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North's policies are exposing South's economies to shocks

Dr. Yilmaz Akyuz (extreme left) making his keynote presentation at the conference.

Since the onset of the global economic crisis, the South Centre in its analysis had indicated that the policy responses to the crisis by the US and EU are exposing developing countries to serious shocks in the future. Dr. Yilmaz Akyuz (Chief Economist of the South Centre) notes that these arguments are no longer predictions but hard reality. He was speaking at the South Centre Conference in Geneva.

By Kinda Mohammadieh
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Dr. Yilmaz Akyuz, chief economist of the South Centre, delivered the keynote speech of the first session.

Dr. Yilmaz Akyuz commenced his keynote presentation by noting that, since the onset of the crisis, the South Centre has argued that policy responses to the crisis by the EU and the US suffered from serious shortcomings that would delay recovery and entail unnecessary losses of income and jobs, and also endanger future growth and stability. He reminded the participants that while his analysis indicated that developing countries could benefit in some respects in the short-term, notably from the policy of easy money, he had highlighted that they would be exposed to serious shocks in the future.

Dr. Akyuz noted that there is little to add to what was previously said, except that these arguments are no longer wild guesses or prognostications, but hard reality. He called for reassessing the situation and thinking of ways to respond to a renewed turmoil.

Dr. Akyuz highlighted that the world economy is not in a good shape, despite cautious optimism from the IMF. Six years into the crisis, which was declared recession at the beginning of 2007, the US has not fully recovered, the Euro zone has barely started recovering, and developing countries are losing steam, Akyuz noted. There is fear that the crisis is moving to developing countries, he added.

Dr. Akyuz noted his concern in regard to the longer-term prospects for three main reasons. First, the crisis and policy response aggravated systemic problems, whereby inequality widened. Inequality is no longer only a social problem, according to Akyuz, but also presents a macroeconomic problem. Inequality is holding back growth and creating temptation to rely on financial bubbles once again in order to generate spending. Secondly, global trade imbalances have been redistributed at the expense of developing countries, whereby the Euro zone - especially Germany - has become a deadweight on global expansion, Akyuz added. Third, systemic financial instability remains unaddressed, despite the initial enthusiasm in terms of reform of governance of international finance, and in addition there are new fragilities added due to the ultra easy monetary policy.

Moreover, China is not only moving to slower growth but can also face hard landing due to the debt overhang created by its response to fallouts from the crisis, Akyuz added. According to him, the situation of China is becoming a problem rather than a solution. Furthermore, Akyuz was of the opinion that developing countries have not responded to the situation properly, thus often failing to manage booms in commodity prices and capital flows, which made them vulnerable to financial shocks.

The policy response to the crisis has been an inconsistent policy mix, including fiscal austerity and ultra-easy monetary policy, Akyuz explained. While the crisis was created by finance, the solution was still sought through finance, he cautioned. Countries focused on a search for a finance-driven boom in private spending via asset price bubbles and credit expansion. Fiscal policy has been invariably tight. The ultra-easy monetary policy created over USD 1 trillion fiscal benefits in the United States, which was more than the initial fiscal stimulus, Akyuz noted. The entire initial fiscal stimulus in the United States was limited to USD 800 billion.

Akyuz indicated that there was reluctance to remove debt overhang through comprehensive restructuring (i.e. for mortgages in the United States and sovereign and bank debt in the European Union). Thus, the focus was on bailing out creditors, he noted. There was also reluctance to remove mortgage overhang and no attempt to tax the rich and support the poor – particularly in United Kingdom and the United States - where marginal tax rates are low compared to continental Europe, Akyuz added. There has been resistance against permanent monetization of public deficits and debt, which according to Akyuz does not pose more dangers for prices and financial stability compared to the ultra-easy monetary policy.

