An Assessment of the Global Impact of the Financial Crisis

Edited by Philip Arestis,
Rogério Sobreira
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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

Source: IMF (2010).

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.