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Current growth optimism is built on weak foundations

Over the last year, much of the talk on global economic prospects has been about a new phase of sustained recovery, escaping, at last, the lingering influence of the global financial crisis. Synchronised growth ticks have been recorded in all the major regions and international trade has picked up steam. Many observers have reinforced that optimism, albeit with sporadic warnings about downside risks. However, too little has changed over the past decade since the crisis hit and that the recent growth bounce is built on weak and shaky foundations.

An influential current of opinion holds that the fiscal prudence followed by policy-makers in many developed economies in recent years is starting to pay off through a return of market confidence. The growth acceleration in the developed world to 2.2 per cent in 2017, up from 1.6 per cent in 2016, is seen as the main reason for broader optimism. However, over the first months of 2018, growth optimism has been shaken on two separate occasions. The first scare took place at the end of January, following a relatively innocuous labour report in the United States which highlighted an uptick of wage growth. Stock markets in the United States and elsewhere tumbled[1]. Speculative investors and corporate strategists interpreted the news about wage growth as a sign of inflationary pressures, anticipating an aggressive reversal of the monetary policy bonanza that had been providing nearly unlimited liquidity for their financial market operations, at home and abroad. Though stock markets recovered partially after the new head of the US Federal Reserve promised to be prudent with the monetary policy reaction, a second scare emerged in early March with talk of a trade war between the US and China. The falls in stock markets and the rise of volatility have persisted as that talk has heated up.

The optimism of a global recovery dependent on stock market appreciation in developed economies is weakly grounded in economic fundamentals; at the same time, threats from a resurgence of protectionism are poorly understood. Talk of retreating from global trade and financial integration has been gaining political traction among those communities in advanced economies that have seen limited gains from hyperglobalization and that have been damaged financially and physically by the global financial crisis and its aftermath. This is less a matter of people being "left behind" from the isolated perspective of any single country, but rather an outcome of how hyperglobalisation has been managed.

Some fundamental differences between North and South

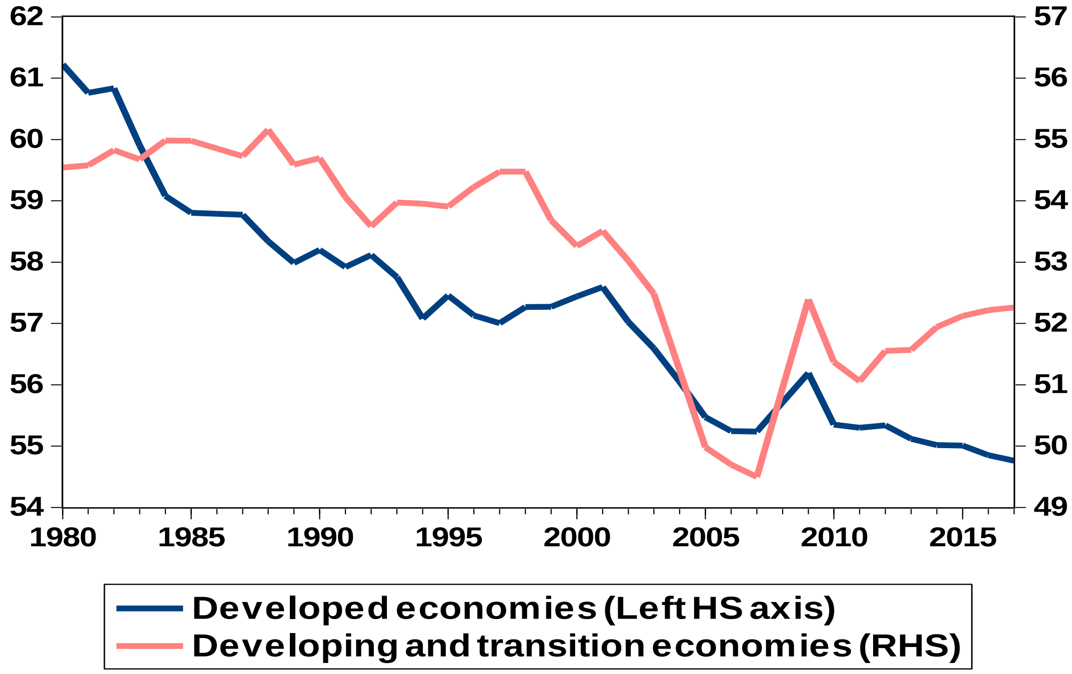
The proportion of national income accruing to labour, i.e. the wage share, has been on a declining path over the last three decades. Even during the global 'boom' from the early 2000s to the peak of 2007, the wage share fell from 57.5 per cent to nearly 55 per cent in developed countries, and from 53 per cent to 49.5 per cent in developing countries, in both cases the lowest points on record. Behind this trend households have often struggled to maintain a

