



# The Global Financial Turmoil, Asian Challenges, Reform Priorities

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United Nations, New York

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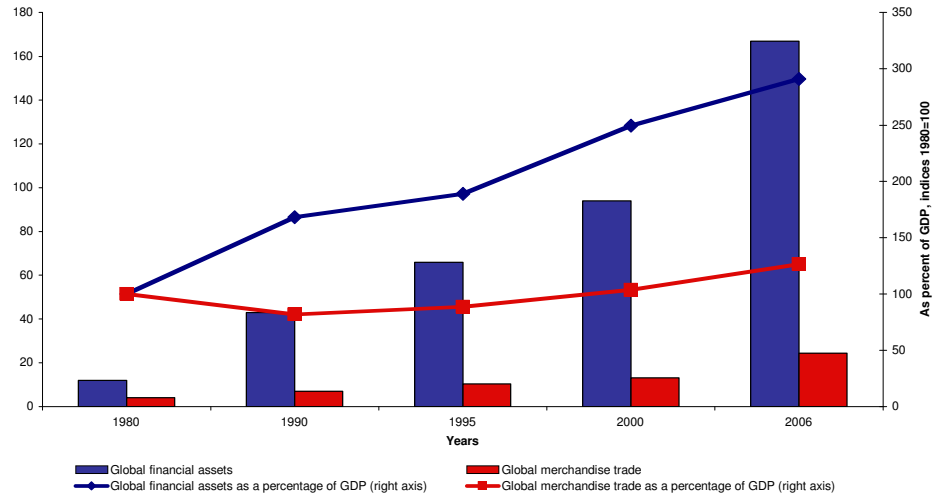
## A Crisis Foretold

- Contrary to media, *crisis was expected*
- *Global imbalances*: unsustainable
- *Systemic crisis*: what system?
- International financial *architecture*?
- *Ideology*: deregulation and self-regulation
- *Capital account liberalization* myths
- *Globalization* myth: trade vs finance
- *Decoupling* myth
- Imposed limits on *policy responses*
- Failure of *international cooperation*

