THEME 02

The new boom-and-bust cycle

GLOBAL FINANCIAL CRISIS | ECONOMY | FINANCIAL CYCLES

Ten years after the Global Financial Crisis (GFC), the current business cycle is long underway. However, the recognition of financial cycles as a destabilizing factor in macroeconomics and the rise of emerging markets mean that the dynamics of the next global economic downturn might be different from any previous one in history. Understanding these dynamics may provide insight into future chances and risks for the global economy.

Our observations

- Research shows that financial cycle peaks are closely associated with financial crises, and that financial cycles are much longer than traditional business cycles. Business cycle recessions are much deeper when they coincide with the contraction phase of the financial cycle. Furthermore, the length and amplitude of a financial cycle have increased markedly, reflecting the financial liberalization and changes in monetary policy frameworks since the mid-1980s.
- Economist Hyman Minsky argued that mainstream economics has neglected financial cycles in its modelling. In his magnus opus *Stabilizing an Unstable Economy* (1986), he tries to integrate financial cycles in macroeconomic analysis.
- Since the 1980s, monetary policy is now often in the hands of independent central banks, while more volatile sectors such as manufacturing and agriculture have been outsourced by developed economies. The consequent reduction of volatility in business cycles – dubbed the Great Moderation – made economists think that the era of economic downturns and recessions was over. This was most famously expressed by Nobel Laureate Robert Lucas, who stated in his Presidential Address in 2003, five years before the GFC, that “the central problem of depression preventions has been solved, for all practical purposes, and has in fact been solved for many decades”.
- Since the 2000s, many emerging markets – China in particular – have run significant current account surpluses. These significant global imbalances reduced aggregate demand in developed markets, which led to lower interest rates in these economies (as they reflected low savings relative to investments), hence partly contributing to the financial crisis.
- Since the 1990s, advanced economies’ share of global GPD has fallen steadily, from almost two-thirds in 1991 to less than a third last year. Since 2007, emerging markets account for a larger share of global GDP than advanced economies.
- The Argentine peso and Turkish lira have performed badly this year, losing about 50% and a third of their value against the U.S. dollar respectively. Many other emerging market currencies have faltered this year, leading to fears about an emerging market crisis.

>> see next page

Connecting the dots

It is ten years after the GFC, and a lot has happened to economics. Historically, financial cycles have not played a big role in macroeconomic thinking and modelling. Before the 19th century, downturns in traditional economies were caused by supply-side shocks, such as bad harvests and wars. When economies became more industrialized and new middle classes emerged in the 19th century, economic cycles became less correlated with agricultural output and downturns were primarily caused by demand-side shocks, such as falling investments and consumption, caused by a collapse in business and consumer confidence. With the rapid accumulation of fixed asset investments (e.g. fabrics, machinery) and the increase in cross-border capital investments at the beginning of the 20th century, a new source of economic downturns emerged: financial shocks. The first real financial crisis that sparked a real economic – even global – recession was the Great Depression in the 1930s, starting after U.S. stock markets lost about 85% of their market capitalization between August 1929 and June 1932. John Maynard Keynes argued in his "General Theory of Employment, Interest and Money" (1936) that depressed, lower capital investments, rising unemployment, lower consumer spending, and deflationary pressures caused an erosion of aggregate demand, creating a dangerous downward-spiraling cycle, which was worsened by the isolationism and nationalist protectionism in the run-up to WWII. The "Keynesian Revolution" of postwar economic policy up until the 1970s therefore stressed the need to keep up domestic demand by fiscal stimulus, while containing financial markets in order to limit their effects on the real economy. However, as the stagflationary pressures (high unemployment and inflation in combination with sluggish economic growth) of the 1970s couldn't be solved by traditional Keynesian thinking, the monetarist school, as formulated by Milton Friedman, introduced the monetary supply as the primary variable to solve crises, as well as financial liberalization. The neoliberal paradigm that evolved from this – combining monetarism with free markets (deregulation and privatization) and small governments (little fiscal stimulus) – in the 1980s means a greater role for the financial sphere of the economy again, hence the financial cycle has magnified in recent decades. In his time, Marx already warned that the financial sphere of the economy might detach from the real economy. But the 2008 financial crisis showed that the financial might even come to dominate the real economy. Since then, there has been renewed interest in integrating the financial sphere in macroeconomic models. Doing so has led to the acknowledgment that economic downturns can occur when financial troubles spill over from the financial sphere to the real economy, from Wall Street to Main Street. Considering the dominance of advanced economies (they accounted for 80% of global GDP between 1960 and 1980) and ongoing U.S. dollar clout in the global economy, many emerging market crises in the past occurred because of changing monetary policy in the U.S.: when "the Fed sneezes, emerging markets catch a cold".

However, emerging markets have become much more important in the global economy in recent decades, hence their business cycles might have "decoupled" from developed economies. This is reflected by the fact that many emerging markets recovered more quickly from the financial crisis. This might imply that the traditional causality of global boom-and-bust cycles might be reversed for the first time. This is magnified by the fact that after the financial crisis, many emerging markets received significant capital inflows, as ultra-low interest rates and abundant liquidity pushed investors in advanced economies to more risky investment opportunities in their search for yield. This, however, has also made them even more vulnerable to monetary transmission from the U.S. and other advanced economies. And indeed, as the Fed is underway in its tightening cycle, the U.S. dollar has risen strongly this year and U.S. bond yields rose to their highest levels in almost a decade. This has caused fear that financial troubles in emerging markets might now spill over to other economies, and create troubles for the global economy.

Implications

- There have been new academic attempts in economics to create a "paradigm shift" in mainstream economic thinking. A recent project is the 2018 "Rebuilding Macroeconomic Theory" project, led by Oxford economists David Vines and Samuel Wills, along with many prominent economists, which tries to integrate financial cycles in macroeconomic theory and create more interdisciplinary, heterodox macroeconomic models. Other examples are the Nobel prize-winning works of Lars Peter Hansen (2013) and Paul Krugman (2008), which explain the linkages between the financial and real sphere of the economy.

- Previously, emerging markets were often grouped together when financial crises hit the global economy, as they were primarily defined by their dependence on monetary policy in developed economies (especially in the U.S.). However, since many emerging markets have made structural improvements to their economies and pushed for political reforms, diversified their exports and more debt has been issued in local currencies, the correlation between the performance amongst emerging markets has weakened. This enables emerging markets with sound fundamentals and strong institutions to outperform more easily than before, beginning in the current round of U.S. monetary tightening.

- The world has become more connected since the 1970s, with the emergence of multinational companies and international production chains. However, dependency always ran from developed to emerging economies, but now developed economies have become dependent on emerging markets as well, given their size and emerging middle classes. As such, the dynamics of the upcoming global crisis might require more international coordination and collaboration.

- While emerging markets' share in the global economy has risen steadily in the past decades, there is reason to think that they still pose low systemic risk. That is because their share of global trade is relatively low, with most of them exporting manufacturing and commodities to developed economies, hence there are few spillover effects when emerging markets go into crisis. The current Sino-American trade war and the globalization backlash in general pose risk to global trade. However, trade as a share of global GDP was on a declining trajectory even before the rise of economic protectionism and the trade war, and dropped from 60.5% in 2011 to 56.2% in 2017.

>> see next page