Weathering the Global Economic Crisis:
Lessons for Emerging Markets

by

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Excellencies, Distinguished Guests, Ladies and Gentlemen:

Good afternoon. I am delighted to be in South Africa and at UNISA, one of Africa's pre-eminent centers of knowledge and online learning. As an academician, on leave from Peking University and on 'loan' to the World Bank, I feel perfectly at home in this great academic setting.

We are meeting at a very challenging time. Our society is facing a financial crisis, an economic crisis, and as recent research is increasingly showing, a humanitarian crisis. My remarks this afternoon will cover four points.

- First, while the crisis originated in the financial sector, the challenge now is in the real sector. Growth has plummeted and unemployment has risen in developed and developing countries alike. Significant excess capacity has built up, and unless this issue is addressed, we will face a deflationary downward spiral and the crisis will become protracted;
- Second, while the crisis originated in a developed country, the developing world is going to suffer even more and the poverty reduction and other MDGs could be jeopardized;
- Third, in order to address the issue of excess capacity, we all need to adopt some kinds of Keynesian interventions. However, we need to go beyond the Keynesian approach and beyond national boundaries so that the global economy can get out of the current crisis and we can build a much better foundation for sustainable economic growth in the developing countries, and

- Fourth, the crisis has inevitably hurt the South African economy and the government has appropriately deployed fiscal expansion as its main policy response. The crisis can be seen as an opportunity to tackle critical growth and productivity bottlenecks. However, unlike China and some other large middle-income countries, South Africa does not have substantial domestic savings, which will limit its fiscal space, putting even more onus on greater efficiency of public expenditure.

Origin of the Crisis

As you may recall, the current crisis was preceded by six years of boom in the world. The boom can be traced to the bursting of the Internet bubble in 2001, and the subsequent expansionary monetary policy pursued by the United States Federal Reserve Board, that led to excess liquidity, which, in turn, contributed to the large increases in real estate and equity investments in the United States, as well as private capital flows to the developing countries, supporting their investments in the manufacturing sector. Together with financial innovations brought about by financial deregulation, this created a boom in the housing market, which later became an equity bubble. As markets surged, the perceived wealth effects prompted households to divert a steadily increasing share of their income to consumption.

Given the explosion of sophisticated and unregulated financial derivatives which had sustained the process, the boom was bound to turn to bust. And, in mid-2007, this process began with the crisis unfolding in the sub-prime mortgage market in the US. The drop in value of the off-balance sheet assets pushed many financial institutions into insolvency. Even worse, the financial innovations of the past decade – many of which had been sold on the promise that they would diversify and minimize risk but now have been amply demonstrated to be of dubious quality – turned out to be the transmission mechanism for instability in the global financial system. The subprime mortgage crisis thus became a full-fledged global financial crisis.

The losses precipitated by the financial crisis have been enormous. Total capitalization of world stock markets almost halved in 2008, that is, nearly $30 trillion of wealth disappeared in 2008. Markets have recovered about $2 trillion in value so far in 2009. In the United States alone, the wealth loss for households related to the fall in home prices was roughly $4 trillion by end-2008.[1] As can only be expected, losses of this magnitude have significant wealth effects on consumption and savings.[2]

The governments in the developed countries responded quickly and decisively to provide rescues to their financial sectors. However, the crisis has spread from the financial sector to the real sector. Industrial production in the first quarter of 2009 fell 23% in Eastern Europe, 62% in Japan, and 42% in Germany, at seasonally adjusted, annualized rates (SAAR). Globally, industrial production declined by 28% in the first quarter following a 22% in the final quarter of 2008, before easing to a pace of contraction of 19% in April (on a rolling quarterly, SAAR basis). During the first quarter of 2009, for East Asian economies such as China, Japan, exports declined by 50% or more, and 43% in Korea. This year we will encounter the largest trade contraction since 1929.

[1] Source: RGE Monitor, January 7, 2009.
[2] In the past, collapses in asset prices have not always dampened consumption by as much as feared, perhaps because in many cases households viewed prices at either the peak or the trough as transitory.

Why did the situation get from worse to worst despite so many measures and interventions taken since the financial crisis first erupted? In my view, it is because the financial sector issue has become a real sector issue due to the excess capacity problem.

As I noted earlier, the investments in real estate and in manufacturing during the period 2002-07 have now turned into capacity. With the sudden loss of wealth, households will reduce consumption, and extra capacity will appear. Meanwhile, the deleveraging of the financial sector will reduce the funds available for investment, further reducing aggregate demand.

