

CHAPTER 1

The Deepening Global Recession and the Great Depression Fear*

LIM CHONG YAH

The chapter gives four reasons why the world would not degenerate into a Great Depression as in the early 1930s, nor into a deepening slump. Time is on the side of the recovering process. The world-wide adopting of a cheap money and cheap credit policy and fiscal stimulus packages augers well for the road to recovery. The article also discusses the Ninja loans mortgage crisis and its spread to the whole US and world economy, and attempts by the Bush and Obama Administrations to contain the crisis. A brief comparison between crisis management in the US and China is also made. Finally, there is also a brief commentary on crisis management in Singapore.

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Road to Depression

The world will degenerate into a Great Depression if, among economic superpowers such as the US, China, Japan and the European Union:

- (1) protectionism rears its ugly head,
- (2) international trade war develops,
- (3) competitive exchange rate devaluation unfolds, and
- (4) pro-cyclical measures are pursued.

Fortunately, all nations on this earth, big or small, economic superpowers or otherwise, have eschewed (1), (2), (3) and (4). Historically, it was their blind pursuit of (1), (2), (3) and (4), especially among the then economic superpowers, that plunged the world into the Great Depression in the early 1930s. The contraction of governments was ubiquitous; all to save money to make ends meet. Mankind, including its governments, has since learned that the pursuit of (1), (2), (3) and (4) will plunge the sinking ship of recession into a more severe depression.

All governments in the early days of the 21st century pursue the following two macroeconomic anti-recession policies. One is to have a cheap money and cheap credit policy. And two is to have a sizeable budget stimulus or deficit financing. When the new US Secretary of State, Mrs Hillary Clinton, first made her maiden official visit to Beijing, she calmed the nerves of the Chinese by saying of the current global recession, "We are all not only in the same boat, but fortunately, we are all rowing in the same direction". Since the world is fighting the global recession at the same time, the probability of the world sliding into a Great Depression is almost zero, and that of a deepening recession into a global slump, very low indeed. Granted, there are others who may not hold this view.

Cheap Money Policy

Interest rate cuts

Effectiveness questionable

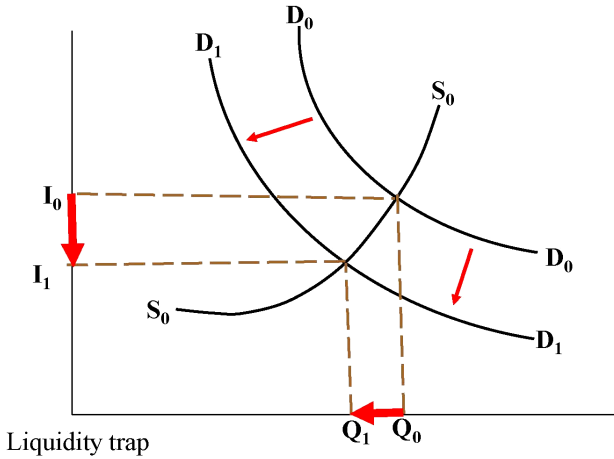


Figure 1.1: The effects of a cheap credit policy.

Cheap Money Policy

Figure 1.1 shows the operation of a cheap money and cheap credit policy. Interest rate is reduced from I_0 to I_1 , and notwithstanding that, the quantity of money in use is also reduced from Q_0 to Q_1 , because the demand (liquidity preference) curve D_0 has fallen to D_1 consequent on the recession. Thus, even if the interest rate is reduced to near zero, it will have no impact on demand if the demand curve keeps falling, as symbolized by a constant shift of the curve moving south to the left.

Why must the demand curve shift southwards to the left, or decrease, in a recession? This is because, in a recession, the expected rate of return on capital declines. And it is this gloomy expectation that is associated with the concept of a liquidity trap, whereby the near zero interest rate may have no impact on the

demand for money to satisfy the transaction motive. This was basically the situation faced by Japan in the 1990s after the property bubble burst in 1989. That decade was later called the “lost decade” for Japan.

