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Global economic downturn: The challenges ahead

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Following is the 11th K. Sivagananathan Memorial Oration delivered at the Bank of Ceylon Auditorium on 6 March by IPS Executive Director Dr. Saman Kelegama

The global financial crisis has been analysed in-depth quite a lot during the last five years. In the analysis of the crisis however there were several areas that have been proved wrong. One was the decoupling of the East from the West – which was never the case. Then the much-anticipated V shaped recovery did not materialise and what we see is more of a W shape recovery emerging.

The crisis is still prevalent; US economic recovery is slow despite three doses of quantitative easing. EU is in stagnation with few signs of an immediate recovery. The final shape of global recovery may take more time than predicted. In this context we need to re-visit the global financial crisis and attempt to answer a fundamental question. Why is the recovery taking a longer time?

IPS Executive Director Dr. Saman Kelegama delivering the 11th K. Sivagananathan Memorial Oration

The epicentre of the crisis was USA; thus a closer look at the US economy from the perspective of broader global economic reforms at the very start will be useful. One of the key policies we saw in the late 1980s all over the world was the opening up of the financial sector. Developed countries were able to deregulate their financial systems more than the developing countries. Investors, from individual savers to pension fund managers were now able to better diversify their investments across domestic and international assets – thereby increasing the rates of return. Businesses were able to fund promising ideas and fund their expansion plans. Politicians felt that under the new set-up financial resources were being invested more efficiently, thus contributing to higher economic growth and living standards. Thus many political establishments too supported the rapid opening up of financial sectors.

In the US, the growth and development of the financial sector led to an expansion of its ability to spread risks. Thus a range of financial transactions that were hitherto not possible created greater access to finance for both firms and households. Concurrently, we saw the emergence of various intermediaries whose size and appetite for risk was huge. Financial innovation far out-spaced financial regulations. Business was moving, US banks were making profits with new financial instruments, and there was a boom in the economy. The US Government itself benefitted because of tax revenue from booming sectors and these additional funds assisted the Government to spend on social welfare.

Why could not the economists and financial analysts of the US predict the financial crisis? I think many economists and financial analysts knew that the debt financed consumption and investment model with large domestic and external deficits was not sustainable, but there were certain factors that compelled the political establishment in US to believe that it was sustainable. First, there was optimism that the US economy overcame the dot.com dip in 2000 without much policy adjustments; second, the debt financed model was sustained with a low interest rate policy for more than 6 years during the George Bush II years of 2000-2007, thus the economic bubble that was developing was seen rather as an economic boom; third, the financial derivatives were developed by the best mathematical minds in the US, thus it was believed by key players of the US market, that the financial wizards have found new ways to manage risks; fourth, many finance companies that were coming out with innovative financial products were receiving high ratings from the globally known rating agencies, etc. All these factors kept the US political establishment to believe that the so-called economic boom could be sustained.

It only required a small adjustment upwards in the US interest rates for the bubble based on the debt financed consumption and investment model to burst. It was then that it was realised that some of the financial derivatives and products were risky and some went to the extent of calling them toxic. These toxic financial derivatives and products attracted foreign funds and some of the US financial institutions that engaged in business with these toxic products invested overseas and that is what made the US financial crisis spread the world over. This deregulated financial sector in the US was the key policy that triggered the global economic crisis.

The global economic crisis exposed major anomalies in the global economic system. They can be categorised to three broad areas: (1) the problem of having the US dollar as the global reserve currency; (2) the problems of having major global trade imbalances; and (3) lack of rules and regulations to govern global financial flows. I will now deal with each one of these areas.

US Dollar as global reserve currency

As stated, the US economic model was based on debt financed consumption and investment. US followed a relaxed monetary policy with low interest rates to encourage both consumption and investment. Moreover, the US ran a large trade deficit by generating a demand for import of many items from the rest of the world. To fill this gap, US Treasury bills and bonds were sold to foreign investors. It is estimated that the total foreign investment in US gilt-edge securities amounted to nearly US$ 6 trillion.

For these investments which sustained the debt financed investment and consumption boom to remain in the US, policy adjustments to address domestic imbalance, like a large trade deficit via a depreciation of currency became difficult for the US, as foreign funds would go out from the US. In 2008 there was already pressure on the dollar to depreciate due to global commodity price escalation. To take some pressure off the dollar to depreciate, the US Federal Reserve had no

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option but to adjust the interest rates upwards. That is the time that the bubble burst as investment in financial derivatives such as sub-prime mortgages became unprofitable.

