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CRISIS MISMANAGEMENT IN THE UNITED STATES AND EUROPE: IMPACT ON DEVELOPING COUNTRIES AND LONGER-TERM CONSEQUENCES

Yılmaz Akyüz



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SOUTH CENTRE

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I. INTRODUCTION

Before the world economy has been able to fully recover from the crisis that began more than five years ago, there is a widespread fear that we may be poised for yet another crisis. This is largely because the underlying global problems, systemic financial instability, inequality and unsustainable balance-of-payments positions, remain unabated and have indeed been aggravated by the misguided policies pursued in response to the crisis in the US and Europe.

The policy responses to the crisis both in the US and Europe have not been bold enough to match the challenges. First, there has been a reluctance to remove the debt overhang through timely, orderly and comprehensive restructuring, writing down debt to avoid retrenchment and deflation. Instead, efforts have focussed on bailing out creditor banks, enforcing austerity on debtors. This has meant protracted deleveraging and spending cuts. It has also aggravated wealth and income inequality, thereby widening the deflationary gap.

Second, governments have shifted to fiscal austerity after an initial reflation. Even though the net cost of public debt fell significantly as a result of sharp declines in interest rates and increased profit remittances from central banks on their growing holdings of government debt, concerns that public debt may face problems of sustainability once interest rates and central bank balance sheets return to normalcy have dominated the fiscal stance. Central banks have been most unwilling to abandon the obsession against money-financing of budget deficits and permanent monetization of government debt to overcome this dilemma. Nor has any consideration been given to providing fiscal stimulus without running deficits by exploiting the so-called balanced-budget multiplier, raising taxes on top income groups to finance additional spending.

All these have resulted in excessive reliance on monetary policy with monetary authorities going into uncharted waters including zero-bound policy interest rates and quantitative easing (QE) through large acquisitions of long-term public and private bonds. This ultra-easy monetary policy has not been very effective in easing the debt overhang and stimulating spending – hence, the crisis is taking too long to resolve, entailing unnecessary losses of income and jobs and aggravating inequality. But it has generated financial fragility at home and abroad, exposing developing countries (DCs)¹ to a new boom-bust cycle.² This

¹ In this paper DCs refer to the UN definition of developing countries whereas emerging economies (EEs) refer to what the IMF calls “emerging market economies”.

² That such a cycle was in the making was evident right from the beginning of the crisis see, Akyüz (2011a).

is particularly the case for the policies pursued in the US, given its role as the issuer of the key reserve currency.

The US itself is vulnerable because the Fed may not be able to exit from the ultra-easy monetary policy and normalize the size and structure of its balance sheet without market disruption. And it cannot continue without creating bubbles. Tapering does not yet signal a return to monetary tightening and normalization of the Fed's balance sheet. It reduces not the level of long-term assets on the Fed's balance sheet but monthly additions. Besides, the policy rates are pledged to remain at historical lows for some time to come. Thus, ultra-easy money is still with us. But the markets have already started pricing-in the normalization of monetary policy and this is the main reason for the rise in long-term rates and the turbulence in emerging economies.

The crisis has in effect demolished the myth that South has decoupled from the economic vagaries of the North and major EEs have become new global engines. The growth surge in the South before the crisis was driven mainly by exceptional but unsustainable global economic conditions closely linked to credit and spending bubbles in the US and Europe, and their strong recovery after 2009 was due to one-off factors. For DCs medium-term prospects look bleak because of the failure of the US and Europe to establish conditions for robust and stable growth and the vulnerabilities resulting from the ultra-easy monetary policy. They are unlikely to go back soon to the kind of growth rates they enjoyed before the outset and in the immediate aftermath of the crisis. To shift to a strong and sustainable growth path and gain greater autonomy in development, they need to strengthen their underlying fundamentals, rebalance domestic and external forces of growth and reduce their dependence on foreign markets and capital.

Policy response to a deepening of the current financial turbulence in the South should depart from past practices. EEs should avoid using their reserves to finance large and persistent outflows of capital and seek, instead, to involve private lenders and investors in crisis resolution. This may call for exchange restrictions and temporary debt standstills. These measures should be supported by the IMF, where necessary, through lending into arrears. However, the IMF currently lacks the resources to effectively address any sharp contraction in international liquidity that may result from a shift to monetary tightening in the US. A very large SDR allocation, to be made available to countries according to needs rather than quotas, would help. But a greater responsibility falls on central banks in advanced economies, notably the US Fed, which can and should – as the originators of destabilizing impulses that now threaten the South – act as a quasi-international lender of last resort to emerging economies facing severe liquidity problems through swaps or outright purchase of their sovereign bonds.

II. THE GLOBAL ECONOMIC LANDSCAPE

More than five years since the outbreak of the global financial crisis, the world economy shows little signs of strong and sustained expansion. After the bounce-back in 2010, growth has started faltering almost everywhere. In all likelihood in the coming years it will remain below potential in AEs and fall far short of the exceptional rates achieved in the years before the onset of the crisis in DCs.

Even though the US economy was at the origin of the crisis, it has fared much better than other major AEs, the Eurozone (EZ), Japan and the UK. First, the 2009 recession was less severe in the US than in the latter economies. Second, the US economy has enjoyed continued recovery at an average annual rate of some 2.3 per cent, registering positive growth in every quarter since the end of the recession in mid-2009 (Chart 1). However, this is far below the average rate of 4 per cent seen in the first four years of previous post-war recoveries. Thus, the output gap has diminished only a little. Although the unemployment rate has declined from its peak of 10 per cent in October 2009 to 7 per cent, part of the decline is due to the exclusion of discouraged long-term unemployed and the drop in the labour force participation rate (Cohen 2013). At the recent pace, it would take several more years for the US to remove the shortfall in output relative to the pre-crisis trend. On some estimates, the economy would return to pre-crisis (2007) employment levels only in August 2018 if it creates as many jobs as it did in the best year of job creation in the 2000s (Hamilton Project 2013). This is no better than the Great Depression when it took 10 years for employment to fully recover.

Most other major AEs have contracted again after 2009. Following a severe recession in 2009 the EZ as a whole achieved positive growth in the subsequent two years despite continued output and employment losses in the periphery, thanks to a strong recovery in Germany driven by exports. However, as the impact of the crisis spread in the region, the core and Germany in particular could not maintain the momentum. The region had 6 consecutive quarters of negative growth until the second quarter of 2013 with about half of the countries in recession. Average unemployment has exceeded 12 per cent— it is over 25 per cent in Spain and Greece, higher than the levels seen during the Great Depression. At the end of 2013 the region was in outright deflation with producer prices, money supply and private credit all falling. Estimates by the IMF WEO (January 2014 Update) give negative growth for 2013 for the region as a whole. Even if the bounce-back expected for 2014 materializes, output and employment will remain below potential for many years to come.

Although financial stress in the EZ has eased considerably, continued austerity and adjustment fatigue in the periphery could bring it back and even lead to a break-up. However, it is difficult not only to predict the evolution of the EZ in the near future, but also the impact of a break-up, since past economic and financial linkages would provide little guidance for estimating the consequences of such an unprecedented event. Still, even without a total break-up, a re-intensification of financial stress could have serious repercussions for DCs, as

suggested by various downside scenarios simulated by the IMF (2012), the UN WESP (2013) and the OECD (2012).

Of the other major AEs, Japan could not sustain positive growth after recovering from the 2009 recession and went into a second dip in 2011. In the last quarter of 2012 it experienced its 7th quarterly contraction since the collapse of Lehman Brothers. In 2013 it made a rebound thanks to Abenomics, restoring pre-crisis income at the end of the year. However, it may lose steam because of planned fiscal tightening. Again, from 2009 until the end of 2012, the UK had negative growth rates in 9 out of 20 quarters and has lost 3.7 million jobs. In 2013 growth was the fastest in six years and the best among the EU's big 5, but GDP was still below the pre-crisis peak.

DCs enjoyed exceptional growth before the onset of the crisis thanks to highly favourable but unsustainable global conditions, rather than improvements in their own growth fundamentals (Akyüz 2012). In the early months of the crisis they were expected to decouple from the difficulties facing AEs. The decoupling myth came back with full force when DCs recovered rapidly after a short-lived downturn in 2009, while recovery in the US remained weak and Europe went into a second dip.

The IMF has been a major advocate of the decoupling thesis. Its analysis and projections show significant shortcomings in its understanding of growth fundamentals in the South and their global linkages. It underestimated not only the depth of the financial crisis, but also its impact on DCs, maintaining that the dependence of growth in the South on the North had significantly weakened (IMF WEO April 2007 and April 2008). After 2010 it has constantly over-projected growth in DCs. Eventually it has had to recognize the possibility that “recent forecast disappointments are symptomatic of deeper, structural problems”, revising downward the medium-term prospects of these economies (IMF WEO April 2013; 19). In a more recent report submitted to the St. Petersburg meeting of the G20, the Fund “has dropped its view that EEs were the dynamic engine of the world economy” in a “humbling series of U-turns over its global economic assessment” (Giles 2013). It has now come to the conclusion that the “world’s economies moved much more in lockstep during the peak of the global financial crisis than at any other time in recent decades.... The increased comovement ... was observed across all geographic regions and among advanced, emerging market, and developing economies.” (IMF WEO October 2013: 81).

Indeed, as strong upward trends in capital flows and commodity prices ended, recovery in AEs has remained weak, the one-off effects of countercyclical policies in DCs have started fading and the policy space for further expansionary action has narrowed, growth in the South, including China and other major DCs, has decelerated considerably (Chart 2). In Asia, the most dynamic developing region, in 2013 it was 5 percentage points below the rate achieved before the onset of the crisis; in Latin America it was less than half of the pre-crisis rate. In none of these regions current projections for 2014-15 promise a significant improvement (IMF WEO January 2014 Update).

III. POLICY RESPONSE IN THE US AND THE EZ: NEO-LIBERAL FALLACIES AND OBSESSIONS

III.1. Why is the crisis taking too long to resolve?

In his remarks on the state of the world economy, the IMF's chief economist, Olivier Blanchard is reported to have said; "It's not yet a lost decade... But it will surely take at least a decade from the beginning of the crisis for the world economy to get back to decent shape" (Reuters 2012). Presumably, this remark must reflect a judgment not only about the nature and depth of the crisis, but also about the effectiveness of public interventions to resolve it.

There can be little doubt that recoveries from recessions brought about by financial crises are weak and protracted because it takes time to repair balance sheets – to remove debt overhang and unwind excessive and unviable investments generated during the bubbles that culminate in such crises. Recoveries from such crises also tend to be jobless and yield little investment. This was the case in the US during the early 1990s and particularly the early 2000s when it was recovering from recessions brought about by the bursting of the savings and loans and dot-com bubbles, respectively. In the current recovery, the pre-crisis income in the US had been restored by the second quarter of 2011, but employment was lower by some 6.5 million. Sluggish job and investment growth is also a common feature of recoveries of DCs from financial crises (Akyüz 2006).

However, the pace of recovery also depends on the management of the crisis. In this respect, there are two major shortcomings in the policy response both in the US and Europe. First, governments have been unwilling to remove the debt overhang through timely, orderly and comprehensive restructuring and to bring about a redistribution of wealth from creditors to debtors. Instead, they have resorted to extensive creditor bailouts, increasing the moral hazard and vulnerabilities in the financial system, while enforcing austerity on debtors (Kuttner 2013). Second, there have been serious shortcomings in macroeconomic policy measures in support of aggregate demand, growth and employment. After an initial reflation governments have turned to fiscal orthodoxy and relied excessively on monetary means to fight recession. These have not only led to unnecessary output and job losses, but have also caused financial fragility that could compromise future stability and growth.