Ninja Housing Loans

The current US recession has its genesis in the proliferation of NINJA loans almost throughout the USA. NINJA loans are loans given to borrowers by lending institutions, like Lehman Brothers, even though the borrowers have no income, no jobs and no assets. In other words, the lenders follow a high-consumption policy, lending very freely to every Tom, Dick or Harry. For a long time, this free lending policy posed no problem so long as the value of the housing assets kept rising. Even a second loan could be obtained, if the housing boom continued. No one would like to prick the housing bubble. The practice which brought much prosperity to the USA, however, was carried too far and for too long. The housing bubble finally burst. Once housing assets fell below the mortgaged loans, trouble on repayment surfaced. Foreclosures crept in. NINJA loans became toxic assets. NINJA loans were extended to car loans and consumer credit cards as well. Once the lenders were flush with so much toxic assets, the banking system became shaky. The falling values in the housing and banking sectors soon spread to other sectors as well, including the stock market and the automobile industry in a circular cumulative causation process. Because of international connectivity, the US credit crisis quickly spread to other parts of the world directly and indirectly in the first, second, and third round processes.

In other words, when asset prices kept rising, there was euphoria. Mr Alan Greenspan, who was then the much-acclaimed Chairman of the US Federal Reserve Bank basked in much of the euphoric limelight not just in the US and but also in the world. When asset prices fell, there was the crisis. The crisis gained momentum in the last remaining years of the Bush Administration. Neither Mr Bush nor his two most important financial and

economic ministers, namely, Professor Ben Bernanke and Mr Henry Paulson, could stop the decline. Professor Bernanke is the Chairman of the US Federal Reserve and Mr Paulson was the US Treasury Secretary.

Early Attempts at Fighting the Crisis

The epicentre of the global crisis is in Wall Street in the USA. In the early period of the US crisis, Professor Ben Bernanke, as the Fed Chairman, took centre stage with Treasury Secretary Henry Paulson remaining relatively silent; and President George Bush even more reticent. Monetarism, not fiscal stimulus, was to provide the answer, the cure. More than that, the diagnosis of the crisis was equivocal. Bernanke expressed the fear of inflation instead of recession or deflation. Thus, the interest rate cut was very piecemeal, and consequently, very frequent. This vicissitude and equivocation in the diagnosis and prescription must have contributed to the spread, breath and depth of the crisis. There was no attempt to nip the crisis in the bud through clear and resolute monetary and fiscal measures.

When the crisis deepened, Henry Paulson finally stepped in. That was considered too late, and many, including the 2008 Economics Nobel Prize Winner Professor Paul Krugman, would add, too little had been done. When Paulson asked Congress to approve the release of funds for fiscal stimulus, he changed his mind on the use of the money. He said that it was to be used to bailout toxic debts, not for infrastructural development and rejuvenation. Then he left office when President Obama succeeded President Bush as the 44th President of the USA.

Figure 1.2 shows the role of fiscal response to bring back falling income and falling investment resulting from a deepening recession. Private sector demand D_0 , in a recession, falls to D_1 . The objective of public policy is how to bring demand back from D_1 to D_0 . Since monetary policy in itself cannot lift private sector demand back to D_0 , fiscal policy is resorted to. In other words, public sector demand is brought in to counterbalance the falling private sector demand.

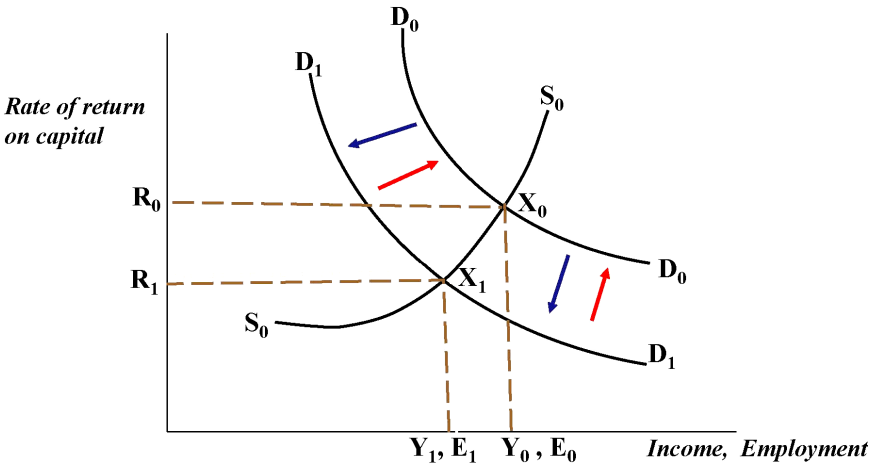


Figure 1.2: Theory on fiscal response (A simplified model).