The fundamental question that one could pose is how did the US manage to attract large amount of foreign investment despite the low interest rates? This happened because the US dollar is the reserve currency of the world and any nation would be willing to keep large reserves of dollars for their own macroeconomic stability. The US thus had this unique advantage to borrow from the rest of the world at low interest rates. At the time Special Drawing Rights (SDRs) were created in 1960, it was hoped they would become a major component of global reserves, thus creating a system in which growth of global liquidity would depend on deliberate international decisions. This expectation was not fulfilled due to veto power the US possessed over decisions n the IMF Governing Board.

The US Government abused this power of being the custodian of global reserve currency to the maximum by running budget deficits and financing the debt via printed dollars. As long as those dollars did not come back to the US but remained outside the US, it did not cause US prices to rise. Even when the dollar-gold link was broken in 1971, the US Dollar as the global reserve currency prevailed. So as long as this was the case, US remained the world's consumer and importer of last resort and the world's Central Banker.

China, being the largest investor in US Treasury bills and bonds (US$ 1.2 trillion), was obviously worried on investment returns when the dollar started depreciating. So China took the lead to propose an alternative reserve currency to the dollar. The Chinese recommendation was not to re-invent the wheel and introduce a new world currency but to make the SDR as Super Sovereign Reserve Currency, which had the backing of the BRICS. The SDR is basically a basket with four currencies, i.e., US dollar, Euro, Yen and GBP and the weights of the four currencies are revised every five years. The Chinese proposal was to expand this basket to include currencies of other major global trading and financial powers.

The UN-backed Stiglitz Commission report of September 2009 reiterated that if the world is to come out of the global economic crisis, the dollar being the global reserve currency has to end. The Stiglitz Commission Report went further by recommending converting the IMF to a Global Reserve Bank – so that it becomes something like a Global Central Bank. The major advantage of holding the global currency in a diversified way is that it would generate more stability and strengthen value of the reserve holding. The Commission also recommended broader reforms in the IMF Governing Board. Voting weight is heavily biased towards industrialised countries, and the recommendation was to increase the IMF quota so that more inclusive and representative governance could be introduced at the IMF. IMF quota reform received serious attention in 2010 where efforts were made to enhance the voice and representation of emerging economies and developing countries through a comprehensive review of the quota formula by early 2013.

ESCAP (2010) estimates that close to US$ 5 trillion out of the US$ 6 trillion foreign funds invested in US Treasury securities are of Asian origin. Clearly, if the current US model where its currency is the global reserve currency did not exist, the bulk of the Asian funds which are now stuck in US Treasury bills and bonds could have been re-invested in Asia. With the development of financial instruments and deepening the Asian financial markets, the ESCAP (2010) argues that a portion of these funds can be reinvested in Asia and the funds could have been used to address pressing issues in the Asian region such as developing the infrastructure and achieving MDG goals.

Changing the existing reserve currency system is not going to be straightforward. It is a political process. No country would like to lose its super-power status if it had acquired it over a long time period. Global projections show that by 2050, China would be the largest economy in the world and India would occupy the third place with the US squeezed in between the two. Knowing this, the US will always attempt to keep its lead by retaining its existing powers, and possessing the global reserve currency is one component of that power.

Global trade imbalances

As the change to a new global currency system will take time, the immediate requirement to get out of the global economic crisis is for the US to gradually move away from a debt driven

economy. For this purpose, the US should increase exports and reduce imports to cut its large trade deficit.
US National Export Initiative aims to double exports in the next five years; i.e., achieving 15% export growth. The US Dollar was allowed to react to US domestic policy measures like the Quantitative Easing QE1, QE2, and QE3, and consequently the dollar weakened – so obviously with a depreciated dollar, the demand for imports in the US economy has declined.
While the US is engaged in an export drive, the G-20 has identified the major imbalances in the global economy as the key contributor to the crisis. China, Japan, Germany, etc., having huge trade surpluses while the US, some European countries, etc., having huge trade deficits were highlighted as the prime examples of this imbalance. The G-20 view is that as long as such imbalances exist, the global recovery will take a longer time with outbursts of competitive devaluations of currencies by export-led industrialisation countries. These competitive devaluations will not be conducive for global economic recovery and stability. So according to G-20, countries like China should focus less on exports and more on increasing consumption in the domestic market. Many developed countries are of the view that the Chinese Yuan is heavily under-valued thus giving Chinese exports an undue advantage over its competitors. The US has brought pressure on China on several occasions to revalue the Chinese currency to accurately reflect China's cost of production, but China has resisted this request.
China seems to be having reservations on this request for revaluation of the Yuan – based on what the 1985 Plaza Accord did to Japan. Some economists attribute the ending of the high growth in Japan in the late 1980s and the two decades of consequent recession that Japan experienced since 1990, to the Japanese currency revaluation under the Plaza Accord. China has among other factors, this fear. So Chinese adjustments will be slow to come.
G-20 did not empower the IMF to carry out surveillance responsibilities for ensuring that countries are making an attempt to rectify these imbalances. So G-20 has not been effective in implementing what it saw as a doable thing to come out of the global economic crisis. Thus, the much expected trade imbalance adjustment is not taking place as rapidly as expected.

