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INTRODUCTION

This book is a collection of papers written for the South Centre during 2009-2011 on the global crisis triggered by speculative lending and investment in the United States and Europe – its actual and potential effects on developing and emerging economies (DEEs), the immediate international policy response needed in order to contain the damage and to restore stability and growth, and global systemic reforms that need to be introduced with a view to reducing the likelihood of such crises and managing them better if and when they occur.

Chapter 1, originally published in May 2009, provides an overview of the key issues regarding the policy response to the crisis from the point of view of DEEs. It discusses both the immediate countercyclical measures that need to be undertaken at the national and international levels and the reform of the international financial architecture. While recognizing that many DEEs had considerable policy space to counter destabilizing and deflationary impulses from the crisis, it is argued that several poorer countries faced resource constraints. Even though they could use trade and financial policies to ease the tightened payments constraint resulting from reduced private capital flows and exports, in most cases effective policy response depended crucially on the provision of adequate international liquidity on appropriate terms and conditions through multilateral financial institutions. The paper then goes on to make an assessment of the international liquidity support agreed on or already provided and makes proposals for alternative and additional mechanisms that could be used in the event of such crises.

Regarding the reform of the international financial architecture, on crisis prevention the chapter emphasizes the need to significantly improve the effectiveness, evenhandedness and the quality of International Monetary Fund (IMF) surveillance over macroeconomic, financial and exchange rate policies of systemically important countries; the reform of the existing international reserves system centred on the dollar, advocating a much greater role for the Special Drawing Right; and the regulation of international financial markets and systemically important financial institutions, without, however, imposing a one-size-fits-all model on DEEs and narrowing their policy space in regulating their domestic financial system and international capital flows and determining access to their markets in financial services.

On crisis intervention and resolution, the chapter argues against structural and deflationary macroeconomic conditionality in the provision of international liquidity to countries facing contagion. It also argues against bailouts of international lenders and investors in countries facing rapid exit of capital and proposes that ways and means should be found to involve international private creditors and investors in the resolution of balance-of-payments and debt crises in emerging economies, drawing on the principles of national insolvency laws. Several of the above measures needed for reducing the likelihood of financial crises with global repercussions and ensuring better crisis intervention and management call for fundamental changes in the IMF – an issue taken up in much greater detail in the last chapter on the reform of the international monetary system, written 18 months later, in November 2010, taking into account various initiatives and proposals in the UN, G20 and IMF in the interim.

Chapter 2, written at a time when recovery was under way in the major advanced economies, moves beyond the crisis and looks to medium-term prospects for the world economy. It is argued that the global economy suffers from a demand gap in large part because of sustained declines in the share of labour income in most major economies, including the US, Europe, Japan and China. Until the outbreak of the subprime debacle, the deflationary threat posed by underconsumption was averted and the global economy enjoyed a rapid growth thanks to debt-driven consumption and property bubbles in the US and several European economies. This, however, resulted in growing global trade imbalances and financial fragility which eventually culminated in a global crisis.

A return to the pre-crisis pattern of growth can prove to be more damaging. A global rebalancing between major surplus and deficit countries would be necessary. This cannot be done through nominal currency adjustments. These cannot address the problem of underconsumption associated with sluggish wages and create additional demand for the world economy as a whole, but simply serve to redistribute demand impulses across countries. A nominal appreciation of the Chinese yuan against the dollar will not solve Chinese underconsumption or US overspending. China should move to consumption-led growth through faster growth of wages. This would appreciate the real exchange rate of the yuan and reduce net exports, but it would at the same time provide a domestic offset by expanding domestic consumption, and hence allow it to maintain strong growth. The US should move to export-led growth not through wage cuts but through increased productivity through investment in infrastructure and education.

However, a US-China rebalancing would not be sufficient to restore an acceptable pace of growth in the world economy. The two major mature surplus economies, Japan and Germany, which have been siphoning global demand without adding to global growth, would also need to reduce their reliance on exports and add to global demand. Germany has been relying on exports for growth even more than China, primarily by wage suppression and competitive disinflation, which gave it a competitive advantage (that is, a real depreciation of the euro for Germany) vis-à-vis other eurozone countries, notably in the periphery where wages have been keeping apace with and even ahead of productivity growth. Until the outbreak of the subprime crisis, the resulting trade deficits in the periphery were financed with large capital inflows from the core eurozone countries, notably from German and French banks, encouraged by the changed risk perceptions and convergence of interest rates after the move to the Economic and Monetary Union. These unsustainable intra-eurozone imbalances and debt accumulation were laid bare with the global crisis. The crisis in the eurozone now constitutes the single most important threat to stability and growth in the world economy, in particular in DEEs.

German adjustment cannot be based on a nominal appreciation of the euro. This would not generate higher wages and faster growth of private consumption in Germany, but would hurt other eurozone countries. Indeed, it could simply give rise to further wage restraint through competitive disinflation.

By contrast, higher wage settlements in Germany would increase domestic consumption while producing a real appreciation of the euro for Germany, without leading to a corresponding appreciation for the periphery. In other words, higher German inflation holds a key not only to global rebalancing, but also to rebalancing within the eurozone.