The capacity utilization rate of manufacturing sector was 69.1 percent in the US in March, 2009, the lowest since the statistics was collected in 1967. Similarly, the capacity utilization rate was 72 percent in Germany and about 65 percent in Japan, all the lowest records in the recent decades. In some developing countries, the rate was as low as the 50 percent.

Once excess capacity appears, the economy gets trapped in a vicious cycle, because it becomes hard for firms to find viable investment opportunities. So investment demand declines and some firms are forced into bankruptcy, or at least into reducing their work force. This in turn, threatens incomes and job security of the workers, who then try to reduce spending, and so on. With the reduction in aggregate consumption and investment demand, excess capacity becomes even larger and the financial sector problems deepen as toxic assets and non-performing loans grow. In October last year, IMF estimated the write-off in the US's financial sector to be $1.4 trillion and in April this year, the estimate increased to $2.7 trillion. Recently, the European Central Bank estimated that the banking sector in EU required $283 billion additional write-off in 2009. If the excess capacity in the developed and developing countries is not eliminated, the financial sector in the developed countries may require more rescues in the future and the financial crisis may erupt in some developing countries.

In the past, when similar situations occurred, some countries could depreciate their currencies and increase exports to pull themselves out of the recession. However, this time, the crisis is of a global nature so no country can count on using currency depreciation and exports as a way out of the recession. Therefore, unless we deal with the excess capacity situation, we will have a protracted crisis that will continue to wreak havoc on all countries.

Impact of the Crisis on Developing Countries

While developed countries are experiencing some of the sharpest economic contractions, households in developing countries are much more vulnerable, and likely to experience acute negative consequences, both in the short- and long-term.

Declining growth rates combined with high levels of initial poverty leave many households in developing countries highly exposed to the crisis. Vulnerability is heightened if, at the same time, governments are constrained in cushioning the impacts due to limited institutional capacity and fiscal resources.

When the financial crisis first broke, it was thought that developing countries in general would not be affected because their financial sector was not fully integrated in the global financial system. But now as the crisis has entered the second stage and problems in the real sector have emerged, it has become clear that developing countries will also be seriously affected by the downturn.

Between 2002 and 2007, these countries grew rapidly because of global trade expansion and the large inflows of private capital, including foreign direct investment (FDI), the increase in remittances and the surge in commodity prices. In fact, in 2007, private capital flows to the developing countries amounted to $1.2 trillion, a six-fold increase compared to the beginning of the decade, thanks in part to the rise in FDI which responded to the higher export earnings of the resource-rich developing countries. These higher earnings, in turn, were made possible by higher world commodity prices. Also, workers' remittances expanded three times to $328 billion over the same period. Now, with the crisis taking its toll, it is estimated that total FDI and private capital flows will decline from $1.2 trillion in 2007 to $363 billion this year. As a result of declining exports and reduced capital inflows, the developing countries may encounter a financing gap of between $352 billion to $635 billion. Moreover, remittances are likely to fall by 7.3 percent in 2009 to the level of $305 billion.

The GDP growth rate in developing countries in 2009 is forecast to drop to 1.2 percent, a sharp decline from 8.1 percent of growth rate in 2007 and 5.9 percent growth rate in 2008. This decline alone will cause more than 30 million workers to lose their jobs according to the United Nations International Labour Organization, and of course, poverty will rise. In fact, if we don't do anything, this may just be the start of the worst scenario.

New estimates for 2009 suggest that lower economic growth rates would trap 53 million more people in poverty, those living on less than $1.25 a day than was expected prior to the crisis. If the $2-a-day poverty line is used, 65 million will stay trapped. If the recession protracts, more and more people will fail to get out of poverty.

These new forecasts, along with research finding that sharply lower economic growth rates will significantly retard progress in reducing infant mortality, highlight the serious threat posed to achieving the MDGs which have a due date of 2015. Preliminary estimates for the 2009 to 2015 period forecast that an average 200,000 to 400,000 more children a year, a total of 1.4 to 2.8 million, may die if the crisis persists.

As Robert Zoellick, World Bank Group President, has said, "The global economic crisis threatens to become a human crisis in many developing countries unless they can take targeted measures to protect vulnerable people in their communities."

Critical to protecting households in countries exposed to the crisis will be the ability of governments to cope with the fallout of the downturn: to finance programs that create jobs, ensure the delivery of core services and infrastructure, and provide safety nets. Yet, only one-third of the exposed countries have the fiscal capacity (i.e., ability to expand fiscal deficits) to render significant countercyclical spending. In countries with limited fiscal capacity it is imperative that assistance be provided via grants and concessional financing wherever possible. Moreover, one-third of the countries with a reasonable amount of fiscal capacity are aid dependent, and will also require external support to finance increased spending.