International financial architecture

There is another issue that has to be focused to ensure a faster global economic recovery. That is to ensure stronger checks and balances on financial flows in the world. Today globalisation is driven mainly by global financial flows rather than global trade flows. Unlike international trade which is to a large extent governed by WTO rules and regulations, financial flows have little rules to govern them. There does not prevail an international financial architecture. Perhaps this was not seen as essential as there was a school of thought that financial regulation was an impediment for financial innovation and that always whatever regulations were brought in they lagged far behind financial innovation.
Regulatory lags and regulatory failures need to be addressed, if not, rapid financialisation of the economies, commodity markets, etc., does not augur well for the global economy. In many developed countries today, the financial economy dominates over the real economy. Two decades ago the financial sector was the servant of the real economy and today the clock has turned around – financial economy has come to become the master of the real economy in some developed economies. The players in the developed economies see some financial institutions as too big to fail, while policy-makers feel that they are too powerful to regulate. So the international financial architecture should be able to discipline not only the global financial flows but also the domestic financial markets.

The Stiglitz Commission recommends the creation of a Global Economic Coordination Council – at the level equivalent to the Security Council of the United Nations. The argument behind this recommendation is that the failure of regulation by one country can have adverse effects on others. Thus, there is a need to have global coordination on regulation. The process of rapid financialisation has many ramifications and these have to be disciplined via a regulatory framework if global financial stability is to be gained. Two cases can be highlighted, viz., rating agencies and commodity markets.

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"So to come out of the global financial crisis, fixing the problems of the US financial sector alone is not adequate, but a whole gamut of issues in which the foundations of the current global economy is based has to be addressed. I have aggregated most of these issues under three broad areas, viz., (1) the need to create a new global reserve currency; (2) need to reduce global trade imbalances, and (3) need to create an international financial architecture. Although these are three broad areas, I believe that all the micro level recommendations to come out of the global economic crisis that are available in the current literature can be plugged into one of these three areas"

As the process of financialisation deepened, the influence of rating agencies grew in proportion. They began to shape market sentiments and their ratings became integral to the functioning of the modern market economy. The track record of these rating agencies is questionable. For example, some rating agencies gave a high sovereign rating for Thailand one week before the East Asian financial crisis that started in fact with the collapse of the Thai financial system. Similarly, they gave a high rating to Lehman Brothers in late August 2008, a fortnight before the downfall of the company. But these rating agencies were not accountable to anyone. The self-proclaimed disciplinary role played by rating agencies is not legally prosecutable for reasons that they merely give 'opinions' on the riskiness of assets. For example, in the US the rating agencies claim protection under the first Amendment as a matter of free speech and freedom of the press. Take another example of financialisation of commodity markets that have in part contributed to the escalation of commodity prices. During 2003-2010, assets allocated to commodity index trading have risen from US$ 13 b to US$ 320 b and the number of outstanding contracts of commodity futures and options have risen from 13 million to 66 million. This has disrupted the traditional trading relationship between future prices and supplies. Financialisation of commodity markets is a major concern for developing countries as speculative capital moves to commodity markets and make their prices volatile.

The need for global financial market governance first appeared in international discussions after the East Asian crisis in 1997/98. The Financial Stability Forum (FSF) was created in the aftermath of that crisis in order to promote international financial stability, improve functioning of financial markets, reduce the tendency of financial shocks to propagate from country to country, and to enhance the institutional framework to support global financial stability. The framework of rules to guide the financial markets was under the underlying theme that financial markets are self-correcting or self-regulating.

This framework based on voluntary compliance is based on international good practices by various issuing bodies – (a) Banking supervision under the Basel Committee, Securities regulation under the International Organization of Securities Commission, and Insurance supervision under the International Association of Insurance Supervisors (these areas come under Financial Regulation and Supervision); (b) Insolvency under the World Bank, Corporate Governance under the OECD, Accounting under the International Accounting Standards Board, Auditing under the International Federation of Accounts, Payment and Settlement under the Committee of Payment and Settlement System, and Market Integrity under the Financial Action Task Force(these areas come under the Institutions and Market Infrastructure), and (c) Monetary and Financial Policies, Fiscal Policy and Data Dissemination –the guideline issuing body is the IMF(under Macroeconomic Policy).

