THE STATE OF THE WORLD ECONOMY AND LONGER-TERM PROSPECTS

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OVERVIEW

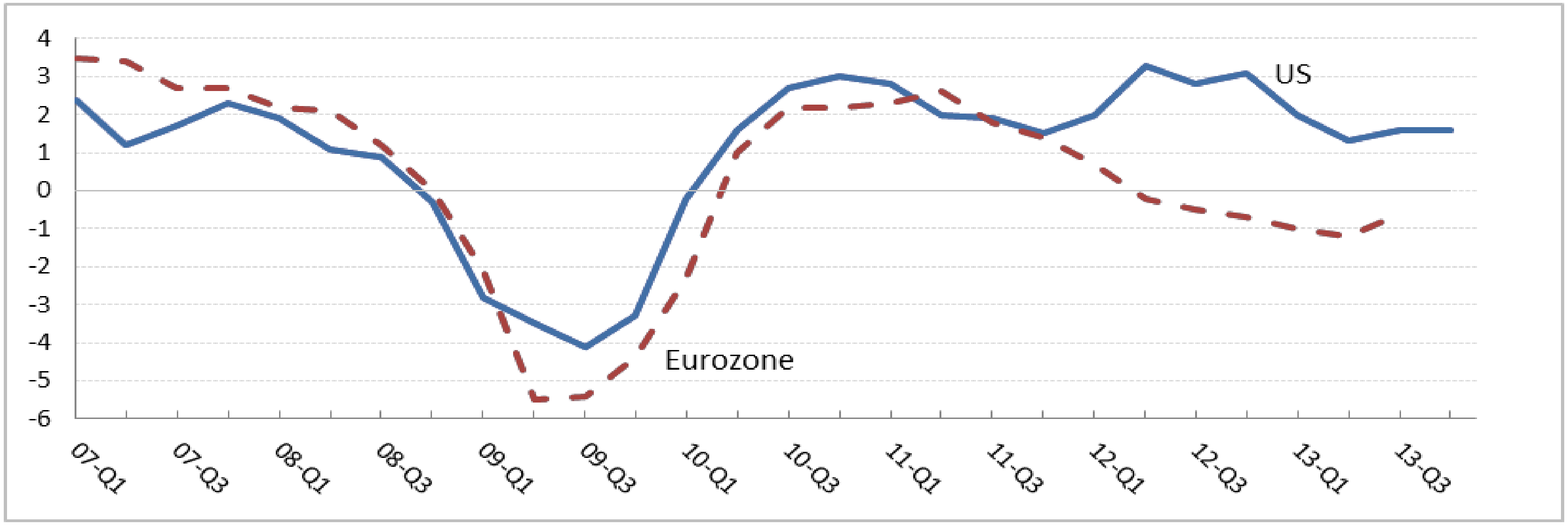
- World economy not in good shape: before full recovery there is talk of new crisis

