GROWING OUT OF CRISIS

Guest Editorial

BY RAJ NALLARI

HOW COULD SMALL LOSSES on subprime housing loans in the United States, estimated at about $100 million in early 2007, lead to a global financial and economic crisis? Worldwide stock markets plunged and housing values declined sharply during 2007-08; and the IMF has projected that output losses are likely to be about $4.7 trillion between 2008 and 2015. Most experts were blindsided by the magnitude and speed with which this financial crisis, which originated in the U.S., spread to the rest of the world. Large investment banks, big corporations, millions of jobs, and about $1 trillion of private capital flows to developing countries evaporated within days of the collapse of Lehman Brothers on September 12, 2008. Some argue that if Lehman had been bailed out, the U.S. financial system would not have melted down and, consequently, a global recession could have been avoided. Others, such as Kenneth Rogoff (The Economist, 9/12/09), argue that even if Lehman had been saved it would still have had to be sacrificed later, along with other investment banks, because the system had exceeded sustainable levels: trillions of dollars had been borrowed against an asset bubble in stock and house prices.

In this issue of Development Outreach, we asked experts with diverse perspectives to address the key questions that concern the developing countries. These questions include: what were the prevailing economic conditions when the crisis struck; what was the impact during the first year of the global crisis; what policies have the developing countries taken in response; and what effects will these policies have on output, employment, poverty, and public finances. In this overview article, we provide our own thoughts on these questions.

What were the economic conditions before the crisis?

A "PERFECT STORM" WAS BREWING as U.S. and European housing defaults began piling up in late 2006, oil prices doubled during late 2007 and early 2008, and rice, wheat, and corn prices jumped by 40-50 percent during the same period. Sustained global growth between 2000 and 2007, especially in emerging and developing economies, had catalyzed demand for many commodities, including oil, metals, and food. At the same time, supply had been slow to catch up to this growing demand, causing prices to rise. Beginning in 2006, a number of other factors also contributed to the rapid jump in food prices. For example, unfavorable weather conditions reduced harvest yields; rising biofuel production in advanced economies jacked up corn prices as well as feedstock costs; the rise in oil and energy prices boosted production costs for food commodities through higher prices for transportation fuels and fertilizer; and the growing use of export restrictions by food exporters as a way of raising domestic food supplies and lowering domestic prices has put pressure on world prices, contributing substantially to the run-up in rice prices in 2008.

Finally, the bursting of the housing bubbles in the U.S. and Europe in 2007 led to a surge in defaults and foreclosures, which resulted in a plunge in the prices of mortgage-backed securities. These financial losses have left many financial institutions with too little capital relative to their debt. They have, therefore, been unable to provide the credit required for economic growth.

Many other culprits have also been implicated and it is more than a government or regulatory failure. Markets also failed. A long period of abundant liquidity, low interest rates, and a global "search-for-yield" led to rising asset prices. In addition, there was a steady build-up of macroeconomic imbalances as Asian countries and oil-importers were pursuing policies of foreign exchange reserve accumulation. All this was taking place at a time when financial systems were going global and integrating through new technologies. Complex, nontransparent financial instruments were mispriced and levels of risk were misunderstood. Regulators in some cases failed to respond to, and in other cases facilitated the build-up of imbalances. Service providers, including credit rating agencies, loan originators and payment collectors were also involved.

When Lehman Brothers went belly-up, the global financial system itself was on the verge of collapse. Globalization, defined as the increasingly free flow of ideas, people, goods, services, and capital that leads to the integration of economies and societies, has become a major force for global change. It has also added to the number of channels through which shocks can be transmitted across borders more quickly. As shocks have become larger and more frequent, economies from North and South have to move in lock-step. This co-dependence reduces the ability of individual economies to manage their way out of a crisis, especially when it is the largest economy that is transmitting the shock.

What has been the immediate impact of the crisis?

WORLD OUTPUT DECLINED by an unprecedented 2.25 percent (annualized) in the last quarter of 2008; and global trade and industrial activity have fallen substantially since November 2008. All the major industrial economies entered a
period of deep recession, and several emerging markets were sputtering in late 2008. Growth in emerging and developing economies has decelerated abruptly to 3.25 percent, mostly because of external pressures—lower foreign demand, reversal of capital inflows, and plunging commodity prices. Anemic global growth has reversed the commodity price boom and lowered inflation. These price declines (except for gold) have dampened growth prospects for a number of commodity-exporting economies.

In the first few months of the global crisis, there were massive lay-offs of workers in China’s garment, toy and electronics manufacturing sectors, in Bangladesh’s jute mills, in Cambodia’s garments industry, and in India’s diamond polishing, textile and garment firms. Martin Ravallion’s article in this issue describes how more than 50 million people may have been pushed below the poverty line during the first few months of the crisis. If the Asian crisis is any indication, poverty levels are likely to be much higher in several of the affected countries and to remain so, long after the global economy recovers.

Professor Sinn’s essay makes an interesting point: that the U.S. was the main shock producer because it reduced its imports more than its exports during late 2008 and early 2009. To a lesser extent, China, Brazil, the United Kingdom, and South Korea followed a similar practice. In contrast, Germany, Japan and Russia were the main shock absorbers as their imports exceeded exports during the same period.

How did policy makers react to the global economic crisis?

Policy makers understood early on that the current global downturn was far from your normal garden-variety recession. The central banks were the first to react, while commercial banks were sharply curtailing credit in the face of global deleveraging—there was monetary easing as interest rates were cut dramatically, liquidity provision was stepped up, limits to deposit insurance were expanded, and special credit lines were set up for use by troubled banks.

The size of governments expanded overnight. First, several crisis-afflicted and crisis-prone countries directly supported their financial sectors by injecting funds to recapitalize banks, insurance companies and investment banks, especially those deemed "too big to fail." For example, the International Monetary Fund (IMF) estimates that advanced G-20 economies spent about 3.5 percent of their GDP on such financial support. Hungary, Poland, and Ukraine took similar steps in providing direct support to the financial sector. Second, as growth slowed in almost all countries, declines in the price of equities, properties, and commodities led to reductions in government revenues and private and public spending. Aggregate demand had to be shored up by fiscal stimulus packages. Third, the losses on funded pension schemes increased governments’ fiscal liabilities. For example, countries in the Eastern and Central Asian region have automatic stabilizers such as unemployment benefits. Fourth, several countries used public resources to bail out their troubled industries (for example, General Motors and Chrysler in the U.S. and the French auto industry). Fifth, the governments became "market makers." However, despite this expansionary fiscal policy, John Taylor’s article details why the U.S. and European governments’ fiscal (and monetary) policies may not work and could actually exacerbate the problem, including prolonging the recession.

As a result, public finances have deteriorated in a number of advanced and developing countries, and this has increased fiscal risks and raised premiums for government-issued bonds. Early IMF estimates for advanced economies are that fiscal balances could decline by about 8 percent of GDP between the end of 2007 and the end of 2009, and by 5 percent of GDP in the case of emerging economies. There is likely to be a dramatic increase in public debt levels in both advanced and developing economies. Carmen Reinhart’s paper, in this issue, is based on an historical analysis which concludes that this crisis is essentially no different from past crises and that they always end with deficit, debt, and default. But small open economies such as the Caribbean and Pacific Islands are highly dependent on external economic conditions and on imports. As Dwight Venner’s piece argues, these countries cannot use fiscal stimulus packages to respond to an external shock since their increased spending will fully leak out through higher imports.

To date, few countries have taken major steps toward trade protectionism, despite the fact that exports fell by as much as 23 percent in China and other emerging markets. However, some have targeted export firms for subsidies and included protectionist measures in their fiscal stimulus packages. Anne Krueger’s essay makes a strong case for open trade policies, since resumption of global trade is imperative for economic recovery. She argues that with the liquidity crunch, international traders needed more secured means of payment and there is a demand for newer trade-finance instruments than the traditional letters of credit. Moreover, countries have refrained from "beggar-thy-neighbor" competitive exchange rate devaluations to ensure their own exports. Brian Kahn’s essay details the policy mix that was used to stabilize the South African economy.

Joseph Stiglitz’s essay focuses on international coordination issues. This is a global crisis and therefore there is a need for collective action, such as the attempts made by the G-20 since November 2008. Fiscal stimulus in the U.S. will not be very effective if the Euro zone countries do not stimulate their economies. When all countries act in concert, the amount of global fiscal stimulus needed is much less, and the world economy will recover much sooner.

What is the outlook for the world economy after one year of meltdown?

There were some signs of recovery or “green shoots” in the U.S. and a few other advanced economies between July and September 2009, but unemployment is still rising in the Western world. After increasing between 2000 and 2007, world output growth slowed down to about 3 percent in 2008 and is projected to decline by 1 percent in 2009. Underlying these averages is the fact that advanced economies, which grew at
about 0.6 percent in 2008, are projected to decline by 3.4 percent in 2009, and begin to show some recovery in the year 2010. The reason for this low performance is that the financial system in the U.S. and Europe has been damaged and the fiscal burden of the economic and financial crisis is quickly mounting. On the other hand, emerging and developing economies are expected to grow at about 6 percent on average in 2009, with China, India, and other Asian countries pulling the world wagon. Conversely, there have been steep declines in output in Central and Eastern Europe, Russia, Mexico, and a few other countries. Vladimir Gilgoforov’s essay on Southeastern Europe points out that output declines in crisis-affected Eastern European countries may never come back to the trend growth rate.

How can countries sustain their economic recovery? There is a need to recover the funds released as bail-outs and to ensure liquidity. Central Banks need to be aware that their balance sheets have expanded because of measures they took to achieve monetary easing, and their debt levels have risen. There is an increased likelihood of a sudden jump in inflation. But policy makers should not be tied too strongly to inflation-targeting and they must learn to better manage asset bubbles. Interest rates have to be increased gradually as the economy gains strength. Asian central banks have to be more prudent in foreign exchange reserve accumulation and move away from currency manipulation. More and more countries are moving to intermediate exchange rate regimes such as managed float, target bands, and basket pegs. On the fiscal side, highest priority should be assigned to bringing down deficits and debt levels that were incurred in fighting the recent recession. Subsidies to large auto industries and financial firms puts similar entities in developing countries at a disadvantage.

Fiscal discipline has to be reinstated and governments will have to reform health and pension systems. Financial regulations are urgently needed to deal with institutions such as banks, investment banks, insurance, housing-finance entities and so called too-big-to-fail firms. Further, prudential regulations need to be counter-cyclical if they are to be successful in managing credit growth and asset bubbles. In developing countries, a lack of financial intermediation is an underlying cause of global macroeconomic imbalances.

For almost a decade, international economic observers have advised that the world economy needs a major adjustment. Sustained global growth requires that the U.S. cut back on its domestic demand and let the dollar depreciate to increase net exports, which will enable the U.S. to improve its current account balances. Conversely, China and other Asian countries should stimulate domestic demand and let their exchange rates appreciate. Such a rebalancing of aggregate demand, away from the U.S. and toward China, would help sustain a global recovery. If this rebalancing does not happen quickly, global growth may be flat.

With the U.S. at the epicenter of the financial crisis, countries such as the BRICS (Brazil, Russia, India, China, South Africa) and oil producers holding large foreign exchange reserves primarily in U.S. dollars began to worry about the efficacy of the dollar as the main reserve currency. Barry Eichengreen’s essay discusses why the euro and the yen may find it hard to dislodge the dollar as the reserve currency.

This crisis can prompt a structural transformation that could change the economic history of the world. The developing economies, which together account for about 50 percent of world output, are on the rise and playing a major role in the world recovery. Some of them have the fiscal space to borrow, but the volume of financing they need at fair prices, without crowding out the private sector, may not be available. To address such impediments, the World Bank has set up a new Asset Management Corporation through its private sector wing (the International Finance Corporation) to invest in banks, equity, infrastructure, and development of local currency bond markets, and to facilitate debt restructuring.

Conclusion

Is the financial crisis over and could it happen again? National supervision and regulatory systems were inadequate to manage transnational institutions, such as Lehman Brothers, Citibank, AIG, DEXIA Bank and others. Consequently, national authorities have to pay closer attention to risk-taking behaviors, to limit leveraging, tighten capital regulation, attend to liquidity supervision as well as supervision of complex cross-border financial institutions, and to improve transparency of transactions.

The crisis has also revealed deficiencies in international coordination such as the IMF’s weak surveillance of advanced economies and its lack of enforcement authority. National and global solutions are needed to regulate capital flows and prevent systemic and global risks by reining in financial firms and conglomerates; to ensure higher international standards for credit rating agencies; and to eliminate inconsistencies in national legal frameworks. There is even talk of creating “a global college of supervisors.”

How can we deter another crisis? One way is for central banks not only to keep inflation low but also to manage asset bubbles early on. Rapid growth in credit should be tracked and carefully analyzed to ensure that it is in line with financial development and not fueling asset price increases. Some would prefer that the early warning systems of macro- and micro-prudential indicators be further developed. However, each financial crisis is different and such indicators may not be very useful in predicting a banking or financial crisis because they do not take into account the inter-linkages between credit flows to various sectors and issues of “too-big-to-fail” conglomerates and cross-border financial flows.

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Endnote

1 It is estimated that in the United States there were almost 7 million housing loans “under water” and close to default, each loan averaging about $300,000; this totals to $2.1 trillion. In addition, potential defaults on credit card payments, student and car loan payments are estimated to be in the range of about $10-12 trillion. The government could have directly taken over these bad housing loans and loans held potential defaulters but moral hazard (rewarding bad behavior will incentivize even non-defaulters to default on loan payments) can exacerbate the problem.