The Way Out: Global Turmoil and Policy Recommendations

Turhan, Ibrahim M.

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THE WAY OUT

The world has been struggling with the economic and financial crisis for the last seven years and yet, in spite of all efforts several times we have so far witnessed hopes have been faded away. We have to admit and understand how serious and challenging the problems we are facing today are. Despite some positive developments, challenges to the global economic outlook could not been surmounted completely. The turmoil in the financial markets we have been observing since the beginning of this year is a clear indicator of those challenges and the risks regarding global output are still downside. The weak and uneven recovery of the world economy is expected to continue and the momentum is shifting to the advanced economies as economic growth in emerging and developing countries has recently decelerated. We are sailing in unchartered waters; for the first time for at least two decades contribution by the emerging market economies to the global output has been slowing down successively and stubbornly. The average growth of all emerging markets except China and India is expected to remain below the US growth rate. Volatility in financial and commodity markets, protracted low inflation in some advanced economies, debt overhang and geopolitical risks cast a shadow over the global outlook. In addition, in many economies policy accommodation has continued, but structural reforms are lagging. On several occasions since 2010, hopes have risen but every time when we felt confident about a robust and widespread recovery, very soon we found ourselves at the starting point like a voyager of a cursed, ill-fated journey, who is trapped in a vicious circle. Thus I think it would worth to revisiting the history in order to take some lessons.

Since the beginning of the 19th century when the world economy started to get integrated through rapidly developing cross-border trade and finance, almost once every forty to fifty years, financial markets have been witnessing a deep-shaking and destructive distress. Post-Napoleonic depression that broke out in 1815 in the continental Europe spread over UK and later Americas where it prevailed until 1830s. Thanks to introduction of steam power and machine tools in the production process a more efficient and productive framework of economic structure and economic relations was achieved and with a paradigm shift economies recovered strongly. This spring climate has endured only until the next crisis episode, which was the Long Depression that ruined again the world economies between 1873 and 1896. It could only be overcome owing to the second industrial revolution or the rise of electrical power and oil. However, after forty prosperous and affluent years, the world economy collapsed once more and that episode was baptized as the Great Depression. Humanity could fly out of that darkness and retouch the light thanks to an Icarusian inspiration; advances in transportation and especially in aerospace technology enabled another economic paradigm shift. Laws of boom-boost business cycles won the game again and the economies of almost all nations came to the edge of downfall when the Bretton-Woods system collapsed in 1973. Both developed and developing economies fell again into the clutches of a long lasting recession for approximately a decade. The victory was virtual; developments in the telecommunication and information technologies and the emergence of the Internet realm permitted the last economic paradigm shift. The achievement was thought triumphant and amazing, hence the rhetoric that was praising the glory was remarkable; End of the History, Globalization, the Great Moderation …

However was this time really different? In the fall of 2008 we all learned at a very high price that in fact it was not. The history does not repeat itself but we, human beings tend to repeat same mistakes throughout the history again and again. The introduction of a new technology (financial derivatives and financial engineering more precisely) triggers an overblown growth and creates an irrational exuberance environment, which in turn fuels excessive leverage and risk taking and finally like herds that have gone crazy, economies are dragged into the vortex of crisis. Although the similarities between what happened seven years ago and countless previous crisis episodes, nevertheless this time is more frightening. Given the level of financial integration of global markets, unprecedentedly high covariance between asset classes, interdependence of global systemically important financial institutions, and cross-border business models that has already created international or rather multinational companies and value chains aggravate the complexity of situation.

Hopefully we are learning out of what we have done. Since the beginning of the crisis we have come to an understanding that stand alone type solutions are not going to work. Either we will survive together or we will continue to suffer and ultimately be swept away all together. The coordinated and prompt action of central banks, regulatory cooperation among financial sector supervisors around the world, and most importantly the acknowledgement of G20 as the premier forum for global economic and financial cooperation are all remarkable moves in the right direction. Off course this is far from being enough, but yet it is good beginning. With reference to Winston Churchill and in his own words; “Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning”.

In an environment where risks and uncertainties concerning the future of the global economy still persist, the world needs better cooperation between key players and more effective decision-making in order to prevent or, at least, alleviate the possible economic turbulences. However it has become more evident and obvious than ever, monetary policy and especially loosening the already easy monetary stance falls short to respond market turbulence. We definitely need additional policy action to safeguard economic stability. There is no doubt structural reforms would enhance the resilience of economies, both advanced and emerging, but they can only be effective in the medium to long run. Although one can argue that through improving expectations such reforms will have a short-run impact, a stronger policy support is still necessary. This cannot be anything but fiscal policy.

Many economists, including Krugman, Summers, and Stiglitz have already mentioned this. The world, especially advanced economies are rightfully worried about too low interest rates. On the other hand, any move towards higher rates by central banks triggers turbulence in the financial markets and given the level of global liquidity, hence size of positions, and elevated covariance among asset classes poses a threat for already fragile economic growth. Moreover such a disorderly turmoil may aggravate the situation and harm what is left from international coordination. However there is another way of rising interest rates; decreasing bond prices. Too low interest rate, if put in other words, means too high bond price. So increase in supply of bonds, all other things being the same would cause a decrease in bond prices, and this will bring higher interest rates. Since it would absorb extra funds parked at the banking sector with zero or even negative return and enable the governments to spend more without curtailing disposable private income, the growth will remain immune against this higher interest rate environment. The only critical issue is to find the right place to allocate this money.

If we assume that the course of events will follow the same pattern as they did several times in the past, it means there is a significant probability that in order to resolve our problems we have to wait for the next economic paradigm shift, which is about to happen. We should be aware that we are heading towards a new scientific, technological and economic revolution that will be the ultimate solution to all of our fundamental and structural problems. So we must be prepared for it, and especially emerging markets should focus on this topic. In the past each and every time we had a technological jump, combined with the economic implementation of it, it paved the way to innovation, productivity increase, higher efficiency and finally a superior production possibility boundary and thus a more auspicious efficient market frontier at macro level. We all know such a shift will be particularly dependent to sizeable investments where public money may be needed. Resources that will be generated out of fiscal space when possible and appropriate, should be allocated to areas such as infrastructure, high value added innovative research and development, and structural reform financing. On the other hand if we want to alter the rules and improve our performance in this game, the best way of doing it would be to bring new players in. Meaningful improvements in terms of inclusiveness in the less developed nations and emerging market economies will allow us to achieve this goal. Implementation requires dedication, determination and perseverance. We should be ready and willing to provide necessary resources for implementation phase, taking into account that any structural reform will follow a J curve pattern where during the first episode you will need to carry some costs but soon, it will pay you back. Hence we may come to the conclusion that the "three I" formula that Turkey put forward as the main theme for G20 this year; investment, inclusiveness, and implementation are the key elements for our future and for our salvation. As the darkest hour is just before the dawn, challenges are getting tougher and tougher. In fact these challenges and problems should be seen as labor pains of a new dawn whose first lights have already appeared; dawn of the next economic paradigm shift.