtors.
  - Shortcomings in macroeconomic policy response. Return to fiscal orthodoxy after initial reflation. Excessive reliance on monetary means.

THE DEBT OVERHANG

- US interventions: ended financial crisis but not economic crisis
  - Bank bailouts (TARP); QE to buy toxic assets, lower long-term rates on Treasuries
  - No statutory mortgage write-down; two voluntary schemes not very successful.
  - Generating large profits for banks; too-big-to-fail banks are now bigger.
  - Foreclosures not prevented. Household debt now lower but so is wealth (foreclosures);
  - Widened income and wealth inequalities.

- EZ: financial (debt) crisis unresolved, economic crisis continuing
  - Wrong diagnosis: treated as fiscal rather than BOP/external debt crisis (as in EEs)
  - Baker strategy: lending + austerity. ECB interventions to lower cost of sovereign debt
  - Write-offs insufficient; 70% Greek debt now official (untouchable?). Debt ratios rising
  - Too many banks survived with public money, adding to sovereign debt.
  - Inconsistencies in bank restructuring; depositors treated differently.

EZ Periphery Public Debt (as per cent of GDP)



FISCAL ORTHODOXY

- Fiscal fallacies:
  - Deficit spending adds more to debt than to income: fiscal multipliers small because of crowding-out (nonsense under liquidity trap) and Ricardian equivalence (nonsense when incomes are falling).
  - High debt/GDP reduces growth (Reinhart-Rogoff: proved shaky)
  - Thus "expansionary austerity" fallacy.

- IMF *mea culpa* (2012) about fiscal multipliers after its projections in EZ periphery went off the mark.

  - IMF *mea culpa* (2013) for Greece; its debt sustainability analysis was misleading, austerity damaging; Greece should have received more write-off, less adjustment.

  - Still, fiscal orthodoxy has reigned both in the US and EU.

  - Fiscal stimulus without deficits – progressive taxes and higher spending. Balanced budget multipliers are large under deflation.

ULTRA-EASY MONETARY POLICY (UEMP)

- Zero-bound policy rates, QE and forward guidance – gone too far, too long
  - Not very effective in raising private spending. Credit to non-financial sector flat.
  - But search-for-yield in high-yield bonds, subordinated debt and leveraged syndicated loans (BIS); buying long-term assets with short-term debt. Financial fragility: Bernanke "asset mispricing", risk of bubbles
  - Longer-term consequences of UEMP not known; uncharted waters.

- Resistance to permanent monetization of public deficits/debt (helicopter money). More effective for recovery and less dangerous for financial stability than UEMP.

- True that without UEMP recession would have been deeper and unemployment higher. But what about counterfactual: debt-write off plus fiscal stimulus (monetization of deficits and debt, spending based on progressive taxation)?

