THE FINANCIAL CRISIS AND THE GLOBAL SOUTH

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OUTLINE

- Outlook: global and major advanced economies (AEs).
- Why is this crisis taking too long to resolve? Shortcomings in policy response.
- Impact on developing countries (DCs)
- Impact on global imbalances
- Growth prospects and policy challenges in DCs

GLOBAL ECONOMIC LANDSCAPE

- 5 years into crisis and still no sign of world economy returning to normalcy. After a mediocre growth of 2.2% in 2012, UN is now forecasting 2.4% growth in 2013.

- All AEs but US have gone into second dip.

- Serious downside risks in three drivers of the world economy: US fiscal cliff and EZ debt crisis unresolved and there are question marks about the sustainability of investment-led growth in China.

- Growth in DC is now slowing after historical highs before the crisis and strong recovery after the crisis. Without major policy reorientation, DCs are unlikely to go back to rapid growth in the coming years.

WEAK RECOVERY IN US; DOUBLE-DIPS IN EZ, UK and JAPAN

- **US:** recovery sustained but sluggish; better than other AEs; but output is still \$800b below what economy could produce; employment 2.5 million below 2008/Q1

- **EZ**: modest recovery during 2010–11, second dip in 2012 as impact of periphery crisis spread to the core. Contraction to continue in 2013 (IMF); unemployment almost 12%, over 25% in Spain and Greece; 60% for youth.

- **UK:** negative growth in 2012 as government turned to fiscal austerity. Since 2008 UK had negative growth in 9 out of 19 quarters. 2013 growth around 1%, still the fastest among the EU's big 5.

- **Japan**: second dip in 2011 when hit by earthquake. Reconstruction helped recovery but contracted again in 2012/Q3; it was the 7^{th} quarterly contraction since Lehman collapse. 2013 growth not much more than 1%.

Real GDP growth in selected advanced economies

Per cent change

	2008 (IMF)	2009 (IMF)	2010 (IMF)	2011 (IMF)	2012 (IMF)	2013 (IMF)	2012 (EC)	2013 (EC)
United States	-0.3	-3.1	2.4	1.8	2.3	2.0	2.1	2.3
Eurozone (EZ)	0.4	-4.4	2.0	1.4	-0.4	-0.2	-0.4	0.1
Germany	0.8	-5.1	4.0	3.1	0.9	0.6	0.8	0.8
Japan	-1.0	-5.5	4.5	-0.6	2.0	1.2	2.0	0.8
United Kingdom	-1.0	-4.0	1.8	0.9	-0.2	1.0	-0.3	0.9

WHY IS IT TAKING TOO LONG TO RESOLVE THE CRISIS?

- IMF (Blanchard): crisis could take 10 years to resolve.
- Recoveries from financial crises are sluggish because it takes time to repair balance sheets – excessive debt and wrong and excessive investment.
- Still there are two interrelated shortcomings in policy response both in US and EU:
  - Inability to remove debt overhang through comprehensive restructuring and cleaning bad loans; now more creditor bailouts than in past crises (IMF).
  - Failure to reconcile the need for short-term fiscal stimulus with a credible program for longer-term consolidation; return to fiscal orthodoxy

BAILOUTS AND DEBT OVERHANG IN THE US

- US interventions:
  - Treasury injection of capital to rescue banks (TARP: 2008-09).
  - Fed buying mortgage-backed securities and government bonds to lower long-term rates (QEs).
  - No write down of household mortgages in line with their ability to pay; voluntary mortgage modification and refinancing schemes not vey successful.

- Interventions helped stabilize banks, moved their net worth to positive territory. End-2012 profits are best since 2006. Too-big-to-fail banks are now bigger; assets of top 5 banks are now 55% of US economy; up from 43% 5 years earlier.

- But they have done little to reduce debt overhang, prevent foreclosures or increase lending. Many households lost homes; others continue to grapple with large debt, and this is still stifling demand.

US FISCAL DRAG

- Fiscal policy gains added importance when private sector is retrenching and monetary policy is ineffective in stimulating spending.

- Initial US stimulus averted deepening. Then fiscal drag (public job and spending cuts) due to concern over public debt. Now joined austerity club (UK/EZ).

- Without further action on top of the recent deal on tax increases, that is, if $120b spending cuts (sequester) go ahead as planned and there is no new fiscal stimulus, growth could drop to 1%.

- Obsession against monetization of deficits: Fed prints money to give to banks to lend to private sector to raise spending. But this does not work. Why not print money to finance government spending. Inflationary? Nonsense; a lot of slack in the economy. No economic rationale, but politics and ideology.

EZ: WRONG DIAGNOSIS AND HARMFUL RECIPES

- False diagnosis that EZ crisis is due to fiscal profligacy; not true except in Greece. A BOP crisis resulting from loss of competitiveness, excessive spending and growing CA deficits in the periphery financed by intra-EZ capital flows.

