Global Economic Crisis, Its Origin, Impact and Challenges

Dr. Alok Agrawal
University of Allahabad
Allahabad

Abstract
In 2008 the world economy faced an unprecedented global economic crisis. The global economy slipped into a deep recession, and it took more than a decade for the world economy to revive back. The current paper draws various roots of that global economic crisis and how a financial crisis became a global economic crisis

Introduction
The paper draws the impact of global economic crisis on foreign trade and suggests what are the steps that should be taken to meltdown the crisis.

Introduction
In this history of economic development the present global economy is facing its most serious financial crisis and economic slowdown; especially the year 2008 was marked as an unprecedented global economic crisis. The Global economy slipped into severe recession in 2008 inflicted by a massive financial crisis and acute loss of confidence. Here, the used term financial crisis and economic slowdown are the two different terms. The financial crisis is a situation in which the supply of money is outpaced by the demand for money. This means that liquidity quickly vanishes because accessible money is withdrawn from banks (called a run), forcing banks either to sell other expenses to make up for the shortfall or to collapse, while on the other hand economic slowdown is a situation of setback or slow growth in overall economic activity combined with rising unemployment.

A Birds-eye - View of Global Financial Crisis
The origin of the global financial crisis followed by economic crises can be drawn to the year 2007 when significant and influential financial institutions began to incur substantial damages as a result of their exposure to the market for sub-prime mortgages. Uncertainty in the market about the extent of these losses reduced the desire for risk on the part of lenders and critically constrained credit flows to businesses and consumers, as well as between banks. This situation worsened significantly with the failure of Lehman Brothers investment bank of U.S.A. in September 2008.
The fall in equity values and decline in housing markets, gave a significant shock to household wealth in developed countries. This reduced the consumers consumption and pushed them to precautionary savings. Firms cut back on investment spending in response to the heightened level of economic uncertainty.

OVERVIEW OF DEVELOPMENTS IN THE INTERNATIONAL TRADING ENVIRONMENT (2009)
The resulting fall in aggregate demand caused world trade and output to contract sharply in the last quarter of 2008 and the first quarter of 2009. Reduced availability and higher costs of trade finance exacerbated the decline of export demand for some developing countries. The economic slowdown rapidly became a global phenomenon yet India and China, who are Asian Tigers suffers bit little. This registered a sharp contraction at the beginning of 2009, in the world trade and output.

Roots of Global Economic Crisis
The identification of the causes of this depression would help in finding a long lasting solution or would at least help in moderating the immediate impact of the crisis. Till now there has been no unanimity on the factors responsible for the crisis. There have been two different, but not mutually exclusive viewpoints on what is behind the crisis,(What caused the global economic crisis,2009) which are discussed below.

I. Global Imbalance
According to one view, shared among others by Nobel prize winner and New York Times columnist Paul Krugman, the financial sector debacle has its origins in the "global imbalance" - the
phenomenon of large current account surpluses in China and a few other countries co-existing with large U.S. deficits. The global imbalance is reflected in large mismatches in the current account positions of some countries and its mirror image in the form of domestic savings-investment mismatches. Understanding such imbalance is not that difficult even for lay people. The U.S. has been running huge deficits. Countries such as China and Japan needed an outlet to deploy their surpluses. It was mutual convenience, as it were, for the savings of Asian countries to find a haven in the U.S., which needed the money because it saved very little.

An important manifestation of the global imbalance has been the flood of money into the U.S. that kept interest rates low, inflated prices of real estate, shares and other assets. When the bubble burst the financial sector crisis surfaced. So an ‘orderly’ unwinding of imbalance alone will help mitigate the crisis. If this viewpoint is accepted, macroeconomic policies of countries need fine tuning.

The U.S. government’s efforts to persuade China to revalue the Yuan, making its exports less competitive arises from the belief that global imbalance is a primary cause for the current crisis. The U.S. has not been successful so far and similar efforts to influence other countries will not bear fruit unless there is a high degree of understanding and co-operation among nations. A consensus is highly doubtful at the forthcoming summit.

2. Deficient financial regulation and the failure of market discipline

According to another viewpoint that is very different view has been presented by the IMF in a recent paper. Global imbalance is only an indirect cause. The main culprits were deficient financial regulation and the failure of market discipline resulting in a systematic flouting of rules and regulations by banks.

As the sub-prime crisis showed, practically all banks used their ingenuity to develop structures and products that were outside the normal regulatory confines of banking in order to satisfy their customers seeking high returns. In the process they created a large number of shadow banking institutions- investment banks, hedge funds and the like. These shadow institutions grew over time to be systemically important. Through securitisation and other means the banks convinced themselves that the risks were spread out.