III.2. The debt overhang

A key intervention in the crisis in the US was the Troubled Asset Relief Programme of 2008-09 whereby \$700 billion was injected into banks whose net worth was moving into red as a result of loss of asset values as well as some large corporations in the auto industry to prevent bankruptcy. Furthermore, after cutting its policy rate sharply, the Fed launched a policy of QE, buying US government bonds and mortgage-backed securities to boost their prices. In December 2012 the Fed provided forward guidance by announcing that it would

keep the funds rate near zero and continue buying \$85 billion worth of bonds until unemployment fell below 6.5 per cent or inflation rose above 2.5 per cent under what has come to be known as QE3.

A main objective of QE is to reduce the cost of debt by lowering long-term rates. The government also introduced two voluntary schemes to encourage lenders to lower mortgage payments of homeowners facing the risk of foreclosure and help homeowners with negative equity to refinance their mortgages. However, so far it has not chosen to bring down household mortgages in line with their ability to pay by forcing the creditors to write down debt.³

These interventions have prevented a banking collapse and hence ended the financial crisis but not the economic crisis. They have allowed the banks first to recover their pre-crisis profitability and then reach record profits. The four biggest US banks are now 30 percent larger than they were before the crisis and the too-big-to-fail banks are bigger (Warren 2013). However, they have done little to reduce the debt overhang, prevent foreclosures or increase lending. Although household debt has dropped by some 10 per cent of GDP since the beginning of the crisis, much of this has been due to foreclosures and hence reflects a corresponding reduction in household wealth. Homes of many households continue to be worth less than the principal balances on their mortgages. As recognized by Bernanke (2013), “gains in household net worth have been concentrated among wealthier households, while many households in the middle or lower parts of the distribution have experienced declines in wealth since the crisis.” In the US the income gap between the rich and the poor has also widened. From 2009 to 2011, the top 1 per cent incomes grew by 11.2 per cent while the bottom 99 per cent incomes shrunk by 0.4 per cent (Saez 2012). The households in the middle now have lower real incomes than they did in 1996 and this is slowing the recovery by holding back aggregate spending (Stiglitz 2013).

In the EZ the policy response has been premised on a wrong diagnosis, thereby deepening the recession. The periphery is, in effect, facing a balance-of-payments-*cum*-external-debt crisis resulting from excessive spending and foreign borrowing of the kind seen in several DCs in the past decades. Contrary to the official diagnosis, this had little to do with fiscal profligacy except in Greece (Lapavistas *et al.* 2010; De Grauwe 2010). It is total external debt, both public and private, rather than total public debt that is the key to understanding the EZ crisis. For instance Belgium had a higher public debt ratio than most countries in the periphery but did not face any pressure because it has had a sustained current account surplus and a positive net external asset position (Gros 2011).

³ The Federal Housing Finance Agency which regulates government-controlled mortgage financiers Fannie Mae and Freddie Mac has constantly opposed principal reduction. In mid-2012 a bipartisan bill was introduced to allow the so-called underwater home owners whose home values fall short of their debt to reduce their monthly payments in exchange for a portion of any future price appreciation on the home (known as shared appreciation), effectively implying a debt for equity swap - see Griffith (2012). At the time of writing this paper this legislation had not yet taken effect.

The crisis-hit periphery countries all had larger current account deficits than other EZ members in the run-up to the crisis. In Spain and Ireland, deficits were entirely due to a private savings gap. Two interrelated factors played an important role in rapid increases in external deficits and debt in the periphery. First, after the monetary union, wage and price movements diverged sharply between the periphery and the core (Chart 3). From early 2000 Germany was engaged in a process of “competitive disinflation”, keeping real wages virtually stagnant, reducing unit labour costs and relying on exports for growth (Akyüz 2011b, Palley 2013). By contrast, in the periphery wages went ahead of productivity, leading to an appreciation of the real effective exchange rate. This created a surge in imports, mainly from other EU countries.

This was greatly helped by a surge in capital flows from the core to the periphery, including loans from German banks, triggered by the common currency and abundant international liquidity (Sinn 2011). They fuelled the boom in domestic demand, reduced private savings and widened the current account deficits in the periphery (Atoyan *et al.* 2013). As in Latin America in the early 1980s, this process also ended with a shock from the US, this time the subprime crisis, leading to a sharp cutback in lending.

The strategy adopted by EZ policy makers in dealing with the debt problem was very much like that of the failed Baker Plan pursued in response to the Latin American debt crisis in the 1980s – official lending to keep debtors current on their payments to private creditors and austerity (UNCTAD TDR 1988: chap. 4). For this purpose several facilities have been introduced and used together with IMF lending. The European Central Bank (ECB) has also engaged in purchasing sovereign bonds in order to lower borrowing costs to troubled debtors, and provided long-term loans to banks at low interest rates to enable them to buy high-yield sovereign bonds and earn large spreads.

Despite occasional references to the need to involve the creditors in the resolution of the crisis, interventions have mainly served to bail out creditor banks. As pointed out by the chairman of the European Banking Authority, Andrea Enria, too few European banks have been wound down and too many of them have survived (Reuters 2013). Public money has been used to bail out banks, leading to increased sovereign debt. By contrast, the debt-restructuring initiatives have brought limited relief to debtors. Greek workouts in 2012 failed to remove the debt overhang. Greece now needs a deep write-off, but around 70 per cent of its sovereign debt is held by the official sector, including the ECB, IMF, national central banks and other EZ governments, and the write-down of this debt is resisted by the ECB and Germany. There have also been inconsistencies in the approach to bailing in creditors. In Ireland and Spain where the crisis originated in the banking system, creditors and depositors of troubled banks have largely escaped without haircut. Ireland gave a blanket guarantee to its bank depositors and Greek workouts also spared deposit holders both at home and abroad. In most of these cases rescue operations involved large amounts of public money to prop up

and recapitalize banks. By contrast, in Cyprus the bailout package inflicted large losses on deposit holders, notably Russians.⁴

Public debt ratios have been rising in the periphery because of recession, relatively high spreads and the failure to bail in creditors (Chart 4). A fundamental dilemma is that when the debt ratio is high and the real interest rate exceeds the growth rate by a large margin, the primary surplus needed to stabilize the debt ratio would be quite high, but cuts made in primary spending to achieve this would create a sizeable contraction in output, making the task even more difficult. Thus, debt ratios of Spain and Ireland have reached 100 per cent and 120 per cent, respectively, from around 40 per cent on the eve of the crisis. For the same reason, the intensification of fiscal consolidation has not always resulted in lower budget deficits.

Not all countries hit by the bursting of the speculative bubble have failed to remove the debt overhang. In this respect, Iceland's debt resolution initiatives stand in sharp contrast to the approach pursued in the US and the EU. Relative to the size of its economy, Iceland faced the biggest banking failure in economic history. However, it has managed to restructure the banking system by letting some of the banks fail and bailing in private creditors, sparing both taxpayers and domestic depositors from paying the price. It has imposed capital controls to stem exit and passed an important part of the burden onto international creditors including bondholders and depositors.⁵ More importantly, from the end of 2008 until 2013 Iceland's banks wrote off debt for more than a quarter of the population, by some 13 per cent of 2012 GDP. An important part of this is on mortgage debt exceeding 110 per cent of home values. This has played an important role in the recovery of Iceland from a deep recession. Iceland has achieved some 2 per cent growth per annum since 2011, with an unemployment rate of around 5 per cent, against continued recession and double-digit unemployment in the EZ periphery.⁶

III.3. Fiscal orthodoxy

The failure to intervene directly to remove the debt overhang in a timely and orderly manner has meant protracted deleveraging and spending cuts in both the US and Europe. As

⁴ Ironically, while the operation in Cyprus was meant to penalize "Russian money launderers", the forced conversion of deposits into shares has led the Russians to take control of Bank of Cyprus – Higgins (2013).

⁵ However, the resolution of the failed banks has not been completed and a number of contentious issues still remain, particularly with respect to claims by creditors and depositors in the UK and Holland, posing threats to Iceland's financial stability – see Bowers (2013) and Baldursson and Portes (2013).

⁶ In November 2013 the government announced, against the advice of the IMF and rating agencies, a further debt relief package for mortgage holders to assist over 100,000 households, to be financed through tax hikes on financial institutions and a haircut on debt owed to overseas investors by Iceland's failed banks, now largely held by hedge funds which acquired them at deep discounts, see *Reuters* "Iceland government launches debt relief package for households", 30 November 2013.

a result, monetary policy has become largely ineffective in expanding credit and stimulating private spending. Fiscal policy has gained added importance, but both the US and Europe have shifted to austerity after an initial reflation. In the EZ, the core has also joined in the austerity imposed on the crisis-hit periphery.

The case for fiscal austerity is premised on two propositions. First, budget deficits add more to public debt than to GDP so that they would raise the debt-to-GDP ratio. Second, high ratios of public debt to GDP are detrimental to growth. It is thus believed that fiscal austerity would not undermine growth and could even stimulate it by lowering the ratio of public debt to GDP—hence the so-called “expansionary austerity”.

The first proposition implies that fiscal multipliers are small. This is derived from highly controversial theories that higher public spending would crowd out private spending by pushing up the interest rate and that private sector would start spending less and saving more in order to provide for future tax increases needed to meet increased government debt servicing. These theories make no sense under conditions of liquidity trap and falling incomes. Still, in the early years of the crisis, the fiscal policy advice of the IMF was premised on extremely low multipliers and was invariably pro-cyclical. Because of the underestimation of fiscal multipliers, IMF growth projections turned to be more optimistic than growth outcomes in several periphery countries with IMF programmes (Weisbrot and Jorgensen 2013). However, as a result of mounting evidence on fiscal drag, the IMF has finally admitted that fiscal multipliers are much greater than was previously believed and that they are state-dependent, particularly large under recessions, with the implication that fiscal austerity could in fact raise the debt ratio by depressing income (IMF WEO October 2012; Blanchard and Leigh 2013).

The second proposition that high debt ratios could deter growth found support in the finding of an empirical study by Reinhart and Rogoff (2010) that economic growth slows sharply when the ratio of government debt to GDP exceeds 90 per cent. However, it is generally agreed that such an association says effectively nothing about causality – slow growth could cause high debt rather than high debt leading to slow growth. More importantly, subsequent research by Herndon *et al.* (2013) has found that several critical findings of the Reinhart and Rogoff (2010) study are wrong and in fact a 90 per cent debt ratio is associated with a much higher rate of growth than was found by these authors.

In any case expansionary fiscal policy does not necessarily entail greater public deficits and debt. The combination of progressive taxation with increased public spending could give a significant boost to economic activity without creating deficits and debt or significantly crowding out private spending. Under conditions of deflation when private spending remains depressed, the so-called balanced-budget multiplier tends to be quite high particularly if public spending is financed by additional taxes on top income groups. This is particularly true for the US and UK where income and wealth inequality is much greater than

other major OECD countries and taxation is much less progressive.⁷ However, the ideology behind the crisis intervention has excluded such socially progressive and economically beneficial solutions.

In the US the immediate fiscal stimulus introduced in response to the subprime crisis no doubt played an important role in initiating recovery (Blinder and Zandi 2007). However, as soon as the economy started to show signs of life, fiscal orthodoxy has returned and “discretionary fiscal policy hasn’t been much of a tailwind” (Yellen 2013a: 4). Cuts in public sector jobs and other government spending reduced growth by 0.6-0.8 percentage points during 2011-12. Fiscal retrenchment has continued into 2013 and is estimated to place a significant drag on GDP growth (Conference Board 2013).

