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The Financial Crisis and the Global South: Impact and Prospects

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The world economy has not fully recovered from the effects of the financial crisis that began a decade ago in the US. Despite the recent cyclical bounce-back global income growth remains well below the levels recorded in the run-up to the crisis. Recovery in the US has been sluggish by historical standards and unbalanced between the poor and the rich, and finance and industry. The Eurozone has been unable to resolve its financial crisis let alone economic and social crisis. Potential growth has fallen in both the US and Europe because of inadequate demand, weak investment and sluggish productivity growth. Exceptional monetary policy measures introduced to deal with the crisis are still in place.

The economic landscape is not much better in the global South. The crisis has moved in a third wave to several emerging economies after having swept from the US to Europe. Major emerging economies that were expected a few years ago to become global locomotives are now struggling to revive growth. The jury is still out on whether the second largest economy, China, will be able to avoid financial turmoil and growth collapse.

A central factor responsible for this state of affairs is policies pursued in response to the crisis in the US and Europe. There are two major shortcomings: the reluctance to remove the debt overhang through timely, orderly and comprehensive restructuring, and fiscal orthodoxy. These resulted in excessive reliance on monetary policy, with central banks going into uncharted waters including zero and negative policy interest rates and rapid liquidity expansion through large acquisitions of public and private bonds.

These policies have not only failed to secure a rapid recovery, but also aggravated the global demand gap by widening inequality and global financial fragility by producing speculative bubbles and a massive build-up of debt almost everywhere, by some additional $50 trillion since 2008, outpacing the growth of world nominal income. They have also generated strong deflationary and destabilizing spillovers for emerging and developing economies (EDEs).

The fortunes of EDEs traditionally varied with conditions in international commodity markets because of their dependence on commodity exports. However, global financial conditions have increasingly become a stronger influence because of their deepened integration into the international financial system, financialization of commodities, and mutually reinforcing impulses between international financial and commodity markets, described as commodity-finance nexus. There has been a strong correlation between commodity prices and capital inflows to EDEs in the new millennium, and growth in the South has gone up and down with them.

Conditions in global financial markets are shaped by policies in major advanced economies, notably the US, while China has a strong influence on commodity prices. The boom in capital flows resulting from the very same credit and spending bubbles that culminated in a severe crisis in the US and Europe, and the so-called super cycle in commodity prices, largely due to increased demand by China and other major EDEs, came to an end with the collapse of Lehman Brothers in the US in 2008. However, the downturn was short-lived. Capital flows recovered rapidly due to the sharp cuts in interest rates and rapid monetary expansion in the US and Europe. Commodity prices also picked up thanks to a massive investment package introduced by China in response to contraction of its exports to the US and Europe and a rapid recovery in EDEs.

The boom in capital flows started to dampen in 2014 on expectations of tighter monetary policy in the US. In 2015, for the first time in many years, net capital flows became negative and reserves declined in EDEs, just as their current account financing needs increased. Currency and assets markets came under strong pressure after sustained booms supported by capital inflows. The downturn in commodity prices that started in 2011 coincided with a slowdown in China and other EDEs. Declines in energy prices have been steeper than other commodities because of excess supply created by large investment projects financed with cheap money, notably in US shale oil. They have depressed growth not only in EDEs but also globally because of sluggish demand in advanced economies.

World trade slowed significantly from the mid-2000s. This is caused not so much by the rise of protectionism as structural factors. First, there has been no more big-bang liberalization. Second, the expansion of global supply

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chains has lost its initial momentum. Third, the slowdown in investment has led to a decline in trade relative to income since investment is more import-intensive than consumption. Fourth, the rebalancing of external and domestic demand by China has resulted in a slowdown in its imports because Chinese exports are more import intensive than domestic spending. Finally, there is significant import substitution in export sectors in China where imported parts and components have gradually come to be produced domestically.

