

From Global Financial Meltdown to Global Economic Crisis

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Global financial meltdown that started in August 2007 had its origin in the United States. A combination of easy monetary policy, rapid economic growth, rising asset prices, low interest rates and financial innovation created conditions whereby the American dream of a home for everyone became almost a reality. As the creditworthy and deserving borrowers had saturated the mortgage market the lenders took excessive risks by moving down the curve to provide subprime mortgages to otherwise suspect borrowers. The banks themselves originated the loans but did not keep them on their balance sheets as they bundled them and sold them to other financial institutions or kept as off-balance sheet items such as Special Investment Vehicles. In a rising asset price scenario there was hardly any problem either for the borrowers or the lenders but when the housing prices started dropping the same mortgage backed securities began to lose their values. International accounting standards demanded the assets to be marked to market and the banks were hit first. But the damage was controlled as the banks were able to offset their write downs by raising capital from Sovereign Wealth Funds which were flush with liquid funds collected from the windfall gains of oil and commodity price hikes. But the loss in values was not limited to the banks alone but had a cascading effect throughout the financial markets across the globe that have all, by now, gotten interconnected through the forces of financial integration. As financial innovation accelerated and became more sophisticated the opacity also became more pronounced and it became difficult to know where the ultimate risk was residing. Financial institutions of all sorts were holding assets with complex risks characteristics which they could not fully comprehend.

Since September 2008 the financial markets are witnessing another round of intensified risks that is threatening financial stability. Credit risks have risen resulting in higher loan losses. The flight from risky assets and illiquid market conditions has increased funding costs. The heightened counterparty risks and the need to hoard cash

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for possible redemption purposes have made interbank markets dysfunctional. The abrupt pull back from emerging market assets by investors in advanced countries have spilled over the adversity to otherwise solvent and creditworthy borrowers in the emerging economies.

Extensive government support by the U.S., U.K. Germany and other European countries in form of bank recapitalization, loan guarantees, purchase of toxic assets, etc. and the central banks' concerted and coordinated efforts to inject liquidity, cut policy rates and relax monetary policy conditions did improve the situation somewhat in 2007/08. But the recent shock to bank earnings at end of 2008 and other bad economic news has put further downward pressure on bank equity prices. The credit default swap spreads have widened and it seems that the systemic risks to the financial system have not been subdued or mitigated. As a consequence, confidence in the financial markets has been substantially eroded and the financial institutions are unable to attract needed capital from private investors. The contagion effect has hit even otherwise healthy banks such as J.P. Morgan, Chase and Barclays. IMF estimates that for European and US banks the net capital shortfall to meet the expected write downs in 2009 and 2010 would be in the order of magnitude of at least half a trillion dollars. This amount will only prevent further deterioration in their capital position but does not take into account additional capital injections to clean up the troubled assets from the balance sheets.

The above requirements do not factor in the hedge funds, mutual funds, insurance companies and other components of the shadow banking system. So what is happening in the international financial markets? Domestic private sector credit growth has fallen across a large number of countries while public sector growth is expanding. This is happening on both supply and demand sides. Demand for credit is falling due to recessionary economic situation while at the same time the banks have tightened their credit standards. Cross-border bank lending has slowed down hurting the emerging market countries that depend on these funds for trade finance or for domestic credit growth. As long as the banks continue to deleverage their balance sheets there is little hope that the supply of bank loans to emerging countries will improve.

How long can the advanced countries continue to provide support to their financial sectors? With large fiscal stimulus packages that could cost 1.5 percent of

GDP of G-20 countries in 2009, there are rising concerns whether these governments can afford further bank recapitalizations, guarantees, asset purchases on the top of what they have already done. Fiscal balance in advanced countries is projected to decline to negative 7 percent from 3.25 percent in 2008. Can the tax payers in these countries go beyond this level?

