

Trade, Finance, and the Global Recession

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This year the International Monetary Fund (IMF) predicts that real global growth will be close to zero (figure 1). The last time a global recession of this severity took place was in 1982. That recession triggered the Latin American debt crisis, and the region's collapse can be seen in this chart. This time around, it is the center not the periphery that has collapsed. Growth in advanced, industrial economies is projected at -2 percent for this year. Moreover, the widespread banking problems and the credit crunch, especially in the United States and Europe, give this recession the feel of something much closer to the 1930s Great Depression than anything experienced in the past several decades.

Synchronized Global Recession

This global recession is also marked by a tighter synchronization, or correlation, of downswings across countries than in the 1982 recession (figure 2). For the main industrial countries, the fall in growth rates projected by the IMF and the Blue Chip private forecasters is nearly identical for the United States, the eurozone, Japan, and the United Kingdom; and the rebound predicted for 2010 is also strikingly similar. In contrast, in 1982 it was the United States that experienced a sharp decline; Europe and the United Kingdom maintained or increased growth.

Figure 1 Global growth over 3 decades

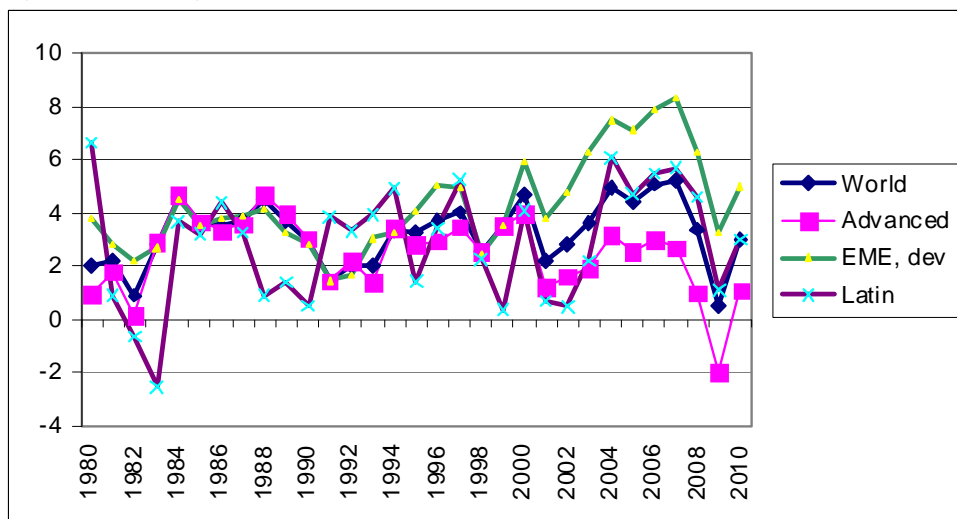
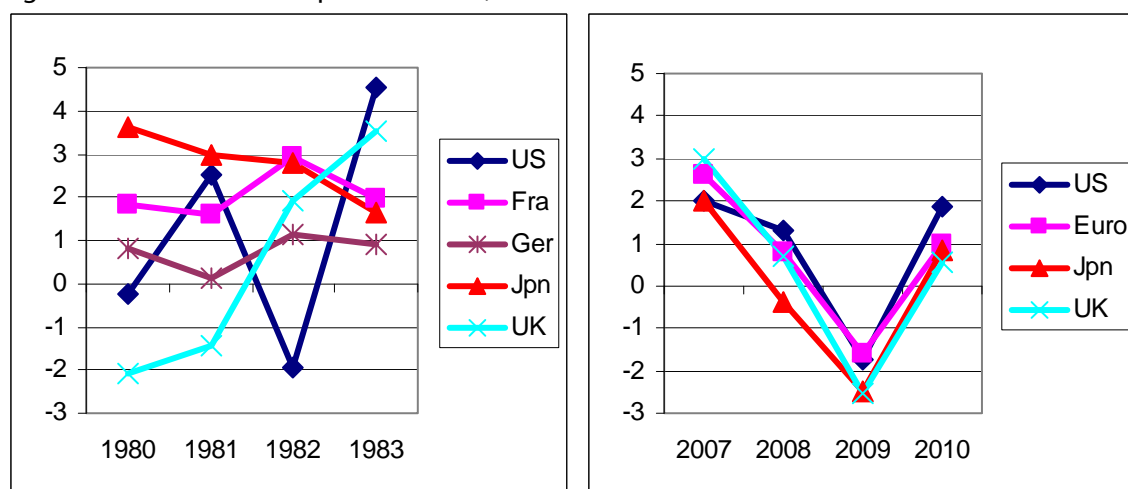


