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TOP ARTICLE | Forget The Great Depression

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With rising unemployment, job losses and salary cuts, there is a great deal of fear in Europe and America that the world is headed for another great depression. Following the crash of 1929 thousands of businesses collapsed across the world, millions lost their jobs and hunger stalked the cities as well as the countryside. Some historians believe it set the stage for the Second World War. Are we headed down a similar path today? Nobody really knows, but there are compelling reasons to believe that the final denouement may be much less severe than in 1929

The roots of the current global crisis lie in the interplay of several developments that have fundamentally transformed the finance capitalism that existed in 1929 or even as recently as just 30 years ago. Traditionally banks were careful to lend only to trusted clients, and carried the debt on their books. They bore the risk. Now there is securitisation. Lenders pool the loans and resell them as asset-backed securities. These securities are then repackaged, leveraged, tranched and resold many times over. A second related development is the emergence of highly sophisticated derivative products. Especially important among these today are the credit default swaps (CDSs). Taken together, asset-backed securities and derivatives widely spread the risk, but they also breed complacency towards risk. The selling and reselling of risk also lays the foundation for quick contagion. Defaults on original loans at the base rapidly contaminate the entire superstructure of assets and derivatives that rest on this base.

The third key development is the rise of highly-leveraged investment banks in the US. Commercial bank leveraging is limited by stringent capital adequacy norms and their exposure to the capital market is regulated under the Glass-Steagal Act. In contrast, till their recent demise, Wall Street investment banks could raise and invest funds up to 30 times their equity base, thus vastly increasing the fragility of the system. Finally, there is globalisation of the financial system. One aspect of this is a major imbalance between economic and political power. China, India and other emerging economies in Asia and the Middle East are now the creditors of the world, especially the US. Yet they have little say in the design of the global financial architecture. Another aspect of this is technological. Billions of dollars can now be transmitted instantaneously across the globe. But so can market information and market sentiments, unleashing huge waves of exuberance or fear among investors.

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Securitisation, derivatives, leveraging and globalisation have made the global economy much more volatile and risky than the world of 1929. However, there is another major development that provides comforting insurance against such risks of global systemic collapse. Out of the great depression was born Keynesian economics. In 1929, governments had relatively little understanding of macroeconomic management. Today, governments and central banks have many tools to restore confidence and revive the economy. The pace at which the US subprime loan defaults snowballed into a global financial crisis was astonishing, but so was the speed with which the G-7 country authorities and emerging market economies responded.

In a period of less than two months after the collapse of Lehman Brothers, the advanced countries and emerging economies had all introduced broadly similar measures to deal with the crisis, a remarkable feat of global coordination without a single formal treaty or agreement. The initial interventions were followed up with further measures to revive demand and the flow of credit. Now, with President Barack Obama ready to launch a recovery package worth trillions of dollars, the US is about to resume leadership of the Keynesian path to global recovery.

It is difficult to fully comprehend the depth of the global crisis in a country like India that will record growth of around 7 per cent for fiscal 2008 at a time when most developed countries are shrinking. Some sectors like exports, real estate, textiles, IT and transport equipment have been affected severely. But overall, the impact has been limited, thanks in no small measure to the prompt and sustained measures taken by the RBI and the government. The markets have stabilised. The decline of the rupee has been arrested. The stock market has started recovering, the Satyam shock notwithstanding, and the flow of credit is reviving.

The important question is what more should the government do now to contain the expected decline in growth in fiscal 2009. Critics point out that most of the steps so far have been monetary measures to ease the supply of credit, few fiscal measures to revive demand. Beyond a point, that is like pushing on a loose string if the binding growth constraint is now on the demand side. Actually, a very substantial fiscal stimulus has been provided through the supplementary demand for grants in September and a second supplementary demand in December.

This should be followed by a large deficit in the budget for fiscal 2009, ignoring the FRBM for now. Also, a part of the deficit should be monetised, temporarily shelving the agreement that the RBI will not finance central government debt, in order to minimise the crowding out of private borrowers. The government is currently focusing on additional spending on infrastructure. This is welcome. However, it should also target additional spending on education and health. There is compelling research evidence that such spending is not only more effective than infrastructure spending in reviving current demand, but also more effective in enhancing future growth potential.

The writer was a director with the Asian Development Bank.