Two important aspects of the fiscal stimulus must be considered here. They have often been overlooked in public discussion. One is the composition of the stimulus expenditure. Two is the financing of the fiscal stimulus. The composition may, very roughly, be broken down into two parts: one, income transfer in favor of direct consumption; and two, the building up of income-bearing assets which will lead to increase in consumption in the second round. The second approach implies that there are such projects that merit fiscal support and not all such projects are readily available or can be made available within short notice. The US appears to be short of supply in such strategic projects. Strategy one can aggravate the already bad balance of payments deficit on current account in the US with little or no impact on productivity and competitiveness, particularly external competitiveness.

The financing of the fiscal stimulus, too, has often been sidelined. If the country is well prepared for such an economic aberration, it will finance it from the strategic accumulated foreign exchange reserves such as in the case of China and Singapore. If it is not pre-prepared, such as in the case of the United States, it may

have to be financed from foreign borrowing and fiduciary issue, which is a euphemism for printing of more money. Fiduciary issues can be inflationary. A small amount, in the US and US only, however, might help the economy to break away from the liquidity trap. A surfeit can easily lead to inflationary pressures and exchange rate devaluation. If the rest of the world would continue to accumulate US dollars as an international reserve currency, fear of exchange rate devaluation need not happen in the case of the US. External borrowing will only increase the already high external indebtedness of the US, accumulated under the Bush Administration under its budget deficit program during the NINJA loans boom years.

The “Change” Strategy

When President Obama won the election on 4th November 2008, there was great expectation of his ability to handle the deepening recession. His first-rate rhetoric had convinced everyone both within and outside the US. He meant business by focusing his whole attention in transforming the recession into recovery. The cheap money policy was followed with more vigor together with a very much bigger budget stimulus.

Unfortunately, there was many a slip between the cup and the lips. President Obama needed a good and credible and able economic team to manage the *modus operandi* in the recovery program. He appointed two previous Bush Administration’s luminaries to manage his urgent economic affairs. They are Mr Timothy Geithner as Treasury Secretary and Professor Ben Bernanke who would continue as the Fed Chairman. Dr Larry Summers, a former Treasury Secretary, is to be his chief economic adviser. All three are considered to be closely connected with Wall Street. All three have different degrees of association with the previous free-spending and free-wheeling policy of achieving affluence through high consumption.

Mr Timothy Geithner, the head of the trio, was immediately handicapped by President Obama’s inability to have the two much-needed deputies for him. Besides, Mr Geithner nearly opened up a

possible trade war with China by accusing China of contributing to the US balance of payment problem. He too incurred the wrath of Europeans and others by having an “only buy American” and “use American labor only” policies. To them, that was protectionism’s ugly head. He has other incipient problems. Fortunately, other more-reasoned members of the Obama Administration, including Vice President Joe Biden, Secretary of State Mrs Hillary Clinton, Economic Advisor Dr Larry Summers and the President himself stepped in to sideline the issues so that the Administration could concentrate on more urgent domestic recovery matters through appropriate fiscal stimulation, including arresting the widening toxic debt problem and the very important declining automobile industry. Foreign economic issues should not be a red herring for the task of getting out of the US domestic economic crisis under the overall “change” policy of the new Administration. It is a pity that cost-cutting measures seem to be politically inappropriate.

However, both the toxic debt problem, increasing in spread and depth with time, and the Achilles’ heel in the three US automobile icons, defy an easy solution. Again, the Obama Administration appears indecisive and equivocal in strategy: the wavering between the “to be or not to be” in following the lender of last resort function and the time-honored and time-cherished American philosophy of pursuing a policy of creative destruction, even for important corporations and industries such as these. The new Administration’s unexpected vicissitude and equivocation, reminiscent somewhat of the Bush Administration, has contributed to prolonging the crisis in the USA and, therefore, the world. But the three Wise Men in the USA, the three economic tzars, one should not forget, are basically also rowing in the same direction as the rest of the world in advocating a big fiscal stimulus and a cheap credit policy. The world is in the same team.

