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Unravelling the crisis

While economic prospects may appear gloomy, **Mauro F. Guillén*** believes one must not underestimate the ability of market economies to adjust

The global financial crisis is testing the world's most cherished institutions and the very sense of economic security. Although central banks have injected billions of dollars into the banking system around the world and governments have stepped in to buy troubled assets and acquire stakes in troubled banks, the crisis is not over. Each round of bad news has been met by decisive, though piecemeal, action by monetary and economic policymakers. The crisis continues to take its toll, and more countries are being sucked into the downward spiral.

It is important to note that, while severe, the present crisis may not be as damaging to the global economy as the 1997 Asian flu or the Russian, Brazilian and Argentinean crises of the late 1990s and early 21st century. Although GDP growth has vanished in Europe and the US, the world is still far from seeing the economy really plummet as a result of the credit crunch. This is in part due to the swift and massive injections of liquidity, and to the general realisation that governments are unlikely to let financial difficulties infect the rest of the economy.

Another frequent reference point for the current crisis is the Great Depression of the 1930s. The situation, however, could not be more different. First, we can count on competent central banks and various government programmes, including unemployment insurance, to avoid the kind of deflation that led to a 30 per cent loss in GDP. Second, financial markets are much more flexible and responsive today than 80 years ago, meaning that policies can have an immediate effect. And third, the world seems to be increasingly united in an effort to cope with the crisis, something that was ostensibly missing back in the 1930s.

Still, this is not a time for complacency. In the US, more than half the population own shares in listed companies, up from less than one per cent in the 1930s. Mutual and pension funds have become such an important part of the economy, that dramatic downturns in stock prices have a large impact on consumer spending and lead people to postpone retirement. Companies are also much more dependent on all sorts of financial instruments for funding investments as well as day-to-day operations, ranging from commercial paper to bonds, and from bank loans to equity. Governments are also affected by the situation because tax revenue is sensitive to fluctuations in the business cycle and to sharp declines in capital gains. Above all, this crisis has destroyed wealth and lowered standards of living.

Another factor to watch is the changing power dynamics in the global economy. If China emerges unscathed from the crisis, it would consolidate itself as a major economic, financial and trading power. While the malaise may still spread to the world's third largest economy, it is likely to weaken the US, Europe and Japan more than China or India, whose domestic markets are growing very rapidly.

Observers also speculate over whether the dollar might lose its status as the world's reserve currency, something that would lower US standards of living by placing upward pressure on interest rates. This, however, is unlikely to happen because the dollar's main challenger is the euro. Europe too is suffering from the crisis, and so is its currency.

The financial crisis is also damaging the chances of troubled companies to survive in the new competitive environment. The cases of GM and Ford in the automobile industry are perhaps the clearest examples. After years of decline, they now find themselves in a dire situation, with declining sales and an inability to keep up with Toyota, Honda and the new Chinese manufacturers. Consumers in developed countries are postponing the replacement of their automobiles until the crisis subsides, and they are moving away from US-made gas- guzzling SUVs and embracing smaller, more efficient cars. Other consumer durable industries such as electrical appliances and computers are also feeling the clinch.

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It remains unclear just when real-estate prices will finally hit bottom in the US and around the world. Even the booming Middle East market is showing signs of fatigue. Stabilising home prices will be clear evidence that the crisis has hit rock bottom. We may be a couple of years away, however.

While the situation is gloomy, one must not underestimate the ability of market economies to adjust. The US and EU have become much more dynamic over the last two decades. In spite of the crisis, mechanisms for relocating capital and labour from one set of declining activities to another of expanding ones are much more efficient today than two or three decades ago. This is especially true of most emerging and developing economies. It is truly important, now more than ever, to continue providing businesses and investors with clear and consistent macroeconomic policies focussed on facilitating investment and job creation. While the short-term challenges facing us are daunting, we must not forget that economies cannot embark upon a path of non-inflationary economic growth without stability and productivity increases. This crisis should not prevent us from keeping the focus on education, training, and market development policies. They are the key to the future, regardless of the immediate problems confronting us.

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