2009.5.13 (No.6, 2009)

Newsletter

Institute for International Monetary Affairs
(財)国際通貨研究所

Beyond the Global Recession: Did we hit bottom? [1]

Yoshihiro Watanabe
Managing Director,
and
Ayako Yamaguchi
Lead Economist,
Institute for International Monetary Affairs (IIMA)

Global Recession: Did we hit bottom?

The global economy is now experiencing one of the most severe deterioration since the Great Depression. In the fourth quarter of 2008, almost all the advanced economies have shown negative economic growth. Even Asian region sees economic slowdown where a relatively steady growth had been observed. The economies which rely heavily upon exports, such as NIEs, have also shown negative growth. At the beginning of the current crisis, the emerging Asia was expected to be a good example of “decoupling” by showing steady growth and by being less affected by the economic slowdown of the industrialized nations in other regions of the world. However, we now can see that even the emerging Asia could not be an exception after having been washed out by the waves of the sudden contraction of world trade, falls in the stock and foreign exchange markets, and capital outflows.

Even in this annihilative situation, there are signs that conditions will improve. Entering into the second quarter this year, we feel that the pace of the US economic slowdown has become milder than that in previous months. The US housing market, which was known as the “crisis epicenter”, may have hit bottom, albeit its slow activities. Measures such as the tax reduction on housing investments, and the lower interest rate produced by mortgage backed securities purchasing plan by the FED, may

[1] This paper is the script of a speech delivered at the 2nd ABAC Meeting on May 13th, 2009 in Brunei Darussalam.

have become effective. In Asia, China has not yet made a recovery in its exporting activities. However, its domestic demand, especially investments in infrastructure, is rigidly maintained. We may now say that China's large-scale economic revitalizing measures have started showing their effect.

Financial markets are gradually recovering from the state of "paralytic symptoms" and, in fact, the credit spreads are shrinking. Stock markets are also recovering and are now in a temporary period of tranquility. However, it is hard to believe that the recovery will be steady and fast. Rather, we will see lots of twists and turns in the process of recovery in the months to come. Although I cannot say the asset price hit bottom, I would like to say that the worst situation may be behind us.

Governmental Responses with Affirmative Monetary/Fiscal Policies

According to the forecast by the IMF, the current global recession will be longer and deeper than the previous recessions we had experienced in the past as it was triggered by the financial crisis and is shared concurrently by the whole world. The expected world GDP growth rate of 2009 is minus 1.3%, which is the worst figure since World War II. It is expected to be better in 2010, but the growth rate will be as little as 1.9%.

Under these circumstances, the monetary measures taken by the developed economies were much quicker than any measures taken in the past. The policy rates in G3 nations, except for the European Central Bank, have reached at around 0 %. The US and UK are trying to deliver direct effects on the markets through untraditional monetary strategies. In Asian economies, the tight monetary policies were implemented to control inflation before the crisis. But, with less possibility for the inflation due to the crisis, their monetary policies have been defused in response to the recession and receding prices of primary products.

However, under the circumstances where lending capacity of financial institutions is becoming lower than before and many restrictions on lending policies are implemented because of the financial crisis, the effect of those monetary policies is limited and more public spending is expected.

In addition to the fiscal measures by the Obama administration with a total amount of US$ 800 billion, other large scaled measures were taken such as EUR 200 billion in Europe, RMB 4 trillion in China and JPY 57 trillion (pure increment of JPY 15 trillion) in Japan. As for the Asian economies, depending upon one's fiscal situation, more or less 5% of one's GDP amount is expected to be used for the economic rescue plan. These measures by respective economies are implemented not only to stimulate the economy on a short-term basis or to enhance the social safety net, but also to respond to middle-term subjects such as the environment, medical care, education and infrastructure, which are expected to stimulate potential growth.

We may now recognize that alleviated economic slowdown is the gradual effects of those fiscal and monetary policies.

