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Analysis

Some Positive Consequences of the Global Economic Crisis

Mario Lamberte*

Asia did not contribute to the global economic crisis (GEC) by saving too much but rather was an innocent bystander. Now, addressing the GEC provides an opportunity to rethink Asia's growth strategy and macroeconomic paradigms.

Origins of the crisis

There are two views about the causes of the crisis. One view suggests that the global imbalance was its major cause. There was a global 'savings glut', the source of which was Asia. It is not clear ex ante whether the large current account imbalance between the US and the rest of the world can be attributed primarily to excess demand in the US or excess savings in the rest of the world. Bernanke (2005) had argued that the low level of US interest rates implied the latter rather than the former. Bosworth and Flaeen (forthcoming), however, show results suggesting that this view cannot be supported. They add that it is not evident that imbalances should translate into a strong impact on the level of global interest rates.

The other view is that lax monetary policy contributed to the crisis. Global liquidity, measured by the ratio of the broad money supply (M2) to nominal GDP ratio in the US, Western Europe and Japan, has been increasing since the first quarter of 1999, reflecting the easy money stance. This led to the lowering of interest rates which encouraged investors to invest in risky assets to obtain higher yields. The result was an asset bubble in the US, especially in the mortgage market, and in a number of European countries.

Lax monetary policy alone is not a sufficient condition for creating a financial crisis. Lax prudential regulation at the microeconomic level encourages unwarranted financial innovation in times of lax monetary policy and together they contribute to a crisis. History shows that boom and busts have been associated with financial innovation. In the current GEC, the main innovation was securitization of loans, especially mortgage-backed securities associated with the 'originate-to-distribute' model of banks in the US, with a supporting role played by credit default swaps, a kind of insurance against bankruptcy. Interestingly, rather than selling the securitized assets, banks held on to them in unregulated off-balance-sheet vehicles to circumvent the Basel I and Basel II capital adequacy rules so that they maintain less capital though the risk remains the same.

Even if crises occur in other economies, particularly in the large economies, with increasing globalization, Asia is likely to be affected in various ways, and hence cannot remain a passive bystander. For one thing, Asia needs to actively participate in reforming the international financial architecture so that it performs its global surveillance role more effectively.

Positive consequences

The global financial and economic crisis has had an unexpectedly large impact on Asian economies. The GDP growth rate for the region is expected to be only a little over one third of the 9.5 per cent growth rate Asia enjoyed in 2007. But unlike a few months ago, when market sentiment was all decidedly gloomy, today many have started to become

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The Institute of Energy Economics, Japan optimistic and claim that we will soon hit the bottom of the crisis. This is because, although output in many economies has continued to decline in recent months, the rate of decline has moderated. The debate has shifted to the shape of the recovery, and many now hope that we are going to have a V-shaped recovery.

This is not likely to be the case. Reinhart and Rogoff (2008) have shown that recoveries from financial crises for industrialized economies whose financial systems have been severely battered by the crisis seem be more gradual and could take several years. Banks need to rebuild their balance sheets and restore public confidence before they can expand their lending activities again. Households need to rebuild their financial balance sheets to make up for the erosion of wealth during the crisis, and that means they have to reduce consumption and raise savings. For the US, consumption is likely to fall well below the 72 per cent share of GDP it achieved in 2007. Recent statistics suggest that this adjustment has already started to take place.

How about Asia? Although many Asian economies encountered financial stresses and liquidity shortages as the crisis deepened, they entered the crisis with relatively sound financial systems. Does this mean that they can expect a V-shaped recovery similar to that after the 1997-98 crisis? Asia has never come out of recession through export growth at a time of weak growth in the US, as Gupta and Miniane (2009) demonstrate. With the expected decline in US consumption ratio and sluggish consumer spending in Europe, exports cannot be relied upon to pull Asia's growth to pre-crisis levels it the way that it once could. Asia must itself work for rebalancing growth.

Rebalancing growth means altering the composition of aggregate demand in favor of internal demand, rather than external demand, matched by changes in the production structure in favor of non-tradable goods and services. On the demand side, many economies in the region have still room for increasing consumer spending and one challenge is to remove obstacles to stronger spending. Fiscal resources could be directed to strengthening social sector protection (including health, unemployment insurance and pensions) to reduce precautionary motive for saving. On the supply side, incentives that favor export-promotion and export-production have to be phased out. This does not mean a return to import substitution regime least policymakers may be tempted to entertain the idea of introducing all kinds of industrial policy measures.

The current situation will also provide a stimulus to find ways to mobilize Asia's high level of savings to support spending in the region. For example, there are still plenty of worthwhile infrastructure projects in the region. This includes promoting development of regional bond markets and developing institutions to facilitate funds transfers among Asian countries.

In short, the crisis will compel Asia to diversify its sources of growth, an accomplishment for Asia that can make it less vulnerable to external shocks and more resilient in the event of future crises.

The Great Depression challenged mainstream economic thinking in the 1930s and produced revolutionary economic theories and paradigms. If the severity of the current GEC has so far been unmatched since the Great Depression, it is likely to have similar effects on economic thinking and policy making. If there is a fundamental change in the way of economic thinking, global and national institutions, such as the central bank and macroeconomic policies, could change too.

Countries that followed strict inflation targeting are already reassessing that monetary framework to take into account other indicators that could contribute to a crisis. Economic models will then be more accommodating of the need to insure against risks. Finally, banking has become global but regulatory regimes remain national. This, too, must change if we are to learn from the recent experience of Europe.

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