The complex instruments presumed to minimise risks with the original issuer and guarantee a high return for those who bought them. In the end those who created them did not comprehend their risks. The collapse of the ho using market was followed by a great squeeze in the credit markets. The IMF’s prescriptions (in one of the background papers to the G-20 summit) are to step up regulation, to bring ‘shadow banking’ within the ambit of regulation. Obviously, both viewpoints have merit and at the forthcoming summit a judicious mix of the two- winding down global imbalance and enhanced regulation - will be agreed upon.

Global Financial Crisis Turn in to global Economic Crisis

The current situation is turbulent and challenging for the world economy. the unprecedented financial crisis, perhaps the worst since the era of the Great Depression, has shaken the foundations of even some of the strongest economies of the world. Many governments responded to the crisis with timely stimulus packages to prevent a total collapse. Through immediate objective has been achieved, the major industrial economies are still grappling with after effects of the recession. Unemployment rates continue to be unacceptably high. This has a cascading effect on their economies leading to loss of demand for goods and services. International trade and commerce is suffering in the aftermath. Besides this because of the critical role banks play in the current market system, when the large banks show signs of crisis, it is not just the wealthy that suffer, but potentially everyone. With a globalized system, a credit crunch can ripple through the entire (real) economy very quickly turning a global financial crisis into a global economic crisis. The global economy is teetering on the brink of recession. The downturn after four years of relatively fast growth is due to a number of factors: the global fallout from the financial crisis in the United States, the bursting of the housing bubbles in the US and in other large economies, soaring commodity prices, increasingly restrictive monetary policies in a number of countries, and stock market volatility. The crisis is not limited to the meltdown of financial markets, the real economy at the national and international levels, its institutions; its
productive structures are also in jeopardy. As stock values collapse, lifelong household savings are eroded, not to mention pension funds. The financial meltdown inevitably backlashes on consumer markets, the housing market, and more broadly on the process of investment in the production of goods and services. The global financial crisis, brewing for a while, really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.

On the one hand many people are concerned that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelihoods of almost everyone in an increasingly inter-connected world. The problem could have been avoided, if ideologues supporting the current economics models weren't so vocal, influential and inconsiderate of others' viewpoints and concerns. A collapse of the US sub-prime mortgage market and the reversal of the housing boom in other industrialized economies have had a ripple effect around the world. Furthermore, other weaknesses in the global financial system have surfaced. Some financial products and instruments have become so complex and twisted, that as things start to unravel, trust in the whole system started to fail.

Impact of Global Economic Crisis on Foreign trade

The future of world trade was devastated in the immediate aftermath of the twin crisis on Wall Street and on Main Street. There was much concern towards the prospects for a robust, open world economy because trade volume had collapsed faster than world income. It is so because the world trade had been growing faster than world income in the previous quarter of a century, due to internationalization of production. This trend was facilitated by the progressive dismantling of trade barriers. So, if we went into reverse, trade would fall faster than income. This meant that the measured value of trade to GNP would rise immensely because of the fact that trade is measured by sales, i.e. by gross value, whereas GNP is the measure of "value added". Thus, a "basic" unfinished car would be exported from France to Portugal to add a bumper and then exported in turn to Spain to put on leather seats and then to Germany for installment of electronic guidance systems. Each time, four times in this example, the basic car value would be counted as part of trade volumes whereas the GNP of the countries together would be going up only by the one-time value of the basic car in France and by the value of the additions made to it in the other three countries. The internationalisation of production creates also a genuine expansion of trade through sourcing of components worldwide. What may have been produced in a vertically integrated production facility is now increasingly in sourced from foreign suppliers; even though the GNP overall is affected marginally, trade expands far more. So, as the world economy revives, world trade will return to its trend of growing faster than world GNP.

Nonetheless, the actual damage to trade is still within bounds, though we must remember that a tsunami starts with a slow surge of the waves. But why has protectionism been contained? It is believe that the answer lies in the interdependence today in the world economy as production and world trade have become globalised. There are far too many firms today that depend on world markets. General Electric, Boeing, and Caterpillar are among the hundreds of US firms that have actively lobbied to contain US protectionism: they fear that retaliation by other nations will hurt them. But liberalising trade, i.e. moving forward, is a hard slog. Rarely have democratic nations successfully liberalised during recessions. But we now have an added problem: the virtuous statements on finally closing the Doha Round carry little salience when the biggest Rottweiler on the block, the US, is paralysed on trade.

