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Hazardous path out of crisis
By Joergen Oerstroem Moeller

The global financial crisis lands an acute challenge on the table for policymakers in Asia, as it is the only place in the world having room to maneuver for active economic policies and is in possession of the world's savings.

For some time, the question was open as to whether deregulation and privatization - the policies of president Ronald Reagan and prime minister Margaret Thatcher - were permanently shifting the paradigm of the global economy, or were just another cyclical wave of political preferences. Now we know. It was a cycle.

For the past 30 years the world has lived under the spell that the market gets its right. This was the basis for economic and financial policies first in the US, then Europe and after that most other countries. Bastion after bastion of well-established and renowned enterprises, many of them public utilities, were transferred from public ownership (service to the population) to private ownership (where the priority is profit). The philosophy was that profit would ensure efficiency and that would guarantee the high-quality service the public looked for. The global financial crisis demonstrates that if left alone, the market tends to get it wrong - not right. When the assumption has been proved wrong, the policies cannot and will not be kept in place unchanged.

More international regulation and control will certainly be included on government agendas. That does not necessarily mean that deregulation and privatization will be rolled back completely, but it does mean that more deregulation and privatization is unlikely to take place and that some of the privatized enterprises probably will be brought back under public ownership.

It is noteworthy that US mortgage guarantors Fannie Mae and Freddy Mac have been nationalized - deprivatized, so to speak - and insurance giant AIG is in reality undergoing a similar process. Forced by circumstances, a US administration judged to be the least likely to nationalize and deprivatize has ordered two of the most spectacular and far-reaching nationalizations of financial institutions the world has seen. This lesson will not easily be forgotten.

Second, a new wave of concentration of financial institutions is under way. The Bank of America has bought Merrill Lynch and there will be other mergers and acquisitions. The days where genuine competition ruled between the mayor financial institutions are gone and will not come back.

The world will be left with a few mastodons so powerful and in possession of enormous financial might that they soon will throw their weight around with regard to economics and politics. We witness the gradual phasing out of specialized financial institutions, crowded out by the mega institutions without healthy competition and where wrong decisions may cause havoc because of their size. Until recently we could hope that if a financial institution got it wrong, the other ones might have got it right - not so anymore. Out of this may not come a more robust system, but a more fragile one.

Third, deregulation and privatization gave birth to investment funds. Many having enjoyed themselves during a spending spree buying public utilities one after another, they now may face a rough time.

Many operated on the assumption that the valuation of the assets (bridges, toll roads, airports and so forth) would continue to rise, allowing them to expand by increasing borrowing using new loans to repay former loans. Now these assets are starting to fall in value, with the inevitable consequence that it won't be long before we read about such investment funds in difficulties.

They excelled in complicated and opaque financial operations selling and buying among each other, sometimes between different subsidiaries inside the same mother company, and often publishing obscure annual reports. Their owners were sometimes pension funds, which did not want to undertake such risks under their own name.

Fourth, it has so far primarily been the American and British financial systems that have been in the firing line, with some Japanese banks also exposed. We cannot be sure that the rest of Asia and the eurozone continue to be relatively unharmed. It seems, however, a reasonable fair assumption that, if they are drawn in, the repercussions will be smaller than for the US and the UK.

One wonders what the consequence of that will be for the future global financial system. It is difficult to see the US regain its former position after having demonstrated such incompetence. For years, observers have amused themselves by pointing out that the eurozone was no match for London as a financial center. Perhaps perceptions will change. Perhaps investors will start to feel more at ease investing via more cautious, more conservative, and less sophisticated but also less risky financial institutions in the eurozone, and perhaps financial centers in Asia will start to emerge for real.

Fifth, the world needs a financial system ready to take calculated risks; otherwise many investments will not be undertaken. The virtue of a good financial system is that it knows how to weigh pros and cons and gets it right most of the time. For the next years, the global financial system will tend to be cautious and the risk for the global economy is that it may be too cautious, always thinking of 2008 and fearing to repeat mistakes.

Human nature indicates and history shows this kind of behavior. After a period of assuming unsustainable risks the world may move into a period with a financial system

that is too risk-aversive. Many developing countries and newly industrialized countries will feel the pinch, and this may lead to lower global growth.

The global authorities face a challenge to tell the financial system that even if it is understandable in view of the 2008 crisis that they prefer to avoid risks, continued global growth requires some risks and accordingly it should not be too cautious. The balance must be found. The world may end up with a financial system being extremely solid because it does not dare to lend, which is why it is there. A strange outcome to a crisis started by reckless lending.

