World Economic Crisis: The Roots, Effects and Prospects

BY

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Introduction:

It is now commonplace that the global economy is in a grave crisis. In fact, the present crisis is the deepest the world has encountered since the great depression of the 1920s. Although the present crisis started basically as a financial one, the meltdown in the financial sector has now contaminated other sectors. Likewise, although the origin of the crisis can be clearly located in the United States, it has today become global, affecting virtually all economies of the world.

In this short presentation we seek to outline what we understand to be the origins of the crisis, the channels through which the crisis spread from the originating sector and nation to other sectors and nations, as well as examine responses to the crisis and the impact on Nigeria.

Understanding the Origins of the Crisis

Many analysts trace the origin of the present crisis to the collapse of the US sub-prime mortgage market and its impact on the financial sector. Tales are told of how banks and other mortgage institutions pushed unsustainable mortgages unto borrowers. The resulting high incidence of default, leading to foreclosure and repossession at a scale not hitherto witnessed created a crisis of confidence and credit shortage. This situation was further complicated by the pervasiveness of financial instruments such as securitization where banks would pool their various loans into sellable assets, thus off-loading risky loans onto others. Increasingly, derivatives and credit-default swaps took on the character of gambling bets as there were no real financial instruments traded. With these, one party pays the other a pre-agreed amount if certain events happen. Whereas such transactions were initially developed to mitigate risk, they have in large measure become pure bets. As Joseph Stiglitz has noted, "the problem is that, with this complicated intertwining of bets of great magnitude, no one could be sure of the financial position of anyone else or even of one's own position".

As BBC's former economic editor and presenter, Evan Davies noted in a documentary called *The City Uncovered with Evan Davis: Banks and How to Break Them* (January 14, 2008), rating agencies were paid to rate these products (risking a conflict of interest) and invariably got good ratings, encouraging people to take them up.

Starting in Wall Street, others followed quickly. With soaring profits, all wanted in, even if it went beyond their area of expertise. For example,

- Banks borrowed even more money to lend out so they could create more securitization. Some banks didn't need to rely on savers as much then, as long as they could borrow from other banks and sell those loans on as securities; bad loans would be the problem of whoever bought the securities.
- Some investment banks like Lehman Brothers got into mortgages, buying them in order to securitize them and then sell them on.
- Some banks loaned even more to have an excuse to securitize those loans.
- Running out of who to loan to, banks turned to the poor; the subprime, the riskier loans. Rising house prices led lenders to think it wasn't too risky; bad loans meant repossessing high-valued property. Subprime and "self-certified" loans (sometimes dubbed "liar's loans") became popular, especially in the US.
- Some banks even started to *buy* securities from others.
- Collaterized Debt Obligations, or CDOs, (even more complex forms of securitization) spread the risk but were very complicated and often hid the bad loans. While things were good, no-one wanted bad news. (culled from http://www.globalissues.org/article/768/global-financial-crisis.).

But all this was made possible only because there was no regulation. The true origins of the collapse of the financial market in the United States can be traced to the systematic whittling down of regulation and regulatory frameworks beginning under the Presidency of Ronald Reagan. In 1987, the replacement of Paul Volcker with Alan Greenspan as the Chairman of the Federal Reserve Board signaled the assault on financial market regulation. The doctrine of free market supremacy and deregulation became the defining elements of the long years of Greenspan. It was under him that the regulations separating commercial banks from investment banks were repealed. These regulations had been enacted after the great depression to guide against conflict of interest and other excesses. Commercial banks are not supposed to be high risk takers. They are supposed to lend prudently and manage depositors' money conservatively. Investment banks are more of risk takers. Combining commercial banking and investment banking in the same business organization has resulted in exposure of depositor's money to greater risk, which has been one element in the present financial meltdown in the United States.

The tearing down of regulation has also resulted in the manipulation and cooking of the books in financial institutions. This came forcefully to light during the Enron saga. The more recent investment fraud perpetrated by Madoff could only have been possible where there is no effective regulation. It is clear, therefore, that the true origin of the crisis lies in the ideology of free market and capitalism. The crisis is fundamentally a crisis of capitalism. Greed and self interest, which are the defining drivers of capitalism need to be controlled and regulated if they are not to wreak havoc on the collective good.

From Financial to Economic Crisis

We have already emphasized that the present crisis started as a financial crisis in the United States. It is obvious, however, that today it has become a fully blown economic crisis, not just in the USA but globally. Economics teaches us that finance is to the economy what blood is to the body. The financial collapse meant that credit could not be extended to other sectors of the economy. With the drying up of mortgage finance and other forms of credit, the housing, manufacturing and other sectors were faced with major bottlenecks, resulting in closures and lay-offs. The downturn in the overall economy, as well as the downward pressure on the capital market, helped to weaken consumer confidence resulting in lower consumer demand.

The financial crisis in the USA, of course, has had direct impact on financial markets in other countries, given the high degree of integration of financial markets. Economies of most countries in the world have, therefore, come under stress. Apart from the direct linkage of financial markets, export markets have contracted and continue to contract. The outlook for the global economy has become very bleak. Although some economies, such as China, are still expected to grow this year, the global economy is projected to experience negative growth for the first time since the sixties.

Response to the Crisis

Starting with the United States, the response to the crisis has been largely to inject huge public resources to shore up ailing private financial institutions and other companies. Starting with the Bush stimulus package and followed by the Obama stimulus, huge taxpayers' funds are committed to bailing out the private companies. While we do agree that there is need to save some of the enterprises and stimulate the economy, it is our view that a condition precedent to such intervention is to institute a regime of strong and effective regulation. To commit huge sums of taxpayers' money to bailing out private companies without a prior clear agreement as to the role of the government going forward actually amounts to robbing the poor to save the rich. The scandalous situation in which AIG collects money from the government only to proceed to pay out over $37 million in bonuses to management staff under whose watch the company has been run down highlights this situation.

Some other countries, such as the U.K, have been less bashful about the role of government. The U.K has gone on to acquire direct equity in a number of companies. Such direct nationalisation provides a clearer leeway for government to guide the process of recovery. What is needed is strong government direction and regulation if the crisis is to be turned around. As important as injecting funds to stabilize the companies in distress may be, the key to revival is largely in realising the error of thinking that markets are self-adjusting and that government's role should be minimal.

A careful reading of the post-great depression policy architecture reveals that the need for strong government regulation was one of the lessons learnt from the depression. The Breton Woods global financial architecture that followed the great depression and the war was meant to ensure a financial system based on rules and regulations. That system collapsed in 1971 when the U.S abandoned the maintenance of gold backing for the dollar. The importance of an activist government, which came to be associated with Keynesian economic analysis, came out of the rethinking which came out of the great depression.

Impact on and Implications for African Economies

The global financial and economic crisis has had significant impact on Africa. To begin with, the crisis brought to an end the longest commodity boom period since the war. The collapse of oil and other commodity prices has had immediate and significant impact on many African economies whose exports are dominated by raw commodities. Government finances have fallen sharply in a number of countries. Domestic currency exchange rates have depreciated significantly in a number of countries and there is now a general slowdown of economic activity. Growth is projected to slow to about 2 percent this year in the continent.

The emerging stock markets in some of the African economies have experienced huge meltdowns. However, although there are some indications in some countries that banks are beginning to weaken, they have remained reasonably stable and solvent. This is largely because banks and other financial institutions in most African countries are stringently regulated. But even now, regulation needs to be strengthened in various countries.

The major channels of impact of the crisis on Africa include the following:

- Reduced global demand for African exports, resulting in collapsing commodity prices.
- Global credit squeeze has reduced capital inflows and the availability of trade finance, thus further weakening the ability to export.
- Financial crisis in donor countries could lead to cutting their aid to Africa.
- Reduced flow of home remittances to Africa.
- Reduced trade flows would result in falling government revenues, thus weakening the capacity of governments to finance social and development programmes.
- Dry-up of foreign institutional investors' participation in emerging African capital markets has led to major capital market meltdown in countries like Nigeria.
- Deceleration in overall economic activities is resulting in huge unemployment.

In the West African sub-region, the financial sectors of Nigeria and Ghana seem to be coming under some pressure. In Nigeria, five of the twenty four banks have recently been declared as near distressed by the Central Bank. The management of the banks have been removed and interim management has been appointed for each of the five banks. This has elicited a crisis of confidence which the monetary authorities are still grappling to reign in. Countries in the unified Francophone monetary zone seem to be less prone to the threat of banking failures. Going into the future, this suggests that implementing a sub-regional monetary union for the whole of ECOWAS and possibly Africa would help to ensure stable monetary and financial markets.

What are African governments doing in response to the crisis? Many governments seem to be concerned solely with the impact of the crisis on government finances. This then limits our focus in seeking interventions. Because we see the crisis in terms of the fall in government revenues, we pursue measures to shore up government finances and cut expenditures without a careful consideration of the implications for other sectors of the economy. In Nigeria, for example, one of the responses to the fiscal crisis is the attempt to withdraw subsidies on domestic energy products. This has pitched the labour unions against the government. Moreover, government is backsliding on agreements reached with labour unions. This has resulted in a spate of strikes and general industrial relations strife. African governments need to think creatively and act both collectively and as individual national governments to evolve policies to mitigate the negative impacts of the crisis.

We have already talked of the importance of regulation and an activist government in the global environment of today. As important as this is for mature economies, it is even more crucial for developing economies like our own where the private sector is relatively underdeveloped. There are critical and crucial investments in which government has to play the role of pioneer, either alone or in partnership with the private sector.

Meeting the Challenges of Revival

Periods of crisis are usually the best periods for rethinking and re-charting development. At the global level, there is urgent need for re-creating new global governance and regulatory frameworks. A new global financial architecture, which will take into consideration the diverse stages of development, needs to be fashioned. The process of doing this must be inclusive of all interests. At the national level, there is need for inclusive national discourse on the philosophy to drive development. At a time when most countries of the world are realizing that market fundamentalism is not capable of leading their economies out of recession, we cannot continue to be more catholic than the pope.

Admitted, corruption has rendered public management extremely perilous and ineffective in many of our countries. What we need to do is reinvent the public sector by embarking on a committed anti-corruption campaign. Management models of public management can be evolved that will be shielded from the corrupting influence of politics.

In conclusion, we wish to emphasize that periods of crisis also present openings of opportunity. African governments and their peoples should seek to take advantage of the present crisis to create more humane and development promoting policies and programmes. Such policies include reform of production structures to promote diversification of national economies and strengthening regulatory frameworks to guide financial and asset markets.

Regional integration also needs to be strengthened and promoted with a view to stimulating inter-African trade. Integrated financial and regulatory frameworks also need to be developed.