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Why the US and Europe Have Not Managed Their Economic Crises Properly

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This is the first in a series of articles by the South Centre's chief economist on the current global economic situation. This first article analyses why the economic policies of the US and Europe have been inappropriate in getting these major economies out of the crisis. The next few articles provide more details of this. Further articles will deal with how the developing countries' economies are experiencing the adverse spillover effects of these major economies' policies.

There are two major failings in policy interventions in the crisis in the US and Europe - the reluctance to remove the debt overhang through timely, orderly and comprehensive debt restructuring and the shift to fiscal austerity after an initial reflation. These have resulted in excessive reliance on monetary policy, including non-conventional means.

However, monetary measures have largely been ineffective in stimulating credit for the expansion of spending on goods and services – hence, the crisis is taking too long to resolve. Moreover, they have created financial fragility not only in the advanced economies practising such policies, but also globally and particularly in emerging economies. Exit from the policy of ultra-easy money is full of pitfalls with attendant consequences for growth and stability.

Table: Real GDP Growth in Selected Advanced Economies *(Per cent change)*

	2008	2009	2010	2011	2012	2013
United States	-0.3	-3.1	2.4	1.8	2.3	1.9
Eurozone (EZ)	0.4	-4.4	2.0	1.4	-0.6	-0.3
Germany	0.8	-5.1	4.0	3.1	0.9	0.6
Japan	-1.0	-5.5	4.7	-0.6	2.0	1.6
United Kingdom	-1.0	-4.0	1.8	0.9	-0.2	0.7

IMF, World Economic Outlook (April 2013).

Current economic landscape

More than five years since the outbreak of the global financial crisis, the world economy has little signs of stabilizing and moving towards strong and sustained expansion. Global growth started faltering after the bounce-back in 2010-11 and there is increased agreement that in the coming years it will remain far below the exceptional rates achieved before the onset of the crisis. Because of policy shortcomings in removing the debt overhang and providing strong fiscal stimulus to make up for private sector retrenchment, the crisis in the US and Europe has been taking too long to be resolved. On the other hand, developments in the past two years have shown that developing countries (DCs) are not decoupled from conditions in advanced economies (AEs) and it is a fallacy to expect major emerging economies such as China, India and Brazil to replace AEs and act as a locomotive to the world economy.

Even though the US economy was at the origin of the crisis, it has fared much better than other AEs - the Eurozone (EZ), Japan and the UK - since the outbreak of the crisis. First, the 2009 recession was less severe in the US than in the latter economies. Second, the US economy has enjoyed continued, albeit moderate, recovery at an average annual rate of 2 per cent, registering positive growth in every quarter but one since the end of the recession in mid-2009. However, the output gap (that is, the difference between what the economy could and does produce) has diminished only a little. At the end of 2012, it was around $800 billion with the cumulative loss since 2008 reaching some $3 trillion. Although the unemployment rate has declined from its peak of 10 per cent in October 2009 to 7.4 per cent in mid-2013, part of the decline is due to the exclusion of discouraged workers as the labour force participation rate dropped since the beginning of the crisis. Indeed, total non-farm employment is still 2.5 million less than what it was at the beginning of 2008.

Most other major AEs have contracted again since 2009. Following a severe recession in 2009 the EZ as a whole managed positive growth in the subsequent two years despite continued output and employment losses in the periphery, thanks to strong recovery in Germany driven primarily by exports. However, as the impact of the crisis spread in the region through trade linkages, the core and Germany in particular could not maintain momentum. In the first quarter of 2013 the region had its 6th consecutive quarter of negative growth. 9 of the 17 EZ countries were in recession with France as a notable addition to the list. IMF (WEO July 2013) projects recession for 2013 for the region as a whole. Unemployment has reached 12 per cent for the total labour force and 24 per cent for the youth. In Spain and Greece, at some 25 per cent, the unemployment rate is higher than the levels seen during the Great Depression of the 1930s; for the youth it is well over 50 per cent.

No doubt the EZ continues to be the Achilles' heel of the global economy and the immediate threat to stability and growth in DCs. Although financial stress in the region has eased considerably, continued contraction and adjustment fatigue in the periphery could bring it back and even lead to a total break up. However, it is difficult not only to predict the evolution of the EZ in the near future, but also the impact of a break-up, since past economic and financial linkages would provide little guide for estimating the consequences of such an unprecedented event. Still, even without a total break-up, an intensification of financial stress could have serious repercussions for DCs, as suggested by various downside scenarios simulated by the IMF (2012), the UN WESP (2013) and the OECD (2012).