In the EZ lending to debtor countries incorporated austerity in the form of tax hikes, spending and wage cuts, leading to a deepening of contraction. In a subsequent evaluation of the 2010 Stand-By agreement for Greece, the IMF (2013a) has admitted that it had underestimated the damage done to the economy from spending cuts and tax hikes imposed in the bailout and that it deviated from its own debt-sustainability standards and should have pushed harder and sooner for lenders to take a haircut to reduce Greece's debt burden. However, Greece is still suffering from a severe debt overhang and is unlikely to recuperate income and employment losses incurred since 2008 for many years to come.

III.4. Ultra-easy monetary policy

The reluctance to use fiscal policy to expand aggregate demand has resulted in excessive reliance on monetary policy, particularly as fiscal austerity has become self-defeating by lowering growth. However, rapid expansion of liquidity and historically low interest rates has not been very effective in stimulating lending to the non-financial sector and private spending. Much of the money injected into the economy through massive QE programmes, notably in the US and UK, has ended up back in central banks in the reserves accounts of the banking system as excess reserves. Because of increased risk aversion, banks have been unwilling to lend to households and small businesses while big businesses have little need for loans or appetite for new spending on labour and equipment in view of sluggish demand.⁸ Nor is there any sign of a strong wealth effect on spending from rising asset prices because the gains are reaped mainly by the very rich.

Still, by lowering long-term interest rates and rapidly increasing the central bank holding of long-term government debt, the ultra-easy monetary policy has served to widen

⁷ See Piketty *et al.* (2011) who argue that the top tax rate on the top 1 per cent income earners could be raised to over 80 per cent without impairing growth and that the potential tax revenue at stake is very large.

⁸ An additional impediment to lending is sharp increases in bank capital ratios. While this may be useful in preventing the next crisis, it is a procyclical measure in so far as the ongoing crisis is concerned.

fiscal policy space. On the one hand, it has resulted in a significant decline in interest payments on government debt. On the other hand, much of the interest payments on debt held by central banks have gone back to the budget as profit remittances. It is estimated that by the end of 2012, total benefits of governments in the US, UK and the EZ taken together from both reduced debt service costs and increased profits remitted from central banks reached \$1.6 trillion (Dobbs *et al.* 2013). This space has not been used effectively and fiscal orthodoxy has prevailed. In the US alone, for 2007-12 total benefits were above \$1 trillion, exceeding the total fiscal stimulus of some \$800 billion provided throughout this period (Amadeo 2013). In other words, beyond the space provided by the ultra-easy monetary policy, discretionary fiscal stance in the US has been contractionary.

Not only has monetary policy failed to fuel a strong recovery by lifting private spending, but it has also given rise to an important build-up of financial fragility by triggering a search-for-yield in “the riskier part of the credit spectrum” including high-yield bonds, subordinated debt and leveraged syndicated loans, “a phenomenon reminiscent of the exuberance prior to the global financial crisis.” (BIS 2013: 1, 7). There has also been a growing willingness to take leveraged positions in long-term assets with short-term finance, both in the US and globally. These have created a strong recovery if not a bubble in equity prices with the benchmark US equity index, the Dow Jones Industrial Average (Dow), reaching historical highs.⁹

These developments have caused concern at the Fed with Bernanke (2013) warning that asset prices may get delinked from fundamentals, generating mispricing (see also IMF GFSR April 2013 and Yellen 2013b). There is indeed considerable uncertainty regarding the implications of an extended period of ultra-easy money for financial stability, since these are largely uncharted waters (White 2012). If it persists much longer, credit and asset bubbles could start to form and reach dangerous levels, leading to yet another boom-bust cycle (Roubini 2013). As the incoming Fed chairman Janet Yellen has argued, even though there may yet be no bubbles in equity or property markets, the longer the QE continues, the greater the risk for financial stability (Fontevicchia 2013). However, it may be also difficult to exit without disrupting markets and impairing growth (Stein 2013). Although the Fed and the IMF appear to be taking note of the longer-term risks to stability and growth, they may not be able to identify them correctly or act in a timely and effective manner better than they did during the subprime build-up.

Since the large quantities of liquidity provided to the banking system through QE has failed to expand credits and private spending, a way out could have been to make the money

⁹ These imply that monetary conditions are too tight for the real economy but too loose for financial markets. To put in conventional terms, because of the zero lower bound, monetary policy could not bring down the interest rate to a level needed to create sufficient demand to close the deflationary gap – if, of course, such a level exists. It could not raise inflation in markets for goods and services, but is capable of doing so in markets for assets. Thus, avoiding bubbles and securing growth would depend very much on fiscal expansion and redistribution from the rich to the poor.

available directly to those who are willing to spend but cannot do so because of tight budget constraints and debt overhang. Milton Friedman has long suggested dropping money from helicopters to avert deflation. In a speech given in 2002 before becoming the chairman of the US Fed, Bernanke referred to helicopter money as a way of reversing deflation, noting that “the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost” and that “a determined government can always generate higher spending and hence positive inflation.” He then went on to argue that “the effectiveness of anti-deflation policy could be significantly enhanced by cooperation between the monetary and fiscal authorities” and that “money-financed tax cut is essentially equivalent to Milton Friedman's famous ‘helicopter drop’ of money.” He also added that instead of tax cuts the government could also go for money-financed spending on current goods and services (Bernanke 2002: 4, 6).

However, QE is an exchange of assets, newly printed dollars for bonds including toxic assets in the balance sheets of the banks, not a helicopter drop of money which bypasses the banking system. The Fed's purchases of long-term Treasuries do not provide the government non-debt creating, interest-free resources unless such debt is monetized indefinitely. As long as the bonds acquired by the Fed stay on its balance sheet, they do not entail net cost to the government because of profit remittances noted above. But as soon as the expansion of the Fed's balance sheet is reversed and these bonds exit the Fed's balance sheet (that is, if they mature without being replaced or they are liquidated), these profits would dry up. This, together with the return of interest rates to normalcy, would increase debt servicing cost significantly. Thus, permanent monetization of government debt provides a viable answer to deflation and long-term debt sustainability.¹⁰ The case for overt monetary financing also applies to deficits resulting from debt write-downs and bailout operations to recapitalize insolvent banks. It allows stabilizing the banking system without adding to government debt and hence shifting solvency concerns from banks to sovereigns, as has happened in the EZ periphery (Turner 2013b).

Under deflationary conditions “money-financed” spending or tax cuts need be no riskier for financial stability than the ultra-easy monetary policy, since the money thus created would not find its way directly into asset markets. As the former chairman of the UK Financial Services Authority has argued, the attempt to escape from the deleveraging trap by excessive monetary accommodation could lead to severe future vulnerabilities and the idea that overt money finance of fiscal deficits is inherently any more inflationary than the other policy levers used to stimulate demand is without any technical foundation.¹¹ Rather, the main challenge is how to “design institutional constraints and rules that would guard

¹⁰ This could be done in two ways. The government can issue debt directly to the central bank to finance its additional spending or the central bank acquires the additional debt through QE operations. In both cases the central bank makes a commitment that it would not reverse the expansion of its balance sheet resulting from the additional acquisition of government bonds.

¹¹ If a permanent increase in money supply resulting from deficit financing turns out to be inflationary, it can be reduced by using bank reserve requirements rather than selling government bonds – see Turner (2013).

against the misuse of this powerful medicine.” (Turner 2013a: 24; see also White 2013; Turner 2013b; Wolf 2013a). However, none of the governments in the AEs in crisis have been willing to break the taboo and abandon the obsession against direct financing of budget deficits and permanent monetization of government debt even though some central banks, including the Bank of England are reported to have given considerations to such a solution.¹²

Many studies have found that without ultra-easy monetary policy, recession would have been deeper and unemployment higher in the AEs hit by the crisis.¹³ This is beyond doubt. However, these studies do not explore what could have happened to employment and output under a counterfactual scenario including orderly and comprehensive debt restructuring, permanent monetization of government deficits and debt, or additional public spending financed by progressive taxation in comparison with the policy approach actually adopted, combining fiscal orthodoxy, creditor bailouts and ultra-easy money. Nor do they examine possible future costs due to vulnerabilities entailed by such a policy mix.

¹² See *Financial Times*, “Waiting for Growth. Bank of England must get its Money into the Economy”, 12 August 2012. In 2011 Bernanke ruled out direct lending to state and local governments, saying that the Fed had limited legal authority to help and little will to use that authority, see *Wall Street Journal* “Bernanke Rejects Bailouts”, 8 January 2011.

¹³ See e.g., IMF (2013b). For a review and the impact of unconventional monetary policies on distribution and stability see, Dobbs *et al.* (2013). A study at the San Francisco Fed found that QE2 added just 0.13 percentage points to growth in 2010 and that interest rate forward guidance has greater effect than asset purchases; see Curdia and Ferrero (2012). According to a study by Reinhart and Rogoff (2014) of 100 systemic banking crises in the US and elsewhere, on average it takes 8 years to reach the pre-crisis per capita income while in the current crisis the US has achieved full recovery after 6 years. However, no attention is paid to jobs and pay and no question is raised about whose income is rising and by how much.

IV. SPILLOVERS TO DEVELOPING COUNTRIES

The failure to achieve a rapid recovery and remove income and employment gaps in AEs has meant strong and sustained trade shocks to DCs, notably the major exporters of manufactures as well as smaller countries heavily dependent on markets in the US and Europe. However, until recently growth in DCs has shown considerable resilience after an initial downturn in 2009. Three factors have played a major role.

First, DCs were able to give an unprecedented, swift and strong countercyclical policy response through monetary and fiscal measures, turning increasingly to domestic demand for growth. This was made possible by favourable payments, reserves and fiscal positions built-up during the preceding expansion (Akyüz 2012). Second, China's policy response to the crisis through massive investment in infrastructure and property to offset the decline of its exports to AEs provided a major boost to commodity exporters. Third, despite occasional protests against the pressures put on their currencies by rapid expansion of liquidity in major AEs, the impact of the ultra-easy monetary policy on DCs has generally been benign. It has played a major role in the quick recovery of private capital flows after the sudden reversal triggered by the Lehman collapse, thereby allowing many deficit DCs to expand domestic demand without facing a payments constraint.

However, the momentum could not be sustained. In DCs, except China and a few others, fiscal and payments constraints have started biting as they shifted to domestic-demand-led growth, leading to fiscal tightening.¹⁴ Second, China could not keep on filling the demand gap with investment in view of several problems created by its earlier stimulus package, including excess capacity and over-indebtedness. Third, capital inflows have weakened and become highly unstable, first with the deepening of the EZ crisis and then with the prospects of the Fed tapering bond purchases. Consequently, DCs have started to face greater difficulties in maintaining strong growth at later stages of the crisis than at the beginning, losing momentum from 2011 onwards with growth falling well below the rates seen before the onset of the crisis and in the aftermath of the Lehman collapse.

IV.1. Trade shocks and imbalances

Trade has been the single most important channel of transmission of contractionary impulses from the financial crisis and recession in the US and Europe to DCs. While all DCs have been hit directly or indirectly, the incidence varied from country to country according to their dependence on exports, the relative importance of markets in AEs and the import content of their exports.¹⁵ Cuts in exports of DCs to the US and Europe have also resulted in

¹⁴ According to Ortiz and Cummins (2013) many DCs joined fiscal austerity after 2010 and premature expenditure cuts became widespread.