Akyuz noted that the International Monetary Fund (IMF) and central banks have been releasing evidence that without the ultra-easy monetary policy the crisis would have been deeper. Yet, there is no discussion of an alternative policy mix, including debt workouts and fiscal stimulus nor attempts to discuss what outcome could have resulted from such alternative interventions, he stressed.

Akyuz reviewed the situation in various regions. According to him, the situation in the United States has been better than other advanced economies. The United States dealt with the financial but not with the economic crisis, whereby recovery has been slow due to fiscal drag and debt overhang, he explained. Akyuz noted that employment is not expected to return to pre-crisis levels in the United States before 2018.

As for the Euro Zone, Japan, and the United Kingdom, Akyuz noted that all had second or third dips since 2008. None of them have restored pre-crisis incomes and jobs, Akyuz added. The Euro Zone has been struggling to turn the corner from recession to recovery, according to the IMF. Akyuz highlighted the prospects of seeing the Euro Zone heading into deflation. He highlighted the weak demand, which stands at 5% below 2008 levels, including 15% lower than 2008 levels in the periphery countries. Financial stress has eased in the Euro Zone, although there is still high fragility and more turmoil could be possible in 2014, Akyuz noted. According to him, the recovery has been too weak to generate jobs and the jury is still out on the situation of the Euro.

Advanced economies, including the United States, European Union, and Japan have witnessed potential output constantly falling below usual trends because of the lack of investment and declines in labor participation, according to Akyuz.

He added that inequality has been widening, whereby the top 1% in the United States captured the entire income gains in 2009, and wealth has been further concentrated. Bank profits soared and Wall Street bonuses have been back to historical highs, while the 'too-big-to-fail' banks are today bigger, Akyuz added.

In the Euro Zone, the periphery has joined Germany in the trend of wage suppression, Akyuz noted. Real wages in the United Kingdom are not expected to go back to pre-crisis levels before 2020 even with accelerated growth, he added. Downward trend in the share of wages has been accentuated, Akyuz highlighted, whereby the threat of deflation due to under-consumption has been rising. Until 2008, deflation was avoided thanks to bubbles in the United States and the European Union and several emerging economies. These bubbles have led to deepening fragility and crisis. Yet, what is witnessed today is a temptation to rely once again on asset and credit bubbles for growth, Akyuz added. He noted that Lawrence Summers and Paul Krugman argue that there is a constant demand gap in the United States, which would face circular stagnation without bubbles that have been driving growth since the 1980s.

Akyuz addressed trade imbalances noting that they have not been removed, but redistributed. East Asian surplus dropped sharply and Latin America and Sub-Saharan Africa moved to large deficits, Akyuz noted. Developing countries' surplus fell from USD 720 billion to USD 260 billion. On the contrary, advanced economies moved from deficit to surplus, whereby the United States' deficits fell and the Euro Zone moved from USD 100 billion deficits to USD 300 billion surplus.

Of three main surplus countries, Japan started running deficits from mid-2013 while China's surplus declined sharply after 2007, Akyuz added. Germany replaced China with a surplus of 7% of GDP. Unlike in China where strong exports complemented buoyant domestic spending, in Germany exports offset sluggish domestic demand, Akyuz explained. The German surplus has been falling against that of the Euro Zone periphery, Akyuz explained, but rising against the rest of the world. Competitive disinflation (i.e. internal devaluation), lid on wages and domestic demand, and deflationary bias are witnessed across the world economy and not just in the Euro Zone, he added.

Akyuz noted that until recently the impact of easy monetary policy has been felt mainly in asset markets, stocks hitting historical highs without much wealth effect, and in surges in capital flows and bubbles in emerging economies. But household borrowing in the United States has been rising again, Akyuz noted, whereby the last quarter of 2013 saw the largest increase in household debt in the United States since 2007.