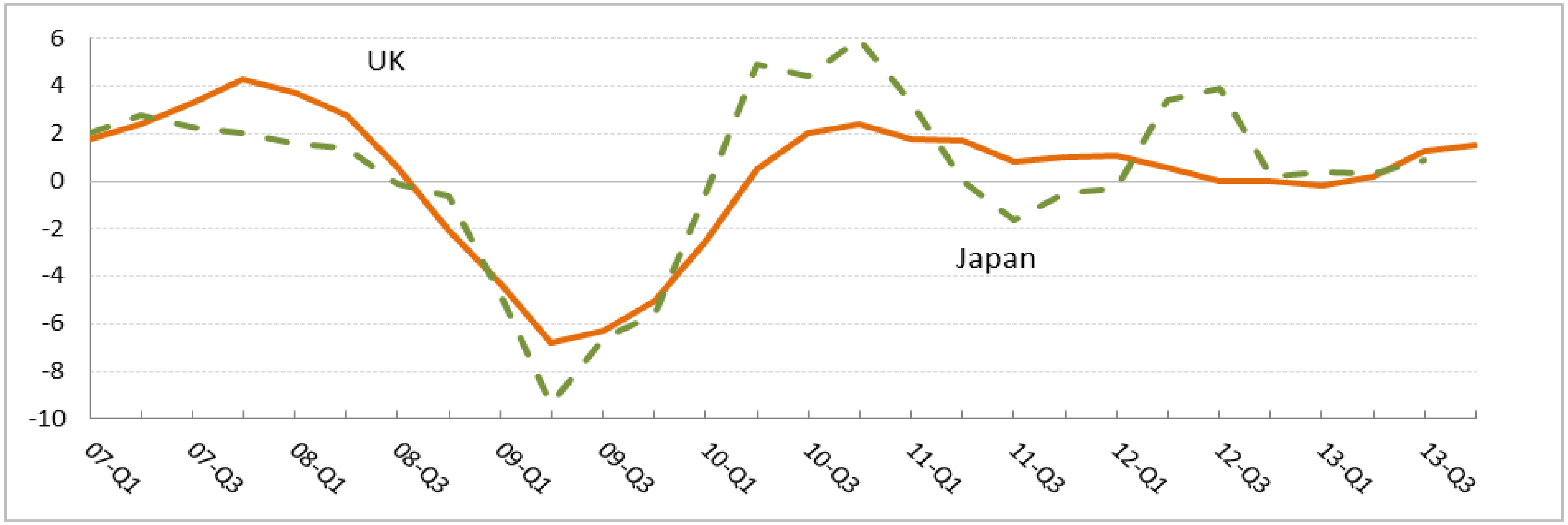
- Longer-term prospects are bleak:
  - Crisis mismanaged in US & Europe: policies not bold enough, problematic
  - China’s response misguided, creating excess capacity and debt overhang.
  - Most DCs failed to manage booms in commodity prices and/or capital flows
  - Systemic problems aggravated:
    - Inequality widened, declines in purchasing power of the masses over goods and services produced, holding back growth.
    - Systemic financial instability unaddressed; new sources of fragility.
    - Trade imbalances redistributed at the expense of DCs, not removed; now more difficult to resolve.

GLOBAL ECONOMIC LANDSCAPE

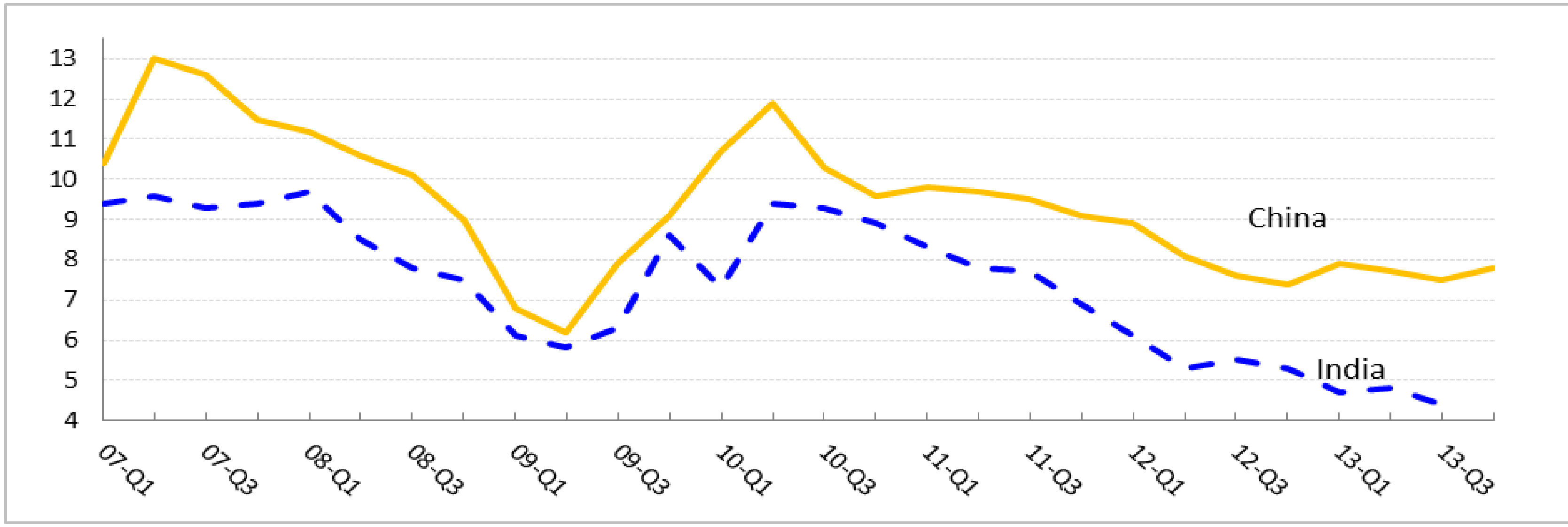
- More than 5 years into crisis little signs of robust growth. Bounce back in 2010 followed by slowdown in both AEs and DCs **(Charts).**
- US better than other AEs; but growth fragile, output and job gaps still large.
- EZ, Japan, UK have all had second or third dips since 2008. EZ struggling to get out of recession; now looks going into outright deflation.
- DCs: End of myths of “decoupling” and “becoming new engines of growth.” IMF constantly over-predicting growth in DCs after 2010; eventually coming to terms after many U-turns. Now several EEs under stress as markets started pricing-in normalization of monetary policy in US even though there is yet no shift to monetary tightening (**HSBC Chart – 19 EMs)**.

