World Economy

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Global hangover proves costly

Economic growth is uneven around the world and new jobs a priority, says *Chris Giles*

Illustration: Hitandrun

Six years after the global economic meltdown of 2008-09, the world is suffering a lasting hangover. Economic growth has disappointed, failing to regain the vitality of the years before the crash. Emerging economies are far from the dynamic miracle they once seemed and rich countries are still grappling with problems exposed by the worst crisis for almost a century. A return to the days of buoyant global growth seems far over the horizon.

The level of dissatisfaction with the current state of the global economy was summed up in September's meeting of finance ministers and central bankers of the Group of 20, accounting for 85 per cent of the world output. "Growth in the global economy is uneven and remains below the pace required to adequately generate much-needed jobs," they concluded at the end of their meeting in Cairns, Australia. Worse, they saw new threats in financial markets and in geopolitics. Unity of purpose was, as usual, in thin supply, with the US again rounding on eurozone economies for not pulling their weight.

Simple disappointment, however, no longer adequately describes the global scene. Unlike in the teeth of the recession, there are stunning recent examples of economic revival such as the UK's growth surge, alongside the surprising weakness of France, its close neighbour. Among poorer countries, the recent optimism in India comes as the shortcomings of two other Bric economies, Russia and Brazil, have been exposed. Across the world, the recoveries cannot easily be characterised as V-shaped or L-shaped. Instead, as the Organisation for Economic Cooperation and Development said last month, there is a "growing degree of divergence between the major economies".

The US, about to be dislodged by China as the world's largest economy, appears to be finally enjoying a solid period of expansion, despite a weather-related blip in the first quarter of the year. As the Federal Reserve noted after its September meeting, economic activity is "expanding at a moderate pace" and is on track to meet its mandate of maximum employment and 2 per cent inflation. The UK and Canada are also growing at or above their normal rates of expansion. It is in the eurozone where there is still most concern. With inflation falling close to zero – the annual rate of price rises in September was 0.3 per cent – concern has spread to the European Central Bank that demand in the single currency area remains insufficient to bring down an 11.5 per cent unemployment rate and prevent the bloc sliding into deflation.

Mario Draghi, ECB president, said last month that "the loss in economic momentum may dampen private investment, and heightened geopolitical risks could have a further negative impact on business and consumer confidence".

In Japan, the early euphoria over Abenomics – the economic policies of Shinzo Abe, the prime minister – dissipated once it became clear that raising taxes to start on sorting out the country's public finances would hit growth. This led to renewed questions over whether Japan would continue on its path.

Yet in today's global economy, in which China is taking over from the US as global top dog, it is no longer the advanced world that is most important for global trends. Fully 30 per cent of global growth in 2014 will occur in China – about twice the share of the US – and the success of its economy is now vital for the rest of the world.

While it appeared to be struggling at the start of the year, laid low by weak house building and prices, the Chinese economy is set to grow close to its new average of about 7.5 per cent. However, Diana Choyleva of Lombard Street Research notes that much of the recovery has been driven by a resurgent

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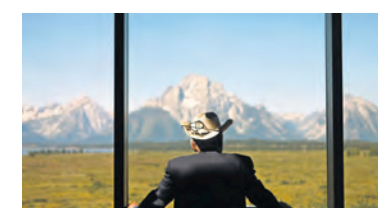

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Testing times for those seeking open markets

POINT OF VIEW

Shawn Donnan

Viewed from on high and away from the niggling of the negotiating rounds, there are two ways to look at what is happening in the world of trade.

The optimistic view is full of promise. The global economy, it holds, is about to reap the fruits of the most ambitious effort at trade liberalisation in two decades.

Better yet, when it succeeds Liberalisation will help restore growth and put globalisation back on track after years of a slowing contribution to growth by trade.

Negotiators in Geneva may be struggling to rescue the Doha Round of world trade talks, and to overcome the new Indian government's objections to a deal struck in December by the World Trade Organisation's 159 members in Bali. And, now the 13-year-old Doha Round does look like an awkward teenager, making life difficult for its parents while the WTO, about to turn 20, seems increasingly caught in its own post-pubescent existential funk.

Yet the pragmatists working outside the WTO are winning, the optimists argue.

Within months a grand "mega-regional" deal could be struck in the form of the Trans-Pacific Partnership (TPP), a union of 12 Pacific Rim countries now dominated by the US and Japan. US President Barack Obama has said he wants to announce significant progress on the partnership at the Asia-Pacific Economic Cooperation forum in Beijing in November.

By the end of next year the EU and US may close their own Trans-Atlantic Trade and Investment Partnership (TTIP). Moreover, the EU has announced the successful end of negotiations with Canada, notching up its first trade agreement with a G7 country.

There are tangible steps towards freer trade being being taken in Africa, Latin America and southeast Asia. And all seems to be well with a major "plurilateral" effort at liberalising the global trade in services.

> The pessimistic take is that all the negotiations now under way are ridden with naive false promise

The optimists argue that amounts to the most promising collection of trade liberalising measures since the Uruguay Round of the mid-1990s.

It is a compelling vision. But there is that other view of the state of things.

The pessimistic take – and its advocates would, of course, call it the realist's view – is that all the negotiations now under way are ridden with naive false promise.

Whether it is across the Atlantic or the Pacific, negotiators – led by American officials – are bogged down in the complexity of their undertaking, even as their political masters demand rapid progress.

Moreover, they are being outfoxed by vested interests determined to keep whatever protections they enjoy in place.

Few, if any, of the major attempted agreements now being negotiated are likely to succeed, the pessimists argue. And when they fail the world will fall back into a creeping protectionism, one that will contribute to an extended era of below-par growth for the global economy.

The problem the optimists face is that the world of trade recently has generated plenty of reasons to be gloomy.

And that, as power politics return in the form of the crisis in Ukraine or gunboat stand-offs in the South China Sea, suspicions are rising.

The US may, with a sharp focus on China, be leading the charge for much of the trade liberalisation now on the agenda, but President Barack Obama still lacks the fast-track authority he needs from Congress to close any trade deal. And that is evident in the slow progress of its negotiations, particularly with Japan where every promise of bold reform by Shinzo Abe, prime minister, seems to stiffen opposition to opening its agricultural markets in the negotiating room.

Worse still, from the point of view of trade negotiators, the 2016 US presidential elections are rapidly approaching.

Within the EU there is a growing public scepticism fed by frenetic social media campaigns about the value of concluding a trade deal with the US even as the strategic case for one grows via the belligerence of Russia's president Vladimir Putin.

Across the developing world there is a suspicion that all attempts at "mega-regional" agreements, such as the TPP and the TTIP, are about the rich world seizing back the control it has progressively lost over the agenda in the WTO.

That suspicion is not without foundation. In a September speech in Washington, Michael Froman, the US trade representative laid out in unusually stark terms the justification for the Obama administration's trade agenda.

"US trade policy is a central part of what may be the most consequential strategic project of our time: revitalising the post-world war two international economic order," Mr Froman told a forum on the TPP and its strategic merits.