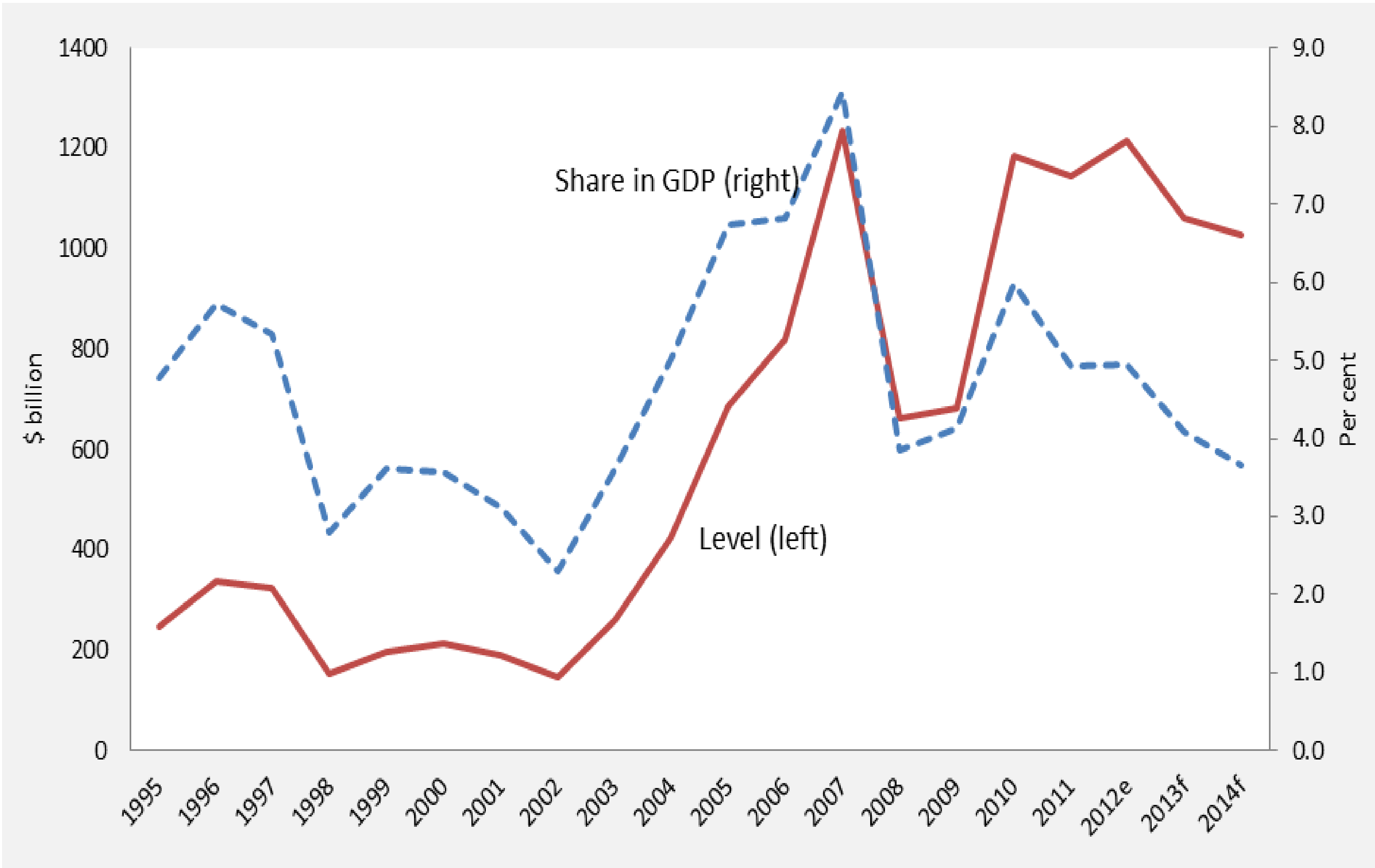
RISE AND FALL OF THE SOUTH

- Initial resilience: overall shocks not very severe except trade shocks for X-oriented Asia and EU-dependent SSA and CEE:
  - Quick recovery of capital flows thanks to UEMP.
  - China's massive investment package bailed out many commodity exporters.
  - Unprecedented countercyclical response in DCs, made possible by improved CA and fiscal balances during pre-crisis expansion – shift to domestic demand.