Japan could not sustain positive growth after recovering from the 2009 recession and went into a second dip in 2011. In the last quarter of 2012 it experienced its 7th quarterly contraction since the collapse of Lehman Brothers. Its income now is below the pre-crisis level. Again, from 2009 until the end of 2012, the UK had negative growth rates in 9 out of 20 quarters and has lost 3.7 million jobs. 2013 growth is expected to be less than 1 per cent, but still the best among the EU's big 5 – Germany, France, the UK, Italy and Spain.

Why is the crisis taking too long to resolve?

In his remarks on the state of the world economy, the IMF's chief economist, Olivier Blanchard, is reported to have said that "It's not yet a lost decade… But it will surely take at least a decade from the beginning of the crisis for the world economy to get back to decent shape" (Reuters, 2012). Presumably, this remark must reflect a judgment not only on the nature and depth of the crisis, but also on the effectiveness of public interventions to resolve it.

There can be little doubt that recoveries from recessions brought about by financial crises are weak and protracted because it takes time to repair balance sheets – to remove debt overhang and unwind excessive and unviable investments generated during the bubbles that culminate in such crises. Recoveries from such crises also tend to be jobless and yield little investment. This was the case in US recoveries during the early 1990s and particularly the early 2000s from recessions brought about by the bursting of credit and asset bubbles – that is, savings and loans and dot-com bubbles, respectively. In the current recovery, the pre-crisis income in the US had been restored by the second quarter of 2011, but employment was lower by some 6.5 million. Sluggish job and investment growth is also a common feature of recoveries of DCs from financial crises (Akyüz, 2006).

However, the pace of recovery also depends on government intervention and management of the crisis. In this respect, there are two major policy shortcomings in the policy response both in the US and Europe. First, governments have been unwilling to remove the debt overhang through timely, orderly and comprehensive debt restructuring and cleaning-up of bad loans. Instead they have resorted to extensive creditor bailouts and, in the case of the EZ, to ad hoc, politically motivated and disorderly mechanisms to involve private creditors in debt resolution, subject to highly procyclical policy conditionality. Comparing with interventions in earlier crises in emerging economies of Latin America and Asia, an IMF Staff Discussion Note argued that in the current crisis "the diagnosis and repair of financial institutions and overall asset restructuring are much less advanced than they should be at this stage and that moral hazard has increased. Consequently, vulnerabilities in the global financial system remain considerable and continue to threaten the sustainability of the recovery." (Claessens et al., 2011; italics in original).

Second, there have been serious shortcomings in macroeconomic policy measures in support of aggregate demand, growth and employment. The failure to intervene directly to remove the debt overhang in a timely and orderly manner has meant slow deleveraging and protracted retrenchment in private spending. As a result, monetary policy has become largely ineffective in expanding credit and lifting private spending even though policy interest rates were cut down drastically and central bank balance sheets expanded rapidly through quantitative easing (QE). Fiscal policy has gained added importance, but both the US and Europe have shifted to austerity after an initial reflation because of growing hostility towards public spending, deficits and debt. In the EZ, the core has also joined in the austerity imposed on the crisis-hit periphery.

The case for fiscal austerity is premised on two propositions. First, budget deficits add more to public debt than to GDP so that they would raise the debt-to-GDP ratio. Second, high ratios of public debt to GDP are detrimental to growth. It is thus believed that fiscal austerity would not undermine growth and could even stimulate it by lowering the ratio of public debt to GDP - hence the so-called "expansionary austerity".

The first proposition implies that fiscal multipliers are small. In the mainstream economic theory, this is often attributed to two different mechanisms. First, there is the crowding-out hypothesis –

that is, higher public spending leads to lower private spending. The main reason is that increased public spending financed by borrowing would raise interest rates, thereby reducing private investment and other interest-sensitive private expenditures. However, this need not happen if monetary policy is accommodating or when the economy is in the so-called liquidity trap and there is considerable slack. Indeed, despite rising budget deficits and debt, US long-term rates have remained at exceptionally low levels after 2009.

The second mechanism derives from a highly controversial theorem based on neoclassical rational behavior - that is, as government spending and debt increase, the private sector would start spending less and saving more in order to provide for future tax increases needed to meet debt servicing. In the same vein tax cuts financed by borrowing would be saved by rational individuals in anticipation of future taxes. The assumption of such rationality is untenable.   It is highly unlikely that when income is falling and living conditions are deteriorating households would save a greater proportion of their income as public sector deficits and debt increase.

In the early years of the crisis, the fiscal policy advice of the IMF in Article IV consultations was premised on extremely low multipliers and was invariably pro-cyclical. Because of the underestimation of fiscal multipliers, IMF growth projections turned to be more optimistic than growth outcomes in several European countries such as Greece undergoing fiscal consolidation with IMF agreements (Weisbrot and Jorgensen, 2013).   However, as a result of mounting evidence on fiscal drag, the IMF has finally admitted that fiscal multipliers are much greater than was previously believed and that they are state-dependent, particularly large under recessions, with the implication that fiscal austerity could in fact raise the debt ratio by depressing income (IMF WEO October 2012; Blanchard and Leigh, 2013).

The second proposition that high debt ratios could deter growth has found support in the finding of an empirical study by Reinhart and Rogoff (2010) that economic growth slows sharply when the ratio of government debt to GDP exceeds 90 per cent, as has been the case in the US and most EZ countries hit by the crisis. However, it is generally agreed that such an association says effectively nothing about causality – slow growth could cause high debt rather than high debt leading to slow growth. More importantly, subsequent research by Herndon et al. (2013) has found that several critical findings advanced in the Reinhart and Rogoff (2010) study are wrong and the corrected evidence shows that a 90 per cent debt ratio is associated with a much higher rate of growth than was found by these authors.

Excessive Reliance on Monetary Policy

Supported by such dubious theories and shaky empirical evidence, fiscal austerity has gone unabated both in the US and Europe, dragging growth. The reluctance to use public spending to expand aggregate demand has meant excessive reliance on monetary policy, particularly as fiscal austerity has become self-defeating by lowering growth. Not only have interest rates been kept at exceptionally low levels for an extended period, but unconventional means have been used including long-term central bank lending to banks and purchases of asset-backed securities in order to expand liquidity and lower long-term interest rates.

Rapid expansion of liquidity and historically low interest rates, notably in the US, has led to a non-negligible build-up of financial fragility and vulnerability by triggering a search for yield and excessive risk taking, both in the US and globally, very much in the same way as during the sub-prime bubble. Inflows into high-yielding assets in emerging economies have placed strong pressures on their exchange rates, leading to unsustainable current account deficits in some. Exceptionally low interest rates have also encouraged corporate borrowing in reserve currencies, which has risen by 50 per cent over the past five years, resulting in increased exposure to interest rate and exchange rate risks (IMF, 2013a; Oprita, 2013b).

There are also signs of excessive risk taking in the US in various forms including “reaching for yield,” increased corporate leverage and maturity transformation - developments that seem to be causing concern at the Fed with Bernanke (2013) warning that these may delink asset prices from fundamentals and lead to mispricing (see also IMF, 2013a and Yellen, 2013b). Equity markets have already reached historical highs and may undergo a sharp correction if real economic growth lags. Furthermore, credit as well as asset bubbles could start to form and reach dangerous levels if the exit from exceptional monetary policy is delayed, as under the sub-prime boom (Roubini, 2013).

There is considerable uncertainty regarding the implications of an extended period of ultra-easy money for future financial stability, since these are largely uncharted waters (White, 2012). As discussed in the final section, it may not be possible to engineer an orderly exit so as to combine financial stability with strong and sustained growth in AEs as well as emerging economies. Although the Fed and the IMF appear to be taking note of the longer-term risks to stability and growth, they may not be able to identify them correctly or act in a timely and effective manner better than they did during the sub-prime build-up.

Severe Future Vulnerabilities

While central banks in the US and the EU have provided ample liquidity to banks and financial markets and purchased government debt in secondary markets in order to lower interest rates and payments on public debt, they have not been willing to abandon the obsession against direct financing of budget deficits and permanent monetization of government debt. However, as recognized by several mainstream analysts, under present circumstances these need be no riskier for monetary and financial stability than the ultra-easy monetary policy. For instance, former chairman of the UK Financial Services Authority, Lord Turner, has argued that the attempt to escape from the deleveraging trap by excessive monetary accommodation could lead to severe future vulnerabilities and the idea that overt money finance of fiscal deficits is inherently any more inflationary than the other policy levers used to stimulate demand is without any technical foundation. He concludes that the main challenge is how to "design institutional constraints and rules that would guard against the misuse of this powerful medicine." (Turner, 2013: p. 24; see also Wolf, 2013).

However, none of the governments in the AEs in crisis have been willing to go in that direction even though some central banks including the Bank of England are reported to have given considerations to such a solution (Financial Times, 2012).

This is an extract from the South Centre's Research Paper No. 48, on Waving or Drowning: Developing Countries After the Financial Crisis. The full paper is available at www.southcentre.int**.**

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