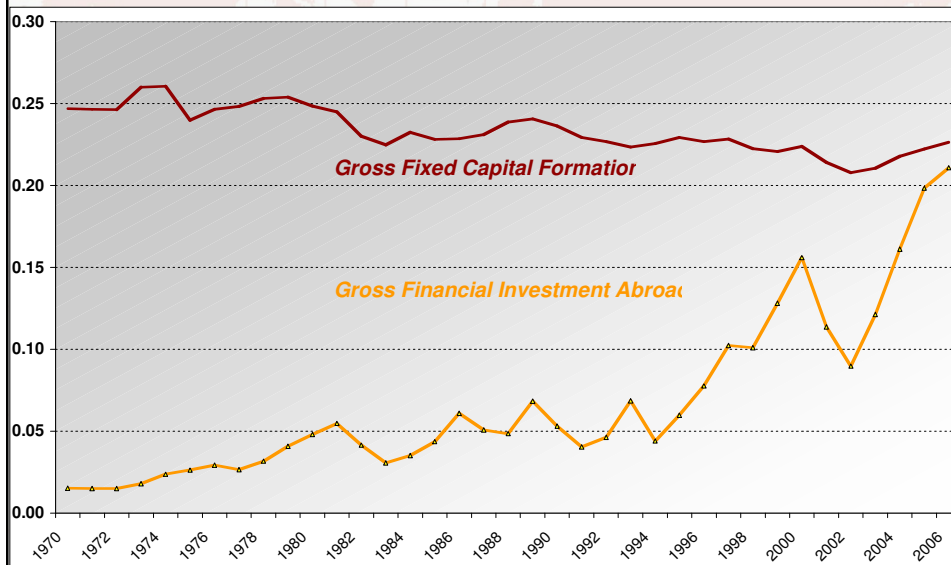
# Globalization driven by finance



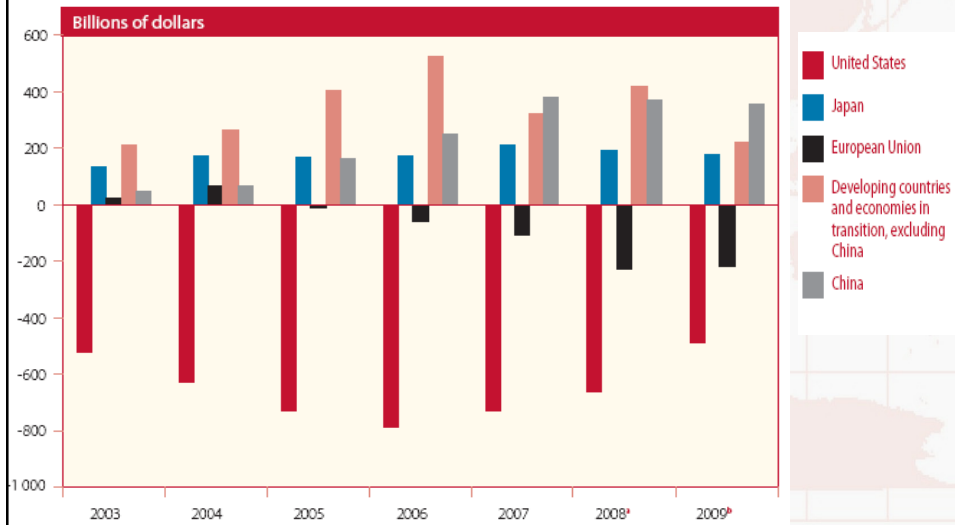
Figure 1  
Finance driven globalization



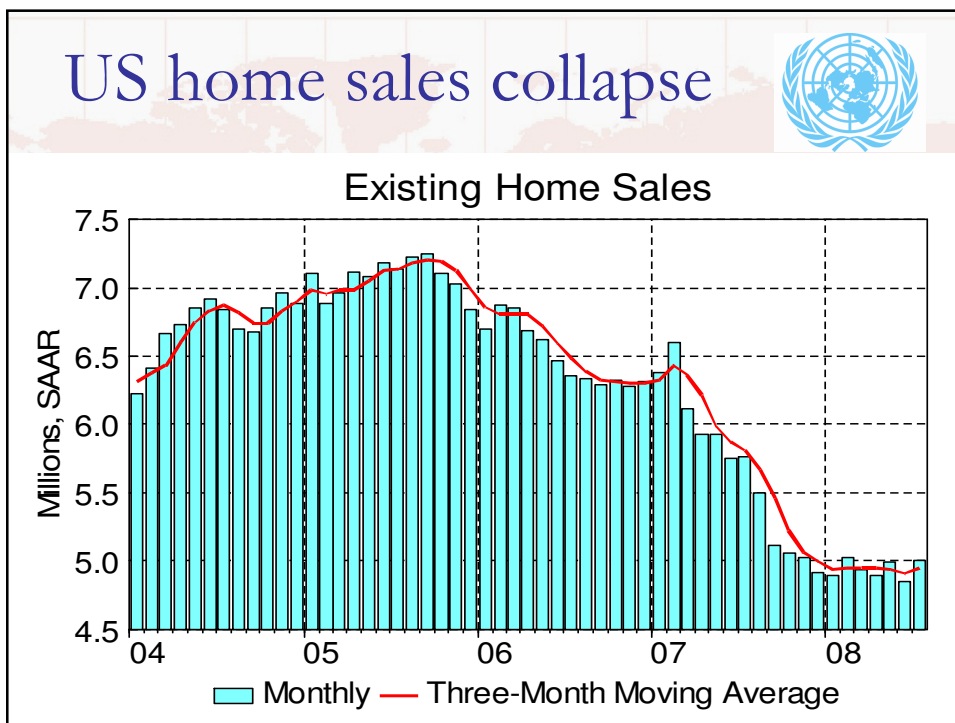
# Finance flows not investment



# Global imbalances



# US home sales collapse



## US financial crisis



Sub-prime crisis → credit crunch  
→ asset price deflation → recession

### *Earlier asset price bubbles due to:*

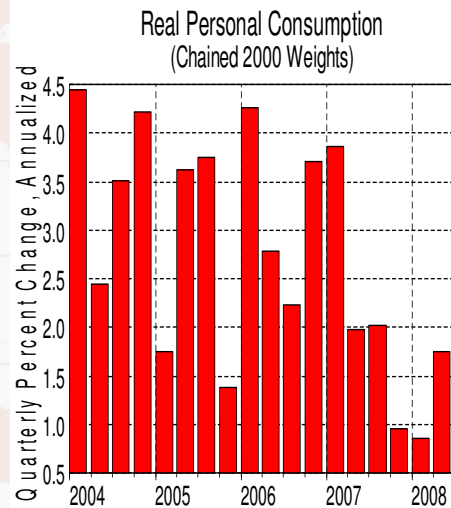
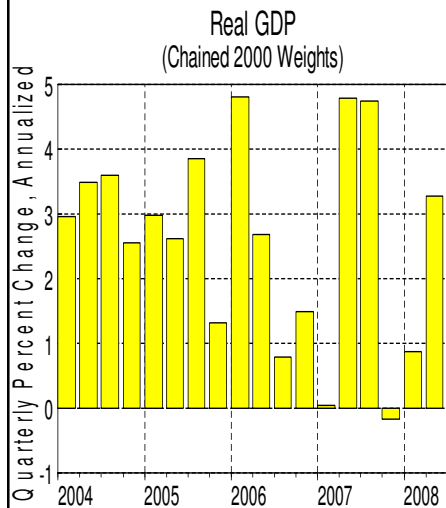
- 1990s' financial deregulation,  
e.g. 1999 repeal of Glass-Steagall Act
- aggressive monetary easing sustained  
following 2001 downturn: *pro-cyclical*
- greatly increased US household debt-  
income ratios financed by Asian savings