Figure 2 Growth in developed countries, 1980–83 and 2007–10



There is similarly a close correlation across the main Latin American economies in the decline in growth rates projected by the IMF and private forecasters for 2009 and in the partial rebound for 2010. Although this decline is more closely correlated, it is far less severe than in the 1982–83 debt crisis (figure 3). Fortunately, the Latin American economies are in far better shape today than they were in the early 1980s in terms of sustainability of external debt. They have built up large external reserves and kept their debt moderate relative to GDP (figure 4). As a result, their ratios of net external debt (gross debt minus reserves) to GDP are typically in the range of 10 to 20 percent now, in contrast with about 50 percent or higher in the early 1980s. It seems unlikely that the second-worst global recession since the depression will trigger a Latin American debt crisis similar to the first one. A major reason is that this time international interest rates are low, whereas in the early 1980s there was the Volcker shock to international interest rates, monetary tightening made necessary by the worst postwar global inflation. The burden of debt depends on both the amount of debt and its price, the interest rate.

Figure 3 Growth in Latin America, 1980–83 and 2007–10

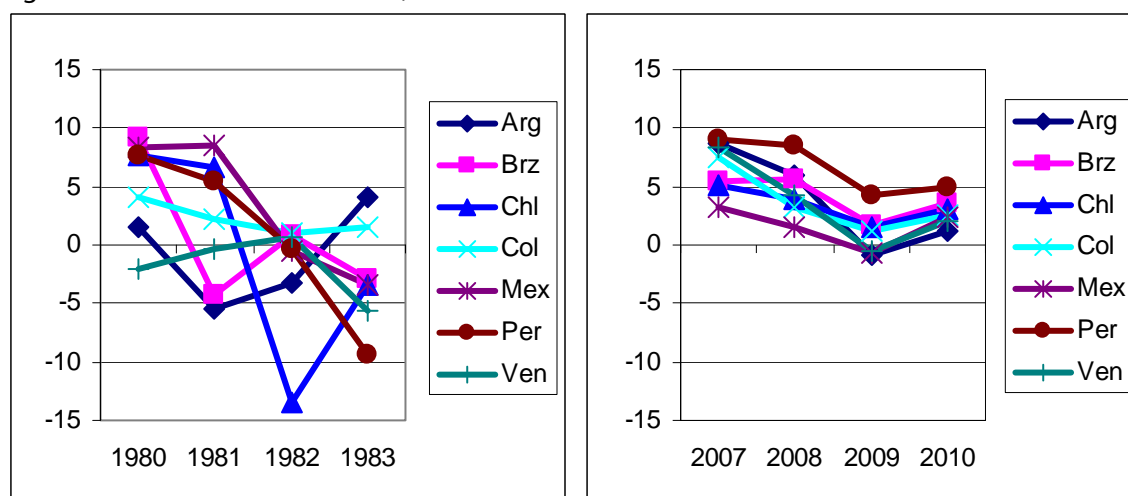
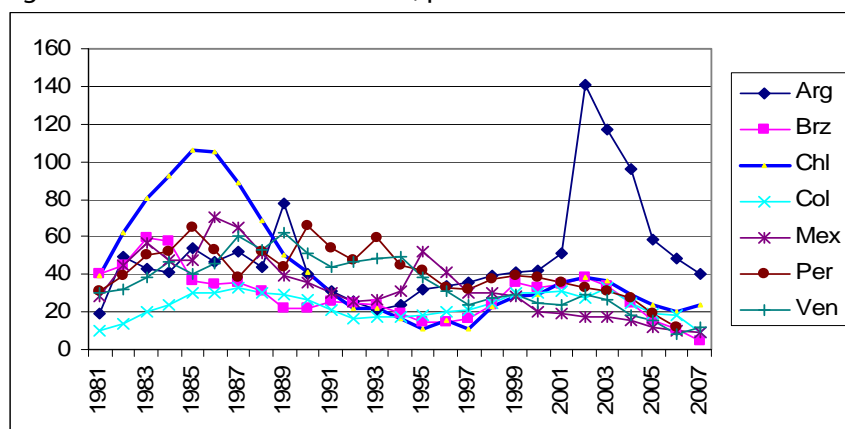
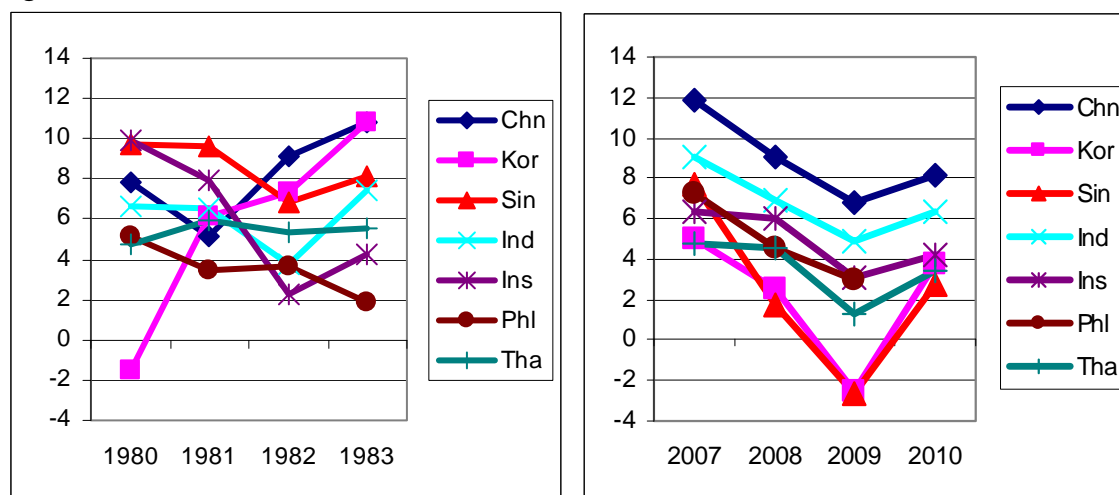


