Understanding the Global Financial Crisis

Department of Economic and Social Affairs,
United Nations, New York

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Crisis no one expected?

- Contrary to media, crisis foretold
- Global imbalances unsustainable
- Systemic crisis what system?
- International financial architecture?
- Ideology: deregulation and self-regulation
- Capital account liberalization myths
- Financial Globalization: growth, stability?
- Decoupling despite globalization?
- Policy responses double standards
- International cooperation: G7, G20, UN
Globalization: finance → trade

Figure 1
Finance driven globalization

Years

Global financial assets
Global merchandise trade
Global financial assets as a percentage of GDP (right axis)
Global merchandise trade as a percentage of GDP (right axis)

Finance-investment nexus?

Gross Fixed Capital Formation
Gross Financial Investment Abroad
Global imbalances remain, but shifting

Crisis unfolds

Sub-prime crisis $\rightarrow$ financial crisis
$\rightarrow$ credit crunch
$\rightarrow$ US recession
$\rightarrow$ Asset price deflation
$\rightarrow$ Less investment
$\rightarrow$ Less consumption
$\rightarrow$ Reduced demand for imports, i.e. for exports of others
$\rightarrow$ Prices, output decline
$\rightarrow$ Growth, employment decline
Asset price bubbles

due to:
• financial deregulation,
• aggressive monetary easing since 2001 downturn
• greatly increased US household, government debt financed by Asian savings

International finance reversal

* Global financial crisis → intl investors more risk averse, reducing exposure to emerging mkts (pension funds, mutual funds, hedge funds)
* Also forced to withdraw by "margin calls" at home;
  • Uncertainty → ‘flight to security’
  • Thus, losses in home markets force them to pull out of emerging markets
  • Also, global financial crisis seriously weakens growth and profits worldwide
  → including earnings in emerging markets
  → reducing investor interest in emerging mkt stock
Emerging markets tumble

* Plunged by about 50% on average, some > 60% much more than average 30% in rich countries
* Not only rich, but many middle income households (HHs) own equities
  → direct impacts on HH income, wealth
* As stock markets plummet,
  solvency of banks + firms depend on capital
* Hence, when capital values plunge,
  even ordinarily solvent firms look overleveraged

Credit crunch slows economy

* Many banks have reduced lending
  → firms cut investment spending,
  less investments → more lay offs
* Drop in stock market prices → wealth effect
  → less disposable income
  → reduced spending, effective demand
* World economic slowdown,
  → more unemployment, less decent work
  → less govt revenue → limits govt spending
Credit crunch: interest rate down, but lending down

(Rising spread on interbank lending, % points)

Key Interest Rates

<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>16 Dec</td>
<td>1.0</td>
<td>0 to 0.25</td>
</tr>
<tr>
<td>ECB</td>
<td>5 Dec</td>
<td>3.25</td>
<td>2.5</td>
</tr>
<tr>
<td>UK</td>
<td>8 Jan</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Japan</td>
<td>19 Dec</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>China</td>
<td>23 Dec</td>
<td>5.58</td>
<td>5.31</td>
</tr>
<tr>
<td>Malaysia</td>
<td>21 Jan</td>
<td>3.25</td>
<td>2.5</td>
</tr>
</tbody>
</table>
Worse in emerging markets

Foreign Direct Investment

* FDI inflows more stable than short-term equity investments + other portfolio flows
* Hence, global financial crisis + global recession will also affect FDI inflows negatively
* With slowdown, FDI to emerging markets slowing
Implications for global economy

- **Global economy in recession?**
- Many OECD countries in recession since 2008 and slowing GDP growth in developing world (not delinked)
- Export-led growth in developing countries not sustainable with import demand drop
- Limits to domestic demand growth without fiscal stimuli, redistribution.

World economy in recession

![Graph showing world economy in recession](image)
Globalization: Parallel fates

Growth prospects bleak

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1.1</td>
<td>-1.6</td>
</tr>
<tr>
<td>EU</td>
<td>1.0</td>
<td>-2.0</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.3</td>
<td>-2.6</td>
</tr>
<tr>
<td>China</td>
<td>9.0</td>
<td>6.7</td>
</tr>
<tr>
<td>India</td>
<td>7.3</td>
<td>5.1</td>
</tr>
<tr>
<td>ASEAN</td>
<td>5.4</td>
<td>2.7</td>
</tr>
<tr>
<td>World</td>
<td>3.4</td>
<td>0.5</td>
</tr>
</tbody>
</table>
Recession in most developed economies

Slowing growth in all developing countries
Synchronous growth: The US, transition & developing countries

![Graph showing economic growth compared to world income per capita decline in 2009.](image)

World income per capita will decline in 2009

Dashed lines represent pessimistic scenario
Recessionary impacts, trade channels

- Exports decline → all developing countries
- Terms of trade → primary exporters
- Trade surpluses, reserves may run down quickly
- Lower energy, food prices → net food and oil-importers

Reduced exports

- 50% of US imports from developing countries
- Shrinking demand has significant impacts
- Slowdown in export growth of developing countries, especially Asia → significant slowdown in industrial production
- In LA + Africa, X growth of primary commodities
- Most Xs have weak linkages with domestic economy, more vulnerable to external shocks
- Commodity prices began declining from mid-2008
- Oil price dropped >70% since August 2008
Strong US demand lifted developing country exports