## US real side consequences



- US *GDP growth* seemed surprisingly  
resilient; but ***recession since late 2007***  
08H1 US real GDP growth driven by  
cheaper exports and government spending  
down in 08H2, unemployment up, strong \$!
- US *employment* contracting
- US *household consumption* receding

## US GDP, consumption down

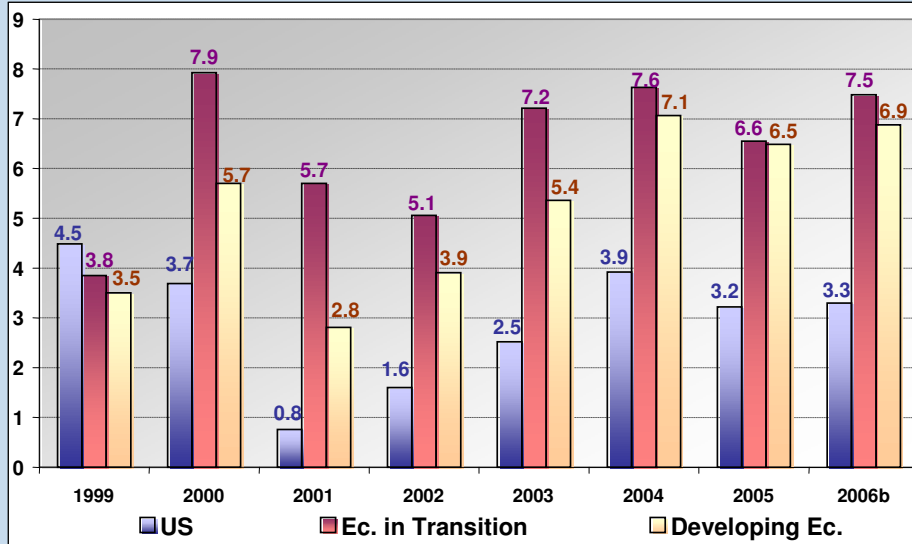


## Implications for global economy

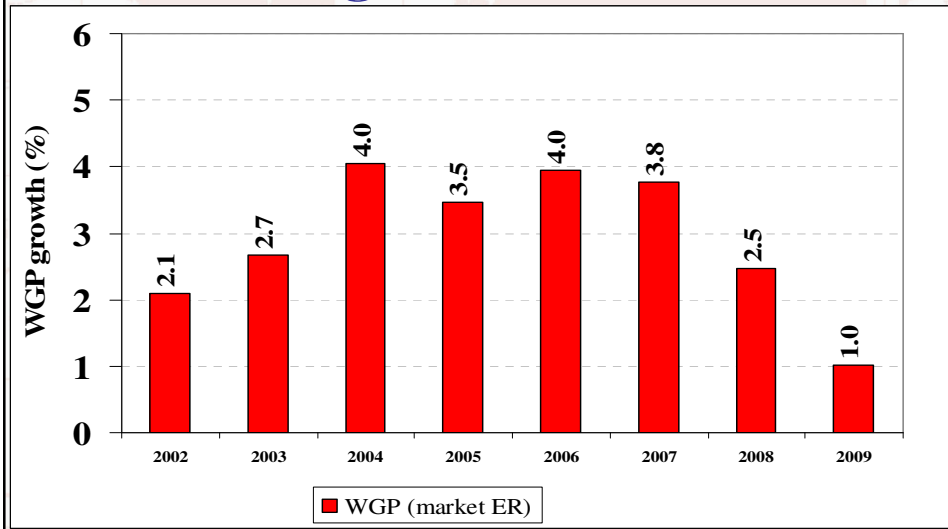


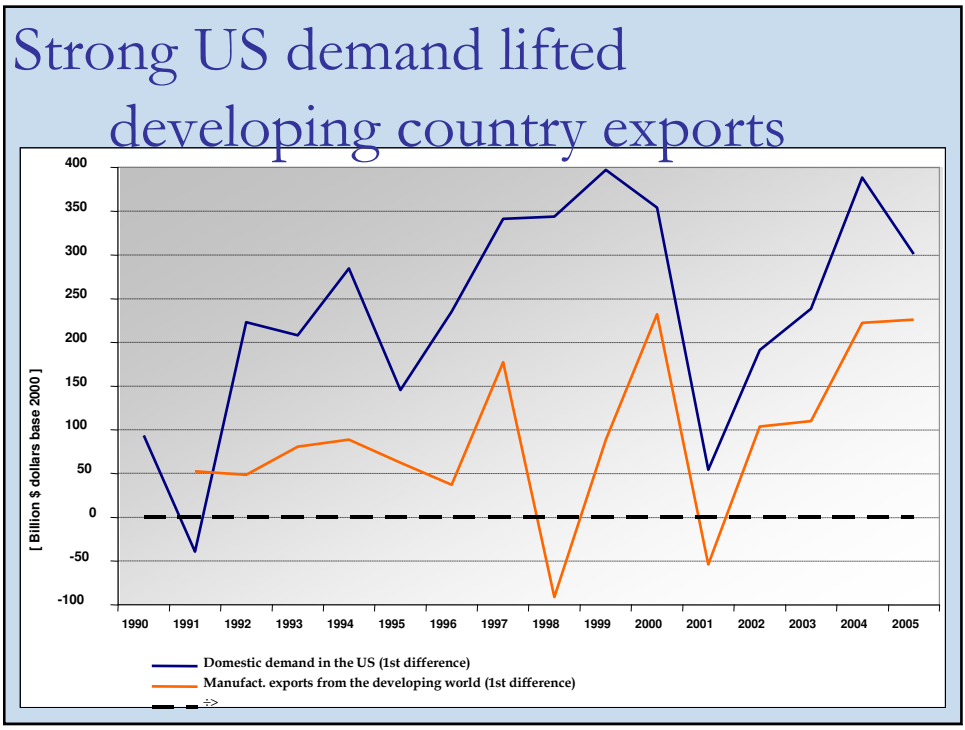
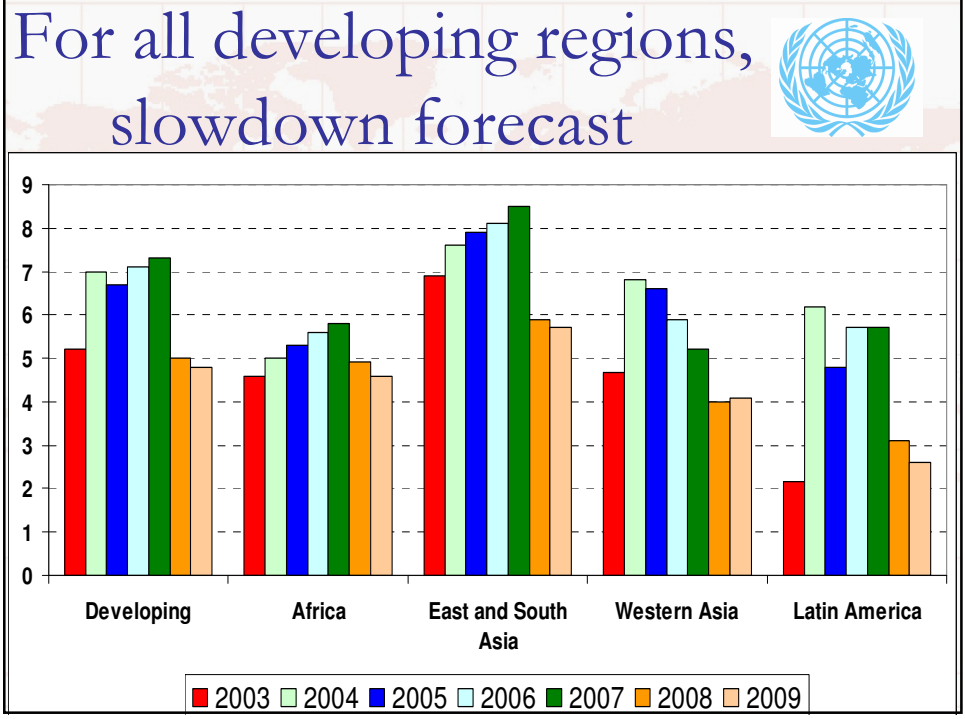
- ***Global economy at brink of recession?***
- Slowing GDP growth in OECD countries and, increasingly, the developing world.
- Export-led growth in developing countries slowing. EU cannot/will not take on external deficits as US did.
- Limits to domestic demand growth without fiscal stimuli, redistribution.

## Synchronous growth: The US, transition & developing countries

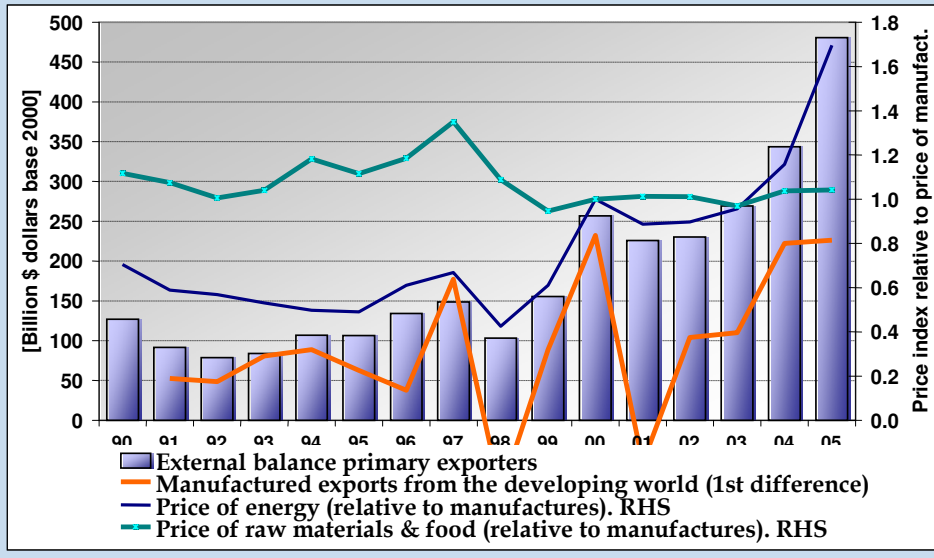


## World economy nearing recession





## Manufacturing demand supported high primary commodity export prices

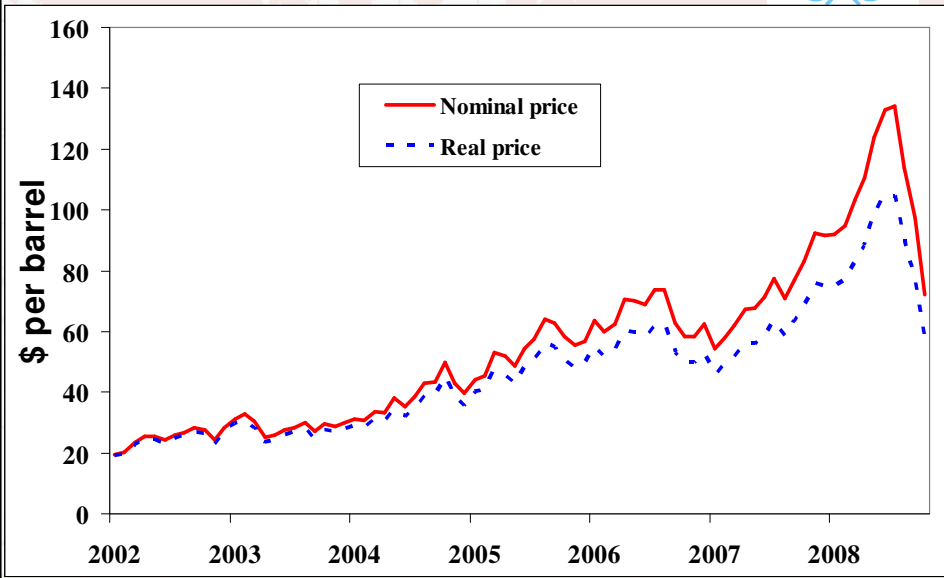


## High commodity prices over

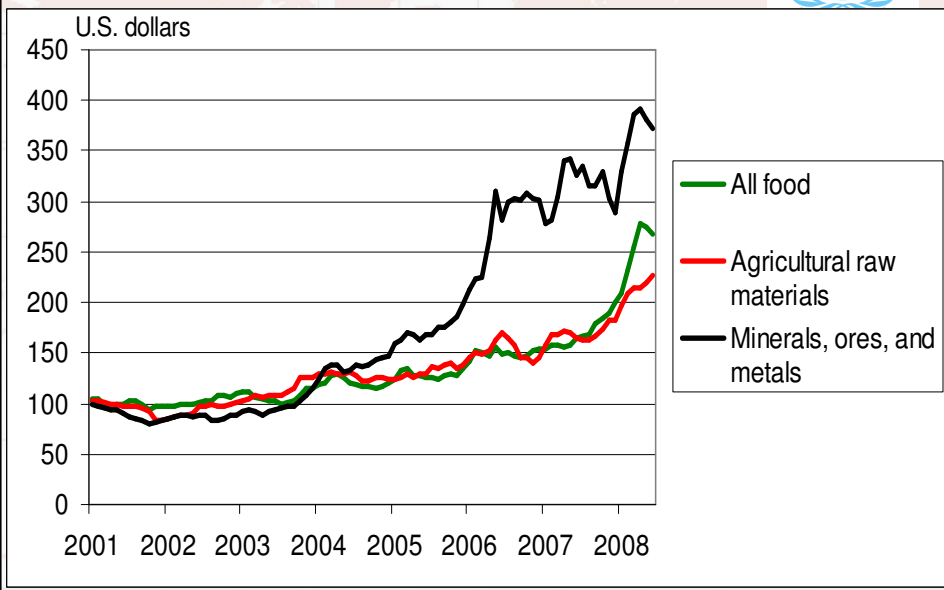


- Last 5 years rare opportunity for many developing countries to generate substantial financial resources from primary commodity exports for productive investments – *largely over*
- Recent price spikes for energy and food likely due to speculation following flight from ‘Wall Street’ (finance) to ‘Chicago’ (commodity futures)