Risk still remains

According to the IMF, the total accumulated loss that the financial institutions in the world would suffer from due to the financial crisis and economic recession is estimated to amount to around US$ 4 trillion between the year 2007 and 2010. Out of this US$ 4 trillion, US$ 2.7 trillion will account for the loss realized in the US market. The estimated amount has been doubled, compared to the one estimated last fall. Although the framework of the US rescue plan has been announced, it is not certain if this will function well. We cannot deny the risk of non-performing asset increase due to further economic deterioration during the cleaning up process of the balance sheets of major financial institutions after the stress tests. Consequently, anxiety among investors could be reignited and the stock market might be largely readjusted.

The risk remains for a slower economic recovery due to prolonged balance sheet adjustments of the US households. If this is the case, the housing market, which is currently in a temporary period of stand-still, will face with adjustment again. This could lead to a vicious spiral of deteriorated economic conditions and inferior balance sheets of financial institutions.

In addition, there is a risk that capital flow towards emerging/developing economies would not come back. It is already predicted that this capital flow towards emerging/developing economies will be extremely decreased and, in 2009, this tendency will show a net outflow due to deleveraged movements together with a flight to quality and home bias among the financial institutions of the industrialized nations. We will have to pay extra attention to Central and Eastern Europe where a backward capital flow is observed. This backward flow could eventually make it difficult to roll-over funds this year, and this tendency or risk could spread out widely to the other emerging/developing economies.

Building Up a New Global Financial System

Under the circumstance of decreasing capital flow towards emerging/developing economies, we would need to enhance global cooperative systems such as currency swap arrangements among central banks and credit enhancement by international financial institutions for the purpose of maintaining the cross-border capital flow towards emerging/developing economies.

Many agree that additional regulations towards financial institutions in industrialized economies are inevitable. Simultaneously, we have to be aware that excessive regulations could spoil market dynamics. It is needless to mention that financial institutions should maintain sufficient capital in order to minimize the impacts from the crisis. However, we have to remember that reinforcing such a capital maintenance regulation during the period of crisis could aggravate the crisis itself. The point is, from now on, that how we can change from the procyclical regulations to more countercyclical ones.

There are intensive discussions these days on how to strengthen the functions of international institutions as the IMF. We can highly appreciate that the IMF's recent actions such as enhancing credit lines would contribute to bringing global financial stability. However, establishing a unified supervisory system of regulation and control by a powerful international institution cannot be a practical solution on a short term basis. The immediate task is to promote global cooperation among the regulatory authorities of each economy, in addition to strengthening the conventional international institution's functions.

Economic Subject among APEC Economies: Formula to Rebalance the Growth

As a result from the global financial crisis, it is already predictable that in 2009 the world economy will experience one of the biggest falls since the Great Depression in terms of economic growth. It is anticipated that the US economy will hit bottom and start heading towards recovery. However, considering the negative factors such as the balance sheet adjustment in the household sector and negative wealth effect, its recovery pace will be quite slow. As for the Europe, the negative spiral of Western and Eastern European economies is being accelerated, and thus its recovery pace is thought to be slower than that of the US.

Under such circumstances, the economies with current account surplus, mainly in Asia, may not anticipate repeating the export driven economic recovery as they used to have in previous recessions. Therefore, creating a new economic development model with less dependence upon excessive export activities has become their immediate task. Some economies, depending on their priorities, are expected to promote structural reform to vitalize domestic consumptions and investments. Thus, the expansion of financial functions for development and regional cooperation become very important.

At present, all the economies in the world are making their best endeavors, with both monetary and fiscal measures, in order to get out of the current crisis. UK and the US authorities are using "untraditional" approaches by hypertrophying their balance sheet. While these measures are showing certain effects, their side effects are also concerned. Much attention should be paid to exit strategies so that they shift smoothly to stable monetary policies in the normal period. In addition, as a result of the aggressive fiscal measures, each country is facing large amount of negative fiscal balances. Developed economies cannot avoid a deterioration of fiscal imbalance due to disproportionate population ageing. Thus, authorities of each economy should take urgent and appropriate responses to maintain fiscal sustainability on medium term basis when the financial crisis is over.

Address: 3-2, Nihonbashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3235-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp