Is It All About the Fundamentals? A Structural Interpretation of Global Crisis

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A Structural Interpretation of Global Crisis

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Abstract

The world has been struggling with the economic and financial crisis for almost a decade and yet, in spite of all efforts we have so far witnessed, problems persist. 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. Furthermore, economies both advanced and emerging exhibit some very unusual, unprecedented and even odd patterns; Policy makers are bounded with data dependency due to contradicting and confusing economic data.

Surprisingly, despite the overwhelming reign of real business cycle models in graduate teaching and despite the prevalence of mainstream economics whose inspiration is mainly neoclassical approach, there is almost no emphasis on real factors which might have caused to this controversial situation. This study argues the crisis is related with the permanent total factor productivity decline and it is simply another iteration of boom-bust cycles due to arriving at the edge of productivity for the existing system of economic relationships that has already happened four times for the last two hundred years.

Keywords: Crisis, real business cycle, productivity, economic history

JEL Classification: E23, E65, N1, N10, O40

The world has been struggling with the economic and financial crisis for almost a decade and yet, in spite of all efforts we have so far witnessed, sprouting hopes several times 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 end of 2014 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. Furthermore, economies both advanced and emerging exhibit some very unusual, unprecedented and even odd patterns; including lack of growth recovery despite all monetary stimuli by central banks, stubborn disinflation even with historic low levels of unemployment, contradicting and confusing economic data leading data dependency and finally ending up idled, ineffective, and a void-like policymaking. Keeping in mind there is nothing new under the sun, hence 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. Humans last victory in this battle was literary virtual;

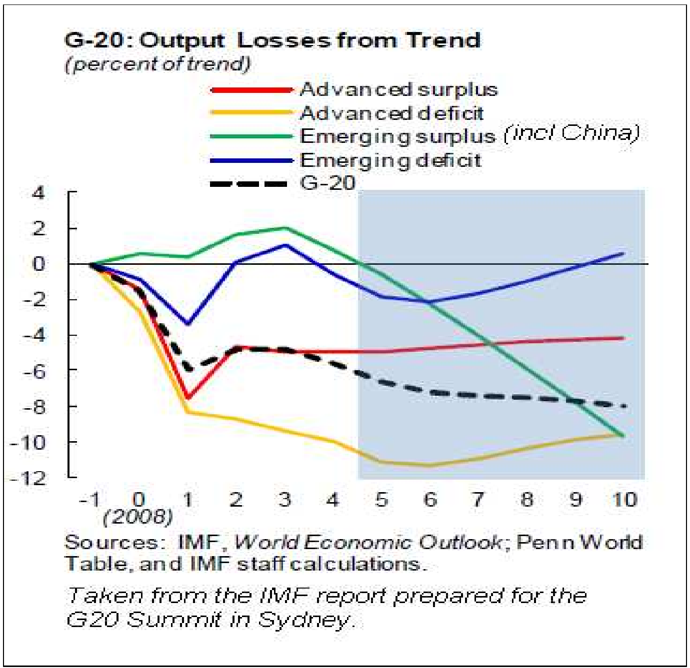
developments in the telecommunication and information technologies and the emergence of the Internet realm permitted the last economic paradigm shift. The achievement was thought triumphant and amazing, hence the rhetoric that was praising the glory was remarkable; End of the History, Globalization, the Great Moderation … Thank to globalization, prizes were shared between advanced and emerging market economies, everybody was satisfied.

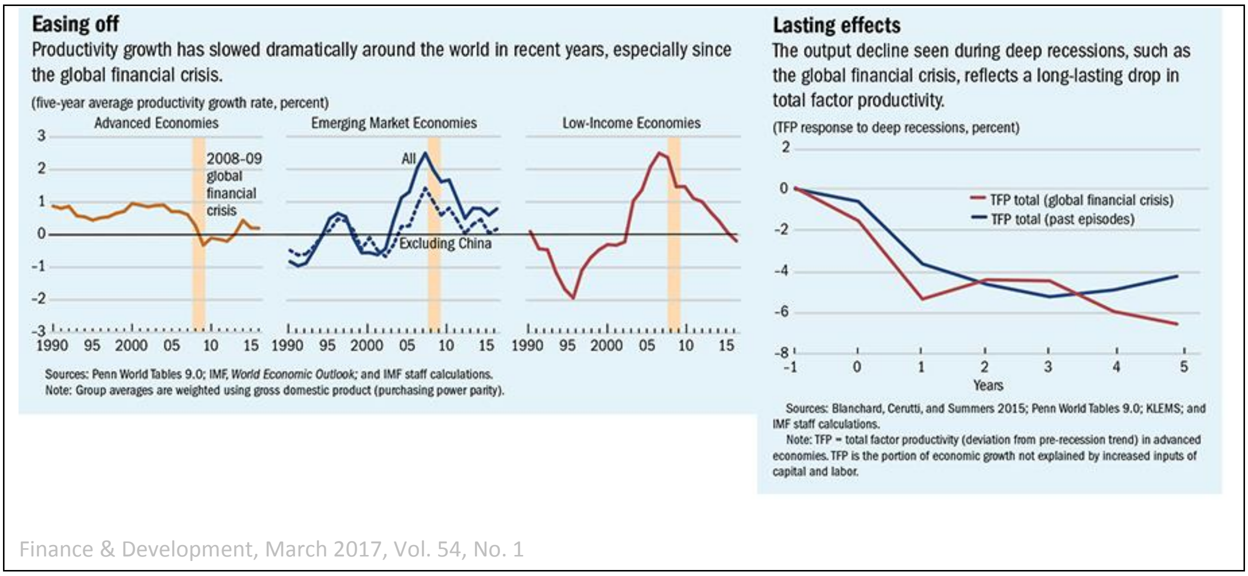
However was this time really different? In the fall of 2008 we all learned at a very high price that in fact it was not. The history does not repeat itself but we, human beings tend to repeat same mistakes throughout the history again and again. There was also an excessive confidence on market forces and over reliance on the working of the invisible hand to correct all errors. The pre-crisis period was the time the risk was supposed to be controlled, even disappeared, thanks to the use of very sophisticated techniques, including instruments like Credit Default Spread, CDS. However the introduction of this 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 and our globalized reality is missing appropriate governance architecture, 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”.

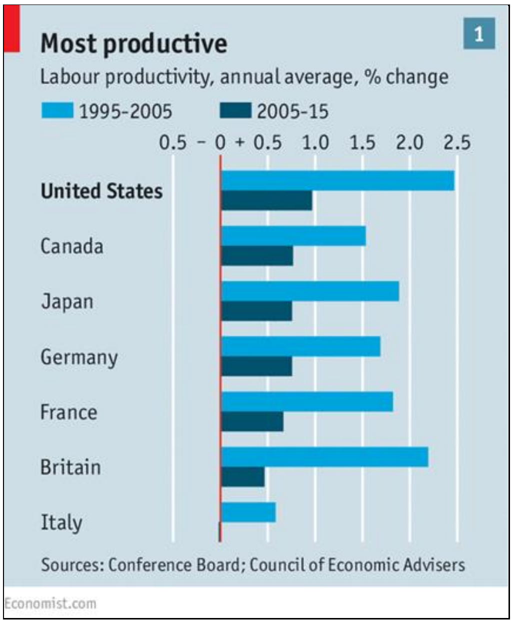
In an environment where risks and uncertainties concerning the future of the global economy still persist, the world needs better cooperation between key players and more effective decision-making in order to prevent or, at least, alleviate the possible economic turbulences. However it has become more 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.

Surprisingly, despite the overwhelming reign of real business cycle models in graduate teaching and despite the prevalence of mainstream economics whose inspiration is mainly neoclassical approach, there is almost no emphasis on real factors which might have caused to this controversial situation. It is unanimously agreed that the crisis was rooted in the US financial system and contagion of it was again through mainly financial channel. However what has been observed in the aftermath of the global financial crisis, length and scope of its effects, permanence of aftershocks causing a persisting volatility in global markets, odds and irregularities being at the bottom of incompetence of economic policies to resolve the crisis should provide some suspects enough to start questioning the underlying real factors. In fact it is widely recognized that global economy has been suffering from a permanent loss of output associated with a significant decline in productivity, since the global financial crisis. IMF studies exhibit that there is still an output gap compared with pre-crisis growth trend even after 10 years.

