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Beyond the Global Recession[1]

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Global recession

Currently, we are in the worst recession since the Great Depression, and the financial market is continuously under extreme stress. Due to confidence lost by consumers and the corporate sector, most developed countries reported substantial negative economic growth at the rate of -3.8 % for the US, and -12 % for Japan for the 3rd quarter of 2008 on a yearly basis, and are expected to further deteriorate during the fourth quarter of 2008. Moreover, developing countries have been much affected as well. As if hit by a tsunami, these countries are experiencing credit crunches, higher financial costs, and rapid drops in exports and foreign reserves.

Even for China, which had double-digit growth in the past, the actual growth in the fourth quarter was as little as 6.8 %. The economic recession can be seen globally.

Loss of confidence in the financial markets

The current crisis started in August 2007, when major investment banks revealed substantial mark-to-market losses. However, it is apparent that the global economic recession triggered by the financial crisis has been spread by enhanced inter-relations among the economies in the region. Loss of confidence in the financial markets spread immediately. In addition, the bad assets of commercial banks increased due to the negative spiral of finance and the real economy; thus, economic deterioration rapidly accelerated.

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[1] This paper is the script of a speech delivered at the ABAC Meeting on February 10th, 2009 in Wellington, New Zealand.

Easing monetary policy at full throttle to boost the economy

The economic recession is severe and has been characterized as a "Once-in-a-century" phenomenon. Thus, policy makers have adopted a series of extraordinary measures. Policy interest rates have been decreased almost to zero in both Japan and the USA. The ECB and BOE have lowered interest rates to historically low levels. Some central banks have guaranteed credit for commercial banks, and have also dared to take on the companies' credit risks by "credit easing" measures, as they are called by the FED, including purchasing MBS, CP and corporate bonds.

The IMF estimates its losses borne by the US financial sector due to CDOs, etc. to be greater than proposed; as much as US $2.2 trillion. The IMF thinks the capital injection of US $800 billion made so far is not yet sufficient.

Regrettably, the credit spread of the major international banks remains high, yet liquidity has been continuously supplied to the market. The crisis goes on and evidence of recovery is scarce.

We must pay attention to protectionism in the form of the governments' financial support to the corporations, and cross-border disputes on the bankruptcy of international banks. Such protectionism could be the other side of financial mercantilism. Coordination among each economy is needed within the G20, etc.

Fiscal policy on the edge

Now that most of the possible financial policy measures have been exploited, the expectation is that fiscal policy will be utilized. In particular, the economic stimulus measures by the new Obama administration in the US have received much attention. The magnitude of US $825 billion is approximately 6% of the US GDP, which is highly appreciated, albeit only executed over the course of two years (2009 and 2010). China's stimulus package is 4 trillion Yuan, which is 16% of its GDP. Although such an amount is enormous for China, the equivalent of US$583 billion, it could underpin the entire economy in the Asian region.

For self-recovery of the economy

Although these policy measures will soothe the severe economic recession, they do not guarantee a sustainable recovery. Self-recovery is necessary to boost the economy. What will be the keys to this recovery? When will it be realized? I would like to state my opinion in light of my experience in the years after the Japanese bubble burst.

The current global recession began in the USA. The key for recovery may be the recovery of the US, particularly in the housing market. The economic problems of the US market were caused by over-leveraging combined with the appreciation of asset prices. The solution will require capital inflow from investors as well as the adjustment of excessive asset prices. Excessive investments in the US residential markets and housing price appreciation have been rapidly readjusted. New housing starts have fallen by 27 % of their peak, and housing prices are now 25 % below peak according to the S&P/Case-Shiller Home Price Indices. If the asset price adjustment is made at the current pace, the market expects housing prices to reach the normal level by the latter half of 2010, compared with the flow of income. The US population grows at slightly less than 1 % per year, and the price adjustment will create demand for consumption. However, a further decline of housing prices in the next year or later could worsen the negative net worth of households. Contrary to market prospects, the decline of housing prices could trigger a prolonged economic recession.

As experienced in Japan through the recovery process after the bubble burst, the rapid upward trend of asset prices could bring a significant confidence boost to the overall economy, even in the US. When asset prices bottom out, the imbalance between supply and demand will decrease. A demand increase will shrink the bad assets, recover the balance sheets of financial institutions, and facilitate economic recovery. This is called a "positive spiral".

On the other hand, adjustment of the balance sheet still remains an issue. For example, in the case of Japan, it took more than 10 years to adjust the balance sheets of the household and corporate sectors, during which time the nominal growth rate was almost zero. Likewise, it may be difficult for the US to return to high economic growth (3-4 % per year), even after asset prices bottom out and the economy begins to recover. This is because the current low level of savings will be adjusted and consumption will not increase; consumption based upon borrowing was the main stimulant of economic growth in the past.

Over-leveraging and over-saving

What should we do in order not to make the same mistakes in the future?

The economic developments in the US after the 90's are characterized by over-leveraging. Credit relied too much on the increase of asset prices, resulting in excessive sub-prime borrowers. Such excessive risk taking caused investors in many countries to over-leverage; complex and opaque transactions were built into the loans and investments held by investors and banks.

In order to avoid over-leveraging, we must review the regulations and supervisions, financial architecture including the role of international institutions, as well as corporate governance; discussion regarding these topics is expected in the G20, FSF, APEC and ABAC.

As is often pointed out, over-leveraging is a counter to the concept of over-saving. High savings and positive current balances in East Asian countries were on the opposite side of low savings and current deficits in the US. I believe that it is incorrect that high savings in the East Asian countries directly brought about over-leveraging in the US and Europe. It is difficult to understand the causes and results of the money flow, determine if the flow is healthy, and figure out a way to cope with it.

However, depending upon the timing needed to restore the balance sheets of US households, the past Asia Pacific growth model may not be effective at this moment. Such a model, started in Japan in the 50's, assumes that the global manufacturing function supplied mainly by East Asian countries enjoys profits and wealth through the expansion of US demand. Household consumption underpinned by fiscal policy does not necessarily increase international trade. Considering this concept, changes are needed for the development model in the specific region, especially in East Asia.

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