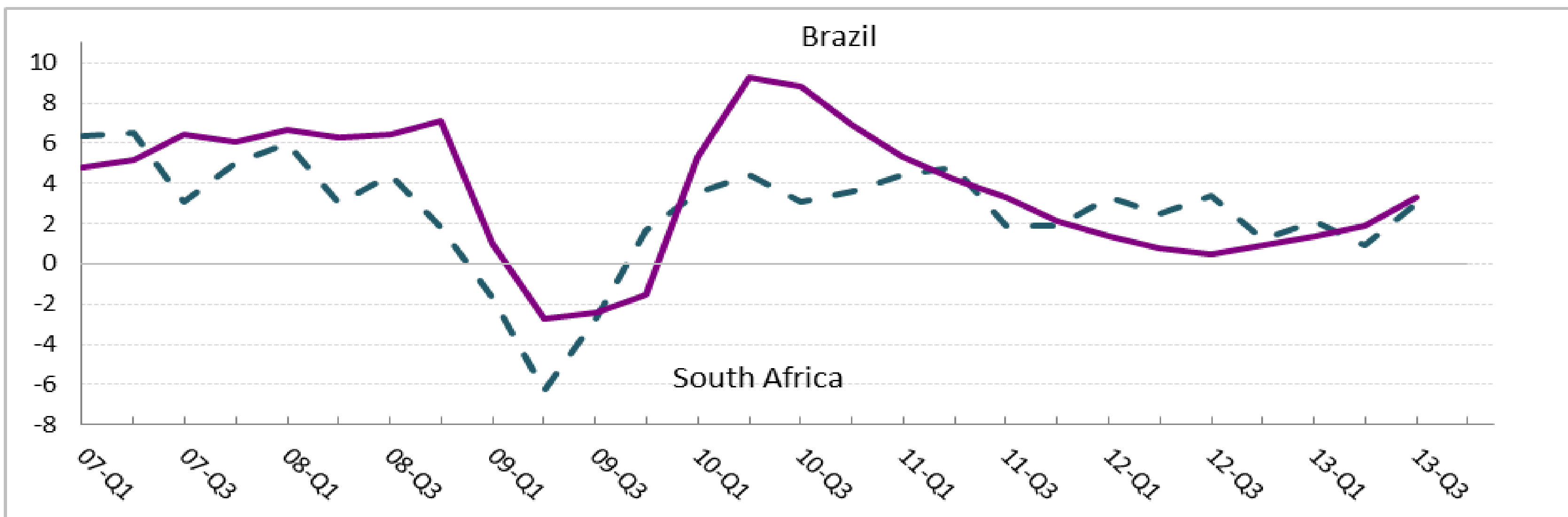
GDP Growth in Major AEs



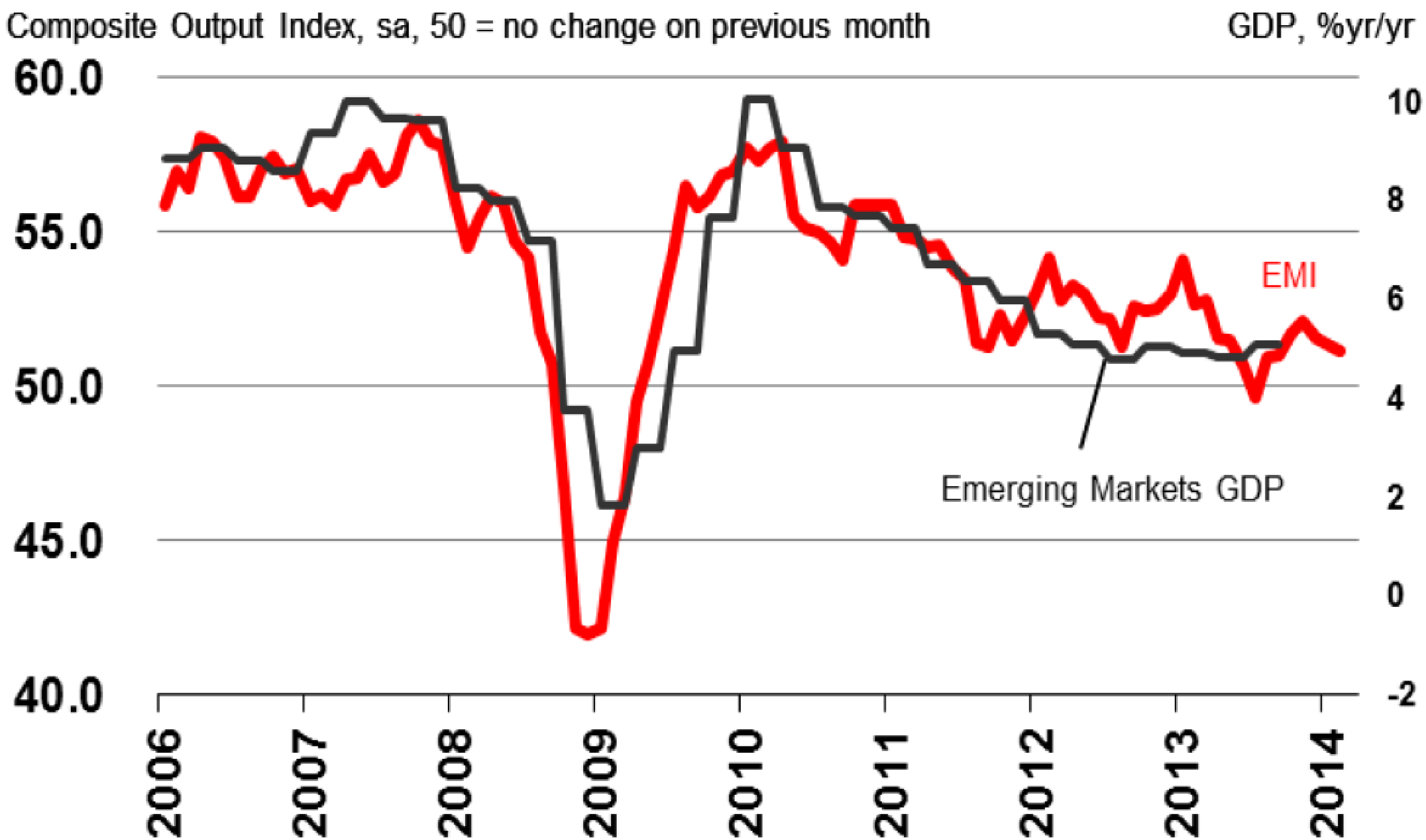


GDP Growth in Major DCs





HSBC Emerging Markets Index (PMI)



Sources: HSBC, Markit.

WHY TAKING TOO LONG TO RESOLVE THE CRISIS?

- 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).
  - Shortcomings in macroeconomic policy response. Return to fiscal orthodoxy after initial reflation.
  - Excessive reliance on unconventional monetary means.

THE DEBT OVERHANG

- US interventions:
  - Ended financial crisis but not economic crisis
  - Generating large profits for banks; too-big-to-fail banks are now bigger.
  - No statutory mortgage write-down; voluntary schemes not working. Foreclosures not prevented. Household debt now lower, but so is wealth
  - Widened income and wealth inequalities.

- EZ: neither financial nor economic crisis resolved
  - Wrong diagnosis: treated as fiscal rather than BOP and external debt crisis
  - Failed Baker strategy: lending + austerity.
  - Write-offs insufficient; 70% Greek debt now official. Debt ratios rising. IMF *mea culpa (*lending *on* misleading debt sustainability analysis).
  - Too many banks survived with public money, adding to sovereign debt.