Figure 4 Net external debt: Latin 7, percent of GDP



The same pattern of highly correlated growth decline can be seen in the main Asian emerging-market economies (figure 5). Even China will see its growth fall from 12 percent in 2007 to about 7 percent in 2009. This pattern is similarly in contrast to the much more disperse growth performances in the region in the 1982 global recession, when average growth rates remained broadly unaffected.

Figure 5 Growth in Asia, 1980–83 and 2007–10



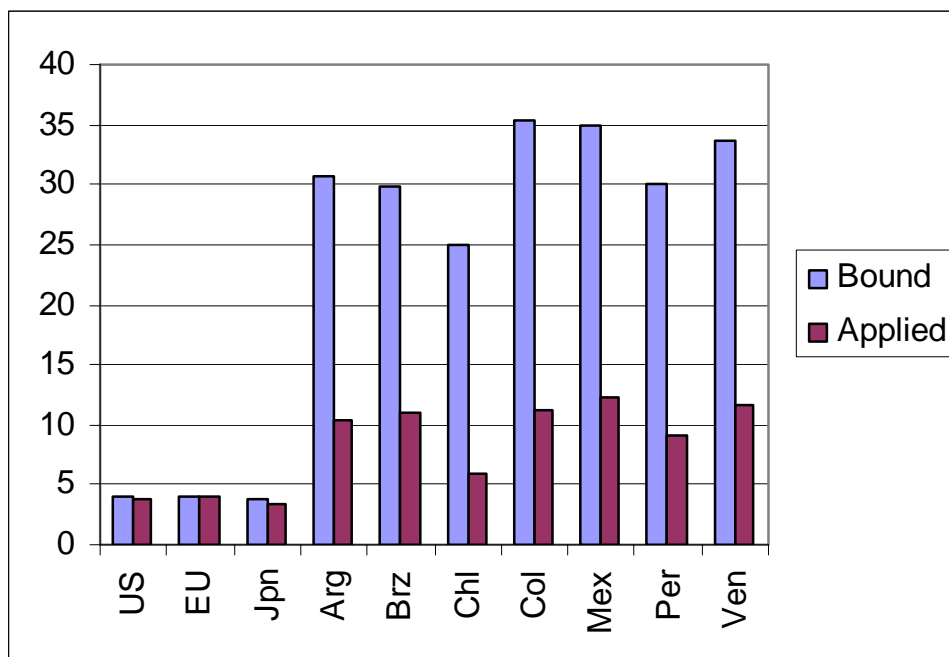
Trade Policy and Recovery

Because of the nearly universal pattern of falling growth in this global recession, it will be difficult for individual countries to export their way out of the slowdown. In the East Asian crisis of the late 1990s, it was possible for Thailand, Korea, Indonesia, and other affected countries to recover growth through sharp export expansion and a swing from current account deficits to large current account surpluses, because the United States and other major economies were sustaining growth. In the present global recession, some emerging-market economies may be able to achieve export growth as a consequence of the substantial currency depreciation that has already taken place. However, the

contribution to recovery from exports seems likely to be modest because of the uniformly weak growth prospects of trading partners.

If rising exports hold limited potential, some countries will be tempted to boost domestic demand by raising import protection. But that would be a negative sum game: Each country acting this way in isolation would generate an overall outcome that would amount to a downward spiral in trade and growth, as happened in the global depression of the 1930s. For Latin America and many other emerging-market regions, the temptation to impose protection could be especially seductive because the levels of bound tariffs are much higher than those of tariffs actually applied (figure 6). Bound tariffs on manufactures are in the range of 25 to 35 percent in the main Latin American economies, in contrast to applied tariffs averaging about 10 to 12 percent for manufactures. The rates could be more than doubled without violating WTO obligations.

Figure 6 Bound versus applied tariffs on manufactures, percent



In Latin America, it may also be tempting for some of the regional trading area partners to indulge in increased nontariff barriers. Within the MERCOSUR, the imposition of such barriers, justified on grounds of macroeconomic crisis, has frequently occurred in recent years. But again the overall result would be counterproductive.

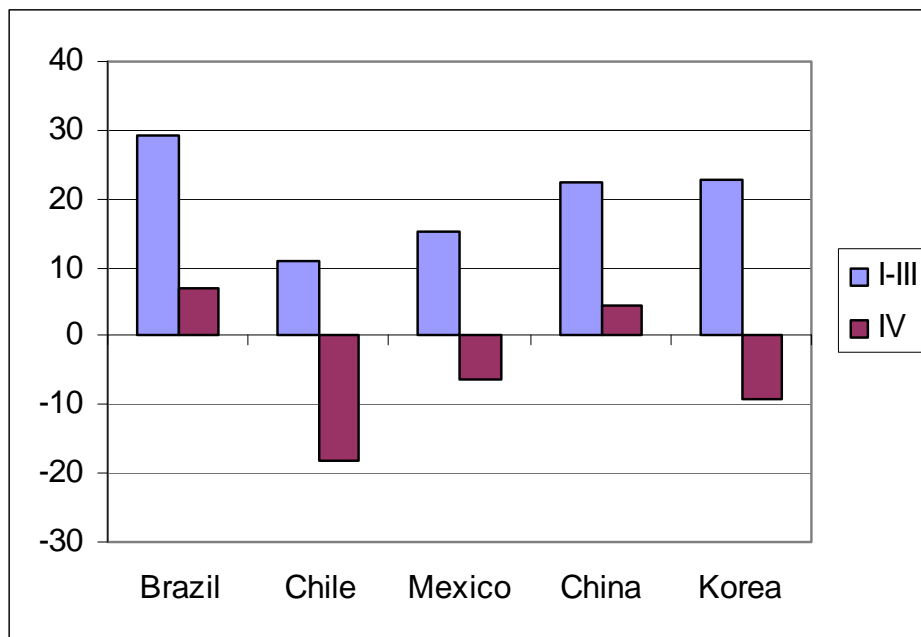
So far there has been no widespread outbreak of international protectionism resembling that in the 1930s global depression. The United States is providing an auto bailout just to domestic firms, and it has limited import eligibility for public spending in the stimulus package to foreign trading partners that are comembers in the government procurement agreement. These measures are a far cry, however, from the Smoot-Hawley tariff increases of 1930. Moreover, WTO obligations today limit overt tariff increases for countries with applied rates close to the bound ceilings, as is true for the United States and other industrial countries.