[1] The S&P500 index fell by 10 per cent in less than two weeks, and in the same period stock the FTSE fell by 8 per cent and the Nikkei by 11 per cent.

sustained growth of spending with an adverse knock-on effect on productive business investment.

When private expenditure was buoyant during the boom years after 2001, it was often the result of risky financial innovation and de-regulation that allowed a debt-driven spending spree in some countries and export-led growth in others. Widening global imbalances and rising debt burdens had their reckoning in 2008. While asset prices tumbled, the crisis was felt hardest by the vulnerable sectors of the population in all countries, those who depend more on wage income and on support from their governments.

The wage share in perspective
(per cent of aggregate GDP)



Source: UN Global Policy Model based on national statistics and UNSD records)

Over the last ten years, the wage share in developing countries has seen a steady rise, succeeding in the aggregate to regain by 2017 the levels close to those in the early 2000s, even if this is still below the levels of the previous two decades.[2] As part of the policy mix, and long after the extraordinary fiscal stimuli of the immediate post-crisis, government expenditure in 2017 was still supportive of GDP growth. The average growth of real government expenditure of developing countries in the post crisis was 4.6 per cent per annum. Inevitably, the size of the fiscal deficit in developing countries grew during these years, but on average such growth was not disproportionate (from about 1 per cent of GDP in the early 2000s to about 2 per cent of GDP in the post-crisis) given that the policy mix has served to underpin GDP growth as well.

From a global and macroeconomic perspective, the problems in the post crisis period, and which are now triggering the talk of trade protectionism and recent volatility and growth concerns, reside in the policy mix of most developed countries. Policy-makers in many of these

[2] The wage share of the group of developing countries in 2017 was 55.2 per cent while in the year 2000, before it started to fall significantly, it was 53 per cent. The average of the previous two decades can be estimated at about 54 per cent.

economies have not supported wage incomes; rather, by leaning towards labour market flexibilities, under the guise of 'structural reforms,' the aggregate wage share of developed countries in 2017 was still marginally below that of the already low 2007 figure.[3] A similar contrast with the policy stance of developing countries was apparent in the fiscal policy stance. The average growth of real government expenditure of developed countries during the post crisis (excluding the extraordinary stimuli of 2009-10) was a mere 0.5 per cent, at a staggering distance from the growth of real government expenditure in the early 2000s, which was 2.7 per cent, and from that of 4.6 per cent of developing countries.

Not only was the configuration of policies in the developed economies not supportive of economic growth, but the process of income generation and wealth accumulation was uneven. Such conditions provided little support to the growth of global aggregate demand. Facing a sluggish growth impetus from developed regions, which continued for several years, it is natural that financial vulnerabilities would arise in many developing economies. As noted above, such vulnerabilities were also exacerbated by the inconsistency of policies in the major economies, as liquidity made available in these countries spilled over to the corporate and financial sectors of many developing regions, with the consequent debt build-up described below. Talk of fiscal imprudence and financial irresponsibility in developing countries seems misplaced. Granted, there is considerable variety in policy stances and performance across both the developing and developed regions and country by country analysis is required, but this variety cannot ignore the aggregate patterns described above.

Before turning to the analysis of debt and financial vulnerabilities that currently weaken the ability to sustain economic growth and that potentially represent the triggers of an impending financial crisis, a word is in order about the scope and limits of global growth prospects. Though under current conditions a crisis of some kind would seem inevitable, a situation of weak growth, volatility and uncertainty could persist for quite some time, resulting from an extension of accommodating monetary policy, postponing or softening the sequence of interest rate rises that is expected to materialize in the major economies. This way, flows of 'easy-money' will continue to support asset appreciations worldwide, including through outflows to developing countries.