Comparison with China

China, in PPP terms, has become nearly half the size of the USA. She can use “moral suasion” as an instrument of monetary policy.

US, however, appears to be handicapped in this. "Moral suasion" means the central bank can persuade the commercial banks, most of whom are state-owned banks in China, to lend out more money to customers. On fiscal stimulus, China has at least two comparative advantages. One is that she has the largest foreign reserves in the world, nearly US\$2 trillion. Two is that she has a good supply of worthwhile projects to implement. China has a rolling five-year development plan. She can thus bring forward the projects to serve as an anti-recession move as well. Under the circumstances, should one be surprised when Chinese Prime Minister Wen Jiabao announced that China in 2009 would be able to have a positive GDP growth rate of eight percent? By way of contrast, USA would probably have a reported negative rate of three to four percent like that of many other developed economies. So, fiscal stimulus may work differently in different countries. India and Vietnam too have reported a positive growth rate of between five and six percent for 2009. Of note is that China, India and Vietnam are developing countries with more potential for infrastructural development than developed countries, like the US or Japan and Western Europe.

The Singapore Scenario

As this lecture is given in Singapore and to Singapore's teachers of economics, I would like to make a few observations on the domestic economic scene. The global recessionary impact on Singapore is very great, particularly on GDP and export income, but not on the unemployment rate. This is because of the flexible wage policy pursued in Singapore, resorting to retrenchment only as a last resort.

Besides, the government has introduced two important new measures to combat the recession. One is called the Job Credit Scheme under which an employer will be refunded 12 percent of an employee's wages for a period of three months, for employees paid less than \$2,500 per month. This provides an incentive for employers not to retrench workers, particularly lowly-paid workers.

Two is that, under the Special Risk Sharing Initiative (SRI), the government is prepared to guarantee up to 80 percent of the bank loans for a period of one year should there be any default. This is to encourage banks to lend to SME borrowers and to prevent the liquidity trap scenario from developing in Singapore. To finance these two temporary measures, the government obtained a portion of the fund, a very small portion indeed, from its huge accumulated reserves. This withdrawal is being made for the first time in Singapore's history as the severity of the fall in export income and GDP are the most severe in Singapore's history since the Great Depression.

Notwithstanding such innovative anti-recessionary measures, and the strong economic fundamentals in Singapore, the official forecast is that Singapore is likely to have a serious negative growth rate in 2009. The validity of this negative forecast is based primarily on a pessimistic forecast of the world economy. It may also be partly due to the fact that in making the forecast, more emphasis is given to year-on-year (*y-o-y*), quarter-to-quarter comparison of GDP and export figures instead of, in the recovery phase, the more relevant quarter-on-quarter (*q-o-q*) and month-on-month (*m-o-m*) comparison in the same year and not over the previous year (2008), when there was a boom in the first two quarters (Q1 08 and Q2 08). There was also a tendency in Singapore, in a deepening recession, to excessively publicize only retrenchment figures but not within the context of total job creation for the periods in question.

Global Silver Linings

As stated earlier, unlike during the Great Depression, man has learned how to combat global recessions. All governments, big and small, have adopted cheap money and cheap credit policy and all have a fiscal stimulus package or packages. If we *sigma* these fiscal packages, the total (the sum-of-parts) can be a staggering figure. There might be an infrastructural boom, if not some threats of over-heating in this sector with time. The credit and banking sector, too, may get an early stimulation. Already, stock markets all

over the world have reacted positively to this joint global stimulus, the day-to-day volatile mood and poor company reports, based on past performances, notwithstanding. The stock markets are often used as fairly dependable leading indicators in macroeconomic forecasting.

My own conclusion is that there has been in more recent months a deceleration in the negative growth rates in many economies in the world, including the US, and this deceleration will continue until probably the last two quarters of 2009 when more positive growth rates would appear. Time is in favor of recovery, including in the USA, and Singapore will be positively affected by this global upturn.

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