In the financial sphere, there has been some protection but also some international cooperation. The Federal Reserve extended \$30 billion in swap lines each to Brazil, Mexico, Korea, and Singapore, an action that in effect helped assure that special support to US banks did not have the effect of draining resources away from major emerging-market economies toward a US safe haven.

Trade Performance

Despite any widespread surge in protection so far, exports show signs of sharp deceleration (figure 7). In contrast to continued rapid growth in the first three quarters of 2008, by the fourth quarter there were major declines in exports for the leading emerging-market economies. In Brazil, annual export growth fell from 30 percent in the first three quarters to 7 percent in the fourth. The decline is partly due to the partial reversal of the commodities price boom, as illustrated by the case of Chile, but there has been a large deceleration for manufactured exporters as well (including Korea and China).

Figure 7 Export growth over year earlier: 2008, Q1–Q3 versus Q4, percent



Capital Flows

The financial crisis has reversed the period of artificially low risk spreads, and private capital flows to emerging-market economies declined substantially in 2008 and are likely to fall further in 2009, according to the Institute of International Finance (figure 8). Total net inflows fell from a peak of about \$930 billion in 2007 to about \$470 billion in 2008, and will fall further to less than \$200 billion this year. Foreign direct investment has held up the best, but even it is declining. Emerging-market exchange rates also came under pressure in the second half of last year, as it became apparent that emerging-market economies could not remain “decoupled” from the global crisis (figure 9). Even so, the

depreciations have generally not been extreme, especially when compared with the euro, which also has fallen against the dollar.