Ultra-easy monetary policy is still on, Akyuz stressed, whereby interest rates are still unchanged. He clarified that tapering is not tightening or exiting from the ultra-easy monetary policy. Exiting this policy would mean reducing and normalization of the Federal Reserve's balance sheet and shortening maturity of assets held by the Federal Reserve. Yet, there is still uncertainty about normalization of the Federal Reserve's balance sheet. Akyuz stressed that it would be difficult for the Federal

Reserve to exit without disruption, or to maintain its policy without creating bubbles. The longer the ultra-easy monetary policy is kept the more abrupt the exit would be, Akyuz noted, which creates a dilemma for emerging economies.

Akyuz highlighted that as tapering comes to an end and the Federal Reserve stops buying further assets, the attention will be turned to the question of exit, normalization, and the expectations of increased instability of financial markets for both the United States and the emerging economies. This exit will also create fiscal problems for the United States, he added. For as bonds held by the Federal Reserve mature and quantitative easing ends, long-term interest rates will rise and fiscal benefits of ultra-easy monetary policy would be reversed.

In regard to the South, Akyuz noted that the initial resilience of developing countries could be associated with three main reasons, including: the quick recovery of capital flows; the Chinese massive investment package that gave a boost to commodity exporters; and the countercyclical response in developing countries that was made possible by improved fiscal balances during pre-crisis expansion, thus allowing to shift focus to domestic demand.

However, developing countries have lost steam as recovery in advanced economies remained weak or absent due to the fading effect of countercyclical policies and the narrowing of policy space, Akyuz explained. He also added that China could not keep on investing and doing the same thing. Another factor contributing to the change of context in developing countries has been the weakened capital inflows that became highly unstable with the deepening of the Euro Zone crisis and then Federal Reserve's tapering. Several emerging economies have been under stress as markets are pricing-in normalization of monetary policy even before it has started, Akyuz pointed out.

Akyuz added that the external financial vulnerability of the South is linked to developing countries' integration in the global financial markets and the significant liberalization of external finance and capital accounts in these countries. These include opening up securities' markets, private borrowing abroad, resident outflows, and opening up to foreign banks. While developing countries did not manage capital flows adequately, the IMF did not support in this area, tolerating capital controls only as a last resort and on temporary basis.

Akyuz added that while sovereign debt in emerging economies is leveled off as proportion of GDP, foreign presence in local credit and bond markets have been increasing. Private borrowing abroad has been massive in China, India, and Brazil, while corporate bond issues and interbank borrowing have been at record levels in these countries, Akyuz noted. Many portfolio (carry-trade) investors in emerging economies are leveraged, he added, all of which are highly susceptible to swings in the United States' monetary policy.

Several deficit developing countries with asset, credit, and spending bubbles are particularly vulnerable, Akyuz stressed. Countries with strong foreign reserves and current account positions would not be insulated from shocks, as seen after the Lehman crisis. When a country is integrated in the international financial system it will feel the shock one way or another, although those countries with deficits remain more vulnerable, Akyuz stressed.

In regard to policy responses in the case of a renewed turmoil, Akyuz called for avoiding business-as-usual, including using reserves and borrowing from the IMF or advanced economies to finance large outflows. The IMF lends not to revive the economy, he noted, but to keep stable the debt levels and avoid default. He also argued against adjusting through retrenching and austerity.

Akyuz called for finding ways of bailing-in foreign investors and lenders, and using exchange controls and temporary debt standstills. Akyuz stressed that the IMF should support such approach through lending into arrears.

More importantly, Akyuz underlined, the Federal Reserve is responsible for the emergence of this situation and should take on its responsibility and act as a lender of last resort to emerging economies, through swaps or buying bonds as and when needed. These are not necessarily more toxic than the bonds issued at the time of subprime crisis, Akyuz noted. He was of the opinion that the United States has a lot at stake in the stability of emerging economies.

Akyuz also called for addressing systemic issues, including governance of international finance, which was addressed in the Outcome Document of the 2009 UN conference on the World Financial and Economic Crisis and its Impact on Development. Akyuz called upon developing countries to put this issue on the Post-2015 agenda.

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