Key Challenges

We noted that the current financial crisis is largely a result of excessive risk taking and faulty risk management practices in financial markets, inconsistent macroeconomic policies, which gave rise to domestic and external imbalances, as well as deficiencies in financial regulation and supervision in some advanced countries.

The key challenges is to resolve the financial crisis is a durable manner and to mitigate the impact of the crisis on global economic activity through comprehensive, coordinated and timely
measures as appropriate. Measures must be designed not only to restore growth and financial stability, but also to minimize the negative social impact particularly in emerging and low income countries.

Although the worst was avoided, much pain remains. The crisis culminated in a collapse of asset prices at the end of 2008. Middle-class and wealthy households around the world felt poorer and therefore cut their spending sharply. Sky-high oil and food prices added to the pain, and thus to the downturn. Enterprises could not sell their output, leading to production cuts and layoffs. Rising unemployment compounded the loss of household wealth, throwing families into deep economic peril and leading to further cutbacks in consumer spending.

The big problem now is that unemployment countries to rise in the US, Europe, and other continents because growth is too slow to create enough new jobs. Dislocations are still being felt around the world. A huge debate has ensured a round the so-called "stimulus spending" in the US, Europe, and China. Stimulus spending aims to use higher government outlays or tax incentives to offset the decline in household consumption and business investment. In the US, for example, roughly one-third of the $800-billion two-year stimulus package comprises tax cuts (to stimulate consumer spending); one third is public outlays on roads, schools, power, and other infrastructure; and one third takes the forms of federal transfers to state and local governments for health care, unemployment insurance, school salaries, and the like.

Stimulus packages are controversial, because they increase budget deficits, and thus imply the need to cut spending or raise taxes sometime in the near future. The question is whether they successfully boost output and jobs in the short term, and, if so, whether they do enough to compensate for the inevitable budget problems down the road. The true effectiveness of these packages is not clear. Suppose that the government gives a tax cut in order to increase consumers’ take-home pay. If consumers expect that their taxes will rise in the future, they may decide to save the tax cut rather than boost consumption. In that case, the stimulus will have little positive effect on household spending, but will worsen the budget deficit.

**Collective Steps to be Taken to Meltdown Crisis**

1. All countries must expose the risks associated with excessive leverage and improve their regulatory and supervisory regimes in order to deliver improved risk assessment and management by financial institutions, to enhance transparency and accountability in financial markets, as well as to strengthen international cooperation to identify and respond pre-emptively to national and international systemic risks.

2. There is a most urgent need to improve the supervision and governance of financial institutions, at both national and international levels. In this regard, we should consider ways of enhancing the identification of systemically important institutions and ensure proper oversight of these institutions, including credit rating agencies.

3. The financial institutions should have common accounting standards and clear internal incentives to promote stability and that action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking. Regulators and supervisors should enhance their vigilance and cooperation with respect to crossborder flows.

4. The next important concern over the impact of the spreading international financial crisis on the real economy through trade, credit and currency transmission channels. We considered in particular the severe challenges it poses to short-term growth. Advanced economies, where the crisis came into being, are slowing markedly and some are already close to or in recession. We are also seeing evidence of slower growth in emerging markets, and while overall these countries should continue to play an important role in supporting world growth, emerging economies are facing external financing pressures. We recognized that a pronounced lack of confidence has led to severe credit constraints, which affects consumption, investment and employment.

5. There is a need to support the efforts of the emerging economies and, especially, to help them find additional resources for their development. Thus all countries should resist protectionist pressures, whether in respect of trade or investment to shield the economy.
6. One of the most deleterious aspects of the current crisis is the freeze in the private credit and equity markets and the tendency of capital to flow back to where the current crisis originated. We should explore ways to restore emerging and developing countries access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.

7. It is noted that fiscal policies have served as an important instrument to address the current financial crisis, including through government support to the financial sector and have performed an important stabilization role and in mitigating further negative effects on markets and on economic activity. Some countries are also considering additional fiscal measures to stimulate the economy and we agreed that countries must use all their policy flexibility consistent with their circumstances, to support sustainable growth, while we recognize the importance of fiscal sustainability for macroeconomic stability and growth. It is essential that the recent gains in reduction of poverty and social inequality are not set back by the financial crisis and global economic slowdown. Less developed countries would probably need more flexible frameworks. Furthermore, in cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

8. It was observed that many low income countries are particularly vulnerable to commodity price volatility and changes in investor sentiment due to the financial crisis. Thus it is important to maintain the official flows, including aid flows, to these countries and all multilateral development banks to work to sustain the momentum of infrastructure investment for development in low income countries.