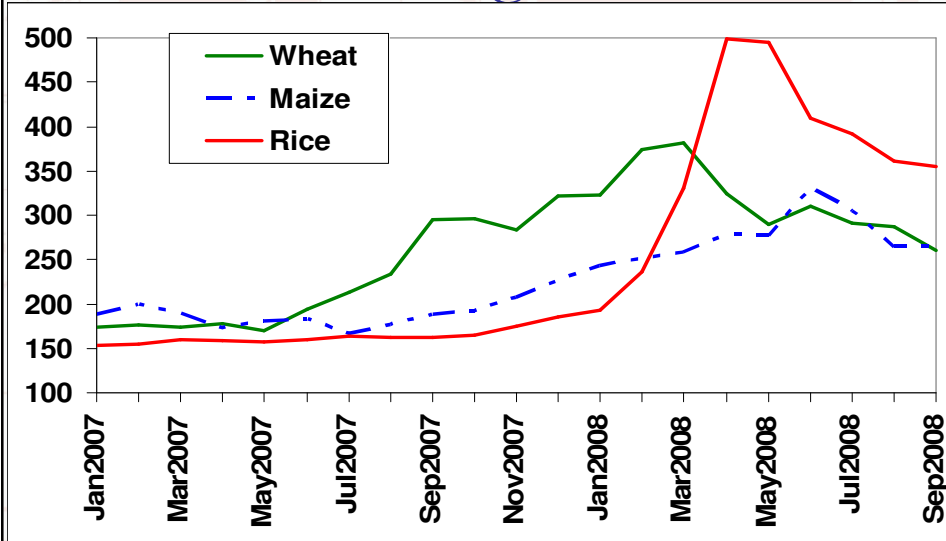
# Oil prices roller-coaster?



# Non-oil commodity prices



## World food prices also declining



## Why high food prices?



- Long term neglect since 1980s in public investments, WB funding, R+D
- Productivity increases (GR) limited, also over by 1980s
- Land use, environment, climate changes
- Demand > population growth, e.g. meat
- Abandonment of food security policies
- 'Asymmetric' trade liberalization
- Greater power of agro-businesses

## Food security neglect



US Agriculture Secretary John Block in 1986: “anachronism from bygone era”

X oriented agriculture, import food staples

Subsidies in the North

Asymmetric trade liberalization

Most developing countries

- often previously self-sufficient –
- now net importers of food

## Short term factors



- Western bio-fuel policies
- Speculation (esp. from mid-2007)
  - *Elimination of speculation position limits*
  - *Commodity index funds*
- Oil price effects
  - *Transport costs*
  - *Chemical input costs*

## High food prices over?



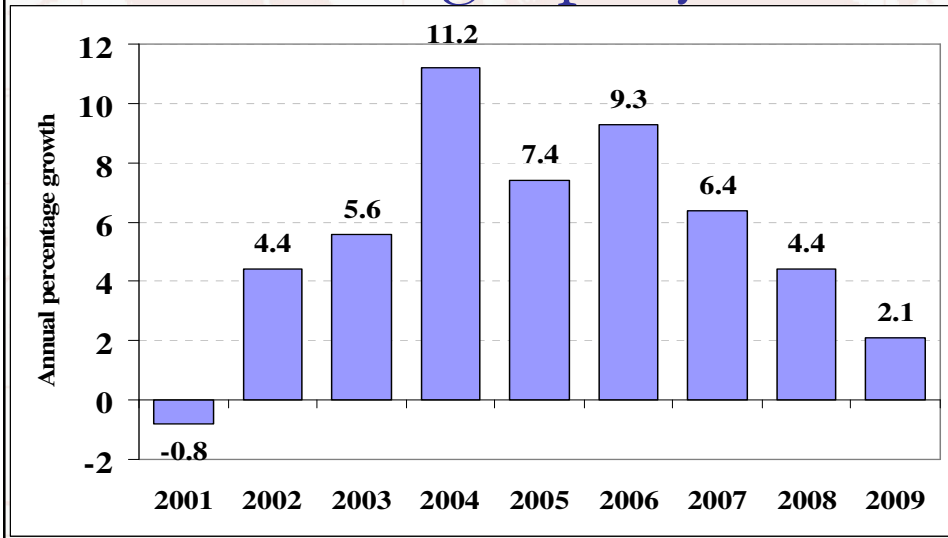
- Recent food price spikes until February
- Food prices still high, but declining
- But few longer term investments so far, likely to be forgotten until next crisis

