

An Assessment of the Global Impact of the Financial Crisis

Edited by Philip Arestis,
Rogério Sobreira
and José Luis Oreiro



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Contents

<i>List of Tables and Figures</i>	vii
<i>Notes on the Contributors</i>	xi
1 Introduction <i>Philip Arestis, Rogério</i>	1
2 Current Crisis in the US and Economic Policy Implications <i>Philip Arestis and Elias Karakitsos</i>	12
3 The Global Economic and Financial Crisis: Which Way Forward? <i>Ajit Singh and Ann Zammit</i>	36
4 Crises and the Bretton Woods Institutions and the Crises of the Bretton Woods Institutions <i>Howard Stein</i>	60
5 Crisis in the Euro Zone <i>Jonathan Perraton</i>	84
6 The Impact of the Current Crisis on Emerging Market and Developing Countries <i>Jesus Ferreiro and Felipe Serrano</i>	108
7 The Crisis in Western and Eastern EU: Does the Policy Reaction Address its Origins? <i>Özlem Onaran</i>	135
8 The Impact of the Subprime Financial Crisis on the Transition and Central Asian Economies: Causes and Consequences <i>Nigel F.B. Allington and John S.L. McCombie</i>	159
9 The World Financial Crisis and the Implications for China <i>Shujie Yao and Jing Zhang</i>	182
10 The 2008 Financial Crisis and Banking Regulation in Brazil <i>Luiz Fernando de Paula and Rogério Sobreira</i>	209

11	Exchange-Rate Derivatives, Financial Fragility and Monetary Policy in Brazil during the World Financial Crisis <i>José Luis Oreiro and Flavio Basilio</i>	236
	<i>Index</i>	261

List of Tables and Figures

Tables

1.1	Current account surplus as a share of GDP (selected countries, 2007–2009)	2
3.1	Summary table of the causes of the economic and financial crisis	39
3.2	Current account balances (selected economies), 2000–2004	41
3.3	Fiscal stimulus to address the global financial and economic crisis	46
3.4	Growth of world output and that of selected countries and regions, 1991–2007 (% per annum)	48
3.5	Explaining the productivity surge in the US	49
4.1	IBRD and IDA lending, 1998–2009 (US\$ million)	62
4.2	IMF resources, disbursements, repayments, income and outstanding credit (billions SDRs), 1998–2010	63
5.1	Real GDP growth in the euro area	85
5.2	Unemployment rates in the euro area	86
5.3	External position of PIGS, end-2009	102
6.1	Distribution of goods exports depending on the destination (% total exports)	117
6.2	Distribution of the imports of goods by destination (% total imports)	119
7.1	Average annual growth in GDP, employment, productivity, and real wage, 1991–2009, Selected Western EU MS	141
7.2	Average annual growth in GDP, employment, productivity, and real wage, 1989–2009 and sub-periods, Eastern EU MS	149
8.1	Growth of real GDP: Transition economies (annual percentage growth rates)	161

8.2	Current account balances: transition economies (percentage of GDP)	164
8.3	Growth of real GDP: Central Asian economies (annual percentage growth)	175
9.1	Evolution of the financial crisis	187
9.2	AIG and the RBS Group	191
9.3	Percentage changes in industrial production	192
9.4	Stock market prices (close price adjusted for dividends and splits)	196
9.5	China's economy in the first half of 2009	200
9.6	Regional comparison, 2008–2009	203
10.1	Mergers and acquisitions with incentives of PROER	214
10.2	Privatisation of state-owned banks	215
10.3	Basel ratio in selected countries (%)	217
10.4	Banks' portfolio (percentage share)	219
10.5	Market share by shareholder control (in percentage of total assets)	221
10.6	Return on equity (%)	223

