

***THE GLOBAL ECONOMIC CRISIS —  
MEETING THE CHALLENGE.  
GLOBAL ECONOMY***

by  
Danny Quah  
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## **1 INTRODUCTION**

The world economy shows yet little sign of recovery. Many analysts now silently agree that the economic downturn around us carries features larger than any single national policy-maker can comfortably deal with, try though each policy-maker might to stave off the downturn's worst impacts.

Many observers also believe that global macro imbalances, together with microeconomic irresponsible behaviour and bad judgement, have landed us in this mess.

However, the deep cause and critical fault-lines of those global imbalances remain in dispute. Without resolving those, no longer-term global solution is sustainable, and therefore any short-term solution will simply store up problems for an even larger crash in the near future.

## **2 GLOBAL IMBALANCES**

One conventional view of global imbalances is that that is often repeated by many influential observers and important policymakers around us. This view is as follows.

Over the last two decades China and other rapidly-growing economies in Asia undertook development and exchange-rate policies that encouraged exports and raised domestic savings. The integration of those economies into the world's trade and financial systems brought about, in mirror image, high trade deficits and steep borrowing in richer, developed economies like the US.

In this telling of the story, we can deduce that high savings from the East caused borrowing and current account deficits elsewhere—capital flowed uphill from the poorer countries of the world to richer ones—because world interest rates were low and falling throughout the 1990s and early 2000s. The world economy confronted a Global Savings Glut driven by Asian Thrift. Outside of Asia the world's current account deficits and high borrowing were simply passively responding to market signals.

And, in this interpretation low world interest rates did more than just induce high borrowing in the US. Low global rates of return induced a *race for yield*, where financial market participants were compelled to search ever more creatively for higher returns, overlooking how greater returns obtain only with greater risk. This creativity manifested in an explosion in the size of the financial sector, as banks lent to yet other banks, dealing in progressively exotic financial instruments the need for which was driven pretty much only by the internal dynamics of the sector itself. Unnoticed, this massive build-up replicated many times over the riskiness of the original outlays.

Built on a superstructure of debt, house prices in country after country soared to historically unprecedented multiples of disposable incomes. Financial sector profits exploded upwards, and the industrial structure of economies changed.

When in 2007 these multi-varied chains unwound off of the US subprime mortgage market, the effect has been a dramatic 180-degree over-shooting turnaround in the blind faith previously held store within these financial transactions. Whereas before, financial instruments that were only dimly understood nonetheless transacted in billion-dollar quantities, now parties and counterparties face each other with a general lack of trust and confidence, and many institutions find it difficult to roll over debt. Normal lines of business—almost surely the great majority of them worthwhile and rock-solid—are nonetheless unable to raise funds, and economies worldwide are seeing unprecedented falls in GDP as goods and services are simply not being produced and traded.

### 3 WHAT'S WRONG WITH THAT PICTURE?

There are many things attractive on a gut instinctual level and most likely even right with that global picture I just drew for you.

For one, the numerical facts are not in dispute. The US began from approximate trade balance in 1990. Over the next couple decades the US saw its current account explode into progressively larger deficit until by 2006 the US economy was consuming almost \$900bn more than it was producing. That trade deficit, 7% of US GDP, was alone as large as the total output of goods and services produced by the billion-people economy of India.

Despite this massive US borrowing on international capital markets—consuming beyond its immediate means—world interest rates and inflation rates were indeed low and falling through the 1990s and early 2000s.

And the US did see its trade deficits against China in particular and East Asia more generally exhibit an exactly identical time path as the overall US trade deficit—both in trend and in fluctuation. So the East did accumulate capital reserves in exactly the patterns that the US needed to borrow.

But some of the chains of reasoning in the story do not hold up to more careful scrutiny.

Put to one side why financial markets, faced with low returns, decided to turn creative in exactly the way that they did. Sure, easy credit facilitates greater borrowing. But in the history of the world most borrowers when faced with however high or low the interest rate might turn out to be, somehow, actually find a way to behave responsibly and not over-extend their financial dealings.

[In most US liberal arts colleges, the knowledge to build an atomic bomb is taught the average third-year university physics student. Almost all such students, however, don't go on and construct such a device—although when I was a US college student, one did do exactly that at my university. But those were simpler times then and we found the entire incident only amusing, not sinister.]

Reduced interest rates or lowered barriers to entry cannot induce irresponsible or ill-judged behaviour, any more than can heightened interest

rates or elevated barriers to entry. Greed is a constant and operates the same way regardless of the external environment. Instead of extreme financial engineering and sky-high financial leveraging, low world interest rates could instead easily have led to investment in US infrastructure that would have improved health care provision; upgraded the Internet; provided more funding for research and higher education; developed green, low-carbon or renewable fuel technologies—indeed to many of the planks in the current US fiscal stimulus plan.

I will leave for careful microeconomists the analysis of the “race for yield” part of the mechanism in the story. What I want to turn to now is Asian Thrift and its role in the global economic crisis.

#### 4 ASIAN THRIFT

When you plot US bilateral trade accounts against China, those figures mimic the US trade deficit overall. Does this mean that China’s economic policies drove global imbalance?

When you graph US bilateral trade accounts against the EU, they too mimic the US trade deficit overall. Indeed, when you plot US bilateral trade accounts against the oil-exporting countries ... again, they mimic the US trade deficit overall. When you add together EU and oil-exporter trade surpluses against the US, the result is a bilateral trade surplus series that matches almost exactly, dollar for dollar, China’s bilateral trade surplus against the US.

It turns out that as a fraction of its overall trade deficit, the US trade deficit against China has been pretty much constant for the last 20 years, as have been pretty much constant the ratios for the US trade deficit against the EU and against the oil exporters.

So, the simple fact is, for the last two decades, the US has been massively over-consuming not in any special way relative to China or East Asia. Instead, the US has been doing this against a lot of the world (well, outside of the UK anyway).

If the cause of global imbalance is Asian Thrift or under-priced Chinese renminbi, then there must also have been EU Thrift and Oil-Exporter Thrift, and under-priced European currency and under-priced oil. Perhaps that was indeed the case. But a more parsimonious explanation is simply that US profligacy drove the entire constellation of global imbalances, and the US's comparative advantage came to be to run large trade deficits.

## **5 GLOBAL POLICIES**

Disentangling this matters, because it informs how we evaluate the potential efficacy of alternative global policies.

Under the view that surplus savings drove global imbalances, the policy recommendation on many people's agenda is to get the current surplus countries to boost aggregate demand. If global imbalances were due to some surplus country—oh say China—manipulating its currency or however else under-pricing its exports, then re-asserting the correct prices will again restore trade balance. In both cases, the recommendation is doubly compelling as the move would also allow the current deficit countries to grow from increased international demand, without worsening their trade deficit position but instead restore global balance.

If, however, the root cause of global imbalances were the profligate habits of the current deficit countries, something more nuanced is called for. What that alternative policy recommendation is should also reflect some perhaps lesser-known facts about the current global distribution of economic activity.

It is relatively well known that world GDP now runs about US\$50 trillion a year. The US, on the one hand, and the UK and the Euro area, on the other, each accounts for about one-quarter of the world economy. In these two parts of the world, jointly over 50% of the world economy, financial institutions with trillions of dollars of assets and whose names were formerly gold-plated bastions of risk and enormous private return have vanished in the six months. The exact mechanisms for their subsequent downturns differ: in the US, the crisis in mortgages led crisis in the financial sector; in the UK, it was the other way round. But the end result nonetheless has been credit channels that are now clogged and infected, and significant economic downturn.

In counterpoint to this, consider the following.

Over the last quarter of a century—about the same time period as when the US economy nose-dived into massive trade deficit—economic growth in China brought 627 million people out of extreme (\$1/a day) poverty. This number is about double the entire population of the US, and exceeds poverty reduction in all the rest of the world combined.

The last two times the US economy went into recession was 1991 and 2001. In the first of those US output actually fell, the same way it will do this year. But in 1991 China contributed to world economic growth **three** times at market exchange rates what the decline in US GDP turned out to be; East and Southeast Asia contributed nearly **twenty** times. In 2001 China contributed to world economic growth nearly one and a half times the US's contribution, again at market exchange rates; East and Southeast Asia, nearly double.

So, longer term over this entire time period, even if China and East Asia were indeed the root cause of global imbalance—and I have already said I think not—they have arguably done more for improving the human condition than pretty much everyone else. And, in recent US recessions, East and Southeast Asia have more than respectably held up their end of world economic growth.