Figure 8 Net private capital flows to emerging markets, billion USD

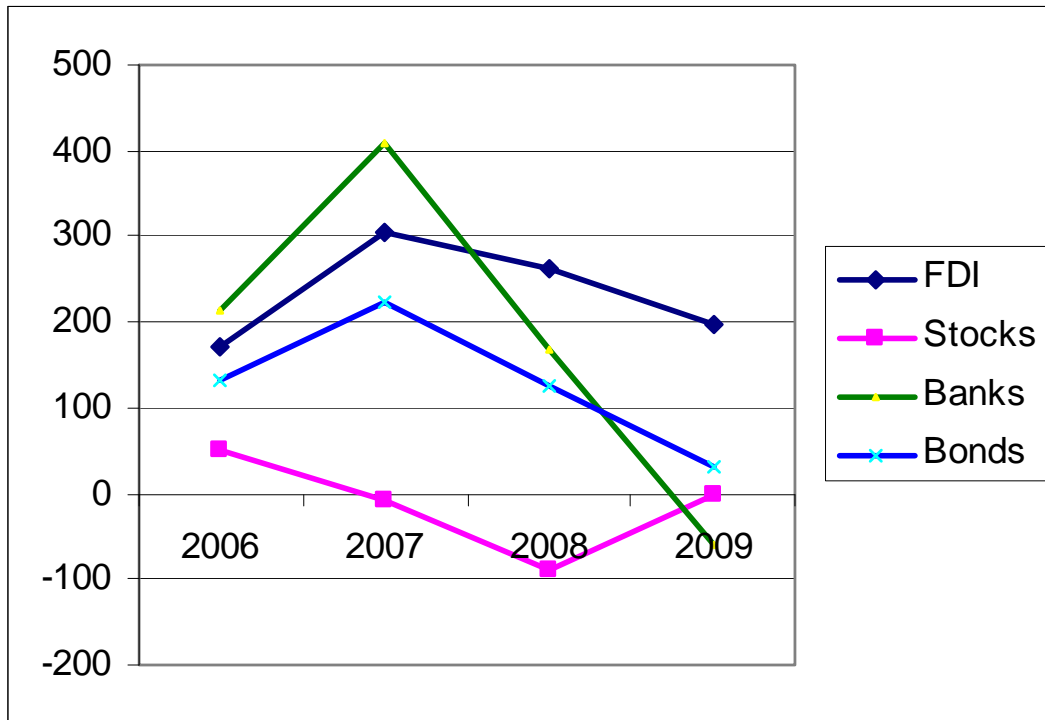
