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Recovery will be slow and steady in 3Q of 2009

By early December we should see some turnaround - Dr Saman Kelegama


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Many said the prevailing economic downturn is much worse than the great depression in 1930s. No timeline was given for the recovery and the belief was that it would take more than the usual time the economists advocate for a recession to bottom out. Earlier it was believed that recovery from the recession would be 'V- shaped'. But Noble Laureate for Economics last year, Paul Krugman says the recovery would be 'W-shaped' and even strenuous.

In the same way, some said Sri Lanka will not be affected by the global recession since it was not exposed and inter-linked to the world economy to the extent as other larger economies had. However when the country's export numbers began to collapse, the authorities who earlier claimed recession was not our business had to humbly accept that it was their business too.
Having all this in mind, The Nation Economist interviewed Economist Saman Kelegama, a well known authority in the South Asian region on economic matters, and who also is the Executive Director of the Institute of Policy Studies, to obtain his view over the current situation of the global recession

Q: Have we seen the bottom of the global economic crisis and a start of a recovery?
A: Yes, I think we have now passed the worst of the global economic crisis. Many countries have performed better than expected and the recovery is faster than predicted. The recovery is faster in the developing countries like China, India and Brazil. These countries have large domestic demand-generated growth with domestic investment and consumption playing a key role. In China, the export growth during the first half of 2009 was down by 25%, but the overall economic growth during the same period was 6%. In India, exports during March 2008 - March 2009 grew by 3.6% (compared to 28.9% during 2007-2008) but the overall economic growth was 6.7% (compared to 9% during 2007-2008). The forecast growth for 2009-2010 is 7%. This shows the contribution from

domestic demand-generated growth. In fact, China is temporarily shifting from the export-led growth model to a domestic demand-generated growth model (this does not mean totally abandoning the former but it is receiving less emphasis). It can afford to do this given the huge foreign exchange reserves it has, and the large domestic market it commands.
Most of the East Asian countries are recovering faster through the experience gained from the 1997/98 crisis. For instance, Singapore showed a 20.4% growth in the second quarter of 2009 over the previous quarter.

Of course, the recovery is still slow in OECD countries; their economic fundamentals are still weak, although there seems to be some positive sentiments. For instance, the US was expecting a -1.5% growth in the second quarter of 2009 (over the previous quarter), but the actual growth was -1.0%, better than the forecast. Japan's second quarter growth was 0.9 % compared to -3.1% in the first quarter of 2009. Over-debted consumers in the US and Europe are gradually trying to increase their savings, and the conservative consumers are sticking to their normal saving habits. In these countries, adjustment of corporate and household balance sheets remains painful given the excesses in the past.

So we are seeing a kind of "decoupling" (which was proved to be incorrect as far as the adverse impact of the crisis was concerned,) in the recovery process where some emerging economies are less dependent on the full recovery of developed countries.

Q: So you are saying the recovery is faster than we expected?
A: Yes, some said that at the start of the 2008 crisis, that it was like the recession of the 1930s. It was not the case. In the 1930s there was starvation, some people died due to the recession, but this was not the case with the 2008 crisis. We can recall that even after the East Asian Financial Crisis of 1997/98, some commentators saying that East Asia will take 4 to 5 years to recover but they recovered within 1 to 2 years. We are seeing a similar phenomenon today.

Those countries that had adequate fiscal space depended on a fiscal stimulus (or a Keynesian injection to the economy) to revive their economies. The stimulus package varied in size depending on the fiscal space and policy framework of the respective governments. Singapore gave an 8% GDP and China gave a 6% GDP fiscal stimulus to revive their economies, whereas Philippines – 4%, Korea – 3.5%, India – 1.5 %, US – 1%, and Thailand – 1% of GDP fiscal stimulus packages were offered. We are now seeing the lagged impacts of these fiscal stimulus packages in terms of improved economic growth. Those countries that could not afford a large fiscal stimulus package like Sri Lanka had to depend more on an accommodative monetary policy and structural adjustment to revive the economy. Even the lagged effect of such policies is now gradually seen in the economy.

Global trade will fall by 9% in 2009 due to the crisis, and there were protectionist tendencies in the developed world (for example, "buy America" campaign). These tendencies are gradually easing, and the 7th WTO Ministerial will take place in early December 2009 in Geneva. This also is a positive sign to stimulate global trade from the position it has fallen into during mid-2008 to mid-2009. All these factors have, in one way or another, contributed to the faster recovery.

Q: What would you say are the main fundamental errors that triggered the global financial crisis?
A: At the external level, the US economic growth was governed by external debt financed consumption and investment during the last decade. It was not sustainable because the large US trade deficit was sustained through large foreign exchange reserves in the Asian countries that flowed into the US on the basis of the strength of the US dollar. These flows were bound to decrease with the dollar losing its strength and this is precisely what happened in 2007/2008.

At the domestic level, the US economic model was based on two assumptions of supply side economics, i.e., tax cuts are self-financing and financial markets are self-regulating. As tax cuts were not self- financing, the US had to depend on a relaxed monetary policy and low interest rate to stimulate the economy. Thanks to the Asian foreign capital inflows to finance the US trade deficit, the US was able to maintain a low interest rate. It is this low interest rate that created the housing/real estate boom that resulted in an asset bubble.

