Global Economic Crisis: An Empirical Study on the Diverging Scenario of Emerging Economies Post Crisis

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Abstract: The global crisis, that began in July 2007 with the credit crunch, is considered by many economists the worst financial crisis since the Great Depression of the 1930s. The crisis played a significant role in the failure of key businesses, declines in consumer wealth estimated in trillions of U.S. dollars, and a downturn in economic activity leading to the 2008–2012 global recession and contributing to the European sovereign-debt crisis. With half a decade's hindsight, it is clear the crisis had multiple causes. The most obvious is the financiers themselves—especially the irrationally exuberant Anglo-Saxon sort, who claimed to have found a way to banish risk when in fact they had simply lost track of it. The “Great Moderation”—years of low inflation and stable growth—fostered complacency and risk-taking. The Fed’s defenders shift the blame to the savings glut—the surge of saving over investment in emerging economies, especially China. That capital flooded into safe American-government bonds, driving down interest rates. Low interest rates created an incentive for banks, hedge funds and other investors to hunt for riskier assets that offered higher returns. The low volatility of the Great Moderation increased the temptation to “leverage” in this way. If short-term interest rates are low but unstable, investors will hesitate before leveraging their bets. But if rates appear stable, investors will take the risk of borrowing in the money markets to buy longer-dated, higher-yielding securities. That is indeed what happened. Likewise, this study tends to focus upon the long sustaining issues developed from the crisis and analyzing the prospective future trends to the growth of world economy as a whole.

Keywords: The Crisis; Collective Economic Impact; Ways to recover up, Siblings of Recovery, Way Ahead.

1. Introduction

Financial crises have been pervasive for many years. Bordo - Eichengreen - Klingebiel - Martinez - Peria (2001) find that their frequency in recent decades has been double that of the Bretton Woods Period and the Gold Standard Era, comparable only to the Great Depression. Nevertheless, the financial crisis that started in the summer of 2007 came as a great surprise to most people. During the fall of 2007, the prices of subprime securitizations continued to fall and many financial institutions started to come under strain. Although the financial system and in particular banks came under tremendous pressure during this time, the real economy was not much affected. All that changed in September 2008 when Lehman’s demise forced markets to re-assess risk. In the months that followed and the first quarter of 2009 economic activity in the U.S. and many other countries declined significantly. Unemployment rose dramatically as a result. The general consensus is that the crisis is the worst since the Great Depression. What initially was seen as difficulties in the U.S. subprime mortgage market, rapidly escalated and spilled over first to financial markets and then to the real economy. The crisis has changed the financial landscape worldwide and its full costs are yet to be evaluated.

The effects on the financial system

The problems started in securitized subprime mortgages but then they spread to many other parts of the financial system because of the interaction with the real economy. These credit risk problems have led to a flight to quality with many people wanting to buy government securities. The central banks have facilitated this with all these programs that they have where they allow financial institutions to swap a wide range of securities for Treasuries. As a result the Federal Reserve’s balance sheet has expanded form about $800-$900 billion before the start of the crisis to about $2,000-$2,500 billion afterwards.

Policy responses

The U.S. Federal Reserve, in the period, announced the establishment of temporary swap lines with the Central Banks of Brazil, Mexico, Korea, and Singapore. However there is a concern that the SLF is “essentially dividing developing countries into an A-list of nations that qualify for loans without strings, and a B-list of everyone else.” As Kemal Derviş, UNDP Administrator (Washington Post, November 2, 2008) put it: “Emerging markets cannot be easily and simply divided into two categories: those with good and those with bad policies” (Bhattcharya, Derviş and Ocampo, 2008). For low-income countries, the enhancement of the Poverty Reduction and Growth Facility (PRGF) to compensate for the adverse terms of trade shocks, and the Exogenous Shocks Facility (compensatory financing without a PRGF) are clearly insufficient, especially as regards the scale of the lending (Griffith-Jones and Ocampo, 2008).*

Discussing about the regional responses funded by developing countries, these countries are in an excellent position to contribute to the task of development, given their large foreign exchange reserves and their ability to use those reserves more actively.

2. The Crisis and Policy in Developing Countries

The BRICS and other emerging markets, and the developing world as a group, saw the United States as perpetrator and epicenter of the crisis. The crisis and its aftermath may be seen in the developing world as an illustration of the apparent
benefits of resorting in the manner of China to executive discretion in the interests of an effective state that can act quickly and effectively (Birdsall, 2012).