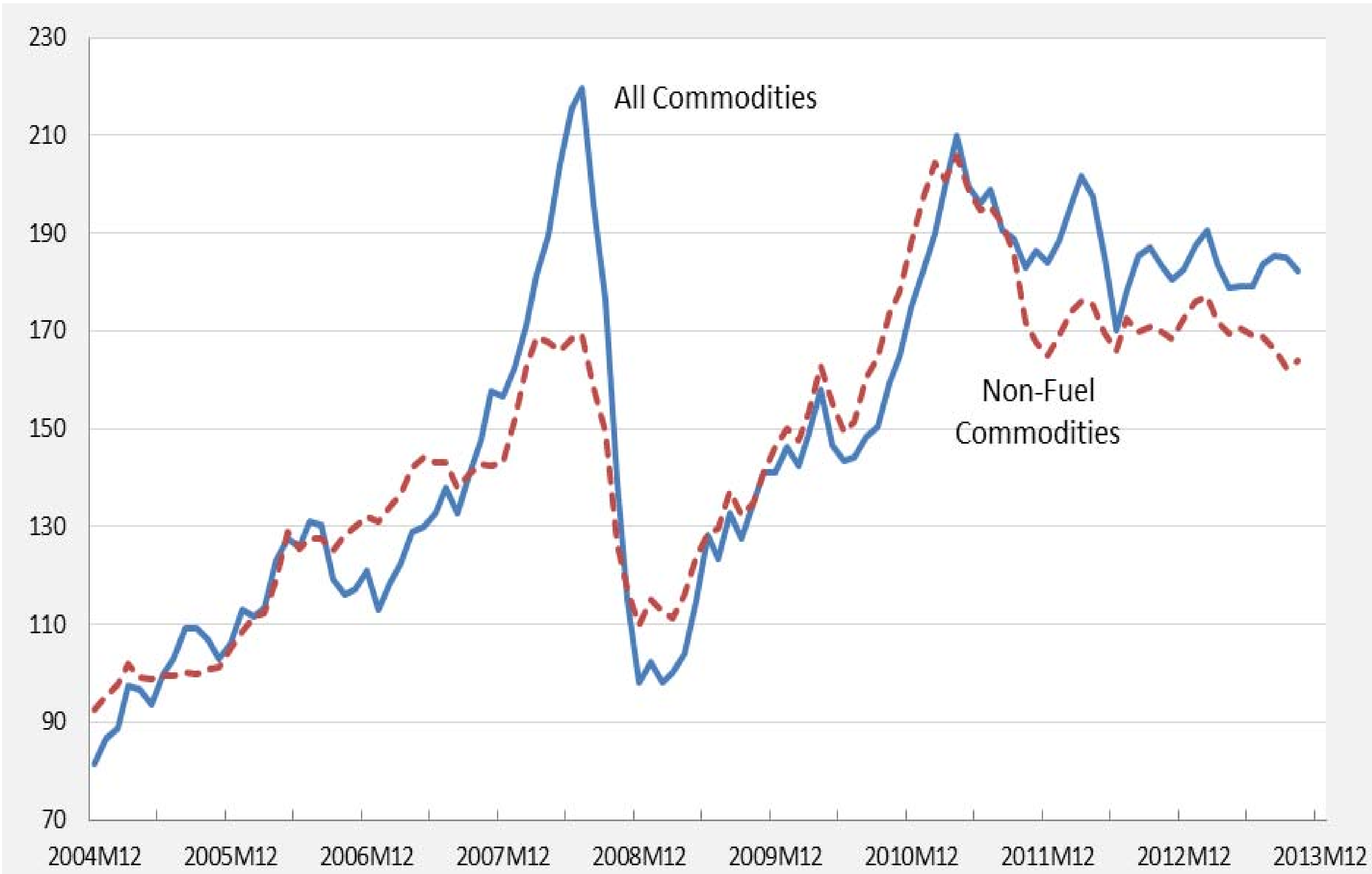
- Loss of steam as recovery in AEs remained weak, erratic or absent:
  - Effects of countercyclical policies of DCs fading and policy space narrowing
  - China could not keep investing (excess capacity and debt); commodity prices softened as China slowed down.
  - Capital inflows weakened/highly unstable with deepening of EZ crisis and then prospects of Fed tapering bond purchases