At the domestic level there were two major misconceptions. First, the ideology that financial markets are self-regulating was misplaced. When you assume that financial markets are self-correcting, then the development of a bubble in the financial sector has to be ruled out. In fact, the Federal Reserve Governor, Alan Greenspan profoundly believed that a bubble will not develop in the US economy because of the IT revolution. In other words, the asymmetry of information in the financial market will be minimised by the internet, and all other IT related information flows, and thus investors will not make imprudent decisions and will make rational judgments not leading to a bubble.

Second, the belief that financial deregulation is a must for financial innovation for minimising financial sector risks was also misplaced. True, risky lending is an inevitable consequence of expansion of credit as banks search for higher returns. And ‘securitisation’ of these risks via innovative financial instruments (Collateralised Debt Obligations, Credit Default Swaps, etc.) was welcome. But these instruments were not subject to self-regulation. Whatever regulations were operating in the system always lagged behind these innovations, and the development of an asset bubble could not be avoided.

In a nutshell, human greed overtook the rational judgments that could be made by investors with more information under their command, with the benefits of the IT revolution, and human greed was facilitated by innovative financial instruments that were not self-regulating.

Q: You referred to the 1930s global recession and the 1997/98 East Asian Financial crisis. With all this experiences why could not economists/financial experts predict the Global Economic Crisis of 2008?

A. There were confusing signals coming out of the system, thus the total picture was not very clear. I will mention some of them:

1) Many economists were aware of the individual risks in large financial companies, but could not clearly see the overall risks to the global system.

2) Some of the US financial experts who saw the crisis coming did not want to do any mid-way correction. They argued that let it manifest and result in a downfall, then it could be quickly put in order just like the US did after the 'dotcom' crash in 2000. (One can recall that the US did not fall into recession after the 'dotcom' crash due to the debt financed investment and consumption momentum at that time).

3) Busy financial operators and market players did not have time to go into details of accounts of leading financial companies and relied on Rating Agencies. These agencies, who are not accountable to anyone, gave their ratings based on the past track record of the institution, age of the institution, reputation of the Governing Board Directors, etc., rather than on a detailed analysis of the financial accounts. Accordingly, an institution like Lehman Brothers received an 'A' rating a few weeks before the collapse. This is only an example. Such ratings misled many financial operators and investors.

4) The financial derivatives were developed by the best mathematical minds in the US. Thus it was strongly believed by key players of the US market that the financial wizards have found new ways to manage risks. Since the debt financed investment and consumption boom lasted from 2000 to 2006, key players of the market believed that the new ways of combating risks through securitisation was working and was thus a sustainable model.

5) Since business was booming, US banks were making profits with the new financial instruments. The government benefited too because the tax revenue from the booming real sector, and services was more and these additional funds assisted the government to spend on social welfare, in particular, health and education. Such benefits to the government created a "psychology of denial," that a crisis was on the way.

Q: Were there different viewpoints among economists on the crisis?
A: Yes, that further complicated the picture. The guru of the 'rational expectation' theory in economics, Robert Lucas, in his Presidential Address to the American Economic Association in 2003 said that the 'central problem of depression prevention has been solved for all practical purposes'. This philosophy of people making rational judgments with more information, is what guided people like Greenspan. On the other hand, Nobel Laureate, Paul Krugman has been arguing for stricter regulations and was blaming the Bush administration for going too far in the financial deregulation exercise. In his latest book 'The Return of Depression Economics', Krugman clearly shows that Lucas was wrong in his prediction. Economists like Martin Wolf, who writes a regular column for the Financial Times absolves the US government from the financial crisis stating that it is difficult for a Central Bank to detect and unbundle an asset bubble in a low inflationary

environment as was the case in the US. So different opinions have been expressed by economists and this further confused the picture.

Let me add that even with regard to the recovery, there are different viewpoints put forward. Krugman, for instance, argues that to get out of the slump there is a need to heat up the economy. Accordingly, he argues that the US stimulus package should be at least 4% of GDP and not 1% of GDP. This is in a way the old Keynesian fiscal stimulus which many countries have engaged in to revive their economies. But critics argue that exclusively focussing on Keynesian fiscal stimulus could leave an economy vulnerable to disturbances in aggregate supply caused by expectations of inflation.

Q: What are the prospects for the Sri Lankan economy?
A: In my address to the Chartered Institute of Marketing on 2009 22 May, I said that Sri Lanka's growth for 2009 can be revised from the pessimistic 1.5 % to 3.5 to 4%, with the defeat of the LTTE. The Central Bank has said the same recently, that the prospects are brighter and 4% growth is a possibility. Several factors will contribute to this: (1) end of the war, (2) political stability, (3) IMF package, (4) enactment of the new Electricity Act, appointment of the Taxation Commission, etc. It is true that there are issues of concern from the investors' perspective like the hedging deal, reversals of earlier privatisations, collapse of some finance companies, etc., but no economy is perfect, and these areas will gradually get rectified with time. The positive aspects will be the driving force in the economy.

If we look at the tea and rubber sectors, the prices are once again on the rise; tourism has picked up and in July 2009 arrivals were 28% up from last years' arrivals; in the vehicle market there is a pick-up in sales in motor vehicles below 1000cc, single cabs, vans above 2000cc, buses, and trucks. These are sign of recovery. The revival of the North and East will give a further boost to the recovery process. The recovery will be slow but steady in the third quarter of 2009. By about early December, we will be able to see some turnaround.