3. China’s Economy in the Crisis: Impact and Policy

Initially, China was less affected by the global financial and economic crisis than many other countries. But, in September 2008, its economic development, particularly export-oriented industries, suffered a setback. To cope with the negative impacts of the global financial and economic crisis on the Chinese economy, particularly on exports, the Chinese Government took swift action. In November 2008, the Government announced a 4 trillion RMB (US$ 586 billion) fiscal stimulus package for 2009 and 2010 – equivalent to 13.3 per cent of China’s nominal GDP in 2008. (Schüller and Schüler-Zhou, 2009). Shortly after, China also launched industrial revitalization plans to promote the long-term competitiveness of its 10 pillar industries (Ministry of Commerce of China, 2009b). As the global financial crisis severely affected Chinese exports, the Government revised the tax rebate policy again in August 2008, particularly for labor-intensive products.

Outcomes of China’s expansionary policies

The Chinese Government’s expansionary policies have had positive effects on the country’s exports and macroeconomic stability. China’s GDP growth rates were 9 per cent in 2008 and 8.7 per cent in 2009 – the highest among the major economies of the world. China’s exports, after a drop to a 36-month low in March 2009, experienced a turnaround for the first time since the start of the economic and financial crisis in December 2009, with a year-on-year increase of 17.7 per cent. The increase in imports of raw materials and oil contributed to narrowing China’s trade surplus, which in December 2009 shrank to US$ 18.43 billion from US$ 19.1 billion the previous month (Yang - Huizenga, 2010).

Sustaining Growth In Global Downturn: The Case Oof India

Like other countries, India was hit by the spillover effects of the crisis due to its increased integration into the global economy. The overall GDP growth rate almost halved, from a peak of 10.6 per cent in the third quarter of 2006 to 5.8 per cent in the fourth quarter of 2008. Consequently, India was affected by the global crisis through both the trade and the financial channel. The situation on the eve of the crisis was worsened by the adverse effects of a severe terms-of-trade shock that resulted from a sharp rise in global food and oil prices. The overall adverse impact of the global financial crisis was mitigated by a series of proactive policy measures.

Indian Policy Initiatives

With the transmission of crisis, India, like many other countries, initiated a slew of fiscal measures to increase aggregate demand, introduced in three tranches: early December 2008, and early January and late February 2009. The measures included a general reduction of four percentage points in excise duties on non-petroleum products, reduction of the service tax by two percentage points, and approval for additional expenditure of Rs 200 billion in 2008-09.

Responding to the Monetary Outturn, RBIintroduced a series of measures aimed at injecting liquidity, that ranged from lowering CRR to unwinding Market Stabilization Scheme (MSS) bonds. The rupee was allowed to depreciate in a controlled manner, thereby ensuring against a speculative run on the currency that would have had disastrous consequences for the external debt and balance of payments. To attract foreign capital, interest rates on non-resident Indian (NRI) deposits were progressively raised by 100 to 175 basis points. While India’s monetary policy largely aimed at enhancing domestic liquidity, which had shrunk considerably since the collapse of Lehman Brothers, its fiscal policy sought to boost aggregate demand.

In response to the proactive policymaking, the Indian economy began to exhibit distinct signs of recovery from April 2009. The economy grew by 7 per cent in the first half of 2009, despite a poor monsoon that dampened agriculture growth. The manufacturing sector posted a strong recovery, growing at 6.3 per cent compared to a contraction of 0.3 per cent in the second half of 2008-09. Merchandise exports, after contracting for 13 months, experienced a positive upturn in November and December 2009. Imports also experienced growth in December 2009, for the first time since the onset of the crisis (Gupta, 2010).

4. Brazil and India in the Global Economic Crisis: Immediate Impacts and Economic Policy Responses

Brazil and India, much like most other developing countries, suffered the immediate impacts of the global economic crisis. Since September and more intensely in October 2008, both countries have suffered from a sudden stopping of foreign capital, nominal exchange rate depreciation and a strong credit squeeze. By comparing the behavior of the nominal exchange rate depreciation between September 2008 and December 2008, it can be concluded that India was more successful than Brazil in stabilizing its foreign exchange market. There are two reasons why negative expectations were stabilized quicker in India: (i) India is currently open to foreign capital inflows for direct investment and the stock market, but it still imposes high restrictions on foreign investment in treasury bonds and fixed income assets; and (ii) although derivative transactions in India before the 2008 crisis were allowed, since April 2007 all derivative contracts have been tightly regulated by the RBI. In contrast, in Brazil, the existence of a large foreign exchange market, as well as equity and credit derivative markets connected to domestic and global markets, was not only responsible for deeply worsening the financial health of banks and companies, but also caused a sudden and lengthened halt to both interbank lending and final credit (RBI 2009 and Subbarao, 2009).
5. Africa And Global Economic Crisis