Chapter 3 takes a closer look at China, now the number two economy in the world, whose policies are widely seen as the main source of global trade imbalances and currency instability. It is estimated that, despite a high import content ranging between 40 and 50 per cent, about one-third of Chinese growth before the global crisis was due to exports because of their phenomenal growth of some 25 per cent per annum. This figure goes up to 50 per cent if spillovers to consumption and investment are accounted for. The main reason for excessive dependence on foreign markets is underconsumption. This is due not so much to a high share of household savings in GDP as to a low share of household incomes and a high share of profits. It is argued that China can no longer maintain such high growth rates for its exports given the need for global rebalancing and prospects of slow and erratic growth in major advanced economies. It thus needs to turn to consumption-led growth by expanding the share of wages and household income in GDP and accelerating public spending in social infrastructure.

However, during 2008-09 China responded to the slowdown in exports with a massive investment programme, creating considerable excess capacity not only in property and infrastructure but also in some industries such as steel, financed by rapid credit expansion and debt accumulation by local governments. While investment filled the demand gap, consumption lagged behind income. As the effects of this package started to fade out in the course of 2011, another investment boom appears to have got under way, with fixed investment growing by almost 26 per cent and property investment by 33 per cent year-on-year in the first half of the year. Unless accompanied by rapid export and/or consumption growth, such debt-driven investment booms can eventually threaten stability and growth no less than did the debt-driven consumption and property bubbles in the US. Efforts to keep filling the demand gap with investment may postpone the underconsumption crisis, but only for it to come back with greater force.

In the coming years – possibly by the middle of the decade – Chinese growth can be expected to come down considerably compared to pre-crisis levels, particularly if the EU and/or the US experience a second dip. Given the problems of inflation, overinvestment and fragility of many of its lending institutions, China has limited policy space in responding to the demand gap in the same way as it did in the last three years. A sharp drop in Chinese growth could mark the end of not only the asset and credit bubbles there, but also the boom in commodity markets and capital inflows to DEEs.

If strong growth in China sustained through rapid credit expansion and investment is one factor making a major contribution to growth in several DEEs, notably commodity-rich ones, another factor is the surge in capital inflows from advanced economies. This issue is taken up in Chapter 4, which examines the capital flows to DEEs during the subprime boom-bust cycle in a historical context. It is noted that while advanced economies continue to encounter debt deflation, financial stringency and insolvency, many DEEs have been facing rapid credit expansion and asset inflation and the risk of overheating and hard landing. Except for a brief interruption in 2008 after the collapse of Lehman Brothers, they have been getting large capital inflows as major advanced economies have responded to the crisis caused by excessive liquidity and debt by creating still larger amounts of liquidity to bail out troubled banks, lift asset prices and lower interest rates. Quantitative easing and close-to-zero interest rates have been generating a surge in capital flows into countries with higher interest rates and better growth prospects.

This is the fourth post-war boom in capital flows to DEEs. The previous booms were also associated with a rapid expansion of global liquidity and exceptionally low interest rates in the US, and all ended with busts under tightened global financial conditions, including higher US interest rates and a stronger dollar. The first one ended with a debt crisis in the 1980s when US monetary policy was tightened, and the second one with a sudden shift in the willingness of lenders to maintain exposure in East Asia. The third boom developed alongside the subprime bubble and ended with the collapse of Lehman Brothers and flight to safety in late 2008. Unlike previous episodes, the Lehman reversal did not cause serious dislocations in DEEs because of generally strong payments and reserve positions, reduced mismatches in balance sheets and, above all, the short duration of the downturn and rapid recovery of capital inflows in 2009.

The renewed surge in capital inflows has created different imbalances and fragilities in different DEEs according to their degree of openness to various forms of capital and policy response. Major economies such as Brazil, India, South Africa and Turkey have been relying increasingly on foreign capital to meet their growing external shortfalls and many of them have been experiencing currency appreciations faster than surplus DEEs in East Asia. By contrast, most East Asian countries have been successful in maintaining strong payments positions, but they have also been facing credit and asset bubbles. In other words, all major recipients are now exposed to the risk of a sudden stop and reversal, though in different ways, even to a greater extent than that experienced after the Lehman collapse.

The risk-return profile and growth differentials that now favour DEEs in the eyes of international lenders and investors cannot be expected to last indefinitely. Still, experience shows that it is almost impossible to predict the timing of stops and reversals and the events that can trigger them even when the conditions that drive the surge in capital flows can be diagnosed to be unsustainable with a reasonable degree of confidence. Various scenarios are explored in Chapter 4 regarding possible events that could end the boom with a sudden stop and even reversal, including a sharp increase in interest rates in the US resulting from increased inflationary pressures associated with the commodity boom or pressures from bond markets, a sharp slowdown in China, a payments crisis in a major emerging economy with growing current account deficits and international contagion thereof, and widening and deepening of the debt crisis in the eurozone and a consequent double dip in the US and EU. Indeed, growing risks in many of these areas are now making international investors highly nervous, creating a tendency to flight to safety and sizeable capital outflows from some emerging economies and sharp drops in asset and currency markets.