¹⁵ On variations of dependence on exports of DCs, see UNCTAD (2009).

a significant compression of imports used both for exports and domestic consumption and investment. As a result of these cumulative effects, the world trade volume declined at much the same rate as the rate of decline of volume of imports by AEs.

Trade shocks have been particularly severe for China because of its dependence on exports to AEs. In the period 2002-07, Chinese exports grew by more than 25 per cent per annum, accounting for about one-third of GDP growth, taking into account their import content. The dependence on exports to AEs was even higher for smaller exporters of manufactures in Asia, both directly and through supplying parts and components to China. With the crisis in AEs, exports of Asian DCs first slowed sharply in 2008 and then dropped in 2009, and became a major drag on activity, reducing growth by 5-6 percentage points (Akyüz 2012). Import cuts in Europe have also hit Africa especially hard because of strong trade linkages (IMF 2011; OECD 2012; Massa *et al.* 2012).

Countercyclical policy response in major commodity-importing countries, notably China and to a lesser extent India played a major role in the rapid recovery of commodity prices after a sharp decline in 2008 (Chart 5). China's shift from export-led to investment-led growth created a massive increase in its commodity imports since investment in property and infrastructure is much more intensive in commodities, notably in metals, than exports of manufactures which rely heavily on imported parts and components. China's primary commodity imports doubled between 2009 and 2011 compared to some 50 per cent increase in its manufactured imports. During the same period prices of metals rose by 2.4 fold, much faster than other primary commodities. As growth fell in China and India after 2011, commodity prices have levelled off and showed sharp declines in some categories, notably metals.

All these have resulted in significant changes in the pattern of world trade. Before the crisis South-South trade was largely conditioned by trade between DCs and AEs. China's imports from DCs accounted for a large proportion of South-South trade and an important proportion of these were used, directly or indirectly, for its exports of manufactures to AEs (Akyüz 2012). With the shift of China to investment-led growth, not only has there been a shift in Chinese imports from manufactures to commodities, but also a larger proportion of its imports have come to be used for domestic demand. This has also meant that for many commodity-dependent DCs, China has become the single most important market. For instance, in 2007 Brazilian exports to the EU and US were four times and twice the level of its exports to China, respectively. Now Brazilian exports to China and Europe are about the same and Brazilian exports to the US are one-half of its exports to China.

The crisis has not removed but reallocated trade and payments imbalances. In the run-up to the crisis DCs taken together had a current account surplus of more than \$700 billion while the US and, to a lesser extent the EZ, was in deficit. Germany, Japan and China were all running large surpluses, relying on exports for growth. GDP was growing faster than domestic demand and the share of private consumption in GDP was falling in all three countries (Table 1) (Akyüz 2011b). After the onset of the crisis, domestic demand in

Germany continued to remain sluggish and its overall surplus increased rapidly, reaching \$260 billion or more than 7 per cent of GDP at the end of 2013 despite a significant decline of its surplus with the EZ; that is, it has been running a growing surplus vis-à-vis the rest of the world. This, together with massive import cuts in the periphery, has shifted the current account of the EZ from a deficit of \$100 billion to a surplus of \$300 billion. By contrast, China's surplus declined from a peak of 10 per cent of GDP in 2007 to 2.5 per cent and this has been a major factor in a drastic drop of the surplus of DCs while Japan started running trade deficits in the second half of 2013.

IV.2. Financial spillovers and vulnerability of emerging economies

Although the boom in private capital inflows to EEs that had begun in the early years of the 2000s came to an end with the flight to safety triggered by the Lehman collapse in September 2008, the recovery was quick, helped by monetary policies in the US and Europe and shifts in risk perceptions against AEs (Chart 6). Throughout 2010-12 capital inflows in absolute nominal terms were only slightly below the peak reached in 2007, but were lower as a per cent of GDP of recipient countries – around 4 per cent compared to over 8 per cent in 2007. This relative weakness of private capital inflows reflected, in large part, sharp drops in inflows to European EEs due to strong fallouts from the EZ crisis. By contrast, net inflows to Asia and Latin America exceeded the peaks reached before the crisis (Chart 7).

The surge in capital inflows led to a strong recovery in currency, equity and bond markets of major DCs which had come under severe pressures in the immediate aftermath of the Lehman collapse. While most DCs welcomed the recovery of capital inflows and the boom in asset prices they helped to generate, many of them, notably the deficit DCs, were ambivalent about the strong upward pressure they exerted on exchange rates (Chart 8). The ultra-easy monetary policies in AEs were seen as an attempt to achieve beggar-thy-neighbour competitive devaluations to boost exports to drive recovery in conditions of sluggish domestic demand. It was described as a “currency war” by the Brazilian Minister of Finance while the Governor of the South African Reserve Bank alluded that DCs were in effect caught in a cross fire between the ECB and the US Fed (Marcus, 2012).

Most Asian DCs intervened heavily in foreign exchange markets, absorbing inflows in reserves and trying to sterilize interventions by issuing government debt. These countries avoided sharp appreciations. Others, particularly those pursuing inflation targeting, including Brazil, South Africa and Turkey, abstained from extensive interventions and experienced considerable appreciations. However, as upward pressures on the currencies of DCs persisted, there was an unprecedented resort to capital controls. Generally, market-friendly measures rather than direct restrictions were used, including reserve requirements, taxes and minimum stay periods.

These measures were designed not so much to prevent asset bubbles as to avoid currency appreciations. Generally, they were not very effective in limiting the volume of

inflows as exceptions were made in several areas. In many cases the composition of inflows changed towards longer maturities and types of investment not covered by the measures. Furthermore, taxes and other restrictions imposed were too weak to match arbitrage margins.

It is true that the hands of some DCs are tied by bilateral investment treaties and free trade agreements with AEs which prohibit controls over capital flows. However, the half-hearted approach rather than international obligations played a major role in the failure to manage capital inflows effectively. For instance, despite the absence of such obligations Brazil was unable to avoid sharp appreciations of its currency and deterioration of its external payments while Korea managed inflows successfully and avoided appreciations despite being a member of the OECD and hence subject to the provisions of its Code of Liberalization of Capital Movements (Chamon and Garcia 2013; Singh 2010). In fact the Korean won has been one of the weakest currencies in the entire post-crisis period eliciting remarks that, together with the UK, it is the most aggressive “currency warrior” of the past five and a half years (Ferguson 2013).

Capital inflows to DCs have become weaker and unstable first with the deepening of the EZ crisis and subsequently with the prospect of the US Fed tapering the bond purchases under the QE3 programme. On the other hand, even though most developing economies have started to cool after 2011, many of them have seen their current account deficits widen. Thus, their need for foreign capital increased just as inflows have become weaker and unstable. These have led to a reversal of upward pressures on currencies and assets in several EEs. Capital controls over inflows have been dismantled and protests against ultra-easy monetary policies in AEs have vanished. Some countries have even introduced measures to attract foreign capital.

The EZ crisis has led to increased global risk aversion and greater preference for relatively safe assets. It has also impinged directly on the volume of global capital flows. Before the crisis, Europe was the main source of (gross) capital flows to the rest of the world, with \$1600 billion per annum during 2004-07, higher than total outflows from the US and Japan taken together. With the outbreak of the crisis, total outflows from Europe fell sharply, registering a bare \$300 billion a year during 2008-11.¹⁶ The EZ crisis has also led to considerable short-term, month-to-month volatility in capital inflows to DCs which have become increasingly sensitive to news coming from the region.

Subsequently, in 2013, capital inflows have also become sensitive to statements by US Fed officials about bond purchases and economic data from the US. Ironically, weaker-than-expected growth and employment data have often lead to a rally in asset and currency markets of EEs, particularly those dependent on foreign capital, since they implied delays in tapering and normalization of monetary policy. This reflects that these countries are a lot

¹⁶ IIF (January 2012). See also Lund *et al.* (2013) for the drop in cross-border claims by EZ banks.

more exposed to financial shocks from tapering and monetary tightening than to trade shock from sluggish growth in the US.

The pronouncements by the Fed in May-June 2013 that it could start tapering in the summer triggered a hike in the 10-year Treasury bond yield, from 1.7 per cent to almost 3 per cent and a sharp decline in capital inflows to DCs. However, subsequent weaker economic data led the Fed to postpone tapering and this gave a push to asset markets almost everywhere and to currencies of EEs. After relatively strong monthly job figures and increased concerns about the effectiveness and risks of QE, the Fed decided in December 2013 to gradually end its monthly purchases in the course of 2014, starting with a modest reduction of \$10 billion in January, and tempered the taper by signalling that the policy rates would not likely be changed much before the end of 2015 (Cassidy 2013).

The initial reaction of financial markets to the removal of uncertainty about tapering and the reassurance that historically low policy interest rates would stay two more years was positive. However, subsequently, in the early weeks of 2014, currency and securities markets of several EEs have come under significant pressure, creating fears of a new round of crises in EEs. Most of the EEs that have come under pressure have been in unsustainable positions, running large current account deficits. The combination of various factors has contributed to this rapid reversal, including political turmoil in some countries and increased concerns with stability and growth in China, but a key reason appears to be changes in expectations regarding the speed of tapering, triggered by stronger-than-expected growth in the second half of 2013 and optimistic forecasts in the US. The state of confusion and instability is likely to prevail in the immediate period ahead. Even if the current turmoil does not evolve into a full-blown crisis, many EEs remain highly vulnerable, particularly as and when the Fed shift from quantitative easing to quantitative tightening and from zero-bound to positive policy interest rates.

The nature of vulnerability of EEs to financial shocks from AEs has changed significantly in the past decade because of changes in the nature and composition of their external liabilities in the course of pre- and post-Lehman booms in capital inflows (Akyüz 2011a). Governments in EEs have increasingly shifted from external to domestic markets in meeting their financing needs, opening domestic bond markets to non-residents. At the end of 2012 the size of local market debt in EEs, including corporate and sovereign debt, reached over \$9.1 trillion and the share of non-resident holdings increased to an unprecedented 26.6 per cent, compared to 12.7 per cent in 2008, with this proportion exceeding 40 per cent in some (World Bank 2013). Higher interest rates and currency appreciations in EEs have played a significant role in attracting foreigners to local debt market by creating highly profitable carry-trade opportunities.

While increased foreign acquisition of local-currency securities has shifted the exchange rate and interest rate risks onto non-residents and reduced foreign exchange exposure of EEs, the greater foreign presence in domestic markets has also strengthened their link with international financial markets and heightened their vulnerability to external

financial shocks. This is true even for countries with strong payments and reserve positions, as seen in Asia during the Lehman turmoil when several countries experienced sharp drops in domestic asset markets. Vulnerability is now greater because many carry-trade creditors and investors in local debt markets of EEs are highly leveraged and thus susceptible to changes in monetary conditions in the US.

By contrast, since the onset of the crisis, the exceptionally low interest rates in major AEs and low risk spreads have encouraged both financial and non-financial corporations of EEs to borrow abroad in reserve currencies, resulting in increased private sector exposure to interest rate and exchange rate instability (IMF GFSR April 2013; Oprita 2013). According to the BIS data, between 2010 and mid-2013, net external debt financing by EEs reached \$1.9 trillion, of which over \$1 trillion was in bonds and the rest in bank lending. Corporate bond issues during that period were \$830 billion. These were undertaken mainly by non-financial corporations while banks in EEs relied primarily on international bank lending. Net bond issuance by corporations from EEs remained strong in the third quarter of 2013 despite the turbulence created by the expectations of tapering by the Fed (Turner 2013). As of mid-2013, bond issues by corporations from EEs in offshore financial centres exceeded issues by corporations from AEs (McCauley *et al* 2013).

