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THE GLOBAL ECONOMIC CRISIS AND SOUTH ASIA

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INTRODUCTION

What began as a financial crisis in 2008 rapidly metastasized into a global economic crisis that pushed the world economy into the deepest recession since the Great Depression of the 1930s. In this paper we will examine the origins and nature of this crisis in the context of the dynamics of world capitalism, indicate the policy challenges in the process of recovery and analyze its impact on South Asia.

I. STRUCTURAL CHANGE AND FRAGILITY OF THE FINANCIAL SPHERE

In the process of its growth the world economy has undergone a structural change in the post war period in terms of two important features:

(i) The dominant form of the production unit of goods and services that emerged in the post war period was the large multinational corporation (MNC) in contrast to the large national corporation in the late 19th century and the small firm in the late 18th century.[1] The MNCs were not only able to sell goods and services on a global scale but were able to achieve internationalization in their production processes, such that different components of a particular good could be manufactured in their facilities in different countries to take advantage of country specific resource

[1] For a more detailed analysis of Growth and Structural Change in the Global Economy since the Industrial Revolution, See: Akmal Hussain, Imperialism, in, Syed B. Hussain (ed.), Encyclopedia of Capitalism, Volume-II, Golson Books Limited, New York, 2004.

endowments. This laid the basis of an unprecedented growth in productivity, and profits. Given the problem of investing these profits within the sphere of production, due to demand constraints, profits from the sphere of production began to flow into the financial sphere[2].

(ii) Within two decades in the second half of the 20th century (1963 to 1985) the relative weight of the financial sphere in the world economy changed dramatically: It became larger than the sphere of production, in contrast to the preceding two centuries when the sphere of production far outweighed the financial sphere. As Table 1 shows, in 1964 international banking was only about one-tenth of the value of the international trade in goods and services. During the next two decades the financial sphere grew about twelve times faster than the sphere of production. By 1985, international banking had become greater than the value of international trade in manufactured goods and services.

The diffusion of computers to the household level and the internet associated with the ‘I.T. revolution’ gave millions of individuals and firms the capacity to buy and sell stocks at the touch of a button. At the same time the inter linkages of stock markets across the world, and the crafting of new financial products such as derivatives, laid the basis of explosive growth in what had by the late 20th century become a globalized banking system. It is not surprising therefore that the financial sphere which was only about 11 percent of the sphere of production had by 1985 become greater than the size of the production sphere. In the next two decades the financial sphere continued to grow rapidly, although at a slower pace than in the preceding two decades, so that the size of this sphere had reached US $ 214,424 billion by the year 2008. (See Table 1).

The emergence of finance as the dominant sphere imparted to the global economy a new fragility. Banks and finance companies could rapidly devise a wide range of new

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2 P. A. Baran and P.M. Sweezy, Monopoly Capital: An Essay on the American Economic and Social Order, Monthly Review Press, New York, 1966.

financial products and sell them in the global market at a speed that would be unimaginable in earlier decades.

II. RISK, MARKET FAILURE AND CRISIS

The Nature of Systemic Risk and the Problem of Measurement. There is an important dimension to the tendency for crisis in a finance dominated global economy: The weak institutional framework combined with the nature of risk measurement in economic science. The dynamics of the financial sphere produced escalating systemic risk, and yet it was inherently difficult to measure it, let alone the incapability of the market to provide a feedback mechanism for it. While the institutional framework and the state of economic science allowed measurement of individual risk it did not enable measurement of systemic risk. As Michael Spence has pointed out, in a situation where individual risks were positively correlated, systemic risk was difficult to estimate[3]. This is because the estimation of risk at the aggregate level of the system, in probability theory, is based on a particular distribution of individual risk. If, as happened in the case of the current crisis, the distribution of individual risk is changing then, it becomes difficult to accurately model systemic risk[4].