Figures

2.1	UK wages as a percentage of GDP	14
2.2	UK wages relative to productivity	14
2.3	Percentage deviation of real wage rate from productivity (January 1968 = 100) and unemployment	15
2.4	Compensation of employees and its components	16
2.5	US profits as a percentage of GDP	17
4.1	IBRD and IDA lending trends, fiscal 1970–2000	61
5.1	Headline interest rates	88
5.2	Net household savings rates (% disposable income)	94
5.3	Peak-to-trough decline in output	99
5.4	Peak-to-trough changes in unemployment	100
6.1	Annual rates of real economic growth (%)	110

6.2	Growth rate in developed economies and difference between economic growth of developing economies with regard to developed economies	110
6.3	Economic growth rate (%)	112
6.4	Growth gap between developing economies and developed economies	113
6.5	Economic growth rates (%) in the period 2003–2010	114
6.6	Annual growth rates (%) of developed economies and current account balance of developing economies (in %GDP)	116
6.7	Balance on goods and services US–China and nominal exchange rate of renminbi	121
6.8	Balance on goods and services USA–Euro zone and nominal exchange rate of renminbi	122
7.1	Adjusted wage share, selected Western EU MS	140
7.2	Adjusted wage share, Eastern EU MS	150
9.1	Asymmetric reaction to gains and losses	184
9.2	Evolution of market bubbles, crisis and recovery	185
9.3	Monthly indices of primary commodity prices, 2007–2009	190
9.4	Housing price change in the US and the UK, 2005Q1–2009Q1	193
9.5	Nominal GDP of top five economies (\$ billion)	202
10.1	Total credit-to-GDP	211
10.2	Number of banks	215
10.3	Bank spread (%)	220
10.4	Portfolio investments in 2008–2009	224
10.5	Real effective exchange rate (1994=100)	226
10.6	Domestic credit-over-GDP (%)	228
10.7	GDP growth in 2007–2009	229
10.8	Contribution to GDP growth in 2007–2009	229
11.1	Amounts outstanding of over-the-counter (OTC) derivatives in billions of US dollars	240

11.2	Effective and equilibrium values of the real exchange rate (indexed – average value of 2000 = 100)	245
11.3	Nominal exchange rate and currency surplus/deficit form September 2008 to March 2009	246
11.4	Evolution of banking spread – genreal (% p.y)	247
11.5	Evolution of international reserves	249
11.6	Percentage change (p.m) of reserve requirements and banking reserves in Brazil (2008.01–2009.01)	249
11.7	Percentage change of industrial output (compared to the same month in 2007)	250
11.8	Evolution of the international prices of five commodities (2007/12–2008/12)	251
11.9	Causality diagram	254

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1

Introduction

Philip Arestis, Rogério

Recent economic events have had a profound impact on the global economy. According to the *World Bank Economic Outlook* published in April 2010, the major advanced economies experienced a fall of 3.2 per cent of GDP in 2009 and are expected to record a moderate growth of 2.3 per cent in 2010. The impact of the crisis was stronger in Japan and euro area than in the United States, the centre of the financial crisis. Indeed, the US economy experienced a decline of 2.4 per cent in GDP compared to a 4.1 per cent fall in GDP in the euro area and 5.2 per cent in Japan. The United Kingdom is also projected to experience a huge fall of 4.9 per cent of GDP in 2010.

These numbers are in sharp contrast to those observed in developing countries. For instance, the Newly Industrialized Asian Economies (Korea, Taiwan, Hong Kong and Singapore) had a fall of only 0.9 per cent of GDP in 2009. For the rest of Asia, the numbers are even better. In the case of China and India, GDP growth of 6.6 per cent was recorded in 2009, and in 2010 the growth in GDP is expected to be 8.7 per cent. The ASEAN-5 (Indonesia, Thailand, Philippines, Malaysia and Vietnam) experienced only modest growth of 1.7 per cent in 2009, but is expected to have robust growth of 5.4 per cent in 2010. Even in Latin America the impact of the crisis will be weaker than has been the case in developed countries: South America and Mexico experienced a fall of only GDP 1.9 per cent in 2009. For 2010, this region is projected to achieve robust GDP growth of 4.1 per cent.