FISCAL ORTHODOXY

- Fiscal fallacies:
  - Deficit spending adds more to debt than to income: fiscal multipliers small because of crowding-out (under liquidity trap?) and Ricardian equivalence (controversial and makes no sense when incomes are falling).
  - High debt/GDP lowers growth; Reinhart-Rogoff shaky (now says IMF too)
  - Thus “expansionary austerity” fallacy.
- IMF *mea culpa* about multipliers after its projections in EZ periphery went off mark.
- Still fiscal orthodoxy has reigned both in the US and EU.
- Fiscal stimulus without running deficits – progressive taxes and higher spending. Balanced-budget multipliers are large under deflation; now IMF is also blessing progressive taxation.

ULTRA-EASY MONETARY POLICY (UEMP)

- Zero-bound policy rates, QE and forward guidance – gone too far, too long
  - Failed to make a significant dent on debt overhang
  - Not very effective in raising private spending.
  - But search-for-yield in risky assets & bubbles in equity markets and EEs.
  - Creating financial fragility: longer-term consequences unknown – pitfalls in exit

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

- Without UEMP recession would have been deeper and unemployment higher. Yes, but what about the counterfactual: debt-write offs plus fiscal stimulus (money-financed deficits and/or spending based on progressive taxation)?

RISE AND FALL OF THE SOUTH

- Initial resilience in DCs thanks to:
  - Quick recovery of capital flows (UEMP)
  - China’s massive investment package – boost to commodity exporters.
  - 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, slowing and commodity prices softening.
  - Capital inflows weakened & highly unstable first with deepening of EZ crisis and then prospects of Fed tapering bond purchases

EXTERNAL FINANCIAL VULNERABILITY IN THE SOUTH

- EEs not managed capital inflows; capital controls half-hearted; not worked (Brazil vs. Korea). IMF not encouraging – tolerating only as a last resort and if temporary

- External vulnerability: Sovereign external debt lower, but foreign presence in local credit and bond markets greater. Many carry-trade investors are leveraged. Increased private foreign debt. Offshore corporate bond issues and interbank borrowing at record levels. All of these are highly susceptible to swings in monetary policy and conditions in US.

- Tide is going out at a time when most DCs have higher CA deficits and greater need for them; now becoming clearer "who has been swimming naked". From BRICS ("EMs with brightest prospects") to "Fragile 5" (Brazil, India, RSA, Turkey, Indonesia).

SYSTEMIC IMBALANCES

- Rising inequality, falling share of wages in AEs and China and threat of underconsumption (**Chart**). Still, until 2008 deflation was avoided thanks to bubbles in US and EU and several EEs; leading to fragility, imbalances and crisis.

