The Missing Global Recovery

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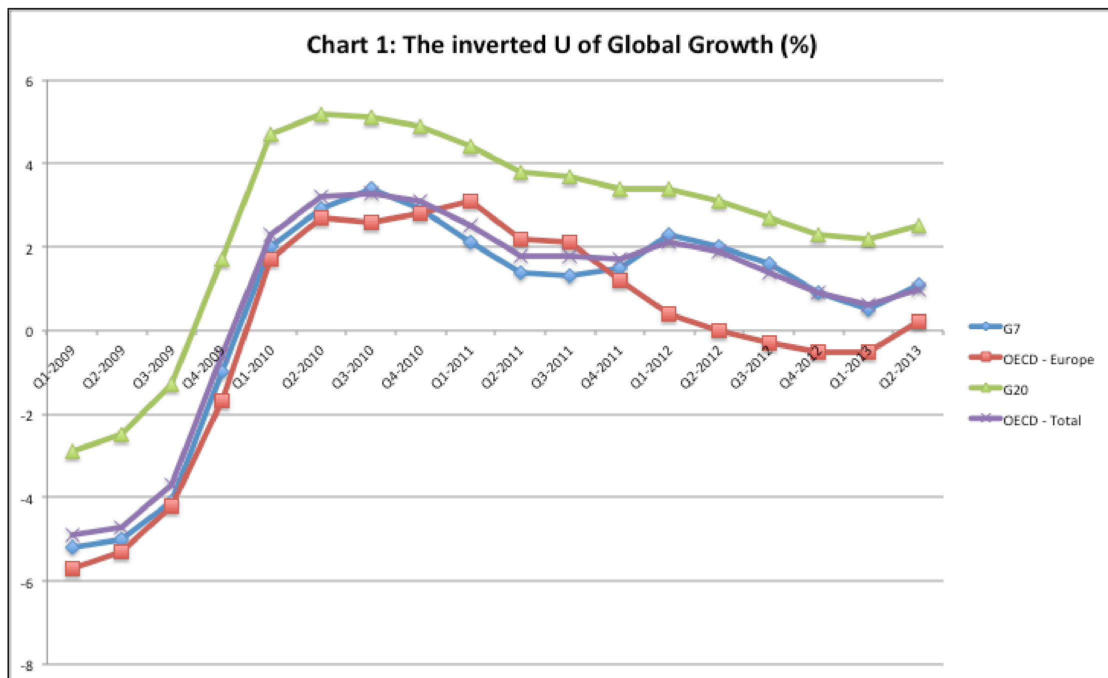
In mid-November the OECD Secretariat issued the second of its annual assessments of the Economic Outlook for the world economy. The previous assessment was in May. In the short span of time between these two reports, the outlook has indeed changed. The optimism that desperately-searched-for-and-found "green shoots" of recovery generated has waned. To quote the OECD's report: "The global recovery remains modest and uneven ... Outcomes this year and near-term prospects appear a little weaker than had been expected in May, at the time of the previous Economic Outlook, with global GDP growth revised down by just under ½ percentage point both this year and in 2014 to 2.7% and 3.6% respectively."



Even this assessment seems overly optimistic if we take a longer view. Chart 1 shows the annual (quarter-on-quarter) growth rates in all quarters since the onset of the crisis in major developed country groupings and in the G20, which includes leading "emerging market economies" (EMEs). In all cases, growth over time follows an inverted-U shaped trajectory, with a sharp recovery from the depths of 2009 to a peak at the middle of 2010, followed by a trend downturn that afflicts all groups, though it is sharpest in the case of the European members of the OECD. If there was any cause for optimism it was the slight upturn in the second quarter of 2013. But recent evidence suggests that even that seems to be fading, since there is no sign of that continuing in the G7 and there are expectations that it has ended in many EMEs belonging to the G20.

An aspect of this inverted-U behaviour that needs noting is its relationship with the nature of government response to the crisis. To recall, in 2009, immediately after the onset of the crisis, governments responded with a fiscal stimulus, resulting in high fiscal deficits in all major OECD countries, but especially the US and UK, which were the growth drivers. The graph (Chart 2) depicting the annual ratios of the

government deficit to GDP almost mirrors the growth chart, being in the nature of a regular-U. The period of recovery was one in which the fiscal stimulus was the strongest and the 'retreat from recovery' seems to coincide with the winding down of that stimulus in most countries.