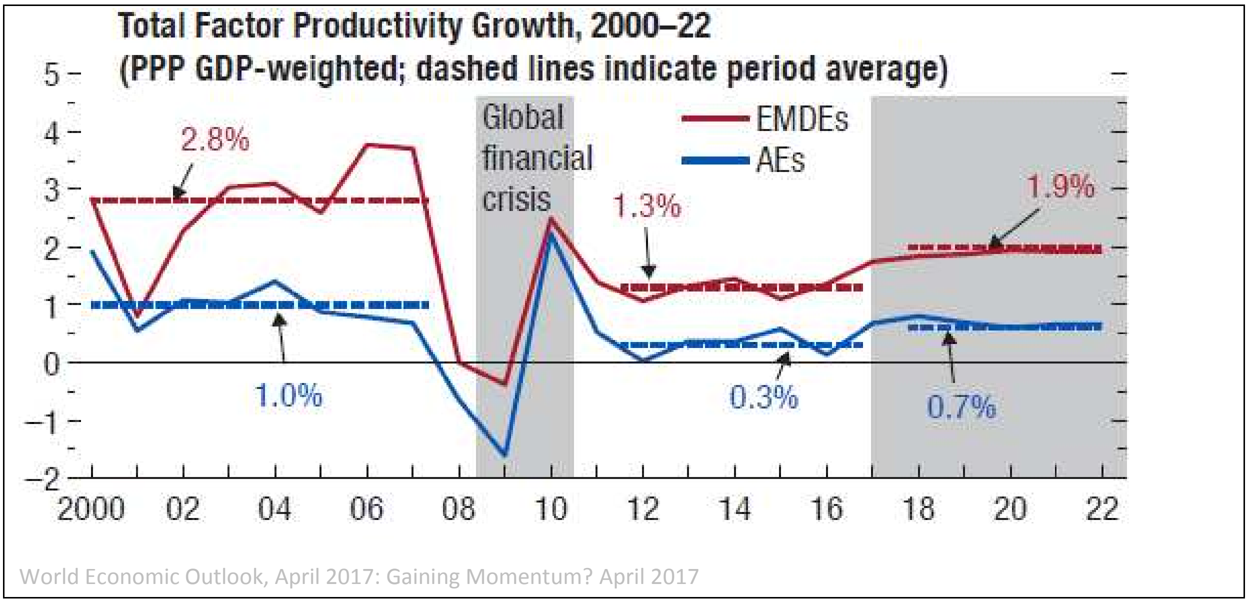




There are several studies which provide evidence for universality of this lack of productivity, i.e. both advanced and emerging market economies are facing with the same problem. Moreover, productivity decline is associated with long-lasting potential growth loss in almost all economies be it advanced or developing.