- Periphery had larger CA deficits than in all others, but not always higher public deficits and debt – Spain and Ireland better than Germany. Their BOP problems due to private spending and borrowing booms, sustained by intra-EZ capital flows.

- EZ has now put growth and jobs aside, focusing on procyclical fiscal adjustment without a viable medium-term growth strategy. A vicious circle which now worries even IMF: cuts in public spending reducing income, generating more deficits and necessitating further cuts. IMF now recognizes that fiscal multipliers are much bigger than were believed (Blanchard and Leigh).

PRE-CRISIS DEBT AND DEFICITS IN THE EUROZONE

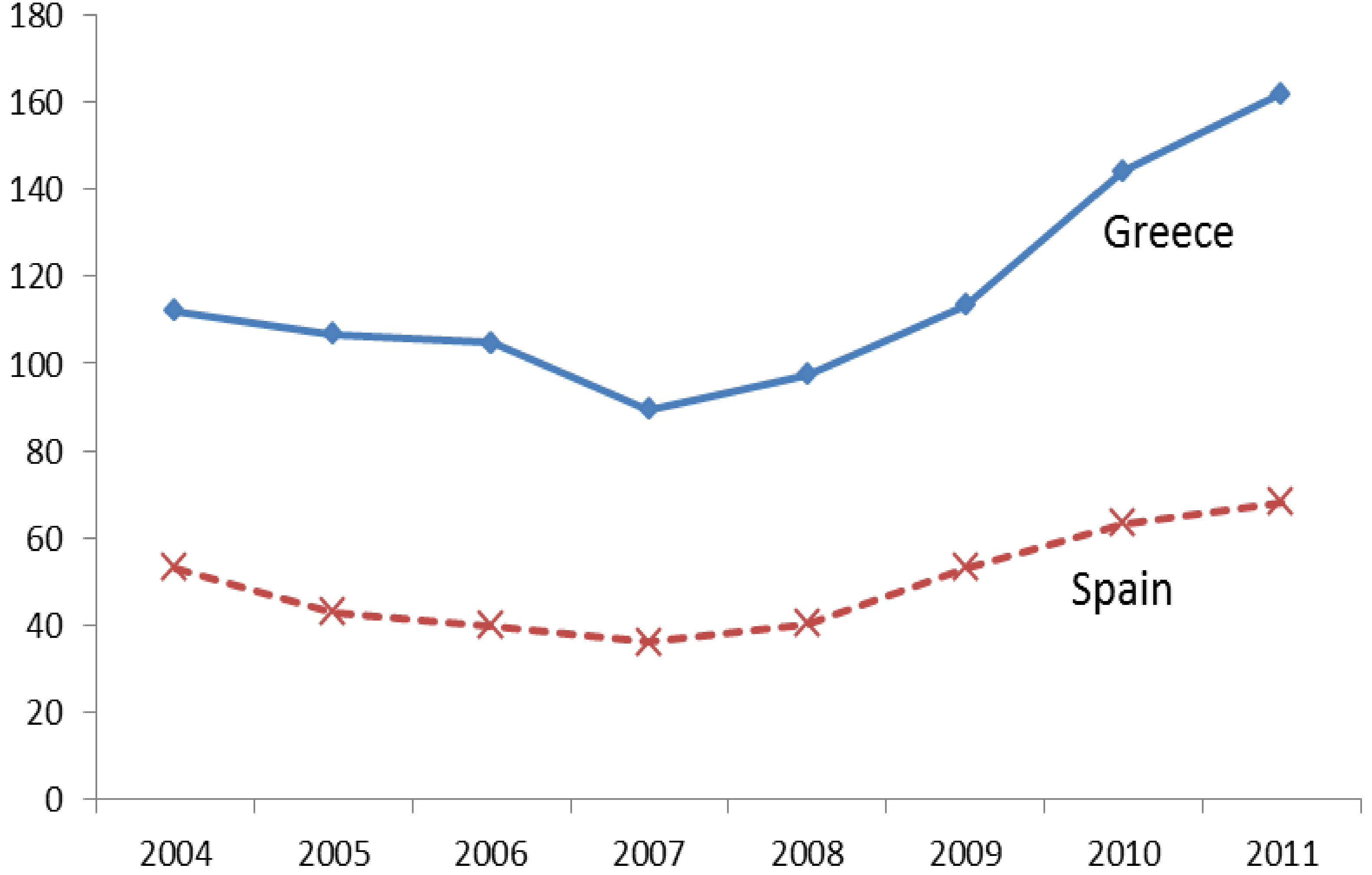
(% of GDP)

	Fiscal Bal. (2000-07)	Public Debt (2007)	Priv. Bal. (2000-07)	CA Balance (2000-07)
Greece	–5.4	89.5	–3.0	–8.4
Portugal	–3.7	63.6	–5.7	–9.4
Spain	+0.3	36.2	–6.1	–5.8
Ireland	+1.5	24.9	–3.3	–1.8
Germany	–2.2	64.9	+5.4	+3.2

