Global economic crisis

How to recover?

Are we out of the global economic crisis and crisis of capitalism? **Stephen Gelb** thinks not as one necessary factor, global economic leadership, is missing and China is unlikely to take on this role. And what of South Africa in this critical time, what needs to be done to encourage exports and promote growth and job creation?

To understand why the world economy, and South Africa as part of it, has not yet recovered from the global financial crash of 2008/9, we need to understand fully the underlying causes of the slump.

Financial deregulation in most OECD (Organisation for Economic Cooperation & Development with a 30-country membership) economies was of course a major issue, especially the scrapping of regulations barring financial institutions from operating across many different markets. Investment banks, for example, could move into traditional banking activities and insurance companies and banks into housing loans or derivatives trading. This and other issues have been well-recognised problems and the focus of policy-makers' attention.

There were two other crucial, but less acknowledged, factors behind the crash or at least behind the boom which preceded the crash.

First, the rising prices of assets, like shares and houses, produced strong 'wealth effects' amongst middle-class households in many economies. Wealth effects are peoples' *perception* that they are richer because market prices of their assets are higher, especially houses and retirement investments. Feeling richer, they consume more and save less, if necessary even borrowing cash for consumption against their higher-valued assets.

The consumption boom in many countries was in turn supported by low inflation and low interest rates, and also by low-cost manufactured goods and services exported from China, India and the rest of Asia.

Second, China and other Asian countries promoted export-led growth which was made possible by very low household consumption in these countries and correspondingly high savings. The strategy was intended to create large holdings of foreign exchange reserves which could ensure these countries against a repeat of the Asian crisis of the late 1990s, and particularly against dependence on the IMF (International Monetary Fund) and the West for bailouts.

These two factors created an *interdependency* between developing Asia and the OECD, and most directly between China and the United States. The US needed capital to pay for imports and for consumption and housing loans. China provided the capital, because large flows of Chinese savings had to be invested outside China.

With dollar assets offering secure and attractive returns, these Chinese savings became capital inflows to the US and financed its large trade deficit. Effectively high Chinese savings were substituting for low US savings, and enabling US consumers to keep spending, while at the same time driving the asset price bubble.

China now has the world's largest holdings of foreign exchange reserves at over $2-trillion, of which about 70% are estimated to be in US dollar assets. And about a quarter of *foreign* holdings of US government securities (an investment instrument issued by a government which shows evidence of debt or shares) are held by China, a larger share than any other country.

Once the economic slump began, the US-China interdependency became a trap. Neither China nor the US could afford for China to withdraw suddenly from dollar assets. If China did so, the US would have difficulty financing its imports and it would have to raise interest rates and cut domestic spending, leading to an even more serious contraction of the economy. At the same time, the dollar would crash, destroying a large chunk of the value of China's foreign assets.

Jim Trippon

Shenzhen harbour – China has the world's largest holdings of foreign exchange at over $ 2-trillion and a quarter of foreign holdings of US securities.

CRISIS OF CAPITALISM

In other words, the structure which supported growth has now become an obstacle. The financial crash and the recession represent a crisis of capitalism in its present form.

The growth model of the past 30 years, the 'free-market model' for supporters and 'neo-liberalism' to its critics, has reached its 'sell-by' date. Capitalism does not face 'imminent collapse' but has reached yet another 'turning point' where a new growth model is needed.

In other words, while financial and banking reform are necessary, tinkering with regulation or fiscal stimulus will not *alone* restore stable long-term growth. It is not possible that 'normal service' will quickly and easily resume and the world economy return to the boom conditions before 2008.

Today's crisis, a sudden financial implosion followed by the collapse of demand for goods and services, is different from the last one, which was triggered by the oil price hikes of 1973 and 1979 and featured a slow decline of long-run growth. Current events parallel more closely the stock market crash in 1929 which led to the 1930s Depression.

It is useful to examine the 1930s to fully comprehend the challenge today.

In his masterful *The World in Depression 1929-1939*, written during the 1970s crisis, Charles Kindleberger argues that the length, depth and breadth of the Depression was primarily the result of the lack of global economic leadership. Leadership was needed not simply to marshal collective action amongst governments, but to carry a *disproportionate* share of the cost of stabilizing the *global* economy, by providing resources to others.

In other words, the lead country, and there can only be one leader, must be willing and able to put global recovery ahead of its own 'national' interest in restoring its domestic growth. It must be able to absorb imports and provide capital to support production and employment in *other* countries.

In the 1930s, policy-makers knew what was needed technically, but as ever, politics intervened. The United Kingdom was willing to resume its role as global leader, but was according to Kindelberger 'too feeble', while the US had the resources but not the will.

In mid-1933, a World Economic Conference was held in London, attended by leaders of the 'G20' of the time (including Jan Smuts and the Soviet foreign minister). US President Franklin Roosevelt did not attend (he went on a sailing holiday instead!) but two weeks into the conference, he sent a telegram announcing that he would neither strengthen the dollar against other currencies nor export gold to finance production elsewhere. This signaled his choice of focusing on domestic rather than global concerns, and effectively ended any chance of international stabilisation.

It took 11 years and a major war before global stabilisation rules were agreed at Bretton Woods, with the US then accepting the broader global financial responsibilities equal to its power.

Just as in the 1930s, establishing a new growth model today will require internationally coordinated action and a global leader. The US is now like the UK was then – willing to lead, but not able. The US cannot afford to be the world's growth engine and import everybody else's goods. It is already importing too much while not exporting enough and it is dependent on loans from others.

The world needs countries with trade *surpluses* meaning larger exports than imports, in order to shift to domestic-led growth, by raising imports and cutting exports. The US and the other indebted countries do the reverse with more exports and lower consumption and lower imports.

If one country shifted to raising imports and cutting exports this would support recovery both in the

IMF

The United States had the largest delegation and bought economists and politicians to the Bretton Woods Conference in 1944.

US and a resumption of stable growth elsewhere, including Africa.

There is only one serious candidate as the 'leader-in-waiting', the role played by the US in the 1930s, and that is China with a massive trade surplus and the largest pool of foreign reserves in the world.

It might be thought that Germany could lead as the world's second-largest economy and until 2008 its biggest exporter. But even if it was willing to absorb more imports, Germany could not strengthen its currency, the euro, without taking account of the needs of other eurozone members. A stronger euro would have contradictory impacts. Germany would draw in imports from recession-hit countries, but so would other eurozone countries, many of which already have large trade deficits and need a weaker currency, rather than a stronger one. So Germany's European leadership role probably rules out its global leadership role.

Will China behave differently today than the US did 75 years ago, and accept the responsibility of global leadership? It's not looking likely at this point.

In late 2008, like most other G20 governments, China adopted a massive stimulus package, raising spending by 7% of GDP per annum for two years. (The Obama stimulus package was 2.6% of US GDP per annum.) The Chinese government also ordered banks to raise lending to both producers and consumers to boost domestic spending further. This helped Chinese growth to an incredibly strong 10.7% during the last quarter of 2009.

But China's imports were still lower in 2009 than 2008, meaning that its stimulus package did not do much good for global growth as a whole – indeed OECD countries' growth barely rose above zero. So even if South Africa and the rest of Africa can maintain earlier levels of raw material exports to China, *overall* export levels may not recover soon.

It is true that Chinese exports dropped faster than its imports, but it ended 2009 for the first time as the world's biggest exporter, as other countries' exports dropped further. An important reason was that the Chinese government strongly depreciated its currency against the dollar from late 2008, precisely the opposite action to what the rest of the world needed. And worryingly, Chinese exports to large developing countries like India, Brazil and Mexico grew at around 30%.

A leading Chinese economist argued in August 2009 that, 'China needs to strike a fine balance between crisis management and structural reforms. If China fails to tackle its structural problems, including export dependency, high investment rate and wide income gaps, growth is unlikely to be sustainable.' At the same time, without higher exports and investment, crisis management may fail and employment drop.

In the end, the Chinese government's biggest worry is political stability, and hence their emphasis on restoring growth during 2009.

Yet, there is a big question as to whether China can sustain its strong growth. Though middle-class consumers with access to cheap loans have raised the purchases of big items like cars, washing machines and computers (largely produced in China, rather than imported), they will not keep on borrowing indefinitely.

Chinese companies invested 32% of GDP in plant and equipment during 2009, but they cannot repeat such large additions to productive capacity without either raising their exports, or suffering losses which would feed through into bad debts and problems for the banks. In fact, the government began to push against its 'easy money' policy in early 2010 amidst concerns about asset bubbles (inflated value of goods) and bank weakness.

In sum, China is not willing or able at this time to haul the rest of the world out of its slump, which suggests that the crisis of capitalism is a long way from over.

WHAT ABOUT SOUTH AFRICA?

South Africa escaped the worst of the financial meltdown because our banking system was not as tightly integrated into the global banking market as many thought. But both the productive economy and the banking system in South Africa were badly hit by the second wave of crisis, the collapse of world production and trade which followed the financial crash.

The government appears to be doing all the right things in a defensive, or *reactive*, sense. It has shifted from a budget surplus to deficit stance, following to some extent the lead of the US, UK and other trade deficit countries. The central bank has moderated its previous position on inflation, cutting interest rates and acknowledging that inflation will be out of its target range until late 2010 at least.

The idea which became a cornerstone of South Africa's previous growth model that central banks *should* follow a pre-defined policy and be independent of political pressures, has been shown up as a daydream, especially in today's capital-poor world. Our trade policy will increasingly focus on non-traditional partners, especially in Asia. Though this is a positive move, trade with China will not alone restore growth.

But we need to recognise the potential pitfalls in South Africa's crisis strategy.

First, we congratulate ourselves for initiating a major infrastructure repair and expansion programme *before* the crisis hit. Unlike many other countries, we had many projects underway as exports and other drivers of growth faltered. But government plans for a huge share of this programme to be undertaken by state enterprises, and we now find that state enterprises' weak balance sheets leave them in no position to do the job. As a result, projects are being postponed, and it is unclear how big the stimulus from infrastructure will be in the end.

Second, government announced a major expansion of job creation and job support initiatives and training schemes, talking of the crisis as an 'opportunity' to re-skill and upgrade the workforce. But are these programmes sufficient, and even more worrying, are they efficient?

In other words, is the scale of these support progammes ambitious enough for current circumstances? And, based on their past record, will the public sector be able to implement these programmes even at the planned scale? Basic systems in government are not working and yet they are facing even more pressure to implement programmes.

A third risk is the likelihood of increased uncertainty of capital inflows from our usual sources, as more competition for lenders' resources emerges. Our need for foreign capital is unlikely to be eased by higher domestic savings in the context of the slump, and imports will probably keep rising, driven by our trading partners' efforts to raise their exports.

But beyond these issues, it needs to be asked whether South Africa has been bold enough in its crisis response.

Although we have shifted from a pre-occupation with inflation as the greatest threat to our economic well-being, we have not abandoned a complacency about the positive consequences for growth of addressing the concerns of financial investors, both domestic or foreign.

Our assumption is that high marks on the financial investors' good behaviour chart will be rewarded with high economic growth. This was the core feature of our macro-economic policy over the past decade and a half, and it was not terribly successful (though many insist that it was). But in any event circumstances are now fundamentally different, and a different ethos is needed.

We need to be much bolder in our thinking. Even conservative institutions like the Bank of England and the Federal Reserve have recognised this since the financial crash and adopted 'quantitative easing' (what we used to call 'printing money').

While this particular tactic may not be appropriate for South Africa, the case has become irresistible for the devaluation of the rand. The time has surely come for government to move aggressively and urgently in this direction in order to encourage exports and promote job creation. LB

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