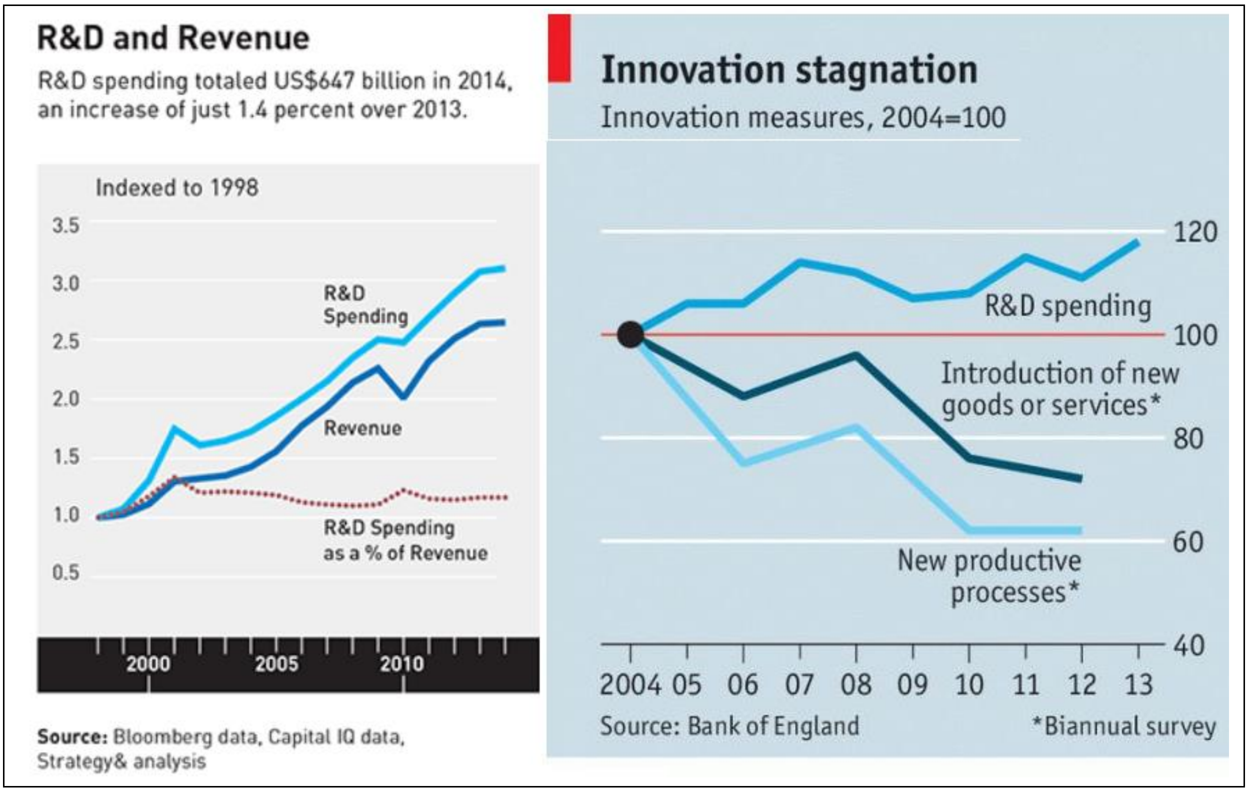


IMF World Economic Outlook (April 2017) shows that total factor productivity which had slowed sharply following the 2008 global economic crisis, both in advanced and emerging market economies is not projected to return to its pre-crisis pace, at least within the one and a half decade following the adverse shock. Weak investment and the associated slow pace of adoption of capital-embodied technologies appears as key factor behind the slowdown. However persistence of productivity gap cannot be explained by merely lack of investment. There should be something else.



A theoretical explanation focusing in the lack of productivity may be useful to resolve the dilemma US central bank Federal Reserve is facing. Being tasked with a dual mandate of maximum employment and price stability, Fed has to consider labor market conditions. However there is a controversial situation in the US labor market; unemployment has come down to its historic low levels, nonetheless an upward pressure on wages that theory would suggest is missing. If one keeps in mind that wage is the price of labor, which itself is one of the factors of production hence the straightforward relationship between labor productivity and wage becomes obvious. Mild recovery in economic activity may help to reduce unemployment but unless labor produce more efficiently its unit price would not record noticeable increase. Another more controversial observation is the fact that despite the well-known relationship between innovation and productivity, the decrease in average total factor productivity for the last decade compared to the previous one has been remarkable in advanced economies where investment in R&D was not halted. Thus innovation (and as a consequence productivity increase) per R&D spending seems to be somehow lower than its previous levels.

Could it be possible that the very roots of this crisis are somewhere deeper in productivity, as we have witnessed at least four times for the last two centuries? Is it another iteration of boom-bust cycles due to arriving at the edge of productivity for the existing system of economic relationships? Empirical data may be providing evidence suggesting an affirmative answer to those questions. The graphs below show the efficiency of R&D spending in the USA and the UK.



It turns out that the trite phrase once again seems to be proven true; nothing is new under the sun. What we have been observing for a decade is nothing but a repetition of what has happened four times for the last two hundred years. Existing production paradigm has reached to its frontiers; the system of economic relationships does not suffice to create the same momentum it used to. This crisis, in some respects, was a warning sign that cautions us about the inner conflicts of the system of economic production and relationships. The problems we face today do not arise from some operational failures that can be corrected by some fine tuning (core capitals a little higher, leverage ratios a little lower), but from the system itself and the underlying philosophical framework. This is a crisis of, first, the economic world view, second, the institutional structure of globalization -or lack thereof- and third, the existing economic paradigm.

Since early 1990s we have been increasingly living in a de facto global system lacking institutional infrastructure. Dani Rodrik argued, akin to Mundell's impossible trinity theory, that democracy, national sovereignty and global economic integration are mutually incompatible. We can combine any two of the three, but never have all three simultaneously and in full. The problems we face today may be seen as a manifestation of this conflict. Policy makers are quite willing to assume the benefits of globalization, but reluctant and more and more quite hostile to give up their grip over national policies, in part fearing backlash from voters who insist on saying the final word in democratic societies. The events since 2015 have shown that internal conflict within globalization, due to lack of institutional infrastructure is no longer sustainable. Taking into account that what is at stake is the global peace and prosperity, we have to design a new global governance architecture based on universally accepted pillars; fairness, transparency, accountability, responsibility.

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. Aforementioned global governance will ensure a global environment enabling more participation and hence inclusiveness. Meaningful improvements in terms of inclusiveness in the less developed nations and emerging market economies will allow us to achieve this goal. Implementation of those policies requires dedication, determination and perseverance.

Advanced economies should be ready and willing to provide necessary resources for capacity building to on the one hand develop competitive and efficient business environment, and on the other improve rule of law, transparency and accountability in emerging market economies. 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, idle funds causing disturbances and excess volatility in advanced financial markets would rather be invested in innovative investments in emerging and developing world. One should see the problem as an economic externality issue where the risk is to be caught by a loop of bad Nash equilibrium. This requires first a change in the world view; globalization is an irrevocable, one way journey and, until and unless we will recognize and acknowledge that a globally integrated system cannot be managed depending on parameters of old Westphalian international structures it is not be possible to design a good governance architecture for the global world order. 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.

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