Financial Fragility and Dynamics of the Crisis. The basis of fragility in the global financial system lay in two fundamental features of the new financial edifice:

(i) The new financial products were priced by financial experts on the basis of risk estimates drawn from mathematical probability which were not transparent to the buyers. This asymmetry of information between producers and buyers of financial products created a tendency for individuals and organizations to undertake overly risky investments without being aware of it. This gave a fragility to the global financial edifice.

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3 Michael Spence, Agenda for the Next Few Months, chapter in, What G20 Leaders must do to Stabilize our Economy and fix the Financial System, VoxEU.org Publication, CEPR, 2009.

4 Ibid.

(ii) What made the fragility acute was the fact that many of these financial products such as sub prime mortgage, debt bonds and risk insurance while appearing individually distinct products, were actually interlinked and hence created escalating risk at the systemic level.

It is these two features of asymmetric information at both the micro and the macro levels that gave to the global financial system the potential for market failure within an inadequate regulatory framework. Spiraling production and sale of derivatives, with multiplying systemic risks that were unknown to the individual investors, created a time bomb that could threaten the global financial system and thereby the real economy. The evidence shows that every major financial entity was highly levered and at the same time held potentially toxic assets. This fact exposed all the major financial organizations in the world to extreme financial distress[5]. When the time bomb exploded some of the most important banks and finance companies suffered simultaneous and major damage which brought the financial and economic system of the world into the most serious crisis in a century.

III. THE IMPACT OF THE GLOBAL ECONOMIC CRISIS ON SOUTH ASIA

The crisis in the sphere of finance rapidly permeated into the sphere of the real economy resulting in negative GDP growth rates and sharply rising unemployment levels in Europe, the US and Japan. Unlike the Western world, China and India did not suffer economic contraction in absolute terms but nevertheless their GDP growth rates which were over 8 percent in earlier years declined significantly. The deepening recession in the rich countries was associated with a sharp decline in demand for the exports of the South Asian countries, combined with a sharp decline in foreign investment. Consequently, South Asian countries suffered from the globalized recession, although the magnitude of the adverse effect in individual countries varied, depending on the degree of vulnerability of the particular country and the sate of its economy at the time of the global recession.

[5] Michael Spence, Agenda for the Next Few Months, chapter in, What G20 Leaders must do to Stabilize our Economy and fix the Financial System, VoxEU.org Publication, CEPR, 2009.

It is at this time of crisis that the lack of integration of the South Asian economies is manifesting itself in terms of the relatively intense adverse impact on individual economies. Intra regional trade in South Asia is only 5 percent of the trade of South Asian countries with the rest of the world. If there had been a greater integration of the South Asian economies, the regional home market would have substantially cushioned the decline in global demand for South Asian exports. As it was South Asian countries in most cases following the global economic recession suffered a sharp decline in GDP growth rates, increased poverty, worsening fiscal and balance of payments deficits, increased inflation and pressures on the exchange rate. These effects were exacerbated by the fact that South Asian economies were already suffering from inflationary as well as balance of payments pressures associated with the oil price shock and the food price shock that had occurred in the months preceding the onset of global recession.

In this section we will briefly discuss the country specific impact in South Asia with respect to key economic variables, following the global recession. Table 2 shows foreign direct investment following the global economic crisis fell in each South Asian country. The sharpest decline occurred in the case of Sri Lanka where foreign investment although at a low level to start with declined by 42 percent in the year 2008. This was followed by India which had the largest foreign direct investment inflows at the outset, suffered a 36 percent decline. In the case of Bangladesh it declined by 18 percent. In the case of Pakistan while foreign investment did not decline initially it has fallen sharply in the last seven months by as much as 35 percent.

Declining GDP growth rates in South Asia led to a slow down in government revenues. At the same time public expenditure increased as governments in South Asia attempted to provide succor to the poor as well as to the declining industry. Consequently fiscal deficits increased sharply in each of the countries of South Asia except Sri Lanka (See Table 3).