BAILOUTS AND DEBT OVERHANG IN EZ

- EZ interventions:
  - Lending to periphery to avoid default (EFSF, EFSM and ESM)
  - ECB bond purchases and lending to banks to lower periphery borrowing costs
  - Debt write down for Greece using CACs (also retroactively in local-law bonds).
- Greece: Now 70% of its debt is officially held, but ECB and Germany resist official haircut (OSI) despite calls from IMF. Latest deal is a stop-gap to prevent default. Grexit may return soon with adjustment fatigue.
- Spain: €100b bailout from EZ funds to recapitalize banks. Unpayable private debt, including to foreign creditors, becoming public debt; no growth in sight.
- Debt ratios rising. Cannot remove debt overhang by cutting growth and adding to debt – failed Baker Plan (muddling through) in LA in 1980s.

Public debt (% of GDP)



INTERNATIONAL COOPERATION TO RESOLVE EZ CRISIS?

- Calls for international cooperation to resolve EZ crisis including to DCs.
- DCs have strong interests to have crisis resolved and EZ return to growth.
- However, EZ has no moral grounds to call on DCs to invest their hard-earned or borrowed reserved in euro-denominated junk bonds (thus take currency and credit risks) when EZ has all means to resolve this crisis between EZ-debtors and EZ-creditors, having the ability to issue an international reserve currency.
- EZ shifting default risk to IMF shareholders, including poor DCs, by lending to IMF to lend to EZ periphery rather than lending to periphery directly.
- Already IMF is heavily exposed to Europe and highly leveraged (high ratio of debt to equity); threat to its financial integrity.

RESTORING STABILITY AND GROWTH IN EZ

- Need for almost a full debt write-off for Greece. Bad bank debt in Spain should not fall on the government. Haircut by shareholders and unsecured creditors, including those in the core.

- Debt stabilization would not bring growth on its own. Growth in periphery calls for expansionary policies in Germany; wage increases and some inflation to allow periphery to improve competitiveness and reduce CA deficits.

- If Germany does not create demand and cut its surplus, periphery cannot reduce deficits by expanding exports, but by retrenching – cutting growth and imports.

- Adjustment in periphery based on internal (real) devaluations through cuts in wages is counterproductive – lessons from Argentina.

IMPACT OF THE CRISIS ON DCs: NO DECOUPLING

- Combination of rapid growth in DCs and weak growth in AEs before the crisis was widely interpreted as decoupling of the South.

- In the early days of the crisis DCs were also expected to decouple.

- However, mood changed as DCs were hit hard after Lehman collapse in 2008. Changed again when they recovered rapidly while AEs went into a tailspin.

- However, strong growth in DCs could not be maintained as global conditions have become generally unfavourable in almost all respects affecting their performance, including capital flows, worker's remittances, commodity prices and trade with AEs. Thus, a slowdown from pre-crisis 7.5% towards 5%.