The present crisis is due to one single factor and nothing else: high and persistent imbalances in the US building up over decades and culminating in explosive growth of these during the past eight years. The US government's liabilities and long-term commitment stands at almost US$50 trillion - four times total annual production. The total federal debt is more than $10 trillion. Next year, the budget deficit will probably surpass $500 billion. The balance of payments has been in deficit for years.

Total demand can surpass production for some years - as it has - but not indefinitely. The longer it lasts, the more painful the alignment will be. It has become a global crisis because the US was and still is the largest and most powerful economy, with one-quarter of global production. Consequently, a solution must be a global one defining the burden-sharing between the US and the rest of the world.

Restoring balance for the US economy requires lower demand or increased production and/or a combination of both. Demand can be reined in by restrictive economic policies, but that will deepen the recession. Stimulating policies can be applied to combat recession through an upswing, but will aggravate the imbalances. The policy implication is that US fiscal and monetary policies cannot be applied effectively.

Years of irresponsible policies have removed any room of maneuver. It is good to hear plans of expansionary economic policies, but where does the money come from? More borrowing, and if so from whom? Private households already dissaving, a business sector facing alarming falls in profit, a maimed financial sector? The rest of the world is already up to the hilt with Treasury bonds, it definitely does not want to accumulate more of these.

That leaves us with two not very attractive policies: depreciation of the US dollar and/or protectionism.

They can do at least some of the job by reducing real incomes, thus cutting total demand and enhancing competitiveness and thus stimulating production through exports. It looks fine, but it isn't.

What the US gains the rest of the world loses. These policies redress US imbalances by shifting them to other countries. Only if other countries are willing to accept this will such policies work. And they can only be expected to do so if the US is ready to enter

into some kind of arrangement ensuring that their burden is accompanied by a comparable effort by the US.

Irrespective of which policies are set in motion, the result is a transfer of purchasing power from America to other countries and a lower real income for the US - a lower share of global gross domestic product (GDP). The US can scream or squirm or whatever it likes, this is going to happen.

Here follows a sketch about how to manage adjustment and minimize the negative repercussions:

First, the US undertakes to reduce oil consumption, in particular in the transport sector. For an incoming administration, the opportunity arises to introduce a new energy policy. The political question is whether the American people, having resisted such measures for years, are now finally ready.

Second, a commitment by everybody to refrain from protectionist steps, thus guaranteeing continued free trade and international investment banning any attempts to solve one's own problems by shifting them to other countries. There is talk about relaunching the Doha-round, and that would be wonderful, but let us have both feet on the ground and not jump for the moon however desirable it looks.

Third, policymakers announce guidelines for a US dollar depreciation, signaling that a falling US dollar is the preferred option and thus removing the risk that such a policy triggers speculation. Major economic powers must align domestic monetary policies in particular interest rate changes so as not to open windows for speculators to exploit any differences.

Fourth, measures to stimulate domestic demand in countries having room to maneuver to do to uphold global demand. The recently announced Chinese stimulus package amounting to $586 billion and composed of three elements - loose monetary policy, tax reductions and investments - is a step in the right direction.

Fifth, a US commitment to follow economic policies in conformity with guidelines normally laid down by the International Monetary Fund (IMF) for countries needing assistance to sort out economic imbalances. The interpretation is limits for deficits on the public budget and the balance of payments.

Sixth, the top 10 or 20 global economic powers (not G-10, but the 10 countries with the largest share of global GDP) agree to coordinate economic policies to better synchronize the global business cycle.

Seventh, a keen awareness of the risk to the global economy of countries that may not be able to weather the crisis sliding into political anarchy and economic chaos, thus joining the list of failed states.

This is where the world really needs preemptive and preventive policies. The normal blueprint imposing restrictive economic policies will not do in these circumstances; something more imaginative is needed to keep the economy going. The IMF should step in, but the IMF does not possess money itself. It borrows from member countries to lend to other member countries. Only if creditors find it attractive or necessary will they place the necessary funds at the disposal of the IMF, and global leaders must create an atmosphere in which they are ready to do so.

These seven steps look like a tall order, and other methods to rebalance the US economy without too much harm for the rest of the world may be available - but they are not easy to spot.

Joergen Oerstroem Moeller *is Visiting Senior Research Fellow, Institute of Southeast Asian Studies, Singapore and Adjunct Professor Singapore Management University & Copenhagen Business School.*

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