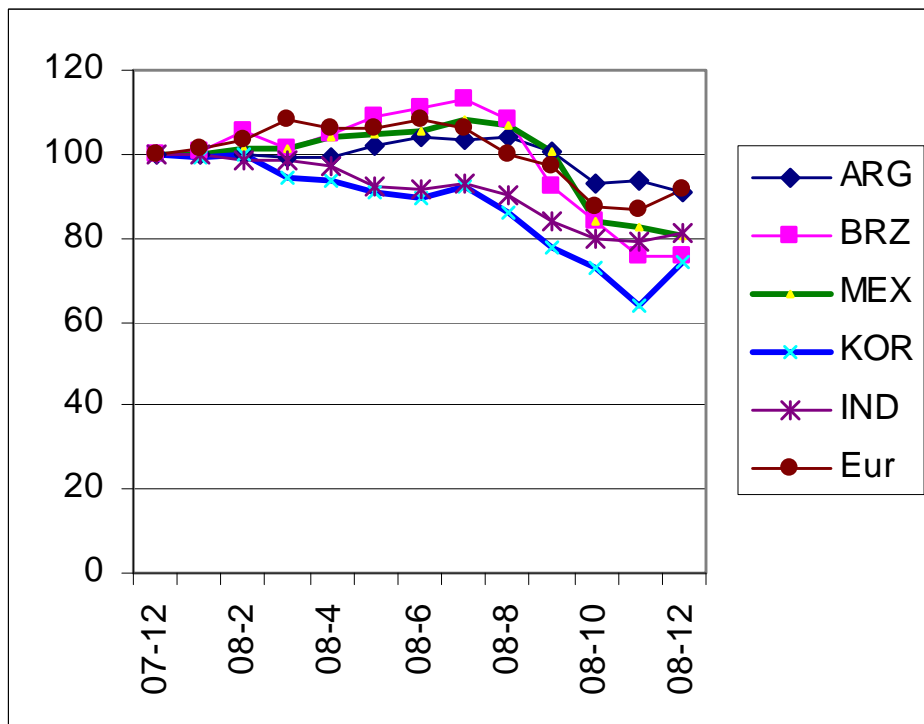
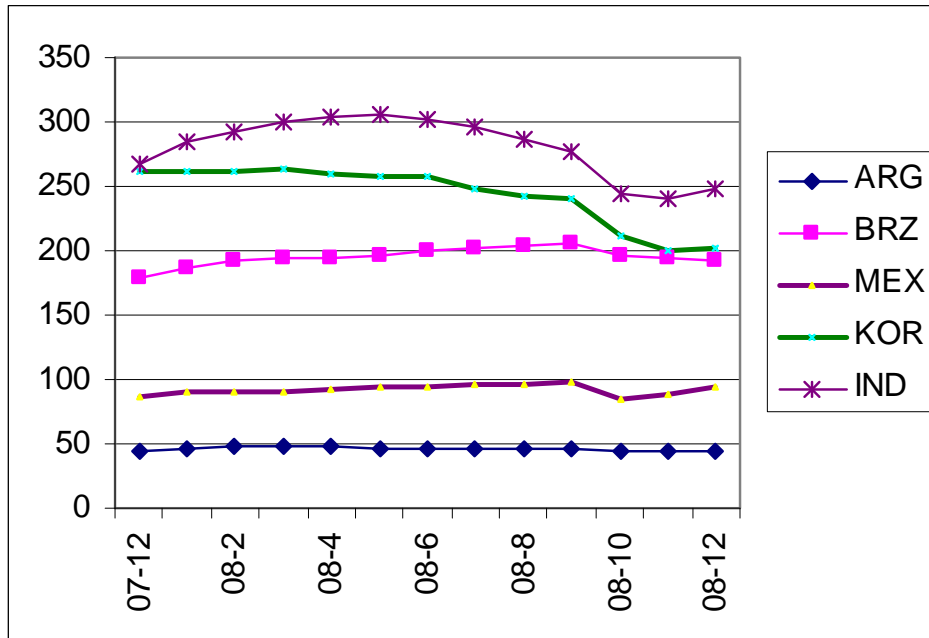