Thus, several EEs are highly exposed to a shift to monetary tightening in the US because of a rapid accumulation of private external debt and increased foreign presence in their domestic bond markets. Those with large current account deficits are particularly vulnerable since in the past few years these deficits have been increasingly financed by debt rather than equity inflows.¹⁷ It is true that many of these countries have also accumulated high levels of international reserves, but these could be drawn down quickly because they have been piled up from capital inflows (i.e., they are borrowed reserves) rather than earned from current account surpluses. Even countries with strong payments and reserves positions such as China can be hit hard by a hike in the long-term interest rates in the US because of growing international indebtedness of its corporations.¹⁸ Three of the five BRICS countries that had been identified a decade ago by financial markets as the “emerging markets” with the brightest economic prospects, Brazil, India and South Africa, are now listed among the countries dubbed “fragile 5” by Morgan Stanley (Lord 2013), with the addition of Turkey and Indonesia, again countries among the rising stars of recent years.

¹⁷ Between 2009 and 2012 private bond issuance increased by 2.5 times while equity issues declined – see IMF GFSR (October 2013).

¹⁸ See Turner (2013) for channels of transmission of the effects of a sudden stop in international lending to domestic banking systems in EEs.

V. LONGER-TERM PROSPECTS

While recovery from the Great Recession is still incomplete and fragile, longer-term prospects are not very bright. The likelihood for the world economy to move to a path of growth that is both stable and strong is slim. A fundamental systemic problem is the deflationary gap due to underconsumption resulting from the low and declining share of wages in GDP in all major AEs including the US, Germany and Japan, as well as China (Chart 9).¹⁹ Until the crisis the threat of global deflation was avoided thanks to property and consumption booms driven by credit and asset bubbles in the US and the EZ periphery. Several Asian DCs, notably China, also experienced investment and property bubbles while private consumption grew strongly in many DCs elsewhere, often supported by the surge in capital inflows. This process of debt-driven expansion created mounting financial fragility and payments imbalances, culminating in the Great Recession.

The crisis has produced new sources of financial fragility because of excessive reliance on ultra-easy monetary policy. It has also aggravated the underconsumption bias and widened the deflationary gap by increasing inequality both in the US and Europe. Furthermore, it has reallocated rather than removed payments imbalances. Germany has replaced China as the centre of global imbalances. It maintains a lid on domestic demand and creates a deflationary bias for the world economy as a whole as well as for the EZ (US Department of the Treasury 2013b).

Longer-term global prospects depend significantly on the US because of its central position in the world economy and the international reserves system. US growth is fragile. There is a fear of a permanent demand gap and secular stagnation (Summers 2013; Krugman 2013). The US cannot easily shift to a wage-led growth in the near future.²⁰ Nor can it shift to export-led growth, with exports growing vigorously and faster than domestic demand and the share of private consumption in GDP falling. Thus, a key question is if the US would be inclined to go back to “business as usual” and rely on credit and asset bubbles in search of strong growth.²¹

¹⁹ Financialization, welfare state retrenchment and globalisation of production are found to be the main reason; see Stockhammer (2012); see also Akyüz (2011b).

²⁰ On wage-led growth, see Lavoie and Stockhammer (2012).

²¹ According to Summers (2013) and Krugman (2013) there is a deflationary gap and risk of secular stagnation because real interest rates cannot be brought down to (negative) levels needed to generate adequate spending due to zero lower bound on nominal interest rates and the inability of monetary authorities to raise inflation in markets for goods and services. They thus argue that inflation (bubbles) in asset markets may be necessary to close the deflationary gap and avert secular stagnation. However, a sound alternative would be to address the causes of the deflationary gap, notably increased inequality and underconsumption and fiscal orthodoxy. For a critique of this “Bubbleonian” growth, see Wray (2013).

This is closely connected to its exit from the ultra-easy monetary policy. A full exit implies not only the end of zero-bound policy rates but also the normalization of the Fed's balance sheet – a significant contraction of its size and a large shift of its asset composition back to short- and medium-term Treasuries. As announced, the Fed has started to taper in January 2014. However, this does not mark the beginning of monetary tightening, as emphasized by Bernanke after the Fed meeting in December 2013 (Cassidy 2013). For one thing, policy rates are pledged to remain at historical lows for some time to come, even after the unemployment rate falls below 6.5 per cent, as long as inflation remains low. For another, tapering reduces not the level of long-term assets on the Fed's balance sheet but monthly additions. This means that the ultra-easy monetary policy is still with us. But the markets have already begun pricing-in the normalization of monetary policy and this is the main reason for the rise in long-term rates and the turbulence in EEs.

It is not clear when and how the Fed would start normalizing its balance sheet. Too gradual an exit whereby the Fed reduces its holding of long-term bonds as they mature would imply that the Fed's balance sheet would remain inflated and tilted towards long-term assets for several more years because of long maturities of the bonds held.²² On the other hand, faster normalization of its balance sheet through liquidation of its bond holdings could pose several difficulties. According to projections of a recent report by the US Treasury, based on market expectations of the Fed's exit strategy, a tightening beginning in 2015 could raise the ten-year rate by 200 basis points by 2018 and the average interest on government debt to 4.3 per cent over the next ten years (US Department of the Treasury 2013a). This could push the dollar up if other AEs do not follow suit and dampen growth. It could also lead to fiscal problems. Simulations made in the Fed and elsewhere assuming exit starting in 2015 and ending by 2018-19 show large income losses and declines in remittances to the Treasury.²³ All these explain why the Fed is unclear about normalizing its monetary policy; for, it may not be able to exit without market disruption and it cannot persist without creating bubbles. Uncertainty abounds because there are not many historical precedents for zero-bound interest rates and QE.

The longer-term prospects of the EZ are even more uncertain and less encouraging. Deleveraging and recovery in the periphery remain slow and many countries cannot be expected to recuperate output losses incurred after 2008 for several years to come. Even if the EZ avoids further turmoil, it would not generate much growth under the current policy approach. Pre-crisis growth in the EZ was mediocre, barely reaching 2 per cent per annum during 2002-07, and much of that was due to debt-driven expansion in the periphery. Post-crisis growth could even be slower.

²² According to Lenzner (2013) as a result of 4 years of QE, the Fed has accumulated 36 per cent of all Treasury securities between 5 years and 10 years in maturity plus 40 per cent of those government bonds over 10 years in maturity as well as 25 per cent of all the mortgage backed securities not owned by Fannie Mae and Freddie Mac.

²³ See Carpenter *et al.* (2013) and Greenlaw *et al.* (2013). Both studies use the Blue Chip forecast for interest rates which puts the 10-year rate at close to 5 per cent at the end of the exit.

The EZ periphery cannot go back to the spending spree and large current account deficits that culminated in the crisis. It needs payments adjustment based on an expansion of exports as well as debt restructuring. However, it is locked in a currency whose nominal exchange rate is beyond its control. Consequently, in the absence of a significant shift of policy in Germany to boost domestic demand and allow appreciation of its real effective exchange rate, the only way for the periphery to restore competitiveness would be by cutting wages. So far a certain degree of internal devaluation has been achieved through wage suppression and adjustment in unit labour costs. There are also significant improvements in current accounts in the periphery largely due to cuts in investment and imports (Atoyan *et al.* 2013). Unemployment would need to remain high in order for wages to be kept under control and for unit labour costs to continue declining. This may face serious social and political obstacles and could eventually lead to default and exit.

Finally, the fortunes of many DCs depend crucially on China. The crisis marks the end of spectacular export-led growth in China. Its response has served to rebalance domestic and external demand, but aggravated the imbalance between investment and consumption which had already been building up before the crisis. Despite the recognition of the problem of underconsumption and low share of household incomes in GDP, the distributional rebalancing is progressing very slowly and consumption has been growing only marginally faster than income. China cannot keep on pushing investment to fill the deflationary gap created by the slowdown in exports. That would aggravate financial fragility and internal imbalances. Nor can it go back to pre-crisis export-led growth. This would be resisted by its trading partners, possibly causing disruptions in the trading system.

The most likely medium-term scenario for China is a sizeable drop in its trend growth compared to double-digit rates it enjoyed in the run-up to the crisis, with a better balance between domestic and external demand and a gradual rebalancing of domestic consumption and investment. A transition to slower growth is already under way and on some accounts the growth rate would come down to 6.5 per cent during 2018-22 after three decades of double-digit levels (Wolf 2013b). China seems to have come to terms with such a slowdown with its Finance Minister pointing out that 6.5 per cent growth would not be a big problem for it (Bloomberg 2013).

The transition of China to a lower growth path and a rebalancing of its domestic demand towards consumption would imply slower growth of its demand for commodities. This means that China would cease to be a strong locomotive for commodity exporters. Not only Latin American but also Sub-Saharan African countries are highly vulnerable to a permanent slowdown in Chinese investment. According to a recent estimate, a 1 percentage point increase in China's domestic investment growth is associated with an average 0.6 percentage points increase in SSA countries' export growth and the impact is larger for resource-rich countries, especially oil exporters (Drummond and Liu 2013). From 2002 to 2012 China's domestic investment grew on average by around 13 per cent per annum. A rebalancing in China would call for a sizeable fall in its share in GDP. With real income

growing by 6-7 per cent per annum, this would necessitate a decline of 7-8 percentage points in the average annual growth rate of investment. On the basis of the estimates above, this could cut export growth of SSA by some 5 percentage points.

Nor can China be expected to become a locomotive for exporters of manufactures in the South. Since its imports of manufactures from DCs are destined mainly for exports rather than for domestic consumption, a greater balance between exports and domestic consumption would imply slower growth of imports of parts and components from other DCs. On the other hand, although there are instances of relocation of low-skill, labour-intensive production in some sectors to lower-wage DCs in Asia through Chinese FDI, there is still some time before China could exit from such industries and a Flying Geese type of process could pick up momentum.

VI. CONCLUSIONS: WHERE NEXT?

The rapid rise of the South that began in the early years of the new millennium has come to an end. This should not come as a surprise since the exceptional performance of DCs in the run up to the crisis was driven to a large extent by highly favourable but unsustainable global conditions. The prospects for global economic conditions look quite unfavourable to DCs not only in comparison with pre-crisis years, but also in some respects the period after the onset of the crisis.

The remarkable growth performance of most DCs in the past decade is in danger of remaining a “one-off success” unless they raise productive investment, accelerate productivity growth, make significant progress in industrialization and expand domestic markets. Despite growing disillusionment in the South, the Washington Consensus is dead only in rhetoric. There is little roll back of the policies introduced on the basis of that consensus in the past two decades. On the contrary, the role and impact of global market forces in the development of DCs has been greatly enhanced by continued liberalization of trade, investment and finance unilaterally or through bilateral agreements with AEs and this has narrowed the policy space of DCs and heightened their exposure to external shocks.

DCs need to be as selective about globalization as AEs and reconsider their integration into the global economic system, in recognition that successful policies are associated neither with autarky nor with full integration, but strategic integration designed to use foreign finance, markets and technology in pursuit of development. This implies rebalancing external and domestic forces of growth and reducing dependence on foreign markets and capital. The role of the state and markets needs to be redefined in all key areas affecting development, keeping in mind that in most cases catch-up is not possible without industrialization and industrialization is not possible without active policy.