There was a sharp decline in exports in South Asian countries following the global recession. However given their composition, import expenditures did not decline proportionately with the decline in GDP growth rates. Consequently the current account of the balance of payments worsened in each South Asian country as seen in Table 4. The sharpest increase in the current account deficit occurred in the case of India where this figure as a percentage of GDP doubled from -1.5 percent in the year 2007 to 3 percent in the year 2008. Pakistan was close behind with this figure increasing from -4.8 percent in 2007 to -8.4 percent in 2008, Sri Lanka's current account deficit increased from -4.5 to -7.1 in the same period. Bangladesh which had a current account surplus in the year 2007 merely suffered a decline in this surplus, which fell from 1.4 percent in 2007 to 0.9 percent in 2008.

Poverty and inequality in South Asian countries has increased following the adverse impact of global recession on South Asian GDP growth rates. At the same time balance of payments and fiscal pressures have severely constrained the ability of governments to address the problem of mass poverty. In the years ahead this will create stresses on state structures, and the process of building democracies, particularly in a situation where some of the South Asian countries face internal social conflict.

IV. ECONOMIC RECOVERY AND INSTITUTIONAL CHANGE: AN AGENDA FOR ACTION

The path to recovery in the global economy requires careful selection of policy instruments and precise timing and coordination of policy initiatives by countries. Equally important, reducing the vulnerability of the world economy to acute crises in the future will require changes in the institutional regulatory framework of the world's financial system. The following issues in this context require urgent attention:

1. Leaders across the world need to unite against unilateral actions such as protectionist measures which could push the world into a deeper recession. This is particularly important because in a situation of rising unemployment and fluctuating exchange rates, there is a temptation within individual countries to raise import barriers. As Dani Rodrik has pointed out the

experience of the Great Depression of the 1930s shows that such protectionist measures are counter productive as they deepen the crisis[6].

2. As the economies of the Western world and Japan which had earlier suffered negative growth rates have shown signs of recovery in the last quarter, these countries are considering the gradual withdrawal of the stimulus packages initiated earlier. Yet recovery in the Western countries is still fragile. It is not yet clear whether this recovery can be sustained without a government stimulus and by private sector investment and consumer demand. For example, the rising GDP figures of the US in the fourth quarter of the 2009 (annualized output growth of 5.7 percent) may be misleading because firms were merely re-building their stocks. With restrained consumer demand and underutilized productive capacity of firms, it is unlikely that new investment will take place quickly to sustain an economic recovery. In Europe also the prospects of a sustained recovery are grim as the earlier crisis of banks has been replaced by the danger of sovereign defaults by countries such as Greece, Portugal and Spain.

While there is a continued need to stimulate the economy in the West, the choice of policy instruments has to be carefully considered. The recent massive stimulus packages have increased the fiscal deficits in Europe four fold, to an average of 9 percent of GDP. Similarly public debt has reached unsustainable level in rich countries, increasing from 80 percent of GDP to almost 100 percent of GDP in two years. The IMF estimates that it will increase further to 120 percent by 2015[7]. Therefore the earlier unlimited liquidity facility offered on an emergency basis to banks could be withdrawn. At the same time the composition of public expenditure needs to be changed towards generating revenue streams for the government in the future. Economic stimulus in the years ahead will therefore have to rely less on

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6 Dani Rodrik, Making International Finance Safe for the World Economy – Not the other way around: What should the G20 Communique say?, chapter in, What G20 Leaders must do to Stabilize our Economy and fix the Financial System, VoxEU.org Publication, CEPR, 2009.

7 The Economist, February 13 to 19, 2010. Pages 73 to 75.

government largesse to collapsing firms and more on using the interest rate and continued tax cuts to stimulate investment and demand.

3. In the case of India and China where GDP growth rates have largely weathered the crisis, there may be a need to take early remedial measures (as China and India are doing) to prevent over heating and the build up of inflationary pressures in the economy. This is being done by increasing the reserve requirements of banks and restricting credit. At the same time an institutional framework needs to be put into place to prevent speculative investment in real estate.