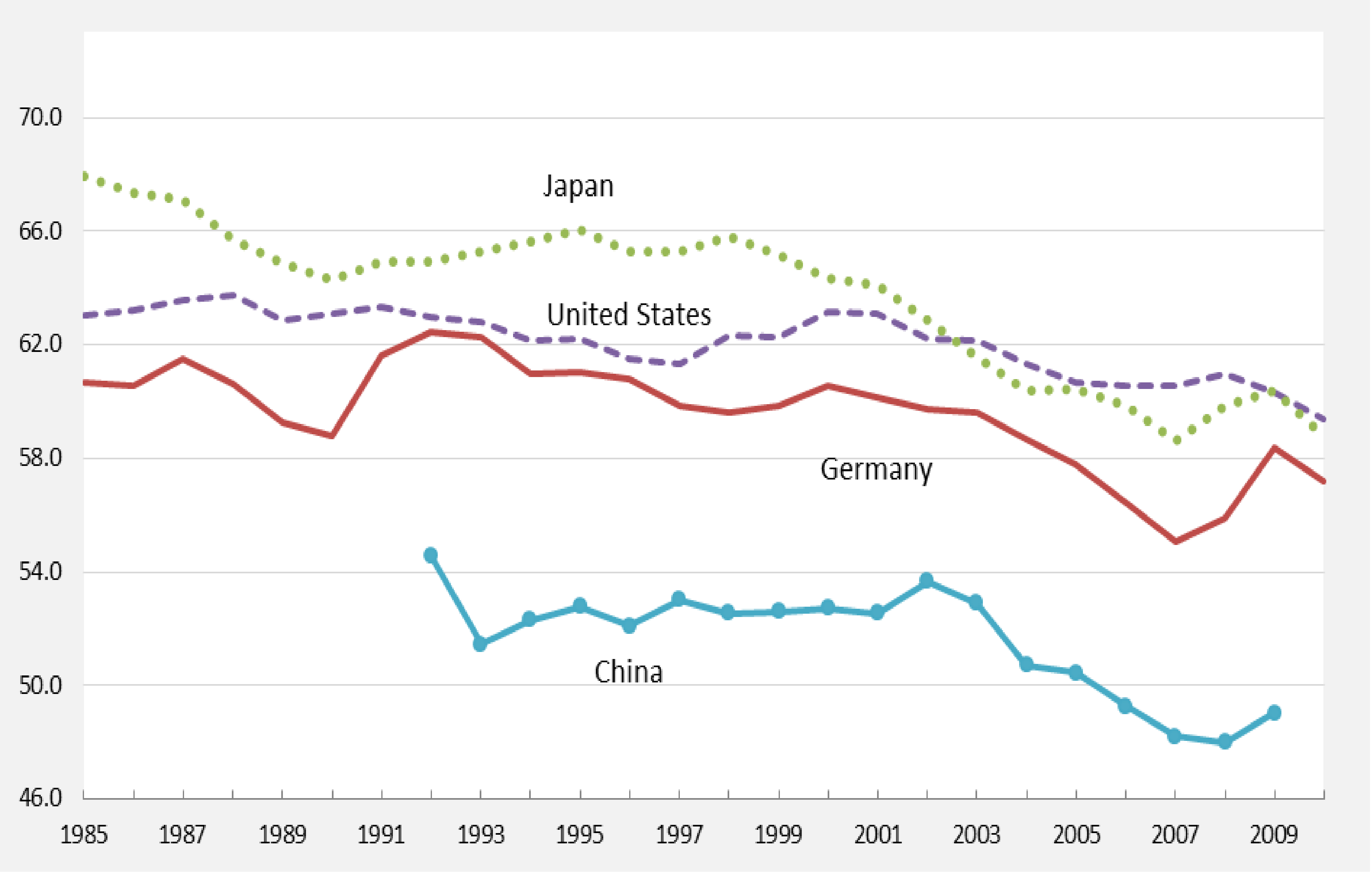
- Crisis widened inequality and deflationary gap and added to financial fragility.

- Trade imbalances redistributed, 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 some $500b to a surplus. US deficit fell, EZ moved from $100b deficits to $300b surplus.

- Germany replaced China in global imbalances. 7% surplus, falling against EZ but rising against rest of the world. Competitive disinflation (wage-suppression and internal devaluation), lid on domestic demand, deflationary bias for the world economy as a whole as well as for the EZ (US Treasury Report).

SOUTH CENTRE

Wage Share (as per cent of GDP)



LONGER-TERM PROSPECTS

- US growth is fragile; talk of persistent demand gap and secular stagnation. Debt-driven bubbles only way out (Summers, Krugman)? Renewed signs of consumer re-leveraging (UK as well)!

- Fed cannot maintain UEMP without creating bubbles or may not be able to exit without market disruption (and turmoil in EEs). It is uncertain about normalization beyond tapering. Increased instability towards the end of 2014 when attention turns to balance-sheet normalization (size and composition).

- EZ promises little growth but a lot of instability. Jury still out on euro. Can create big shocks for EEs.

- China's spectacular X-led growth is over. Shift to a lower growth led by private consumption (even if orderly) can seriously affect commodity exporters.

KEY POLICY ISSUES

1. No more tailwinds for DCs. They should put their house in order, reduce dependence on foreign markets (Asia) and capital flows/commodities (LA, SSA) and improve growth fundamentals.

2. Policy response to possible crises in EEs: do not use reserves to finance large and sustained outflows or borrow to remain current on debt. Bail-in investors and lenders; use exchange controls and temporary debt standstills; IMF should support by lending into arrears. Fed should take its responsibility and act as a LOLR to EEs (swaps or buying emerging bonds) as and when needed.

3. 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 Development Agenda.