Beyond these long-lasting policy challenges, DCs are also facing strong destabilizing pressures resulting from the boom-bust cycle triggered by the ultra-easy monetary policy in AEs, notably the US. For the reasons discussed above, these pressures may well intensify in the months ahead with the tightening of global liquidity, hikes in interest rates and increased risk aversion, in addition to protracted weaknesses in AEs and sluggish international trade.

In several EEs policies pursued in recent years have no doubt made a significant contribution to the build-up of external imbalances and fragility (Akyüz 2012, 2013). Many commodity-dependent EEs have failed to manage the twin booms in commodity prices and capital flows that started in the early years of the millennium and continued until recently, after a brief interruption in 2008-09. These countries, and several others, have often stood passively by as their industries have been undermined by the foreign exchange bonanza, choosing, instead, to ride a consumption boom driven by short-term financial inflows and foreign borrowing by their private sectors and allowing their currencies to appreciate and external deficits to mount. Hastily erected walls against destabilizing inflows have been too

little and too late – they were neither wide enough nor high enough to prevent build-up of imbalances and fragility.

The IMF, the organization responsible for safeguarding international monetary and financial stability, has also failed to promote judicious policies not only in major AEs generating destabilizing impulses for the world economy, but also in EEs. It has been unable to correctly identify the forces driving expansion in EEs, joining the hype about the “Rise of the South” and advocating that EEs are largely decoupled from AEs and have become new engines of growth, thereby underestimating their vulnerability to shifts in policies and conditions in AEs. Even when it became clear that capital inflows posed a serious threat to macroeconomic and financial stability in EEs, its advice was to avoid capital controls to the extent possible and introduce them only as a last resort and on a temporary basis.

Policy response to a deepening of the financial turbulence and tightened balance of payments constraint in the South should be similar in many respects to that recommended by this author in the early days of the Great Recession (Akyüz 2009). The principal objective should be to safeguard income and employment. DCs should not be denied the right to use legitimate trade measures to rationalize imports through selective restrictions in order to allocate scarce foreign exchange to areas most needed, particularly for the import of intermediate and investment goods and food.

EEs should also avoid using their reserves to finance large and persistent outflows of capital. Experience suggests that when global financial conditions are tightening, countries with large external debt and deficits find it extremely difficult to restore “confidence” and regain macroeconomic control simply by allowing their currencies to freely float and/or hiking interest rates. Nor should they rely on borrowing from official sources to maintain an open capital account and to remain current on their obligations to foreign creditors and investors. They should, instead, seek to involve private lenders and investors in the resolution of balance-of-payments and debt crises and this may call for, *inter alia*, exchange restrictions and temporary debt standstills. These measures should be supported by the IMF, where necessary, through lending into arrears.

The IMF currently lacks the resources to effectively address any sharp contraction in international liquidity resulting from a shift to monetary tightening in the US. A very large SDR allocation, to be made available to countries according to needs rather than quotas, would help. But a greater responsibility falls on central banks in advanced economies, notably the US Fed, which can and should – as the originators of destabilizing impulses that now threaten the South – act as a quasi-international lender of last resort to emerging economies facing severe liquidity problems through swaps or outright purchase of their sovereign bonds. The Fed could buy internationally issued bonds of these economies to shore up their prices and local bonds to provide liquidity; and there is no reason why other major central banks should not join this undertaking.




The extent to which these unconventional measures – exchange restrictions and temporary debt standstills, IMF lending into arrears, a sizeable SDR allocation and provision of market support and liquidity by major central banks – should be used no doubt depends on the specific country circumstances. However, they need to be included in the policy arsenal available to all developing countries to ensure an orderly response to unavoidable shocks and to mitigate unnecessary economic and social pains.

The world economy is facing bleak prospects largely because the systemic shortcomings in the global economic and financial architecture that gave rise to the most serious post-war crisis remain unabated. The Outcome Document of the 2009 UN Conference on the “World Financial Crisis and Economic Crisis and Its Impact on Development” had clearly recognized that “long standing systemic fragilities and imbalances” were among the principal causes of the crisis and proposed “to reform and strengthen international financial system and architecture” so as to reduce the likelihood of the occurrence of such crises (UN 2009). It pointed to many areas where systemic reforms are needed including regulation of “major financial centres, international capital flows, and financial markets”, the international reserves system including the role of the SDR, the international approach to the debt problems of DCs, and the mandates, policies and governance of international financial institutions. So far the international community has failed to address any of these issues in a significant way. They need to be put back on the agenda if recurrent financial crises with severe international repercussions are to be averted.

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Table 1: GDP, Domestic Demand and Current Account in Main Surplus Countries*(Annual per cent change unless otherwise indicated)*

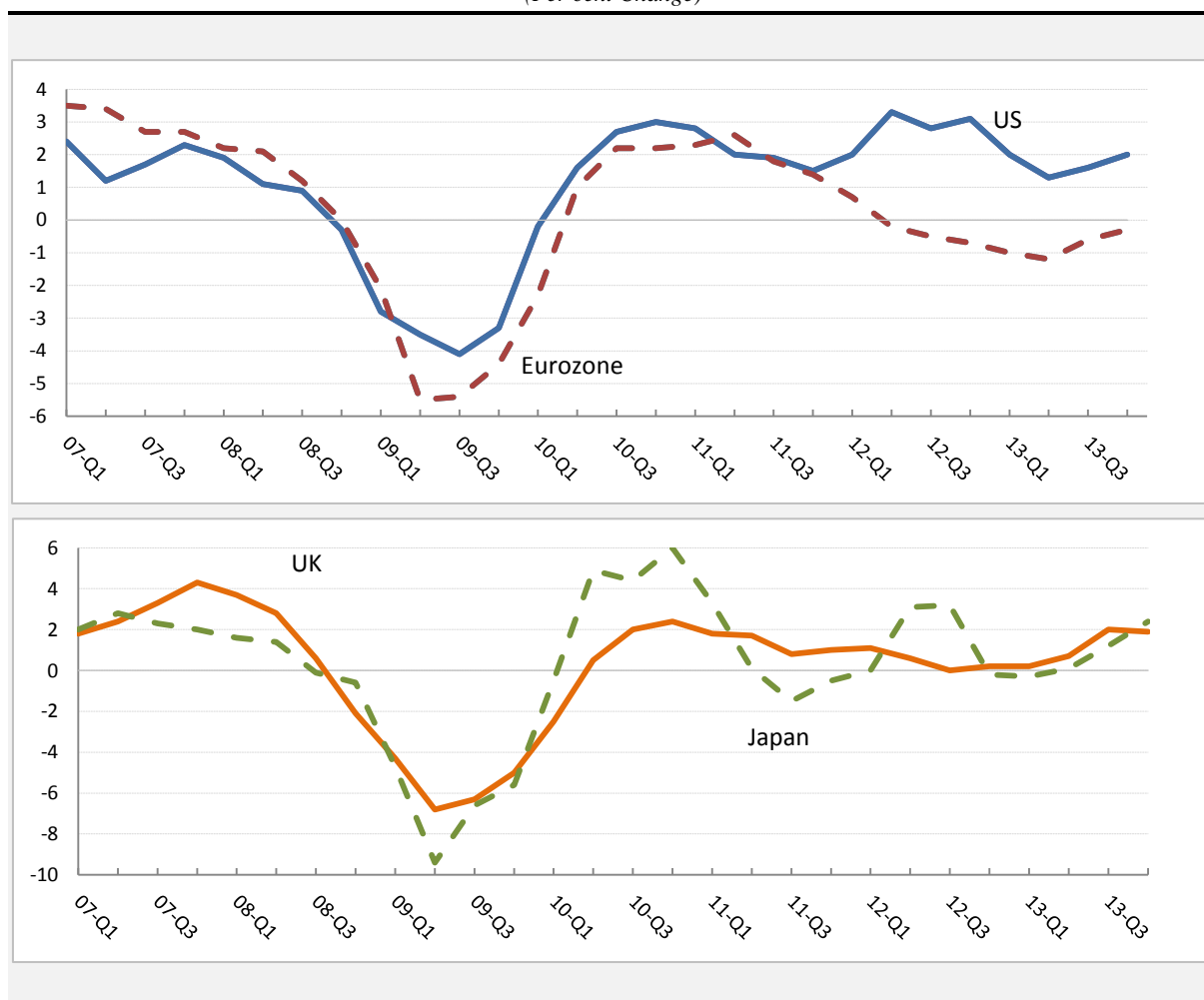
	2004-07	2010	2011	2012	2013
Germany					
GDP growth	2.2	3.9	3.4	0.9	0.4
Domestic demand	1.1	2.4	2.8	-0.3	0.7
Consumption (private)	0.5	1.0	2.3	0.8	0.9
CA (% of GDP)	5.9	6.3	6.2	7.0	7.0
Japan					
GDP	1.9	4.7	-0.6	2.0	1.8
Domestic demand	1.1	2.9	0.3	2.8	1.9
Consumption (private)	1.2	2.8	0.4	2.3	1.8
CA (% of GDP)	4.0	3.7	2.0	1.0	0.9
China					
GDP	12.1	10.4	9.3	7.8	7.7
Domestic demand	10.3*	10.6	10.2	8.4	8.3
Consumption (total)	8.8*	9.2	11.0	8.4	11.5
CA (% of GDP)	7.1	4.0	1.9	2.3	2.3

Source: South Centre estimates based on IMF WEO database; IMF Report: Article IV Consultation with the People's Republic of China; Eurostat; OECD Economic Outlook; and National Bureau of Statistics of China.

* 2005-2007 average.

Chart 1: GDP Growth in Major AEs

(Per cent Change)

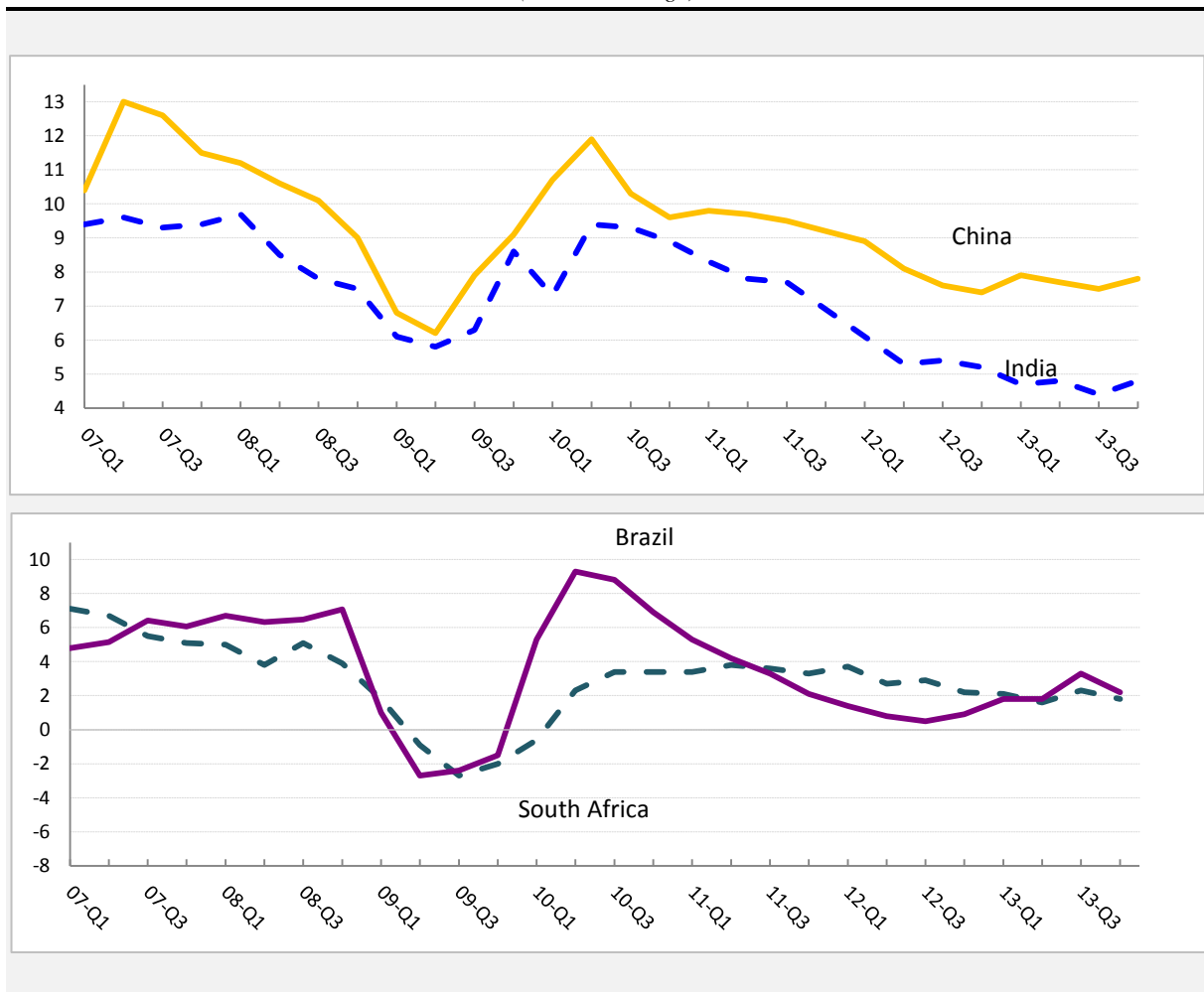


Source: TradingEconomics (<http://www.tradingeconomics.com>).

Note: Quarterly data.

Chart 2: GDP Growth in Major DCs

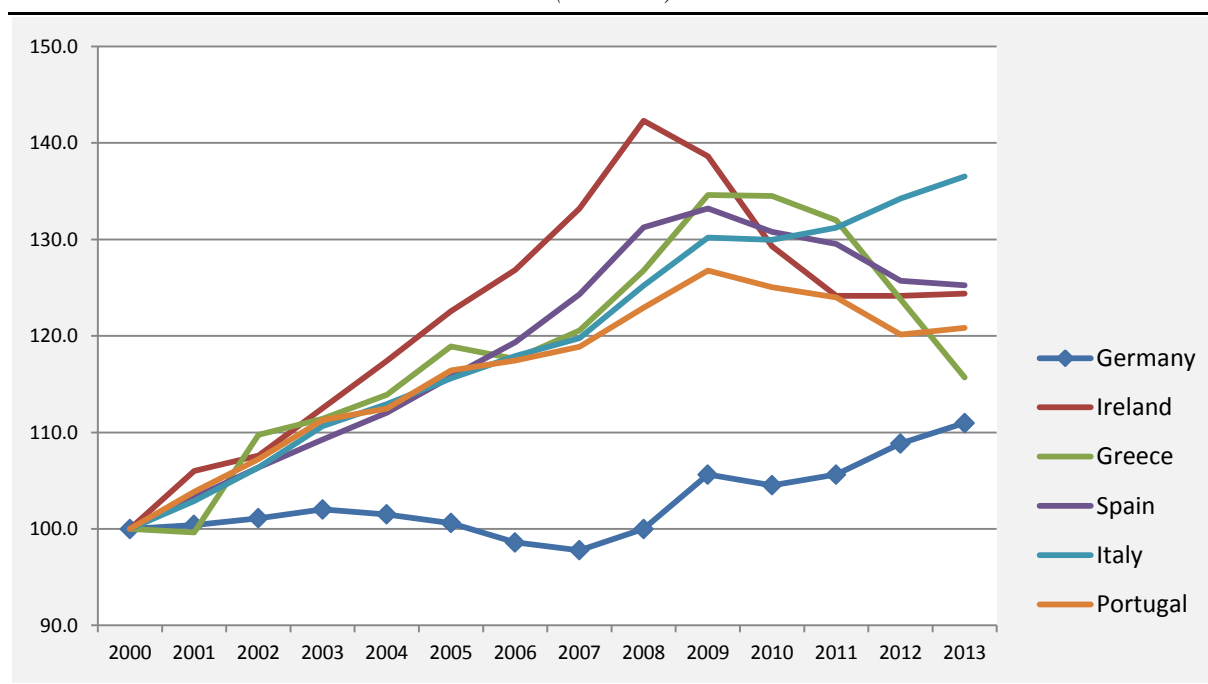
(Per cent Change)



Source: TradingEconomics (<http://www.tradingeconomics.com>).

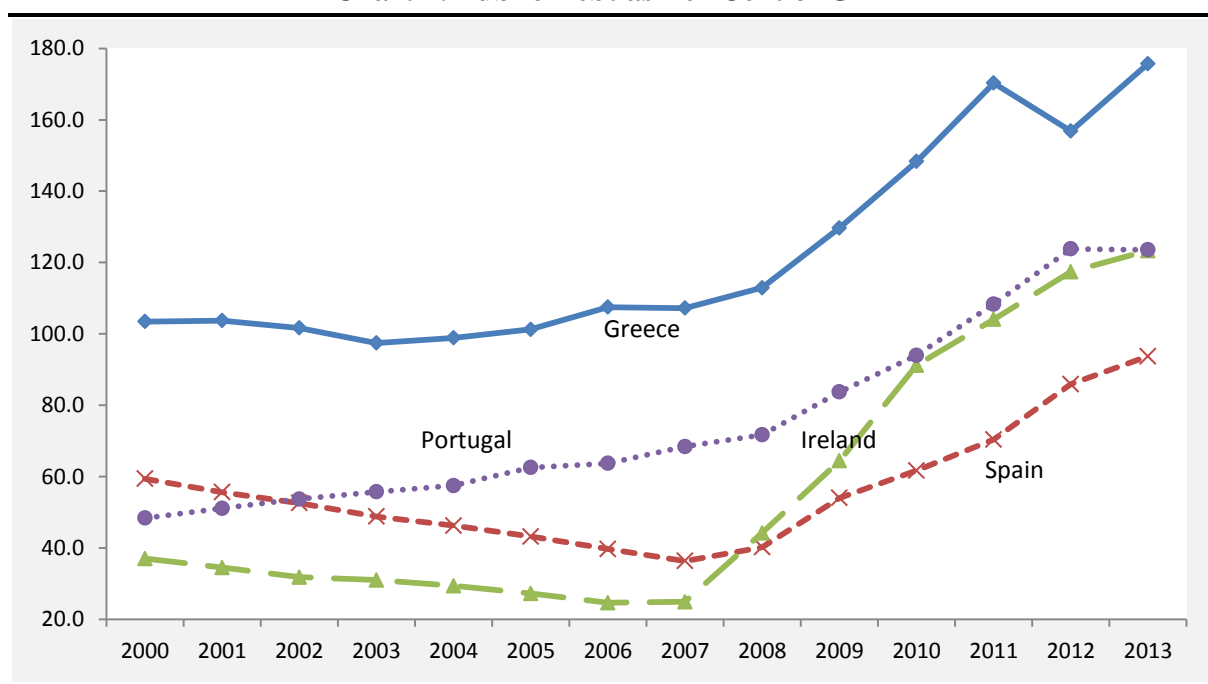
Note: Quarterly data.

Chart 3: Unit Labour Costs in the Eurozone
(2000=100)



Source: Eurostat.

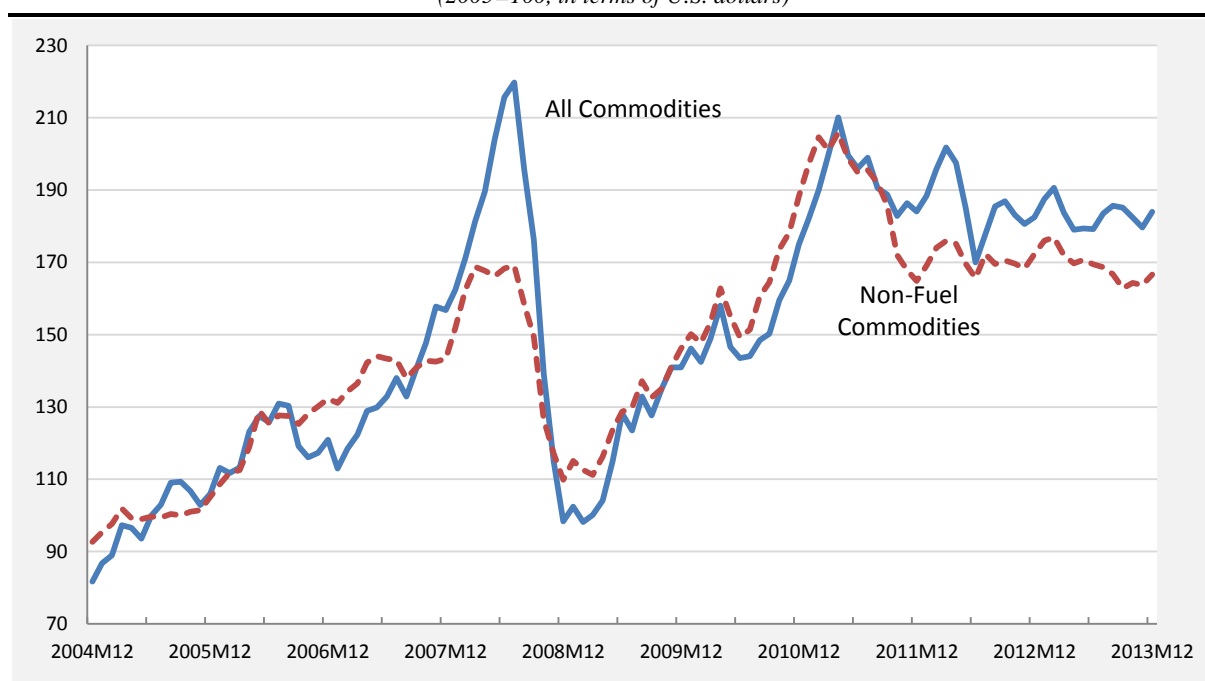
Chart 4: Public Debt as Per Cent of GDP



Source: IMF Fiscal Monitor Database (October 2013).