4. The earlier ideological belief that markets are self regulating and always deliver efficient outcomes, needs to be put to rest. There is a need to recognize as we have argued in this paper, that the very nature of risk and the asymmetric information in markets creates a systemic risk of market failure. Therefore there is a need to establish a new regulatory framework for the global financial system. The aim should be to provide strong disincentives to individuals and firms to being carried away by escalating speculative risk. Perhaps early warning systems need to put into place by the regulatory authority. At the same time there is a need to carefully consider Dani Rodrik's suggestion: The rules that govern financial globalization need to be re-designed to ensure that finance serves its primary goals: allocate savings to high return projects and enhance risk sharing without leading to crises[8].

[8] Dani Rodrik, Making International Finance Safe for the World Economy – Not the other way around: What should the G20 Communiqué say?, chapter in, What G20 Leaders must do to Stabilize our Economy and fix the Financial System, VoxEU.org Publication, CEPR, 2009.

TABLE 1

INTERNATIONAL BANKING, ECONOMIC ACTIVITY, AND INTERNATIONAL TRADE

	AMOUNT (BILLIONS OF DOLLARS AT CURRENT PRICES AND EXCHANGE RATES)					
	1964	**1972**	**1980**	**1983**	**1985**	**2008****
GROSS DOMESTIC PRODUCT (WORLD)*	1,605	3,336	10,172	10,140	12,825	--
INTERNATIONAL TRADE IN GOODS AND SERVICES (WORLD)¤	188	463	2,150	1,986	2,190	--
INTERNATIONAL BANKING¤¤	20	208	1,559	2,253	2,598	214,424

SOURCE: RALPH C. BRYANT, INTERNATIONAL FINANCIAL INTERMEDIATION (WASHINGTON, D.C.: THE BROOKINGS INSTITUTION, 1987), P.22.

SOURCE**: IMF, GLOBAL FINANCIAL STABILITY REPORT, OCT. 2009, Table 3.

NOTE¤: WORLD, EXCEPT EASTERN EUROPE.

NOTE¤¤: BANK ASSETS, BONDS AND EQUITIES (GLOBAL)

TABLE 2

FOREIGN DIRECT INVESTMENT

Us $ Million

Country	2006	2007	2008
Bangladesh	743	793	650
India	21,991	32,327	20,700
Pakistan	3,450	5,026	5,078
Sri Lanka	451	548	313

Sources: (1) Asian Development Outlook, 2009.

(2) Cited in: Rashid Amjad and Musleh ud Din, Economic and Social Impact of Global Financial Crisis: Implications for Macroeconomic and Development Policies in South Asia (Preliminary Draft), PIDE, Islamabad October 2009.

TABLE 3

FISCAL DEFICIT AS PERCENT OF GDP

Country	2004	2005	2006	2007	2008
Bangladesh	-3.2	-3.3	-3.2	-3.2	-4.7
India	-7.5	-6.7	-6.4	-5.4	-6.0
Pakistan	-2.9	-3.3	-4.3	-4.3	-7.4
Sri Lanka	-7.9	-8.4	-8.0	-7.7	-6.8

Sources: (1) Asian Development Outlook, 2009.

(2) Cited in: Rashid Amjad and Musleh ud Din, Economic and Social Impact of Global Financial Crisis: Implications for Macroeconomic and Development Policies in South Asia (Preliminary Draft), PIDE, Islamabad October 2009.

TABLE 4

CURRENT ACCOUNT BALANCE AS PERCENT OF GDP

Country	2004	2005	2006	2007	2008	2009
Bangladesh	0.3	-0.9	1.3	1.4	0.9	0.2
India	-0.4	-1.2	-1.1	-1.5	-3	-1.5
Pakistan	1.3	-1.6	-4	-4.8	-8.4	-6
Sri Lanka	-3.1	-2.7	-5.3	-4.5	-7.1	-7.5

Sources: (1) Asian Development Outlook, 2009.

(2) Cited in: Rashid Amjad and Musleh ud Din, Economic and Social Impact of Global Financial Crisis: Implications for Macroeconomic and Development Policies in South Asia (Preliminary Draft), PIDE, Islamabad October 2009.

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5. The Economist, February 13 to 19, 2010.