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A weak and problem-ridden global economy

The world economy is in poor shape. Economic growth is at the lowest level since the global crisis erupted and almost half of what it was during the pre-crisis peak. Misguided policies in the US and Europe in response to the crisis, namely fiscal orthodoxy, creditor bailouts, debtors' austerity and ultra-easy monetary policy have played an important part in this state of affairs. These policies have not only failed to secure a rapid recovery, but have also aggravated the global demand gap by widening inequality, and increased financial fragility by producing a massive build-up of debt and speculative bubbles in asset markets in several countries, including in the South. Potential output has been falling due to lack of investment despite historically low interest rates, and productivity has been slowing down.

The South is also not in good shape. As we stated in our statement to the October 2016 ministerial meeting, there is a feeling that the crisis has moved to emerging and developing economies in a third wave after having swept from the US to Europe. Developing economies had exceptional growth in the run up to the crisis, surpassing growth in advanced economies by an unprecedented five percentage points. They also had a rapid recovery from the 2009 downturn. However, South Centre research indicates that rapid growth in the South was due not so much to improved fundamentals such as investment and productivity growth as to exceptionally favourable global economic conditions, notably the twin booms in commodity prices and capital inflows, brought about by policies in the three key economies. When these booms petered out, growth in the South started to converge to the depressed levels of advanced economies. Today it is less than half of what it was on the eve of the financial crisis and the growth differential with the North has fallen from five percentage points to two points.

In the medium term, confronting inequality, the demand gap and financial fragility

The evolution of the world economy over the coming years will depend very much on how systemic and structural problems will play out and on policies and conditions in the major economies. How much success can be achieved in addressing the interacting challenges of inequality, the demand gap and financial fragility is most critical.

The global economy suffers from a deflationary gap because of growing inequality in major economies. Contrary to the predictions of mainstream economics, the share of labour in national income has been on a downward trend in all major advanced economies including the US, the EU and Japan since the 1970s. This was also the case in China until 2011 when it was reversed thanks to efforts to rebalance external and domestic demand, and investment and consumption.

The declining and low share of wages in income, together with increased concentration of wealth and asset incomes at the top means that the purchasing power of workers over the goods and services they produce have been falling, resulting in underconsumption and a structural demand gap in the world economy. This is also the main reason why investment has been sluggish despite historically low interest rates. In other words, rising inequality is not just a social problem but has also become a macroeconomic problem.

Sluggish wages also reduce inflationary pressures and allow and encourage central banks to pursue expansionary monetary policy. There is a remarkable correlation between declining wage share and declining real interest rates. Moreover, a strong inverse correlation is found between declining real interest rates and rising debt as a proportion of GDP in major advanced economies. Since rising debt makes it even more difficult for central banks to raise interest rates, wage suppression and growing inequality tend to push capitalist economies into a debt trap.

Challenges and policy issues for the Global South

Even in the absence of renewed external trade and financial shocks, emerging and developing economies are unlikely to show a strong growth performance in the years ahead because of their weak growth fundamentals, investment and productivity. On the other hand, their resilience to external shocks is generally weak, particularly in comparison to the situation before the onset of the sub-prime crisis.

The significantly deepened integration of many of these economies into the international financial system in the new millennium has resulted in new vulnerabilities and heightened their exposure to external financial shocks. There has been a massive build-up of dollar debt by their non-financial corporations since the crisis. On the other hand, the presence of non-residents in local financial markets of these economies has reached unprecedented levels, increasing their susceptibility to global financial boom-bust cycles.

Second, many countries in the South have seen a significant deterioration in their current account balances and net foreign asset positions since the crisis. In most countries international reserves built up in recent years came from capital inflows rather than current account surpluses. They are thus “borrowed” rather than “earned” reserves.

Finally, the fiscal space of developing countries for countercyclical policy response to deflationary shocks is much more limited today than in 2009. There is also a significant loss of monetary policy autonomy as a result of their deepened global financial integration. Flexible exchange rate regimes adopted in many emerging economies since the last bouts of crises are no panacea in the face of severe and sustained financial shocks, particularly in view of currency risks assumed by non-financial corporations.

In sum, many emerging and developing economies have not only lost their growth momentum but find themselves in a tenuous position with an uncanny similarity to the 1970s and 1980s when the combined booms in capital flows and commodity prices that had started in the second half of the 1970s ended with a debt crisis as a result of a sharp turnaround in the US monetary policy, costing them a decade in development.

This state of affairs raises three sets of policy issues for the South. The **first** one concerns the policy response to severe balance-of-payments shocks. In this respect they would be well advised to avoid "business as usual", hiking interest rates, using reserves and borrowing from the IMF to maintain an open capital account and stay current on debt payments to foreign creditors, socializing private liabilities, and resorting to austerity. Rather, they should seek to bail in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills and use selective import controls to safeguard economic activity and employment. They would also need to push for action at the multilateral level in support of such policies through provision of adequate international liquidity without deflationary conditionality and protection against creditor litigation.

Second, there is a need for rethinking global integration. Emerging and developing economies have allowed too much room for global market forces to drive their development, relying excessively on foreign markets and capital, and transnational corporations. In many economies, income and wealth are highly concentrated but there is limited savings and investment by the rich, and hopes are pinned on foreign investors to come and lift the economy. The pendulum has swung too far and would have to be rebalanced, and this requires putting one's house in order in the first place. Many emerging and developing economies are bewildered by the popular backlash against globalization in the North. This should not have come as a surprise. It is the outcome of inequalities, instabilities and insecurities produced by global integration driven by corporate interests.

What is surprising is that several emerging and developing economies have been willing to join arrangements such as the TPP designed mainly to promote the interests of TNCs, or that the backlash against NAFTA is not led by Mexico which has suffered poor economic performance since its inception. It is striking that both Mexico and the US could claim that they lost from NAFTA. The question is often posed whether international trade and investment are a zero-sum game among nations, but these are rarely seen as a negative-sum game. However, nations are not the correct focus here; it is not nations that lose or gain, but different segments of the population – corporations, bankers, workers, farmers, and so on. This suggests that the analysis of globalization based only on their national impact is inadequate and that there should be greater attention to its impact on different classes and segments of the population.

Finally, the challenges that emerging and developing economies now face raise once again the question of global economic governance – reform of the international trading and financial architecture so as to prevent beggar-my-neighbour policies of major economic powers, to reduce exposure of the South to external shocks, and to introduce adequate mechanisms for the prevention and effective management of financial crises with international origins and consequences. Several ideas for reform have been advanced in the past three decades in these areas. Although some of these have found their way from time to time into the international agenda, particularly after bouts of virulent crises, hardly any action has been taken to bring them to conclusion because of opposition of major advanced economies.

Developing countries have not been very effective in pursuing these matters and suffer from a collective action problem. Political solidarity and a common reflection may be needed among them about the policy response to the next major turmoil and in setting priorities and the agenda for change in the global economic governance. Efforts to upgrade the effectiveness of the G24, as well as the G77 and other groupings of developing countries, acting as a group will require the strengthening of technical support and intensifying coordination activities. The stakes are getting too high now to continue with business as usual. The South Centre stands ready to do its part in this regard.