## Food policy reform priorities



- Food security vs agric. trade liberalization
- Long-term investments for productivity
- Review bio-fuel policies and impacts
- Reconsider and limit role of speculation
- Review and update UN system  
Comprehensive Framework for Action

## World trade growth decelerating rapidly



## Limitations of growth in Asian developing countries



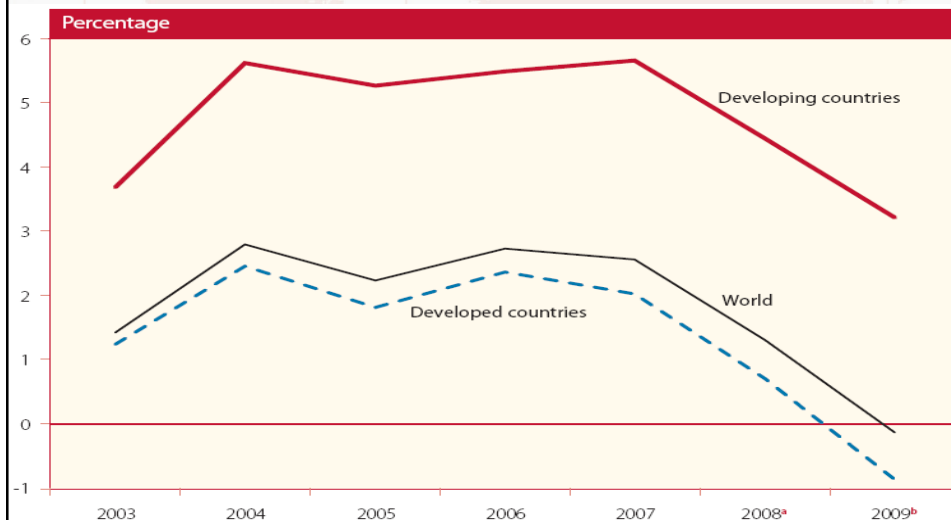
- Growth often not very inclusive
- Growth characterized by weak employment expansion  
-- “Jobless growth”
- Even during expansion, inequality usually increased

## 'Decoupling' Illusion: Developing countries will be hard hit

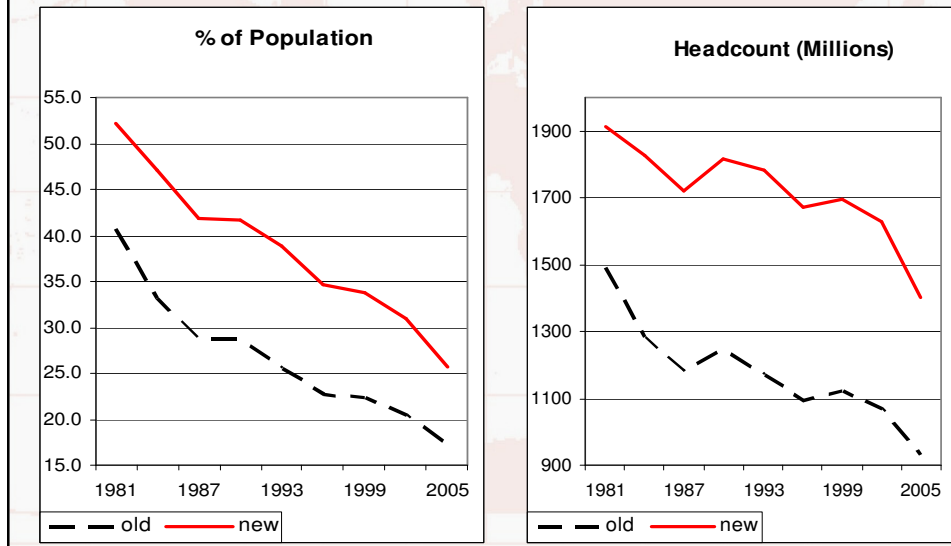


- Financial markets → **mid-Y countries**
- Slowing trade growth →  
**all developing countries**
- Terms of trade → **primary exporters**
- **Lower energy, food prices** → **net food and oil-importers**
- **BoP constraints** likely
- **Reserves** may run down quickly

## World income per capita will decline in 2009



## New and old poverty estimates for developing countries, 1981-2005



## Implications for international community



- Despite growing interdependence, international cooperation has weakened
- Bretton Woods institutions, OECD, G7 and G20 failing to provide leadership
- Declining aid since 2005 likely to worsen with slowdown
- Need to rethink financial, macroeconomic policy priorities, policy space