CAPITAL FLOWS, CURRENCIES AND FINANCIAL MARKETS

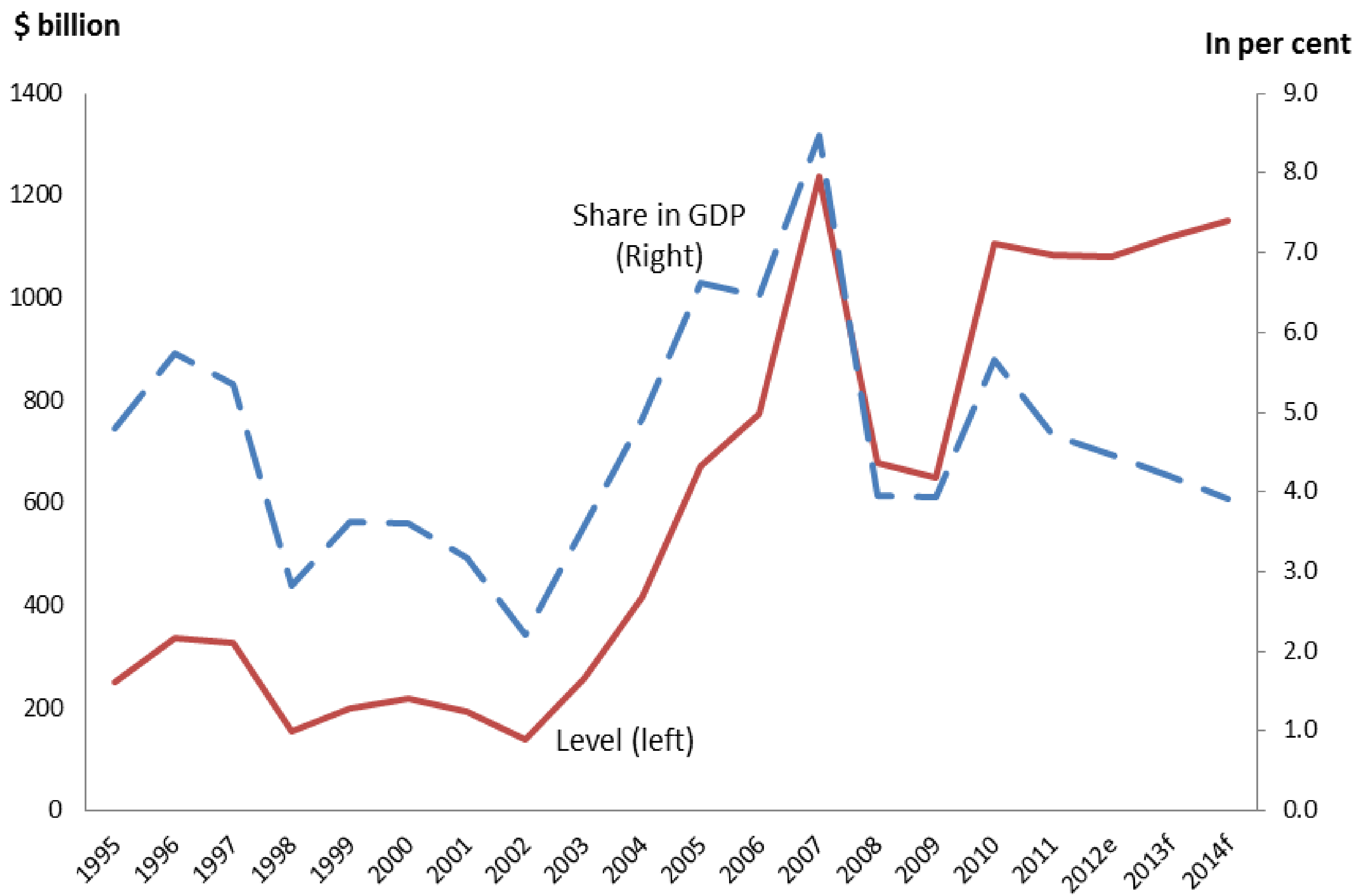
- Recovery of inflows after Lehman, helped by rate cuts and QE in AEs. But they are now 4% of recipient GDP against 8.5% in 2007. Pull factors now important.

- EZ main source globally. Pre-crisis EZ outflows exceeded US+Japan. They now fell from $1.6tr to $300b. EZ crisis has also added to instability; inflows became highly sensitive to EZ news (bearish in 2011/H2 and 2012/Q2; bullish now).

- But so far impact of EZ news on equity and bond markets of DCs is moderate Still, exit/default could lead to massive capital flight, as after Lehman.

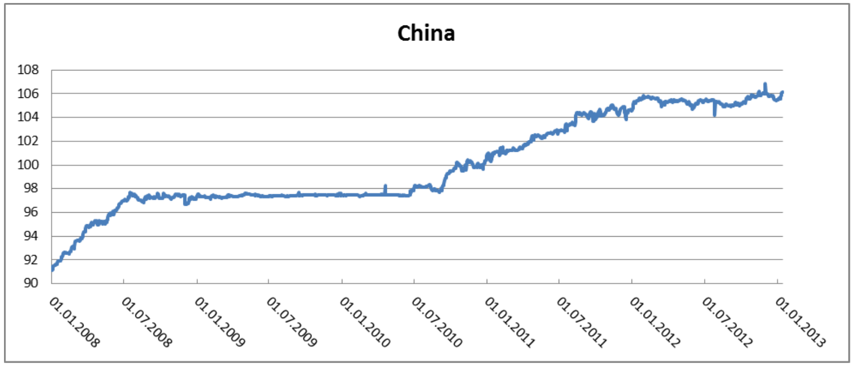
- Rate cuts and QEs in AEs initially led to upward pressures on currencies of DCs (currency wars and cross fire between Fed and ECB) when DCs were overheating. But since mid-2011 most DCs have slowed and seen depreciations. Currency war still going on among reserve currencies (now BoJ raising inflation target).

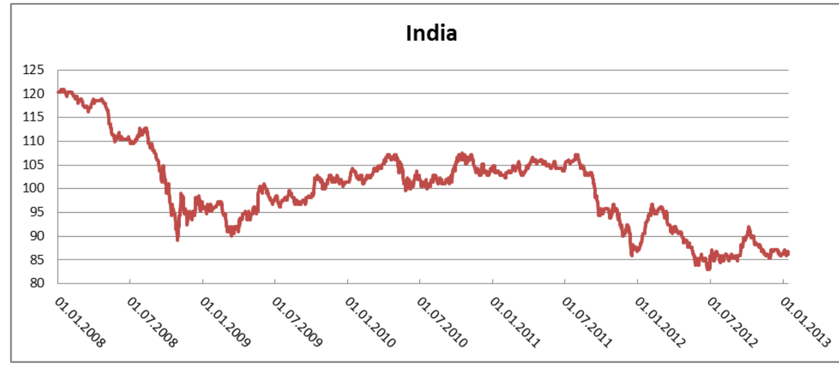
PRIVATE CAPITAL INFLOWS TO EMERGING ECONOMIES (IIF)

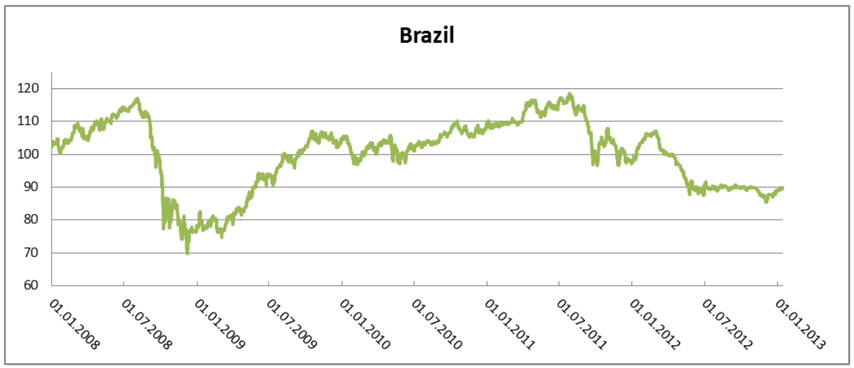


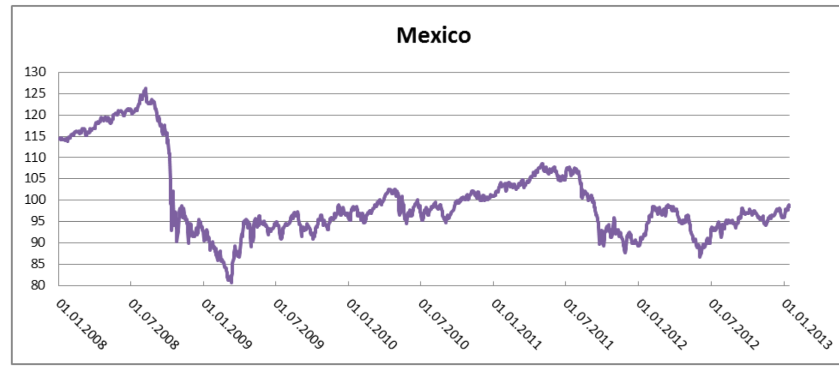
Exchange Rates 2008-2012

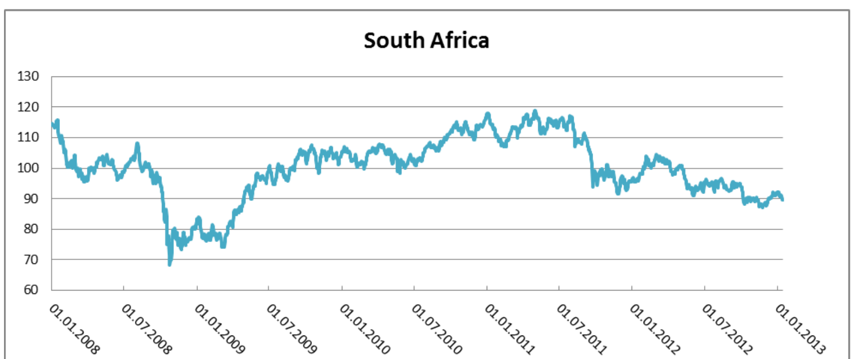
(U.S. dollars per domestic currency: period average=100)

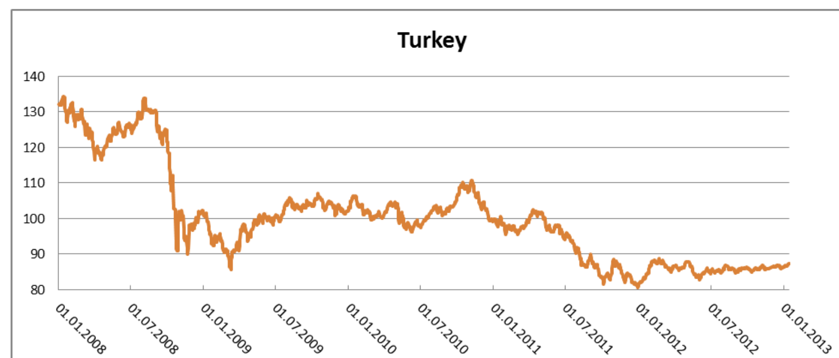








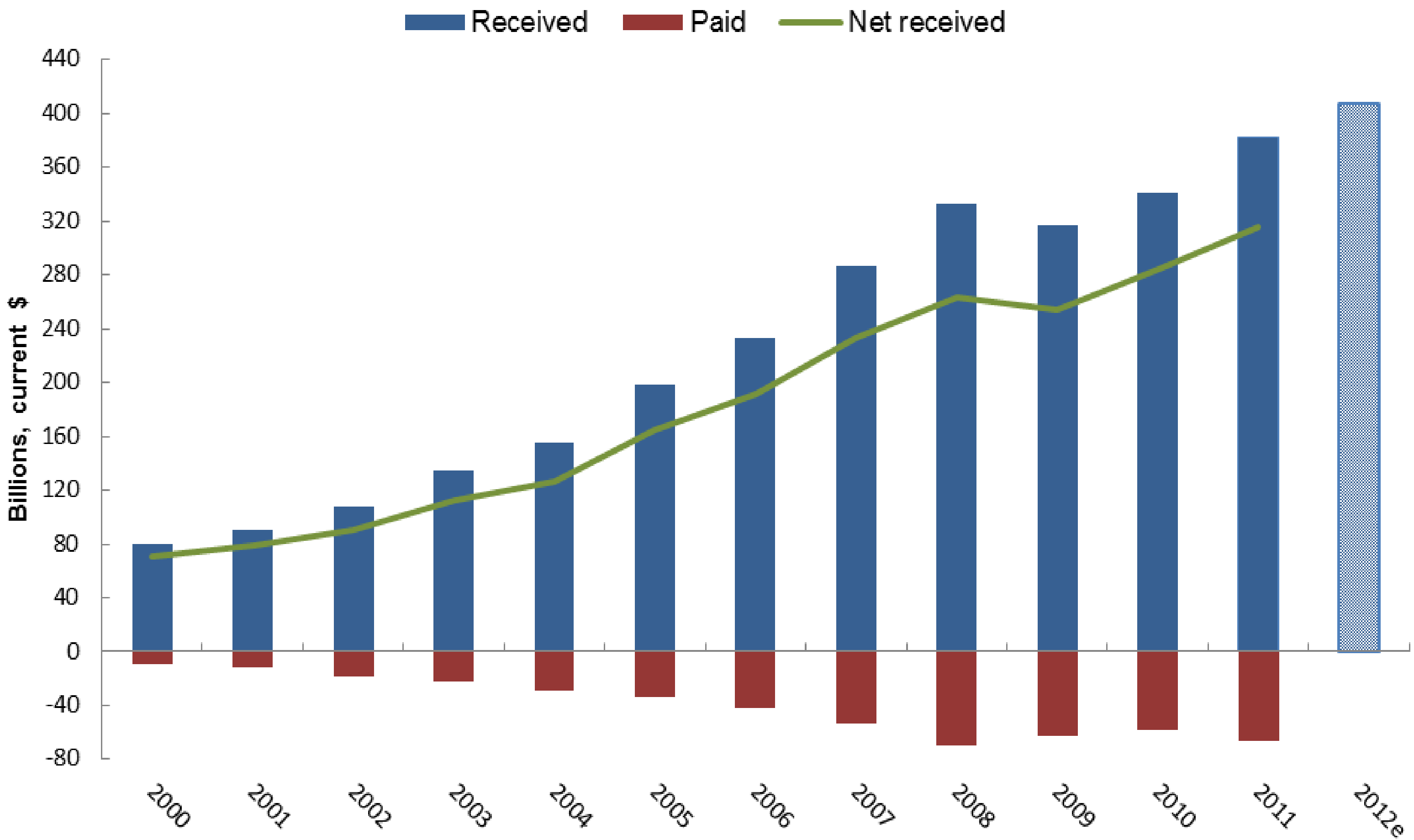




WORKERS' REMITTANCES

- US and EU crises have had some but not very strong impact on remittances even though they are main sources.
- Pre-crisis surge, with remittances growing 20% pa during 2002-08, reaching $320 billion and exceeding all inflows except FDI. Important for CA financing in many DCs (even in India, over 3%of GDP)
- With crisis a moderate decline in 2009, but recovery subsequently despite rising unemployment in EU and US and hardening political attitudes towards new migration; estimated to have reached $400 billion at the end of 2012.
- However, an increasing part appears to be coming not from current wage incomes but wealth accumulated by workers abroad, used for investment in DCs – capital flight from AEs because of growing risks and low return?

Remittances flows in developing countries *(2000-2012)*



COMMODITY PRICES

- Pre-crisis boom was driven by major importing DCs (China and to a lesser extent India) and made a major contribution to growth in LA and SSA.