The foundations of that order, he said, had been disrupted by "a series of seismic shocks", including "the rise of emerging markets". But the US was now working to fix that.

"We're now engaged in a major effort to ensure that, as the current order evolves, it continues to reflect our interests and our values, and that the US continues to play a leading role in it. And trade is one of our most promising tools for that project."

The global economy may indeed be on the cusp of something big when it comes to trade. But monumental things always face monumental obstacles. This time is no different.

Detail from black figure Greek amphora depicting a foot race

Moving forward

National Bank of Greece, with its substantial presence in SE Europe and the East Mediterranean, is moving ahead dynamically as it embraces the challenges of the times and joins the endeavour to place the Greek economy back on a growth trajectory. Supported by its strong deposit base, improving liquidity, enhanced capital adequacy and steadily improving profitability, the NBG Group aspires to be a key business partner wherever it operates. The NBG Group's positive performance vindicates the strategic choices that it has made, and reflects its ability to respond effectively to the considerable challenges of the times.

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Global hangover proves costly

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export sector. "China's economy has seen very little rebalancing, if any," she says.

The IMF sees activity accelerating into 2015, but warns that the threats are again growing. It went to the recent G20 meeting with a downbeat message. Although a combination of less austerity, continued extraordinarily low interest rates and improved finances of banks and households would boost global expansion, the fund still worried that geopolitical tensions from the Middle East and Russia could "trigger large spillovers on activity in other parts of the world, through a renewed bout of increased risk aversion in global financial markets". Even if financial markets remained strong, the IMF said they might in fact be too frothy, which "could eventually trigger abrupt corrections".

With mood music like this, the fund is gearing up for a bout of forecast downgrades, with the first already implemented at its annual meetings in October. It is important not to exaggerate the gloom. The world economic recovery is disappointing policy makers, but this is normal. With output across the world growing at a little over 3 per cent, it is almost identical to the average of the 1980s and 1990s. Individual countries are growing at a slower rate in rich and poor countries alike, but because the faster-expanding emerging markets are now so much larger than they were, the world economy as a whole is doing no worse than usual.

The big question is why countries are struggling to inject the dynamism into their economies that they so desire. Much has to do with the remaining hangover from the financial crisis.

Although professors Carmen Reinhart and Kenneth Rogoff warned five years ago in their book *This time is different* that financial crises historically have long-lasting negative effects, many countries thought they would be an exception to the rule.

When households and governments found they were significantly poorer than they had hoped, they realised that their debts had been designed for a different age and would take a long time to work down. In fact, according to the 16th annual Geneva report from the Centre for Economic Policy Research, the remaining high levels of borrowing – much in the public sector – are still increasing global debt burdens at a time when the nominal growth rate of global incomes continue to slow in what the authors describe as a "poisonous combination".

These dangerous forces are weighing on the minds of policy makers, made worse by signs that productivity growth across the world is slowing, limiting the potential for a sustainable growth revival. Mark Carney, Bank of England governor, has responded by stressing how "gradual and limited" interest rate rises will be when they come. But he has gone further, suggesting in August that even if there was no slack left in the UK economy, "the appropriate level of Bank Rate would not be far from [the 0.5 per cent level] where it is today".

Policy makers are in a bind in many countries. In the eurozone and Japan the onus is still on finding ways to stimulate demand. In the US and UK, the clock is ticking on the first rise in interest rates although everyone is concerned that any movement back to normal might trigger financial turmoil, but leaving monetary policy extraordinarily loose will encourage excessive borrowing which threatens an even worse outcome. In emerging markets, the need is to push forward on structural reforms to labour and product markets as well as education and social security to enable more secure and rapid growth. None of it will be easy and mistakes are almost certain.

The world economy in 2014 might defy those who like simple characterisations, but it remains far from boring. That is all that is certain about 2015.

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World Economy

An extraordinary state of 'managed depression'

MONETARY POLICY

Martin Wolf

Suppose we had been told two decades ago that a time would come when the highest short-term intervention rate implemented by the four most important central banks of the high-income countries was just half a per cent. Suppose, too, we were told that the European Central Bank was down to 0.05 per cent, after a brief and unsuccessful effort to raise the rate from 1 per cent to 1.5 per cent in 2011.

Suppose, not least, we had been told that by late 2014, rates almost as low as this, or even lower, had been in effect for more than five years, and in Japan for two decades. What would we have expected as the result of such policies? High inflation, if not hyperinflation, would have been our answer. Indeed, we would have wondered why policymakers had gone mad.

Suppose we then learned that the yield on 10-year government bonds was just 2.6 per cent in the US, 2.4 per cent in the UK, 1 per cent in Germany and 0.6 per cent in Japan. One would have to forget the notion of high inflation; we would suggest instead that these economies had been allowed to fall into a deep, prolonged depression. If we were told that central banks had also implemented huge expansions of their balance sheets, confidence in this hypothesis would strengthen. Why else would policymakers have been so unorthodox?

Up to a point, we would also have been right. In the US, UK and the eurozone, output has fallen far below what virtually everybody expected eight years ago. The same is true of Japan, though the trend in question ended two and a half decades ago.

Yet, contrary to what we might also have expected, we do not observe accelerating deflation: the latest data on annual consumer price inflation are 1.7 per cent in the US, 1.5 per cent in the UK and 0.3 per cent in the eurozone. None of these figures, even the last, are all that distant from announced targets.

When we look at the high-income economies in this way, we must recognise that they are in a truly extraordinary state. The best way to describe it is as a managed depression: aggressive monetary policies have been sufficient to halt accelerating deflation, but they have been insufficient to produce a strong expansion.

This is particularly true of the eurozone, where real domestic demand in the second quarter of this year was 5 per cent lower than in the first quarter of 2008. In the US, by contrast, real demand was 6 per cent higher. The latter is an extraordinarily feeble recovery, but the eurozone's performance is little short of appalling.

Recent suggestions by the ECB's president, Mario Draghi, that the eurozone needs a radical shift in policy regime, is the self-evident truth. Yet the powers that be in the eurozone – notably, the German government – plan to do nothing about it.

How are we to make sense of this predicament? The answer is that it reflects a prolonged slump in aggregate demand to which policymakers have failed to craft an adequate response. Lawrence Summers, former US treasury secretary, has even recalled the phrase "secular stagnation", first used in the 1930s.

In my book *The Shifts and the Shocks*, I argue that pre-crisis trends – huge global current account imbalances, rising inequality and weak propensity to invest – had already created weak underlying demand in high-income countries. The *de facto* response of policymakers was toleration, if not promotion, of credit booms. When these collapsed, extraordinary policy easing was needed both to replace the lost demand impetus from the credit bubbles and to offset the drag on demand from debt overhangs, predominantly in private sectors: too many people had borrowed too much.

We can, at last, see some reasons for optimism about the US and UK. We can envisage the beginnings of a return to more normal policy, though confidence in the ability of these economies to weather normalisation cannot be strong. More radical alternatives, such as higher inflation targets and debt restructuring, may yet be needed.

In the eurozone and Japan, however, the picture looks more uncertain. In the eurozone, more action is needed if a successful and widely shared recovery is to be achieved. In Japan, achievement of the inflation target of 2 per cent is not yet assured.

Adding to the challenges for a world in which high-income economies are not yet restored to anything close to health is the gathering slowdown of the emerging economies. These provided most of the economic dynamism both before and after the financial crises in high-income economies.

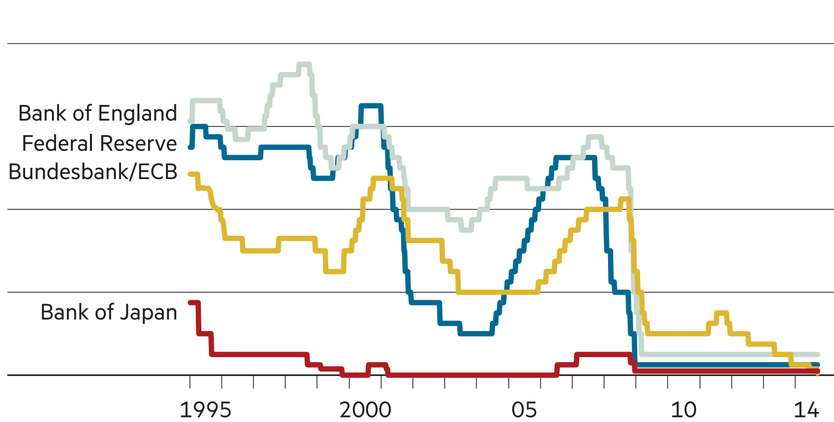
In a noteworthy blog, Sweta Saxena of the IMF notes that growth of emerging economies has slowed from 7 per cent a year before the crisis to a forecast of 5 per cent between 2014 and 2018. Moreover, this decline is not just due to the slowdown in China and India. Growth rates are now "lower than the pre-crisis average in . . . 70 per cent of emerging economies".

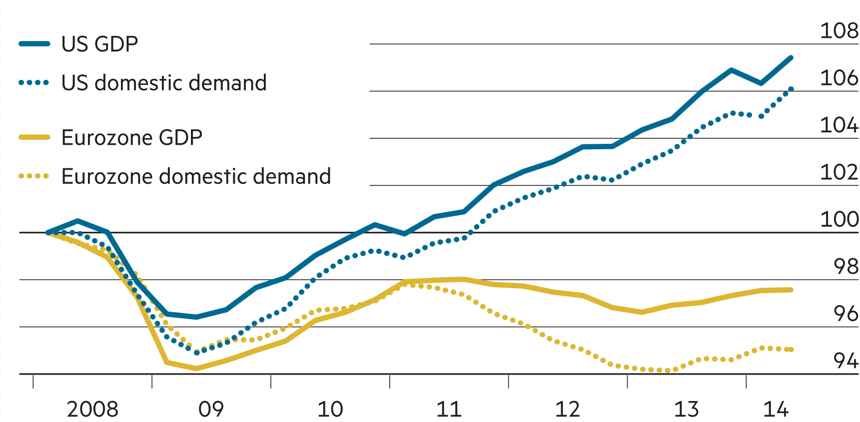
This slowdown in emerging economies is due to the prolonged weakness of high-income economies, failure to sustain economic reforms and the exhaustion of policy-induced post-crisis boosts to domestic demand. The slowdown will mean weaker growth of world trade and lower commodity prices, and is likely to reveal unexpected losses in the financial sector.

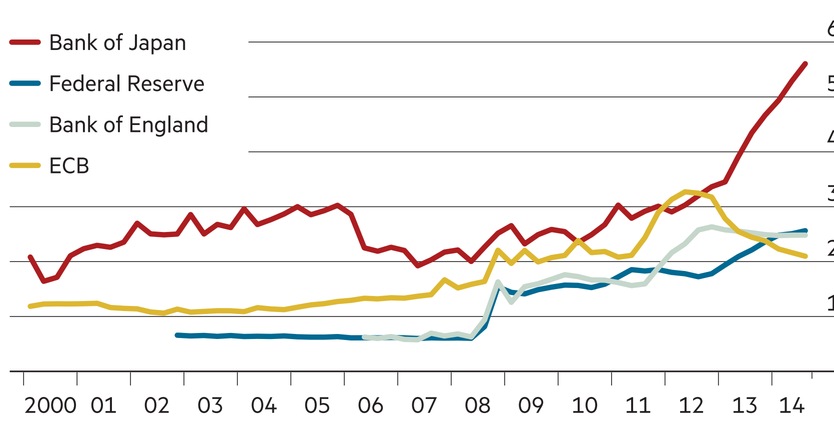
> In the eurozone, more action is needed if a widely shared and successful recovery is to be achieved

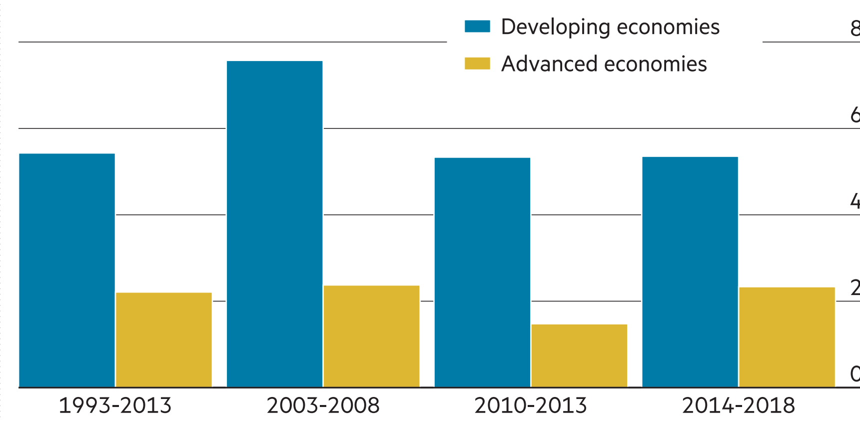
With growth in high-income economies constrained by inadequate domestic demand, a risk of feedback effects exists. The channels go from slowing emerging economies to high-income economies, especially the more export-dependent ones, and back again, as the IMF's 2014 Spillover Report argues. Complacency would be foolish. The room for further disappointment is far too large for that.

Risky business









Sources: Thomson Reuters Datastream; IMF

Purists forced to retreat in global debate on fiscal policy

Economic recovery

The choice between austerity and growth is no longer straightforward, with rich and poor countries settling on different solutions, writes *Chris Giles*

A global fight over fiscal policy has raged since the International Monetary Fund shocked the world in 2008 by recommending governments stimulate their economies by cutting taxes and increasing spending.

Almost seven years later, the battle is stuck in a quagmire with questions still to be resolved. How far should governments attempt to offset economic weakness with fiscal activism?

Are attempts to reduce public borrowing in difficult economic times automatically counter-productive? And what constitutes prudent public finance management in an era of extreme uncertainty over sustainable levels of output?