Additionally, measures like the recent tax reform in the US (which represent a net windfall gain of nearly 1 per cent of US GDP per annum, and correspondingly a loss for the public sector), together with similar injections of cash into the hands of the corporate sector and high-wealth individuals in other developed economies, for example via privatizations, could continue to support financial activity, innovation and speculation, including mergers and acquisitions, stock buy-backs and other portfolio operations that contribute to increased financial concentration and political leverage. Under these conditions, significant protectionist moves will likely remain muted, given their adverse consequences on corporate profits in a highly integrated global trade and financial system.

It is plausible, under these circumstances, that the vulnerability of developing countries will increase with the possibility of triggering severe crises in at least some of them. Provided that such countries are relatively marginal in the global context and any contagion is contained, these crises need not prove consequential for the global economy. However, if income and wealth inequality persist at current levels, or rise even further, stretching the social and

[3] The wage-share of developed countries was in 2017 about 54.8 per cent, slightly below the level in 2007, of 55 per cent.

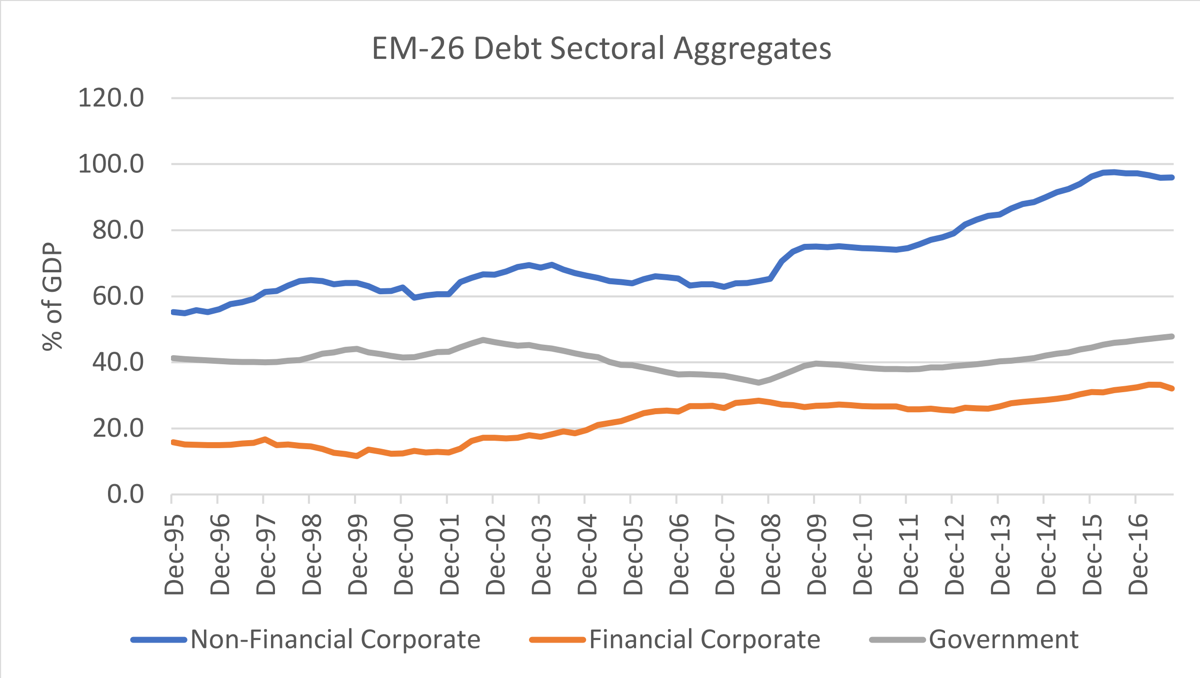
economic fabric in advanced and developing countries alike and widening global financial imbalances, the next crisis will be much more damaging when it comes.

There is of course scope for an alternative growth scenario, more inclusive and more sustainable. The tenor of the policies that are required is however so different from the previously described patterns, that it is perhaps unimaginable that there could be agreement and political will to take such an alternative direction. What is required is to strengthen efforts to support wage growth, to provide government services, infrastructure and social protection, and to regulate finance and weaken corporate concentration. Many developing countries have gone some way in these directions, but the current conditions seem to suggest that there is little more they could do in isolation. International organizations and country groups, such as the G77, the G24, the G20, the OECD and others, could play a defining role in helping to change the mindset and effectively influence a shift in policy stances.

Rising debt and financial vulnerabilities warn of another debt crisis

Against this background of weak macroeconomic trends, the continued strong dependence of global growth on debt remains a core concern. By the third quarter of 2017, global debt stocks had risen to US $ 230 trillion - or to more than three times the gross world product – from US$ 142 trillion at the onset of the global financial crisis; the ratio of global debt to GDP is now 40 per cent higher than in 2008. While the bulk of this debt is held in advanced economies, the share of developing countries in rising global debt stocks increased from around 7 per cent in 2007 to around 26 per cent a decade later. Keeping in mind poor data availability in many developing countries, this likely underestimates the true scope of developing country indebtedness that now clearly threatens to reverse the achievements of the 2000s, during which many developing countries managed to stabilise and improve their debt positions due to the combination of a favourable external economic environment, international debt relief and consequent strong domestic growth performances.

Not only do global debt stocks continue to reach new heights, year after year. Equally relevant are the changing economic dynamics that drive ballooning debt burdens and potential debt crises. A decade ago, unsustainable household debt in the US and excessive borrowing by financial institutions triggered disaster. With core banking sectors in lead economies having deleveraged - to an extent and not least due to tighter regulatory measures- the biggest worry at present is non-financial corporate debt, in developed and emerging economies alike. By some estimates, globally, over a third of these corporations are now highly leveraged, with gearing (or debt-to-earnings) ratios of 5 and above. This mostly reflects unfettered corporate access to the avalanche of cheap credit churned out by the quantitative easing and asset purchase programmes of lead central banks over recent years. An important implication is that corporate leverage in emerging markets is now less determined by conventional factors, such as domestic growth and sector- and firm-specific features of the real economy, but by the determinants of cyclical fluctuations of liquidity in the global markets, such as primarily US monetary and fiscal policies as well as the “animal spirits” of private financial investors.



Source: IIF

The EM dataset comprises 26 emerging market countries. Data refers to GDP weighted average. List includes Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Ghana, Hong Kong, Hungary, India, Indonesia, Israel, Kenya, Malaysia, Mexico, Nigeria, Pakistan, Poland, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Thailand, and Turkey.

More generally, developing country debt sustainability has been dealt a heavy blow in the wake of their hastened integration into rapidly expanding international financial markets and the concomitant much larger presence of private lenders and borrowers in developing country liabilities. Thus, for developing countries as a whole the share of public and publicly guaranteed (PPG) external debt owed to private creditors increased from 41 per cent in 2000 to over 60 per cent in 2017. In Sub-Saharan Africa alone, private non-guaranteed external debt (PNG) rose from a low share in overall external debt of around 6 per cent in 2000 to about a quarter of this debt by 2015. As a result, substantial amounts of developing country debt have become a financial asset, subject to speculation and the logic of private financial risk managers, rather than a viable and stable financing instrument to promote long-term developmental projects. Such speculative capital inflows do not, for the most part, result in productive long-term investments into structural transformation.

While not long ago, the amount of debt that even least developed economies could have sold to eager investors from abroad seemed almost limitless – international sovereign bond issuance in these economies rose from just $2 billion in 2009 to almost $18 billion in 2014 - fortunes have reversed quickly in this volatile environment. In sub-Saharan Africa, for example, debt service costs rose from an average 5.4 in 2011 per cent of government revenues to 12.2 per cent in 2017, and the medium debt-to-GDP ratio of 19 sub-Saharan economies rated by an international credit rating agency has risen from a mere 28.6 per cent in 2011 to 52.6 per cent in 2017. Of 67 poor developing economies - those eligible for concessional loans under its Poverty and Growth Trust (PRGT) – the IMF currently lists 5 as in default (up from 3 in 2015), 24 as at high risk of default (up from 15 in 2015) and 27 at moderate risk of default (down from 33 in 2015). Only 11, or a mere 16 per cent, of these countries are assessed as being at low risk of default (down from 20 in 2015). This, of course, does not include higher-income developing countries, known to be in or close to debt distress. As the IMF notes in its recent macroeconomic report on low-income countries, nine of twelve countries that moved from “low/moderate risk” to “high risk/in debt distress” are in sub-Saharan Africa.

In addition, sluggish global aggregate demand undermines developing countries’ ability to service existing external debt and volatile commodity markets, themselves affected by financialization, speculation and economic downturns, add to the unease. Nor is a turn to domestic debt in order to avoid the exchange rate risks associated with debt issuance in foreign currency, a panacea. This comes with its own risks, such as inflationary pressures and maturity mismatches, arising from the prohibitive costs of long-term government securities in most developing countries. Moreover, where foreign investors hold large positions in domestic bond markets, exposure to volatile global financial and economic conditions in host markets remains high.

With private sector – and in particular corporate – indebtedness on the rise, not only in larger emerging economies but also in the mostly poorer economies of sub-Saharan Africa, an important Achilles heel of debt sustainability is the close interdependence between private and public sector debt. Unless private firms have hedged their debt exposure in foreign currency by liquid assets held abroad, their liabilities ultimately are claims on foreign reserves held in the domestic banking system. If private sector external debt becomes unsustainable in systemic fashion, governments often have no choice but to transfer these debts onto public balance sheets, especially where they may already have supported private-public partnership schemes through public guarantees.

Yet, and despite these rising multiple challenges to developing country debt sustainability with systemic implications, the liberal international order, which prides itself on being a rules-based system, still lacks any rules for managing sovereign debt defaults. This is a severe shortcoming of the multilateral system. UNCTAD has developed comprehensive and widely recognized ‘soft-law’ principles to guide debt crisis prevention, the UNCTAD Principles of Promoting Responsible Sovereign Lending and Borrowing. In the UNCTAD Roadmap, we have also laid out guidelines toward a multilateral framework for sovereign debt crisis resolution, and the UN General Assembly has adopted Basic Principles on Sovereign Debt Restructuring Processes that should be further pursued.

These observations sum to a severe warning of a pending new developing country debt crisis. The global economy, and its governing institutions, are in no shape to cope but instead are adding fuel to the fire. In our statement to the IMFC last year, we noted that fears of a “Minsky moment” in China had been assuaged by a sustained solid growth performance in China in the context of modest signs of a wider global economic recovery. With external pressures on the Chinese economy rising through ill-advised trade wars and a steady fragmentation of what remains of international economic governance structures, such fears may be more justified now than then.

Recent moves towards trade protectionism result from a broader policy failure

Along with persistent global imbalances, rising global indebtedness and weak global aggregate demand, recent moves towards trade protectionism should be understood as part of a more general policy failure to generate a sufficient number of well-paid jobs and achieve inclusive recoveries in advanced economies after the financial crisis. Such measures will not achieve such outcomes and there is a real worry that just when greater policy coordination is needed to address mounting global challenges, the systemically important economies are moving in the opposite direction.

Over the last 30 years, at bilateral, regional and multilateral levels, trade rules have been shaped not simply by the demands of advanced economies but in alignment with the interests of a subset of corporations that dominate their trade. The root cause of the current “trade war” conflict is a valid complaint by advanced country middle classes, shared by the poorest LDCs, that the globalization of international trade embodied in the multilateral system has left them behind.

There is little doubt that developing countries would face serious collateral damage from tit-for-tat retaliation between the leading trading powers. In response, and with an impasse in trade negotiations at the WTO, it will be important that developing countries fashion a more positive integrated trade agenda that seeks to reshape the rules in a way that gives countries the policy space they need to build sustainable and inclusive growth paths but retains a multilateral commitment to flexibilities, safeguards against shocks and a willingness to deal effectively with any resulting disputes.

Along with persistent global imbalances and weak global aggregate demand, recent trade measures should be understood as part of a more general policy failure to generate a sufficient number of well-paid jobs and achieve inclusive recoveries in advanced economies after the financial crisis. Greater policy coordination is needed to address these challenges, - however, the systemically important economies are moving in the opposite direction. In response, it is important that developing countries fashion a more positive integrated trade agenda that seeks to give countries the policy space they need to build sustainable and inclusive growth paths but retains a multilateral commitment to flexibilities, safeguards against shocks and a willingness to deal effectively with any resulting disputes.