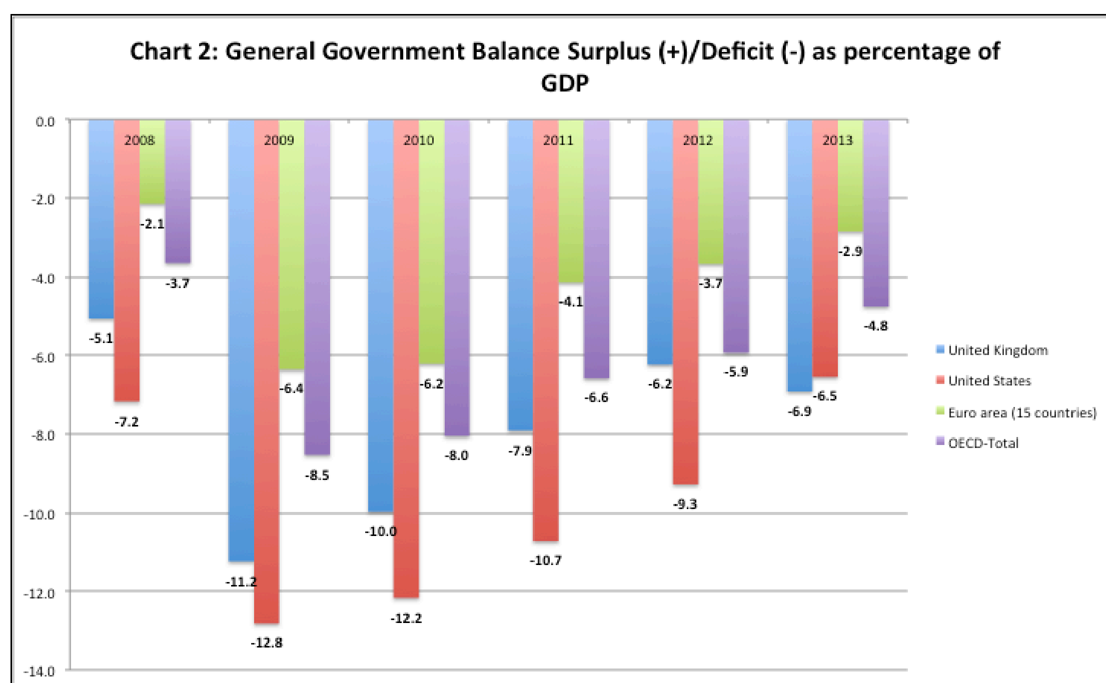
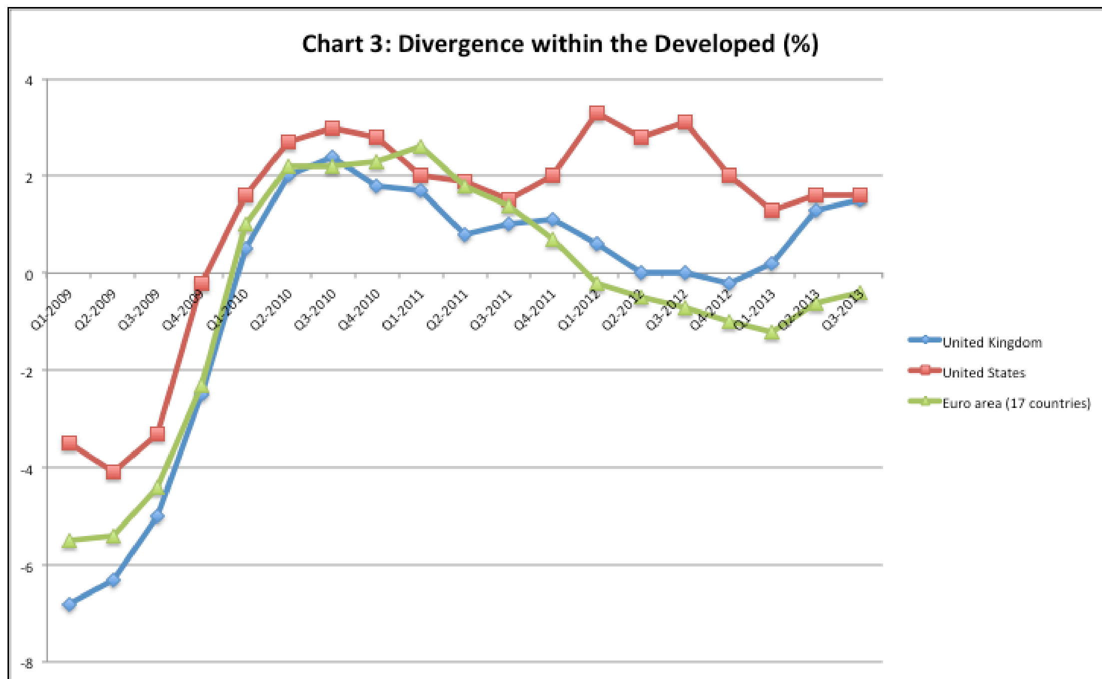