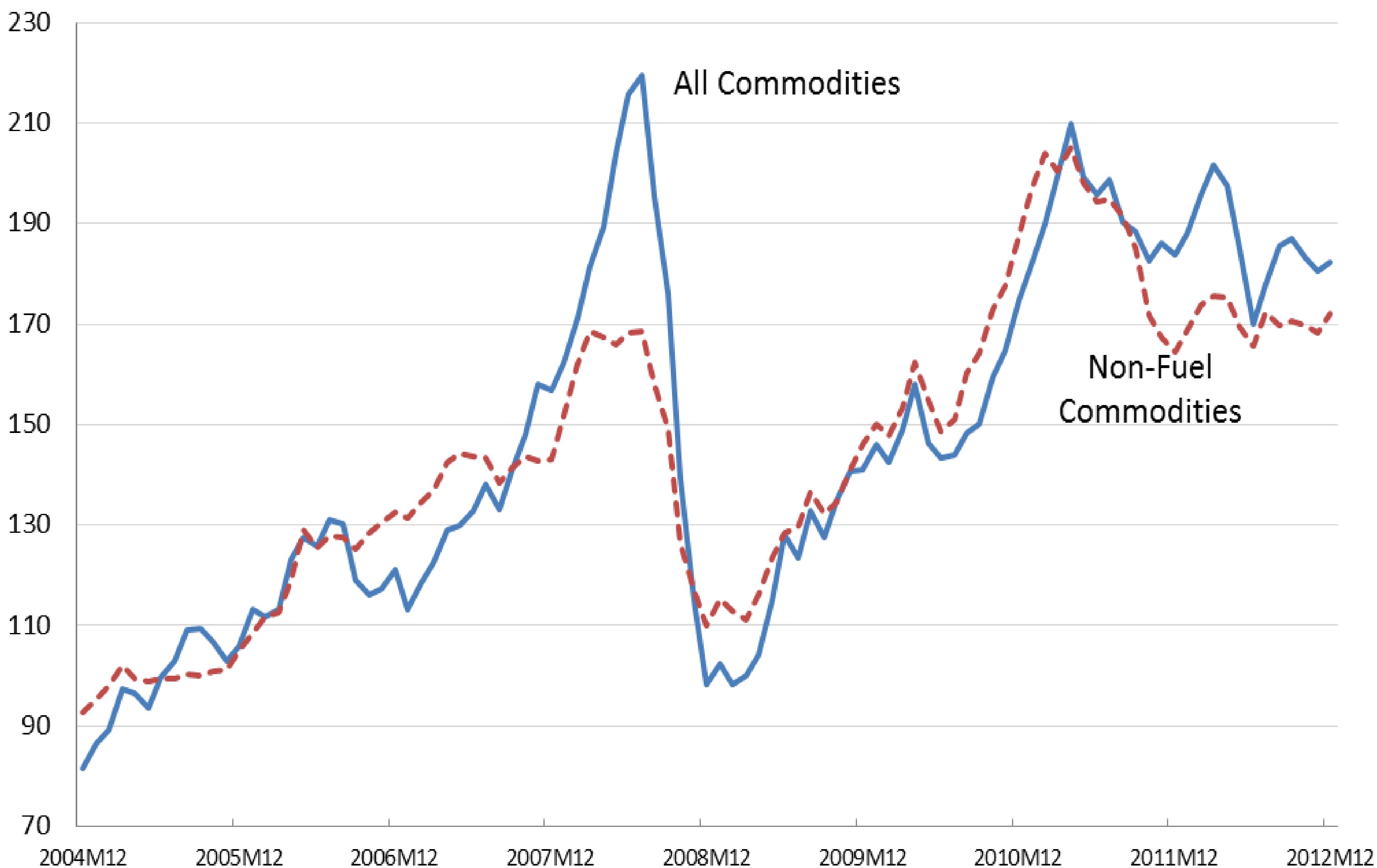
- Despite downturn in AEs, strong recovery in China lifted prices after 2008. Its commodity imports rose by 150% during 2007-11, manufactures by 60%.

- With slowdown in China and anaemic growth in AEs, prices softened after mid-2011. End-2012 nonfuel index was down 10% from 2011 and is expected to continue its downward trend in coming years.

- EZ crisis has made prices weaker by making dollar stronger than it would have otherwise been. It has also added to instability by triggering surges of entry and exit in markets for commodity derivatives; like capital flows, commodity speculation is highly sensitive to EZ news (optimism/pessimism)

Monthly Indices of Primary Commodity Prices, 2005-2012

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



TRADE IMPACT

- Crisis affected more severely export-led DCs of EA, notably China, as well as DCs in North and SSA closely linked to EU. Their exports fell sharply during 2008-09 followed by a weak recovery.

- Export declines to EZ during 2011-12 estimated to account for ¾ of the fall in growth in RSA, ¼ in China and India and hardly any in Brazil (OECD).

- Many poor DCs in SSA (Mozambique, Ivory Coast, Uganda) are highly susceptible to slowdown in EU because of strong trade links. 1% drop in export growth is estimated to reduce GDP growth by 0.5% points in LICs (ODI).

- For several commodity exporters China is now more important than AEs, both as a market and because of its effect on world prices. In 2007 Brazilian exports to EU (US) were 4 (2) times its exports to China. Now its exports to China are nearly same as to EU and almost twice its exports to US.

CRISIS AND GLOBAL IMBALANCES

- Pre-crisis debt-driven spending bubbles in US, UK and EZ. Major surplus (under-consumption) countries, Germany, Japan and China, all relying on exports. But unlike others China adding to global growth through strong imports.

- Now DCs have larger deficits or smaller surpluses. Before crisis, DCs in LA, Asia and SSA had a total CA surplus of $420b; now turned into deficit.

- EZ moved from $100b CA deficit to $140b surplus largely due to import cuts in periphery. Germany sustaining large CA surplus; now runs surplus against Asia and even China while Japanese and Chinese CA surpluses declining

- China rebalancing external and domestic demand, but Germany still dependent on exports; its GDP growing faster than domestic demand both before and since the crisis; main source of imbalance not only in EZ but also globally.

GDP, Domestic Demand and CA in main Surplus Countries

	2004-07	2010	2011	2012
Germany				
GDP growth	2.2	4.0	3.1	0.9
Domestic demand	1.1	2.6	2.6	0.1
Private consumption	0.5	0.9	1.7	0.7
CA (% of GDP)	5.9	6.0	5.7	5.4
Japan				
GDP	1.9	4.5	-0.6	2.0
Domestic demand	1.1	2.8	0.1	2.5
Private consumption	1.2	2.6	0.1	2.3
CA (% of GDP)	4.0	3.7	2.0	1.6
China				
GDP	12.1	10.4	9.3	7.8
Domestic demand	10.3	10.6	10.2	9.2
Consumption (total)	8.8	9.2	9.8	9.8
CA (% of GDP)	7.1	4.0	2.8	2.3

GROWTH PROSPECTS IN DCs

- Initial DCs resilience thanks to a strong countercyclical response.
- As impact of stimulus measures faded, recovery in US remained weak and EZ/UK/Japan have gone into double-dip, strong domestic-demand-led growth in DCs has come to an end.
- China is trying to avoid falling below 7.5% by large infrastructure investments, but others do not have the policy (fiscal or BOP) space : India, Brazil, Argentina, RSA and many others going back to their pre-subprime trend growth rates (around 6% for India and 3-4% for the others).
- Medium-term prospects are not very bright because of problems in three major drivers of the world economy; China, US and EU.

THE GLOBAL DRIVERS

- China's investment-led growth cannot work indefinitely. Although consumption has accelerated during 2011-12, still long way to go in domestic rebalancing and this faces hurdles. Risk of hard landing.

- US growth still hangs on fiscal cliff, though it is likely to be resolved. Ironically now brightest spot among AEs. But even if US could return to sustained growth, it cannot start acting again as a locomotive for underconsumption economies.

- EZ is the Achilles heel of the world economy. It cannot promise much growth even if it could stabilize debt. Periphery cannot go back to spending spree and large CA deficits. Unless Germany changes course, EZ will not add much to global demand and growth.

POTENTIAL SPILLOVERS FROM EURO BREAK-UP

- Global disruptions from a break-up of euro would be severe, even though not easy to estimate because past financial linkages provide little guide. Still, even without a break-up, deepening of the crisis could have strong global impact.

- IMF simulations of output losses due to higher EZ spreads: 5% in EZ; non-EZ Europe would be equally hard hit; 1-2.5% in US, India, China, Brazil and Africa. With policy response the impact could be weaker. But not all DCs have space.

- In a similar UN downside scenario, output losses would be greater in DCs than in US and Japan, with the strongest impact on Africa.

- If combined with hard-landing in China and more fiscal drag in US, a deepened EZ crisis could push world economy into depression. Strong spillovers among the three, now discovered to be stronger than is assumed in standard models.

STATE OF AFFAIRS IN THE SOUTH

- Rise of the South or decline of the North?
- Rapid pre-crisis growth but not much progress in industrialization outside China. Cannot be sustained (and there is no development) without industrialization.
- LA is becoming increasingly dependent on commodities (also in industry). Same in SEA. Brazilian commodity exports now exceed manufactures.
- India selling labour services (skilled and unskilled), not manufacturing products.
- Little industrialization in SSA – windfalls from large capital flows (Chinese FDI) and the commodity boom.
- Dependence of DCs on foreign capital and markets unabated; vulnerability.
- No significant change in the role of DCs in global economic governance.

POLICY AGENDA

- Is WC really dead? Not much roll back of policies shaped by WC
- Reconsider global integration; cannot leave development to global market forces. Successful industrialization is associated neither with autarky nor with full integration, but strategic integration in trade, investment and finance designed to use foreign markets, technology and finance to pursue industrial development.
- Redefine role of the state and markets, not only in finance but also in trade and industry. No industrialization without active industrial policy.
- Reorient macroeconomic policy from narrow monetary and financial objectives towards employment, growth and distribution.
- Need for collective action to reform global economic governance