There have also been significant shifts in global balances. First, current account balances have been moving against EDEs and in favour of advanced economies. The sharp decline in commodity prices is an important but not the only factor. Second, there is a remarkable convergence between current account balances of the US and China and a significant decline in China's bilateral trade surplus with the US. Finally, current account of the Eurozone shifted from deficit to surplus as a result of austere policies pursued in the region. German surplus as a per cent of GDP now surpasses China's by a large margin.

Global economic prospects depend on how systemic and structural problems would play out. Growing inequality in major advanced economies and China is creating a problem of underconsumption and restraining aggregate demand. The attempt to address the demand gap with debt-driven spending bubbles generates significant financial instability. In the same vein, the beggar-thy-neighbour policies pursued to overcome stagnation by relying on foreign demand are a source of tension in the international trading system.

These difficulties could be aggravated by policies advocated by the new US administration. On the macroeconomic side they could produce a steeper path for US interest rates and stronger dollar – factors anathema to financial instability and crises in the South through their effects on capital flows and commodity prices. Tariffs and export subsidies advocated could also hit EDEs since they account for a large proportion of US imports and trade deficits. Japan and Germany also run high surpluses in absolute terms, but as a per cent of GDP, top five countries running surpluses with the US are EDEs.

Global prospects also depend crucially on developments in China. Its efforts to create a vibrant domestic consumer market have so far yielded little results and it keeps going back to debt-driven investment bubbles as growth falters. It faces a secular decline in growth, from double-digit levels to some 6 per cent. Although its corporations are over-indebted, a Lehman-type meltdown is highly unlikely in view of close state control over creditors and debtors. Global spillovers from a financial turbulence in China can be expected to remain more limited than those from the subprime crisis.

Even in the absence of renewed external trade and financial shocks, EDEs are unlikely to repeat their pre-crisis growth performance in the years ahead because of weak investment, slow productivity growth and a less favourable global economic environment. Their resilience to external shocks is weak, particularly in comparison to that during the subprime crisis. The deepened global financial integration of many of these economies has resulted in new vulnerabilities and heightened their exposure to external financial shocks. Their policy options are limited in responding to deflationary and destabilizing external impulses. Many EDEs 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. It would now be difficult for some of them to avoid liquidity and even debt crises in the event of severe and durable financial shocks.

This state of affairs raises three sets of policy issues for the global South. The first one concerns the policy response to a possible tightening of global financial conditions resulting from a reversal of ultra-easy monetary policy in the US. EDEs need to avoid "business as usual" response, hiking interest rates, using reserves and borrowing from the IMF and resorting to austerity to maintain an open capital account and stay current on debt payments. 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.

Second, they need to rethink global integration. Most EDEs have allowed too much room for global market forces to drive their development, relying excessively on foreign markets and capital, and transnational corporations. The pendulum has swung too far, particularly in investment and finance and would have to be rebalanced.

Finally, the challenges that EDEs now face raise once again the question of global economic governance – reform of the international trading and financial architecture so as to discipline beggar-thy-neighbour policies of major economic powers, to reduce exposure of the global South to external shocks, and to introduce adequate mechanisms for the prevention and effective management of financial crises with international origins and consequences. 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. The global South has not been very effective in pursuing these matters and suffers from a collective action problem. Political solidarity and a common reflection may be needed among EDEs about the policy response to the next major turmoil and in setting priorities and the agenda for change in global economic governance.

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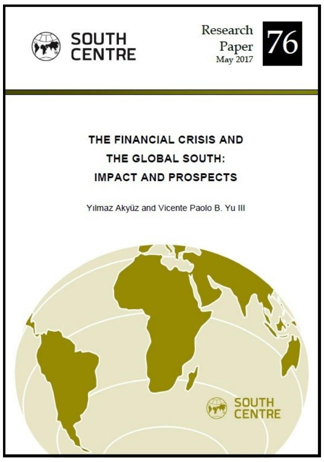

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