9. The adoption of sound monetary policies has relevance too, to mitigate the crisis impact. The recent slowdown in world growth and consequent reduction of commodity prices have decreased inflationary pressure especially in advanced economies and permitted central banks to decide on monetary easing. In those economies facing currency depreciation and still suffering from second round effects, inflationary pressures may be more persistent. In this context, monetary authorities will need to continue to carefully monitor economic developments, including the consequences of financial deleveraging, in order to take appropriate action if needed.

10. The Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.

11. At this juncture, the IMF, the World Bank Group and other international financial institutions have an important role to play, consistent with their mandates, in helping to stabilize and strengthen the international financial system, advancing international cooperation for development and assisting countries affected by the crisis. To meet this task, we should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral developments banks and stand ready to increase them where necessary. In this context, we welcome the use of the IMF’s emergency procedures to provide substantial assistance quickly to countries in need, and also the creation of a new short-term liquidity facility, which allows quick disbursements without traditional conditionality for countries with strong economic policy track records. Thus the IMF should continue to review and adapt its lending instruments to adequately meets its member need sand revise its lending role in the light of ongoing financial crisis.

12. It is important that the IMF must enhance its early warning capabilities with due regard to systemically important economies, in order to anticipate stresses and identify at an early stage vulnerabilities, systemic weaknesses and spill over risks across financial markets that can endanger both the international financial system and the global economy. We also underline the importance of strengthening the IMF surveillance and policy advice leading to appropriate and timely macroeconomic policy responses from all countries.

Outcome of the Global Financial Crisis
In some way, the global financial crisis and its fallout are forcing economic agents to acquire new knowledge in regard to what might happen in the future. For both governments and central bankers, the past has ceased to be an accurate guide for determining future policy. In some ways, the global financial crisis and its fallout are forcing economic agents to acquire new knowledge in regard to what might happen in the future. For both governments and central bankers, the past has ceased to be an accurate guide for determining future policy.

Commenting on the way the global stock markets were shooting up in recent time, the head of a Mumbai broking company said "there was absence of knowledge in the short run". What he had meant was that it was difficult to explain rationally why the stock markets were furiously running up even as company balance sheets were still bleeding. Quite possibly, the world economy may well be faced with a situation where there is an absence of knowledge in the longer term as well. This is very clear from the way governments and central bankers have so far responded to the global economic crises.

In some ways, policy makers and central banks have done the only thing they could think of - inject massive fiscal and monetary stimuli. But this is old knowledge. For there is a consensus that the fiscal and monetary stimuli of $3 to $4 trillion across the world may be just about preventing the global recession from deepening further. There is immense comfort in the knowledge that we are not falling any further! The US banking system appears to have seen its worst and the economy too has shown tentative signs of bottoming out. But is this recovery durable? No one wants to answer this question yet. To answer this question you need new knowledge Old will not do.

Policies in the US and other rich countries should stimulate those investments through special incentives. These include a cap-and-trade system for greenhouse gas emissions, subsidies for research and development on sustainable technologies, feed-in tariffs and regulatory incentives for renewable energy, consumer subsidies and other inducements for the uptake of new "green" technologies, and implementation of "green" infrastructure programmes, such as mass transit.

The rich world should also provide the poorest countries with grants and low-interest loans to buy sustainable energy technologies, such as solar and geothermal power. Doing so would add to the global recovery, improve long-term environmental sustainability, and accelerate economic development. The crisis can yet be an opportunity to turn from a path of financial bubbles and excessive consumption to a path of sustainable development. In fact, seizing this opportunity is the only recipe for genuine growth that we have left.

RBI governor D Subbarao recently said that no much has been done by nations to debate the fundamental imbalance in the global economic system which could in fact have been the primary cause of the Wall Street financial crises. This imbalance essentially made the United states merrily borrow from the rest of the world to consume. Of course, in the past year or so some of this imbalance in partly correcting with the US current account deficit dropping and its savings rate going up. But is this enough?

The US needs to recover its real growth impulse by becoming a prime exporter of high technology goods- it is no more competitive in the manufacturing sector- if it wants to reduce its borrowing from the rest of the world. If the US fails to do this, it will again be tempted to use finance capital as a steroid to create an illusion of growth. Wall Street helps in doing this. You don't sustain long-term growth with pure finance capital play. Finance capital works only when complemented by dynamic elements of the real economy. This was the big lesson of last year's crises. Another crisis will surely occur if this lesson is not internalised.
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