The global financial and economic crisis has led to the drying up of important sources of development finance in Africa and jeopardized recent efforts to boost growth and reduce poverty in the region. Although the current crisis was externally induced, African countries responded swiftly and, where possible, adopted countercyclical policies that reduced the potentially negative impact on output. Consequently, several countries now have widening fiscal deficits which they will have to monitor closely to ensure that they do not lead to medium- and long-term macroeconomic instability. There is also the need for African policymakers to make greater efforts towards transforming the structure of their economies to reduce vulnerability to external shocks (Osakwe, 2010).

6. The Crisis and Global Economic Governance

The financial and economic crisis that broke out in 2007 has, once again, shown the close connection between financial fragility and current-account imbalances, and between banking and currency crises. It has also shown that macroeconomic and financial imbalances in the developed countries continue to have strong repercussions on growth and stability in developing and emerging-market economies (Kotte, 2010). Thereby, the new regulatory governance should be based on a well-functioning network of national and regional authorities and include truly international supervision of financial institutions with a global reach. There are two broad principles on which future financial regulation needs to be built (D’Arista and Griffith-Jones, 2008).* The first is counter-cyclicality, in order to correct the main market failure of banking and financial markets - their boom-bust nature (Ocampo, 2003).* This would strengthen banks in boom times and discourage them then from excessive lending. The second key principle for modern, effective regulation should be comprehensiveness. Developing countries need to make sure that new regulatory standards allow enough flexibility, so they can be adapted to their needs and characteristics.

Institutional shortcomings and the case for reform

In the build-up to the financial crisis, IMF and Financial Stability Board failed in maintaining international monetary and financial stability. One reason why the IMF has been unable to play a decisive role in the prevention of financial crises has been the limited reach of its surveillance; another has been its definition of “sound” macroeconomic policies. However, when warnings were issued by institutional observers that the risk of an adjustment crisis was mounting, they were ignored by policymakers. For example, three years before the eruption of the financial crisis the Bank for International Settlements had already pointed to the financial and macroeconomic risks associated with the housing bubble in the United States (BIS, 2004), and for several years UNCTAD had warned that the increasing current-account imbalances were unsustainable, and that without an internationally coordinated macroeconomic policy effort a “hard-landing” was likely to occur (UNCTAD, 2005; UNCTAD, 2007). The result was a revival of countercyclical policies, including discretionary fiscal action, at the national level, and a modest effort by governments of the leading countries to coordinate such policies at the international level (Kotte, 2010).

Preventing global imbalances

Today, the Asian countries are the ones that have the money. But, the countries that are accumulating reserves must lower their consumption to do so and there must be other countries that run deficits to offset these surpluses. In this behalf, a number of Chinese officials have made proposals for a global currency to replace the dollar. The problem with this proposal is that there would be a need for an institution to implement the currency. A more likely medium term scenario is that the Chinese RMB becomes fully convertible and joins the U.S. dollar and the euro as a third major reserve currency. With three reserve currencies there would be more scope for diversification of risks and China itself would have very little need of reserves.

7. Other Key Reforms

One of the most important principles guiding policy during the current crisis has been that large institutions are “Too big to fail”. Additionally, “Too big to fail” does not mean “Too big to liquidate”. Resolution of large complex cross-border financial institutions, limited government debt guarantees for financial institutions & a role for public sector banks in a mixed system are some other reformatory measures. The current crisis may have some way to go, especially as the two factors of commercial property and corporate defaults may lead to another round of problems in the banks (Allen - Carletti, 2009).

8. A Way Looking Forward: A New Role of SDRs

Beyond the existing SDR allocations, SDRs could also be used to play a more systematic role in the global financial system. If appropriately designed, a new role for SDRs could also contribute to preventing the build-up of imbalances by exerting pressure on the United States to adjust. In particular, SDR could be allocated at times of crisis, where countries would be required to rebuild the SDR holdings once the crisis has passed. However, this form of pooling only works as long as there is a sufficient and credible size of the pool in relation to the drawing rights (Mateos, Duttagupta and Goyal, 2009).

References