Figure 9 Exchange rate against the dollar, end-2007=100



In broad terms, the emerging-market economies have not been devastated by the crisis yet. An important reason is that many of them had built up large war chests of external reserves (figure 10). Reserve levels of \$200 billion to \$300 billion for Brazil, Korea, and India are extremely high by historical benchmarks, and the reductions in recent months to help stabilize currencies have been relatively limited. China's reserves remain virtually off the charts, rising from \$1.5 trillion at the end of 2007 to \$1.9 trillion at the end of 2008.

Figure 10 Reserves, billion USD



Policy Action

This global recession started in the United States, and US policymakers have responded vigorously. The Federal Reserve has increased its loans to the financial sector by about \$1.4 trillion, and extended large guarantees in addition. The new fiscal stimulus program of \$800 billion amounts to about a 2.5 percent fiscal boost per year for two years. European central banks have also been aggressive in shoring up banking systems, although the ECB has not lowered interest rates nearly as aggressively as the Federal Reserve. China has adopted fiscal stimulus that amounts to about 6 percent of GDP annually for each of the next two years. The IMF estimates that the total fiscal stimulus impulse in 2009 in G-20 countries will amount to about 1.5 percent of GDP, not counting automatic stabilizers that will push the total increase in fiscal deficits to about 3 percent of GDP.

The broad strategy needs to be for both monetary and fiscal stimulus to counter global recession, with each country's approach tailored to its situation. In Brazil, for example, where the interest rate is still at nearly 14 percent and inflation is 6 percent, one would think there is room for monetary easing.

Demand will need to grow internationally in part because the United States can no longer be the single locomotive of the world economy or the global consumer of last resort. From the mid-1990s to the middle of this decade, the increase in the US trade deficit with the developing countries contributed cumulative additional demand amounting to about 5 percentage points of the developing countries' GDP. The US current account deficit has now begun to fall, from 6 percent of GDP in 2006 to 4.5 percent in 2008, and it could fall to 3 or even 2 percent this year given the decline in oil prices and the sharp reduction in imports associated with severe recession. This broadly means that not only China but also other major emerging-market economies will increasingly need to find demand for continued growth domestically rather than relying primarily on export expansion.

In terms of the international institutions, Japan has already offered the IMF \$100 billion in increased lending capacity. It remains to be seen, however, just how much additional funding the IMF will need; so far, its new programs have been mainly for Eastern Europe, where current account deficits had reached excessive levels on the strength of integration with the European Union. Ironically, for many emerging-market economies the credit crunch this time seems to be affecting mainly corporations rather than governments, and the policy issue is how much governments should assist domestic firms in access to dollar borrowing.

In summary, we are in the midst of the most severe and most globally synchronized recession since the Great Depression of the 1930s. Returning to the central forecasts, it will probably be fortunate if the IMF and private sector projections for a return to 3 percent global growth in 2010 are actually achieved. If so, this recession will not have been all that much worse than the 1982 downturn. Downside risk dominates the forecast, because this is the first time in the postwar period that global recession has been provoked by a banking crisis at the center. Moreover, past recessions were largely the consequence of monetary tightening to combat inflation; once inflation fell, it was easy to reignite growth by reducing interest rates. This time the banking crisis and the collapse of housing and asset prices have driven the recession, despite the reduction of interest rates to nearly zero, so the exit from recession cannot be prompted simply by reducing interest rates even further. There is also much deleveraging to be accomplished, and achieving growth while limiting or reducing debt will be a tall order. The severe risk in the situation explains why the actions of US and other policymakers have been unprecedented. It will be crucial that all major countries pursue appropriate expansion measures and, especially, refrain from imposing new trade protection as the best means of helping ensure that this cycle turns out to be only another severe global recession rather than a global depression.