SOUTH CENTRE

Private Capital Inflows to EEs



Primary Commodity Prices



GLOBAL TRADE IMBALANCES AND DEFLATION

- Trade imbalances redistributed at the expense of DCs, rather than eliminated. Total DCs surplus fell from $720b to $260b: Asia from $430b to $140b, and LA and SSA moved from small surpluses to large deficits.

- AEs moved from a deficit of $500b to a surplus. US deficit fell, EZ moved from $100b deficits to $300b surplus.

- Germany replaced China at the centre of global imbalances. Engaged in competitive disinflation (wage-suppression and internal devaluation), keeping a lid on domestic demand and creating a deflationary bias for the world economy as a whole as well as for the EZ (US Treasury Report).

FINANCIAL VULNERABILITY IN THE SOUTH

- Asians managed inflows and CA better than LA (and inflation-targeting DCs elsewhere). Capital controls half-hearted; not really worked (Brazil vs. Korea).

- External vulnerability: sovereign external debt of DCs reduced, but increased foreign presence in local debt market (27%). Highly leveraged carry-trade investors. Offshore corporate bond issues and interbank borrowing are at record levels. These are highly susceptible to changes in monetary conditions in US.

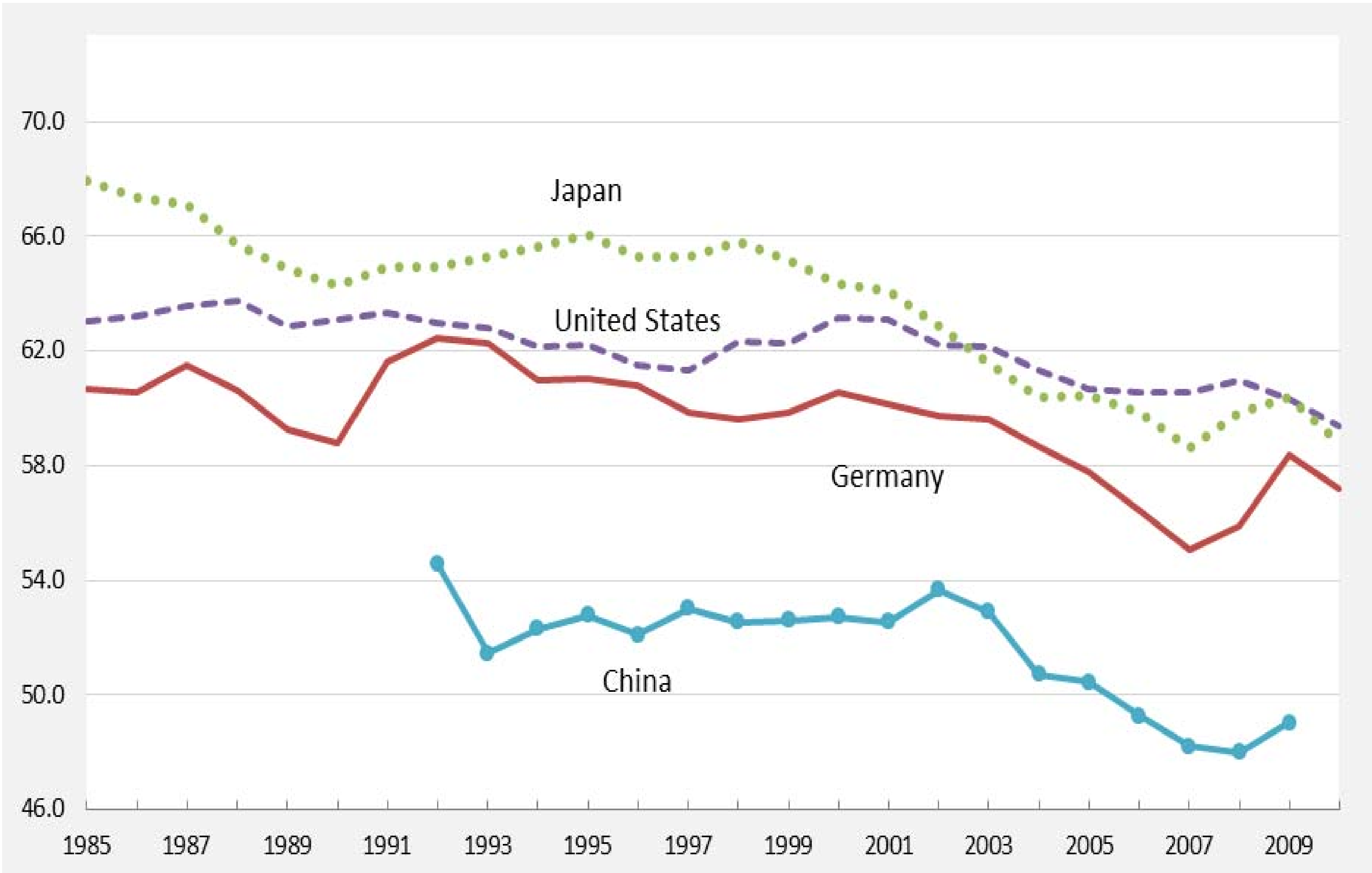
- Inflows now sensitive to Fed and US data. Bad US data cause market rally in DCs. Tapering fears from May to September pushing up long-term rates and reversing inflows. Now tapering postponed; a short respite for DEs

- Tide is going out at a time when most DCs have growing CA deficits. From EMs with brightest prospects to “Fragile 5”; (Brazil, India, RSA, Turkey, Indonesia).

LONGER-TERM PROSPECTS

- Bleak because key problems aggravated by the crisis and policy responses
- Low wages and underconsumption; until 2008 deflation avoided thanks to debt-driven bubbles – property and consumption in US and EU, investment in China and consumption in some DCs; leading to fragility, imbalances and crisis
- Crisis widened inequality and deflationary gap. UEMP has created fragility.
- US growth fragile, persistent demand gap and secular stagnation. Cannot shift to X-led or W-led growth. Relying on UEMP. Fed hesitant about tapering. Persistence can create bubbles; exit can disrupt markets and growth
- EZ promises little growth and a lot of instability. Can create big shocks for the rest
- China's spectacular X-led growth is over. Shift to C-led growth and lower growth path (even if orderly) can hurt commodity producers.

Wage Share (as per cent of GDP)



KEY POLICY ISSUES

- No more tailwinds for DCs. Only China has prospects for ***rapid*** industrialization (though road bumpy) and graduation. The rest has weak industry and growth fundamentals. LA and SSA dependent on commodities and foreign capital; India selling labour. Despite 2002-07 boom little progress in industrialization.

- DCs should put their house in order and seek strategic integration. Reduce dependence on foreign markets (Asia) and capital flows/commodities (LA, SSA).

- Policy response to a tightening of global financial conditions and BOP constraint in DCs: selective trade measures; control over capital outflows and temporary debt standstills; IMF lending into arrears; need for global liquidity (large SDR allocation).

- Need to address systemic issues raised, *inter alia*, in the Outcome Document of the 2009 UN Conference on Crisis; place them firmly on the post-2015 Agenda to move from poverty alleviation to development proper.