Some Thoughts on How to Solve the Global Economic Crisis

The current crisis is the first "synchronized" crisis in almost eight decades. While there have been some improvements in segments of the financial system targeted for direct support by US authorities, in general, monetary policy in developed countries is unlikely to stimulate investment and consumption in excess capacity situations. As a result of the synchronization marking the current crisis, dealing with it

alone is beyond the capability of any single country. Instead, decisive and concerted actions efforts are needed by the international community as a whole. In particular, there is an urgent need for a global, coordinated fiscal stimulus. Even as major fiscal stimulus packages are being implemented around the world to complement monetary policy, it is clear that in environments where firms face large adverse shifts in demand, some fiscal policy features such as tax cuts and subsidies may have little effect. There are two major limitations with fiscal stimulus packages in their current form.

First, most developing countries are constrained by either fiscal space or/and foreign exchange reserves, and thus, in many cases, will not be in the position to implement counter-cyclical policies. Many low-income countries entered the current crisis immediately on the heels of the fuel and food crises, which led them to increase fiscal subsidies. Their fiscal positions are already weak. Moreover, one-third of developing countries have already had current account deficits exceeding 10 percent of their GDP. They will not be able to finance the inevitable increase of imports due to the fiscal stimuli.

Second, the proposed fiscal stimuli that are currently feasible are in developed countries, where their impact will be the least. In the current climate of uncertainty, households tend to put increased value on precautionary savings. Thus, contrary to Keynesian wisdom, the impact of fiscal stimuli will be muted by the tendency of households to adjust their consumption and saving patterns on the basis of expectations about the future. Japan's experience in the 1990s is an example. After the collapse of equity and housing market in 1991 and the consequent recession, the Japanese government was quite aggressive in introducing fiscal stimulus. The government debt as a percentage of GDP, in 1991 it was 60 percent of GDP. By the year of 2002, it increased to about 140 percent of GDP. That means that in eleven years it increased by 80 percent. That means each year the government debt rose by about 7 percent. But Japan did not get out of the recession so we call that it lost decade. The reason was the government increased spending and the people increased saving.

Developing country economies, on the other hand, are less susceptible to this problem since they face many more bottlenecks of growth and if the stimuli were used to invest in projects that release these bottlenecks, productivity is bound to increase. If the gains in productivity are large enough, these investments may indeed be self-liquidating ensuring that precautionary concerns and expected future tax rises will no longer inhibit spending.

In 1998, because of the East Asian financial crisis, China encountered a situation very similar to the situation now. So Chinese government adopted a fiscal stimulus package in 1998-2002.Those packages were used to release the bottle-necks of in infrastructure. In 1997 China only had 4,700 kilometers of highway. By the time of 2002 it increased more than five times to 25,000 kilometers. The transportation situation improved greatly and also port facilities – airport, seaport – as well as the electronic grid. With that kind of fiscal stimulus, China average annual growth rate was maintained at 7.8 percent. More importantly, after the crisis the growth rate accelerated. In 1979 to 2002, the average annual growth rate in China was 9.6 percent. However, from 2003 to 2008, not only did the growth rate not decline; the growth rate increased from 9.6 percent up to 10.8 percent. It was because of during the period of investment enhanced the growth potential by releasing all kinds of bottlenecks in the economy. And as a result, their government debt as a percentage of GDP declined over time – during the stimulus periods the debt increased from about 30 percent of GDP to 36 percent in 2002. But because the growth was enhanced, government revenue increased; and the economy became much larger. So by the time of 2006- 2007, the government debt as a percentage declined down to 20 percent.

Thus, the key to solving the two problems outlined above is through investments in projects with rates of return high enough to generate higher growth, which in turn, can generate enough revenues to pay for the costs of the fiscal stimulus itself. By contrast, such bottlenecks tend to abound in developing countries. Clearly, some fraction of fiscal resources must be injected in developed countries that are the epicenter of current crisis, but the main policy objective should be to create demand as quickly and efficiently as possible. This can be done by channeling investment to where it can be most effectively utilized, by investing in eliminating the bottlenecks to growth in the developing world. Infrastructure in many developing countries, both domestic and regional, is the main bottleneck to growth. Increasing investments in infrastructure can increase the productivity of the private sector, improve the business environment, and generate high economic returns.