Recently, the evidence has not been kind to anyone taking an extreme stance on these questions. Critics of austerity can certainly point to Japan, which raised its consumption tax in a move that appears to have backfired. By contrast, its supporters can once again point to the UK's ability to marry rapid economic growth with deficit reduction, leading Christine Lagarde, IMF managing director, to apologise for the fund's previous criticism of the UK's deficit reduction strategy.

The mood in Tokyo has soured since the spring. Abenomics, named after the radical economic policies of Shinzo Abe, the prime minister, has taken quite a knock after April's three percentage point increase in the consumption tax to 8 per cent hit the economy harder than expected. While everyone had forecast a weak second quarter as consumers spent in advance of higher prices, the severity of the crunch has been much deeper than expected.

Japan's economy contracted 1.7 per cent in the second quarter, worse than the hit caused by the 2011 earthquake and tsunami, and has raised questions over the second stage of the planned tax rise to 10 per cent next April. Even the bold Mr Abe is now more cautious, saying in September that he was "neutral" on the question of the second tax rise.

Apologetic: Christine Lagarde

Within the eurozone, the picture is as mixed as it is on the global stage. For every country whose prospects appear to be damaged by fiscal austerity, there is a counter example of surprising strength amid the pain.

Economists have been revising higher their forecasts for growth in 2014 in Spain, Ireland, Portugal and Greece, in a sign that the deficit reduction was no longer dragging their economies deeper into recession. In contrast to the better news from the crisis economies of 2011, France and Italy, two of the eurozone's three largest economies, remain in the doldrums, unable simultaneously to sustain expansion and deficit reduction.

In the summer, Matteo Renzi, Italy's prime minister, and François Hollande, the French president, joined forces to call for a fiscal compromise in which eurozone countries would be given more time to bring budget deficits under control in exchange for commitments to implement difficult reforms to their economies, battling deep-seated vested interests. France even declared a new budget, delaying its target to bring borrowing down to 3 per cent of national income by another two years to 2017.

Their call for flexibility on budget rules was met with a predictably outraged German, Finnish and Dutch response and predictions that backsliding on fiscal policy would destroy the hard-won improvement in confidence across the eurozone.

Amid the arguments, it is noteworthy therefore that the European Central Bank and the Organisation for Economic Cooperation and Development (OECD), both bodies renowned for their tough stance against government profligacy, have called for more flexibility "within EU fiscal rules".

The clear implication was that the bloc, as a whole, should spend more EU money on capital investment projects and Germany, which is running a budget surplus, should also open its purse strings to improve its infrastructure and boost growth rates across the EU.

Globally, the IMF, the organisation which started the global debate in 2008, has tried to advocate a "horses for courses" approach to fiscal policy.

Looser fiscal policy through tax cuts and spending increases is fine, it says, if a country has the scope and the strong public finances to underpin such a move. But if these do not exist, either because financial markets will not finance higher borrowing or the underlying fiscal position is very weak, countries must attempt to bring their budget back closer to balance, it says.

This more pragmatic approach is catching on. The OECD suggested in September that because Japan still had a long way to go to bring its public debt under control it needed to implement further tax rises, despite the pain of April's move. The US, by contrast, could ease off for now so long as it worked on a medium-term plan.

Emerging economies, too, are subject to this emerging trend of more nuanced debate.

For India and Brazil, where slow growth has exposed weakness in the public finances, the OECD called for greater action to reduce borrowing by cutting state subsidies and eliminate distortions at the same time. In contrast, it said that fast growth in China implied its "broadly neutral fiscal stance is appropriate".

The new tone in the fiscal debate around the world reflects the divergent fortunes of rich and poor economies alike. It has not settled the six-year war on fiscal policy, but suggests that the purists are no longer forcing policy makers into a false choice between austerity and growth.

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Fears of housing crash in China raise global alarm

Property

Residential sales are falling in major cities, putting growth and even the worldwide recovery at risk, reports *Emily Cadman*

Fears of a housing market crash are weighing on forecasts for global growth. But this time it is China, not the US, which is causing concern in a sign of the shift under way in the world economy.

Ask economists what factors could hamper global growth this year and the majority will reel off a list that includes a hard landing for the Chinese economy.

The alarm is caused by property, with Moody's Investors Service warning in its latest outlook that a "steep housing downturn in China could derail the global recovery".

Residential sales dropped 9.3 per cent year on year in the second quarter of this year, with sales registering the deepest contraction since late 2008. Data from the National Bureau of Statistics showed house prices in August fell in 68 of 70 major cities.

Moody's estimates that, in a pessimistic but plausible scenario of a 10 per cent fall in both property transactions and prices, China's GDP growth would be between 1.5 and 2 percentage points lower than currently forecast – falling to about 5 to 6 per cent.

Lower growth in China, it warns, would "dampen" world trade, hit confidence and "could lead to a significant negative impact on global growth".

Laura Eaton, an economist at Fathom Consulting, says the risk of a hard landing in China has been "creeping up over the past few years", adding: "There is not a full-blown banking crisis in China yet, but we are certainly in the foothills."

But in the west, there is little sense that property markets present the same systemic risk to the world economy as they did before the subprime bubble burst in the US.

House prices are beginning to inch up around the world, with the International Monetary Fund global house-price index having increased for the past seven quarters in a row.

Over the past year, 33 out of the 51 countries in its index have shown rises. Adam Slater, a senior economist at Oxford Economics, a consultancy, says there are still "pockets of housing risk" and that in Australia and Canada prices look overvalued. But given substantial price drops in recent years in many key markets "the macroeconomic fallout from any further market correction should be less severe than in 2007".

In the US, house prices have recovered since bottoming out in early 2012, but have still only recovered about half of the decline from the housing crash at a national level. Hui Shan, a US economist at Goldman Sachs, says as the wider economy and labour market recovers "we expect improvements in the housing market, although the pace is likely to be measured".

Burnt by the contagion inflicted by the subprime crash, national regulators and international bodies are keen not to be seen as complacent.

In June, Min Zhu, deputy managing director at the IMF, warned that regulators needed to "guard against another unsustainable boom", but that the tool kit to manage booms "is still under construction".

One of the major factors in rising house prices around the world has been ultra-low interest rates and exceptionally loose monetary policy, which has both made borrowing money cheaper for people with mortgages and depressed yields on other assets, leading many cash rich buyers to pile into real estate.

Hong Kong first imposed caps on loan-to-value ratios in the 1990s, and since then more than 20 advanced and emerging countries have followed their example and introduced some form of macroprudential regulation, according to IMF calculations. In his speech, Mr Zhu warned of two scenarios where macroprudential tools may not be effective: "Housing booms that are driven by the shortage of housing, or by increased housing demand from foreign cash inflows that bypass domestic credit intermediation".

> 'There is not a full-blown banking crisis in China yet, but we are certainly at the foothills'
> Laura Eaton

This is one factor troubling regulators in a number of countries: while Berlin, London and Sydney may be showing many of the characteristics of an overheating market, which might require interest rate rises to combat, the same cannot be said for other areas.