The slow down in the world economy is much more pronounced than what was envisaged even in October 2008. The IMF has revised downwards its estimates for 2009 and projected that the global growth is expected to fall to 0.5 percent (in PPP terms) and turn negative in terms of market exchange rate. Advanced countries will have a negative 2 percent growth in 2009 compared to 2.5 percent in 2008 while the emerging and developing countries growth rate will almost halve to 3.25 percent from 6.25 percent achieved in 2008. This will be the worst recession since 1982. The risks of deflation have also become real as inflation in advanced countries would be 0.25 percent in 2009 and in the emerging and developing countries to 5.25 percent. Central banks have already cut policy rates and the US discount rate is close to zero. Whether traditional monetary policy tools will be effective in such a scenario is a big question mark. World trade volumes are also likely to hit rock bottom and thus the countries pursuing export led growth would feel the pinch the most. As economic prospects have deteriorated for 2009, the pernicious feedback loop between the slowing real economy and financial markets will intensify leading to even more negative effects on global growth.

The sharp drop in asset values, particularly, that of housing will decrease the household wealth putting downward pressure on consumer demand. The associated high level of un-certainty is pushing the households and businesses to postpone expenditures reducing demand for consumer and capital goods. At the same time disruptions in credit availability are reinforcing the constrained household spending and also curtailing the businesses in production and trade.

The dilemma that confronts the policy makers is that all the positive steps they have taken over past two years by providing liquidity support, recapitalization, deposit insurance, loan guarantees, have not done much to minimize this uncertainty. The equity markets are signaling that they are not too sure about the long term solvency of

these financial institutions despite the strong public sector support. In this view the process of loss recognition and restructuring of bad loans is still incomplete and many other asset classes may be hit in the future.

What will come out of this crisis is the moot point for all of us to ponder? If we see that the adjustment will lead to a viable financial sector that is less leveraged, more prudently regulated and therefore smaller relative to the real sectors of the economy, then the price paid so far will be worth the while. But if it ends up in a weaker financial intermediation capacity that is unresponsive to the needs of the households or businesses then it would not be fair to expect the kind of growth rates we have witnessed in the past decade or so. The emerging economies that are aspiring to graduate to the ranks of advanced countries in the next two or three decades will suffer serious set back. In presence of anaemic global growth, weak commodity prices, restricted international financial flows and slow world trade, the prospects for the emerging and developing countries to reduce the incidence of poverty and bring prosperity to their population would remain bleak.

The banks and financial institutions in the advanced countries have scaled up deleveraging and in the process withdrawing or curtailing capital from emerging market economies as they consider these assets as risky. Private net capital flows are estimated by the Institute of International Finance to fall to \$165 billion or less than a fifth of the level two years ago, putting stress on the emerging economies to roll over their foreign debts, slow down their investment plans and forego future growth prospects. The process of deleveraging if extended beyond a limited period of time will be a source of agony and pain for the emerging market economies. Eastern European Countries will be worst hit by this shrinking of loan books by advanced countries banks and financial institutions.

Fears about protectionism in the advanced economies have further compounded the uncertain outlook about the absorption of exports from emerging and developing countries. If the trade protectionism is accompanied by slow down in capital flows countries such as China will also suffer and the global growth rate may become negative rather than positive. Asia has already been hit hard because it is more intimately bound to the global economy. A decade ago, Developing Asia's exports accounted for

37% of its GDP. By 2008 the ratio had risen to 47%. As the Asian countries made spectacular gains when the world trade was booming the reverse is also true. Today when world trade volumes are shrinking due to economic downturn and the ugly head of protectionism is surfacing the dependence of Asian countries on exports has made them highly vulnerable to external demand shocks.

How soon can the global economy get out of the present recession? This will very much depend on the speed with which confidence is regained by the households, businesses and banks and how successful the policy makers are in fostering this confidence. The current projections by IMF staff show that economic recovery will begin in 2010 but there are many risks associated with that scenario. It can be concluded safely that the year 2009 is going to be a difficult year for the world economy as a whole and for Pakistan also.