Of course, as is true every other time as well, this time, this current recession is different. Emerging economies now face sharply declining export demand, falling commodity prices, and rapidly shrinking FDI. In the category of bad news, Taiwan's exports in 2009 January are 40% lower than a year ago. In South Korea the decline in industrial output in 2008 December over the past year is the steepest on record. Russia's industrial output fell 20% in January from the previous month. Japan's industrial production fell by 21% in the three months to 2008 November, and its GDP fell last quarter by the steepest rate of decline since 1974.

Even China's exports fell 13% in the fourth quarter of 2008—but actually this means they are only 3% lower at the end of 2008 than a year before. This is hardly a catastrophic collapse. And, remember, even without a global economic and financial crisis, China's economy was already having a rough 2008, with paralyzing ice storms last February, the massive Sichuan earthquake in May, and then the tight grip of the Beijing Olympics in August.

And in the category of relatively positive news, the Shanghai stock market has continued to rise since China's 4-trillion renminbi fiscal stimulus announcement last November; it was up 13% by mid February from the start of the Chinese New Year. Total bank loans in China rose 19% at the end of 2008 from 12 months before, and continued their climb in January. New cellphone subscriptions in India reach a record of 11 million in January 2009, as rural customers—who don't typically own land or hold extensive financial portfolios, and so are unaffected by plunging stock markets and real estate prices—continue to see the benefits from digital mobile telecommunications. Malaysia's financial system has only 0.3% of its banking capital exposed to the US subprime mortgage market, and profits remain high.

Sure export demand is down everywhere but, with some notable exceptions, many of Asia's financial structures are now relatively stripped of short-term foreign-currency denominated commercial bank loans.

To be sure, there has never been any question that *some* export demand decline in the circle of economies surrounding China would be in the works, given the sharp reduction in US and EU demand. Globalization pretty much forbids decoupling.

However, globalization can live quite happily with clustering. So, three things useful to know about Japan, still the world's second largest economy: First, as a fraction of Japan's total trade, that that it undertakes with China has more than tripled in the last 15 years; second, Japan's trade with the US reached a peak of 35% in the mid-1980s; since then the ratio has fallen to 15%; and third, Japan's trade with China exceeded that with the US for the first time ever in 2006 and continues to expand. And, finally, three similar things to remember about South Korea, Asia's largest economy after Japan and China: First, as a fraction of Korea's total trade, that that Korea undertakes with China has quadrupled in the last 15 years; second, Korea's trade with the US topped out at over a third in the mid 1980s; since then it has fallen to only 10%; and third, Korea's trade with China exceeded that with the US by 2004, even earlier than did Japan's, and too continues to grow.

## 6 CONCLUSION

In this round-up of a global-economy view of the current economic crisis, I have not disagreed with the observation that much of the world's banking and financial systems are clogged and inoperative. I have, however, described what I think to be doubts on the root causes of global imbalances. And I have given what I consider to be the salient facts of the shifting distribution of global economic activity, and how they reassure on the relative health of the world economy.

What does this leave on policy prescription? Three emerge.

First, there is no disagreement that much of the world's banking and financial systems need to be rebooted. Financial intermediation needs to resume. But just as in rebooting a modern computer system, the virus—toxic debt in this case—needs to be isolated and excised, for otherwise the system when it does come up again will simply be re-infected. A “bad bank” that concentrates all toxic assets, leaving the rest of the financial system clean for normal operations, seems to me a good idea. Similarly, a “new bank” that begins uninfected, starting with a clean slate, can achieve the same purpose.

Second, rebalance the global economy by all means, but with an eye to fostering aggregate supply as much as aggregate demand. The current paradox of policy is that while it was the massive amount of over-extended debt that unwound sharply to generate the fear, uncertainty, and doubt currently incapacitating credit channels, many policy-proposals are asking for even more debt to finance demand stimulus. If surplus countries are being urged no longer to save, who will now buy US Treasury bills?

Third, if excess savings in one part of the world are a problem for the global economy, recognize that they are a nation's savings, not an individual's. Chinese consumers have savings rates not dramatically different from consumers elsewhere (of course except for the US consumer). Instead, it is the corporate sector and the government together that provide the bulk of high savings in China. If a nation saves more because it confronts high national risk and insecurity, the situation is not helped by stoking yet greater perception of fear from external protectionist and alarmist rhetoric.