Yolande Barnes, director of world research at Savills, suggested some of the bubble concerns were "overblown", adding "some of our world cities may look very expensive in relation to the countries in which they sit, this is not indicative that all of the markets are overheated".

"Anglophone countries with good legal title and transparent markets, have taken on a 'safe-haven, store-of-wealth' status with many private buyers," she adds.

Paul Bloxham, Australia chief economist at HSBC, says while he believes Australia does not have a housing bubble, "it seems likely that, if the current housing market trends were to persist for too long, there would be a risk of inflating one".

Regulation can be a useful tool

Housing booms and busts felled a number of advanced economies in 2007-09. Lately, warning lights have been flashing again.

On September 24, Australia's central bank signalled its concern about the breakneck property gains it was seeing in some regions, saying it was talking to regulators about ways of strengthening lending practices.

Its policy makers are not alone in fretting. A global index from estate agents Knight Frank shows more housing markets are seeing double-digit growth than at any time since the US subprime collapse.

Finding ways of quelling such booms is a crucial part of the central banking agenda.

Whereas central banks in the 1990s and 2000s focused their attention on targeting inflation, they now recognise that approach was too narrow, and that developments in the financial sector also matter.

The response is increasingly being found in the nascent field of macroprudential policy.

This involves using the regulation of banks and other financial institutions to head off boom-to-bust cycles in finance.

Central banks in countries including Britain, Switzerland, Israel and New Zealand have been active participants, as they focus on the risks of over-exuberant housing markets. In June, for example, the Bank of England staged its first significant regulatory foray into the housing market since the 1980s, imposing limits on large mortgages.

Its powerful Financial Policy Committee is about to get yet more statutory powers, as the Conservative-led government fends off accusations it is turning a blind eye to a new housing boom in London and southeast England.

The Bank may go yet further. A consultation paper released in August suggested it could vary a limit on banks' overall indebtedness – the so-called leverage ratio – in an attempt to act against excessive lending.

In the US, the Federal Reserve has been more cautious about using regulatory tools to fine-tune the financial cycle.

However, in September it emerged that the central bank had created a new financial stability committee to scan for threats in the system.

Fed vice-chairman Stanley Fischer, who made extensive use of macroprudential rules when he led the Israeli central bank, will preside over the new committee.

The appeal of using regulation to quell booms is clear.

Many western central banks are desperate to avoid having to raise interest rates to prevent overheating asset prices, given their worries about the fragility of the recovery.

Macroprudential policy involves measures such as adjusting banks' capital ratios, or imposing ceilings on the amount of debt a borrower can take on relative to incomes or home values. These cooling measures can be taken even when interest rates remain on the floor – as they are in Britain.

There remains confusion as to whether macroprudential policy should have a narrow goal – namely ensuring banks are strong enough to weather economic storms – or should be used to pursue a wider agenda of curbing fluctuations in the broader credit cycle.

The Bank for International Settlements – the central bankers' bank – has been notably cautious about how heavily regulators should rely on their shiny new macroprudential weapons.

Jaime Caruana, its general manager, says that macroprudential policy can be a helpful tool to target overvaluations in particular asset classes.

However, he says that monetary policy may still have to be deployed to deal with broader imbalances.

"You should not think that macroprudential policy will be enough in all cases," he told the Financial Times.

Sam Fleming

The macroprudential armoury

- Regulators can adjust the so-called countercyclical capital buffer, which is part of the Basel III regime and sets capital held against lenders' assets
- Officials can also change risk weights for lending to particular asset types, for example residential mortgages or commercial property, in order to build up resilience
- The Bank of England is looking at varying the leverage ratio – which sets the overall indebtedness of banks – to curb booms and busts
- Instead of focusing on banks, the authorities can target their customers. For example, ceilings can be imposed on the size of mortgages people can take out relative to income or to a property's value.
- Supervisors could attempt to reduce banks' exposure to liquidity crises, for example by reducing reliance on short-term funding.

Shifting dynamics at Jackson Hole underline a new divergence

Monetary policy Central banks are revising their positions on interest rates, writes *Robin Harding*

There was a subtle change in the dynamic at this year's Jackson Hole jamboree of central bankers, organised every year by the Federal Reserve Bank of Kansas City in a Wyoming national park.

Recently, many of the international central bankers have used Jackson Hole to take the US Federal Reserve to task for its easy monetary policy, or explain why they have not taken similar action themselves.

"The volatility of [capital] flows has been very pernicious and to some extent unconventional monetary policies have affected such volatility," Agustin Carstens, Mexico's central bank governor, said in 2013.

Masaaki Shirakawa of the Bank of Japan (BoJ) and Jean-Claude Trichet of the European Central Bank (ECB), two regular guests at Jackson Hole, often struck a cautious contrast to the more aggressive rhetoric of their American hosts.

But this year the pattern was different, reflecting a new divergence in global economies, and in the central bank response to them. The US Fed is now edging towards the exit from easy policy, with the Bank of England cutting a path slightly in front.

Instead, it was the BoJ and the ECB talking about bold action. Haruhiko Kuroda has launched massive bond purchases at the BoJ, while Mario Draghi is trying to stop the eurozone from following Japan's dismal path.

Indeed, Mr Draghi used Jackson Hole to tee up a new cut to eurozone interest rates, by dropping into his speech two paragraphs warning of the decline in eurozone inflation expectations.

"If this period of low inflation were to last for a prolonged period of time, the risk to price stability would increase," said Mr Draghi, in what turned out to be the biggest news story of the conference.

The effect of this has been to freeze the status quo for global monetary policy. Following the "taper tantrum" in the summer of 2013 – when bond yields jumped as investors anticipated a halt to Fed buying – many investors had anticipated a further tightening of financial conditions this year as markets anticipated the first Fed rate rise.

It has not happened. The US 10-year yield started the year at 3 per cent, but now trades at about 2.5 per cent. One plausible explanation is that the easing of monetary policy elsewhere, reflecting worsening economics in Europe in particular, has weighed down on US yields as well.

"The story there, I think, is the spectre of [European Central Bank] quantitative easing has gotten larger and larger, and with inflation in Europe at only four-tenths of 1 per cent it's looking increasingly likely," said James Bullard, president of the Federal Reserve Bank of St Louis, in an FT interview at Jackson Hole.

This new pattern of divergence is likely to dominate the global economy for the next year. The ECB has not launched asset purchases yet. But with inflation in Europe continuing to drift downwards amid slow growth and high unemployment rates in many countries, there is every chance Mr Draghi's colleagues will have to let him do so.

On the horizon: the Teton Mountains have been the backdrop for heated talks – Andrew Harrer/Bloomberg

The Bank of Japan is yet to end deflation decisively, with the most recent figures showing the slowest pace of price rises for 10 months. About three-quarters of private analysts expect further easing at some point.

The consequences of this divergence – not least a stronger dollar that is likely to restrain US growth – are another reason for the Fed to take it easy on its way towards higher interest rates.

The US central bank is almost certain to end its asset purchase programme this month, with a balance sheet well north of $4tn.

But the mantra of Fed officials on a first interest rate rise is "patience". Unless strong growth or a rise in inflation force their hand, the most likely timing for a first rate rise is the middle of 2015, with June a plausible date.

At the Fed as well as the Bank of England, an important debate continues on whether it makes sense to start raising rates early then move back to normal slowly – or whether it would be best to delay lift-off, followed by a faster pace of rises.

According to the Fed's latest projections, US interest rates will not get back to normal until the end of 2017, by which time they will stand at 3.75 per cent. That points to a slow path of rate rises, although the market has priced in a path that is even slower.

Monetary policy may be diverging in the world's advanced economies, but even five years after the end of the recession, high interest rates and tight financial conditions are nowhere in sight.

Policy makers worry that investors are underpricing risk

Volatility

The end of US quantitative easing is sending ripples across financial markets, says *Delphine Strauss*

Last year, Ben Bernanke's first hint that the US Federal Reserve was preparing to scale back its stimulus sent global markets into a tailspin. US borrowing costs spiked, shares tumbled and emerging markets currencies plunged.

The so-called "taper tantrum" was a sharp reminder of the damage that could be done if policy makers were too abrupt in reversing the exceptional policies put in place during the global financial crisis.

Yet, this month, tapering will have run its course. The end of US quantitative easing is sending little more than ripples across financial markets and the Fed is inching its way towards the first rise in interest rates.

Instead, world stock prices remain close to record highs, bond yields are low – and volatility remains relatively tame across asset classes.

The Vix index – known as the "Wall Street fear gauge" – spiked in July, as the US and EU stepped up sanctions against Russia, and rose again last month. But it remains well below the average of recent years.

However, commodity prices suffered sharp falls in September. Volatility has also picked up in currency markets, as the diverging paths of US and EU monetary policy drive a sustained rally in the dollar against the euro, but it, too, remains low by historical standards.

The long lull frustrated money managers, who thrive on volatility since it provides trading opportunities. But it also worried those who remember similar periods of tranquillity – in the run-up to the global financial crisis, or to earlier episodes of regional turbulence.

"This summer was so reminiscent of 2007 – and from the FX perspective we'd seen this before, in the mid 1990s," says Simon Derrick, currency strategist at Bank of New York Mellon, who notes that FX volatility ticked up from unusual lows before the Asian debt crisis.

Policy makers also worry that their efforts to revive growth are distorting markets, encouraging investors to underprice risk and to build up risky bets that could swiftly unwind when monetary policy returns to normal, or another shock materialises.

Confidence 'This is a market for risk assets; it's not a market for worrying,' says **Ramin Nakisa**, a UBS strategist

The Bank for International Settlements has warned central banks to head towards an exit from extraordinarily loose monetary policies before they find themselves constrained by fears of a sharp market reaction. In its latest quarterly review, it notes that "by fostering risk-taking and the search for yield, accommodative monetary policies . . . continued to support elevated asset price valuations and exceptionally subdued volatility".

It also observed that investors' confidence in interest rates remaining low had led them "to take increasingly speculative positions on volatility in derivatives markets".

Yet, policy makers face a dilemma: leaving monetary policy extremely loose will encourage risk-taking, but any move to restore normality could trigger financial turmoil. The middle course is to try to nudge markets into a more sober frame of mind, well in advance of actual increases in interest rates.

Janet Yellen, the Fed chair, attempted this in June, underlining the Fed's concern at "risk-taking behaviour that . . . can pose risks to financial stability later". Mark Carney, Bank of England governor, was probably aiming to check investors' exuberance when, in the same month, he warned that UK interest rates could rise "sooner than markets currently expect".

Yet, such warnings are diluted by the fact that – with inflation subdued – neither US nor UK policy makers face immediate pressure to tighten policy. Moreover, the worsening economic outlook in other big economies has raised expectations that other central banks will step up stimulus.

"We're still three quarters away from the Fed raising rates. We're two quarters away from the Bank of England raising rates," says Marc Chandler, strategist at Brown Brothers Harriman. "The ECB is going to pick up stimulus, the Bank of Japan is still buying and China might be easing."

Guillermo Felices, a strategist at Barclays says: "In aggregate, the environment will still feel quite benign for risk assets".

Ramin Nakisa, a UBS strategist, says: "I wouldn't say low volatility is equal to complacency. We're still in a good position globally. Structurally, growth rates are lower . . . but inflation is low, M&A and business confidence are picking up. This is a market for risk assets; it's not a market for worrying."

Volatility is bound to pick up once US interest rates start to rise – and the possible combination of a stronger dollar with weak commodity prices could hit emerging markets especially hard. But as Mr Nakisa says: "In investing terms, six months is a lifetime away."

World Economy

Productivity crisis haunts the power league

State of play As China takes its place as the world's biggest economy, growth performance has been disappointing across the board, says *Chris Giles*

It is all change at the top of the world economy power league. Not since the late 19th century, when the US overtook the UK as the world's largest economy, has there been a reranking this significant. The International Monetary Fund and World Bank annual meetings this October mark roughly the moment that China will become the world's largest economy.

Although the reinstatement of China as economic top dog has been forecast for years, we have leading statistical agencies to thank for bringing forward the date, now likely to be 2014 rather than some time in the 2020s. In April, they found that a typical Chinese citizen could buy more goods and services with one renminbi than previously thought.

Coming together under the International Comparison Program (ICP), hosted by the World Bank, these statisticians announced new conversion factors - purchasing power parity indicators - to estimate what money can buy in different countries.

The logic followed that China's economy was producing much more than previous estimates showed, hence its economy was bigger. The effect of these changes was dramatic. For 2005, when the ICP last looked at purchasing power in different counties, the internationally accepted size of China's economy was deemed to be only 43 per cent that of the US. In the latest estimates for 2011, China's share had increased to 87 per cent. Once the more rapid growth of China since 2011 is included in calculations, it overtakes the US in 2014.

The hurt US reaction was entirely understandable, while the fury in China, which fought for a year to undermine the new data, was more surprising. Those familiar with the process say its leaders did not want exposure to the international pressure that comes with being the world's largest economy.

But China's ascendancy to the top of the league is far from the only significant trend in a rapidly changing global economic landscape. The ICP report also showed that in 2011, the total output of advanced economies had already declined to only 50.2 per cent of the world's total. With persistently stronger growth rates, an increasing majority of global economic activity now occurs in poor and middle-income countries.

The speed of change has exceeded predictions and has been accelerated by the global financial crisis and its aftermath. With recession followed by anaemic recovery, advanced economies have expanded only 4 per cent in the six years between 2007 and 2013. The equivalent growth in emerging economies was 37 per cent, nine times faster.

Emerging economies have not had everything their own way, however. International Monetary Fund figures show that their growth rates have been slowing down for many years from an annual average of 7 per cent between 2003 and 2007 to a forecast annual 5 per cent growth rate between 2014 and 2018. Worse, the emerging economy slowdown has been broad-based and largely unexpected.

The one thing that rich and poor economies have in common is that the growth performance since 2010 has been disappointing. The IMF and independent forecasters have been forced to scale back expectations of economic growth, revising their annual forecasts down in every region since 2010. When countries such as the UK have bucked this trend, surprise has come mostly because expectations were so low, not because growth was historically high.

The Conference Board, an international thinktank, is concerned that a global productivity crisis is haunting the world economy. Productivity growth is the critical factor for raising prosperity in the medium term in rich and poor countries alike, and the world's ability to turn labour and capital resources into goods and services has declined for the first time in decades.

"This stalling appears to be the result of slowing demand in recent years, which caused a drop in productive use of resources that is possibly related to a combination of market rigidities and stagnating innovation," according to the Conference Board.

But there are exceptions to this pessimistic assessment. Many post-communist and post-conflict countries have experienced remarkably rapid expansions over a long period. The top 10 performing countries over the past 20 years include Rwanda, Mozambique and Angola. While Greece, Italy and Japan are near the bottom, instability in Libya was even more damaging.

It is important also to note that with the emerging world far larger than it used to be and still growing faster than rich countries, the overall growth of the world economy is not that slow.

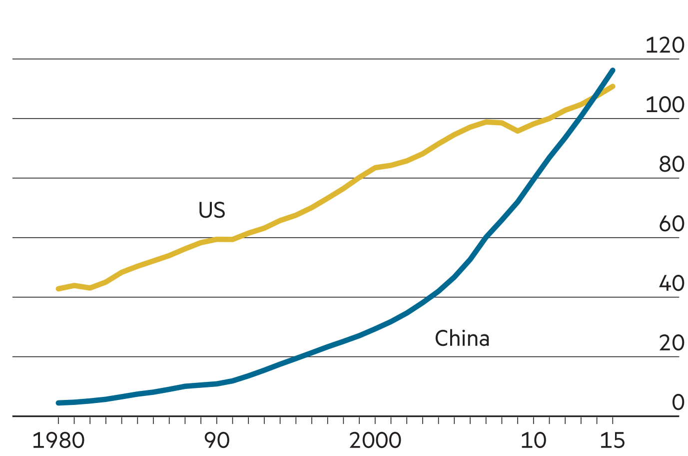
Christine Lagarde, managing director of the IMF, thinks global growth of just over 3 per cent this year is "too weak . . . and uneven". But that rate of expansion is normal in recent decades. The global economy grew at an average rate of 3.2 per cent in the 1980s and 3.1 per cent in the 1990s.

It is only in comparison with the pre-crisis period of 2004-2007, when it averaged just shy of 5 per cent, that the world economy seem sluggish. Unfortunately, it is entirely normal that the world economy faces many deep challenges that prevent faster expansion.

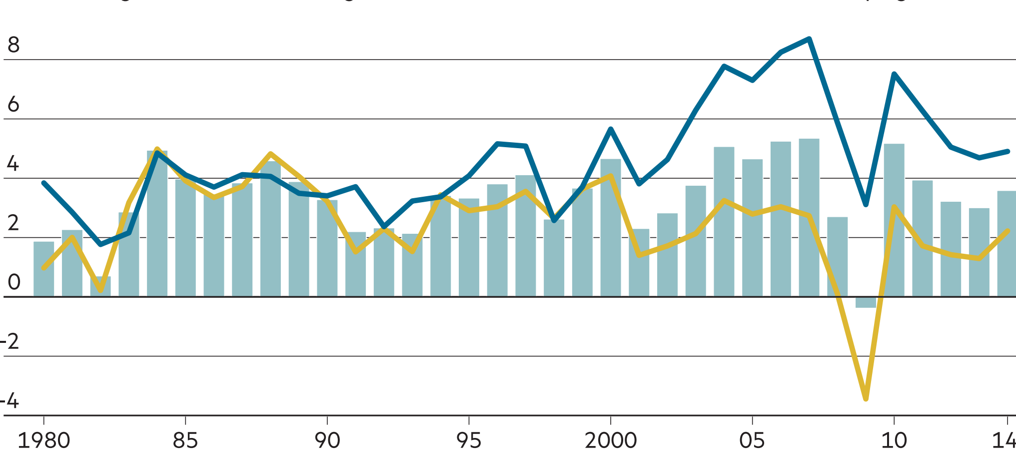
> There are fears of a global productivity crisis haunting the world economy

Developing countries take the lead

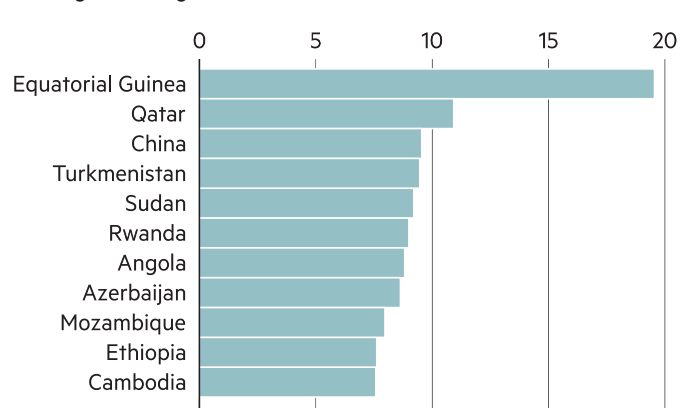
China has overtaken the US ...
Real GDP (US in 2011 = 100)



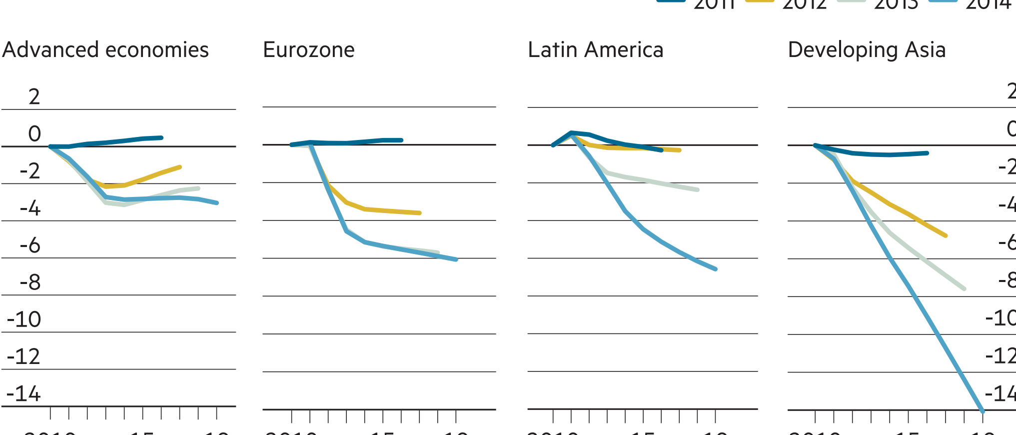
... and developing economies are supporting global growth ...
Global GDP growth (annual % change) World Advanced economies Developing economies



... with several ex-conflict countries to the fore ...
Countries with highest GDP growth in last 20 years (average annual growth 1994-2014, %)



... but expectations are being scaled down in all regions
% change in GDP compared with forecast made by IMF in 2010



Sources: IMF; International Comparison Programme

FT graphic

NEOGAMA/BBH

Photo: Dario Zalis

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Cash-strapped countries eye trillions held offshore

Tax avoidance Foreign structures are tempting targets for governments, says *Vanessa Houlder*

When governments around the world embarked on a drive to plug tax loopholes in 2012, the urgency of the move was underpinned by rising tensions over austerity and inequality.