The objective of the framework was to follow the market decision on the understanding of the risk involved of principles guiding financial policies. The rules that were in place were non-binding in nature unlike the trade rules of the WTO. Thus, global and domestic financial markets functioned in a very liberal space and the inadequacy of the post-1997/98 framework was seen only after the 2008 global economic crisis. Clearly, the reforms that were advocated were inadequate to avoid a major global financial instability. In April 2009, the FSF was re-established as the Financial Stability Board (FSB) to bring about more stability to the global financial system.

The FSB and all other standard setting institutions are not very representative of views emerging from developing countries. Most developing countries are in fact not represented in today's standard setting institutions. The Basel Committee of Bank for International Settlement and the

FSF/FSB set important global economic standards in areas such as bank supervision, financial regulation and corporate governance. The committee's regulator proposals have been generally adopted by most countries. As a result of inadequate representation of developing countries in these ad hoc bodies, these regulations have proved to be biased and carry the notion of "one size fills all".

Evolving structure itself has its problems. There is a possibility that in the face of Basel III rules, some of the higher risk activities such as investment banking and trading moving out of banks into the non-bank sector. This means that risk has been transferred from regulated to relatively unregulated areas of the financial sector. This will call for greater supervision of the non-bank sector.

In 2010, G-20 identified four pillars of financial regulatory reform agenda: (1) a new capital framework; (2) effective supervision; (3) reforming international financial institutions; and (4) transparent international assessment. In February 2013 the first Working Group meeting of the G-20 on International Financial Architecture met in Russia and discussed a number of issues, including governance reform in the IMF. G-20 Working Group seems to be more representative of the voice of developing countries than the FSB, thus some of the policy biases in favour of developed countries will be hopefully addressed in the final recommendations of the G-20 Working Group.

A key suggestion that has been put forward by some commentators on the subject of international financial architecture is to reduce the volatility of capital markets by applying some brakes on large speculative capital flows. It is estimated that US$ 6 trillion worth of capital per day is moved by speculators with significant disruptive impact on global price stability. In this context, the Tobin Tax proposal – a minute tax on global capital flows – has once again come into the agenda of the International Financial Architecture. In the aftermath of the 1997/98 East Asian Financial Crisis, this proposal got rejected due to strong lobbies of speculative fund players in the developed world and only time will tell whether the proposed tax would make a realistic come back under the present circumstances.

Concluding remarks

So to come out of the global financial crisis, fixing the problems of the US financial sector alone is not adequate, but a whole gamut of issues in which the foundations of the current global economy is based has to be addressed. I have aggregated most of these issues under three broad areas, viz., (1) the need to create a new global reserve currency; (2) need to reduce global trade imbalances, and (3) need to create an international financial architecture. Although these are three broad areas, I believe that all the micro level recommendations to come out of the global economic crisis that are available in the current literature can be plugged into one of these three areas.

The fact that the world is taking a longer time to recover from the 2008 US financial sector crisis is now understandable. The 2008 US crisis exposed a whole lot of other issues that remained dormant for a long time in the global economy and these issues are crucial and need serious solutions if we are to get out the current downturn. And addressing the three issues cannot be done in a hurry due to the global political economy.

For the G-7 countries, these recommendations were too heavy to stomach. It is now almost three and a half years since the Stiglitz Commission Report came out with a list of recommendations, and many of these recommendations have not been taken up or followed up. Some powerful state officials who are beneficiaries of the current global system have no interest in reforming the system. Some leading bankers and speculators, who have immensely benefited from the current system are also resisting any changes to the status quo. There is an ‘implementation deficit’ due to the lack of ‘political will’ of the key political players of the global economy.

Whatever reforms that take place, too much austerity in the US will have a significant impact on global demand. Thus, timing and sequencing of these reform measures have to be carefully worked out. In that context, President Obama’s efforts to go slow on the “fiscal cliff” seems a prudent move at least from the “developing countries” perspective.

We are living in the modern world where information and communications technology has stimulated trade, finance, and investment to move faster. Thus people are not prepared to wait for long as seven to eight years like during the 1930s Great Depression to finally see global economic recovery. The picture is gloomy, but let us live in hope that the G-20 will be able to make a breakthrough and get some of the much-needed global economic reforms moving so that the entire world could come out of the current economic downturn soon.