## Impact channels of global economic slowdown



- US financial crisis → credit crunch → recession
- severe protracted global economic slowdown
- depress commodity prices + foreign invts again
- \* US\$ likely to depreciate again
  - due to huge US trade + budget deficits
- \* Most reserves of developing countries held in US\$
  - massive losses
  - Massive trade surpluses used to buy US Treasury bills needed to finance US fiscal deficit, maybe future bailouts

## Emerging markets tumble



- \* Plunged by about 50% on average, some > 60%
  - much more than average 30% in rich countries
- \* Not only rich, but many middle income households (HHs) own equities
  - direct impacts on HH income, wealth
- \* As stock markets plummet,
  - solvency of banks + firms depend on capital
- \* When capital values plunge,
  - even ordinarily solvent firms look overleveraged

## Credit crunch slows economy



- \* Many banks have stopped lending.
  - firms cut investment spending,  
use earnings to cover operational costs
  - may lead to lay offs
- \* Drop in stock market prices part of downward spiral
  - world economy to slow down,
  - more unemployment + worsening work conditions
  - affect govt revenue → limit govt spending
- \* Much will depend on how governments respond with counter-cyclical + social protection policies

## Why international finance pulling out?



- \* Global financial crisis → intl investors more risk averse, reducing exposure to emerging mkts (pension funds, mutual funds, hedge funds)
- \* Some forced to withdraw by "margin calls" at home:
  - losses in rich country markets force them from emerging markets
  - Global financial crisis seriously weaken growth worldwide
- reducing earnings in emerging markets
- reducing investor interest in emerging mkt stock

## FDI in developing countries



- \* FDI inflows more stable than  
S-T equity invts + other portfolio flows
  - \* Global financial crisis will also affect FDI  
inflows negatively
  - \* With funding for developed cties tightening,  
fin. crisis + global recession will reduce invts
  - \* *WIR* expects 10% FDI drop (07-08) to emerging  
markets
- With slowdown, FDI will slow further in 2009

## Reduced export opportunities



- 50% of US imports from developing countries
- Shrinking demand in rich cties significant impacts
- Slowdown in export growth of devg cties, esp. Asia  
→ significant slowdown in ind. production
- In LA + Africa, X growth driven by primary  
commodities
- Most Xs weak linkages with domestic economy  
very vulnerable to external shocks
- Commodity prices began declining from mid-08  
oil price dropped 70% in last 4 months

## Implications for Asian emerging markets



- “Decoupling” unlikely
- Poverty more difficult to lower with slower growth
- Slow progress on other MDGs without major social policy, investments
- Need to embed investment, employment and economic security policies in broader national development strategies

## Severe impacts on Asian developing countries



- \* Developing countries will **bear brunt** of global fin. crisis originating in US + other devd countries
- \* Fin. positions of many devg ctries **much stronger** than during fin. crises in Asia + LA, due to strong foreign reserves, better fiscal balances
- \* Emerging markets **not "decoupled"** from US economy
- \* Crisis impacts **felt by all**, albeit differently

## Financial liberalization responsible



- \* Financial deregulation clearly went too far
- \* Earlier pressures for fin. liberalization will abate, though not clear for how long
- \* Calls for more regulation + govt intervention typical responses during crises,
- \* Once crisis subsides, pressure to reform will be lost
- \* Quick fixes during crisis typically not adequate to prevent future crises

## Policy priorities



- *Limit spread of financial crisis*
  - Across borders (contagion)
  - To real economy (ensuring liquidity)
- *Reflate economy*
  - Fiscal measures (fiscal space needed)
  - Monetary measures (monetary space)
- *Appropriate regulatory reform*
  - National
  - International

## Need to stimulate domestic demand



- To offset weakening foreign demand
- Lower X earnings because of weakening commodity prices + global recession
- Poorer countries' fiscal space more limited  
→ need more foreign aid to cope
- Build, improve needed infrastructure
- Complement investment + technology policies to diversify economies for devt

## Western government responses vs IMF in 1997-98 Asian crisis



West, especially US, pursuing policies IMF criticized during Asian crisis, e.g. lower interest rates, bail-outs, restrictions on short-selling, fiscal stimuli

Role of central banks today: only curbing inflation?

US Fed broader mandate -- obliged to sustain growth + employment than most central banks which focus almost exclusively on containing inflation

## Financial regulation



- Prudential risk management
- Finance growth (output, employment)
- Counter-cyclical: limit pro-cyclicality
- Support investment + technology policies crucial for development
- Inclusive finance

## Developing countries' reform priorities



1. **financial regulation** should be strengthened appropriate to new conditions + challenges  
Regulations should be *counter-*, not pro-cyclical
2. appropriate **capital account management techniques** to stem undesirable + excessive capital inflows, to avoid sudden, disruptive large outflows
3. affordable financing for **productive longterm investments**, e.g. development banks, commercial banks, deeper financial markets, especially bond markets

# Thank you



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