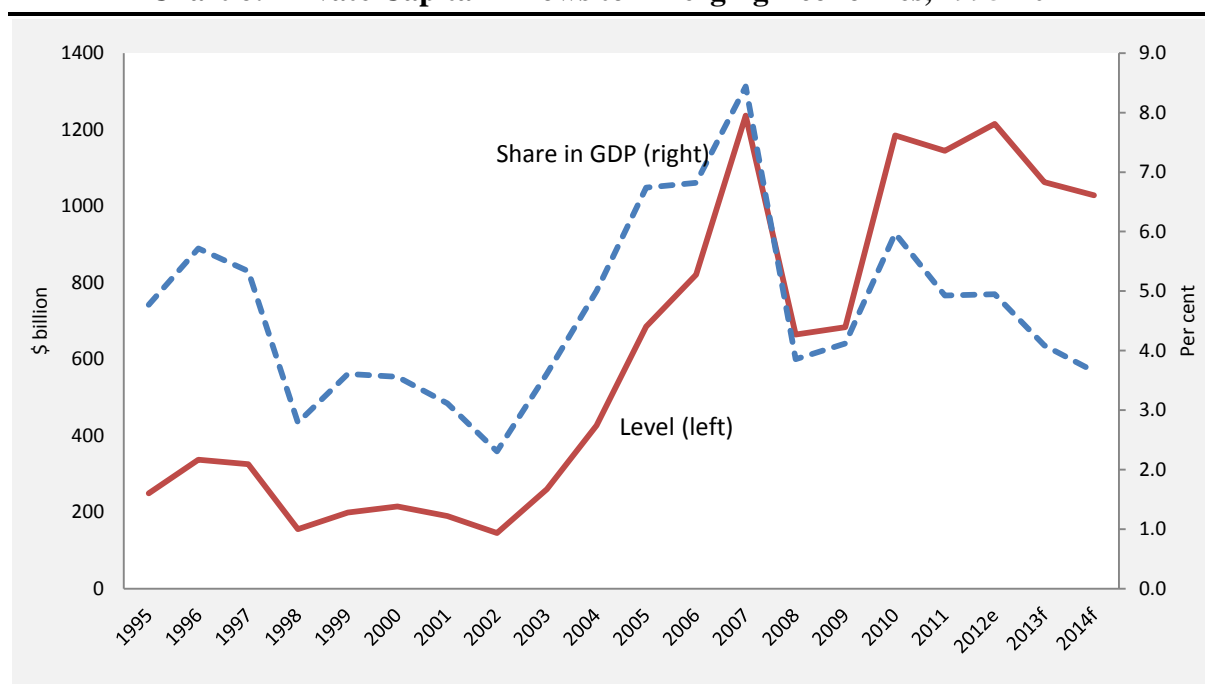
Chart 5: Primary Commodity Prices: December 2004-December 2013

(2005=100, in terms of U.S. dollars)



Source: IMF, Primary Commodity Prices database.

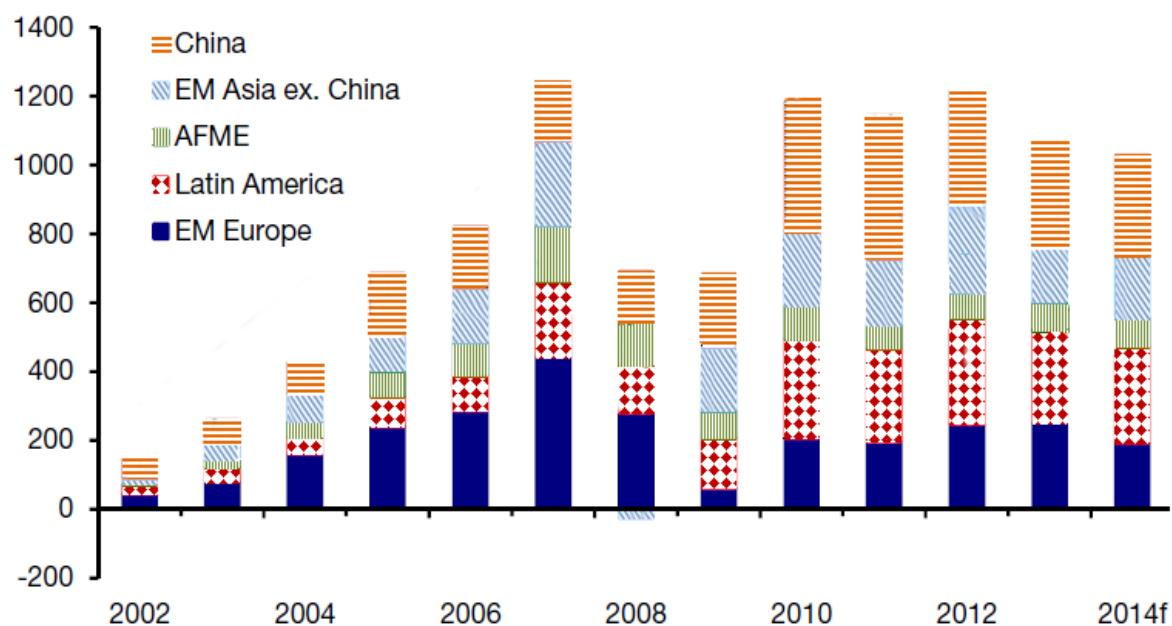
Chart 6: Private Capital Inflows to Emerging Economies, 1995-2014



Source: IIF (October 2013).

Note: f = IIF forecast, e = estimate.

Chart 7: Private Capital Inflows to Emerging Economies – Regions
(Billions of U.S. dollars)

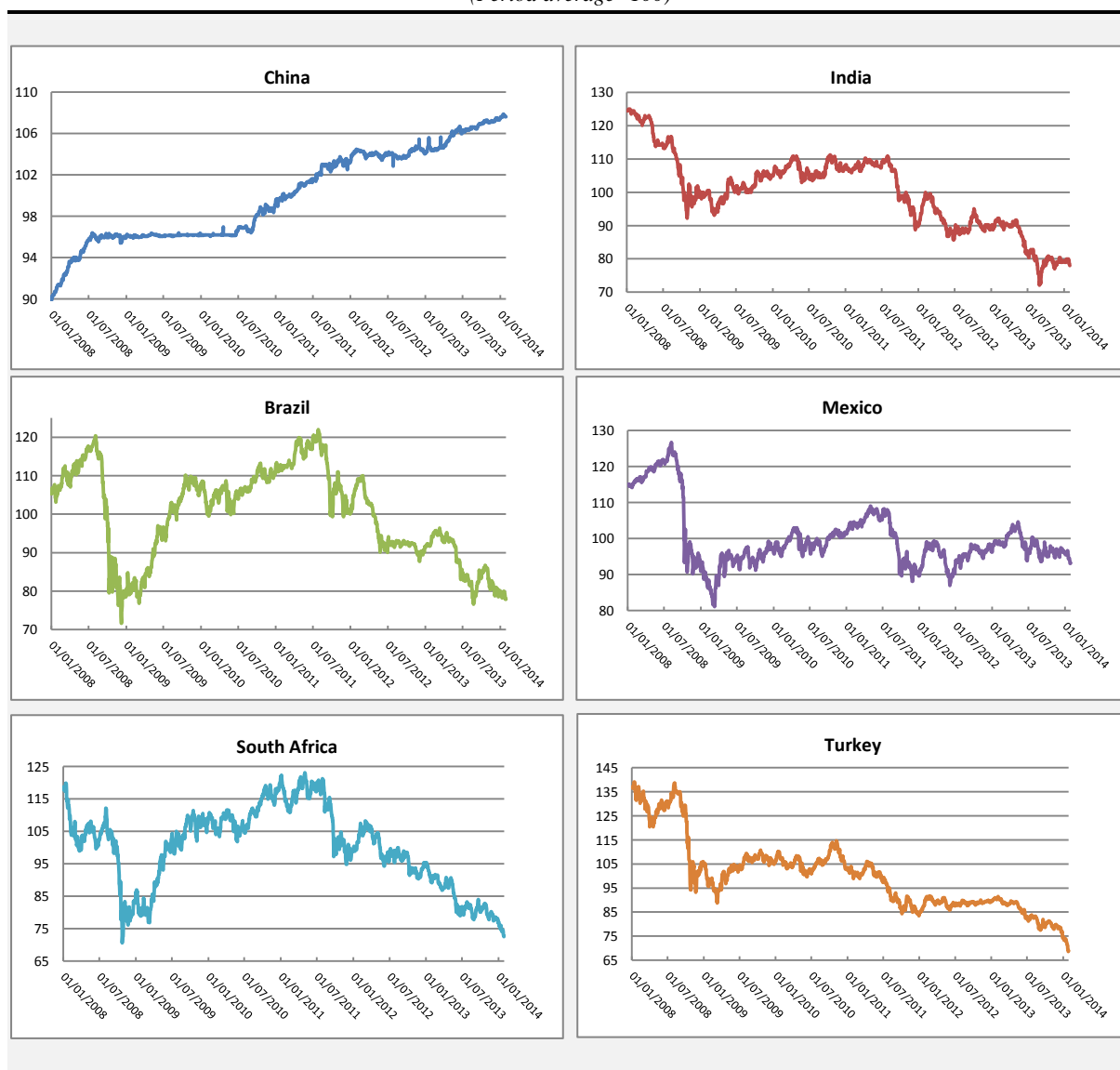


Source: IIF (October 2013).

f: IIF forecast.

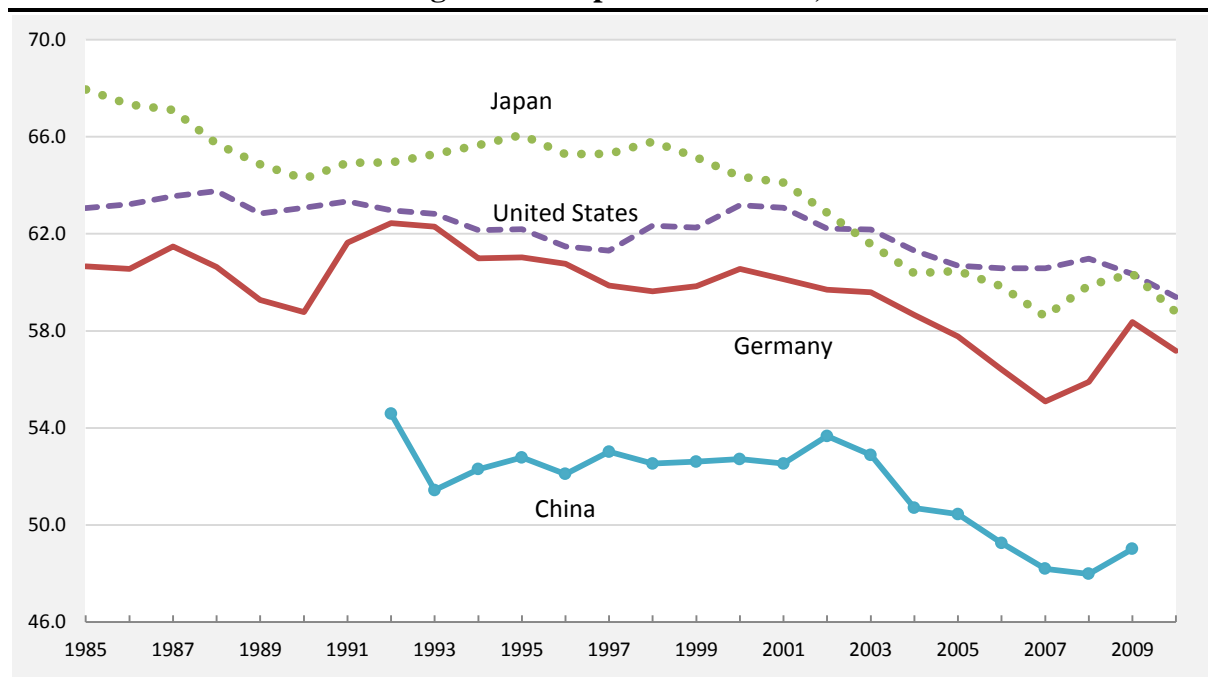
Chart 8: Nominal Exchange Rates in Selected Economies

(Period average=100)



Source: OANDA (<http://www.onada.com>).

Note: US dollar per unit of domestic currency.

Chart 9: Wage Share as per cent of GDP, 1985-2010

Source: Eurostat and China Statistical Yearbooks.



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