Manufacturing demand supported high primary commodity prices
High commodity prices over

- Last 5 years rare opportunity for many developing countries – including LDCs – to generate substantial financial resources from higher primary commodity exports for investments and growth – largely over
- 2008 price spikes for energy and food due to speculation following flight from ‘Wall Street’ (finance) to ‘Chicago’ (commodity futures), other factors

Oil prices roller-coaster

- Chart showing nominal and real oil prices from 2002 to 2008
- Nominal price
- Real price

$ per barrel

2002 2003 2004 2005 2006 2007 2008
Non-oil commodity prices

World food prices declining after spikes
World trade growth decelerating rapidly

![World trade growth chart](chart.png)

Impacts on developing countries

* Developing countries will **bear brunt** of global fin. crisis originating in US + other devd countries
* Emerging markets **not ‘decoupled’** from US economy
* Crisis impacts **felt by all**, albeit differently
* Financial positions of many developing countries **much stronger**
  than during financial crises in Asia + LA, due to strong foreign reserves, better fiscal balances
Policy priorities

- **Limit spread of financial crisis**
  - Across borders (contagion)
  - To real economy (ensuring liquidity)
- **Reflate economy**
  - Fiscal measures (fiscal space needed)
  - Monetary measures (monetary space)
- **Appropriate regulatory reform**
  - National
  - International

Reform priorities

**Financial regulation** should be strengthened appropriate to new conditions + challenges, including better crisis management, prevention. Regulations should be **counter**, not pro-cyclical.

Appropriate **capital account management techniques** to stem undesirable + excessive capital inflows, to avoid sudden, disruptive large outflows.

Affordable financing for **productive long-term investments**, e.g. development banks, commercial banks, deeper financial, especially bond markets.
**Financial liberalization → financialization**

* Financial deregulation facilitated ‘financialization’
* Earlier pressures for financial liberalization will now abate, though not clear for how long
* Calls for more regulation + government intervention -- typical responses during crises, but not after
* Once crisis subsides, pressure to reform will be lost
* Quick fixes during crisis typically not adequate to prevent future crises

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**Financial regulation objectives**

- Prudential risk management
- Finance growth (output, employment)
- Counter-cyclical: limit pro-cyclicality
- Support investment + technology policies crucial for development
- Inclusive finance
Financial globalization

- No contribution to growth
- Volatility, instability worsens
- Cost of funds not lowered
- Net flow of funds from poor to rich, especially to US in last decade
- High costs of sterilization, modest net gains
- Reserves build-up for ‘self-insurance’ further reduces net gains, but may reduce vulnerability this time

US vs IMF?

2008: US pursuing policies IMF opposed during Asian crisis, e.g. lower interest rates, bail-outs, restrictions on short-selling, fiscal stimuli
US could not reflate, bail-out with IMF program
- IMF double standards?
Monetary policy

Role of central banks today:

- primarily curbing inflation - unlike US Fed
- US Fed broader mandate -- obliged to sustain growth + employment
- Also in IMF Articles, but not reflected in recent practices, e.g. capital account liberalization, inflation targeting, strict fiscal constraints

Major Challenges 1

Falling commodity prices
- Contracting export markets
- Trade surplus decreasing quickly
- Domestic demand down too
- Employment, incomes, demand lower
Export Implosion in E. Asia
Dec 2008 exports y-o-y(%) 

<table>
<thead>
<tr>
<th>Country</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>-35.0</td>
</tr>
<tr>
<td>China</td>
<td>-2.8</td>
</tr>
<tr>
<td>S Korea</td>
<td>-17.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>-15.7</td>
</tr>
<tr>
<td>Singapore</td>
<td>-20.0</td>
</tr>
<tr>
<td>Taiwan</td>
<td>-41.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-4.9 (Nov)</td>
</tr>
</tbody>
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Major Challenges 2

- Short-term capital inflows reversal
- FDI slowing
- Stock market collapse → negative wealth effect
- Bank lending growth down
- Domestic investment rate down
Domestic demand

- Lower X earnings because of weakening commodity prices + global recession
- Need to augment domestic demand to offset weakening foreign demand
- Build + improve physical + social infrastructure; extend social protection
- Most countries’ fiscal space limited → need more policy space to cope

Stimulus packages compared (% of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>1st stimulus</th>
<th>2nd</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1.1%</td>
<td>6.0%</td>
</tr>
<tr>
<td>EU</td>
<td>1.5%</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>2.5%</td>
<td>5.8%</td>
</tr>
<tr>
<td>China</td>
<td>18.0%</td>
<td></td>
</tr>
<tr>
<td>S. Korea</td>
<td>1.1%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Singapore</td>
<td>8.5%</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>1.1%</td>
<td></td>
</tr>
</tbody>
</table>
Social protection counter-cyclical

- Employment crucial, especially for poverty reduction
- Fiscal stimulus, esp. for job creation
- Conditional cash/ income transfers
- Universal vs targetted social protection
- Incomes $\rightarrow$ demand maintenance
- Credit, especially for investment

Constraints on developing country responses

- Policy, including fiscal space constrained
- IMF requirement for fiscal stimulus: most countries – including US – not eligible
- Policy, including fiscal space constrained
- Monetary policy less effective, worse with independent central banks
- Systemic, institutional, market procyclicality
- Declining aid likely to worsen deterioration
Thank you

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