Widespread public outrage over alleged tax-dodging by wealthy individuals and multinationals put intense pressure on policy makers to shore up their tax systems. As governments braced themselves to tackle their fiscal deficits in the aftermath of the financial crisis, they agreed a concerted effort to clamp down on evasion and tax planning.

The effort is beginning to take shape this year. One part of the initiative – aimed at making it harder for individuals to hide income in offshore financial centres – is set to usher in automatic exchange of tax information between dozens of countries by 2018.

The other aspect of the global drive is an overhaul of corporate tax rules, which has been billed as "a turning point in the history of international co-operation on taxation" by the Paris-based Organisation for Economic Co-operation and Development (OECD), in charge of the project. Its recommendations will be drawn up by the end of next year. The first batch of reports and rules was released last month, before a meeting of G20 finance ministers in Australia.

For cash-strapped governments, the trillions of dollars offshore owned by companies and individuals make a tempting fiscal target. But how much these initiatives will help countries' public finances is not yet clear – not least because there are no reliable figures on how much governments are losing.

Estimates of personal wealth held offshore run into trillions of dollars, but there is little certainty about the fraction of those funds that represent evasion. Since 2009 more than half a million tax evaders have come forward, taking advantage of reduced penalties. Governments across the world have collected more than €37bn of tax from secret offshore accounts in this way.

As governments tighten the net on tax evasion by obtaining more information on accounts held in tax havens, some are likely to eye a much bigger prize. Trillions of dollars are held offshore – often in structures that are not illegally escaping taxation. But the more information about this money governments have, the easier it will be to tax it.

As far as multinationals are concerned, estimates of the tax losses from avoidance are equally uncertain. In the US, the non-partisan Congressional Research Service has reported that estimates of annual revenue losses from profit shifting vary from about $10bn-$60bn.

The European Commission has suggested that profit shifting in Europe is likely to be on a similar scale to the US, while a paper published by the International Monetary Fund suggested that developing countries may be particularly vulnerable. The task of reducing tax losses of this sort is one of the aims of the "base erosion and profit shifting" project being driven by the OECD for the G20 group of industrialised countries. It is drawing up rules designed to halt treaty abuse, stop companies routing profits to tax havwens and tackle the arbitrage that allows businesses to exploit gaps and mismatches in the international tax rules.

In addition, governments have agreed to make multinationals' tax affairs more transparent by requiring country-by-country reporting of where they make their profits and pay their taxes.

The extent of the co-operation so far between governments on tackling profit shifting has surprised some observers, but there are many problems to be thrashed out over the next 15 months.

The political challenges are exacerbated in cases where the gaps in the international tax rules have been created by countries in a conscious effort to use their tax regimes to attract jobs and revenues. One sticking point concerns tax breaks for intellectual property where the UK, Luxembourg, Netherlands and Spain are at odds with 40 other governments over how to design rules that will stop the poaching of other countries' revenues.

Another looming issue concerns the anti-avoidance rules stopping companies from using tax havens. Both the UK and the US have been criticised for adopting rules that make it relatively easy for their multinationals to strip other countries' tax bases.

The full impact of the crackdown on base erosion and profit shifting will not be apparent for several years. But, according to Pascal Saint-Amans, the top tax official at the OECD, the project is set to re-establish governments' "right to tax". He said: "In spite of the doubts we are delivering".

Financial windfall: countries unite to clamp down on tax evasion — Shawn Thew/AFP

Incomes fail to recover, except for those at the very top of the ladder

The defining feature of the economic recovery since 2009 is how little it feels like a recovery. Part of that is the sluggishness of growth. But even more important is how the rewards have been shared out, with the vast majority going to a small number of people with the highest incomes.

Inequality was on the rise before the financial crisis, but when headline growth was strong and employment robust, it did not seem to matter so much. The post-crisis environment of slow growth and public deficit reduction has changed that and made inequality the subject of intense public interest – demonstrated in the unlikely success of Thomas Piketty's dense tome, *Capital in the Twenty-First Century*.

Increasingly, economists are finding links between rising inequality and problems with macroeconomic performance, although they remain contentious. That possibility – that inequality is hampering overall growth as well as equity – is set to make it an even more important issue in the decades ahead.

"Inequality has been growing for decades in the US, but it was masked by the growth of credit," says Ellen Zentner at Morgan Stanley in New York, the author of a long report on how it will affect consumption. "Most American households feel like they've not been made whole."

According to one of the most definitive sources of data on inequality – the US Federal Reserve's triennial survey of consumer finances – median family income was $53,100 in 2007 and had been stagnant in inflation-adjusted terms for about a decade.

In the three years to 2010, it fell by almost 8 per cent to $49,000; then in the next three years to 2013 it fell by another 5 per cent to $46,700.

The story is true right across most of the income distribution. Only for the highest-earning decile of families have incomes almost recovered to their 2007 level. Given that, it is not surprising the recovery does not feel like a recovery to the vast majority of American families, nor those in other rich countries with similar dynamics. Not only have their incomes not recovered – they have also carried on falling.

For wealth, the picture is broadly similar. Low interest rates and the resulting boom in stocks and house prices fuelled large gains in the wealth of the richest, with the share held by the top 3 per cent of households rising from 51.8 per cent in 2007 to 54.4 per cent in 2013.

From 1989 until today, the share of total wealth held by the top 3 per cent has risen from 44.8 per cent to 54.4 per cent; the share held by the next 7 per cent has changed very little; while the share held by the bottom 90 per cent has fallen from 33.2 per cent in 1989 to 24.7 per cent.

This has had notable effects on consumption patterns. Ms Zentner says that the fastest growing category of consumer spending in 2013 was pleasure aircraft, up by 25 per cent, as the wealthiest indulge in luxury travel.

Rich households tend to save a lot of their income, however.

Inequality
'Most American households feel like they've not been made whole'

Ellen Zentner

Poorer families spend more, but their falling incomes – and limited appetite to take on new debt – have added up to a slow recovery in consumption and new construction activity.

There is a growing fear that inequality will create a continuing tension between economic growth and financial stability. With incomes highly concentrated, it may need rapid credit growth to move cash into the hands of those who will spend it; yet thrusting credit on those with lower incomes is a recipe for another financial crisis.

It seems likely that forces contributing to rising equality between countries – globalisation and free trade – are at the same time creating inequality within countries. That is a painful trade-off and one that may still have years to run.

So the demand for books such as Mr Piketty's is unlikely to abate just yet.

Robin Harding

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