LESSONS FROM THE FINANCIAL CRISES

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SEPTEMBER 15, 2009 marked one year from the day American financial firm Lehman Brothers collapsed. The subsequent onslaught on the global financial system set in a recession of the magnitude not experienced since 1930.

Financial institutions considered rock solid such as AIG and Citibank came almost on the verge of collapse. The world economy contracted for the first time in decades. But a year later the ‘green shoots’ have started appearing and the consensus view is that the global economy is coming out of the storm.

Economic historians will take many years to fully analyse the causes of the crisis but the policymakers cannot afford to wait. It is therefore important to draw some generalised lessons from this crisis.

The first lesson is that the slogan of ‘capitalism is dead’ and the concept that nationalisation of private assets is now the norm are highly misplaced and are not substantiated. Yes, the western governments had to intervene in a big way, spending trillions of taxpayers’ funds to rescue the banks and inject equity, but this was required as a temporary measure to save the financial system from total meltdown. The excesses and greed of the bankers did play havoc, but there is no cogent reason to expect that private ownership and market mechanisms of resource allocation would give way to permanent public ownership and an administered allocation system.

History tells us that systematic banking crises have always been resolved with large injections of public capital. Regulatory and pay reforms are being considered but we should not expect governments to retain the acquired shares in the financial institutions for long or to interfere in the management of these institutions. The US has already announced plans to pare back its emergency support for banks and financial markets.

Second, the spillover effects, the contagion, the herd instinct and the animal spirits have not only remained unscathed but have become more ingrained. While irrational exuberance was so vivid during the days when the markets were buoyant, excessive fear, risk avoidance and abundant caution gripped the same players during the downturn. Sentiments and confidence factors in domestic markets were transmitted to other unrelated markets also. Pakistani banks, however strong fundamentals they may have, will be negatively affected by happenings elsewhere.Third, three large economies – China, India and Indonesia – and emerging economies in general remained relatively more buoyant through the downturn due to strong domestic demand. Although the ‘decoupling’ between the developed and developing countries remained elusive, the increasing weight of emerging economies will prove a countervailing force in the future.

Synchronised decline of the US, European and Japanese economies triggered the present financial crisis but the overall impact may become muted in times of adversity in the future if the emerging economies continue to grow rapidly.

Fourth, reliance on exports to the developed world alone is too risky. China suffered from a sharp fall in its exports when US consumers decided to save more and curtail their demand for foreign goods. Robust and sustained domestic demand in large developing countries can come to the rescue if foreign demand crumbles. This does not mean that we should give up the emphasis on exports (world exports are almost a hundred times more than the entire GDP of Pakistan), but stimulating broad-based non-inflationary domestic demand will have an overall positive effect.

Fifth, the US will no longer be the driver of global economic growth. Excessive debt and deficits resulting from fiscal stimulus have impaired its capacity to run current account deficits of the order witnessed earlier. The real wealth effect arising from the decline in housing prices will force a shift from consumption towards savings. The world savings glut would no longer find an open conduit towards the US. The global economy would need more than one consumer to sustain even modest rates of growth. By 2015 it is estimated that one billion new consumers would emerge in Asia and other developing countries graduating into the ranks of the middle class. They will fill this gap.

Sixth, the conventional thinking espoused by former US Federal Reserve chairman Alan Greenspan and followed by other central bankers (including this writer) that asset price bubbles should not be pricked as they would cause more harm than good has to be abandoned. Price and financial stability have to be managed jointly and the trade-offs and tensions between the two will have to be recognised and resolved.

Bank debts secured by deflating asset bubbles forced substantial write-downs and pushed the banks to a precipice. Confidence in the financial markets, once eroded, takes an awful lot of time and exceptional efforts to restore. Liquidity dries up, capital and trade flows collapse and the firms are starved of credit. Preventive action is perhaps a better option.

Seventh, the accumulation of huge foreign currency reserves in the aftermath of the Asian crisis appeared quite justified. But the accumulation and allocation of these reserves by the central bankers in Asia created serious distortions. As their assets were largely denominated in the US dollar the fear of capital loss deterred these public servants from following alternative strategies. Had China, for example, allowed private savers to hold their assets in foreign currencies this large concentration of assets in one currency would have been avoided.

Eighth, while the world economy is fast integrating and the cross-border spillover effects are becoming more intense the global financial architecture is inadequate to manage this tide. National economies and national economic institutions remain supreme, while they are reluctant to cede their sovereignty to any supra-national or more effective international institution.

The difficulties faced by the European Commission in forging consensus on regulatory reform within Europe simply demonstrate this gap. The International Monetary Fund has been given enhanced responsibilities for surveillance but no enforcement power. This mismatch between inadequate institutional capacity at the global level and a powerful integrated global market will remain a source of vulnerability of the present system.Finally, the recession has enhanced the risk of protectionism by the developed world. Emerging economies need open and unrestricted access to markets everywhere but the push toward protectionism in developed countries is likely to become an obstacle. The powerful domestic lobbies are using the present crisis to magnify the doomsday scenarios for the future and exploiting the sensibilities of the legislators against open trading systems.

A breakthrough in the Doha Development Round would demonstrate whether open markets and unrestricted access will be allowed for the revival of the world economy, or the industrialised countries will remain confined within their cocoons.