South Africa's Experience

South Africa's stable and sustainable macroeconomic environment has been globally recognized as a shining achievement and successful example, attracting billions of dollars of foreign investment each a year at competitive rates,and contributing to robust growth rates of five percent and more in recent years. That enviable record is now under the inevitable long shadow being cast by the global crisis. For example, the slump in global demand has badly hurt South African manufactured exports. The global crisis also accelerated the fall in commodity prices that started in mid-2008, hurting South African mineral and diamond exports. The worldwide credit crunch, amplified by heightened risk aversion toward new lending by local banks, and uncertainty about recovery prospects has curtailed private sector demand. Consequently, South Africa is facing its first recession in 17 years, unemployment has risen according to official numbers, and the government is increasingly being constrained by a shrinking revenue base. This tough position has prompted the Government of South Africa to appropriately choose fiscal expansion as the main policy response, which is in sync with the fiscal stimuli being implemented both in other middle income and developed countries.

I believe that in every crisis lies an opportunity, and three lessons from the recent global experience are worth keeping in mind.

- First, given the broad agreement over fiscal expansion, this may be an opportune time to tackle infrastructure and other growth bottlenecks that require significant public expenditure and investment;
- Second, fiscal space can potentially become a major constraint. Although South Africa entered the crisis from a position of strength, fiscal space over the medium-term could become constrained by its low levels of domestic savings. In this circumstance, as private sector confidence recovers, longer-term public expenditure commitments can potentially have two adverse impacts: (i) it would put upward pressure on the borrowing rate and crowd out private investment, and (ii) it will put further pressure on the current account deficit, and
- Third, the key challenge is to make sure that public expenditures target high-growth areas with a view to removing bottlenecks. Fortunately, even before the onset of the crisis, the South African government had already identified several critical areas of public expenditure: infrastructures including power generation and transport networks; service delivery investments, especially in health, education, and public transportation; and needed expenditures for social protection. The fiscal cost of frontloading these expenditures, many of which are "shovel-ready," can be offset in the future by higher revenues generated by productivity, growth, and employment enhancements resulting from judicious spending choices.

Looking ahead, increasing the efficiency and effectiveness of public expenditures will assume critical importance in the coming years, including for developing a more robust response to other entrenched development challenges such as unemployment and rising inequality.

World Bank Group's Response to the Crisis

The World Bank Group has been quick to offer expanded, innovative products and services to assist emerging economies and developing countries alike. First, the World Bank has the capacity to make new commitments of up to $100 billion over the next three years. This year, combined World Bank Group commitments were $58.8 billion, up from $38.2 billion a year ago. Second, a fast track initiative funded by the Bank's International Development Association (IDA) is now in place with $2 billion available to help the poorest countries deal with the crisis. This follows a $1.2 billion Global Food Response Program (GFRP) set up in May 2008 to speed assistance to the neediest countries to help them cope with the food crisis. The total money that can be used for safety nets, infrastructure, education and health for the poorest people in the coming three years is the $42 billion IDA15 fund. Third, the International Finance Corporation, the World Bank's private sector arm, has launched new facilities to provide $30 billion over the next 3 years and is ramping up support to the private sector through the launch or expansion of five new initiatives.

The World Bank also has an important role to play in providing technical assistance to member countries and assist them in responding to a more demanding macroeconomic and financial environment. This includes assistance to strengthen public expenditure management systems, enhance domestic revenue, improve debt management, and enhance the operational frameworks and instruments for restoring sustained economic growth. In addition, the Bank will continue to monitor commodity price developments, assess the policy responses of member countries, and monitor trade policy developments.

Ladies and Gentlemen,

The magnitude of the current global crisis requires bolder objectives and the strengthening of the international financial architecture.

Robert Zoellick has called for the establishment of a "Vulnerability Fund" in which each developed country would devote 0.7% of its stimulus package to the fund for supporting social safety net, infrastructure investment as well as small- and medium-size enterprises in developing countries. The sovereign wealth funds could also devote one percent of their proceeds to contribute to infrastructure investment in Africa.

So in the spirit of building our common future, I have a plea to make to developed countries. Please use your resources to make investments in emerging markets and the developing countries. This will not only help the latter, but also the former. It would solve the short-term issue, and also pave the way for laying the foundation for a sustainable, inclusive growth in the future.

As I said earlier, in every crisis exists the seed of opportunity. Even as the global economic crisis exacts its toll – economic, social, and environmental – we must work together to mitigate the adverse impacts, especially on the poor and marginalized segments of our society. It is an opportunity that we should not waste, and the time for action is now.

Thank you.