Chart 2: General Government Balance Surplus (+)/Deficit (-) as percentage of GDP

In the US, the fiscal stimulus was accompanied by an unprecedented easing of monetary policy, as the government launched on a financial asset buying spree to infuse liquidity into the system that was to later taken on the appellation "Quantitative Easing" or QE. This possibly explains the divergence in growth trends between the US and other developed countries (Chart 3), with the former having experienced a second rebound or recovery in the first three quarters of 2012. This was the period when the US Federal Reserve launched, first, its 'Operation Twist'—in which it sold short-term Treasury bonds and bought long-term Treasury bonds in order to bring down long term interest rates; and, second, the most recent and still continuing third phase of quantitative easing (QE 3). With the balance sheets of banks having been cleared of toxic assets by this time, these measures seem to have temporarily contributed to boosting real demand by expanding credit. That possibly explains the divergence between trends in the US and elsewhere in the OECD.

It was at this point that the world was seen as being on the road to "multispeed recovery", with growth of around 6 per cent in the emerging economies led by China and India, 3 per cent in the US and less than 2 per cent in the euro area. Clearly, that hope has been dashed. Three factors explain the reversal of the recovery. First, governments have given up on the fiscal stimulus. A number of crisis-hit countries in Europe are subject to austerity. Other OECD countries are reining in spending for fear of being penalised by finance capital with downgrades and interest rate or borrowing cost spikes that could drive them to crisis.