During the recent crisis the economic performance of developing countries has been rather curious. In fact, just one decade earlier, the East Asian Crisis had shown the fragility of the 'Asian Model' of growth compared to the 'Western Model' of capitalism. In 1994–95, the Mexico Crisis had a huge impact on some important Latin American economies,

including Brazil. For a long time Latin America has been considered a region characterised by balance of payments crises, capital flight and high rates of inflation. But now things have changed. The 2008 financial crisis had hit the heart of capitalism, but the effects were much weaker at the 'periphery' of the capitalist system than in its centre. The relevant question is why.

One possible answer is that developing countries have learned from previous crises and have adopted policies that help to reduce their external fragility. Indeed, as can be seen in Table 1.1, developing countries recorded strong current account surpluses in 2007, one year before the crisis. This situation did not change significantly in 2008 and 2009. Why would being a capital-exporting country help to isolate the economy from the effects of a financial crisis abroad? The answer to this question is that current account surpluses are, in general, associated with a substantial accumulation of foreign reserves. This is especially important in avoiding a capital flight from a country in the face of a fall in exports and in foreign direct investment during an external crisis. Capital flight can have disruptive effects over a developing economy since it can produce a huge and sudden devaluation of nominal exchange rate. In general, this can have negative effects over the real output of these countries, essentially as a result of the fact that a significant share of liabilities of private agents and government are expressed in foreign currency, while their assets are denominated principally in domestic currency.

Another problem that can arise as a result of capital flight is an increase in the domestic rate of interest in an attempt by the Central

Table 1.1 Current account surplus as a share of GDP (selected countries, 2007–2009)

	2007	2008	2009
United States	-5.2	-4.9	-2.9
Euro area	0.3	-0.7	-0.6
Japan	4.8	3.2	2.8
United Kingdom	-2.7	-1.7	-1.3
Newly Industrialized Asian Countries	5.7	4.4	8.9
China and India	7.0	5.9	4.1
ASEAN-5	4.9	2.6	5.1
South America and Mexico	0.7	-0.3	-0.3

Bank to avoid a substantial devaluation in the domestic currency. In this case, monetary policy will be used as a device to achieve an external balance, but its effect over the domestic economy will be to internalize the contraction of output occurring abroad by means of a reduction of domestic demand through interest rate increases. If the fiscal position of the country affected by a capital flight was not good before the crisis (for example, the country had a high public debt as a ratio to GDP), the increase in interest rate by the Central Bank would force the Treasury to reduce government expenditures in order to achieve or increase a primary surplus. This would be required to restore the 'confidence' of the financial system in the ability of the government to pay its debt. The combination of a monetary contraction with a fiscal contraction would produce a huge fall in domestic demand at the same time that external demand is falling as a result of the external crisis. The combined result of domestic and external demand contraction would be a huge fall in GDP, which will be higher than the one observed in developed economies. This is so since for the latter, fiscal and monetary policies would be conducted in order to reduce the output loss caused by the financial crisis instead of attempting to avoid a capital flight.

This reasoning shows that a current account surplus and the accumulation of foreign reserves are important for developing countries because they allow them to conduct anti-cyclical policies in the face of a financial crisis in developed countries. Stabilization of output is important for a robust growth in the long term due to its effects over capitalist animal spirits. Developed countries, then, should never pursue a growth strategy based solely on the accumulation of 'foreign savings'. This book presents, therefore, an extensive and widespread analysis of the crisis as it impacted on both developed and developing countries. It will show that the impact of this crisis is far from being homogenous in both the developed and the developing world. The most intriguing aspect of this crisis is the fact that the crisis had less of an impact on those economies responsible for the generation of the 'global savings glut', and more on those economies that are more dependent on foreign capital inflows. In connection with this aspect, the book also addresses the question of why this crisis has been so limited in magnitude and of such relatively short duration. Finally, it is shown that financial liberalisation alone cannot provide a full explanation of the crisis. It is necessary to take a good look at the size of the global financial sector and also to its related redistributive impact. Thus, one of the main lessons that can be learned from this volume is a profound need to implement policies that can guarantee financial stability.