For the DEEs, the greatest threat comes from the European periphery – now the Achilles' heel of global finance. As long as the European Commission and the European Central Bank fail to diagnose the origin of the problems correctly and to put in place viable solutions, the region will remain susceptible to extreme instability and messy defaults, with attendant consequences for growth and stability in DEEs.

In all likelihood, the end of the current boom in capital flows can be expected to be disorderly and to coincide with a reversal of the upswing in commodity prices. The countries which have been enjoying the twin benefits of global liquidity expansion – that is, the boom in commodity prices and capital flows – as well as those running growing deficits are particularly vulnerable. Asian economies with strong current account and reserves positions are unlikely to face serious payments and currency instability even in the event of sharp and sustained declines in capital inflows. However, their financial markets are highly exposed to destabilizing impulses from abroad because of increased foreign presence and their closer integration into the international financial system. The consequent damage could be more severe and longer-lasting than that experienced during the Lehman collapse, given the significantly reduced policy space in responding to renewed instability, at both the global and national levels.

The world economy is now facing renewed risks of instability and downturn before fully recovering from the so-called Great Recession, and the chances of averting such an outcome are becoming quite slim. This is in part because the imbalances and fragilities built up over several years in the past as a result of misguided policies in the US and Europe cannot be easily undone, regardless of the policy pursued today. However, there have also been serious shortcomings in the policy response to the crisis in major mature and emerging economies in both countering the deflationary and destabilizing impulses and addressing the underlying structural and systemic problems.

After a good start in London in early 2009 with a coordinated policy response, disagreements emerged both within and across major members of the G20 group of leading economies regarding how to proceed. Fiscal response in the US has fallen too short to meet the challenge and focussed on private consumption rather than investment as called for by a shift to export-led growth. The EU has been too quick in tightening monetary policy to fight a non-existent inflation and in getting into fiscal consolidation which could well prove to be self-defeating. Governments in advanced economies have been unwilling to devise mechanisms to write off unpayable private debt, in some cases making such debt even less payable by imposing austerity on debtors. The US has been engaged in a beggar-my-neighbour monetary expansion, exploiting its "exorbitant privilege" and flooding the world with dollars, effectively seeking competitive devaluation vis-à-vis its trading partners. No matter of importance has been resolved regarding the reform of the international financial architecture, to address shortcomings in crisis prevention, management and resolution; to secure symmetrical adjustment between deficit and surplus countries; to move away from an inherently unstable international reserve system centred on the dollar; and to establish orderly and equitable sovereign debt workout mechanisms – areas that are particularly important for DEEs.

The latter economies have no doubt incurred a relatively heavy burden due to fallouts from a crisis they could not be held responsible for. But it is also true that they benefited from the global locomotive role played by the US based on debt-driven property and consumption bubbles, through capital inflows, the boom in commodity prices and rapid expansion of exports. But their growing dependence on foreign markets and/or capital inflows has made them particularly vulnerable to shocks from mature economies. They have been generally unwilling to impose effective restrictions on capital inflows, even when they were not needed (that is, in countries with strong payments and reserve positions), allowing them to create credit and asset bubbles and link their economies more closely to mature markets, hence increasing their exposure to external financial shocks.

While many major emerging economies responded vigorously to trade and financial fallouts from the subprime crisis, policy response has not always been designed to address their structural problems. China's stimulus package focussed on investment rather than underconsumption, while several countries running current account deficits started to appreciate their currencies even faster once capital inflows recovered in 2009, allowing their deficits and hence dependence on foreign capital to grow even more rapidly. Given the sluggish growth and even the risk of a double dip in the US and Europe and the growing risk of renewed financial stress, extreme risk aversion and reversal of capital flows, the developing world is unlikely to sustain the strong growth seen since mid-2009. And they would be in a much weaker position to respond to another crisis with their own means.

DEEs need to take measures in order to sustain growth and reduce their vulnerability to external shocks. The main challenge facing East Asia is to reduce their dependence on exports to advanced economies and expand national and regional markets. This calls for a redistribution of income to secure higher shares of wages and the household sector in national income and to establish a welfare state to provide basic needs in housing, health and education to the poor.

For most emerging economies in other regions, there is a need to reduce dependence on capital inflows. Collectively DEEs have been running a current account surplus and they do not need capital from advanced economies for external financing. In fact they have been recycling their twin surpluses to the advanced economies in the form of investment in reserve currencies. However, a number of DEEs have been running structural deficits and are dependent on capital inflows to finance imports, investment and growth. There is thus a need to establish, at both the regional and global levels, reliable and stable mechanisms for South-South recycling from surplus to deficit countries without going through Wall Street or the City.

Finally, many major emerging economies outside Asia need to move away from dependence on commodities, towards high-value manufacturing. This calls for fresh thinking on industrial policy, adapting the traditional instruments and mechanisms to the changed new global environment and innovating new and effective ones.

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