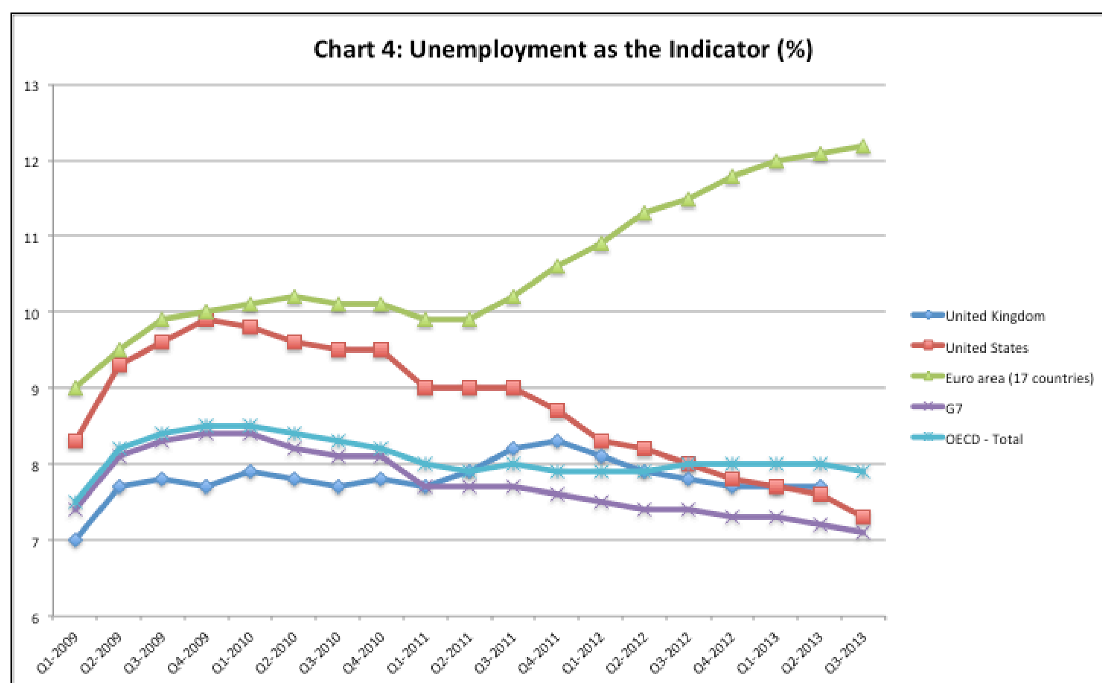


Second the potential for quantitative easing to contribute to sustained real demand in the developed countries, especially the US, has weakened. The reasons are obvious. With the crisis having left most households and even corporates burdened with debt, their ability as groups to take on additional debt is limited and the willingness of the banks to risk further increasing their exposure to these borrowers has diminished. On the other hand, with interest rates already at extreme lows, the monetary authorities find that the only option available to spur growth is quantitative easing. They explain away the failure of that policy by blaming the big banks for acting in ways that smother the transmission of the effects of monetary policy. There is talk that the Federal Reserve may reduce the interest rate it pays the banks on the excess reserves they deposit and hold with the central bank, in order to force them to lend. But there is little conviction that this measure would work. The monetary lever is increasingly incapable of spurring growth.

Third, emerging market countries, including China and India are experiencing significant deceleration in growth. In the case of China this is largely because the huge stimulus resorted to in response to the crisis, mediated in large measure by bank lending, is being unwound. Overheating and fears of bank fragility warrant that stance. In countries like India, the debt-financed boom, which was built on the liquidity infused by the large capital inflows resulting from easy monetary policy in the US, is now proving unsustainable. There is growing evidence of rising defaults and accumulating non-performing assets in bank balance sheets. There too, therefore, banks are reining in credit. In the event growth is slowing in economies in all lanes of the multi-speed highway.

The recent fears generated by the threat of the tapering of the policy of quantitative easing need to be assessed in this background. Though not any more a leading driver of growth, a retreat from QE would affect demand. It would, for example, adversely affect EMEs that rely on the capital flows resulting from such easing to finance large current account deficits. If a retreat from QE results in a sudden decline in capital flows, they would be forced to reduce their current account deficits by curtailing

spending, which would slow growth. Further, while emerging market economies may not be averse to some depreciation of their currencies, a retreat from QE can trigger sudden devaluations that bankrupt firms carrying large foreign exchange debts and/or precipitate currency crises. Finally, the end of easy money can lead to turmoil in financial markets. Despite the poor performance of the global economy, the sector that has gained through the three phases of QE is finance. The S&P 500 for example has experienced a slow rise during these years from less than 700 in early 2009 to around 1800 by October 2013. So finance capital too does not favour a retreat from QE. Not surprisingly, the Fed now seems stuck with a policy that is increasingly ineffective as a stimulus to growth.



The consequence, to quote economist Prabhat Patnaik, is that: "Monetary policy which is an instrument that finance capital approves has become ineffective. Fiscal policy which could conceivably have an expansionary effect is disliked by finance capital." That makes a return to recovery difficult. For global governments this means waiting for another bubble or some other miracle on which the world economy can ride its way back to growth. But for much of the world's population that wait is becoming unbearable. Nothing illustrates this more than the trends in unemployment (Chart 4). It has soared in Europe, with the highest incidence being on the young who on entering the labour force find themselves on the bench. It remains stubbornly high in the UK. And it appears to have fallen in the US substantially because, tired of job search many are just opting out of declaring themselves as seeking for work. The political implications of this in terms of social disruption and violence are dire. A social arrangement with low growth may be sustainable. One with high unemployment will not be.

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